Technology Alert
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Technology Highlights
Challenges Associated With Applying the New Revenue Standard: Nonrefundable Up-Front Fees in Software Arrangements

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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 part of 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

Under some software arrangements, the customer must pay a nonrefundable up-front fee. ASC 606 requires entities to consider whether the fee is (1) associated with the transfer of promised goods or services or (2) an advance payment for future goods or services.[2] In addition, some software arrangements give the customer the right to terminate the contract at the customer's convenience. For example, an arrangement for a one-year term license and postcontract customer support (PCS) may contain a provision that allows the customer to terminate the contract after a 30-day notice period. In many cases, if the customer can terminate a contract without having to pay a substantive penalty, only the noncancelable portion of the contract (e.g., the initial 30 days) is accounted for under ASC 606, even if the customer is unlikely to exercise its termination right.[3] For additional information on the accounting for termination rights, see Deloitte's July 24, 2018, *Technology Alert*.

[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 606-10-55-50 and 55-51.
[3] See ASC 606-10-25-3 and 25-4 as well as paragraphs BC50 and BC391 of FASB Accounting Standards Update (ASU) No. 2014-09, *Revenue From Contracts With Customers*. In addition, see TRG Memo No. 10, *Contract Enforceability and Termination Clauses*, and TRG Memo No. 48, *Customer Options for Additional Goods and Services*.

Questions have arisen in practice regarding how to account for nonrefundable up-front fees associated with a software arrangement that contains a termination provision. The questions and answers (Q&As) below contain examples of this scenario and discuss the accounting considerations.

Interpretive Guidance

Q&A 1 All Fees Are Nonrefundable

A vendor sells a one-year term-based license with PCS for an up-front nonrefundable fee of $1.25 million. The stand-alone selling prices (SSPs) of the license and PCS are $1 million and $250,000, respectively. The vendor's customer has the right to terminate the arrangement at its convenience at the end of each month without paying any penalty. If the customer terminates, it loses the right to use the software and receive support. The customer also has the right to renew the contract annually for the same fee.

The vendor concludes that it has two distinct performance obligations: (1) a one-year term license and (2) one year of PCS.

Question

Is the vendor's conclusion reasonable?

Answer

Yes. The contract term is one year. While the customer has the right to terminate the contract at the end of each month without paying the vendor a penalty, the customer has, in substance, paid up front for all the goods and services in the contract — the one-year term license and one year of PCS. That is, while a termination provision is treated similarly to a renewal option, there is no incremental fee to "renew" (i.e., not terminate) the contract each month, nor is there a refundable payment for termination. Therefore, the nonrefundable up-front fee is payment for the term license and PCS for the full year. In addition, the contract does not give the customer a material right since the annual renewal provision is priced at the SSPs of the term license and PCS.

Revenue Recognized Each Quarter	Q1	Q2	Q3	Q4
License	$ 1,000,000			
PCS	$ 62,500	$ 62,500	$ 62,500	$ 62,500
Total	$ 1,062,500	$ 62,500	$ 62,500	$ 62,500

Q&A 2 A Portion of the License Fees Are Nonrefundable — Pro Rata Refund for PCS

A vendor sells a one-year term-based license with PCS for an up-front fee of $1.25 million. The SSPs of the license and PCS are $1 million and $250,000, respectively. The vendor's customer has the right to terminate the arrangement at its convenience at the end of each month without paying any penalty. If the customer terminates, it loses the right to receive support and $1 million of the up-front fee. However, the customer receives a pro rata refund for the PCS ($250,000) and retains the software license for the remainder of the year. The customer also has the right to renew the contract annually for the same fee.

The vendor concludes that it has two distinct performance obligations: (1) a one-year term license and (2) one month of PCS.

Question

Is the vendor's conclusion reasonable?

