



Health Tech Industry Accounting Guide

September 2025

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Preface

We are pleased to present the sixth edition of Deloitte's *Health Tech Industry Accounting Guide*. The convergence of the technology and health care/life sciences industries has caused unique challenges for management within these sectors. This publication is aimed at identifying and providing guidance on the most difficult technical accounting issues that are encountered in these sectors.

In addition, this guide provides our perspective on recent health tech investment trends related to mental health and wellness (see [Chapter 1](#)).

We also encourage readers to consult Deloitte's *Life Sciences Industry Accounting Guide* and *Technology Industry Accounting Guide*, which include additional guidance relevant to health tech companies.

[Appendix A](#) lists the titles of standards and other literature we cited, and [Appendix B](#) defines the abbreviations we used.

We hope this publication helps you navigate the various challenges with health tech and encourage you to contact your Deloitte team for additional information and assistance.

Contacts



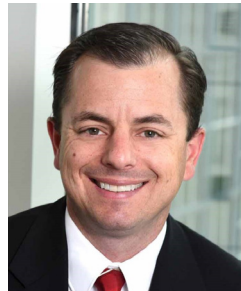
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Chapter 1 — Recent Trends in the Health Tech Marketplace: Mental Health and Wellness¹

1.1 Introduction

Mental health and wellness (MHW) can be divided into two primary areas: prevention and treatment. A wide range of factors contribute to overall well-being, which can directly affect mental health. A preventive approach to sound mental health includes basic necessities and qualitative factors such as an individual's sense of belonging and hope for the future. Treatment of acute mental illnesses presents measurable opportunities for new approaches to health care and consumer channels. MHW companies are actively addressing both aspects, and private investors are deploying more capital to support these initiatives.

Demand for mental health treatment is growing. According to a 2022 survey conducted by the Substance Abuse and Mental Health Services Administration, 23.1 percent of U.S. adults live with a mental illness. However, only slightly over half of U.S. adults with mental illness have received treatment for their condition in the past year through prescription medication or care facilities.

1.2 Investment Trends

To address this significant demand, there must be an increase in treatment options, from physical clinics and telehealth platforms to pharmaceuticals and alternative medicines. Innovative solutions could also expand access to mental health care and address unmet needs. Major challenges exist for commercialization and growth within the U.S. health care market, but direct-to-consumer (DTC) and enterprise models have emerged as viable options to expand the MHW ecosystem.

Private dealmaking trends illustrate this growing push to service the MHW market. Expansion-stage activity in the MHW industry reflects the increased focus on mental health over the past several years, with elevated levels of late-stage deployments of growth capital by venture capital (VC) and private equity (PE) firms. Before 2020, activity was modest, totaling less than \$1 billion in most years. The pandemic changed this, driving investments to triple at over \$3 billion in 2020. The following year saw sustained momentum and even further growth in value, hitting a record \$3.8 billion.

The sudden spike in demand for digital and telehealth services, brought on by lockdowns and in-person treatment options, coincided with adverse societal stressors and fueled a greater need for these services. Despite a market correction in 2022, which reduced overall financing, the number of deals closed actually increased to a record 105. Activity continued to decrease in 2023 by both measures, but 2024 marked an important recovery phase after two years of declines.

¹ Adapted from portions of Deloitte's December 2024 report [Road to Next — Mental Health and Wellness: Dealmakers Respond to Emerging Demand](#).

1.3 Funding Trends in MHW

As the MHW industry matures, many companies are grappling with the challenges of reinvesting the capital gained during the pandemic-driven boom. The extraordinary growth fueled by COVID-19 has now given way to a tighter market, forcing businesses to find ways to sustain growth and finance their operations. This transition is far from easy.

Expansion-stage commercially viable start-ups must have a clear plan for consistent revenue streams and cost controls. Health care companies may face external hurdles such as various reimbursement models, while DTC companies must adapt to potential rapid shifts in consumer preferences. These challenges, combined with the MHW industry's developing status, typically result in smaller investment sizes.

Rising demand for mental health services is the primary driver of value for expansion-stage MHW companies, although investors maintain higher standards for capital compared with the flurry of activity seen in recent years. A declining deal count indicates a more exclusive club of VC- or PE-backed companies attracting necessary capital to operate at critical later stages of development. Despite macroeconomic shocks and other challenges, some companies demonstrated growth that impressed investors. As a result, the overall median premoney valuation increased significantly for the smaller group of companies that successfully raised funds in 2024.

At the peak of the private dealmaking surge in 2021, seven MHW companies achieved postmoney valuations of over \$1 billion and were minted as unicorns. The following year, despite growth in overall expansion-stage dealmaking for the industry, no companies surpassed this threshold. Since 2023, three additional MHW companies have achieved unicorn status, reflecting the slow but steady return to valuation growth across broader markets. Higher valuations incur their own challenges, though, and these companies must earn their growth expectations and stave off competition, which will only grow in a developing market.

1.4 Sector Trends

Improved data-gathering techniques, evolving social values, and the rise of social media platforms are contributing to the understanding of mental health. Major tech companies operating these platforms are receiving mounting criticism for their detriment to users' mental health, the lack of safety measures in place for minors, and the commodification of attention. Social media algorithms and tech intermediaries are deeply rooted in our daily lives and can serve a variety of useful purposes. "Social media platforms can decide to have a role in mitigating the negative mental health impacts of their products, but it is a challenge to thread this needle. Companies may decide to align on ethical design practices and standards for consumers," states Amy Smith, U.S. well-being leader at Deloitte Services LP. Despite social media platforms' contribution to mental health problems, dismantling them is not a reasonable answer. Rather, a multipronged approach to technology use and health care access is more practical. Increased awareness of mental wellness has sparked discussions about built-in safeguards, but complete and effective solutions have yet to be developed.

In the meantime, the industry has seen a larger volume of investment in health care solutions to improve direct treatment and back-end processes that may improve patient experiences. Smith notes that "emerging MHW technologies are increasingly research-backed, supported by advancements in [artificial intelligence (AI)] and predictive algorithms, which helps develop underlying systems that generate health observations and personalized recommendations. Next-generation electronic health record systems are another notable area of innovation that is improving the patient experience."

Within the MHW industry, health care services and health care technology systems top the list in terms of expansion-stage deal count over the past decade. More specifically, enterprise health care systems, along with clinics and outpatient services, are among the top subsectors by growth rate of deals since 2019, with compound annual growth rates of 11.8 percent and 8.8 percent, respectively.

Clinics and outpatient services are the largest subsector within MHW; more than 20 expansion-stage deals in this subsector closed each year from 2020 through 2024, generating hundreds of millions of dollars in cumulative sums annually. These companies operate facilities for short-term care and procedures, including diagnostic testing and rehabilitation. Brick-and-mortar models incur significant costs but are designed to provide essential, timely, and specialized care outside of traditional hospital settings. Rehabilitation facilities can treat an array of illnesses, most notably substance use disorders (SUDs), which can co-occur with other mental health disorders, such as depression, schizophrenia, and personality disorders.

SUDs take a serious toll on public health, which can be quantified in part by emergency department medical costs of \$13 billion for SUD treatment in 2017, as well as employer-sponsored health insurance payouts totaling \$35.3 billion in 2018. Clinics and outpatient services represent an enormous opportunity to specialize in various treatment focuses and geographical areas. They will most likely continue to drive a large share of private mental health investment given the sheer size of the subsector and the public sector focus on these forms of treatment.

Health care companies navigate a complex landscape that requires rigorous focus on the efficacy of treatments as well as the strict regulatory oversight of prescriptions, patient privacy laws, and negotiations with insurance payers. Expansion-stage MHW companies may incur significant legal costs and must avoid perverse incentives such as overprescribing medications, including controlled substances. Such costs can be planned for in advance with the proper preparation, especially as companies look to reach expansion stages, and can often be navigated in partnership with larger, more experienced backers that can help connect with appropriate service providers.

Despite these challenges, several opportunities exist and will most likely support further expansion of private deal volumes in MHW. A large and growing market for prevention and treatment is attracting new entrants and existing players looking to expand their offerings.

The ability to offer patients increased accessibility has the potential to improve health care outcomes and overall wellness, as well as to address inequities in mental health treatment. Personalization is a growing theme in health care more broadly and within MHW. Several of the industry's active unicorns offer personalized approaches to care and treatment options, indicating investor acknowledgment of opportunities for more flexible models, consumer products, and digital platforms.

The outlook for the MHW industry is bright, with a long runway for growth and several well-positioned unicorns that may drive additional investment into these critical areas of health care by overcoming commercialization challenges. Private dealmakers can gain exposure for their portfolios at relatively low-cost profiles in most cases, reflected in smaller check sizes across the industry. Demand for existing treatments, as well as alternative and frontier methods, provides ample opportunity for companies to meet patient needs. While expansion-stage companies have made it through the most difficult early stages of operations, the overall industry within which they operate remains challenging for even the best-positioned players.

For further discussion of recent health tech investment trends and the emerging demand for MHW services, see the full version of Deloitte's December 2024 report [*Road to Next — Mental Health and Wellness: Dealmakers Respond to Emerging Demand*](#).

Chapter 2 — Capitalized Software

2.1 Introduction

Health tech companies rely on the development of proprietary software to serve their customers and clients. In determining which authoritative guidance to apply to the capitalization of software, a company would consider how it plans to offer its software solutions to its customers. ASC 985-20 provides authoritative guidance on software solutions that are often referred to as “external-use software,” while ASC 350-40 contains authoritative guidance on internal-use software solutions.

Specifically, ASC 985-20 addresses the identification and determination of software development costs that are incurred and whether such costs are related to the development or implementation of “external-use” or “internal-use” software. This guidance indicates that in assessing how to account for these software development costs, an entity should determine whether there is a substantive plan to market the software externally or whether one will be created during the software’s development period. ASC 350-40, which applies to software developed or obtained for internal use, including in providing a service (e.g., software as a service [SaaS]), requires that any plan to market internal-use software be substantive before the entity looks to ASC 985-20 to determine the accounting for the software project.

A substantive plan to market the software externally could include the selection of a marketing channel with identified promotional, delivery, billing, and support activities. To be considered substantive, a plan should be at least reasonably possible to implement. Arrangements providing for the joint development of software for mutual internal use (e.g., cost-sharing arrangements) and routine market feasibility studies are not substantive plans to market software.

ASC 350-40-35-9 states that “[i]f, during the development of internal-use software [subject to ASC 350-40], an entity decides to market the software to others, the entity shall follow the guidance in Subtopic 985-20.” As indicated above, this decision should be supported by a substantive plan before the entity switches to ASC 985-20. Specifically, ASC 350-40-35-9 states that if there is a substantive plan to market the software externally, “[a]mounts previously capitalized under [ASC 350-40] shall be evaluated at each balance sheet date in accordance with paragraph 985-20-35-4.”

