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Technology Highlights

Challenges Associated With Applying the New Revenue Standard: EITF Project on Revenue Recognition for Contract Modifications of Licenses of Intellectual Property

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For public entities, the new revenue standard (ASC 606[1]) became effective for annual reporting periods beginning after December 15, 2017. The standard is effective for all other entities for annual reporting periods beginning after December 15, 2018. Early adoption is permitted for annual reporting periods beginning after December 15, 2016.

While ASC 606 will affect organizations differently depending on their facts and circumstances, we have identified certain aspects of its application that are especially challenging for technology companies. This *Technology Alert* is the fifth installment in a series intended to help technology entities better understand the new guidance, particularly private organizations that are currently adopting the standard's requirements.

Executive Summary

ASC 606 requires an entity to recognize revenue for license renewals no earlier than the beginning of the renewal period.[2] In addition, a contract modification, which is a change in price or scope (or both), must be accounted for as a separate contract when (1) the scope of the contract increases because of additional goods or services that are distinct and (2) the price of the contract increases by an amount that reflects the entity's stand-alone selling prices (SSPs) for those additional goods or services, adjusted to reflect the circumstances of the contract (e.g., a discount because an entity may not incur additional selling-related costs when modifying a contract). If a contract modification does not result

1 For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."
2 See ASC 606-10-55-58C(b).

in a separate contract, the entity must determine whether the modification constitutes (1) the termination of the existing contract and the creation of a new contract, (2) a part of the existing contract, or (3) a combination of both.[3]

A modification of a term license of intellectual property (IP) may include an extension to the original license's term with the purchase of additional rights. For example, it is common in the software industry for customers to purchase additional seats to a software product while extending the term of the original seats purchased for that same software product. Views differ on whether to apply the guidance on license renewals to these types of modifications, particularly when the modifications are considered a termination of the existing contract and the creation of a new one because the additional goods or services are not priced at their SSPs.

There is an additional emerging issue in the software industry related to contracts that include (or are modified to include) an option that allows the customer to convert from an on-premise license arrangement to a cloud-based arrangement under which the software is hosted. This issue may become more prevalent because customers of software entities frequently migrate from on-premise software solutions to cloud-based platforms. Views differ on how to account for the revocation of the licensing rights and the conversion to a hosted solution.

At its May 8, 2019, meeting, the FASB decided to add to the technical agenda of its Emerging Issues Task Force (EITF or "Task Force") a project[4] on contract modifications of licenses of IP. While the issues that resulted in the project originated in the software industry, they apply broadly to licenses of IP and could therefore affect many other industries (e.g., media and entertainment, biotech). The FASB staff has also established a working group to provide feedback to the Task Force related to the project. The scope of the project includes:

- Accounting for contract modifications in which the contract term for existing rights is extended and additional rights are purchased.
- Accounting for situations in which licensing rights are revoked, including conversion of on-premise term licenses to cloud-based arrangements.

At the June 13, 2019, EITF meeting, the FASB staff held an educational session on the project and solicited feedback from the Task Force about next steps. The issues, and alternatives developed by the FASB staff for their resolution, are summarized below.

For additional information about the June 13, 2019, EITF meeting, including summaries of other issues discussed, see Deloitte's June 2019 *EITF Snapshot*.

Accounting Issues

Contract Term Extension With Additional Rights

While ASC 606 addresses contract modifications and license renewals, there is no explicit guidance on circumstances in which a modification to a licensing arrangement is not solely a renewal of the same terms and conditions of the original license. As a result, views differ on the accounting for modifications of licensing arrangements that involve extensions of the original license term and grants of additional rights. Application of the current modification guidance may result in revenue recognition for both the extension of the original license and the additional licenses on the date of the modification, particularly if the modification is considered a termination of the existing contract and the creation of a new one. Alternatively, application of the current license renewal guidance may result in revenue recognition for the extension of the original license at the beginning of the renewal period (but recognition of the additional licenses on the modification date).

To address these matters, the FASB staff developed the three potential accounting alternatives described below. In each alternative, the following example (from Issue Summary No. 1 for the project) is discussed:[5]

[3] See ASC 606-10-25-10 through 25-13.
[4] EITF Issue No. 19-B, "Revenue Recognition — Contract Modifications of Licenses of Intellectual Property."
[5] Many entities typically include postcontract customer support (PCS) when selling software licenses. However, for simplicity, the example excludes such PCS.

