Because the entity's accounting for the contract may differ significantly depending on whether there is or is not a software license in the arrangement, it will be important for entities that enter into hosting arrangements (including those that may be characterized solely as SaaS arrangements) with customers to consider whether they are leasing the equipment used to host the software to the customer. And if so, the entity should account for the arrangement as one that includes a software license (i.e. rather than as a SaaS arrangement).

Question A120

Is the conclusion about whether a software license is present in a contract with a customer affected by the customer's or the software entity's use of a third-party hosting service?

Interpretive response: Determining whether a contract includes a software license is not affected by whether the customer uses a third party to host the entity's software or whether the entity engages a third party to host the software.

The fact that the customer uses a third-party hosting provider, or would be required to use a third-party hosting provider if it were to exercise its right to take possession of the software in a hosting arrangement, rather than hosting the software on its own IT equipment, does not affect the conclusion that would otherwise be reached by the entity about whether the contract includes a software license.

Similarly, the fact that the entity uses a third party to host its software, rather than hosting the software in its own data center, should not change the conclusion that would otherwise be reached as to whether the contract includes a software license from that which would be reached if the entity were hosting the software itself; this includes the possibility that the customer *could* be deemed to be leasing (likely sub-leasing from the entity) the third party's equipment.

Example A120.1

Software license or SaaS

ABC Corp.'s typical customer contract provides customers with the right to use its software (Product J) on a SaaS basis. ABC hosts Product J using a third-party hosting provider (XYZ), rather than hosting Product J in its own data center. ABC's customers are not permitted to take possession of Product J. ABC manages and controls the hosting services from XYZ associated with Product J, i.e. ABC has the contract with XYZ for the hosting services. ABC bills customers on a monthly or quarterly basis, which includes proportional reimbursement of ABC's actual costs for the XYZ hosting services related to Product J.

Customer A (an existing customer of XYZ) has expressed an interest in deploying Product J in its own XYZ hosting environment, rather than ABC's, to take advantage of Customer A's favorable contract terms and pricing arrangement with XYZ – i.e. Customer A will realize savings in actual hosting costs by structuring the arrangement in this manner. Notwithstanding Customer A's desire to achieve these cost savings, it is the intent of both ABC and Customer A to have ABC manage and control the hosting of Product J in the same manner as ABC manages and controls its typical arrangements; this includes the provision that Product J cannot be removed from the XYZ hosting environment.

To permit this arrangement, a provision has been added to Customer A's agreement with XYZ to give ABC access, billing, control and management rights/responsibilities for a separate Customer A account with XYZ that is dedicated to hosting Product J. Customer A is not permitted to take possession of the Product J software or transfer the software to another hosting provider or another Customer A account with XYZ.

Notwithstanding the specifics of the new contractual provision, ABC determines that its contract with Customer A includes a license to Product J (i.e. that the contract is not a SaaS arrangement), and does *not* include hosting services. This is because under its contract with Customer A, ABC's performance obligations do not include hosting Product J for Customer A because XYZ is providing the hosting services to Customer A, not ABC. In contrast, under ABC's typical customer arrangements, even though XYZ also hosts Product J, ABC is the principal to the customer arrangement for those hosting services. ABC is not a principal in the Customer A arrangement with XYZ.

Because ABC concludes that there is a license to Product J in the Customer A arrangement, that license is subject to the licensing implementation guidance in Topic 606. ABC transfers control of the license to Customer A when ABC delivers the license to Customer A's hosting agent (XYZ) – i.e. assuming the license term has begun and other considerations outlined in *Chapter F – Recognize revenue when (or as) the entity satisfies a performance obligation* have been satisfied.

In addition, ABC will need to consider whether its promises to provide technical support and unspecified updates, upgrades and enhancements (which it will provide to Customer A in connection with Product J), and to manage Customer A's hosting account for Product J are separate performance obligations (see *Chapter C – Step 2: Identify the performance obligations in the contract*).

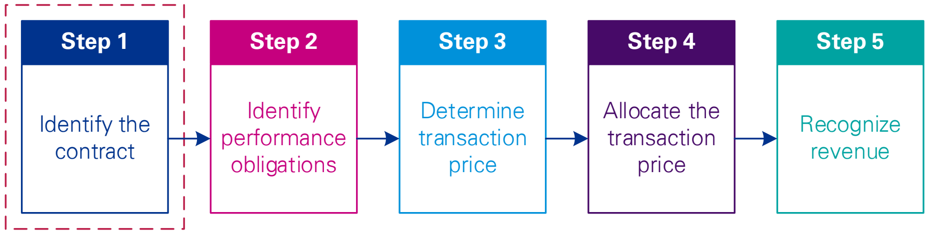
B. Step 1: Identify the contract with the customer

Questions and Examples

Overview

Determining whether a contract exists

Questions & answers



Overview

Topic 606 identifies when a contract with a customer exists and, therefore, is accounted for under Topic 606; how to account for consideration received before concluding that a contract exists; and when two or more contracts should be combined for purposes of applying the model.

Excerpt from ASC 606-10

20 Glossary

Contract

An agreement between two or more parties that creates enforceable rights and obligations.

Customer

A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

> Identifying the Contract

25-1 An entity shall account for a contract with a customer that is within the scope of this Topic only when all of the following criteria are met:

a. The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations.
b. The entity can identify each party's rights regarding the goods or services to be transferred.
c. The entity can identify the payment terms for the goods or services to be transferred.
d. The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).
e. It is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer (see paragraphs 606-10-55-3A through 55-3C). In evaluating whether collectibility of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price

stated in the contract if the consideration is variable because the entity may offer the customer a price concession (see paragraph 606-10-32-7).

25-2 A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral, or implied by an entity's customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries, and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining whether and when an agreement with a customer creates enforceable rights and obligations.

25-3 Some contracts with customers may have no fixed duration and can be terminated or modified by either party at any time. Other contracts may automatically renew on a periodic basis that is specified in the contract. An entity shall apply the guidance in this Topic to the duration of the contract (that is, the contractual period) in which the parties to the contract have present enforceable rights and obligations. In evaluating the criterion in paragraph 606-10-25-1(e), an entity shall assess the collectibility of the consideration promised in a contract for the goods or services that will be transferred to the customer rather than assessing the collectibility of the consideration promised in the contract for all of the promised goods or services (see paragraphs 606-10-55-3A through 55-3C). However, if an entity determines that all of the criteria in paragraph 606-10-25-1 are met, the remainder of the guidance in this Topic shall be applied to all of the promised goods or services in the contract.

25-4 For the purpose of applying the guidance in this Topic, a contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (or parties). A contract is wholly unperformed if both of the following criteria are met:

a. The entity has not yet transferred any promised goods or services to the customer.
b. The entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services.

25-5 If a contract with a customer meets the criteria in paragraph 606-10-25-1 at contract inception, an entity shall not reassess those criteria unless there is an indication of a significant change in facts and circumstances. For example, if a customer's ability to pay the consideration deteriorates significantly, an entity would reassess whether it is probable that the entity will collect the consideration to which the entity will be entitled in exchange for the remaining goods or services that will be transferred to the customer (see paragraphs 606-10-55-3A through 55-3C).

25-6 If a contract with a customer does not meet the criteria in paragraph 606-10-25-1, an entity shall continue to assess the contract to determine whether the criteria in paragraph 606-10-25-1 are subsequently met.

25-7 When a contract with a customer does not meet the criteria in paragraph 606-10-25-1 and an entity receives consideration from the customer, the entity shall recognize the consideration received as **revenue** only when one or more of the following events have occurred:

a. The entity has no remaining obligations to transfer goods or services to the customer, and all, or define, of the consideration promised by the customer has been received by the entity and is nonrefundable.
b. The contract has been terminated, and the consideration received from the customer is nonrefundable.
c. The entity has transferred control of the goods or services to which the consideration that has been received relates, the entity has stopped transferring goods or services to the customer (if applicable) and has no obligation under the contract to transfer additional goods or services, and the consideration received from the customer is nonrefundable.

25-8 An entity shall recognize the consideration received from a customer as a liability until one of the events in paragraph 606-10-25-7 occurs or until the criteria in paragraph 606-10-25-1 are subsequently met (see paragraph 606-10-25-6). Depending on the facts and circumstances relating to the contract, the liability recognized represents the entity's obligation to either transfer goods or services in the future or refund the consideration received. In either case, the liability shall be measured at the amount of consideration received from the customer.

• > Assessing Collectibility

55-3A Paragraph 606-10-25-1(e) requires an entity to assess whether it is **probable** that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the **customer**. The assessment, which is part of identifying whether there is a **contract** with a customer, is based on whether the customer has the ability and intention to pay the consideration to which the entity will be entitled in exchange for the goods or services that will be transferred to the customer. The objective of this assessment is to evaluate whether there is a substantive transaction between the entity and the customer, which is a necessary condition for the contract to be accounted for under the revenue model in this Topic.

55-3B The collectibility assessment in paragraph 606-10-25-1(e) is partly a forward-looking assessment. It requires an entity to use judgment and consider all of the facts and circumstances, including the entity's customary business practices and its knowledge of the customer, in determining whether it is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that the entity expects to transfer to the customer. The assessment is not necessarily based on the customer's ability and intention to pay the entire amount of promised consideration for the entire duration of the contract.

55-3C When assessing whether a contract meets the criterion in paragraph 606-10-25-1(e), an entity should determine whether the contractual terms and its customary business practices indicate that the entity's exposure to credit risk is less than the entire consideration promised in the contract because the entity has the ability to mitigate its credit risk. Examples of contractual terms or customary business practices that might mitigate the entity's credit risk include the following:

a. Payment terms—In some contracts, payment terms limit an entity's exposure to credit risk. For example, a customer may be required to pay a portion of the consideration promised in the contract before the entity transfers promised goods or services to the customer. In those cases, any consideration that will be received before the entity transfers promised goods or services to the customer would not be subject to credit risk.
b. The ability to stop transferring promised goods or services—An entity may limit its exposure to credit risk if it has the right to stop transferring additional goods or services to a customer in the event that the customer fails to pay consideration when it is due. In those cases, an entity should assess only the collectibility of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer on the basis of the entity's rights and customary business practices. Therefore, if the customer fails to perform as promised and, consequently, the entity would respond to the customer's failure to perform by not transferring additional goods or services to the customer, the entity would not consider the likelihood of payment for the promised goods or services that will not be transferred under the contract.

An entity's ability to repossess an asset transferred to a customer should not be considered for the purpose of assessing the entity's ability to mitigate its exposure to credit risk.

• • > Example 1—Collectibility of the Consideration

• • • > Case A—Collectibility Is Not Probable

55-95 An entity, a real estate developer, enters into a contract with a customer for the sale of a building for $1 million. The customer intends to open a restaurant in the building. The building is located in an area where new restaurants face high levels of competition, and the customer has little experience in the restaurant industry.

55-96 The customer pays a nonrefundable deposit of $50,000 at inception of the contract and enters into a long-term financing agreement with the entity for the remaining 95 percent of the promised consideration. The financing arrangement is provided on a nonrecourse basis, which means that if the customer defaults, the entity can repossess the building but cannot seek further compensation from the customer, even if the collateral does not cover the full value of the amount owed.

55-97 The entity concludes that not all of the criteria in paragraph 606-10-25-1 are met. The entity concludes that the criterion in paragraph 606-10-25-1(e) is not met because it is not probable that the entity will collect substantially all of the consideration to which it is entitled in exchange for the transfer of the building. In reaching this conclusion, the entity observes that the customer's ability and intention to pay may be in doubt because of the following factors:

a. The customer intends to repay the loan (which has a significant balance) primarily from income derived from its restaurant business (which is a business facing significant risks because of high competition in the industry and the customer's limited experience).
b. The customer lacks other income or assets that could be used to repay the loan.

c. The customer's liability under the loan is limited because the loan is nonrecourse.

55-98 The entity continues to assess the contract in accordance with paragraph 606-10-25-6 to determine whether the criteria in paragraph 606-10-25-1 are subsequently met or whether the events in paragraph 606-10-25-7 have occurred.

• • • > Case B—Credit Risk Is Mitigated

55-98A An entity, a service provider, enters into a three-year service contract with a new customer of low credit quality at the beginning of a calendar month.

55-98B The transaction price of the contract is $720, and $20 is due at the end of each month. The standalone selling price of the monthly service is $20. Both parties are subject to termination penalties if the contract is cancelled.

55-98C The entity's history with this class of customer indicates that while the entity cannot conclude it is probable the customer will pay the transaction price of $720, the customer is expected to make the payments required under the contract for at least 9 months. If, during the contract term, the customer stops making the required payments, the entity's customary business practice is to limit its credit risk by not transferring further services to the customer and to pursue collection for the unpaid services.

55-98D In assessing whether the contract meets the criteria in paragraph 606-10-25-1, the entity assesses whether it is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the services that will be transferred to the customer. This includes assessing the entity's history with this class of customer in accordance with paragraph 606-10-55-3B and its business practice of stopping service in response to customer nonpayment in accordance with paragraph 606-10-55-3C. Consequently, as part of this analysis, the entity does not consider the likelihood of payment for services that would not be provided in the event of the customer's nonpayment because the entity is not exposed to credit risk for those services.

55-98E It is not probable that the entity will collect the entire transaction price ($720) because of the customer's low credit rating. However, the entity's exposure to credit risk is mitigated because the entity has the ability and intention (as evidenced by its customary business practice) to stop providing services if the customer does not pay the promised consideration for services provided when it is due. Therefore, the entity concludes that the contract meets the criterion in paragraph 606-10-25-1(e) because it is probable that the customer will pay substantially all of the consideration to which the entity is entitled for the services the entity will transfer to the customer (that is, for the services the entity will provide for as long as the customer continues to pay for the services provided). Consequently, assuming the criteria in paragraph 606-10-25-1(a) through (d) are met, the entity would apply the remaining guidance in this Topic to recognize revenue and only reassess the criteria in paragraph 606-10-25-1 if there is an indication of a significant change in facts or circumstances such as the customer not making its required payments.

• • • > Case C—Credit Risk Is Not Mitigated

55-98F The same facts as in Case B apply to Case C, except that the entity's history with this class of customer indicates that there is a risk that the customer will not pay substantially all of the consideration for services received from the entity, including the risk that the entity will never receive any payment for any services provided.

55-98G In assessing whether the contract with the customer meets the criteria in paragraph 606-10-25-1, the entity assesses whether it is probable that it will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. This includes assessing the entity's history with this class of customer and its business practice of stopping service in response to the customer's nonpayment in accordance with paragraph 606-10-55-3C.

55-98H At contract inception, the entity concludes that the criterion in paragraph 606-10-25-1(e) is not met because it is not probable that the customer will pay substantially all of the consideration to which the entity will be entitled under the contract for the services that will be transferred to the customer. The entity concludes that not only is there a risk that the customer will not pay for services received from the entity, but also there is a risk that the entity will never receive any payment for any services provided. Subsequently, when the customer initially pays for one month of service, the entity accounts for the consideration received in accordance with paragraphs 606-10-25-7 through 25-8. The entity concludes that none of the events in paragraph 606-10-25-7 have occurred because the contract has not been terminated, the entity has not received substantially all of the consideration promised in the contract, and the entity is continuing to provide services to the customer.

55-98I Assume that the customer has made timely payments for several months. In accordance with paragraph 606-10-25-6, the entity assesses the contract to determine whether the criteria in paragraph 606-10-25-1 are subsequently met. In making that evaluation, the entity considers, among other things, its experience with this specific customer. On the basis of the customer's performance under the contract, the entity concludes that the criteria in 606-10-25-1 have been met, including the collectibility criterion in paragraph 606-10-25-1(e). Once the criteria in paragraph 606-10-25-1 are met, the entity applies the remaining guidance in this Topic to recognize revenue.

• • • > Case D—Advance Payment

55-98J An entity, a health club, enters into a one-year membership with a customer of low credit quality. The transaction price of the contract is $120, and $10 is due at the beginning of each month. The standalone selling price of the monthly service is $10.

55-98K On the basis of the customer's credit history and in accordance with the entity's customary business practice, the customer is required to pay each month before the entity provides the customer with access to the health club. In response to nonpayment, the entity's customary business practice is to stop providing service to the customer upon nonpayment. The entity does not have exposure to credit risk because all payments are made in advance and the entity does not provide services unless the advance payment has been received.

55-98L The contract meets the criterion in paragraph 606-10-25-1(e) because it is probable that the entity will collect the consideration to which it will be entitled in exchange for the services that will be transferred to the customer (that is, one month of payment in advance for each month of service).

Determining whether a contract exists

Definition of a contract

Topic 606 defines a 'contract' as an agreement between two or more parties that creates enforceable rights and obligations and specifies that enforceability is *a matter of law*. Consequently, the assessment of whether a contract exists does not focus on the form of the contract. Contracts can be written, oral or implied by an entity's customary business practices, depending on the relevant laws and regulations under which the contract is governed.

The assessment of whether a contract exists may require significant judgment in some jurisdictions or for some arrangements and may result in different conclusions for similar contracts in different jurisdictions. In some cases, the parties to an oral or an implied contract (in accordance with customary business practices) may have agreed to fulfill their respective obligations. In cases of significant uncertainty about enforceability (e.g. oral or an implied contract), a written contract and legal interpretation by qualified counsel may be required to support a conclusion that the parties to the contract have approved and are committed to perform their respective obligations. An entity should assess whether the parties intend to be bound by the terms and conditions of the contract. This evaluation may include an assessment of an entity's customary business practices and past practice of what has been enforced.