Under ASC 350-40-35-7, if an entity markets the software after the development of internal-use software is completed, the proceeds received, “net of direct incremental costs of marketing, such as commissions, software reproduction costs, warranty and service obligations, and installation costs, shall be applied against the carrying amount of that software.” Further, ASC 350-40-35-8 notes that “[n]o profit shall be recognized until aggregate net proceeds from licenses and amortization have reduced the carrying amount of the software to zero. Subsequent proceeds shall be recognized as revenue in accordance with Topic 606 on revenue from contracts with customers or recognized as a gain in accordance with Subtopic 610-20 on derecognition of nonfinancial assets if the contract is not with a customer.”

It is critical for an entity to identify software development costs and determine how they should be accounted for; in doing so, an entity's management must exercise significant judgment. The guidance restricts the recognition of any profit when software whose costs were previously determined to be internal-use is marketed in the future.

2.2 Internal-Use Capitalized Software

In their start-up phase, or even upon maturity, health tech companies are likely to incur significant software-related costs. Many of these software-related costs can be identified as “internal-use.” ASC 350-40-15-2A describes internal-use software as having both of the following characteristics:

- a. The software is acquired, internally developed, or modified solely to meet the entity's internal needs.
- b. During the software's development or modification, no substantive plan exists or is being developed to market the software externally.

ASC 350-40-55-1 and 55-2 address situations in which software is for internal use or not for internal use, respectively. While not all of these examples apply to health tech companies, the full list has been incorporated for completeness.

ASC 350-40

55-1 The following is a list of examples illustrating when computer software is for internal use:

- a. A manufacturing entity purchases robots and customizes the software that the robots use to function. The robots are used in a manufacturing process that results in finished goods.
- b. An entity develops software that helps it improve its cash management, which may allow the entity to earn more revenue.
- c. An entity purchases or develops software to process payroll, accounts payable, and accounts receivable.
- d. An entity purchases software related to the installation of an online system used to keep membership data.
- e. A travel agency purchases a software system to price vacation packages and obtain airfares.
- f. A bank develops software that allows a customer to withdraw cash, inquire about balances, make loan payments, and execute wire transfers.
- g. A mortgage loan servicing entity develops or purchases computer software to enhance the speed of services provided to customers.
- h. A telecommunications entity develops software to run its switches that are necessary for various telephone services such as voice mail and call forwarding.
- i. An entity is in the process of developing an accounts receivable system. The software specifications meet the entity's internal needs and the entity did not have a marketing plan before or during the development of the software. In addition, the entity has not sold any of its internal-use software in the past. Two years after completion of the project, the entity decided to market the product to recoup some or all of its costs.
- j. A broker-dealer entity develops a software database and charges for financial information distributed through the database.
- k. An entity develops software to be used to create components of music videos (for example, the software used to blend and change the faces of models in music videos). The entity then sells the final music videos, which do not contain the software, to another entity.
- l. An entity purchases software to computerize a manual catalog and then sells the manual catalog to the public.
- m. A law firm develops an intranet research tool that allows firm members to locate and search the firm's databases for information relevant to their cases. The system provides users with the ability to print cases, search for related topics, and annotate their personal copies of the database.

ASC 350-40 (continued)

55-2 The following list provides examples of computer software that is not for internal use:

- a. An entity sells software required to operate its products, such as robots, electronic game systems, video cassette recorders, automobiles, voice-mail systems, satellites, and cash registers.
- b. A pharmaceutical entity buys machines and writes all of the software that allows the machines to function. The pharmaceutical entity then sells the machines, which help control the dispensation of medication to patients and help control inventory, to hospitals.
- c. A semiconductor entity develops software embedded in a microcomputer chip used in automobile electronic systems.
- d. An entity purchases software to computerize a manual catalog and then sells the computer version and the related software to the public.
- e. A software entity develops an operating system for sale and for internal use. Though the specifications of the software meet the entity's internal needs, the entity had a marketing plan before the project was complete. In addition, the entity has a history of selling software that it also uses internally and the plan has a reasonable possibility of being implemented.
- f. An entity is developing software for a point-of-sale system. The system is for internal use; however, a marketing plan is being developed concurrently with the software development. The plan has a reasonable possibility of being implemented.
- g. A telecommunications entity purchases computer software to be used in research and development activities.
- h. An entity incurs costs to develop computer software for another entity under a contract with that other entity.

Whether software qualifies as internal-use software is not intended to be a choice entities may make freely; rather, they should carefully evaluate whether the software is within the scope of ASC 350-40. If the software is or will be marketed externally (i.e., marketed to be sold or licensed on an on-premise basis), the costs will be within the scope of ASC 985-20. Therefore, if a substantive plan to market the software externally exists or is being developed during the software development period, regardless of whether the software is also intended to meet an internal need, the costs will be subject to ASC 985-20. To be subject to the guidance in ASC 350-40, the software must be intended solely for internal use. As a reminder, to be considered substantive, a marketing plan needs to be relatively detailed and should take into account, among other matters, marketing channels and promotion, delivery, billing, and support systems. Further, implementation of the plan should be at least reasonably possible. Routine market feasibility studies would not be considered a substantive plan. In many cases, it will be obvious that software is obtained or developed solely to meet an entity's internal needs (e.g., enterprise resource planning [ERP] software purchased from a third-party vendor and used solely by the entity to process business transactions). In other circumstances, entities will need to carefully evaluate how the software is or will be used to determine whether it is subject to ASC 350-40. In addition, the guidance in ASC 350-40 must be applied at the individual component or module level. While there is no specific guidance on what an individual component or module might be, an entity could consider the level of functionality each component or module provides as well as the level of interdependence between the components or modules.

Health tech companies often choose to develop a SaaS solution, offering services to their customers in such a way that customers may not take possession of the underlying solution. Rather, the customer accesses the solution, normally via an online portal. The costs of developing the SaaS solution — including, but not limited to, the formulation of conceptual ideas regarding the identified product need, designing of the solution, specific coding associated with the solution, and testing of the different versions developed — are all considered internal-use capitalized software costs that may be subject to the guidance in ASC 350-40.

An entity may encounter difficulties related to determining whether a hosting arrangement or a SaaS solution that the entity is developing should be considered internal-use or external-use.

ASC 350-40

15-4A The guidance in the General Subsections of this Subtopic applies only to internal-use software that a customer obtains access to in a hosting arrangement if both of the following criteria are met:

- a. The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.
- b. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

15-4B For purposes of the guidance in paragraph 350-40-15-4A(a), the term without significant penalty contains two distinct concepts:

- a. The ability to take delivery of the software without incurring significant cost
- b. The ability to use the software separately without a significant diminution in utility or value.

15-4C Hosting arrangements that do not meet both criteria in paragraph 350-40-15-4A are service contracts and do not constitute a purchase of, or convey a license to, software.

Example 2-1

Company A, a telehealth company, is developing a hosted solution that would enable users to directly connect with a health care provider. Company A does not plan on selling the hosted solution as a software product, and its marketing department is not developing or designing promotional material indicating that A would make such a sale. Furthermore, A's executive leadership has confirmed that it is not reasonably possible that it could sell the hosted solution as a software product. Therefore, A does not have a substantive marketing plan and should account for the costs of the new hosted solution under ASC 350-40.

Example 2-2

Company B offers its office productivity software solution as a SaaS in which its customers have access to the solution through an online portal and store data on B's secure servers. The software will always be maintained at the most up-to-date version available, and customers have rights to online and telephone support. Customers do not have the ability to take possession of the software.

Because customers are not permitted to take possession of the software and may use only B's cloud-based service, B concludes that the costs associated with its office productivity software should be accounted for under ASC 350-40.

The terms of a health tech company's agreements may vary from customer to customer. To appropriately apply the guidance in ASC 350-40-15-4, a company may need to evaluate these differing terms at the individual agreement level. If the hosting arrangement does meet the criteria in this guidance, the software would be considered external-use and would be subject to the guidance in ASC 985-20. That is, if the software is externally marketed or sold as a result of only one agreement that the health tech company has entered into with its customers, the software may be considered external-use.

2.2.1 Capitalization of Internal-Use Software Costs

A health tech company's timeline for developing an internal-use software solution is divided into stages: (1) the preliminary project stage, (2) the application development stage, and (3) the postimplementation stage. It is critical to identify these stages and evaluate their distinct characteristics to determine whether costs are capitalizable and, if so, what types.

2.2.1.1 Preliminary Project Stage

In the preliminary project stage, a health tech company assesses alternatives related to the solution to an issue or problem and evaluates its best options going forward. The ASC master glossary defines the preliminary project stage as follows:

When a computer software project is in the preliminary project stage, entities will likely do the following:

- a. Make strategic decisions to allocate resources between alternative projects at a given point in time. For example, should programmers [for the health tech company] develop a new [patient data tracking] system or direct their efforts toward correcting existing problems in [a previously developed patient data tracking] system?
- b. Determine the performance requirements (that is, what it is that they need the software to do) and systems requirements for the computer software project it has proposed to undertake.
- c. Invite vendors to perform demonstrations of how their software will fulfill an entity's needs.
- d. Explore alternative means of achieving specified performance requirements. For example, should an entity make or buy the software? . . .
- e. Determine that the technology needed to achieve performance requirements exists.
- f. Select a vendor if an entity chooses to obtain software.
- g. Select a consultant to assist in the development or installation of the software.

ASC 350-40

25-1 Internal and external costs incurred during the preliminary project stage shall be expensed as they are incurred.

2.2.1.2 Application Development Stage

Upon selecting the alternative that it is going to use as the solution to its need or problem, a health tech company will begin incurring costs related to developing this solution. The costs incurred during this stage are not related to any research and development (R&D) activities. Rather, they pertain to developing a solution that is expected to work as intended.

ASC 350-40-55-3(b) states that a project in the application development stage may consist of the following processes:

1. Design of chosen path, including software configuration and software interfaces
2. Coding
3. Installation to hardware
4. Testing, including parallel processing phase.

ASC 350-40

25-2 Internal and external costs incurred to develop internal-use computer software during the application development stage shall be capitalized.

ASC 350-40-30-1 outlines the different types of capitalizable costs that could be incurred for software developed or obtained:

- a. External direct costs of materials and services consumed in developing or obtaining internal-use computer software. Examples of those costs include but are not limited to the following:
 - 1. Fees paid to third parties for services provided to develop the software during the application development stage
 - 2. Costs incurred to obtain computer software from third parties
 - 3. Travel expenses incurred by employees in their duties directly associated with developing software.
- b. Payroll and payroll-related costs (for example, costs of employee benefits) for employees who are directly associated with and who devote time to the internal-use computer software project, to the extent of the time spent directly on the project. Examples of employee activities include but are not limited to coding and testing during the application development stage.
- c. Interest costs incurred while developing internal-use computer software. Interest shall be capitalized in accordance with the provisions of Subtopic 835-20.