Example 1

- "Entity A enters into a contract on 1 January 2018 with Customer B to transfer a software license to 100 seats of Product A for a 2-year term for $200,000, which reflects the SSP of Product A.
- On 31 December 2018, Entity A and Customer B modify the contract because the customer made an acquisition and needs more seats. As part of the modification, the old license is terminated, and the customer is granted a new license to 150 seats for a 2-year term for an additional $200,000, which reflects the same per-seat pricing of the original contract."

Alternative 1 — Account for the Additional Rights as a Separate Contract and Apply the Renewal Guidance to Existing Rights

Under this alternative, because performance related to the original license seats has been completed (i.e., control of the initial license seats has already been transferred to the customer), a new contract associated with the modification is separate from the original contract and has performance obligations that represent (1) a renewal or license extension of the original seats and (2) a new contract for additional seats. An entity would allocate the transaction price to the two performance obligations and apply the use and benefit guidance[6] to determine when to recognize revenue. The consideration allocated to the performance obligation representing the renewal (i.e., extension of the term of the original license) would be deferred and recognized at the beginning of the license renewal period. The consideration allocated to the new seats would be recognized on commencement of the new contract (when the customer is able to use and benefit from the additional seats).

If Entity A in Example 1 above executes a new contract on December 31, 2018, and applies this alternative, the new contract is separate from the original contract and has two performance obligations: (1) a one-year license for the original 100 seats and (2) a two-year license for an additional 50 seats. Entity A allocates $100,000 of the transaction price to the one-year license for 100 seats and $100,000 to the two-year license for 50 seats. The extension of the term for the existing 100 seats represents a renewal of the original license, and the $100,000 consideration allocated to this performance obligation is deferred and recognized at the beginning of the license renewal period on January 1, 2020. The $100,000 consideration allocated to the 50 new seats is recognized on December 31, 2018 (the modification date).

Alternative 2 — Determine Whether Modifications Represent a Separate Contract or a Termination and New Contract

Under this alternative, an entity would need to determine whether the contract modification of the license of IP represents (1) a separate contract or (2) the termination of an existing contract and the creation of a new contract based on an evaluation of whether the additional goods or services added are priced at their SSPs.[7]

If the additional licenses (the extension of the license for the original seats and the license for the additional seats) are accounted for as a separate contract, revenue for the extension of the license for the original seats would be deferred and recognized at the beginning of the renewal period. Revenue for the license for the additional seats would be recognized on commencement of the new contract. This manner of recognition is similar to that described in Alternative 1 above.

If the modification is accounted for as the termination of an existing contract and the creation of a new contract, revenue for both the extension of the license for the original seats and the license for the additional seats would be recognized on commencement of the new contract. This manner of recognition is similar to that described in Alternative 3 below.

[6] ASC 606-10-55-58C specifies that revenue from a license of IP cannot be recognized before both (1) the entity provides or makes available a copy of the IP to the customer and (2) the beginning of the period in which the customer is able to use and benefit from its right to use the IP. Because the software license has already been provided, it is relevant to analyze when the customer is able to use and benefit from the rights to the software license.

[7] In accordance with ASC 606-10-25-12, a contract modification is a separate contract if additional distinct goods or services are added that are priced at their SSPs. In accordance with ASC 606-10-25-13, a contract modification is the termination of an existing contract and the creation of a new contract if additional distinct goods or services are added that are not priced at their SSPs. In Example 1 above, it is assumed that the extension of the license for the original seats and the license for additional seats are distinct from the license for the original seats transferred before the modification.

The FASB staff acknowledged that determining which modification guidance to apply on the basis of an evaluation of SSP may be operationally challenging because many entities have broad pricing latitude for licenses of IP. For example, because there is typically little or no incremental cost to providing a software license, many entities have a broad range of pricing for their software licenses.[8]

If, in applying this alternative to Example 1 above, Entity A concludes that the modification is a separate contract, the extension of the term for the existing 100 seats represents a renewal of the original license and the $100,000 consideration allocated to this performance obligation is deferred and recognized at the beginning of the license renewal period on January 1, 2020. The $100,000 consideration allocated to the 50 new seats is recognized on December 31, 2018 (the modification date). If instead Entity A concludes that the modification is a termination of the existing contract and the creation of a new contract, it would recognize the entire $200,000 on December 31, 2018.

Alternative 3 — Modifications Always Terminate the Existing Contract

Under this alternative, modifications of licenses always represent the termination of the existing contract and the creation of a new contract. There is no requirement to analyze contract pricing (i.e., determine whether the extension of the license for the original seats and the new license for the additional seats are priced at their SSPs). Entities would apply the use and benefit guidance as of the new contract date and, on the modification date, would recognize revenue related to any additional licenses granted under the modification. Since application of the renewal guidance would be narrower under this alternative than it would be under the others, entities would be more likely to recognize revenue earlier.