Wholly unperformed contracts

A contract does not exist for accounting purposes if each party to the contract has the unilateral right to terminate a 'wholly unperformed' contract without compensating the other party (or parties). A contract is wholly unperformed if two criteria are met:

- the entity has not yet transferred any promised goods or services to the customer; and
- the entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services.

Contract identification criteria

The Boards decided to supplement the definition of a contract by specifying additional criteria beyond legal enforceability that must be met for an entity to conclude a contract exists in accordance with Topic 606 and can apply the revenue model in Topic 606 to that contract. The Boards decided that when some or all of those criteria are not met, it is questionable whether the contract establishes enforceable rights and obligations. Therefore, a contract with a customer is subject to the revenue model in Topic 606 only when it is legally enforceable and meets all of the following criteria.

A contract exists if...

Collection of consideration is probable

Rights to goods or services and payment terms can be identified

It has commercial substance

It is approved and the parties are committed to their obligations

Two of those criteria are that (1) the parties must have approved the contract and be committed to performing their respective obligations and (2) each party's rights with respect to the goods and services, as well as the payment terms, can be identified. At the financial reporting date, a contract may still be (a) subject to contingencies (such as a substantive additional review yet to occur or authorization yet to be obtained), (b) in a preliminary stage (such as a letter of intent) or (c) require additional negotiations and subsequent amendments or revisions. In such cases, criteria (1) and (2) are likely not met and, therefore, a contract does not exist and the revenue model in Topic 606 will not yet apply.

However, there may be scenarios in which an entity continues to provide services to a customer after expiration of a contract but during contract extension negotiations. These fact patterns are discussed in Question B60 and Example B60.1.

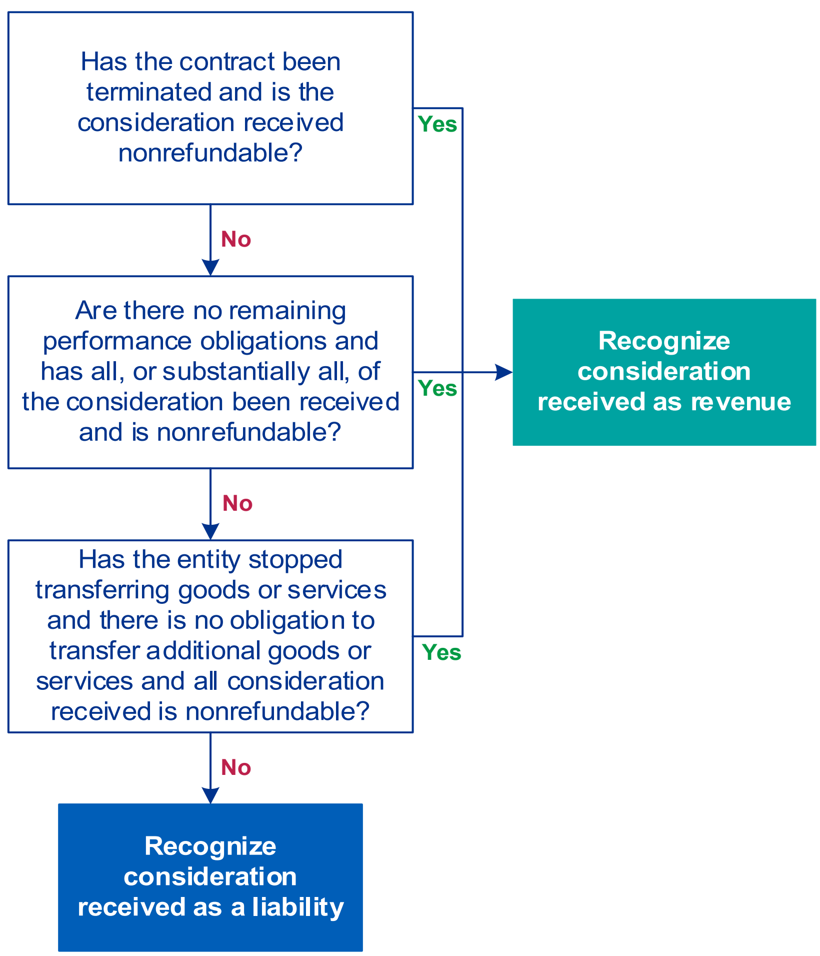
If all of the criteria to account for a contract with a customer under Topic 606 have not been met, the entity continually reassesses the arrangement against them and applies the revenue model in Topic 606 to the contract from the date on which all of the criteria are met, which may result in a cumulative effect revenue adjustment for the entity's performance to-date (e.g. to recognize revenue based on the goods or services transferred to the customer before a contract was determined to exist). In contrast, if a contract meets all of the criteria at contract inception, an entity does not reassess any of those criteria unless there is a significant change in facts and circumstances. If, on reassessment, an entity determines that the criteria are no longer met, then it ceases to apply the revenue model to the contract from that date but does not reverse any revenue previously recognized.

An entity may have a pattern of frequently renegotiating the terms of the contract or have a history of providing concessions to the customer. Typically, such a pattern or history will not affect whether enforceable rights and obligations exist before the renegotiation or concession, or prevent the parties from identifying those rights and obligations, and therefore will not affect whether there is a contract between the parties within the scope of the revenue model. Rather, subsequent renegotiations would follow the contract modification guidance (see *Chapter G – Contract modifications*) and a pattern of granting concessions would affect either (or both) the entity's identification of the promised goods or services in the contract (see Question C90) or its determination of the transaction price for the contract (see Question D130).

However, we believe it is possible that in very unusual circumstances (e.g. significant actions that are unpredictable), an entity's pattern or history could be of such a nature that the entity would not be able to conclude the parties to the contract can identify all of their respective rights and obligations (including customer payment terms). In that case, the criteria in paragraph 606-10-25-1 would not be met and a contract within the scope of the revenue model would not yet exist.

Consideration received from a customer before meeting the contract identification criteria

The following flow chart describes the accounting for consideration received from a customer when the criteria for contract existence in Topic 606 are not met (see paragraph 606-10-25-7). This is also referred to as the alternative model.



Comparison to legacy US GAAP

Legacy US GAAP software revenue recognition guidance specified that, if a software entity has a customary business practice of using written contracts, persuasive evidence of the arrangement is provided only by a contract signed by both parties. Therefore, persuasive evidence of an arrangement would not exist before the final license agreement being executed by both parties. In circumstances where both parties had not executed the contract before the end of the financial reporting period, revenue would not be recognized in that period. Under Topic 606 if the placement of the customer order and shipment of the goods constitute a legally enforceable contract and the other criteria are met, then the new revenue model is applied even if it differs from an entity's customary business practices. Similar arrangements in different jurisdictions may be treated differently if the determination of a legally enforceable contract differs.

Legally enforceable rights may be less restrictive than persuasive evidence

Under the legacy guidance, an entity was required to have persuasive evidence that both parties in a transaction understand the specific nature and terms of an agreed-upon transaction. The form of persuasive evidence is required to be consistent with customary business practices, such as a signed contract.

Under Topic 606, a contract must exist but it may be oral, written or implied by customary business practices and does not have to follow a consistent form. An entity will need to consider the jurisdiction in which the transaction occurs to determine whether an agreement has created legally enforceable rights and obligations. Similar contracts may produce different results based on the jurisdiction. Therefore, it may be prudent to receive legal advice or a legal opinion in certain situations.

Collectibility

One of the criteria that must be met for a contract to be within the scope of the Topic 606 revenue model is that "it is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer." That is, in contrast to legacy US GAAP, under which collectibility was a recognition criterion, under Topic 606, collectibility is a 'gating question' designed to prevent entities from applying the revenue model to non-substantive transactions, and thus recognizing revenue and a bad debt expense at the same time.

In making the collectibility assessment, an entity considers the customer's ability and intention (which includes assessing its creditworthiness) to pay substantially all of the amount of consideration to which the entity is entitled when it is due. This assessment is made *after* taking into consideration any price concessions that the entity may offer to the customer. Concessions are not related to a customer's ability and intention to pay the consideration in the contract; rather, concessions are typically granted in response to other factors such as competition and price pressures, sales channel overload and regulatory changes. See Question B85 for further information regarding 'substantially all.'

Judgment will be required in evaluating whether the likelihood that an entity will not receive the full amount of stated consideration in a contract gives rise to a collectibility issue or a price concession. Topic 606 includes two examples of implicit price concessions: a life science prescription drug sale (Example 2) and a transaction to provide healthcare services to an uninsured (i.e. self-pay) patient (Example 3). In both examples, the entity concludes that the transaction price is not the stated price or standard rate and that the promised consideration is variable. Consequently, an entity may need to determine the transaction price in Step 3 of the model (see *Chapter D – Step 3: Determine the transaction price*), including any price concessions, before concluding on the Step 1 collectibility criterion.

The collectibility threshold is applied to the amount to which the entity expects to be entitled in exchange for the goods and services that will be transferred to the customer, which may not be the stated contract price or the entire transaction price of the contract. The assessment considers:

- the entity's legal rights;
- past practice;
- how the entity intends to manage its exposure to credit risk throughout the contract; and
- the customer's ability and intention to pay.

The collectibility assessment is limited to the consideration attributable to the goods or services to be transferred to the customer for the non-cancellable term of the contract. For example, if a contract has a two-year term but either party can terminate after one year without penalty, then an entity assesses the collectibility of the consideration promised in the first year of the contract (i.e. the non-cancellable term of the contract).

The collectibility assessment is also limited to the consideration attributable to the goods or services the entity *will* transfer to the customer after considering its ability to mitigate any credit risk of the customer. That is, if there is a question about the customer's ability and intent to pay for all of the promised goods or services in the contract, but the entity has the ability and the intent (e.g. based on its customary business practices) to mitigate that credit risk by refusing to transfer further goods or services if the customer does not fulfill its obligations to pay the entity, the collectibility assessment is limited to whether the customer will pay substantially all of the consideration to which the entity is entitled for those goods or services the entity will transfer before it discontinues further performance.

For example, if it is not probable that a customer will pay all of the monthly fees to which a SaaS provider expects to be entitled under a three-year SaaS arrangement, the contract may still be subject to the revenue model if it *is* probable the customer will pay for some of the services (e.g. the first year of the SaaS) and SaaS provider has the ability and intent to shut off the customer's access to the SaaS in a timely manner if the customer does not pay for the service as amounts come due. However, if a contract exists the contract term for purposes of applying the Topic 606 revenue model is three years (see paragraph 606-10-25-3).

An entity may further mitigate its credit risk by requiring security deposits or advance payments. The security deposit, or requiring payments for service periods in advance, may still not make it probable that the customer will pay substantially all of the consideration for the promised goods or services in the contract, but may ensure the entity will collect substantially all of the consideration to which it expects to be entitled for the goods or services that it *will* transfer to the customer after taking into consideration its ability and intent to stop transferring goods or services as discussed in the preceding paragraph.

Term of the contract

Topic 606 is applied to the duration of the contract (i.e. the contractual period) in which the parties to the contract have presently enforceable rights and obligations. The determination of the contract term is important because it affects many other aspects of the model. For example, it may affect:

— the measurement and allocation of the transaction price
— the collectibility assessment
— the timing of revenue recognition for non-refundable upfront fees when such fees will be recognized over the contract period – i.e. rather than over a longer period when the fee provides the customer with a material right
— contract modifications
— the identification of material rights.

The following are some key considerations applicable to determining the term of a contract with a customer:

— *Consideration payable on termination can affect assessment of contract term*

If a contract can be terminated (by either party or just by one party) only by compensating the other party (e.g. a penalty must be paid by the terminating party) and the right to compensation exists and is substantive throughout the contract period, then the contract term (i.e. the period for which enforceable rights and obligations exist for both parties) is the contractual period. However, a right to compensation may not exist, or may not be substantive, for the entire contract period. Under this circumstance, the term of the contract for revenue recognition purposes is the shorter of the specified contract period and the period up to the point at which the contract can be terminated without compensating the other party (or for which the termination penalty is no longer substantive). For example, if a SaaS provider and a customer enter into a five-year arrangement that can be canceled by the customer at any time by paying the SaaS provider a substantive compensation amount that decreases over the contract term until it reaches zero (or a non-substantive amount) at the end of the fourth year of the contract, then the contract term is four years.

However, if a contract can be terminated without substantive compensation being paid, then its term does not extend beyond the goods and services already provided.

In making the assessment of whether the right to compensation is substantive, an entity considers all relevant factors, including legal enforceability of the right to compensation on termination. In general, an entity's past practice of not enforcing a termination penalty (e.g. not pursuing collection of a penalty not paid by the customer) does not affect the contract term unless that past practice changes the legally enforceable rights and obligations of the parties, in which case it could affect the contract term.

— *Only the customer has a right to terminate the contract*

A customer may have the right to terminate the contract without penalty, while the entity is obligated to continue to perform until the end of a specified contract period. In that case, the contract is evaluated to determine whether the option for the customer to continue the contract (i.e. by *not* exercising its termination right) provides the customer with a material right to extend the contract beyond the date at which it can first terminate the contract. For example, a material right may exist if the contractual fee the customer will pay for periods after a termination option is at an incremental discount (see Question C410). Unless the option to continue the contract provides the customer with a material right, there is no accounting by the entity for the customer option and the contract term is presumed *not* to include periods subsequent to the date of the termination option.

— *Compensation is broader than termination payments*

A payment to compensate the other party upon termination is any amount (or other transfer of value – e.g. equity instruments) other than a payment due as a result of goods or services transferred up to the termination date. It is not restricted only to payments explicitly characterized as termination penalties.

— *Ability of either party to cancel the contract at discrete points in time may limit the term of the contract*

If an entity enters into a contract with a customer that can be renewed or canceled by either party at discrete points in time (e.g. at the end of each year) without paying substantive compensation to the other party, then the contract term is the period for which the contract cannot be canceled by either party. Upon commencement of each service period (e.g. a month in a month-to-month arrangement or a year in a year-to-year arrangement), where the entity has begun to perform and the customer has not canceled the contract, the entity generally has enforceable rights relative to fees owed for those services, and a contract exists for that period. For example, a customer may have the right to cancel a SaaS arrangement or a software post-contract customer support (PCS) arrangement at the end of each service year. If the customer does not cancel, and the entity begins providing SaaS or PCS services for the next service year following the optional termination date, generally there is a contract only for the period of time until the next optional termination date (i.e. only for the next year) and the entity has an enforceable right to payment for services provided during the period of time until the next optional termination date only.

— *Evergreen contracts*

For purposes of assessing the contract term, an evergreen contract, such as a PCS arrangement that auto-renews, that is cancellable by either party (or just the customer) each period without a substantive penalty is no different from a similar contract structured to require affirmative renewal of the contract each period (e.g. one that requires the customer to place a new order or the parties to sign a new contract). In these situations, an entity should not automatically assume a contract period that extends beyond the current period (e.g. the current month or year).

Combining contracts

Excerpt from ASC 606-10

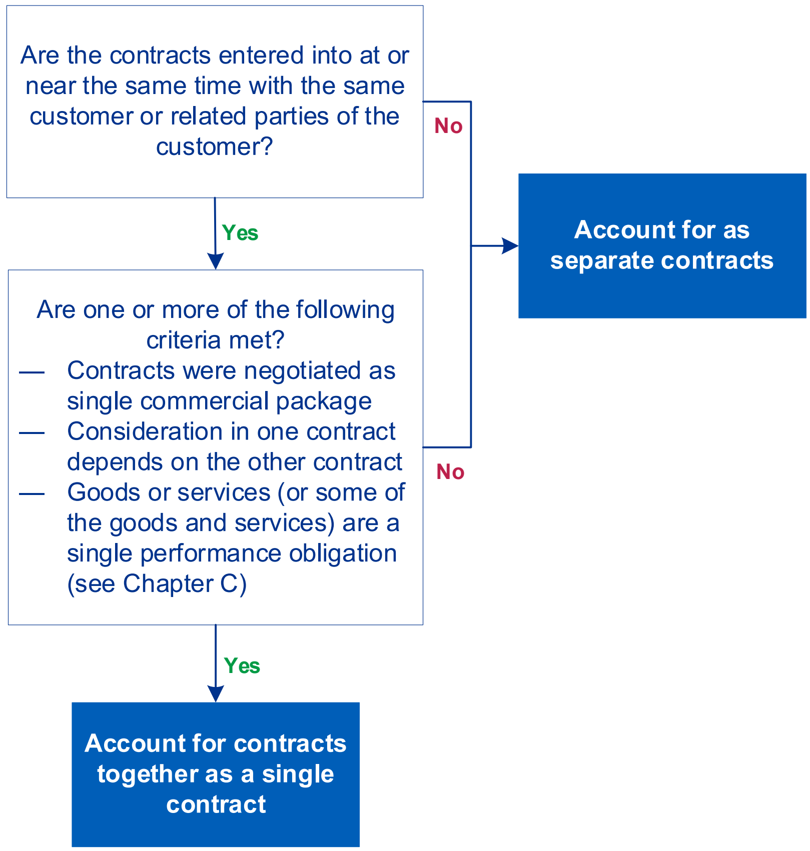
> Combination of Contracts

25-9 An entity shall combine two or more **contracts** entered into at or near the same time with the same customer (or related parties of the customer) and account for the contracts as a single contract if one or more of the following criteria are met:

a. The contracts are negotiated as a package with a single commercial objective.
b. The amount of consideration to be paid in one contract depends on the price or performance of the other contracts.
c. The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single **performance obligation** in accordance with 606-10-25-14 through 25-22.