ASC 350-40-30-2 clarifies that if the health tech company “suspends substantially all activities related to the software developed or obtained for internal use, interest capitalization shall cease until activities are resumed.”

Questions have arisen regarding the inclusion of share-based compensation costs in the payroll and payroll-related costs that the health tech company should capitalize. For example, a health tech company may develop software for internal use. ASC 350-40-30-1(b) requires that payroll and payroll-related costs be capitalized for “employees who are directly associated with and who devote time to the internal-use computer software project.”

Further, paragraph 80 of the Basis for Conclusions of SOP 98-1 states that “AcSEC used SOP 93-7, *Reporting on Advertising Costs* [codified in ASC 340-20], and FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases* [codified in ASC 310-20] as a basis for determining the kinds of costs of computer software developed or obtained for internal use that should be included in amounts reported as assets.” ASC 340-20-30-2 and the definition of “direct loan origination costs” in ASC 310-20-20 address costs that should be capitalized for direct response advertising and loan origination fees, respectively. Both paragraphs state, in part, that the “costs directly related to those activities shall include only that portion of the employees’ total compensation and payroll-related fringe benefits directly related to time spent performing those activities.” Therefore, stock-based compensation plans are part of an employee’s total compensation and payroll-related fringe benefits. Accordingly, costs associated with participants in stock-based compensation plans who work directly on internal-use software development projects should be capitalized to the extent that the capitalization criteria in ASC 350-40 have been met.

Health tech companies may purchase internal-use software from a third party. Such software purchases may include multiple products or elements. ASC 350-40-30-4 states that such elements can include “training for the software, maintenance fees for routine maintenance work to be performed by the third party, data conversion costs, reengineering costs, and rights to future upgrades and enhancements.”

Health tech companies should allocate the cost of the software package among all of the identified individual elements. The allocation should be based on objective evidence of the fair value of the elements in the contract, not necessarily separate prices stated within the contract for each element. The capitalization, or expensing, of such elements to which a portion of the cost incurred is allocated should be based on the nature of the elements, which the health tech company assesses in considering ASC 350-40-30-17.

2.2.1.3 *Postimplementation Stage*

Upon completion of the activities related to developing the health tech company's software solution, costs incurred are identified as part of the postimplementation stage. During this stage, the health tech company will provide training to users of the solution and further maintain the solution by, for example, completing bug fixes.



Connecting the Dots

Health tech company management must use judgment in determining the stage in which the company incurs the types of costs it has identified. Furthermore, the incurrence of costs associated with the health tech company's solution may not be linear. For example, training services could occur during all stages, but the costs of such services are not capitalizable even if the health tech company believes that they are incurred in the application development stage.

2.3 Cloud Computing Arrangements

Many health tech companies rely on service arrangements with cloud computing vendors for multiple functions, including ERP, customer relationship management, and supply chain management, to name a few. Because the expenditures associated with the development and use of such services as part of a cloud computing arrangement (CCA) can be material to a health tech company, such expenditures would need to be considered.

In August 2018, the FASB issued [ASU 2018-15](#), which amends ASC 350-40 to address a customer's accounting for implementation costs incurred in a CCA that is a service contract. ASU 2018-15 aligns the accounting for costs incurred to implement a CCA that is a service arrangement with the guidance on capitalizing costs associated with developing or obtaining internal-use software. Specifically, the ASU amends (1) ASC 350 to include in its scope implementation costs of a CCA that is a service contract and (2) clarifies that a customer should apply ASC 350-40 to determine which implementation costs should be capitalized in a CCA that is considered a service contract.

Capitalized costs associated with a service contract differ in character from costs that are capitalized in connection with developing or obtaining internal-use software. As a result, costs that are capitalized in connection with implementing a CCA are likely to be presented differently (in the recognition both on the balance sheet and in the statement of cash flows and in the subsequent derecognition through the income statement) from costs incurred to develop or acquire internal-use software. Many entities, including health tech companies, are implementing software solutions that combine hosted software in a CCA with owned or licensed (i.e., internal-use) software.

While ASU 2018-15 clarifies what constitutes a "hosting arrangement," it does not modify the scope guidance that differentiates a software license (i.e., internal-use software) from a CCA. That is, under ASC 350-40-15-4A, even if software is being hosted on a third party's platform, an entity will still need to assess the specific circumstances associated with the individual arrangement.

Health tech companies will have to carefully evaluate whether the following criteria in ASC 350-40-15-4A are met:

- a. The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.
- b. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

If both of these criteria are met, the related software is considered internal-use software even if it is being hosted by a third-party vendor or the hosted software is interacting with software that is subject to a CCA (i.e., software that the entity cannot take possession of). If one or both of these criteria are not met, the software is considered part of a hosting arrangement that is a service contract.

ASU 2018-15 aligns a customer's recognition of implementation costs incurred in a CCA with the legacy internal-use software guidance. Such policies have not historically applied to CCA implementation costs; thus, an entity might need to establish new processes for adapting existing accounting policies to address CCA arrangements.



Connecting the Dots

CCA implementation costs incurred during the preliminary project and postimplementation stages are treated differently from those incurred during the application development stage; therefore, an entity should establish processes for distinguishing these costs. In some instances, health tech companies make payments directly to a CCA vendor that will provide both the implementation services and the ongoing cloud computing services under the arrangement with the vendor. Because not all costs incurred during the application development stage can be capitalized, the health tech company will need to determine how best to identify what portion of the fees paid to the CCA service provider must be capitalized and what portion must be expensed as incurred. In such circumstances, an entity typically will be required to identify the activities the service provider is performing that are not eligible for capitalization (e.g., training costs) and allocate the fees paid to the provider to the various activities on the basis of each element's stand-alone selling price (which may not be the contractual price). For some large-scale cloud deployments, implementation costs can be significant (sometimes higher than the cost associated with the CCA service fee), thereby underscoring the importance of appropriately identifying capitalizable implementation costs.

2.3.1 Classifying Capitalized Implementation Costs in a CCA That Is a Service Contract

The model used to determine which costs are capitalized in connection with implementing a hosting arrangement is the same regardless of whether the underlying software qualifies as internal-use or is provided as part of a CCA. However, since there are differences in how the costs are characterized, it will be important for health tech companies to analyze what the costs are related to. This is because capitalized implementation costs related to a CCA that is a service contract are classified and presented differently from capitalized costs associated with developing or obtaining internal-use software. Eligible costs incurred to implement a CCA that is a service contract should be capitalized as a prepaid asset and presented in a company's financial statements in the same line item in the income statement as the hosting service expense (e.g., as an operating expense). Such presentation is consistent with the classification of other service costs and assets related to service contracts. That is, these costs would be capitalized as part of the service contract, and the financial statement presentation of the cash flows, the resulting asset, and the related subsequent expense would be consistent with the ongoing periodic costs of the underlying CCA that is a service contract.

By contrast, any capitalized costs incurred that are associated with developing or obtaining internal-use software become part of the underlying software asset (which is generally considered an intangible asset). As with other intangible assets, the costs incurred to obtain a software asset are generally capital in nature and thus are treated similarly to the costs of acquiring property, plant, and equipment.

2.3.2 Internal-Use Software — Subsequent Measurement

An impairment for an internal-use software product should be recognized and measured in accordance with ASC 360-10. Specifically, the software assets must be grouped at the lowest level at which identifiable cash flows are largely independent of the cash flows of other groups of assets or other internal-use software products. This guidance applies when certain triggering events occur. ASC 350-40-35-1 states that such triggering events include those in which:

- a. Internal-use computer software is not expected to provide substantive service potential.
- b. A significant change occurs in the extent or manner in which the software is used or is expected to be used.
- c. A significant change is made or will be made to the software program.
- d. Costs of developing or modifying internal-use computer software significantly exceed the amount originally expected to develop or modify the software.

Health tech companies should be aware that such triggering events do not include situations in which the software that is developed is no longer in use. In those situations, the company should look to ASC 350-40-35-2, which refers to ASC 360-10-35-47 through 35-49. A health tech company that commits to a plan to abandon a capitalized software asset before the end of its previously estimated useful life should revise depreciation or amortization estimates in accordance with ASC 250-10-45-17 through 45-20 and ASC 250-10-50-4 to reflect the use of the capitalized software asset over its shortened useful life. In such situations, the useful life would usually end on the date the health tech company plans to cease use of the capitalized software asset. Furthermore, ASC 360-10-35-48 notes that “[b]ecause the continued use of a long-lived asset demonstrates the presence of service potential, only in unusual situations would the fair value of a long-lived asset to be abandoned be zero while it is being used. When a long-lived asset ceases to be used, the carrying amount of the asset should equal its salvage value, if any. The salvage value of the asset shall not be reduced to an amount less than zero.” Moreover, ASC 360-10-35-49 indicates that “[a] long-lived asset that has been temporarily idled shall not be accounted for as if [it were] abandoned.”

ASC 350-40-35-3 further clarifies that “[w]hen it is no longer probable that computer software being developed will be completed and placed in service, the asset shall be reported at the lower of the carrying amount or fair value, if any, less costs to sell.” Specifically, this paragraph states that “[t]he rebuttable presumption is that [the uncompleted internal-use] software has a fair value of zero.” In addition, the guidance further provides the following indicators that the internal-use software product “may no longer be expected to be completed and placed [into] service”:

- a. A lack of expenditures budgeted or incurred for the project.
- b. Programming difficulties that cannot be resolved on a timely basis.
- c. Significant cost overruns.
- d. Information has been obtained indicating that the costs of internally developed software will significantly exceed the cost of comparable third-party software or software products, so that management intends to obtain the third-party software or software products instead of completing the internally developed software.

- e. Technologies are introduced in the marketplace, so that management intends to obtain the third-party software or software products instead of completing the internally developed software.
- f. Business segment or unit to which the software relates is unprofitable or has been or will be discontinued.

Health tech companies should continually monitor their software projects to ensure that they have not identified any indicators that the software product may no longer be expected to be completed or placed into service.

