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Technology Highlights
Challenges Associated With Applying the New Revenue Standard: Termination Rights

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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. The questions and answers (Q&As) below on termination rights are the first in a series intended to help technology entities better understand the new guidance, particularly private organizations that are currently adopting the standard's requirements. Stay tuned for more Q&As in the weeks to come on other topics related to applying ASC 606.

Executive Summary

If a customer can terminate a contract without substantive cost or penalty, only the noncancelable portion of the contract is accounted for under ASC 606, even if the customer is unlikely to exercise its termination right. For example, if a customer can terminate at any point and receive a pro rata refund, the arrangement should be accounted for as a daily contract.

Undelivered performance obligations associated with such arrangements must be excluded from deferred revenue and instead must be classified as some other liability account (e.g., "refund liability" or "customer arrangements with termination rights"). They should also be excluded from the requirement in ASC 606 to disclose "remaining performance obligations," although an entity would not necessarily be precluded from specifying amounts that are subject to termination in the notes to its financial statements if it properly describes this GAAP amount.

[1] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

Accounting Framework

Termination Rights — Software Arrangements

Software vendors may give their customers the right to terminate arrangements at the customers' convenience. The impact of termination provisions was discussed at the October 2014 meeting of the FASB's revenue transition resource group (TRG).

Under the guidance before the adoption of the new revenue standard (i.e., "legacy GAAP"), revenue associated with short-term subscription software arrangements (e.g., a license with a one-year term) that include software maintenance (e.g., postcontract customer support (PCS)) is typically recognized ratably under ASC 985-605. Some arrangements may contain a provision that allows the customer to receive a pro rata refund if the customer terminates during the contractual term. Under the contingent revenue requirements in legacy GAAP, revenue is recognized ratably at the contractually stated price. That is, revenue cannot be recognized at an amount greater than what is contractually nonrefundable since amounts are contingent on future performance (i.e., PCS).

Under ASC 606, the contingent revenue requirements in legacy GAAP no longer apply, and any variable consideration is generally estimated, subject to a constraint. In addition, on the basis of the TRG's discussions, termination provisions are treated in a manner similar to renewal options unless there is a substantive penalty associated with them. In the determination of whether a termination provision without penalty affects the contract term, qualitative factors such as the likelihood of cancellation or economic compulsion are not considered.[2]

Q&A 1-1 — Term-Based License

A vendor sells a one-year term-based license with PCS for $1,200. The vendor's customer has the right to terminate the arrangement at its convenience at the end of each month. If the customer terminates, it is entitled to a pro rata refund and loses the right to use the software. The vendor concludes that it has two distinct performance obligations: (1) the license and (2) the PCS. If there were no termination provision, the vendor would have allocated $800 to the license and $400 to the PCS (on the basis of the stand-alone selling price). Further, it would have recognized the license fee ($800) up front and the PCS ratably over time ($33 per month).

Question

How should the vendor account for the term-based license arrangement with the termination provision?

Answer

In a manner consistent with the views in TRG Memo 10,[3] which were summarized in TRG Memo 11,[4] the vendor should account for the arrangement as 12 individual monthly contracts since the term is the lesser of the contractual period or the period in which the contract cannot be terminated without penalty. Accordingly, the arrangement would continue to be accounted for ratably ($100 per month).[5]

Q&A 1-2 — Term-Based License Sold to Reseller

Assume the same facts as in Q&A 1-1, except that the customer is a reseller that has a committed (noncancelable) contract with its end-user customer for the duration of the arrangement (one year).

Question

Would the fact that the end user is unable to cancel allow the vendor to view the arrangement as a one-year contract?

[2] However, in determining whether a stated penalty is substantive, an entity may consider both quantitative and qualitative factors.
[3] TRG Memo No. 10, "Contract Enforceability and Termination Clauses."
[4] TRG Memo No. 11, "Meeting — Summary of Issues Discussed and Next Steps."
[5] Revenue associated with the license would be recognized at the beginning of each month, which is similar to ratable recognition given the short term (monthly).

Answer

Since the vendor is not a party to the end-user arrangement (i.e., the reseller, not the end user, is the vendor's customer), the end-user agreement is not relevant in the performance of step 1 under ASC 606 (i.e., identifying the contract with the customer). The vendor should therefore account for the arrangement in the same manner as it does for the arrangement discussed in Q&A 1-1.

Q&A 1-3 — Perpetual License With Pro Rata Refund

A vendor sells a perpetual license with one year of PCS for $6,000. The vendor's customer has the right to terminate the arrangement at its convenience at the end of each month. The contractual price of the license and the PCS is $5,000 and $1,000, respectively. Upon termination, the customer will be entitled to a pro rata refund for the PCS and a computed pro rata refund for the perpetual license, which has a three-year life. If the customer exercises its termination right, it loses the right to use the software. The vendor concludes that it has two distinct performance obligations: (1) the license and (2) the PCS. If there were no termination provision, the vendor would have allocated $5,000 to the license and $1,000 to the PCS on the basis of the stand-alone selling price. Further, it would have recognized the license fee ($5,000) up front and the PCS ratably over time ($83 per month).