Determining when multiple contracts should be combined requires the use of judgment, and both the form and the substance of an arrangement must be considered in the evaluation. Often entities have continuing and multi-faceted relationships with their customers (including resellers), and this business relationship will lead to numerous signed or oral arrangements between the two parties.

The following flow chart outlines the criteria in Topic 606 for determining when an entity combines two or more contracts and accounts for them as a single contract.



Comparison to legacy US GAAP

The legacy US GAAP software revenue recognition guidance provided six indicators for an entity to consider in determining whether multiple contracts with the same customer should be combined and accounted for as a single multiple-element arrangement. Although one of the indicators was that the contracts are negotiated or executed within a short timeframe of each other, it was only an indicator to be considered *along with* five other indicators.

Under Topic 606, entities are required to combine contracts if they are *both* (a) entered into at or near the same time with the same customer (or related parties) and (b) any one of three specified criteria is met. Although the Topic 606 contract combination guidance is similar in concept to that in legacy US GAAP guidance, the use of criteria in Topic 606 versus indicators in legacy US GAAP may result in some different conclusions about whether multiple contracts are combined.

Software-specific indicators vs specified criteria

Of the six indicators in legacy US GAAP, five are similar to the three specified criteria in Topic 606 that must be considered *if* two contracts are entered into 'at or near the same time' as each other. This is also discussed in further detail in Question B210.

The indicator that negotiations are conducted jointly with two or more parties (e.g. from different divisions of the same company) to do what in essence is a single project is similar to paragraph 606-10-25-9(a) – that is, the criterion to evaluate whether the contracts are negotiated as a package with a single commercial objective.

The indicators that: (1) the fee for one or more contracts or agreements is subject to refund, forfeiture or another concession if another contract is not completed satisfactorily, and (2) the payment terms under one contract or agreement coincide with performance criteria of another contract or agreement are similar to paragraph 606-10-25-9(b) – that is, the criterion to evaluate whether the amount of consideration to be paid in one contract depends on the price or performance of the other contract.

The other two indicators in the legacy US GAAP software guidance: (1) the different elements are closely interrelated or interdependent in terms of design, technology or function, and (2) one or more elements in one contract or agreement are essential to the functionality of an element in another contract are similar to the guidance an entity evaluates in assessing whether the criterion in paragraph 606-10-25-9(c) is met.

The contracts being negotiated or executed within a short timeframe of each other is an indicator that two contracts should be combined under legacy US GAAP but is a gating question under Topic 606 – that is, an entity evaluates whether any of the three specific criteria in paragraph 606-10-25-9 are met *only if* the contracts are entered into at or near the same time (see Question B190).

Legacy US GAAP guidance applied by SaaS providers

Legacy US GAAP revenue guidance applicable to SaaS providers contains a rebuttable presumption that contracts entered into at or near the same time with the same entity or related parties are a single contract. Topic 606 does not include a similar rebuttable presumption and additional criteria must be met. Therefore, it is possible that entities could come to different conclusions under Topic 606 than they did under legacy US GAAP. However, we believe, in most cases, if none of the three additional criteria in paragraph 606-10-25-9 are met, an entity would have overcome the rebuttable presumption that existed in legacy US GAAP and, therefore, would reach the same conclusion under either Topic 606 or legacy US GAAP.

Questions & answers

Determining whether a contract exists

Question B10

If a software entity obtains signed contracts as its customary business practice does the contract have to be signed by both parties for a contract to exist?

Interpretive response: No. Even when a software entity obtains agreements signed by both parties as its customary business practice, a contract may exist without, or before, both parties' signatures (or even without either party's signature). This is because the assessment of whether a contract exists for purposes of applying Topic 606 focuses on whether enforceable rights and obligations exist on the parties based on the relevant laws and regulations, rather than on the form of the contract (i.e. whether it is oral, implied, electronic assent or written).

The assessment of whether there is an enforceable contract may require significant judgment in some circumstances or jurisdictions and may require the involvement of legal counsel. Similar contracts may give rise to different enforceable rights and obligations based on the governing jurisdiction due to differing laws and regulations. Further, entities should be cautious about reaching conclusions that enforceability exists if there are substantive additional reviews of the contract that have not yet occurred, or authorizations not yet obtained, that could substantively alter the terms and conditions of the contract.

It will be important for entities to establish a process (and related controls) for determining when enforceability exists because the contract identification guidance in Topic 606 is not optional – that is, an entity cannot elect an accounting policy to only account for contracts with customers that have been dually-signed by both parties. For example, if a software entity transfers control of a software license on or before the reporting date (see *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*), but incorrectly determines whether a contract with the customer exists on or before that reporting date, revenue may be over- or understated for the period.

Entities will also need to remember that for the revenue model in Topic 606 to apply to a contract, all of the criteria in paragraph 606-10-25-1 must be met, including the collectibility criterion. Therefore, even if enforceability is established, entities will have further work to do before they can begin to apply the Topic 606 revenue model to the contract.

Question B20

What should a contract with a customer describe in order to demonstrate that the parties can each identify their rights regarding the promised goods or services and the payment terms for those goods or services (i.e. that criteria b. and c. in paragraph 606-10-25-1 are met)?

Interpretive response: In general, we believe an entity should consider whether a contract includes a description of the following terms or conditions (not exhaustive):

- the products (e.g. software licenses) and/or services (e.g. SaaS, PCS, implementation services) promised in the arrangement;
- the key attributes of any software license transferred to the customer (e.g. is it perpetual or time-based, or limited as to geography or use?);
- payment terms and fees due from the customer;
- delivery terms;
- warranties, rights (e.g. return rights), obligations and termination provisions – if any; and
- any other pertinent contractual provisions (e.g. price protection, service level guarantees).

Absent the above, it may be questionable as to whether an entity would be able to identify each party's rights and obligations regarding the transfer of goods or services, including the customer's obligation to pay for the goods or services. However, the list above is not necessarily all-inclusive, nor does the absence of one or more of these items necessarily mean that criteria b. and c. in paragraph 606-10-25-1 cannot be met.

If an entity does not have a standard or customary business practice of relying on written contracts to document an arrangement, it may have other forms of written or electronic evidence to document the transaction. An entity should consider developing policies for what constitutes enforceable rights and obligations for each line of business or class of customer as they may be different for each. However, regardless of the form of documentation, the evidence should be final and include (or reference) all of the relevant terms and conditions of the arrangement.

Example B20.1

Contract approval and customary business practice, Part I

ABC Corp. licenses software and has a customary business practice of entering into written contracts with its customers that describe the terms and conditions under which customers can obtain a license to ABC's software and of delivering software upon receipt of an approved customer purchase order in writing.

Customer has established a purchasing policy that requires execution of a contract with its vendors before it will accept delivery of any software products.

ABC and Customer negotiate the terms of an arrangement and execute a written master agreement that is signed by both parties on December 29, 20X4. The master agreement specifies the terms and conditions for the licensing of ABC's various software products (ABC licenses software products A-Z), including the price for each license of each software product; however, the master agreement does not commit Customer to purchase or ABC to transfer any licenses. Subsequent to the execution of the master agreement, Customer requests via an email to the account manager that ABC transfer 100 perpetual user licenses to Software Product A in accordance with the December 29 master agreement, for which it will submit a written purchase order. ABC transfers control of the licenses to Customer on December 30, 20X4 (i.e. ABC has both provided a copy of the licensed software to Customer and Customer can begin to use and benefit from the licenses – see *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*). The actual purchase order from Customer is not received by ABC until January 2, 20X5.

The master agreement signed by both parties on December 29, 20X4 does not, by itself, create enforceable rights and obligations to transfer software licenses because Customer may, or may not, choose to order under the master agreement. However, that agreement, when combined with the email from Customer requesting the 100 perpetual user licenses to Product A that references the December 29 agreement, may constitute a contract in accordance with Topic 606; however, whether the customer email creates enforceable rights and obligations may vary depending on the jurisdiction. After consultation with legal counsel, ABC concludes that the master agreement in combination with the email communication from Customer establish enforceable rights and obligations between the parties with sufficient specificity to meet the contract criteria of Topic 606. Consequently, assuming that this is a single element arrangement or that the 100 user licenses to Product A are distinct from any services (e.g. PCS or professional services) in the arrangement, ABC would recognize revenue for the transfer of the 100 user licenses on December 30, 20X4.

By way of comparison, under legacy US GAAP, ABC would not have had persuasive evidence of an arrangement because ABC has a standard business practice of obtaining an approved customer purchase order in writing to evidence its arrangements (which was not received until January 2, 20X5) and, therefore, revenue related to the delivery of the 100 user licenses could not have been recognized any earlier than January 2, 20X5.

Example B20.2

Contract approval and customary business practice, Part II

Assume the same basic facts and circumstances as in Example B20.1, except that:

— the master agreement outlining the terms and conditions for the licensing of ABC's various software products (ABC licenses software products A-Z), including the price for each license of each software product, is signed, dated and returned by Customer on January 2, 20X5. ABC signed the contract on December 22, 20X4 and it was confirmed received via email by Customer the same day;

— ABC receives a written purchase order from Customer for the 100 perpetual user licenses to Product A on December 26, 20X4, referencing the master contract;

— ABC transfers control of the 100 perpetual user licenses to Customer on December 30, 20X4;

— ABC's legal counsel represents that ABC had a valid contract as of December 26, 20X4 because the contract, signed by ABC and sent to Customer, constituted an offer that Customer accepted by executing the purchase order, even if it did not execute the agreement until a few days later.

There is a contract between the parties under Topic 606 as of December 26, 20X4. Consequently, assuming that this is a single element arrangement or that the 100 user licenses to Product A are distinct from any services (e.g. PCS or professional services) in the contract, ABC would recognize revenue for the transfer of the 100 user licenses on December 30, 20X4.

By way of comparison, under legacy US GAAP, ABC would not have had persuasive evidence of an arrangement because ABC has a standard business practice of using signed written contracts. Because the contract was not signed by both parties until January 2, 20X5, revenue related to the delivery of the 100 user licenses could not have been recognized any earlier than that date.

Question B30

If a Master Service Agreement (MSA) exists between an entity and a customer under which the customer requests goods and services through purchase orders is the MSA a contract under Topic 606?

Interpretive response: It depends, and this is illustrated in Example B20.1. If the MSA merely defines the terms and conditions under which the customer can order goods and services from the entity, but does not create enforceable rights and obligations on the parties (i.e. for the entity to transfer goods or services and for the customer to pay for those goods or services), there is not a contract between the parties until the customer places a purchase order (PO) under the MSA.

Some entities enter into MSAs with customers, which specify the basic terms and conditions for subsequent transactions between the parties and are signed by both the entity and customer. Under such arrangements, no additional contractual agreement is executed and customers request products through POs that specify the products and quantities. An MSA under which a customer places POs in order to obtain goods or services does not itself constitute a contract with a customer. This is because the MSA usually does not create enforceable rights and obligations for the parties. As discussed in

Question B20, in order for a contract to be enforceable an entity should be able to identify each party's rights regarding the goods and services to be transferred. While the MSA may specify the payment terms for goods or services to be transferred, it usually does not specify the goods (e.g. licenses) and services, including quantities thereof, to be transferred. Absent those specific terms and conditions, a contract within the revenue model of Topic 606 does not exist (i.e. the contract will not meet the criteria in paragraph 606-10-25-1).

However, some MSAs may include a requirement for the customer to purchase a minimum quantity of goods or services from the entity. This may be a cumulative minimum for the MSA period or for periods within the MSA (e.g. each year of a multi-year MSA). If the minimum is enforceable, then the MSA itself may constitute a contract under Topic 606. However, if the entity's past practice of not enforcing MSA minimums results in a conclusion that the minimums are not legally enforceable, the MSA would not be a contract under Topic 606 (i.e. just as if the minimum were not included in the MSA at all). In addition, if relevant experience with the customer suggests that the customer will not meet the required minimums, and that the entity will not enforce them, this would typically demonstrate the entity and the customer are not committed to the minimums in the contract as per paragraph 606-10-25-1(a). Consequently, even if the entity's past practice of not enforcing MSA minimums doesn't result in a conclusion that the minimums are not legally enforceable, the contract may still not meet all of the criteria in paragraph 606-10-25-1. It would therefore not be a contract within the revenue model of Topic 606.

When an MSA does not create enforceable rights and obligations with respect to transferring goods or services on its own, it will normally be the combination of a PO with the MSA that does so. Therefore the MSA and the PO would be evaluated together to determine whether the Step 1 criteria are met and a contract exists. However, if additional steps must be taken for the PO to create legally enforceable rights and obligations (e.g. executing a supplemental contract or addendum to the MSA subsequent to receipt of the PO), then a contract with a customer does not exist until those steps are completed. Other examples of additional steps may include acceptance of the PO and/or issuance of a sales order acknowledgment form by the entity to the customer. In some cases, the customer may have to accept the invoice issued by the entity in order for payment of consideration to be legally enforceable.

If either party can cancel a PO entered into under an MSA without penalty before the entity transferring the ordered goods or services (e.g. before transferring a software license), a contract does not exist, even if all the conditions in paragraph 606-10-25-1 are met. In this situation, a contract is not deemed to exist because each party has a right to terminate the contract and the contract is wholly unperformed (the entity has not transferred any goods or services to the customer and the entity has not yet received, and is not yet entitled to receive, any consideration in exchange for the promised goods or services) in accordance with paragraph 606-10-25-4. However, in contrast, if the entity transfers some or all of the goods or services in the PO, the contract would no longer be wholly unperformed. The entity would at least be entitled to receive consideration in exchange for the goods or services transferred to the customer.

Example B30.1
Prepaid spending account

ABC Corp. enters into an arrangement with Customer whereby Customer agrees to spend $2 million with ABC over a two-year period. Customer prepays the $2 million at the date the prepaid spending account (PSA) is agreed to and then 'draws down' from that balance over the two-year period by issuing purchase orders (POs) for specific software licenses and services (which may also require additional Statements of Work (SOWs) depending on the nature of the service) against a mutually agreed price list. The price list includes most of ABC's software licenses and services. The PSA agreement establishes the prepaid amount, the two-year term, and the price list that includes all of the other relevant terms and conditions under which draw-downs (through POs) will be made (e.g. warranties, delivery mechanisms and scope of rights granted for the various software licenses). The $2 million upfront payment is subject to a 'use it or lose it' provision – that is, any amounts Customer does not use through draw-downs by the end of the two-year PSA term is forfeited and none of the $2 million is refundable to Customer.

The price list in the PSA permits Customer to select from a wide variety and quantity of ABC's software licenses and services. For many of the services, an additional SOW would be necessary to establish the parameters of the services to be provided, the PSA merely sets out the hourly rate that will be applied to services of that nature. Consequently, even though the PSA sets out many terms and conditions, and establishes, in effect, a minimum quantity of ABC's software and services that Customer will acquire, until Customer executes a PO (and potentially also an SOW in the case of most professional services offerings on the price list), ABC cannot identify each party's rights regarding the licenses or services to be transferred because the entity does not know what software licenses or services it will be required to transfer. ABC also has no obligation to transfer any licenses or services until Customer executes a PO making its selections.

Only at the point in time that Customer executes a PO (and potentially also an SOW) under the PSA does ABC have a present obligation to transfer licenses and/or services to Customer and can ABC identify each party's rights regarding specific licenses and services it will transfer to Customer. Consequently, the contract between ABC and Customer under Topic 606 is the combination of the PSA and the PO (or PO/SOW if the PO includes services that require an SOW). Each PO will be a separate contract unless it is combined with another PO based on the contract combinations guidance in Topic paragraph 606-10-25-9.

Comparison to legacy US GAAP

Under legacy US GAAP, an MSA did not provide 'persuasive evidence of an arrangement' if the entity's customary business practice was to obtain a purchase order (PO) from its customers to specify the products/services and quantities. If so, the persuasive evidence of an arrangement criterion would only be satisfied upon receipt of the customer's PO. However, if the entity intends to execute a supplemental contract or addendum to the MSA subsequent to receipt of a PO, revenue may not be recognized until both the entity and the customer execute that additional agreement.

The guidance in Topic 606 is similar from the perspective that an MSA may not create enforceable rights and obligations on an entity and its customer. However, under Topic 606, the question is about whether enforceable rights and obligations exist without the PO, rather than on whether the *form* of the contract without the PO is consistent with the entity's customary business practices. Because of this, entities may, in some circumstances, reach different conclusions about the effect of having a PO on whether a contract exists under Topic 606 than they would have reached about whether a PO was necessary to having persuasive evidence of an arrangement.

Question B40

Does the form of an entity's contracts and evidence of approval have to be consistent across customers?

Interpretive response: No. An entity may have a customary business practice of using written contracts or purchase orders to evidence an arrangement. However, the entity may enter into arrangements with certain customers whose business practices of providing evidence of an arrangement differ from the entity's customary practice of using written contracts (i.e. certain customers may license software products only by purchase orders). In fact, the entity may not have a customary business practice if it principally relies on whatever method its customers prefer. For example, an entity may not have a customary business practice of using written contracts or purchase orders but certain of the entity's customers may require signed written contracts or the issuance of written purchase orders to purchase goods or services.

Because, under Topic 606, the form of the contract does not, in and of itself, determine whether a contract exists (see the discussion on enforceable rights and obligations in the overview to this chapter, as well as the discussion in Questions B10–B30); whether the entity is consistent in the form of its contracts and/or its evidence of approval of those contracts also do not, in isolation, affect whether a contract exists.