2.3.3 Transition Between Internal-Use Software and On-Premise Licensed Software

2.3.3.1 Transition to Licensing Software Externally

After the development of internal-use software, a health tech company may decide to license the software externally on an on-premise basis. If so, the entity must first account for any proceeds received from the license of the software, net of any direct incremental costs (e.g., commissions, reproduction, warranties, and installation), as a reduction of the carrying amount of any costs for that software that were capitalized under ASC 350-40. It cannot recognize profit on the software until it has reduced the carrying amount to zero. When the entity has reduced the carrying amount to zero (including any amortization of the software), it can then recognize subsequent proceeds as revenue under ASC 606 (or a gain under ASC 610-20 if the contract is not with a customer). Any subsequent software development costs for that software product are then subject to ASC 985-20.

If the decision to market the software externally is made during its development, any software costs incurred prospectively are accounted for under ASC 985-20. As indicated above, this decision should be supported by a substantive plan before the entity switches to ASC 985-20. In addition, amortization and impairment assessments should likewise be subject to ASC 985-20.

2.3.3.2 Transition to Providing Software Through a Cloud-Based Arrangement

Because there have been significant shifts over time to migrate software solutions to the cloud, it is common for software entities to sell software on both an on-premise licensed basis and a cloud basis. In those circumstances, any software costs are subject to ASC 985-20.

However, scope questions have arisen in situations in which an entity predominantly sells and provides a software solution through cloud-based arrangements. We believe that as long as there continue to be substantive external sales of on-premise software, the software costs should still be subject to ASC 985-20. Neither ASC 985-20 nor ASC 350-40 provides transition guidance on situations in which an entity no longer has substantive external sales of on-premise software. We think that, in such circumstances, it is reasonable to account for any future software development costs that add functionality that will only be available as part of the cloud-based solution in accordance with ASC 350-40 and to account for the aggregate amount of capitalized software costs for the software prospectively under ASC 350-40 (e.g., amortization and impairment). We believe that a health tech company should use judgment in determining whether there are any substantive external sales of on-premise software.

2.3.4 Hybrid Cloud-Based Software Solutions

Some health tech companies sell hybrid cloud-based software solutions, in which on-premise licensed software is sold with cloud-based software. Often, the on-premise licensed software interacts with the cloud-based software and, in some circumstances, the on-premise licensed software may be significantly integrated, interdependent, or interrelated with the cloud-based software.

In these situations, a health tech company must carefully track its software costs to determine which are (1) subject to ASC 985-20 (because there are substantive sales of on-premise licensed software) or (2) subject to ASC 350-40 (because the software is sold only as a service). Even if the on-premise software is significantly integrated, interdependent, or interrelated with the cloud-based software, it generally would not be appropriate to account for all software costs under ASC 985-20 if the software that is sold only as a service is substantive. Likewise, it generally would not be appropriate to account for all software costs under ASC 350-40 if the software sold on an on-premise licensed basis is substantive.

2.3.5 Cloud-Based (or Hosting) Service Arrangements

A health tech company may obtain internal-use software as part of a cloud-based (or hosting) arrangement with a vendor. ASC 350-40-15-4A states that, in such circumstances, the software costs are subject to ASC 350-40 if both of the following criteria are met:

- a. The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.
- b. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

The entity has entered into a service contract if (1) the health tech company does not have “the contractual right to take possession of the software at any time during the hosting period without significant penalty” or (2) it is not “feasible for the [entity] to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.”¹ In this circumstance, only implementation costs incurred would be subject to ASC 350-40. A health tech company may need to use judgment in determining which costs are related to implementation — “implementation cost” is not a defined term because, as paragraph BC14 of ASU 2018-15 states, “[ASC] 350-40 already has appropriate guidance that entities currently apply in practice.”

2.3.6 Multiple-Element Arrangements

Health tech companies that purchase internal-use software or cloud-based services often purchase multiple elements in the same arrangement (e.g., on-premise software licenses, postcontract customer support [PCS], cloud-based services, and professional services). ASC 350-40-30-4 requires health tech companies to allocate the cost to all individual elements on the basis of their stand-alone prices.

2.4 Agile Software Development

Many health tech companies use an agile software development approach in developing their proprietary software modules. Agile software development is an adaptive approach that emphasizes flexibility, integrated customer involvement, and speed. Agile software development methods are both iterative and incremental; they also feature requirements and solutions that evolve through collaboration between self-organizing, cross-functional teams. For many health tech companies, these cross-functional teams consist of the same team members.

Historically, traditional software development (the “waterfall” method or model) involves planning out an entire project in advance. Before commencing work, the project team understands how all parts of the solution are meant to fit together. Work is then completed over a period of months to years in accordance with an established project plan, and the entire solution is tested and implemented simultaneously.

¹ See ASC 350-40-15-4A through 15-4C.

By contrast, agile software development uses time-bound increments (“sprints”) for planning and execution. Although there is typically a goal in mind, there is usually no large-scale, established project plan as there is in a waterfall model. Rather, teams plan smaller-scale development goals, work for two to three weeks, evaluate progress, recalibrate, and repeat. Typically, a product is delivered at the end of each sprint, but the goal or destination may change many times over the course of the project as a result of lessons learned. By placing time constraints on each sprint, teams are able to identify and address issues in a timelier manner and continually adapt plans to better meet the overall goal.

Using an agile development approach may have an impact on the finance and accounting functions for health tech companies. In many organizations’ finance funding models, annual budgeting is used as a key planning mechanism. Software development costs might be estimated for the following fiscal year on the basis of the large projects to be completed. As health tech companies move into agile development processes, these budgeting techniques may no longer be applicable given the iterative and incremental methods employed.

Agile development approaches can also affect how organizations determine which costs related to the development of internal-use software should be capitalized or deferred. In applying the accounting guidance on identifying and classifying the capitalizable costs incurred in agile software development, an entity may need to use significant judgment and keep diligent records of the nature of the costs incurred. As mentioned above, this is because internal-use software costs incurred by a health tech company should be capitalized only during the application development stage of an implementation project. However, agile development activities tend to move through the preliminary-project, application development, and postimplementation-operation stages of development so quickly or even simultaneously that the identification of costs specific to application development may be difficult. Inappropriate application of accounting guidance or insufficient records regarding the timing and nature of development activities can lead to incorrect accounting for these costs (e.g., failure to capitalize all appropriate costs).

As mentioned above, when developing internal-use software and implementing CCAs, health tech companies have to establish processes to distinguish implementation costs incurred during the preliminary-project and postimplementation-operation stages from those incurred during the application development stage. This is because costs incurred during the preliminary-project and postimplementation-operation stages must be expensed as incurred while certain costs incurred during the application development stage must be capitalized or deferred.

Because most of the guidance relevant to the accounting for technology development, implementation, and acquisition was issued more than 20 years ago, it is likely that many health tech companies have accounting policies in place to address it. This guidance is easiest to apply when there are detailed project plans and milestones that might have been common in traditional large-scale software development projects in which the waterfall method was used. However, agile development environments are established to eliminate these structural barriers and foster real-time development and testing and therefore may present certain challenges for entities to overcome in complying with the accounting requirements. A few such challenges are outlined below.

2.4.1 Cost Tracking in an Agile Software Development Environment

All costs incurred by a health tech company in agile software development will need to be carefully tracked to ensure accurate accounting records. These costs include, but are not limited to, payroll and payroll-related costs, fees paid to third-party service providers, costs incurred to obtain inputs from third parties (e.g., the purchase of on-premise term-based or perpetual software licenses), and travel expenses incurred by employees that are directly related to their work in software development.

Entities will need not only to appropriately track costs incurred but also to categorize these costs into the specific development stage in accordance with the accounting guidance. Because stages of development are typically not clearly defined in agile development environments, users will need to determine the appropriate unit of account so that they can assess the achievement of accounting and reporting milestones. Is the completion of a sprint an indication of a key milestone? A group of sprints? An overarching program goal? This is an important area of judgment given that each unit of account will independently move through the phases of development.

Example 2-3

Entity A uses agile software development throughout its software development department to quickly meet the needs of its customers. Under the agile software development model, development of features is divided into sprints in which new features and functions are individually developed, tested, and deployed. Once the features are deemed ready for use, they are incorporated into the overall solution. On the basis of this model, A has determined that, for the development of simple features, each individual sprint is a unit of account to be evaluated against the relevant accounting standards for capitalization given that each sprint moves through the key milestones laid out by U.S. GAAP. Within each sprint, management has determined, on the basis of detailed time and cost tracking, that 20 percent of time and expense is related to planning, 60 percent is related to true application development on upgrades and enhancements, and the remaining 20 percent is related to maintenance within the overall sprint. Therefore, management capitalizes 60 percent of the costs incurred and expenses 40 percent.

Entity A has determined that for the development of more complex features, multiple sprints will be used. Each sprint will develop and test a specific element of a given feature. Once all elements are tested and ready for use, they will be deployed simultaneously into the overall solution. In this case, A has determined that the group of interconnected sprints is the unit of account for accounting purposes. This is because the functionality created by each sprint is interdependent, and the intended functionality would not be available until all of the interconnected sprints were complete. Management must therefore perform an analysis for the interconnected group of sprints to determine the costs associated with each stage of development and thus the appropriate accounting for these costs. This may prove challenging because each of the sprints may be at a different stage of development.

Health tech companies adopting agile development methods should consider which unit of account is appropriate for their development process. Because each agile development milestone may be different (e.g., composed of different sprints with different complexities), entities will need to have policies in place to evaluate each effort to determine the appropriate unit of account and to identify the stages of development for each unit.

2.4.2 Amortization in an Agile Software Development Environment

In accordance with U.S. GAAP, the assets established upon capitalization of technology development costs must be amortized. Entities should begin amortization of the capitalized or deferred costs once the developed technology is ready for its intended use, which occurs after substantial testing is complete. If the functionality of one module (or sprint) depends on the functionality of another, amortization will begin when both are ready for their intended use. Agile development adds complexities given its iterative nature. There may be multiple units of account used in the determination of which costs to capitalize, and interdependencies among sprints must be considered. Further, there could be different amortization periods for the same technology development project given that the project may be divided into multiple sprints, each of which has been determined to be a separate unit of account. This could result in additional complexities in tracking the various amortization schedules specific to each unit of account within the same technology development project.

2.4.3 Impairment and Abandonment in an Agile Software Development Environment

Identification of the appropriate unit of account is also particularly important to the application of the accounting guidance on the impairment or abandonment of capitalized or deferred costs. Specifically, ASC 350-40-35-1 requires that “assets” be assessed for impairment when “events or changes in circumstances [occur] related to computer software being developed or currently in use [that indicate] that the carrying amount may not be recoverable.” Regarding abandonment, ASC 350-40-35-3 requires that “[w]hen it is no longer probable that computer software being developed will be completed and placed in service, the asset shall be reported at the lower of the carrying amount or fair value, if any, less costs to sell.” Impairment and abandonment events may be more common in agile development methods given that each sprint is used as an opportunity to evaluate progress and potentially recalibrate or pivot. Therefore, the identification of the unit of account related to capitalizing or deferring costs is a critical judgment that could affect whether and to what extent an entity recognizes impairment or abandonment charges (e.g., at the end of a sprint determined to be its own unit of account that was unsuccessful). In addition, impairment or abandonment charges could exist if a sprint replaces existing technology and causes previously capitalized software to become obsolete because it is no longer in use.