Answer

Yes. The contract terms are one year for the license and one month for the PCS. While the customer has the right to terminate the contract at the end of each month without paying the vendor a penalty, the customer has, in substance, paid up front for the one-year term license since the fee for the license is nonrefundable and the customer retains the right to use the license for the entire year, even if the contract is terminated. However, the termination provision is treated similarly to a renewal option for PCS since there is a pro rata refund for PCS. Therefore, the incremental fee to renew the contract each month is for optional renewals of PCS only. In addition, the contract does not give the customer a material right since (1) the annual renewal provision is priced at the SSPs of the term license and PCS and (2) the monthly renewal of PCS is priced at the SSP of PCS.

Revenue Recognized Each Quarter	**Q1**	**Q2**	**Q3**	**Q4**
License	$ 1,000,000			
PCS	$ 62,500	$ 62,500	$ 62,500	$ 62,500
Total	$ 1,062,500	$ 62,500	$ 62,500	$ 62,500

Q&A 3 A Portion of the License Fees Is Nonrefundable — Pro Rata Refund for Mandatory PCS

A vendor sells a one-year term-based license with PCS for an up-front fee of $1.25 million. The SSPs of the license and PCS are $1 million and $250,000, respectively. The vendor's customer has the right to terminate the arrangement at its convenience at the end of each month without paying any penalty. If the customer terminates, it loses the right to use the software and receive support, but it receives a pro rata refund that is based on the PCS fee stated in the contract. The vendor intends to enforce compliance with the requirement to relinquish the use of the term license if PCS is not renewed. The stated fee for PCS ($250,000) is refundable, and the remainder of the up-front payment for the license ($1 million) is nonrefundable. The customer also has the right to renew the contract annually for the same fee.

The vendor concludes that it has three distinct performance obligations: (1) a one-month term license, (2) one month of PCS, and (3) a material right.

Question

Is the vendor's conclusion reasonable?

Answer

Generally, yes. If the termination provision is substantive, the contract term is likely to be one month (i.e., the enforceable rights and obligations are likely to be limited to one month). The customer has the right to terminate the contract at the end of each month without paying the vendor a penalty. While the customer does not receive a refund of the up-front payment of $1 million and also loses the right to use the software license in the event of a termination, neither loss is considered a substantive termination penalty. ASC 606 specifies that a termination penalty compensates the other party. We do not believe that the relinquishment of the software would be considered a termination penalty because the customer is not compensating the vendor for terminating the contract. Because software licenses are typically sold on a nonexclusive basis and can be replicated an unlimited number of times at minimal or no cost, no substantive asset is returned to the vendor (i.e., the vendor does not receive a returned product that it can resell or otherwise obtain economic value from). Such licenses can be contrasted with exclusive licenses to intellectual property, which may have value if returned to a vendor. In addition, we do not believe that the loss of the up-front, nonrefundable payment is compensation to the vendor because the initial contract already gave the vendor the right to that payment (i.e., the vendor retains the payment irrespective of whether the customer cancels or renews the contract). Rather, the up-front nonrefundable fee should be assessed under ASC 606-10-55-50 and 55-51.

The termination provision is treated similarly to a renewal option since there is a pro rata refund for PCS if the contract is terminated (which can also be viewed as an incremental fee to renew). In deciding to not terminate the contract (i.e., by renewing the contract), the customer renews both the term license and PCS, because if PCS is not renewed, the customer loses the right to the license. Therefore, because of the termination provision, the vendor might conclude that present enforceable rights and obligations only exist for a term license and PCS for one month.

In evaluating whether the up-front, nonrefundable fee is either (1) a payment for the transfer of promised goods or services in the initial contract or (2) an advance payment for future goods or services, the vendor should determine whether a material right has been provided for the monthly renewals.[4] If the contract is renewed, the incremental fee (i.e., the refundable portion) is only associated with the stated PCS fee. In effect, the customer obtains control of both a term license and PCS by only paying the fee for PCS. Since the monthly renewal is priced at a significant and incremental discount to the price that would be charged to similarly situated customers (i.e., the term license and PCS are not renewed at their SSPs), the customer receives a material right. That material right would be accounted for as a performance obligation that is recognized with the renewals of the term license and PCS. If the practical alternative in ASC 606-10-55-45 is elected, the transaction price would be allocated to the renewals of the term license and PCS by reference to the renewals expected to be provided and the corresponding expected consideration. If renewals are expected over the entire stated term (i.e., one year), the entire contractually stated fee (i.e., $1.25 million) would be allocated evenly to each monthly term license and PCS. The amount associated with each month (approximately $104,000) would then be allocated to the one-month term license and PCS and recognized when the customer obtains control of the term license (at a point in time at the beginning of each month) and as PCS is provided (ratably over the month) on the basis of their relative SSPs.