Example B40.1

Form of the contract and approval does not affect contract conclusion

ABC Corp. is a provider of computer security software. ABC provides time-based licenses to its customers. ABC has a customary business practice of executing formal license agreements with its customers, including amendments for license renewals.

Customer has licensed ABC's software for the last two years and its current term license will expire on December 31, 20X0, which is also ABC's fiscal year-end. On December 30, 20X0, ABC and Customer (i.e. an authorized officer of Customer) correspond via email in which Customer requests to renew its license for an additional two years and ABC quotes Customer a fee of $200,000 for the renewal. The email offer from ABC includes all of the substantive terms and conditions normally included in ABC's renewal amendments. Customer responds via email accepting the offer later on December 30, 20X0, and on December 31, 20X0, Customer emails ABC a purchase order for the two-year renewal license at the agreed-upon fee. For various reasons, a written renewal amendment to the parties' master license agreement is not executed or signed by both parties until January 8, 20X1.

A contract may exist as of ABC's December 31 fiscal year-end. Unlike under legacy US GAAP, the absence of an executed, written renewal amendment does not, in isolation, preclude a contract from existing before that amendment being formally executed.

Depending on various facts and circumstances (e.g. the governing jurisdiction), either the email accepting ABC's offer (which occurred on December 30, 20X0) or the written purchase order (issued on December 31, 20X0) may create enforceable rights and obligations on the parties as well as permit ABC to conclude that the contract existence criteria in paragraph 606-10-25-1 have been met before executing the formal written amendment.

ABC's evaluation of whether enforceable rights and obligations exist would typically include an assessment of its customary business practices and past experience with what has been enforced in the jurisdiction governing this contract. Meanwhile, the substance of the email communications (which, in this case, included all of the substantive terms and conditions normally included in ABC's renewal amendments) and the written purchase order would affect whether the criteria in paragraph 606-10-25-1 are met (e.g. whether the entity can identify each party's rights regarding the goods or services to be transferred and/or the payment terms for the goods or services to be transferred).

Note that even if a contract exists as of ABC's fiscal year-end, ABC will not necessarily recognize revenue from the license renewal during its current fiscal year. ABC will need to consider the guidance in paragraphs 606-10-55-58B through 55-58C in order to make that determination (see *Chapter F – Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation*).

Question B50

Are 'side agreements' contracts under Topic 606?

Side agreements

Software entities may enter into side agreements with customers outside of the normal contracting process (e.g. as part of the negotiation process or in response to an actual or perceived customer service issue). Those entities' sales and marketing staff may be motivated to make commitments to customers (verbally, written or electronically transmitted – e.g. email) that are not part of the master arrangement with the customer (often referred to as side agreements or side deals) in order to consummate a sale.

Interpretive response: All terms and conditions that create enforceable rights and obligations need to be considered in evaluating a contract, regardless of whether the form of some of those terms and conditions (e.g. in an email or letter agreement, which may be considered a 'side agreement') differs from other terms and conditions in the contract (e.g. those included in a formal 'master agreement' or 'statement of work'). The form in which additional terms and conditions are agreed generally will not affect whether those terms and conditions are part of the contract under Topic 606. This is because Topic 606 does not focus on the form of the contract or its approval, but rather on whether enforceable rights and obligations on the parties are specified and the parties are committed to meeting their respective obligations.

However, an entity should assess whether the form used to communicate certain terms and conditions being different from that of the master agreement (or associated agreements) affects whether the terms and conditions have been established or change the enforceable rights and obligations to which the parties are committed. 'Side agreements' often occur outside the entity's standard contract procedures. Those contract procedures may have been established by an entity to ensure enforceability of contracts entered into with its customers.

A particular side agreement may not, in and of itself, create enforceable rights and obligations on the parties. However, in accordance with paragraphs 606-10-25-16 and 606-10-32-7, respectively, the side agreement may create a reasonable expectation on the part of the customer that a promised good or service will be transferred; a valid expectation that a discount, rebate or some other form of price concession (including extended payment terms) will be granted; or even that the terms of the written contract will not be enforced. A *pattern* by the entity of providing free or discounted good or services, or providing subsequent discounts, rebates or extended payments, as a result of side agreements that are not legally enforceable contracts may create implied performance obligations, variable consideration and/or significant financing components that the entity will need to account for in future contracts if they create a reasonable expectation on the part of those customers that they will receive those items or price concessions.

Comparison to legacy US GAAP

Under legacy US GAAP, side agreements were particularly troublesome in software licensing arrangements because of the requirement to have vendor-specific objective evidence of fair value (VSOE) for each undelivered item in order to account for delivered items separately from the undelivered items – that is, in order to recognize revenue for delivered items. If there were undelivered items for which VSOE was not established, all of the revenue under the related contract would be deferred, including for delivered items, until VSOE was established for all remaining undelivered items or until the last item was delivered (unless the only undelivered item was PCS or hosting services in which case the total consideration would be recognized ratably over that service period).

Side agreements were also troublesome because of the relatively punitive guidance that applied to entities with a history of granting concessions to customers. A history of granting concessions to customers would call into question whether the fees in the entity's arrangements were fixed or determinable. Revenue under arrangements for these entities was often significantly deferred, even beyond the point at which cash was received, and was recognized only once the arrangement consideration was deemed to be fixed (i.e. the risk of concession had abated).

Topic 606 eliminates the VSOE requirement that previously applied to software licensing arrangements and substantially changes the effect on a software entity's revenue recognition of a pattern of concessions (see Questions C90 and D130). Therefore, the accounting consequences of many side agreements (e.g. those that grant price or additional good/service concessions) may not be as significant as under legacy US GAAP. That is, these types of side agreements may result in the deferral of *some* of the contract consideration – for example, for additional, undelivered goods or services or for potential discounts or rebates – but will typically not result in the deferral of all contract consideration as frequently occurred under legacy US GAAP due to the VSOE requirement and the restrictive guidance on concessions.

However, other types of side agreements may still result in an entity not recognizing any revenue from a contract even as it transfers goods (including licenses) or services. For example, a side agreement that negates the customer's obligation to pay for good or services would generally prohibit the entity from recognizing any revenue until either one of the events in paragraph 606-10-32-7 are met or until the entity's enforceable rights to consideration are re-established (e.g. through a modification to the side agreement). Similarly, a side agreement that promises unspecified future concessions may result in a conclusion that the entity cannot identify each party's rights and obligations in the contract, which is a requirement for a contract to exist in accordance with paragraph 606-10-25-1.

Question B60

Does a contract exist for services such as PCS or SaaS when an entity continues to provide the services after the expiration of the contract with the customer?

Interpretive response: Entities may continue to provide services to a customer (e.g. PCS, hosting services, or SaaS) after the expiration of the contract. Whether a contract exists in those circumstances depends on whether enforceable rights and obligations exist after the expiration of the previous contract.

Determining whether an enforceable contract exists

Even if there are no provisions in the contract to continue the services after expiration of the contract and the entity continues to provide the services under the terms of the expired contract while a new contractual arrangement is being negotiated, enforceable rights and obligations may still exist and there may be evidence that both parties are committed to those obligations.

There may be circumstances in which an entity could conclude that there are legally enforceable rights and obligations even in the absence of a formal renewal agreement. Judgment may be required to support that both parties are committed to their respective obligations after the expiration of the written agreement. Additional evidence might include consideration by the entity of its past practice of invoicing for the continuation of services subsequent to an expired agreement and whether its customers, including the present customer if this situation has previously arisen, have continued to pay (and the enforceability of those amounts had they not).The entity's provision of the services and the customer's continued payment of the service fees may provide evidence to demonstrate such commitment. Additionally, an entity might consider in its evaluation any received customer purchase orders, whether contract negotiations have begun and/or any email communications evidencing the customer's intent to continue the services and pay for such services. An entity might also consider its history with the customer, and potentially other similar customers, in terms of whether the customer has previously continued services after contract expiration and paid for such services or entered into a contract extension that addressed those services. Ultimately, evidence of behaviors may not be sufficient to conclude that enforceable rights and obligations exist and legal interpretation by competent counsel may be required.

Lastly, the entity would need to conclude that collectibility of amounts due for the continued services is probable.

If there is an enforceable contract within the scope of the revenue model

Revenue would continue to be recognized as the services are provided based on the terms and conditions of the contract. If the fees for the services are uncertain because of ongoing negotiations to enter into a formal agreement, the entity would be required to estimate the total amount of variable consideration (subject to the constraint) to which it would be entitled in exchange for providing the services (for further discussion of variable consideration and the constraint, see *Chapter D – Step 3: Determine the transaction price*). When the formal agreement is executed, if the fees for the services provided post-expiration are changed (e.g. the parties agree on a monthly service fee of $100, while the entity had been invoicing, and the customer paying, $105), this would either result in an adjustment to the variable consideration included in the transaction price by the entity or, if the consideration was not deemed to be variable (e.g. because the entity had no indication that the formal contract would not codify the monthly services fees it was charging the customer), as a contract modification (see *Chapter G – Contract modifications*).

If there is not an enforceable contract within the scope of the revenue model

The entity would first consider the guidance for consideration received before concluding a contract exists (paragraph 606-10-25-7) to determine if revenue can be recognized. We believe the conclusion about whether revenue can be recognized based on that guidance could differ depending on whether the guidance applies:

a. because enforceable rights and obligations do not exist (i.e. a legally binding contract does not exist); or
b. solely because the collectibility criterion is not met.

If there is not a contract within the revenue model because a legally binding contract does not exist ((a) above), we do not believe any of the criteria (a-c) in paragraph 606-10-25-7 can be met. That is, in the absence of a legally binding contract, we do not believe it is possible for the entity to conclude that it has (1) no remaining obligations to transfer goods or services, (2) received all, or substantially all, of the consideration promised (the entity does not have an enforceable promise from the customer to pay any amount of consideration) or (3) received consideration that is nonrefundable. Item (1) must be met to meet criteria (a) or (c). Meanwhile, item (2) must be met to meet criterion (a) and item (3) must be met to meet any of the criteria in paragraph 606-10-25-7.

Excerpt from ASC 606-10

> Identifying the Contract

25-7 When a contract with a customer does not meet the criteria in paragraph 606-10-25-1 and an entity receives consideration from the customer, the entity shall recognize the consideration received as **revenue** only when one or more of the following events have occurred:

a. The entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable.
b. The contract has been terminated, and the consideration received from the customer is nonrefundable.
c. The entity has transferred control of the goods or services to which the consideration that has been received relates, the entity has stopped transferring goods or services to the customer (if applicable) and has no obligation under the contract to transfer additional goods or services, and the consideration received from the customer is nonrefundable.

In contrast, if a legally binding contract exists, but the contract is not within the scope of the revenue model such that the guidance in paragraph 606-10-25-7 applies solely because the collectibility criterion is not met (b. above), the entity may be able to conclude on each of the items (1) – (3) outlined in the preceding paragraph.

For example, if the legally binding contract does not obligate the entity to provide services beyond either those it has already performed or those for which the customer has already paid (e.g. the current month's services paid in advance), the entity would likely be able to recognize revenue for the services it has already provided and for which it has received substantially all of the consideration to which it is legally entitled. That is, in accordance with paragraph 606-10-25-7(a), the entity might be able to conclude that it has no remaining obligation to provide further services (i.e. beyond those already provided after the previous contract expired) and has received substantially all of the consideration to which it is entitled for those services such that it can recognize revenue for the services once those services are complete and substantially all of the consideration to which it is entitled for those services has been received.

Regardless of the reason for concluding that there is not an enforceable contract within the scope of the revenue model, if none of the criteria in paragraph 606-10-25-7 are met, the entity would defer any consideration received from the customer and recognize it as a deposit liability until there is an enforceable contract within the scope of the revenue model. At that point in time, the entity would recognize revenue on a cumulative catch-up basis for the services already provided under the newly established contract and account for the remainder of the contract in the same manner as any other services contract within the scope of Topic 606.

Example B60.1
Contract continuation for PCS

ABC and Customer have a longstanding relationship. The parties' latest 12-month PCS agreement expired on May 31, 20X3 and did not include any provision for automatic renewal of the PCS. Customer paid $12,000 upfront for the 12 months of PCS on June 1, 20X2, which was the observable stand-alone selling price for the PCS.

A new PCS agreement requiring a fee of $10,800 for the 12-month period of June 1, 20X3 to May 31, 20X4 is signed on July 31, 20X3. No agreement existed from June 1, 20X3 until July 31, 20X3, although ABC continued to provide PCS in anticipation of executing an agreement for the 12-month period following the expiration of the prior agreement. As per its customary business practice, ABC invoiced Customer for the June 1, 20X3 through May 31, 20X4 PCS in May 20X3 at the amount that was agreed for the preceding year (i.e. $12,000). ABC concludes, based on advice of legal counsel, that an enforceable contract did not exist between June 1, 20X3 and July 31, 20X3.

ABC recognizes its PCS revenue over time using a time-based measure of progress (see Question F220).

Scenario 1: Customer does not pay initial invoice

Customer did not pay ABC's $12,000 invoice issued in May 20X3. ABC canceled that invoice on July 31, 20X3 when the new contract was executed, and issued a new invoice for the agreed-upon $10,800, which Customer paid timely.

On July 31, 20X3 ABC recognizes PCS revenue of $1,800, which is equal to two months of PCS at an annual rate of $10,800, on a cumulative catch-up basis, that ABC has already provided under the newly established contract. ABC also recognizes a receivable of $10,800 (Customer pays the $10,800 timely thereafter) and a contract liability (deferred revenue) of $9,000. ABC will recognize $900 in PCS revenue per month for the remaining 10 months.

Scenario 2: Customer partially pays the initial invoice

Customer partially paid ($4,000) the $12,000 invoice issued by ABC in May 20X3. When the new contract was concluded on July 31, 20X3, Customer paid ABC the balance of the $10,800 new contract PCS fee ($10,800 – $4,000 = $6,800).

Despite the fact that Customer partially paid the $12,000 invoice, ABC does not recognize any revenue until the new agreement is established on July 31, 20X3. Notwithstanding the fact that services have been provided and cash received from Customer, ABC is unable to conclude that any of the criteria in paragraph 606-10-25-7 are met before the new agreement is entered into. Therefore, ABC records the $4,000 received from Customer as a deposit liability. On July 31, 20X3, ABC recognizes $1,800 in PCS revenue consistent with Scenario 1. However, because of the $4,000 prepayment by Customer, at July 31, 20X3, ABC only has a receivable of $6,800 (versus $10,800 in Scenario 1), and has a contract liability of $9,000.

Scenario 3: Customer partially pays, and entity has history of enforcing payment

Assume the same facts as in Scenario 2 except that ABC concludes an enforceable contract *does* exist based on relevant experience with enforcing similar arrangements and the advice of legal counsel.

Because an enforceable contract exists on June 1, 20X3, ABC continues to recognize PCS revenue as it provides the PCS to Customer, only at an amount other than the $1,000 per month it had been recognizing under the previous PCS contract. Because the transaction price for the PCS it is providing subsequent to expiration of the prior agreement is uncertain – i.e. ABC knows from relevant experience that Customer will likely negotiate a lower PCS fee than the $12,000 in the prior year – ABC is required to estimate the consideration to which it will be entitled (subject to the constraint on variable consideration) for providing the PCS during the post-expiration period and recognize revenue based on that estimate. *Chapter D – Step 3: Determine the transaction price* discusses estimating variable consideration, subject to the constraint, in further detail.

When the new agreement is signed on July 31, 20X3 (assuming, in this scenario, that ABC is unable to resolve the uncertainty associated with the new agreement's transaction price before execution of the new agreement), ABC will true-up the revenue recognized for the post-expiration period based on resolution of the uncertainty surrounding the transaction price for the PCS provided during those periods. For example, if ABC estimated, subject to the constraint, that it would be entitled to $700 for each of the two post-expiration months of PCS, on July 31 when the new agreement is signed with a transaction price for the full year of $10,800 (which equates to $900 per month for the year June 1, 20X3 through May 31, 20X4), ABC would recognize a cumulative catch-up revenue adjustment of $400 ($1,800 – $1,400).

Comparison to legacy US GAAP

While in some of the scenarios addressed by Question B60 an entity may conclude that an enforceable contract exists, under legacy US GAAP, it was generally not the case that an entity could conclude that persuasive evidence of an arrangement existed after expiration of the contract period if its customary business practice was to obtain a signed contract for the extension or renewal period.

Cumulative catch-up vs prospective

Under legacy US GAAP, no revenue was recognized in post-expiration service periods if persuasive evidence of an arrangement did not exist and/or the fees for the services were not fixed or determinable. Once persuasive evidence of an arrangement had been obtained, and the fees were fixed or determinable, the PCS fees were recognized prospectively, on a ratable basis, over the remainder of the new PCS contract term (other than in some scenarios, such as the reinstatement of PCS, where additional deliverables – e.g. specified updates or upgrades – had been transferred to the customer during the lapse in agreement period). For example, in Scenario 1 of Example B60.1, ABC would have recognized the $10,800 PCS fees in the agreement executed on July 31, 20X3 ratably over the period from August 1, 20X3 through May 31, 20X4 ($1,080 per month).

Recognizing revenue on a cumulative catch-up basis, as described in Question B60 and illustrated in Example B60.1 (in Scenario 1 and Scenario 2), is a significant change from legacy US GAAP.