2.5 Software to Be Sold or Marketed

Instead of developing a solution that will provide a service to its customers, a health tech company may wish to market or sell its software solution, depending on what its go-to-market strategy is. Such software solutions are commonly referred to as external-use software and could be in the form of an on-premise perpetual license; a term (or subscription) license; or a SaaS solution that meets the criteria in ASC 350-40-15-4A, as discussed in [Section 2.3](#).

Rather than prescribing distinct phases like the guidance on internal-use software, ASC 985-20 identifies technological feasibility as the moment in which costs incurred by a health tech company can be capitalized.

ASC 985-20

25-1 All costs incurred to establish the technological feasibility of a computer software product to be sold, leased, or otherwise marketed are research and development costs. Those costs shall be charged to expense when incurred as required by Subtopic 730-10.

ASC 985-20 (continued)

25-2 For purposes of this Subtopic, the technological feasibility of a computer software product is established when the entity has completed all planning, designing, coding, and testing activities that are necessary to establish that the product can be produced to meet its design specifications including functions, features, and technical performance requirements. At a minimum, the entity shall have performed the activities in either (a) or (b) as evidence that technological feasibility has been established:

- a. If the process of creating the computer software product includes a detail program design, all of the following:
 1. The product design and the detail program design have been completed, and the entity has established that the necessary skills, hardware, and software technology are available to the entity to produce the product.
 2. The completeness of the detail program design and its consistency with the product design have been confirmed by documenting and tracing the detail program design to product specifications.
 3. The detail program design has been reviewed for high-risk development issues (for example, novel, unique, unproven functions and features or technological innovations), and any uncertainties related to identified high-risk development issues have been resolved through coding and testing.
- b. If the process of creating the computer software product does not include a detail program design with the features identified in (a), both of the following:
 1. A product design and a working model of the software product have been completed.
 2. The completeness of the working model and its consistency with the product design have been confirmed by testing.

In accordance with ASC 985-20-25-2, a health tech company must meet specific documentation requirements to establish technological feasibility, which is a strict point in time. Specifically, the company must complete the (1) product design and (2) detail program design. Upon meeting these requirements, the health tech company would establish technological feasibility, which generally occurs much later in the development life cycle of the external-use software product than it does for internal-use software, resulting in a smaller amount of costs incurred that are eligible for capitalization under the guidance on external-use software guidance than under the guidance on internal-use software.

Technological feasibility can be known before the point required in ASC 985-20-25-2 — for example, when the software product being developed uses only technology that has previously been used successfully or is not significantly different from existing products. However, before technological feasibility can be established, a health tech company must complete a detail program design (see ASC 985-20-25-2(a)) or, in its absence, a working model (see ASC 985-20-25-2(b)). This requirement is analogous to the requirement under ASC 730-10 to have a prototype before R&D activities can be considered complete.

While technological feasibility can be known before the requirements of ASC 985-20-25-2 are met, establishing technological feasibility can be difficult for many health tech companies, including start-ups that are developing their own software solution platforms, because of the specific documentation requirements for product design and detail program design.

The ASC master glossary defines a product design as a “logical representation of all product functions in sufficient detail to serve as product specifications.” Normally, the product design will be prepared in writing before programming and will contain a description of the product specifications, including the following:

- Type of product.
- Objectives of the product.
- General inputs.
- General outputs.
- Major processes or data transformation definitions.
- Data storage and data structure requirements.
- General data flow and interaction with transforming processes.
- General definitions of software control facilities such as processing activity journals, approval checkpoints, and audit trails.

A detail program design is defined as the “detail design of a computer software product that takes product function, feature, and technical requirements to their most detailed, logical form and is ready for coding.” Generally, the detail program design will include narratives and flowcharts addressing the following:

- Description of logic.
- File layout.
- Report definitions.
- Field definitions.
- Algorithms.
- Special routines.
- Specific arrays of data.

The detail program design is often developed and prepared by a systems analyst and reviewed by a senior analyst before coding. In these instances, it should be relatively straightforward to determine whether a detail program design exists. However, in practice, many software development projects are carried out in relatively unstructured environments in which documentation of a product design and a detail program design may not be sufficiently detailed or may not exist at all.

ASC 985-20 requires that the detail program design be consistent with the product design and that it be confirmed by documenting and tracing the detail program design to the product specifications. Accordingly, before capitalization of software costs is permitted, a certain level of documentation is necessary. The actual level of documentation may depend on the software product being developed. Extensive documentation may not be required for minor product enhancements, which will most likely not include all the elements listed above. On the other hand, a more detailed formal program design may be required for new products. The detail program design may be prepared separately or as part of the product design.

In view of the guidance in ASC 985-20, health tech company management is encouraged to create common documentation requirements for the company's software engineers. Doing so could make it easier to identify when the health tech company has a product design and detail program design.

Once a health tech company establishes technological feasibility for its software to be sold, leased, or marketed, it can begin capitalizing costs incurred specifically for those costs incurred associated with coding and testing that are performed after that point. In addition, the health tech company should capitalize costs incurred that are associated with producing product masters. If the software being developed is an integral part of a product package or process, costs associated with the software cannot be capitalized until (1) technological feasibility is established for all portions of the product package or process and (2) all R&D activities for the other portions of the product package or process have been completed (see ASC 350-20-25-4).

Upon completion of the software development process, the health tech company's software product or process will be available for general release. At this point in the development process, capitalization of any additional software-related costs must cease.

The example below describes a situation in which a group of products is not considered to be available for general release even though the group of products has been sold to a few customers for their basic research and study.

Example 2-4

Company D has developed software that monitors analytical data related to practitioner billings to patients. The software helps lower outstanding patient billings and increase collections. Company D has sold two licenses of the software. The customers purchased the software to determine whether there are alternative uses for the technology. After the sale of the two licenses, D incurred certain costs to modify the software for sales to other customers.

ASC 985-20-25-6 precludes cost deferral on a product after it is available for general release to customers. In this scenario, the sale of licenses to the original two customers would not preclude capitalization of the modification costs incurred after that sale.

The license product would not be considered to be available for general release to the other customers because (1) the original two customers will be using the licenses for research and study and this use differs from the design goals for the license and (2) D is still preparing the license for sales to other customers. Therefore, in this example, capitalization would not be precluded under ASC 985-20-25-6. Company D should determine whether the modification costs represent production costs, product enhancements, or maintenance and should account for them accordingly.

The example below illustrates a situation in which capitalization would be precluded because the group of products would be considered available for general release.

Example 2-5

Assume the same facts as in the example above except that, immediately after the sale of the two licenses, Company D also sells a license to a large health care provider that uses the software to monitor its patient billings and collections. After the sale of the license to the health care provider, D continues to incur certain costs to modify the license.

Under these circumstances, if the modification costs are production costs rather than either product enhancements or maintenance, ASC 985-20-25-6 will preclude capitalization of the costs because the product should be considered available for general release to customers. Company D has sold the product in its current state to a customer and that customer is using the license in accordance with its design goals. Therefore, the license is available for general release to D's customers.

However, if the modification costs represent product enhancements, D may capitalize these costs once its technological feasibility has been established. On the other hand, costs representing maintenance should be expensed when the related revenue is recognized or as incurred, whichever occurs first.

As indicated by these different situations, the determination of when certain costs are modification or production costs rather than enhancements or maintenance-related costs (such as bug fixes that do not constitute significant alterations to the operations of the software) depends on the facts and circumstances. Health tech companies will need to use judgment in determining the nature of costs being incurred and whether such costs should be expensed as incurred or capitalized.

2.5.1 External-Use Software — Subsequent Measurement

Unlike ASC 360-20, which contains considerations related to internal-use software, ASC 985-20-35 includes specific guidance on the appropriate amortization of software-related costs that have been capitalized.

ASC 985-20-35-1 notes that software costs should be amortized on a product-by-product basis. Multiple products for which technological feasibility may have been established at the same time should still be amortized separately. ASC 985-20-35-1 indicates that this is because the amortization costs incurred in connection with the health tech company's different software costs should be the greater of:

- a. The ratio that current gross revenues for a product bear to the total of current and anticipated future gross revenues for that product
- b. The straight-line method over the remaining estimated economic life of the product including the period being reported on.

Health tech companies should ensure that they have the forecasting abilities to appropriately calculate the amount of amortization that should be recognized for a reporting period.

2.6 Other Guidance to Consider

Software-related costs may be subject to U.S. GAAP other than ASC 985-20 or ASC 350-40. The discussion below describes other guidance that may apply to such costs.

2.6.1 Web Site Development Costs

Health tech companies may incur Web site development costs, which are subject to ASC 350-50. The guidance is similar to that in ASC 350-40. For example, under ASC 350-50-25-6, if software for a Web site is purchased or developed for an entity's internal needs, costs incurred for (1) purchased software tools or (2) internally developed software tools during the application development stage are generally capitalized. In addition, certain software acquired or developed for internal use related to Web site operation or graphics is directly within the scope of ASC 350-40.

While ASC 350-50 refers to Web site content, it does not address the accounting for such content. Therefore, Web site content is accounted for under other U.S. GAAP. For example, if an entity is a licensee in the record and music industry and relicenses music content, it would apply the guidance in ASC 928-340.

2.6.2 Software Used for R&D Activities

If the software a health tech company uses in R&D activities does not have alternative future uses, it is subject to ASC 730-10. In addition, the following software costs are accounted for as R&D costs:

- For software subject to ASC 985-20, all costs incurred before the establishment of technological feasibility.
- For software subject to ASC 350-40, all costs for pilot projects (i.e., “[d]esign, construction, and operation of a pilot [project] that is not of a scale economically feasible to the entity for commercial production”).
- For software subject to ASC 350-40, all costs associated with a particular R&D project, “regardless of whether the software has alternative future uses.”

Software associated with R&D assets may be acquired in a business combination. If the software will be used for R&D activities, it is subject to the guidance in ASC 805-20 and ASC 350-30. In accordance with ASC 805-20, such software is recognized as an asset and measured at fair value.

2.6.3 Significant Production, Modification, or Customization of Software

Software sold to customers in arrangements that require significant production, modification, or customization is accounted for under ASC 606. If the software is being produced, modified, or customized for a specific customer contract, the costs for such software represent fulfillment costs that are subject to ASC 340-40.