For a vendor to conclude that a termination provision affects the contract term, the provision must be substantive (i.e., the customer is making a purchasing decision to renew or terminate the contract). In determining whether the termination/renewal provision is substantive, the vendor should consider quantitative and qualitative factors. For example, the amount subject to refund must be substantive relative to the total contract fee. Further, there should be a business purpose for the provision, and the vendor must intend to enforce the requirement to relinquish the use of the term license if PCS is not renewed. The factors to consider and the relevance of those factors will depend on the specific facts and circumstances of each arrangement, and the use of significant judgment may be required. Companies are therefore encouraged to consult with their accounting advisers and auditors.

Revenue Recognized Each Quarter	**Q1**	**Q2**	**Q3**	**Q4**
License	$ 250,000	$ 250,000	$ 250,000	$ 250,000
PCS	$ 62,500	$ 62,500	$ 62,500	$ 62,500
Total	$ 312,500	$ 312,500	$ 312,500	$ 312,500

Q&A 4 A Portion of the License Fees Is Nonrefundable — Nonsubstantive Pro Rata Refund for Mandatory PCS

A vendor sells a one-year term-based license with PCS for an up-front fee of $1.25 million. The SSPs of the license and PCS are $1 million and $250,000, respectively. The vendor's customer has the right to terminate the arrangement at its convenience at the end of each month without paying any penalty. If the customer terminates, it loses the right to use the software and receive support, but it receives a pro rata refund for PCS. The vendor intends to enforce compliance with the requirement to relinquish the use of the term license if PCS is not renewed. The stated fee for PCS is $50,000, and the remainder of the up-front payment ($1.2 million) is nonrefundable. The customer also has the right to renew the contract annually for the same fee.

The vendor concludes that it has two distinct performance obligations: (1) a one-year license and (2) one year of PCS.

[4] The contract does not give the customer a material right on an annual basis since the annual renewal provision is priced at the SSPs of the term license and PCS.

Question

Is the vendor's conclusion reasonable?

Answer

Generally, yes. The contract term is likely to be one year (i.e., the enforceable rights and obligations are likely to be for the full stated term). The customer has the right to terminate the contract at the end of each month without paying the vendor a penalty. While the customer does not receive a refund related to the up-front payment of $1.2 million and also loses the right to use the software license in the event of a termination, neither loss is a substantive termination penalty. However, unlike the termination provision in Q&A 3, the provision in this scenario is not likely to be considered substantive since the amount subject to refund is only $50,000.

In evaluating whether the up-front nonrefundable fee is either (1) a payment for the transfer of promised goods or services in the initial contract or (2) an advance payment for future goods or services, the vendor would consider that substantially all of the total contract fee is the up-front nonrefundable fee. The customer has the right to terminate the contract at the end of each month without paying the vendor a penalty; however, the customer has, in substance, substantially paid up front for all the stated goods and services in the contract — the one-year term license and one year of PCS. That is, while a termination provision is treated similarly to a renewal option, there is no substantive incremental fee to "renew" the contract (i.e., there is no substantive refundable payment for terminating the contract). Therefore, as in Q&A 1, the nonrefundable up-front fee (in addition to the nonsubstantive refundable payment) is considered an up-front payment for the term license and PCS for the full year. In addition, the contract does not give the customer a material right since the annual renewal provision is priced at the SSPs of the term license and PCS.

Revenue Recognized Each Quarter	Q1	Q2	Q3	Q4
License	$ 1,000,000			
PCS	$ 62,500	$ 62,500	$ 62,500	$ 62,500
Total	$ 1,062,500	$ 62,500	$ 62,500	$ 62,500

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