Question B70

Does a fiscal funding clause affect whether a contract exists under Topic 606?

Interpretive response: It depends. Fiscal funding clauses sometimes are found in software licensing and other (e.g. SaaS) arrangements in which the customers are governmental units. Such clauses generally provide that the contract is cancellable if the legislature or funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligations under the contract.

A funding contingency, from a business enterprise or governmental unit, may render the agreement to not be an enforceable contract under applicable laws and/or regulations if the chance of the fiscal funding contingency being triggered is more than remote. Judgment will need to be applied in those contracts to determine whether a contract exists before funding has been approved – i.e. whether the contract existence criteria in paragraph 606-10-25-1 are met.

Even if a contract is determined to exist in an arrangement with a fiscal funding clause, a fiscal funding clause *that has a more than remote chance of being triggered* may affect the enforceable contract term. This is because, in accordance with paragraph 606-10-25-3, an entity applies the guidance in

Topic 606 to the duration of the contract (i.e. the contractual period) for which the parties to the contract have *present* enforceable rights and obligations, and such rights may not presently exist beyond the existing fiscal authorization (i.e. the customer has the right to unilaterally terminate services without penalty by not approving funding). For example, an agreement may be for a stated three-year period, but if the entity's enforceable right to payment for providing the services in years 2 and 3 is contingent on the customer obtaining fiscal authorization (i.e. the customer may cancel the contract if the legislature or funding authority does not authorize the expenditure), an enforceable contract may only exist for one year. In that scenario, the contract term under Topic 606 would only be the one-year period covered by the current funding commitment and any period beyond that would be considered cancellable by the customer.

An alternative view exists that we believe is also acceptable when the customer is a governmental unit and a contract otherwise exists in accordance with paragraph 606-10-25-1. Under that view, the unfunded portion of the contract, even if the chance of the fiscal funding contingency being triggered is more than remote, should be considered variable consideration; the software entity includes variable consideration in the transaction price subject to the constraint (see *Chapter D – Step 3: Determine the transaction price*).

Whichever view an entity ascribes to we would expect it to be applied consistently to similar arrangements.

Comparison to legacy US GAAP

Under legacy US GAAP, the existence of a fiscal funding clause in a software arrangement with a governmental unit necessitated an assessment of the likelihood of cancellation through exercise of the fiscal funding clause.

If the likelihood of exercise of the fiscal funding clause with a governmental unit was assessed as being remote (i.e. the chance of the future event or events occurring is slight), the software arrangement would be considered non-cancellable and, thus, revenue would be recognized if the other revenue recognition criteria were met. If the likelihood of exercise was assessed as other than remote, the license was considered cancellable, thus precluding revenue recognition until the funding was authorized or the contingency became remote.

A fiscal funding clause with a customer other than a governmental unit created a contingency that precluded revenue recognition until the requirements of the clause were met.

For software entities that ascribe to the first view outlined in the question, we do not expect that the effect of a fiscal funding clause will be substantially different under Topic 606 than it was under legacy US GAAP. However, the variable consideration approach to the unfunded portion of the contract will be a significant change in how fiscal funding clauses are considered for those entities that apply that alternative to governmental contracts.

Collectibility

Question B80

What factors should an entity consider in determining whether the amount of consideration to which an entity expects to be entitled includes an implicit price concession?

Interpretive response: The collectibility criterion is applied to the amount to which the entity expects to be entitled in exchange for the goods and services that 'will be transferred to the customer'. That amount may not be the stated contract price for those goods or services that will be transferred to the customer. The amount of consideration to which the entity expects to be entitled considers whether the promised consideration is variable (i.e. is different from the stated contract price) due to facts and circumstances that, at contract inception, indicate the entity may offer a price concession to the customer. It may be difficult to distinguish between situations in which there is a significant risk the customer will not pay the promised consideration for the goods and services that will be transferred to the customer (i.e. a collectibility issue) and situations in which the entity will *accept* an amount of consideration that is less than the promised amount in return for those goods and services (i.e. an implicit price concession).

Topic 606, including the two examples of implicit price concessions (Examples 2 and 3 in paragraphs 606-10-55-99 through 55-105), does not provide any explicit guidance about how to determine if an entity may grant an implicit price concession. However, the Basis for Conclusions to ASU 2014-09 (BC192) states that an entity's customary business practices, published policies or specific statements may provide evidence and/or create a valid expectation on the part of the customer that the entity is willing to accept a lower price in exchange for the promised goods and services. BC192 also indicates that price concessions may be more likely to be granted in situations where doing so would enhance a customer relationship or encourage future sales.

The Boards decided against providing further guidance on implicit price concessions. However, the FASB and IASB staffs *proposed* some additional factors that would, to varying degrees (i.e. in some cases, the factors may merely contribute to a price concession conclusion rather than provide determinative evidence in that respect), indicate that, at the time of entering into a contract, an entity intends to offer a price concession if there is a significant risk that the customer will not pay the promised consideration for the goods and services that will be transferred. While these factors are not authoritative because they were not included in Topic 606, we believe they may be useful for software entities to consider in the absence of authoritative guidance. These factors along with our view on how those factors might relate to software entities are as follows.

a. The goods or services promised to the customer are not expected to expose the entity to a significant economic loss if the customer does not pay the promised consideration. For example, an entity would not be expected to incur a significant economic loss in any of the following circumstances:

i. The incremental costs that an entity incurs to produce the good or service or transfer it to the customer would be negligible – *This circumstance may frequently arise in software licensing arrangements because the incremental costs to transfer a software license are typically negligible. It may also frequently be the case that the incremental costs of providing PCS services or SaaS to a customer in a multi-tenant SaaS environment are minor.*

ii. The entity can deny the customer further access to the promised good or service if the customer fails to meet its obligations under the contract – *This is typically the case in SaaS arrangements, but may also be the case in some software licensing arrangements if the entity only provides temporary software keys or has the ability to send out a 'kill' code if the customer does not pay the license fees.*

iii. The good that transfers to the customer is not expected to depreciate substantially (or diminish in value) and, therefore, the good provides the entity with sufficient collateral in the event of the customer failing to meet its obligations under the contract. For example, the good is a tangible asset that is not expected to have depreciated substantially if and when the entity obtains control of the good from the customer – *This circumstance would not typically be the case in software or SaaS arrangements.*

b. The entity has previously chosen not to enforce its rights to the promised consideration in similar contracts with the customer (or class of customer) under similar circumstances – *Evidence that the entity has previously accepted consideration less than the promised amount in similar contracts may call into question whether the entity will accept consideration less than the promised amount in this contract*.

c. *The entity has experience* (or other evidence) about the customer not fulfilling its obligations to pay the promised consideration in other contracts – *If the entity has history of the customer not paying some or all of the promised consideration in prior contracts, the entity's willingness to enter into new contracts with the customer despite that history may suggest it will accept a partial payment as complete performance by the customer.*

d. The entity has experience (or other evidence) about the class of customer to which the customer belongs not fulfilling their obligations to pay the promised consideration in similar contracts under similar circumstances – *Similar to c. the entity's willingness to enter into a contract with a customer in a 'suspect' class – i.e. a class of customer where there is a significant credit risk – may suggest the entity will accept a partial payment as complete performance by the customer.*

Variable consideration and price concessions are discussed in *Chapter D – Step 3: Determine the transaction price.*

Example B80.1

Collectibility threshold assessed based on amount the entity expects to receive for the goods or services transferred

ABC Corp. enters into an arrangement with Customer to license 1,000 seats of Product X for two years for $1,000,000. ABC's standard payment terms for similar customers entering into similar licenses are for Customer to make two equal payments, one due at contract inception and the second due at the beginning of Year 2 of the license.

ABC has a prior history with Customer. Customer has a history with ABC of requesting a reduction in the second payment due, which ABC has frequently granted in order to incent Customer to make additional purchases, including renewals, in the future. ABC further notes that this practice is not isolated to Customer; other similar high-volume customers have made similar requests that ABC has granted.

Based on all relevant facts and circumstances, ABC assesses that it is likely to accept an amount of consideration that is less than the $1,000,000 promised amount. In this contract, after consideration of the guidance on variable consideration in paragraphs 606-10-32-5 through 32-13 (see further discussion of this in *Chapter D – Step 3: Determine the transaction price*), ABC concludes that the amount of consideration to which it expects to be entitled is $900,000.

Accordingly, when assessing whether collectibility is probable, ABC assesses whether it is probable that it will receive $900,000 – i.e. the amount to which it expects to be entitled after the expected price concession.

See also Example B100.1, Scenario 2.

Comparison to legacy US GAAP

Under legacy US GAAP for software entities, collectibility was assessed against the fixed or determinable fees in the arrangement in their entirety – i.e. there was no concept of considering whether collectibility was probable only for a portion of the fixed or determinable fees.

In contrast, collectibility under Topic 606 may be assessed against an amount that is less than that promised in the contract either (1) because of an implied price concession or (2) because the goods or services that 'will be transferred to the customer' (see Questions B90 and B110) differ from the promised goods or services in the contract.

Question B85

How is 'substantially all' defined for the collectibility assessment?

Interpretive response: 'Substantially all' is not defined in Topic 606. In ASU 2016-12, the FASB amended the collectibility criterion so that it is met if 'substantially all' of the consideration to which the entity will be entitled is collectible rather than 'all' of the consideration. The FASB decided that a contract could represent a substantive transaction even if it is not probable the entity will collect 100% of the consideration to which it expects to be entitled. [ASU 2016-12.BC12]

The term 'substantially all' is used in other places in US GAAP – e.g. Topic 842 (leases) – and generally understood to mean approximately 90%. For example, Topic 842 provides guidance that 90% might be appropriate for evaluating 'substantially all'. We believe 90% should *not* be viewed as a safe harbor or bright-line and entities should consider all relevant facts and circumstances about the customer and the transaction. [842-10-55-2]

Question B90

In assessing collectibility, an entity considers only the likelihood of payment for goods or services that 'will be transferred to the customer'. What does this mean in the context of typical software related service arrangements (e.g. SaaS arrangements or PCS services sold separately from a software license)?

Interpretive response: Topic 606 provides that when an entity has *the ability* – i.e. both the right and the capability – and *the intent* (typically, evidenced by its customary business practices) to stop providing services in the event of customer non-payment, the entity does not have credit risk with respect to those services it would not be required to provide. It is for this reason that Topic 606 requires an entity to consider only the collectibility of the promised consideration in the contract (i.e. its exposure to credit risk) for the goods or services that the entity will transfer to the customer *before* it would be able to stop providing further goods or services in the event of customer non-payment. Example 1, Cases B through D, in Topic 606 demonstrate application of this concept to service contracts.

In Cases B and C, even though the contract includes a promise by the entity to provide three years of services, for which the customer pays monthly fees in arrears, the entity has the ability and intent to stop providing the promised services in the event of customer non-payment. Therefore, the services that 'will be transferred to the customer' include only those services that the entity will provide before it follows its customary business practice to stop services to the customer. While not specifically illustrated in either Case, this might mean the services that 'will be transferred to the customer' are only one or two months' of service or some longer period, depending on the entity's customary business practice with respect to how long it permits a non-paying customer to continue receiving services.

In Case D, the illustrated scenario is a one-year gym membership, but the contract requires *advance* payment each month by the customer and services (i.e. access to the gym) are not provided for any given month if the advance payment has not been received. Consequently, in Case D, the services that will be provided to the customer are only the one month of services for which the customer has prepaid.

There may be circumstances where the entity does not have either the ability to stop providing services to the customer or the demonstrated intent to do so, in which case the collectibility criterion is assessed against the promised consideration for all of the promised services in the contract. For example, an entity:

— may not have *the right* to stop providing promised services in the event of customer bankruptcy because bankruptcy rules in some jurisdictions require service providers to continue providing services that are essential to the customer while it undergoes restructuring;

— may not be *able* to discontinue a service, such as a transportation service because the transportation asset (e.g. a ship) cannot for practical reasons dump the cargo into the sea and the ship is needed at the port of call in any event in order to fulfill the entity's next contract; or

— may have demonstrated its intent *not* to discontinue services in a timely manner in the event of customer non-payment. Particularly if the incremental costs of providing services to the customer are minor, an entity may continue providing services and merely intend to pursue collection at a later point. A circumstance of this nature however may strongly indicate a likely price concession (see Question B80).

When an entity does conclude that it has the ability and the intent to discontinue services in the event of customer non-payment, how long the entity's customary business practices (or other evidence of the entity's intent) indicate that the entity will continue to provide services to a non-paying customer may influence whether the collectibility criterion is met for that contract (see Question B100).

Collectibility will generally not be a concern in service arrangements that are prepaid. For example, if the customer is required to prepay for all of the *promised* services in the contract (e.g. prepay for a three-year SaaS arrangement), then the 'will be transferred' notion will not apply.

Comparison to legacy US GAAP

Under legacy US GAAP, collectibility was assessed against the entire fixed or determinable fees in the contract. When collectibility of the arrangement was not reasonably assured, revenue was generally recognized on a cash basis when the other recognition criteria had been met.

There is no mechanism whereby an entity concludes collectibility is probable (or reasonably assured for non-software licensing arrangements, such as SaaS arrangements) based on a partial assessment of the fixed or determinable fees, such as occurs under Topic 606 when the entity concludes there is a likely price concession (see Question B80) or that the goods or services that 'will be transferred to the customer' are not the promised goods or services in the contract. As a result, entities may more frequently pass the collectibility threshold in Topic 606 than they did the collectibility threshold under legacy US GAAP.

Further, as discussed in Question B125, under Topic 606 cash basis recognition is not the default accounting when collectibility is not probable but an entity has transferred control of the related good or service.

Question B100

Does an entity's ability and intent to stop providing goods or services automatically mean that the collectibility criterion will be met?

Interpretive response: No. The collectibility criterion is met only when it is probable that the entity will collect *substantially all* of the consideration to which it will be entitled in exchange for *the goods or services that will be transferred to the customer*. If (1) it is not probable the entity will collect *any* consideration from the customer or (2) the entity does not have the ability or the demonstrated intent to discontinue services in a timely manner after the customer stops paying for the entity's services, the entity may not be able to conclude that it is probable it will collect *substantially all* of the consideration to which it is entitled for the goods or services it will provide. Consider the following examples:

— Consistent with Example 1, Case C of Topic 606, if an entity has the ability and the intent to timely discontinue services but it is not probable it will collect substantially all of the promised consideration for any services it would provide before it discontinues services, the arrangement is not a genuine and substantive transaction (see paragraph 606-10-55-3A and paragraph BC12 of ASU 2016-12).

— Assume an entity concludes it is probable a customer will pay for the first 12 months of service in a 36-month contract, but that collectibility of the remainder of the fees is not probable. If the entity does not have the ability or the intent to discontinue services for a number of months (e.g. four months) after a customer stops paying for those services, the entity may conclude that it is not probable that it will collect substantially all of the consideration to which it will be entitled for the services that will be provided to the customer. For example, assume the monthly service fee is \$100 and the entity 'will' provide 16 months of service, for which the promised consideration is \$1,600. However, it is only probable that the entity will collect \$1,200 (\$100/month × 12 months). In that case, it is not probable the entity will collect substantially all of the promised consideration for the services it 'will' provide to the customer unless the entity concludes that the \$1,200 it expects to collect is also the amount to which it expects to be entitled (i.e. it expects to grant a price concession to the customer – see next paragraph).

In either of the above cases, the entity would account for the contract using the alternative model in paragraph 606-10-25-7 until either (1) one of the events in paragraphs 606-10-25-7 occur or (2) collectibility of a sufficient portion – that is, substantially all – of the promised consideration for the services that will be provided becomes probable. However, in the latter case, it may be that the entity is implicitly willing to accept an amount of consideration that is less than the promised amount (i.e. the entity will grant an implicit price concession) *even if* the entity pursues collection of all amounts owed – see Question B80 for additional discussion of implicit price concessions. If that is the case, the entity may conclude it *is* probable that it will collect the reduced amount to which it expects to be entitled ($1,200 in the preceding bullet) and that, therefore, the collectibility criterion is met.

Example B100.1

Assessment of collectibility for low credit quality new customer

ABC Corp. enters into a non-cancellable 36-month contract to provide SaaS to Customer. Customer is a new customer of low credit quality. The consideration promised in the contract is $3,600, with $100 payable in advance each month. ABC has substantive history with this class of customer, based on which ABC concludes it is *not* probable the customer will pay all of the promised consideration for the promised 36 months of SaaS. However, based on its experience with similar customers, ABC expects Customer to make the payments required under the contract for at least 10 months. If a customer stops making the required payments (i.e. is in material breach of the contract), ABC has the right to deny that customer further access to the SaaS and ABC's customary business practice is to mitigate its credit risk by doing so. In the event of customer default, ABC always pursues collection for unpaid services such that no explicit price concession by ABC is expected.

Scenario 1: Discontinuation of services at the end of the month

ABC's customary business practice is to discontinue services by the end of the month for which a customer has not paid. For example, if a customer pays in advance for May, but does not pay for June, ABC typically discontinues services by the end of June. ABC vigorously pursues collection from all its customers and typically is successful in recovering some portion of the fees for which the customer has not paid.

ABC concludes it is probable it will collect substantially all of the consideration to which it is entitled in exchange for services that will be provided to Customer. This is because ABC expects to collect all of the promised consideration in the contract for at least 10 months of service and, if Customer defaults, some portion of the fees to which it would be entitled for whatever month of service after that Customer does not pay.