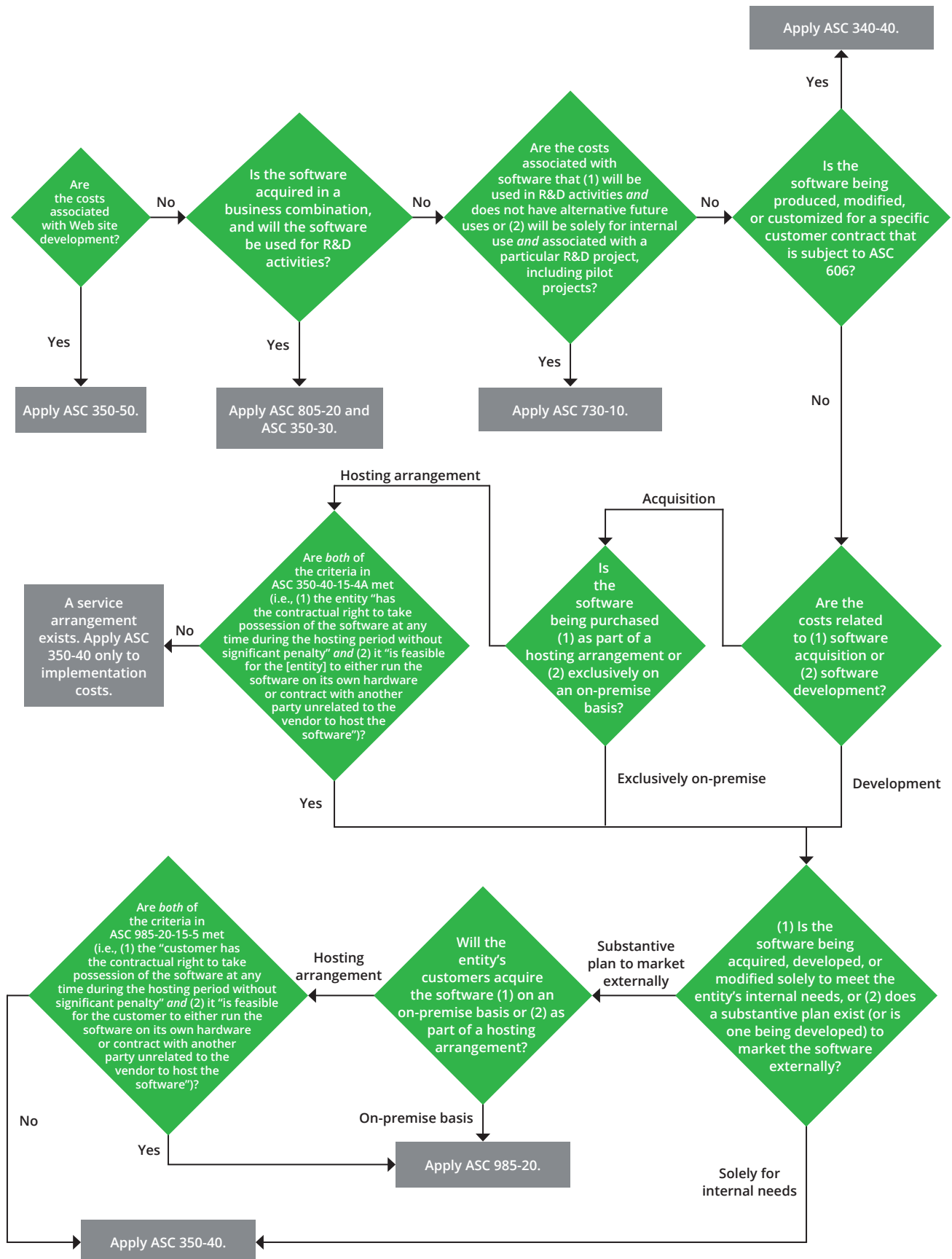
2.6.4 Business Process Reengineering Activities

A health tech company may incur costs associated with business process reengineering activities as part of developing software or implementing cloud-based solutions. Those costs are subject to ASC 720-45 and are expensed as incurred.

2.7 Importance of Ongoing Reassessment of Software Costs

As described above, there are various ways in which a health tech company's evolving business models may affect which guidance applies to the accounting for costs to develop or acquire software. These include changes in how health tech companies are (1) developing or acquiring software solutions from their vendors for internal use and (2) marketing and delivering software solutions to their customers. In the rapidly evolving technology ecosystem, it is important for a health tech company to have sufficient internal controls in place to periodically reassess and document how these changes in facts and circumstances may affect the guidance the entity should apply and the related accounting.

The flowchart below illustrates how an entity determines the appropriate guidance to apply to software and software-related costs.



2.8 Accounting for Generative AI Software Applications Used as Internal-Use Software

2.8.1 Overview

More and more companies are considering purchasing or developing software that uses or leverages AI to enhance internal productivity or are incorporating generative AI into their revenue-generating products. In internal communication and support, AI-powered chatbots and virtual research assistants are streamlining communication and providing instant access to information, freeing up human resources for more complex tasks. Operational efficiency is also being improved through automation of documents and enhanced management systems, among other innovations.

Although developing or enhancing generative AI applications may involve more traditional software development costs (e.g., internal or external labor), some generative AI developments may be more advanced and may incur additional costs. For example, large amounts of data are typically necessary to train generative AI applications. Businesses that invest in generative AI will need to consider the accounting impacts of the software or software-related costs associated with generative AI.

The software costs incurred for generative AI could include fees paid to use third-party foundation models or large language models (LLMs) as well as fine-tuning and other training costs. Entities developing generative AI applications will need to consider whether the developed software will be used internally or whether it will be sold as a hosting arrangement, an on-premise software license, or a hybrid software offering.

The sections below focus on the development of generative AI applications for internal use and how costs related to generative AI should be evaluated under ASC 350-40. For a discussion of accounting considerations related to generative AI technology that is sold or marketed externally, see Deloitte's October 7, 2024, [Technology Spotlight](#).

2.8.2 Background

Generative AI is a subset of AI that focuses on the ability of machines to take in inputs (e.g., text, images) and create outputs in various formats (e.g., text, images, audio, code, voice, video). Generative AI applications serve as interfaces for end users. These applications are powered by significant infrastructure (e.g., cloud-based AI foundation models or LLMs) and generate content on the basis of how the underlying models were trained as well as the end user's inputs. Foundation models typically use neural networks to learn patterns from huge amounts of data and predict outcomes on the basis of historical data patterns. Like traditional AI, foundation models predict outputs by making inferences related to the inputs they receive. However, through fine-tuning, prompt engineering, and adversarial training (discussed further below), these models produce outputs on the basis of their understanding of human-generated inputs.

2.8.2.1 Generative AI Foundation Model

Generative AI applications are powered by foundation models, LLMs that use deep learning to process huge amounts of data. A foundation model can perform a wide range of tasks in natural language processing (NLP), a subfield of AI that enables computers to interpret input prompts and generate outputs such as text, translation, summarization, and answers to questions. With a foundation model, the software can predict outputs on the basis of statistical inferences it makes from the inputs received. The quality, accuracy, and relevancy of a generative AI application's outputs depend on the training the underlying foundation model receives.

Generative AI applications interact with and rely on a foundation model to generate outputs on the basis of user prompts. The dependency of AI applications on foundation models can be thought of as similar to the reliance of traditional software applications on operating systems. As a large-scale, pretrained language model, a foundation model serves as an engine that software developers train and calibrate for specific scenarios when creating their own generative AI applications. Because of the complexity of foundation models, the development of this technology is expected to be labor- and resource-intensive. Therefore, a limited number of companies have developed foundation models, and we expect most generative AI application developers to leverage existing foundation models in their applications rather than create their own.

2.8.2.2 **Generative AI Applications**

Generative AI applications often require further training of the relevant foundation models (the foundational models leveraged by the applications) through various methods, each associated with specific costs:

- *Fine-tuning* — Using specific data to train the foundation model to create outputs for a subset of prompts beyond the existing scenarios for which the model was trained. For example, a company that is creating a generative AI application to produce medical diagnoses for a user's symptoms may need to fine-tune the foundation model by acquiring information from medical encyclopedias, patient data, online databases of research articles, and scientific publications. An entity would expect to incur data acquisition and labor costs related to fine-tuning. In addition, because of the amount of data needed, entities may need to purchase specific hardware (e.g., computers with powerful CPUs, GPUs, or RAM) or platform or infrastructure services from third parties (i.e., cloud services) that offer the same computational scalability as well as incur significant storage costs.
- *Prompt engineering* — Creating or adjusting the prompt to communicate with the foundation model to output an optimal answer. A company could incur specific internal or external software development costs in creating the prompt.
- *Adversarial training* — Pitting two different deep-learning models against each other to train both models. In this approach, one model, the generator, creates synthetic data samples while the other model, the discriminator, receives synthetic data samples and real data samples. The generator's objective is to produce samples that are indistinguishable from real data, while the discriminator's goal is to become better at distinguishing between real and generated data. An entity would expect to incur data acquisition, software development, and other labor costs related to adversarial training.

In addition to the data and training costs, an entity may also incur traditional software development costs (e.g., costs related to developing the software application user interface, infrastructure, graphics, and content) when creating a generative AI application. These costs may also be subject to capitalization or expense under ASC 985-20, ASC 350-40, or other U.S. GAAP.

2.8.3 **Accounting Considerations Related to Generative AI Development Costs**

Because generative AI is essentially a form of software, we believe that general software development accounting considerations apply to generative AI costs, including whether the related project will be used for internal purposes (including being sold as a service) or sold or marketed externally. However, the discussions below focus on generative AI software used as internal-use software.

2.8.3.1 *Generative AI Software Used as Internal-Use Software*

Although the development of foundation models marked a crucial milestone in NLP and AI research, there was initially significant uncertainty about whether this technology would meet its specified performance requirements. Development risks affect whether costs incurred to develop software can be capitalized. Entities developing AI software for internal use would consider applying the capitalization guidance in ASC 350-40 on internal-use software. ASC 350-40-15-2A states the following:

ASC 350-40

15-2A Internal-use software has both of the following characteristics:

- a. The software is acquired, internally developed, or modified solely to meet the entity's internal needs.
- b. During the software's development or modification, no substantive plan exists or is being developed to market the software externally.

When AI software is developed for internal use, a significant portion of the software development costs may be incurred during the preliminary project stage. ASC 350-40 does not require the establishment of technological feasibility² for capitalization but does have other requirements for capitalization depending on the stage of development. Generally, development costs incurred during the application development stage are capitalized, while costs incurred during the preliminary project stage and postimplementation-operation stage are expensed as incurred.