If Entity A in Example 1 above applies this alternative, it would recognize the entire $200,000 on December 31, 2018.

The following table summarizes the timing of revenue recognition under each of the three alternatives above:

	January 1, 2018	December 31, 2018	January 1, 2020	Total
Alternative 1	$ 200,000	$ 100,000*	$ 100,000**	$ 400,000
Alternative 2	(1) Alternative 1 if renewal of original 100 seats and 50 new seats are priced at SSP or (2) Alternative 3 if *not* priced at SSP			
Alternative 3	$ 200,000	$ 200,000***	$ —	$ 400,000

* Recognize revenue for 50 new seats.

** Recognize revenue for the renewal of the original 100 seats.

*** Recognize revenue for 150 seats for the new contract.

Revocation or Conversion of Licensing Rights

An emerging issue in the software industry is the existence of contracts that include, whether from inception or by subsequent modification, a feature that allows a customer to convert an on-premise software license ("software license") to a cloud-based or hosted software solution (e.g., a software-as-a-service (SaaS) arrangement).[9]

Under the guidance in ASC 606, revenue from software licenses is recognized (1) at the point in time when the entity provides (or otherwise makes available) a copy of the software to the customer and (2) when the period in which the customer is able to use and benefit from the license has begun. Revenue from a SaaS arrangement is typically recognized over time because the performance obligation is likely to meet the conditions for such recognition. While ASC 606 also includes guidance on contract modifications,[10] material rights,[11] and sales with a right of return,[12] it does not directly address transactions in which a software license is revoked or converted to a SaaS arrangement. As a result, there are diverse views on the accounting for such arrangements, particularly those in which an on-premise software

[8] See Deloitte's December 14, 2018, and February 28, 2019, *Technology Alert* publications for additional guidance on establishing SSPs for term licenses.

[9] A SaaS arrangement would allow the customer to access the software on the vendor's equipment but not obtain control of the underlying software in accordance with the requirements in ASC 985-20-15-5.

[10] See ASC 606-10-25-10 through 25-13.

[11] See ASC 606-10-55-41 through 55-45.

[12] See ASC 606-10-55-22 through 55-29.

license that is recognized at a point in time is converted to a cloud-based service for the same underlying software product that is recognized over time.

To address this issue, the FASB staff has developed the two potential accounting alternatives described below. Our discussion of each alternative includes references to the following example:

Example 2

On January 1, 2018, Entity D enters into a noncancelable two-year contract with Customer E for $1 million to provide an on-premise software license with PCS for 100 seats and a SaaS conversion right. At the beginning of the second year, E has an irrevocable option to convert any number of seats of the software license to a SaaS arrangement for the same underlying software for no additional consideration. However, E loses its right to the on-premise license and related PCS if it converts to the SaaS arrangement (the SaaS arrangement includes support).

Entity D has similar arrangements with other customers and expects E to convert 50 percent of the seats at the beginning of the second year. The SSP for the software license bundled with PCS is the same as the SSP for the SaaS arrangement for the same term and number of seats (i.e., $5,000 per year per seat). The SSPs per year per seat for the software license and PCS are $4,150 and $850, respectively.

Alternative A — Defer a Portion of the Software License Revenue and Recognize It Over the SaaS Period

Under this alternative, an entity applies a right-of-return model when accounting for the potential that a software license will be converted to a SaaS arrangement. At contract inception, the entity would estimate and recognize an adjustment to the transaction price (and reduce revenue) to account for the potential conversion. The right of return would be accounted for as variable consideration, subject to the constraint, and the estimate would be reassessed in each reporting period (with changes in the return reserve recognized as an adjustment to revenue). If a conversion occurs, the amount previously deferred as a contract liability[13] would be recognized as SaaS revenue over the remaining term.

If Entity D in Example 2 above applies this alternative, it would recognize revenue of $622,500 [($50 seats × 2 years × $4,150) + (50 seats × 1 year × $4,150)] on January 1, 2018, for the software licenses not expected to convert to SaaS arrangements. It would also recognize a return reserve (i.e., a contract liability) of $250,000 (50 seats × 1 year × $5,000) on January 1, 2018. Entity D would recognize $85,000 (100 seats × 1 year × $850) for PCS in 2018 and $42,500 (50 seats × 1 year × $850) for PCS in 2019. Entity D would reassess its reserve estimate in each reporting period. In addition, if Customer E converts 50 seats to a SaaS arrangement on January 1, 2019, D would recognize $250,000 over the one-year SaaS term.

While it is assumed in the above example that Entity D's initial estimate is accurate, we believe that applying this alternative could be challenging to many software entities to determine an appropriate estimate for conversions because they do not have sufficient historical data.