Scenario 2: Discontinuation of service after 5 months

ABC's customary business practice is to discontinue services only after a customer has not paid for the service for five months. For example, if a customer pays in advance for May, but does not pay for June – October, ABC typically discontinues services by the end of October. ABC only discontinues services in this timeframe because its incremental costs to provide the services is minor and, even if it cannot recover the entire contracted fees for the unpaid months, it pursues collection vigorously and will usually recover a portion of those fees that is sufficient to cover its costs of providing the SaaS and an acceptable profit margin. That portion of the promised fees, however, is a minor portion of the promised consideration.

ABC concludes that a substantive contract exists because it will provide services to Customer for a significant period of time and expects to recover consideration that will provide a reasonable profit margin on the contract. ABC's experience with this class of customer and its history of providing services well after a customer has defaulted on its payments suggests ABC is implicitly willing to accept a lower fee than that stated in the contract with Customer. As a result, Customer concludes it is probable that it will collect substantially all of the consideration to which it will be entitled in exchange for the services that will be provided to Customer. However, the transaction price includes variable consideration that ABC must estimate subject to the variable consideration constraint (see *Chapter D – Step 3: Determine the transaction price*) such that ABC will not recognize revenue of $100/month at least during the earlier part of the contract period.

Question B110

How are software licenses considered when determining the 'goods or services that will be transferred to the customer'?

Interpretive response: Software licenses are goods transferred at a point in time (see Questions F10 and F20). They are not services satisfied over the license period, even if the entity has the legal right to revoke that right of use and/or has the ability to send out a 'kill code' or similar in the event of customer non-payment.

Therefore, revoking a customer's right to use the entity's software is a repossession of the software license (i.e. repossession of a good); it is not equivalent to shutting off a service in response to a customer's failure to pay for services already provided. Paragraph 606-10-55-3C states: "An entity's ability to repossess an asset transferred to a customer should not be considered for the purpose of assessing the entity's ability to mitigate its exposure to credit risk." Consequently, the ability to revoke a customer's right to use the entity's software in the event of non-payment of software license fees being paid over time is not considered in assessing whether collectibility of the consideration to which the entity will be entitled for the software license is probable.

If the software license is part of a combined performance obligation

In some circumstances under Topic 606, a software license will not be distinct from other goods or services and, therefore, will be part of a combined performance obligation. Example 10 (Case C), Example 11 (Case B) and Example 55 of Topic 606 illustrate examples of a license that is part of a combined performance obligation together with associated updates or services. Each of those examples illustrates that the entity determines the nature of the combined item in evaluating whether the performance obligation is satisfied over time or at a point in time and in determining the appropriate measure of progress to apply to that performance obligation if it is satisfied over time. Similarly, we believe the entity would consider the nature of the combined item that includes the license in determining whether the entity would be able to stop transferring that good or service in response to customer non-payment, and that this would mean the following for each of the three combined license and updates or services examples in Topic 606:

- **Example 10 (Case C)** – Because the combined good or service is the provision of anti-virus protection to the customer for three years (see paragraph 606-10-55-140F), if the entity has the ability and the intent to stop providing anti-virus protection – i.e. revoke the customer's right to use the anti-virus software and stop providing future updates – the 'goods or services that will be transferred to the customer' may be less than the three years of anti-virus protection promised in the contract.
- **Example 55** – Because the combined good or service is 'ongoing access' to the entity's continually changing intellectual property for three years (see paragraph 606-10-55-365A), if the entity has the ability and the intent to stop providing 'access' to its intellectual property – i.e. revoke the customer's right to use the intellectual property and stop providing future updates/upgrades – the 'goods or services that will be transferred to the customer' may be less than the three years' access promised in the contract.
- **Example 11 (Case B)** – The combined good or service is the software customization, which uses the base software and the entity's customization services as inputs to produce customized software as the output (see paragraph 606-10-55-149). If the entity has the ability and the intent to stop performing the software customization – i.e. revoke the customer's right to use the base software and stop the customization services – the 'goods or services that will be transferred to the customer' may be different from the intended combined output in the contract (i.e. the customized software).

  Note: The discussion in this bullet ignores the technical support and the software updates in the example, which are each determined to be distinct and would be considered in the same manner as any other over-time performance obligation for purposes of determining the 'goods or services that will be transferred to the customer'.

Example B110.1

Credit risk is not mitigated for a software license and PCS

ABC Corp. enters into a contract to license its software to Customer along with technical support and unspecified update, upgrade and enhancement rights (collectively, PCS) for three years. Customer is of low credit quality.

Despite Customer's credit rating, the contract fees are $100 per year, payable at the beginning of each year. Therefore, the transaction price is $300 (for ease of illustration, this example ignores any potential significant financing component that may result from paying for the software license over a three-year period). The stand-alone selling price of the software license is $180 and the stand-alone selling price of the PCS (the PCS is determined to be a single performance obligation – see Question C150) is $120 for the three-year period. Both parties are subject to termination penalties if the contract is canceled. The termination penalty is considered to be substantive.

In assessing whether the contract with Customer meets the criteria in paragraph 606-10-25-1, ABC assesses whether it is probable that it will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. This includes assessing ABC's history with Customer's class of customer and its business practice of stopping PCS services within a reasonable period of time in response to a customer's nonpayment in accordance with paragraph 606-10-55-3C.

At contract inception, ABC concludes that the criterion in paragraph 606-10-25-1(e) is not met because it is not probable that Customer will pay substantially all of the consideration to which the entity will be entitled under the contract for the software license and PCS services that will be transferred to the customer. ABC concludes that not only is there a risk that the customer will not pay for the license and PCS services received from ABC, but also there is a risk that ABC will never receive *any* payment for any PCS services provided (considering the stand-alone selling price of the services is $40 per year). Subsequently, when Customer initially pays $100, ABC accounts for the consideration received as a deposit liability in accordance with paragraphs 606-10-25-7 through 25-8. ABC concludes that none of the events in paragraph 606-10-25-7 have occurred because the contract has not been terminated, the entity has not received substantially all of the consideration promised in the contract (i.e. ABC has received only $100 of $300), and ABC is continuing to provide services to Customer.

Assume that in year 2, ABC continues to conclude that the collectibility criterion has not been met. Customer's credit rating remains poor and even though $200 has now been collected, on a stand-alone selling price basis ABC has provided $220 worth of goods and services (3-year license and one year of PCS) and will provide another $40 worth of PCS before it can contractually terminate PCS if Customer does not pay the Year 3 fees of $100. Therefore, it is not yet probable Customer will pay at least substantially all of the promised consideration to which ABC is entitled for the license and PCS it will provide to Customer. Therefore, the additional $100 paid by the customer at the beginning of year 2 is, like the payment for Year 1, recorded as a deposit liability, resulting in a $200 cumulative deposit liability.

In year 3, ABC receives the remaining $100 payment from Customer B. At this point in time, none of the criteria in paragraph 606-10-25-7 have been met. However, ABC concludes that the criterion in paragraph 606-10-25-1(e) is now met because it is probable that the customer will pay substantially all of the consideration to which ABC will be entitled for the goods and services. In other words, once the final advance payment is made ($100) at the beginning of year 3, ABC concludes that it is probable that it will receive all of the consideration to which it will be entitled in exchange for the license and all three years of PCS services that are transferred to Customer.

Once the criteria in paragraph 606-10-25-1 are met in year 3, ABC applies the remaining guidance in Topic 606 to recognize revenue and the following journal entry is recorded.

	Debit	*Credit*
Deposit liability	200	
Cash	100	
License revenue		180
PCS revenue		80
Contract liability (deferred revenue)		40

Question B115

How should a software vendor assess collectibility for a portfolio of contracts?

Interpretive response: The TRG agreed that collectibility should be assessed at the individual contract level – i.e. the individual contract is the unit of account. [TRG Agenda Paper No. 13]

For example, assume that an entity has 1,000 similar contracts and historical experience indicates that the entity will not collect on 2% of these contracts. This does not mean that the collectibility criterion is not met for 2% of the contracts. Rather, the entity evaluates whether collection is probable for an individual contract based on its customary procedures performed prior to entering into the arrangement to determine the credit risk associated with the individual customer. [TRG Agenda Paper No. 13]

If this evaluation indicates that collectibility is probable, the entity accounts for the contract under Topic 606. [TRG Agenda Paper No. 13]

However, in some situations, an entity may use a portfolio of historical data to estimate the amounts that it expects to collect. This type of analysis may be appropriate when an entity has a high volume of homogeneous transactions.

These estimates are then used as an input into the overall assessment of collectibility for a specific contract.

For example, if on average a software vendor collects 60% of amounts billed for a homogeneous class of customer transactions and does not intend to offer a price concession, this may be an indicator that collection of the full contract amount for a contract with a customer in that class is not probable. Therefore, the collectibility criterion may not be met for that contract.

Conversely, if on average a software vendor collects 90% of amounts billed for a homogeneous class of contracts with customers, then this may indicate that collection of the full contract amount for a contract with a customer in that class is probable. In that case, the collectibility criterion may be met.

However, if the average collections were 90% because the software vendor generally collected only 90% from each individual contract, this may indicate that the vendor has granted a 10% price concession to its customer. For a discussion of the differentiation between collectibility and a price concession see Question B80.

Question B120

Do extended payment terms affect the evaluation of the collectibility criterion?

Interpretive response: Extended payment terms, which would include situations in which an entity pays for a distinct license through equal payments for the license and PCS over an extended period (e.g. three years), do not in and of themselves affect whether the collectibility criterion in paragraph 606-10-25-1(e) is met. However, they will likely factor into the entity's assessment of the credit risk to which it is subject as a result of the contract. That is, extended payment terms introduce credit risk as a consideration about the customer's ability or intention to pay the consideration to which the entity is entitled for the goods and services that 'will be transferred to the customer' where no such question would exist if the customer were required to pay for the goods or services as transferred or under non-extended payment terms.

As discussed further in *Chapter D – Step 3: Determine the transaction price*, extended payment terms may indicate either or both that:

— there is the risk of a future price concession, which would result in a conclusion that the transaction price is variable. In that case, the entity would need to consider whether it expects to provide a concession, and the transaction price would be subject to Topic 606's constraint on variable consideration;
— a significant financing component exists in the contract.

Comparison to legacy US GAAP

Under legacy US GAAP applicable to software licensing arrangements, extended payment terms do not affect whether persuasive evidence of an arrangement exists. Rather, the arrangement fee is presumed not to be fixed or determinable if payment of a signification portion of the license fee is not due until after expiration of the license, or more than 12 months after delivery of the licensed software. As such, revenue is generally not recognized until the payments become due and payable.

The fact that the collectibility of extended payments affects whether a contract exists for purposes of applying Topic 606 is a change from legacy US GAAP. In addition, the fact that extended payment terms may affect the *measurement* of revenue (i.e. if there is determined to be variable consideration or a significant financing component in the contract), but not the timing of revenue recognition, is a substantial change from legacy US GAAP.

Question B125

Can revenue be recognized on a cash basis when the collectibility criterion is not met and the entity continues to provide goods or services to the customer?

Interpretive response: No. If the collectibility criterion is not met, an entity continuing to provide goods or services to the customer cannot record revenue based on its collections unless the alternative model criteria in paragraph 606-10-25-7 are met (see decision tree at the beginning of this chapter). Under the alternative model, an entity cannot recognize revenue when it has a remaining obligation to transfer goods or services to a customer or it chooses to continue to transfer goods or services to a customer when substantially all of the consideration to which it is legally entitled has not been received.

There are limited scenarios in which an entity can continue to transfer goods or services under a contract, determine collectibility is not probable, but nevertheless recognize some revenue. This is because the collectibility criterion is evaluated based only on the goods or services expected to be transferred. See Questions B90 and B100 for the evaluation of arrangements where an entity has the ability and intent to stop providing the promised goods or services due to customer non-payment.

Question B126

When does an entity reassess the collectibility criterion?

Interpretive response: Once an entity determines that a contract exists under Step 1 of the revenue model (including assessing the collectibility criterion), it does not reassess the collectibility criterion unless there is a significant change in facts and circumstances that results in a significant deterioration in the customer's creditworthiness. For example, a significant deterioration in a customer's ability to pay because it lost one of its customers that accounts for 75% of its annual sales would likely lead to a reassessment. [606-10-25-5]

The determination of whether there is a significant deterioration in the customer's creditworthiness will be situation-specific and will often be a matter of judgment. The evaluation is not intended to capture:

- changes of a more minor nature that do not call into question the existence of the contract; or
- changing circumstances that might reasonably fluctuate during the contract term (especially for a long-term contract) that do not have a significant effect. [TRG Agenda Paper No. 13]

If, after a significant change in facts and circumstances, the entity determines that collectibility is no longer probable, it discontinues using the general revenue model and follows the guidance on accounting for consideration received when a contract does not exist – the alternative model in paragraph 606-10-25-7 (see Question B125). However, the entity does not reverse revenue previously recognized.

If an entity determines that a contract does not exist under Step 1 of the revenue model, it continually reassesses the arrangement. If the criteria for Step 1 are subsequently met, the entity begins applying the revenue model to the arrangement.

Example B126.1
Cash received when collectibility criterion is not met

ABC Corp. provides Customer with three years of access to its networking platform in exchange for monthly payments of $10,000. In January of Year 2 of the contract, Customer experiences a significant decline in its business and has difficulty meeting its financial commitments.

ABC agrees to extended payment terms that allow Customer to make nonrefundable payments of $2,000 per month during Year 2, with the remaining amounts due in Year 3. The contract is not terminated, ABC continues to provide Customer with access to its platform and intends to enforce payment for remaining amounts in Year 3. ABC performs a reassessment of the contract existence criteria and determines that collectibility of the remaining consideration to which it expects to be entitled is not probable.

ABC receives $15,000 in partial payments in Year 2. Because the collectibility criterion was not met upon reassessment, ABC must evaluate the alternative model criteria in paragraph 606-10-25-7 to determine how to recognize revenue for the $15,000 nonrefundable payment received.

- The first criterion is not met because Customer has not remitted substantially all of the consideration promised for the services provided.
- The second criterion is not met because the contract has not been terminated.

— The third criterion is not met because ABC has not stopped transferring services to Customer.

Based on the evaluation of the alternative model criteria, ABC cannot recognize revenue for the cash received from Customer in Year 2. Therefore, even though ABC received $15,000 in cash consideration, ABC recognizes a deposit liability for $15,000 and records no related revenue.

Note: If the contract existence criteria (including the collectibility criterion) or one of the criteria in the alternative model is met upon reassessment in Year 3, ABC would record a cumulative catch-up to revenue for the services already provided.

Question B127

Is a receivable recognized if the collectibility criterion is not met?

Interpretive response: No. When an entity concludes that a contract does not exist because the collectibility criterion is not met (or because any of the other contract existence criteria are not met), an entity does not record a receivable for consideration that it has not yet received for the goods or services it has already transferred to the customer.

This is consistent with the premise in Topic 606 that when collection is not probable the contract is not substantive and therefore the legal right to consideration is also not substantive for accounting purposes. [606-10-25-2]

Term of the contract

Question B130

What is the contract term in a period-to-period (e.g. month-to-month or year-to-year) contract that (a) may be canceled by either party or (b) may be canceled by the customer only?

Excerpt from ASU 2014-09

BC50. The Boards decided that Topic 606 should not apply to wholly unperformed contracts if each party to the contract has the unilateral enforceable right to terminate the contract without penalty. Those contracts would not affect an entity's financial position or performance until either party performs. In contrast, there could be an effect on an entity's financial position and performance if only one party could terminate a wholly unperformed contract without penalty. For instance, if only the customer could terminate the wholly unperformed contract without penalty, the entity is obliged to stand ready to perform at the discretion of the customer. Similarly, if only the entity could terminate the wholly unperformed contract without penalty, it has an enforceable right to payment from the customer if it chooses to perform.

BC391. A renewal option gives a customer the right to acquire additional goods or services of the same type as those supplied under an existing contract. This type of option could be described as a renewal option within a relatively short contract (for example, a one-year contract with an option to renew that contract for a further year at the end of the first and second years) or a cancellation option within a longer contract (for example, a three-year contract that allows the customer to discontinue the contract at the end of each year). A renewal option could be viewed similarly to other options to provide additional goods or services. In other words, the renewal option could be a performance obligation in the contract if it provides the customer with a material right that it otherwise could not obtain without entering into that contract.

Interpretive response: A contract under which services are provided period-to-period (e.g. month-to-month or year-to-year) unless canceled by either party, and for which no penalty must be paid for cancellation (i.e. other than paying amounts due as a result of goods or services already transferred up to the termination date), is no different from a similar contract structured to require the parties to actively elect to renew the contract each period (e.g. place a new order, sign a new contract). This is regardless of whether both entities may cancel the contract or solely the customer. Consequently, an entity does not assume a contract period that extends beyond the then-current period. This is the case regardless of whether the contract has a stated contract period (e.g. a two-year stated term, but either entity can cancel the contract at the end of any month during that period for no penalty).

When both parties to the contract have the unilateral right to terminate the contract at the end of any designated period, a contract does not exist for periods beyond the then-current period in accordance with paragraph 606-10-25-4. Only upon commencement of the next service period, whereby enforceable rights and obligations exist for both parties until the next available termination date (i.e. the end of that period), does a contract for that period exist under Topic 606.