The following are some indicators of when an entity is in the preliminary project stage and when costs should therefore be expensed as incurred in accordance with ASC 350-40:

- The entity is considering allocating resources (i.e., developers, financial budget) between different projects (e.g., different AI applications or other software projects).
- The entity is still determining the performance requirements for the AI application or the infrastructure requirements necessary for the application to operate.
- The entity is holding ongoing conversations with vendors (e.g., foundation model vendors, hardware vendors, cloud computing vendors) to determine which products are best aligned with the entity's software performance requirements.
- The entity is still exploring alternatives related to achieving the performance requirements identified (i.e., using internal software developers to train foundation models versus hiring third-party consultants).
- The entity is determining whether there is an existing technology for developing a specific generative AI application to meet the identified performance requirements.

The preliminary project phases for many AI applications and software projects may be longer than those for other software development projects given the use of new and advanced technologies as well as the emergence of high-risk development issues that could affect the successful completion of the project.

Once the preliminary project stage is complete and the application development stage commences, entities developing AI applications will need to identify and capitalize the direct internal and external costs incurred to develop the AI application. As AI applications are being developed, entities will need to carefully track internal and external costs to ensure that they are appropriately deferred or capitalized in accordance with the guidance in ASC 350-40. In addition, the development and implementation of AI

² ASC 350-40 stipulates that to proceed from the preliminary project stage to the application development stage, a company would have to determine that the technology it needs to meet the performance requirements exists.

applications may involve new activities (e.g., training) performed by employees who have not historically tracked time spent on developing software. In such circumstances, entities may need to create new processes and controls to track these costs accurately.

2.8.3.2 *Generative AI Software Acquired as a CCA*

Rather than develop AI software for internal use, an entity may engage with a third party to develop an AI solution that will be accessed as part of a CCA. In such circumstances, the AI software will only be accessed as part of a hosting arrangement. The ASC master glossary defines a hosting arrangement as follows:

In connection with accessing and using software products, an arrangement in which the customer of the software does not currently have possession of the software; rather, the customer accesses and uses the software on an as-needed basis.

Under ASC 350-40, costs incurred to implement a hosting arrangement that is a service contract would be subject to the same recognition and measurement guidance as costs incurred to develop or acquire internal-use software. However, any costs deferred in accordance with this guidance would be presented in the same manner as any prepayments made for the underlying service.

2.8.3.3 *Data Acquisition Costs*

As noted above, entities developing AI applications may need significant amounts of data to train the models. Entities will need to consider whether the costs of acquiring the data should be (1) expensed as incurred, (2) recognized as a separate intangible asset, or (3) considered for capitalization as part of the AI application.

Costs incurred to acquire data from a third party should be evaluated to determine whether it is appropriate to capitalize the costs as a separate intangible asset. The guidance in ASC 350-30 would apply to data that are acquired individually or as a group of other assets (that do not constitute a business) and that have an alternative use (i.e., in more than one software project). ASC 350-30-25-1 states that “[a]n intangible asset that is acquired either individually or with a group of other assets shall be recognized.” Further, ASC 350-30-25-4³ states the following regarding the acquisition of intangible assets:

ASC 350-30

25-4 Intangible assets that are acquired individually or with a group of assets in a transaction other than a business combination or an acquisition by a not-for-profit entity may meet asset recognition criteria in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, even though they do not meet either the contractual-legal criterion or the separability criterion (for example, specially-trained employees or a unique manufacturing process related to an acquired manufacturing plant). Such transactions commonly are bargained exchange transactions that are conducted at arm’s length, which provides reliable evidence about the existence and fair value of those assets. Thus, those assets shall be recognized as intangible assets.

³ The amendments in [ASU 2023-05](#) — which are effective prospectively for all joint venture formations with a formation date on or after January 1, 2025 — add to the exclusions in ASC 350-30-25-4 intangible assets acquired individually or with a group of assets in a joint venture upon formation. In addition, the amendments in [ASU 2024-02](#) — which are effective for fiscal years beginning after December 15, 2024, for public business entities and fiscal years beginning after December 15, 2025, for all other entities — remove all Concepts Statement references from the Codification, including the reference to [FASB Concepts Statement 5](#) in ASC 350-30-25-4. We do not believe that the removal of the reference to Concepts Statement 5 from ASC 350-30-25-4 will affect the application of the guidance in this paragraph to data acquisition costs.

ASC 350-30 (continued)**Pending Content (Transition Guidance: ASC 805-60-65-1)**

25-4 Intangible assets that are acquired individually or with a group of assets in a transaction other than a business combination, an acquisition by a not-for-profit entity, or a joint venture upon formation may meet asset recognition criteria in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, even though they do not meet either the contractual-legal criterion or the separability criterion (for example, specially-trained employees or a unique manufacturing process related to an acquired manufacturing plant). Such transactions commonly are bargained exchange transactions that are conducted at arm's length, which provides reliable evidence about the existence and fair value of those assets. Thus, those assets shall be recognized as intangible assets.

Pending Content (Transition Guidance: ASC 105-10-65-9)

25-4 Intangible assets that are acquired individually or with a group of assets in a transaction other than a business combination, an acquisition by a not-for-profit entity, or a joint venture upon formation may qualify for recognition even though they do not meet either the contractual-legal criterion or the separability criterion for being an identifiable asset (for example, specially-trained employees or a unique manufacturing process related to an acquired manufacturing plant). Such transactions commonly are bargained exchange transactions that are conducted at arm's length, which provides reliable evidence about the existence and fair value of those assets. Thus, those assets shall be recognized as intangible assets.

Acquired data will lack physical substance and will most likely be acquired as part of a contract that defines the rights controlled by the entity. In these cases, the acquired data are likely to meet the definition of an asset (because the data are separately identifiable and provide an entity with a present right to future economic benefits) and could be recognized separately as an intangible asset. Entities would need to determine the useful life of the acquired data and perform an impairment assessment in accordance with ASC 350.

**Connecting the Dots**

The existing guidance in ASC 350-30-25-4 refers to the asset recognition criteria in [FASB Concepts Statement 5](#). However, as noted in footnote 3, ASU 2024-02 removes the references to the Concepts Statements throughout the Codification. Further, the definition of an asset in FASB Concepts Statement 5 was amended by FASB Concepts Statement 8. The definition of an asset in paragraph E17 of [FASB Concepts Statement 8, Chapter 4](#), is as follows:

An asset has the following two essential characteristics:

- a. It is a present right.
- b. The right is to an economic benefit.

A present right of an entity to an economic benefit entitles the entity to obtain this benefit from the right and to restrict others' access to it. We believe that rights to data acquired from a third party would generally meet the definition of an asset. Further, while there are differences in the definition of an asset under the two Concepts Statements, the differences are not expected to significantly change what does and what does not represent an asset. Accordingly, we believe that rights to data acquired from a third party would generally meet either definition of an asset.

Although costs incurred to acquire data from a third party would generally be capitalizable as an intangible asset, data acquisition costs would be expensed as incurred under ASC 730-10 if the data will be used in R&D activities and do not have alternative future uses.⁴ This is because costs incurred to develop technological feasibility are considered R&D activities within the scope of ASC 730-10. ASC 730-10-25-2 states, in part:

Elements of costs shall be identified with research and development activities as follows (see Subtopic 350-50 for guidance related to website development): . . .

- c. Intangible assets purchased from others. The costs of intangible assets that are purchased from others for use in research and development activities and that have alternative future uses (in research and development projects or otherwise) shall be accounted for in accordance with Topic 350. The amortization of those intangible assets used in research and development activities is a research and development cost. **However, the costs of intangibles that are purchased from others for a particular research and development project and that have no alternative future uses (in other research and development projects or otherwise) and therefore no separate economic values are research and development costs at the time the costs are incurred.** [Emphasis added]



Connecting the Dots

ASC 350-40-15-7 refers to the inclusion of costs of internal-use computer software that will be used in R&D activities as being within the scope of ASC 730-10. Therefore, when developing software for use in R&D activities, an entity should expense all costs incurred during all phases of software development as incurred. As stated in ASC 730-10-25-4, (1) costs incurred during all phases of development are considered R&D costs and (2) the alternative future use test, which applies only to intangibles purchased from others, does not apply to internally developed software.

Data may also be acquired for a specific software project that is being developed for internal use and does not have an alternative future use (e.g., other software projects). In this case, rather than being a separate intangible asset, the data costs may be direct external costs incurred to develop internal-use software within the scope of ASC 350-40. Specifically, an entity could purchase data to train generative AI applications, resulting in the creation of new functionalities. If the AI software project is in the application development stage, it may be appropriate to capitalize the data acquisition costs as direct costs incurred during that phase. Alternatively, as discussed further below, if the data and resulting training were only necessary to maintain the existing features or functionality of the generative AI application, capitalization would not be appropriate because the costs would be akin to maintenance costs. Further, any costs incurred in the preliminary project phase of development should be expensed as incurred.

If acquired data have an alternative future use (as discussed above) and are separately recorded as an intangible asset in accordance with ASC 350-30, we do not believe that the subsequent amortization of the intangible asset would be included as a cost eligible for capitalization under the internal-use software guidance. In such circumstances, the subsequent amortization would not be considered a direct cost incurred during the application development stage and would therefore not be within the scope of ASC 350-40.⁵

⁴ The term “alternative future use” is not defined in U.S. GAAP. However, Section 3.14 of the AICPA Accounting and Valuation Guide [Assets Acquired to Be Used in Research and Development Activities](#) states, “For an asset acquired in an asset acquisition for use in R&D activities to have an alternative future use, the task force believes that (a) it is reasonably expected that the reporting entity will use the asset acquired in the alternative manner and anticipates economic benefit from that alternative use, and (b) the reporting entity’s use of the asset acquired is not contingent on further development of the asset subsequent to the acquisition date (that is, the asset can be used in the alternative manner in the condition in which it existed at the acquisition date)” (footnote omitted).

⁵ ASC 350-40-30-1 states that the only internal-use software costs that would be capitalized include (1) “[e]xternal direct costs of materials and services consumed in developing or obtaining internal-use computer software,” (b) “[p]ayroll and payroll-related costs . . . for employees who are directly associated with and who devote time to the internal-use computer software project, to the extent of the time spent directly on the project,” and (3) “[i]nterest costs incurred while developing internal-use computer software.”

2.8.3.4 Upgrades and Enhancements

After the initial release of their generative AI software, entities will most likely improve the functionality of their application through additional software development and fine-tuning. An entity that develops AI software for internal use should consider whether incurring these costs is associated with an upgrade or enhancement to internal-use software as described in ASC 350-40-25-7 through 25-9:

ASC 350-40

25-7 Upgrades and enhancements are defined as modifications to existing internal-use software that result in additional functionality — that is, modifications to enable the software to perform tasks that it was previously incapable of performing. Upgrades and enhancements normally require new software specifications and may also require a change to all or part of the existing software specifications. In order for costs of specified upgrades and enhancements to internal-use computer software to be capitalized in accordance with paragraphs 350-40-25-8 through 25-10, it must be probable that those expenditures will result in additional functionality.