Question

How should the vendor account for the perpetual license arrangement with the termination provision?

Answer

The vendor should account for the license as 36 individual monthly contracts and for the PCS as 12 individual monthly contracts. As a result, the license would be recognized over 36 months and the PCS would be recognized over 12 months, both ratably ($139 per month for 36 months[6] and $83 per month for 12 months).

Q&A 1-4 — Perpetual License With Pro Rata Refund on PCS Only

A vendor sells a perpetual license with one year of PCS for $6,200. The vendor's customer has the right to terminate the PCS at its convenience at the end of each month. The contractual price of the license and the PCS is $5,000 and $1,200, respectively. Upon termination, the customer will be entitled to a pro rata refund for the PCS and no refund for the license. Upon exercising the termination right, the customer retains the right to the perpetual license. The vendor concludes that it has two distinct performance obligations: (1) the license and (2) the PCS. If there were no termination provision, the vendor would have allocated $5,200 to the license and $1,000 to the PCS on the basis of the stand-alone selling price. Further, it would have recognized the license fee ($5,200) up front and the PCS ratably over time ($83 per month).

Question

How should the vendor account for the perpetual license arrangement with the termination provision?

Answer

The vendor should account for the PCS as 12 individual monthly contracts and for the license as part of the initial monthly contract. As a result, the license would be recognized upon delivery ($5,020) and the PCS would be recognized monthly ($80 in the first month and $100 per month thereafter).[7] The total revenue recognized in the first month would be limited to an amount less than what would have been recognized on the basis of relative stand-alone selling price if the contract were to be accounted for as a one-year contract. Note that the result is effectively the same as the amount that would have been recognized if the contingent revenue guidance under legacy GAAP, which was eliminated by ASC 606, had been applied. (Note further that there is no material right for "renewals" of PCS since the renewals are priced at $100, which is greater than the stand-alone selling price of $83.)

[6] See footnote 5.

[7] Total noncancelable consideration of $5,100 for the initial month is allocated on a relative stand-alone selling-price basis — that is, approximately 98 percent to the license and 2 percent to one month of PCS.

Q&A 1-5 — Perpetual License With Negotiated Pro Rata Refund and Separate Stock-Keeping Units (SKUs)

A vendor sells a perpetual license with one year of PCS for $6,000. The vendor's customer has the right to terminate the arrangement at its convenience at the end of each month. The contractual price of the license and the PCS is $5,000 and $1,000, respectively. The contract specifies that upon termination, the vendor and the customer will negotiate, in good faith, the amount of refund, if any, to which the customer would be entitled. The vendor concludes that it has two distinct performance obligations: (1) the license and (2) the PCS.

Question

How should the vendor account for the perpetual license arrangement with the termination provision?

Answer

Generally, if the amount that would be refunded is not stated (i.e., unknown) because it is subject to negotiation and not legally enforceable, the arrangement would be accounted for as a one-year contract since a substantive termination penalty would be legally enforceable.

Q&A 1-6 — License With an Uncertain Pro Rata Refund and a Combined SKU

A vendor sells a one-year term license with coterminous PCS for $6,000. The customer has the right to terminate at its convenience the PCS at the end of each month. The contractual price of the license and PCS are not separately stated. Accordingly, the amount that would be refunded upon termination is not known. The vendor concludes that it has two distinct performance obligations: (1) the license and (2) the PCS.

Question

How should the vendor account for the term license arrangement with the termination provision?

Answer

Generally, if the amount that would be refunded is not stated (i.e., unknown) because it is subject to negotiation and not legally enforceable, the contract would be accounted for as a one-year contract since a substantive termination penalty would be legally enforceable.

Balance Sheet Presentation

An agreement that includes a provision for termination without penalty may not be a contract under step 1 of ASC 606 (i.e., a contract may not exist for the cancelable term). Such a provision may therefore affect the presentation of these arrangements on the balance sheet.

Q&A 2-1 — Presentation of Refund Liability Versus Contract Liability/Deferred Revenue

Question

For a cancelable contract (with a termination right without penalty), can funds received in advance be classified as a contract liability?

Answer

No. A contract liability is defined in ASC 606-10-45-2 as "an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or an amount of consideration is due) from the customer." A contract liability, therefore, represents a liability for future performance that results from a legally enforceable contract.

Funds received in advance that are associated with a cancelable term (with a termination right without penalty) should be presented separately from any contract liability as a refund liability, or similar liability.

This view is consistent with that in Q&A 13-1A in Deloitte's *A Roadmap to Applying the New Revenue Recognition Standard*, which states that refund liabilities should be presented separately from contract liabilities (e.g., deferred revenue).

Q&A 2-2 — Presentation of Refund Liability on a Classified Balance Sheet

Question

On a classified balance sheet, should the refund liability be presented as current and noncurrent if the customer can cancel the contract at any point or within 12 months or less?