When the *customer only* has a unilateral option to terminate a period-to-period contract, some enforceable rights and obligations continue to exist. That is, the customer has the unilateral right to continue to receive services and the entity an obligation to stand-ready to provide those services if elected by the customer for an optional period. However, because those services are *optional* to the customer, unless they provide the customer with a material right, there is no accounting by the entity for the customer option. The entity only accounts for the current period's services, which are not subject to cancellation, until the customer elects its option to obtain services for the next period (which includes by not canceling the services), creating additional enforceable rights and obligations for the entity – i.e. the customer's decision not to cancel the services creates an enforceable obligation on the entity to provide the services and an enforceable right to receive payment for those services.

Example B130.1
Contract with unspecified term cancellable by either party

ABC Corp. contracts with Customer to provide its SaaS offering for a flat fee of $130 per month, subject to annual increases based on the lesser of 5% or changes in the consumer price index (CPI). $130 is the stand-alone selling price of SaaS at contract inception. The contract term is indefinite and it is cancellable at the end of each month by either party without penalty.

ABC determines that the initial contract term is only one month and that the contract term will always be one month under this arrangement. This is because each subsequent month represents a wholly unperformed contract – that is, each party has the unilateral, enforceable right to terminate the contract at the end of the then-current month without compensating the other party. A new contract will be deemed to exist for purposes of applying Topic 606 each month once each party forgoes its cancellation right for that period.

ABC considers whether Customer's option to renew on an indefinite basis provides it with a material right. Consistent with the discussion in Question C410, ABC concludes the options to renew do not provide Customer with a material right because the renewal price will only be greater than or equal to the stand-alone selling price of the SaaS as of contract inception.

Example B130.2
Contract with a specified term cancellable by either party

ABC Corp. enters into a contract with Customer to transfer a three-year term license to software product G, and provide technical support and unspecified updates, upgrades and enhancements (collectively, PCS) for a one-year period. The stand-alone selling price and the contract price of the term license is $600,000 and the stand-alone selling price and contract price of one year of PCS is $120,000. Customer pays $720,000 in combined fees at contract inception.

Scenario 1: Termination option for only part of the license term

Customer has the option to terminate the contract at the end of any month during the first year after the first month and would be entitled to a pro rata refund of the license and the PCS fees paid. For example, if Customer terminates at the end of Month 6, Customer would be entitled to a refund of 30/36ths of the $600,000 license fee ($500,000) and 6/12ths of the $120,000 PCS fee ($60,000). ABC concludes that while the PCS is a single performance obligation (see Question C150), the PCS is distinct from the software license (see Questions C160 and C170). ABC expects Customer to exercise renewal options to continue PCS for Years 2 and 3 at the same price as for Year 1, but there is no obligation for Customer to do so. After Year 1, Customer is no longer permitted to terminate the software license before the end of the contractual three-year term, even if Customer does not renew PCS.

ABC concludes that the performance obligations in the contract include only a one-month software license and one month of PCS, rather than the three-year term license and one year of PCS outlined in the contract. Because Customer has the enforceable right to cancel the contract at the end of any month during the initial PCS term after Month 1 and receive a pro rata refund, each subsequent month (i.e. beyond Month 1) embodies a customer *option* to continue to license software product G and obtain PCS for an additional fee. Therefore, the contract includes 11 one-month renewal options of the software license and 11 one-month PCS renewal options, and options to renew the product G license for two years at the end of Year 1, and to renew PCS for one year at the end of Year 1 and Year 2.

The license and PCS renewal options do not provide Customer with a material right. ABC reaches this conclusion on the basis that the price of each monthly license and PCS renewal, i.e. during the first year of the contractual license term, is equal to the price of the initial one-month license and PCS (calculated as the contractual fees paid, less the pro rata refund due to Customer if the contract is canceled at the end of Month 1). ABC further notes that the two-year product G renewal option, and the two one-year PCS renewal options are also priced consistently with the initial one-month license/PCS contract, and that Customer is entitled to a full pro rata refund of the license fees for the remaining two years if Customer terminates the license. Therefore, because none of the options grant Customer a material right, each renewal is accounted for as a new, separate contract when exercised (see Question G40).

ABC will recognize the same amount in each month of the first year of the contract:

— on the first day of the month, the revenue attributable to a one-month license to software product G; and
— the revenue attributable to one month of PCS over the course of the month using an appropriate measure of progress (see Question F220).

During the second year of the contract, ABC will recognize:

— on the first day of Year 2, the revenue attributable to the two-year software product G license; and
— the revenue attributable to Year 2 PCS over the course of Year 2 using an appropriate measure of progress.

Over the third year of the contract, ABC will recognize the revenue attributable to the Year 3 PCS using an appropriate measure of progress.

Scenario 2: Termination option for the entire license term

Assume the same facts as in Scenario 1, except that the license and PCS term is three years. Customer pays $720,000 at contract inception ($600,000 for the three-year license and $120,000 for Year 1 of PCS) and pays PCS fees for each subsequent year at the beginning of Year 2 and Year 3. Customer has the right to terminate the license and PCS at the end of each month during the three-year stated term. For example, if Customer terminates the license at the end of month 30, Customer would be entitled to a refund of 6/36ths of the $600,000 license fee ($100,000) and 6/12ths of the Year 3 $120,000 PCS fee paid at the beginning of Year 3 ($60,000).

For the same reasons as in Scenario 1, Customer's options to renew the license for another month each month throughout the contract period, do not grant Customer a material right. Consequently, ABC's revenue recognition will be the same each month during the three-year contract. Each month, ABC will recognize:

— on the first day of the month, the revenue attributable to a one-month license to software product G; and
— the revenue attributable to one month of PCS over the course of the month using an appropriate measure of progress.

Scenario 3: Nonrefundable upfront fee

Assume the same facts as in Scenario 2, except that Customer pays a nonrefundable upfront fee of $960,000 at contract inception for the three-year term license and PCS. The stand-alone selling price and the contract price of the term license is $600,000 and the stand-alone selling price and contract price of three years of PCS is $360,000. Customer has the option to terminate the contract at the end of any month during the three-year term. On termination, the customer is not entitled to a refund and loses the right to use the software.

ABC Corp. accounts for this arrangement as a three-year contract. As discussed in Question B150, the termination right is not substantive because the nonrefundable upfront fee is the only consideration in the contract. In contrast to Scenario 2, the absence of a pro-rata refund option indicates that Customer does not have to make a substantive, separate purchasing decision (i.e. substantive option) at the end of any month about whether to acquire additional software licenses, because it is not deciding whether to exercise a right to spend more money to acquire an additional license and PCS.

ABC Corp. allocates $600,000 to the term license, which is recognized upfront on transfer of control (right to use and benefit from the license) and $360,000 to the PCS, which is recognized using an appropriate measure of progress.

Scenario 4: Refund is unknown

Assume the same facts as in Scenario 2, except that on termination, the contract states that ABC Corp. and Customer will negotiate a refund for Customer.

ABC Corp. accounts for this contract as a three-year contract. Unless ABC Corp. can demonstrate it has enforceable rights and obligations to provide a pro rata refund, the termination right is not substantive, because the customer does not have a separate purchasing decision that it can make without ABC Corp., and therefore the termination right is not similar to a customer option to renew.

ABC Corp. allocates $600,000 to the term license, which is recognized upfront on transfer of control (right to use and benefit from the license) and $360,000 to the PCS, which is recognized using an appropriate measure of progress.

Example B130.3
Term-based license with a reseller with monthly cancellation

ABC Corp. enters into a contract with a reseller to transfer a one-year term license to software product G, and provide technical support and unspecified updates, upgrades and enhancements (collectively, PCS) for a one-year period. ABC Corp. determines that there are two distinct performance obligations (term license and PCS). The stand-alone selling price and the contract price of the term license is $200,000 and the stand-alone selling price and contract price of one year of PCS is $120,000. Customer pays $320,000 in combined fees at contract inception.

The reseller has the option to terminate the contract at the end of any month during the one-year term. On termination, the reseller is entitled to a pro rata refund and loses the right to use the software. In a separate arrangement, the reseller agrees to provide software product G and PCS to a third party end-user for a one-year term. The contract between the reseller and end-user is non-cancellable.

ABC determines that the reseller is the customer and that the reseller takes control of the license and PCS before they transfer to the third party end-user. Further, PCS is provided directly to the reseller and not the third party end-user. The contract between ABC Corp. and the reseller is a principal-to-principal contract.

ABC Corp. accounts for this arrangement as 12 individual monthly contracts, i.e. the lesser of the contractual period of one year and the one-month period in which the contract can be terminated without penalty. Therefore, ABC Corp. would recognize as revenue $26,667 per month for the one-year term (monthly ratable recognition). The options to renew do not provide Customer with a material right because the renewal price will be greater than or equal to the stand-alone selling price of the PCS as of contract inception.

ABC Corp. is not a party to the contract with the third party end-user customer (who is the customer of the reseller) and does not provide services to the end user. ABC Corp.'s customer is the reseller and the contract between reseller and the third party end-user does not affect the conclusion reached on the contract between ABC Corp. and the reseller.

Example B130.4
Perpetual license

ABC Corp. enters into a contract with Customer to transfer a perpetual license to software product G, and provide technical support and unspecified updates, upgrades and enhancements (collectively, PCS) for a three-year period, which is the economic life of the software. ABC Corp. determines that there are two distinct performance obligations (perpetual license and PCS). The stand-alone selling price and the contract price of the perpetual license is $600,000 and the stand-alone selling price and contract price of three years of PCS is $360,000. Customer pays $960,000 in combined fees at contract inception.

Scenario 1: Perpetual license and mandatory PCS with pro rata refund

Customer has the option to terminate the contract at the end of any month. On termination of either the license or PCS, Customer is entitled to a pro rata refund for the PCS and perpetual license and loses the right to use the software. The pro rata refund for the perpetual license is calculated based on the economic life of the license of three years. For example, if Customer terminates the license at the end of month 30, Customer would be entitled to a refund of 6/36ths of the $960,000 license and PCS fees ($160,000).

Question C200 and the examples (C200.1 through C200.3) therein discuss mandatory PCS in which a customer forfeits its rights to a perpetual license if it does not renew PCS. Scenario 1 is similar, as Customer must renew the contract and PCS to maintain the software license. Consistent with Question C200 and the related examples, the option to terminate the contract at the end of each month and obtain a pro rata refund of the PCS license fee results in a one-month contract for a term license and PCS with 35 monthly renewal options.

In this scenario, the renewal period lasts for the economic life of the licensed software and, therefore, we do not believe an additional perpetual license is granted at the end of the term. However, if the economic life of the software was longer than three years, at the end of the three-year term a perpetual license would be granted, which likely indicates that there is a material right. See Question C200 and Example C200.2 on mandatory PCS for further discussion.

Scenario 2: Perpetual license with pro rata refund for PCS only

Assume the same facts as in Scenario 1, except that the contractual price for the perpetual license is $300,000, the PCS price is $360,000, the pro rata refund relates to PCS only (i.e. the license fee is nonrefundable) and the license is not forfeited upon termination. The stand-alone selling price of the perpetual license is $600,000 and the stand-alone selling price of PCS is $360,000.

ABC Corp. accounts for this agreement as a contract for the perpetual license and one month of PCS with 35 individual monthly options to renew the PCS. The total non-cancellable amount of $310,000 is allocated to the upfront perpetual license and one month of PCS based on their relative stand-alone selling prices. Therefore, ABC Corp. would recognize license revenue of $304,918 upfront and PCS of $5,082 in the first month.

ABC allocates the transaction price as follows.

Performance obligation	Contract price	Stand-alone selling price	Selling price ratio	Price allocation
Perpetual license	$300,000	$600,000	98.36%	$304,918
PCS	10,000[1]	10,000	1.64%	5,082
Total	**$310,000**	**$610,000**	**100.00%**	**$310,000**

Note:

1. $10,000 is the non-cancellable amount of the PCS fee for the current month (i.e. if the contract is terminated at the end of month 1, Customer would be entitled to a refund of 35/36ths of the $360,000 PCS fee ($350,000)).

Each month thereafter, ABC Corp would recognize $10,000 in PCS revenue. Note that this treatment results in an accounting model that is capped by the cash amounts collected.

Example B130.5

Presentation of prepayment liability for cancellable contracts

On June 30, Year 1, Software Host enters into a contract with Customer to provide Customer with access to its hosted application for three years on a software-as-a-service (SaaS) basis. It concludes that its performance obligation to provide SaaS is satisfied over time because Customer receives and consumes benefits from the hosted application, as Software Host provides that access.

Software Host charges $180,000 a year for access to its hosted application, required to be prepaid at the start of each contractual year. The contract includes a provision that allows Customer to terminate the contract without penalty at the end of any designated month in exchange for a pro rata refund of its prepayment. Software Host concludes that a contract does not exist for periods beyond the then-current month.

The prepayment liability is presented as a deposit liability and not a contract liability. Because the contract term does not exist beyond the then-current month, there is no obligation to transfer a future month of hosting until Customer chooses to renew the contract for the subsequent month by not exercising its right to terminate. The deposit liability is presented separately from contract liabilities in the balance sheet.

Question B140

How does a termination penalty affect the assessment of the contract term?

Interpretive response: It may be the case that services provided under a contract can be terminated only by compensating the other party. For example, one party may be required to pay the other a termination penalty, which may be characterized explicitly as a termination penalty or otherwise characterized (e.g. as a requirement to either (1) continue to pay the contractual fees for a period of time even after services are no longer being provided or (2) forfeit of an otherwise refundable deposit paid to the entity upfront). If the right to compensation in the event of termination is substantive, then the duration of the contract is the *shorter of* the stated term or the period up to the point at which the contract can be terminated without paying substantive compensation.

A substantive termination penalty that compensates the other party is evidence that enforceable rights and obligations exist throughout the entire stated term. In other words, only by paying the penalty is the terminating party relieved of its remaining enforceable obligations, and only in return for that compensation does the non-terminating party forgo its remaining enforceable rights.

Discussions of the TRG at the November 2015 meeting concluded that entities should reach the same conclusion as outlined in the preceding paragraphs regardless of whether both entities have the right to terminate the contract or only the customer. Therefore, if only the customer has the right to terminate the contract in return for paying a substantive penalty, the contract term is the shorter of the stated term or the period up to the point at which the customer has the right to terminate the contract without paying a substantive penalty.

In making the assessment of whether a termination penalty is substantive, an entity considers all relevant factors, including whether the penalty is insignificant. A penalty that is insignificant would generally not change the enforceable rights or obligations of the parties from those that would exist absent the requirement to pay a penalty.

The substantive evaluation would also generally include consideration of the legal enforceability of the right to compensation on termination. For example, depending on the facts and circumstances, an entity's past practice of not enforcing termination penalties (e.g. allowing customers to terminate the contract without enforcing collection of the termination penalty) *may* result in a conclusion that the termination penalty is not enforceable under the relevant laws of the jurisdiction governing the contract. These types of circumstances may require legal analysis. *If* the entity's past practice makes its right to compensation upon termination (and the customer's obligation to pay that amount) unenforceable based on the applicable laws and regulations, then the entity would assess the contract term as it would for a contract without a termination penalty (see Question B130). In contrast, if the entity's past practice does not change the parties' legally enforceable rights and obligations, then that past practice would not affect whether the termination penalty is substantive.

When a cancellation occurs

If a cancellation occurs during the contract term determined in accordance with the first paragraph of this question (e.g. the customer terminates the contract regardless of having to pay a substantive termination penalty), the termination is accounted for as a contract modification as it changes the scope of the contract by shortening it.

Example B140.1

Past practice of allowing customers to terminate without enforcing collection of the termination penalty

ABC Corp. enters into a contract to provide services to Customer for 24 months. Customer has the enforceable right to terminate the contract by paying a substantive penalty to ABC. The penalty does not change during the contract term. ABC has a past practice of allowing customers to terminate substantially similar contracts after 12 months without enforcing collection of the termination penalty.

Because the termination penalty is substantive, it affects the enforceable rights and obligations under the contract for both parties such that the contract term is the shorter of the 24 month stated term or the period for which Customer must pay a *substantive* termination penalty.

The period during which Customer must pay a substantive penalty may be affected by ABC's past practice of not enforcing the termination penalty after 12 months if that past practice is considered to restrict its legal right to enforce the termination penalty, or Customer's legal obligation to pay, after 12 months. The determination in this regard could vary depending on the laws and regulations of the jurisdiction governing the contract and potentially other factors.

If ABC's past practice does *not* change its enforceable rights (and, correspondingly Customer's enforceable obligations), the contract term will be the full 24-month stated term. However, if ABC's past practice results in the conclusion that the termination penalty is not enforceable under the relevant laws and regulations of the governing jurisdiction, the contract term is only 12 months – that is, the period during which a substantive penalty applies.

Example B140.2
Contract term with decreasing termination penalty

ABC Corp. enters into a four-year contract with Customer to provide SaaS. The contract requires Customer to pay an annual fee of $100. Customer can terminate the contract at any point without cause, but until year 4 would incur a termination penalty. ABC always enforces its right to receive a termination penalty. The penalty decreases annually throughout the contract term. The following table illustrates the payments under the contract, as well as the termination penalty that would apply during each year of the stated contract term.

	Year 1	**Year 2**	**Year 3**	**Year 4**
Annual fee	$100	$100	$100	$100
Termination penalty	30	20	10	-
Cumulative fee if customer cancels in this year	**$130**	**$220**	**$310**	**$400**

ABC concludes that the penalty is substantive as it is neither insignificant, nor is there any question as to the enforceability of the termination penalty. In this example, the termination penalty represents at least 10% of the remaining annual fees (in aggregate) in the periods subsequent to the period in which the contract is terminated until it goes away in year 4, which ABC concludes is not an insignificant penalty.