Alternative B — Account for the SaaS Conversion Prospectively

Under this alternative, the conversion from a software license to a SaaS arrangement is a contract modification that results in a separate contract, which is accounted for prospectively. There is no adjustment to or reversal of revenue upon conversion to a SaaS arrangement because control of the software license was transferred at the beginning of the license period. Any "credit" provided (revenue previously recognized for the portion of the license that has been revoked for the remaining term) would not be included in the allocation to SaaS revenue. Rather, consideration related to unrecognized revenue (if any) would be allocated to the remaining performance obligations and recognized over the remaining arrangement term.

If Entity D in Example 2 above applies this alternative, it would recognize $830,000 (100 seats × 2 years × $4,150) of revenue on January 1, 2018, for the software licenses without regard to expected conversions. It would also recognize $85,000 (100 seats × 1 year × $850) for PCS in 2018. Further, upon conversion of the 50 seats on January 1, 2019, D would recognize the remaining unrecognized revenue of $85,000 related to PCS for 50 seats and SaaS for 50 seats over the remaining one-year term.

[13] While right-of-return reserves are typically recognized as a refund liability, a noncancelable contract would result in a contract liability (e.g., deferred revenue) for an entity's expected performance associated with a SaaS arrangement.

This alternative would be less costly to implement, but the amount of revenue recognized for the SaaS portion of the arrangement would be significantly less than its SSP, and the amount of revenue recognized up front for the software license would be significantly more than the SSP of the license actually used.

The following table summarizes the timing of revenue recognition under each alternative:

	January 1, 2018	January 1, 2018 Through December 31, 2018	January 1, 2019	January 1, 2019 Through December 31, 2019	Total
Alternative A	$ 622,500*	$ 85,000**	$ —	$ 292,500***	$ 1,000,000
Alternative B	$ 830,000†	$ 85,000‡	$ —	$ 85,000§	$ 1,000,000

* Recognize revenue for term licenses not expected to be converted to SaaS (100 seats for 1 year and 50 seats for 1 year).

** Recognize revenue for PCS (100 seats for 1 year).

*** Recognize revenue for PCS (50 seats for 1 year) and SaaS (50 seats for 1 year, previously deferred).

† Recognize revenue for term licenses (100 seats for 2 years).

‡ Recognize revenue for PCS (100 seats for 1 year).

§ Recognize remaining unrecognized revenue for PCS (50 seats for 1 year) and SaaS (50 seats for 1 year).

Recycling Revenue Alternative (Considered but Dismissed)

The FASB staff considered but did not propose an alternative that would allow entities to reverse software license revenue upon conversion to a SaaS arrangement (with no reserve for the estimate of conversions at contract inception) and recognize the reversed revenue over the SaaS period (referred to as "recycling revenue"). The staff acknowledges that this approach is currently applied in practice; however, it believes that recycling revenue is not a preferable outcome and is concerned about whether the financial reporting result would be meaningful to users of financial statements.

While the FASB staff reviewed different types of arrangements that include conversion rights, an entity's use of certain structures could add complexity to its application of the accounting alternatives. For example, depending on the facts and circumstances, an entity may have concluded that since its arrangements contain material rights, it should defer revenue under this approach rather than apply a right-of-return method. As another example, an entity may include in its arrangements the ability to switch back and forth between an on-premise software license and a SaaS arrangement at any point as long as the number of seats is capped to an agreed amount. Such an entity may reasonably conclude that it should account for these "remix" rights as (1) revenue allocated to a performance obligation associated with a software license with a cap for the entire term of the arrangement that is recognized up front when control of the license has transferred and (2) revenue allocated to a performance obligation associated with a SaaS arrangement with a cap for the entire term of the arrangement that is recognized over time beginning at the inception of the arrangement if the customer has access to the SaaS from inception (i.e., if the entity is standing ready to provide the SaaS at any point at the customer's option). Further, an entity may include in its arrangements the ability to convert to a SaaS arrangement at several discrete points in time during an arrangement instead of a single point or at any point. We understand that fact patterns such as these are evolving, and we believe that establishing solutions that address as many of these challenging scenarios as possible will be important to the success of the EITF's project.

EITF Discussion and Next Steps

No decisions related to the project were made at the EITF's June 13, 2019, meeting. The Task Force offered suggestions to the FASB staff regarding potential issues as well as questions for the working group to deliberate, and a meeting of the working group has been scheduled for July 16, 2019. At the EITF's September 2019 meeting, the Task Force is expected to redeliberate the issues on the basis of additional outreach and feedback from the working group.

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