Answer

No. All amounts should be recorded as a current liability.

The refund liability is excluded from contract liabilities (see Q&A 2-1 above) because the customer must, in effect, make a separate purchase decision when the noncancelable term ends, at which point it could demand a refund of funds previously paid.

ASC 470-10-45-10, which specifies that loans due on demand should be presented as a current liability, supports this view:

> The current liability classification shall include obligations that, by their terms, are due on demand or will be due on demand within one year (or operating cycle, if longer) from the balance sheet date, even though liquidation may not be expected within that period.

Q&A 2-3 — Presentation of Unpaid Refund Liability

Question

If an entity had a legally enforceable contract (see Q&A 4-7 in Deloitte's *A Roadmap to Applying the New Revenue Recognition Standard*) and amounts have been billed (i.e., there is an unconditional right to payment for amounts billed), but because of a termination right a contract has not been identified under step 1 of ASC 606, should the refund liability be netted with the accounts receivable?

Answer

If the contract is legally enforceable and the recognition of accounts receivable is appropriate, presenting the amounts net would generally be inappropriate. ASC 210-20 provides guidance on evaluating whether an asset and a liability may be netted. For example, ASC 210-20-45-1 outlines the criteria used to determine whether a right of setoff exists, including the requirement that the reporting party have both the legal right and the intent to set off. If the reporting entity does not expect the customer to terminate, it effectively believes that the customer will pay in the normal course and that the entity will provide goods or services. In such a case, the criteria related to the right of setoff would not be met and the entity should not net the amounts.

However, when the criteria related to the right of offset are met, a reporting entity is not required to net the amounts. An entity's decision to offset when the criteria in ASC 210-20-45-1 are met is an accounting policy election that should be applied consistently to all similar types of transactions.

Disclosures

Contracts with termination provisions may also affect a company's financial statement disclosures.

Q&A 3-1 — Effect of Termination Provisions on Disclosures Related to Remaining Performance Obligations

Question

In an arrangement with a termination provision, can an entity include amounts that are subject to termination without penalty in its required disclosures related to remaining performance obligations?

Answer

No. Under the requirements outlined in ASC 606-10-50-13 related to remaining performance obligations, an entity must disclose the amount of the "transaction price allocated to the performance obligations that are unsatisfied . . . as of the end of the reporting period."

When arrangements include provisions for termination without penalty, the amounts excluded from the assessment under step 1 of ASC 606 are, in effect, optional purchases. Any amounts that are paid or due are thus accounted for as a refund liability and not a contract liability. Because these amounts are related to a cancelable arrangement for which a contract does not exist (as determined under step 1), they do not represent any part of the transaction price (as determined under step 3) related to unsatisfied performance obligations (which would be identified as part of step 2).

Q&A 3-2 — Supplemental Disclosures Related to Termination Provisions

Question

Is an entity precluded from *separately* disclosing the amounts of refund liability within the financial statement notes that discuss remaining performance obligations?

Answer

Not necessarily. An entity must not indicate that the refund liabilities are part of the transaction price related to its remaining performance obligations. However, the entity generally would not be precluded from specifying the refund liability in its financial statement notes if it properly describes this GAAP amount.

For example, an entity might provide the following disclosure:

> **Transaction Price Allocated to Remaining Performance Obligations**
>
> As of December 31, 20X7, approximately $4.5 million of revenue is expected to be recognized from remaining performance obligations. The Company expects to recognize revenue on approximately 65 percent of these amounts over the next 12 months, with the remaining balance recognized thereafter. In addition, approximately $0.8 million is recorded as a refund liability in the Company's consolidated balance sheet. This liability is generally related to amounts received from customers but is associated with termination provisions for arrangements that are cancelable at the customer's discretion (and the Company would be required to refund such amounts).

Q&A 3-3 — Effect of Termination Provisions on Contract Balance Disclosures

An entity chooses to present a full rollforward of its contract liability. However, a portion of its arrangements contain termination provisions. Any amounts received that are not associated with contracts identified under step 1 of ASC 606 have been recorded as a separate liability apart from the contract liability.

Question

How should the entity consider the termination provisions when preparing its contract asset and liability disclosures?

Answer

The entity would not be permitted to include the refund liability in its contract liability balance disclosures required by ASC 606-10-50-8. However, one approach may be to reclassify the refund liability as a contract liability when the termination right lapses (i.e., when the contract is no longer cancelable without penalty and the amounts are recharacterized as deferred revenue). The following table illustrates the contract liability rollforward approach for entities that elect such presentation:

Illustrative Disclosure — Contract Balances With Refund Liability

Changes in the contract liability balance were as follows for the years ended December 31, 20X8, and December 31, 20X7:

	December 31, 20X8	December 31, 20X7
Balance, beginning of period	$ XX	$ XX
Deferral of revenue	XX	XX
Reclassification of refund liabilities	XX	XX
Recognition of unearned revenue	XX	XX
Balance, end of period	$ XX	$ XX

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