ABC determines that the contract term is three years under Topic 606. Three years is the shorter of the stated contract term (four years) and the period during which a substantive termination penalty applies to any Customer cancellation (three years).

The termination penalty does not affect ABC's accounting for the three-year contract (i.e. no portion of the penalty is factored into the transaction price of the contract, nor does the penalty change that ABC's performance obligation is to provide the SaaS for three years) unless the contract is terminated, at which point the termination will be accounted for as a modification of the contract.

Question B150

Does forfeiture of a significant upfront fee constitute a termination penalty?

Interpretive response: It depends. A customer may pay a significant upfront fee that it would forfeit upon termination of the contract. Whether forfeiture of this fee constitutes a termination penalty depends on whether the fee would be refundable if the contract is not terminated.

Upfront fee is refundable. In general, forfeiture of an upfront fee does not constitute a termination penalty unless the customer would be entitled to a refund of that fee if it does not terminate the contract. For example, if a customer pays a $100 upfront fee to an entity at the beginning of a four-year contract, and will receive that fee (or a significant portion thereof) back only if it chooses not to exercise a termination right, we believe the requirement to forfeit the upfront fee is no different from having to pay a $100 fee upon termination.

Upfront fee is nonrefundable. If an upfront fee is nonrefundable, its forfeiture generally does not constitute a termination penalty because the refundability is not contingent on termination. Instead, an entity generally considers whether payment of the fee provides the customer with a material right with respect to renewing the services (including by not electing an option to cancel the services). Whether payment of a nonrefundable upfront fee provides the customer with a material right upon renewal of a services contract is discussed in Question C410.

Notwithstanding that the non-refundable fee generally does not constitute a termination penalty, there are fact patterns where the customer's ability to terminate a contract with an upfront fee does not affect the contract term. This would be the case if a nonrefundable upfront fee is the only consideration in a contract that meets the contract existence criterion. In that case, the customer does not have a separate purchasing decision to make with respect to renewing (i.e. by not terminating) the contract because it has prepaid, on a nonrefundable basis, for all the goods or services promised in the contract. Therefore, the termination option is not substantive, and any contractual termination right does not affect the contract term and a material rights analysis would not be performed. For example, a one-year service contract where the customer pays a nonrefundable upfront fee that is the only consideration would be considered a one-year contract regardless of whether the customer could technically terminate the contract.

Question B160

Does a cancellation provision exist if the contract is silent as to cancellation or termination?

Interpretive response: In general, if a contract does not provide for cancellation or termination, the entity should generally conclude the contract term is the stated term in the contract. However, as discussed in paragraph 606-10-25-3, the duration of a customer contract (i.e. the contractual period) is dictated by the present enforceable rights and obligations of the parties to the contract. Therefore, it may be that a legally enforceable cancellation or termination provision exists even if the written contract is silent in this regard. *If* such a provision exists, entities still need to consider whether a termination penalty would apply (see Questions B140 and B150).

Question B170

Does a cancellation provision available only upon a substantive breach of contract affect the contract term?

Interpretive response: No. If a contract exists under Topic 606, that means the parties can identify their rights and obligations under the contract and are committed to perform their respective obligations – see paragraph 606-10-25-1. Therefore, if a contract exists, an entity would not assume that a substantive breach of contract will occur when determining the contract term.

Question B180

Does a contract exist during 'free-trial' periods before the customer accepts an offer to continue the services beyond the free-trial period?

Interpretive response: Entities such as SaaS providers frequently offer customers the right to obtain their services for free for a period of time (i.e. a 'free-trial period') during which the customer can decide to contract for the services going forward (e.g. the customer can decide to obtain the entity's SaaS for 12 or 36 months after the end of the free-trial period). SaaS providers frequently offer additional incentives (e.g. free or discounted professional services or a discounted price of the SaaS) if the customer enters into a long-term contract for the entity's SaaS.

Some stakeholders in the United States asked the question about what services would be sales incentives and what services would be part of a contract with a customer if the customer accepts the entity's offer before the free-trial period ends. Based on discussions with the FASB staff, it is our understanding that their view is that services provided during a free-trial period, before the customer accepts the entity's offer to provide services beyond the free-trial period, should be accounted for as sales incentives. No contract exists until the customer accepts the entity's offer to provide services after the free-trial period because the customer can opt-out anytime during the free-trial period. That is, no enforceable right to consideration exists for the entity until the customer contracts for post-trial period services. Once the customer accepts the entity's offer, the entity should account for remaining free trial period services (from the date a contract exists) *and* the post-free trial services as committed performance obligations of the contract.

The FASB staff further indicated that, in limited circumstances, it may be reasonable to account for only the post-free trial period goods or services (i.e. those that were part of the offer to the customer) as performance obligations of the customer contract. The staff indicated this would be the case only if either (1) the customer's right to the remaining free-trial period goods or services was not enforceable, or (2) on a portfolio basis, accounting for only the post-free trial period goods or services as performance obligations would not materially differ from accounting for both the remaining free trial period goods or services *and* the post-free trial period goods or services as performance obligations of the contract with the customer.

Example B180.1
Free-trial period

ABC Corp. offers three free months of its SaaS to Customer. At any time during the three-month free-trial period, Customer can decide to continue the SaaS for 12 months after the end of the three-month free-trial period for a fee of $12,000, payable $1,000 in advance of each month during the 12-month post-trial period.

ABC's accounting for this contract depends on *when* Customer accepts ABC's offer to provide 12 months of its SaaS after the end of the free-trial period. For example:

— If Customer accepts and agrees to pay for the post-trial period services on Day 1 of the free-trial period, ABC's performance obligation is to provide 15 months of SaaS for $12,000 and, therefore, would recognize $800 each of the 15 months that SaaS is provided under the contract ($12,000 ÷ 15 months = $800). None of the cost of providing the SaaS during the free-trial period would be recognized as a sales and marketing expense.

— If Customer accepts and agrees to pay for the post-trial period services at the beginning of the third month of the three-month free-trial period, ABC's performance obligation is to provide 13 months of its SaaS for $12,000 and, therefore, would recognize $923 each of the 13 months that SaaS is provided under the contract ($12,000 ÷ 13 months = $923). The cost of providing the first two months of the SaaS during the free-trial period would be recognized as a sales and marketing expense.

— If Customer accepts and agrees to pay for the post-trial period SaaS on the last day of the three-month free-trial period, ABC's performance obligation is to provide 12 months of SaaS for $12,000 and, therefore, would recognize $1,000 each of the 12 months that SaaS is provided under the contract ($12,000 ÷ 12 months = $1,000). The cost of providing the three free-trial months of the SaaS would be recognized as a sales and marketing expense.

Note that in either of the first two scenarios, ABC would be recognizing revenue on the SaaS before it is legally entitled to receive any consideration from Customer. For example, in the first scenario, ABC will recognize $2,400 before it is legally permitted to bill Customer for the SaaS. ABC's offsetting entry is to a contract asset, which ABC will derecognize over the 12-month contract period once it begins to bill Customer under the terms of the contract.

Alternatively, it *may* be reasonable, regardless of when Customer accepts and agrees to pay for the post-trial period services, to consider ABC's performance obligation as one to provide 12 months of post-trial period SaaS for $12,000. In that case, ABC would recognize $1,000 each of the 12 months that SaaS is provided under the contract ($12,000 ÷ 12 months = $1,000). The cost of providing the remaining free-trial months of the SaaS would be recognized as a sales and marketing expense. This alternative would only be appropriate if either:

— ABC does not have an enforceable obligation, as a result of entering into the contract with Customer, to provide the remaining free-trial period SaaS; or

— ABC has a number of similar contracts that would permit it to apply this accounting on a portfolio approach basis (i.e. on a portfolio basis, accounting for committed free-trial period SaaS as a sales and marketing cost for contracts in the portfolio would not materially affect the entity's accounting results).

Comparison to legacy US GAAP

Under legacy US GAAP, arrangement consideration is limited to only non-contingent amounts (often referred to as the 'contingent cash cap'). That means, in a SaaS contract that provides the customer with three free or six discounted months of service or discounted implementation services, revenue recognized as those free or discounted services are provided is limited to amounts that are not contingent on the provision of future services.

Topic 606 has no prohibition on recognizing contingent revenue. Entities applying the approach illustrated as Alternative 1 in Example B180.1 will generally allocate more revenue to free or discounted services provided at the outset of a contract than they do under legacy US GAAP, which will accelerate overall revenue recognition under contract.

Combining contracts

Question B190

What constitutes 'at or near the same time' when evaluating whether two or more contracts should be combined?

Interpretive response: Topic 606 does not provide a 'bright line' for evaluating what constitutes 'at or near the same time' to determine whether two or more contracts should be combined. Therefore, we believe an entity might adopt an accounting policy as to what represents a minimum period of time that would evidence two or more contracts were entered into 'at or near the same time'. Many entities have had an accounting policy under legacy US GAAP in this regard, and that policy *may* remain reasonable under Topic 606, provided that policy (or any new policy) appropriately considers the entity's customary business practices and other reasonable expectations, such as recent changes to contracting practices or licenses/services offered. For example, an entity may perform services for a majority of the customers that license its software products or obtain its software-as-a-service and have a business practice of entering into follow-on contracts to provide those services. In this scenario, the entity might specifically consider the period of time that generally elapses between the initiation of the contract for the software license or the SaaS and the follow-on contract for the services in determining what represents a *minimum* period of time within which the entity would conclude two or more contracts were entered into at or near the same time.

However, just because two contracts are not entered into within the minimum period of time established by the entity does not mean they were not entered into 'at or near the same time'. An entity should have processes in place that consider specific facts and circumstances in cases that may not be 'customary' or usual. For example, an entity should not ignore the fact that two non-standard agreements, such as ones that are different from or larger than the entity's typical arrangements, were being discussed or negotiated over the same period of time and would appear to be significantly interrelated solely because they were not executed within the entity's established 'minimum period'.

An entity should have processes and controls to ensure multiple contracts initiated with the same customer at or near the same time are identified on a timely basis and, therefore, appropriately considered as to whether they should be accounted for as a single contract. This may include processes and controls to identify ongoing negotiations so that revenue related to a contract is not recognized until the entity has evaluated whether the contract(s) under negotiation should be combined with other contracts.

Question B200

If an entity and/or its customer have multiple divisions (business units), should contracts entered into between different divisions be evaluated for possible combination?

Interpretive response: Yes. There is no exception for considering whether two or more contracts should be combined because they were executed by different divisions of the entity and/or the customer; in fact, contracts with related parties of the customer that are not part of the same consolidated entity are considered for possible combination. However, whether the contracts were negotiated by the same parties or, instead, were negotiated with different divisions of the entity or the customer may influence whether any of the three specified criteria in paragraph 606-10-25-9 are met. For example, two contracts entered into by different divisions of one or both parties *may* be less likely to have been 'negotiated as a package with a single commercial objective' or to have goods or services that are a single performance obligation.

Question B210

Are the criteria in paragraph 606-10-25-9 similar to the indicators of contract combination in legacy US GAAP?

Interpretive response: Legacy US GAAP software revenue recognition guidance included a series of indicators to consider when determining whether two or more contracts should be combined. Because the contract combination guidance in Topic 606 is similar in concept to that in legacy US GAAP, we believe it is useful to consider how the legacy US GAAP indicators, with which entities should be familiar, compare to the specified contract combination *criteria* in Topic 606. The following table describes the similarities between the indicators under the legacy US GAAP software revenue recognition guidance and the specified criteria under Topic 606. Note that there were six indicators in the legacy US GAAP guidance, and some of them relate to more than one of the Topic 606 criteria.

Indicator under legacy software guidance (para 985-605-55-4)	**Related criterion (or criteria) under Topic 606** (para 606-10-25-9)
a. The contracts or agreements are negotiated or executed within a short timeframe of each other.	The first criterion in Topic 606 for determining when an entity combines two or more contracts and accounts for them as a single contract is that the contracts have to be entered into at or near the same time. This indicator is similar to that first criterion.
b. The different elements are closely interrelated or interdependent in terms of design, technology or function.	a. The contracts were negotiated as a package with a single commercial objective; and/or

Indicator under legacy software guidance (para 985-605-55-4)	**Related criterion (or criteria) under Topic 606** (para 606-10-25-9)
	c. The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation in accordance with paragraphs 606-10-25-14 through 25-22.
c. The fee for one or more contracts or agreements is subject to refund, forfeiture or other concession if another contract is not completed satisfactorily.	b. The amount of consideration to be paid in one contract depends on the price or performance of the other contracts.
d. One or more elements in one contract or agreement are essential to the functionality of an element in another contract or agreement.	a. The contracts are negotiated as a package with a single commercial objective; and/or c. The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation in accordance with paragraphs 606-10-25-14 through 25-22.
e. Payment terms under one contract or agreement coincide with performance criteria of another contract or agreement.	b. The amount of consideration to be paid in one contract depends on the price or performance of the other contracts.
f. The negotiations are conducted jointly with two or more parties (e.g. from different divisions of the same entity) to do what in essence is a single project.	a. The contracts are negotiated as a package with a single commercial objective; and/or c. The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation in accordance with paragraphs 606-10-25-14 through 25-22.

The preceding table is just a 'bridge' between the legacy and the new guidance. Just like under legacy US GAAP, significant judgment will be required in many cases to determine if one or more of the criteria in paragraph 606-10-25-9 are met. And while, as outlined in the preceding table, there is a relationship between the legacy indicators and the new criteria, that relationship does not mean a particular Topic 606 criterion will be evaluated in the same way as the legacy US GAAP indicator. For example, as discussed in *Chapter C – Step 2: Identify the performance obligations in the contract*, an entity may reach different conclusions under legacy US GAAP about whether an element is 'essential to the functionality' or 'closely interrelated or interdependent in terms of design, technology or function' to another element and whether two or more promised goods or services are distinct from each other under Topic 606.

An entity should establish processes and controls to be able to identify multiple contracts entered into with the same customer on a timely manner to ensure that the entity is appropriately determining whether such contracts should be combined. This may include processes and controls to identify ongoing negotiations between the entity and the customer so that revenue related to a contract is not recognized until the entity has evaluated whether the contract(s) under negotiation should be combined.

Example B210.1
Combining contracts, Part I

ABC Corp. licenses trust asset management system software called Product B. The Product B software enables users, typically large financial institutions, to access and value individual US dollar denominated trust account portfolios on a real-time basis. Product B functions as designed without any customization or modification services and can be implemented without ABC's assistance in most cases.

ABC entered into a specific contract with Customer, a large international commercial bank, to grant a license to the Product B software and, approximately 45 days later, enters into a separately papered agreement to provide services to modify the customer's instance of the software. The services include modification of the software code and configuration of certain modified and off-the-shelf settings to allow Customer to access and value its trust account portfolios in multiple foreign currencies.

While executed separately, the two agreements were negotiated during the same time period (even though commencement and completion of the negotiations of each were not co-terminus) and largely by the same ABC and Customer personnel.

ABC concludes that, if the two contracts were combined, the license to Product B and the professional services to customize and configure the licensed software would be a single performance obligation (see Question C230 and Example C230.1). ABC also concludes that the two agreements were negotiated as a package with a single commercial objective – i.e. to enable Customer to use ABC's software across its international operations.

Therefore, because the software license agreement and the services agreement were entered into near the same time, the two agreements constitute a single contract and ABC will account for the Product B license and the professional services as a single performance obligation.

Example B210.2
Combining contracts, Part II

Assume the same facts as in Example B210.1 except for the following:

- The services agreement is executed nearly five months after the software license agreement.
- The size of the two agreements and the extent of the services are larger than any other arrangement ABC has entered into in recent years.
- ABC has an accounting policy, based on its customary business practices, that contracts entered into within 90 days of each other have been entered into 'at or near the same time'.

Consistent with Example B210.1, ABC concludes both:

- That if the two contracts were combined, the license to Product B and the professional services to customize and configure the licensed software would be a single performance obligation (see Question C230); and
- The two agreements were negotiated as a package with a single commercial objective – that is, to enable Customer to use ABC's software across its international operations.

In this case, ABC concludes the two agreements were entered into near the same time as each other even though five months is longer than its established policy of treating 90 days or less as 'at or near the same time'. Consistent with the discussion in Question B190, even though ABC has an accounting policy in this regard that is reasonable to ABC's customary customer arrangements, ABC considers that this is an 'atypical' customer arrangement – i.e. it is unusually large and complex – such that the specific facts and circumstances should also be considered. The significantly overlapping negotiations and negotiating parties, along with the overall context of the two agreements, leads ABC to conclude that a delay in obtaining final agreement on the services contract does not mean that contract and the license agreement were not entered into near the same time as each other.

Example B210.3
Combining contracts, Part III

ABC Corp. enters into a software license agreement with Customer to license Product E. Product E is fully functional upon basic installation that most customers can perform themselves or obtain from numerous service providers other than ABC. However, approximately one month after the license agreement is concluded, Customer decides that it wants ABC to provide some services so that Customer can more effectively use the Product E software. Consequently, ABC and Customer enter into a services agreement for ABC to provide specified implementation and configuration services.

The implementation and configuration services are not complex; ABC will build some simple interfaces, configure available features in the Product E software to Customer's specifications, and then perform some user acceptance testing to ensure everything works as intended. However, Customer views the