25-8 Internal costs incurred for upgrades and enhancements shall be expensed or capitalized in accordance with paragraphs 350-40-25-1 through 25-6.

25-9 Internal costs incurred for maintenance shall be expensed as incurred.

Maintenance activities would be expensed as incurred for all software. ASC 350-40 does not define the term “maintenance,” but ASC 985-20-20 defines it as follows:

Activities undertaken after the product is available for general release to customers to correct errors or keep the product updated with current information. Those activities include routine changes and additions.

A key consideration related to incurring data costs to train the AI software after initial deployment is whether additional training results in the creation of new functionality (e.g., whether the AI application can perform a different task) or whether ongoing training is necessary to retain the relevance of the AI application (e.g., maintain its intended functionality). Data and associated training that are intended to keep an AI application current or relevant would most likely be considered maintenance. Unless the costs are separately capitalizable as an intangible asset, such costs would be expensed as incurred.

In contrast, training that creates new functionality might be considered an upgrade or enhancement. Therefore, entities will need to determine whether the additional fine-tuning they are performing maintains the current software features of their generative AI application or whether the fine-tuning introduces additional software features that did not previously exist. This would dictate whether the data costs incurred to perform the fine-tuning should be capitalized as costs incurred to develop a software upgrade, expensed as software maintenance, or evaluated for capitalization separately as an intangible asset.

2.8.3.5 Computation Resources and Storage Costs

In supporting generative AI applications, an entity may incur significant costs related to (1) hardware for computation resources and (2) storage costs. Generally, such costs will be accounted for under U.S. GAAP other than ASC 985-20 and ASC 350-40. Servers, computers, GPUs, and CPUs purchased to increase an entity's computational power and build out its storage infrastructure would be accounted for as long-lived assets under ASC 360.

If an entity enters into a hosting arrangement with a vendor to leverage the vendor's computation or storage capabilities, it is likely that the arrangement will be accounted for as a service arrangement. Typically, in such circumstances, (1) the entity does not have "the contractual right to take possession of the software at any time during the hosting period without significant penalty"⁶ or (2) it is not "feasible for the [entity] to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software."⁷ Accordingly, the costs incurred to implement third-party infrastructure or storage services would be evaluated for capitalization in accordance with ASC 350-40 and, if capitalized, would be deferred as a prepaid asset and recognized over the contract period (as well as over periods for which contractual renewals are reasonably certain to be exercised). Note that ongoing costs to use or maintain the third-party infrastructure or storage services would not meet the deferral criteria.

In addition, as noted above, AI applications typically need to be developed to work with one or more AI foundation or LLM models. An entity that enters into a hosting arrangement with a vendor to purchase a foundation model will need to determine whether it has (1) purchased or licensed software or (2) purchased a service arrangement. The entity must perform this assessment regardless of whether the foundation model will be used to create a generative AI application for internal use or whether it will be sold as a hosting arrangement or an on-premise license. We expect that most entities will determine that the foundation models or LLMs they acquire will be through a service contract, which could be accounted for as a prepaid asset if an up-front payment is made for the future use of the functionality.

2.9 On the Horizon — Proposed ASU on the Accounting for and Disclosure of Software Costs

In October 2024, the FASB issued a [proposed ASU](#) that would amend certain aspects of the accounting for and disclosure of software costs under ASC 350-40. Rather than revising the guidance on this topic in its entirety, the Board is proposing targeted improvements to address specific issues raised by stakeholders. In addition, the proposed ASU would not amend the cost guidance for software licenses that are within the scope of ASC 985-20.

To clarify that the guidance applies to both linear and nonlinear software development, the proposed ASU would remove all references to "development stages" from ASC 350-40 as well as amend the threshold for the capitalization of costs. Under current GAAP, capitalization of software development costs for internal-use software is required once the preliminary project stage is complete. The proposed ASU instead provides the following two criteria in ASC 350-40-25-12 that must be met for entities to begin capitalizing software costs:

- "Management, with the relevant authority, implicitly or explicitly authorizes and commits to funding a computer software project."
- "It is probable that the project will be completed and the software will be used to perform the function intended (referred to as the probable-to-complete recognition threshold)."

⁶ ASC 985-20-15-5(a) and ASC 350-40-15-4A(a).

⁷ ASC 985-20-15-5(b) and ASC 350-40-15-4A(b).

Under the proposed ASU, the probable-to-complete recognition threshold would not be met when there is “significant uncertainty associated with the development activities of the software (referred to as significant development uncertainty).” The proposed guidance provides the following factors that may be indicative of significant development uncertainty:

- “The computer software being developed has novel, unique, unproven functions and features or technological innovations.”
- “The significant performance requirements of the computer software have not been identified, or the significant performance requirements continue to be substantially revised.”

For more information about the proposed ASU, see Deloitte’s November 5, 2024, [Heads Up](#).

2.10 Income Tax Considerations

2.10.1 U.S. Federal Income Tax Considerations

A taxpayer can claim a research credit (which directly offsets a U.S. federal income tax liability) for performing qualified research activities in the United States. Software development activities may be considered qualified research activities to the extent that they are intended to resolve technological uncertainty. However, development activities to create software to be used primarily for internal use are not considered qualified research activities unless they meet a high threshold of innovation. The determination of whether software development activities are considered primarily for internal use depends on the facts and circumstances but takes into account factors such as whether the software (1) is intended to be used to perform “back office” functionality (e.g., accounting, finance, human resources); (2) is separately sold, leased, licensed, or otherwise marketed to third parties; and (3) enables third parties to interact with the taxpayer.

2.10.2 U.S. International Tax Considerations

Health technology companies invest heavily in developing proprietary software accessible by their customers as well as in creating proprietary data sets, which involve significant activities related to the collection, cleaning, and storage of data. The proprietary data sets themselves can be used for decision-making purposes and may generate valuable insights for these companies and their customers. The aforementioned investments by health tech companies can generate intangible property (IP) that often accounts for a considerable portion of these companies’ overall market value. The expansion by companies into international markets either through sales to customers or by employing personnel may create a potential opportunity for identifying international tax and transfer pricing planning considerations, especially with respect to the development and funding of IP.

One consideration for many health tech companies is to set up an efficient tax structure that is aligned with the company’s overall footprint (including IP) and business objectives and that complies with local tax regulatory regimes across the globe. This process will often depend on a company’s specific facts and circumstances. Potential options for IP management and funding may include intercompany sales of IP, intercompany licensing, cost-sharing arrangements, or incubator structures. It is critical for a health tech company to work with tax advisers to enhance its international tax and transfer pricing structure and align this structure with business realities.

2.10.2.1 Foreign-Derived Intangible Income — IRC Section 250 Deduction

Health tech companies that provide sales or services to foreign customers may have the opportunity to claim, under Internal Revenue Code (IRC) Section 250, a federal income tax deduction on income that is eligible as foreign-derived intangible income (FDII), resulting in permanent cash tax savings and having an impact on the effective tax rate. The IRC Section 250 FDII regulations are very complex, and it can be challenging for companies not only to perform the necessary calculations but also to substantiate them, especially for companies that provide electronically supplied services to customers. Given the complexity with this calculation and the substantiation requirements associated with it, a company should consider working with a tax adviser to evaluate its specific facts and circumstances.

2.11 Considerations Related to Accounting for Income Taxes

One of the overall objectives of ASC 740 is to recognize deferred tax assets and liabilities for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns. A temporary difference is a difference between the financial reporting basis and the income tax basis, determined in accordance with the recognition and measurement criteria of ASC 740. Therefore, if there is a difference between the U.S. GAAP and tax treatment related to software costs, a deferred tax asset or liability may need to be established.

To the extent that a company is eligible for a Section 250 deduction related to FDII, the benefit associated with that deduction is akin to a special deduction and is treated as a permanent item. For more information, see [Section 3.2.1.4](#) of Deloitte's Roadmap *Income Taxes*.

When determining the amount of tax benefit to recognize in the financial statements for research credits, software costs, and FDII deductions, it is important for an entity to consider whether the amounts taken in the tax return meet the more-likely-than-not recognition and measurement thresholds in ASC 740-10. For more information, see [Chapter 4](#) of Deloitte's Roadmap *Income Taxes*.

Chapter 3 — Revenue Recognition for Health Tech Companies

3.1 Health Tech Customer Solutions — What Do They Look Like?

The variety of solutions offered by health tech companies is staggering and can include the processing of billing and medical claims, benefits management services, analytics, automated research, customization of drugs on the basis of individual patient genetics, automated diagnostics based on implantable technology, patient scheduling platforms, cancer detection, and online prescription management, to name a few. Health tech companies provide these technology products or services by using two primary service offerings:

- *SaaS* — In this arrangement, which is typically referred to as a CCA, the customer does not take ownership of the product and the SaaS solution is considered a service provided by the company.
- *On-premise perpetual or subscription licenses* — The software sold by the health tech company to its end customer at a point in time; this software is commonly sold along with PCS services or other products and services, such as professional services, other SaaS, or hardware.

Many health tech companies are applying SaaS delivery models as they digitize current service offerings and update current software offerings. Health tech companies often develop a SaaS platform in which they provide their services to customers via access to a digital platform rather than giving their customers the software code. In contrast, the software delivery model, often referred to as an “on-premise” model, involves a software license transfer in which the customer determines where the software is hosted.

In many software arrangements, however, the customer does not download the software onto servers or computers that it owns or leases; rather, in such arrangements, the software is hosted on the SaaS provider’s or third party’s servers and is controlled by the SaaS provider. The SaaS provider will typically make the functionalities of the software available to the customer through an Internet “portal” hosted on the seller’s hardware. Questions have arisen about whether such an arrangement is (1) an on-premise perpetual license or (2) a SaaS arrangement. This determination is important because it can affect the pattern of revenue recognition. A key consideration in this determination is whether the customer has the option of taking possession of the software without penalty or diminution of value. SaaS contracts include various arrangements involving Web-based delivery of applications or solutions managed by a third-party vendor, typically in the form of a multiple-month subscription to a company’s proprietary software portal. Customers in these arrangements can access the software remotely from their own computer systems; however, they do not take ownership of the software.

The sections below outline the revenue recognition model that applies to common arrangements in the health tech industry.

3.1.1 Step 1: Identify the Contract With the Customer

For contracts within the scope of ASC 606, the first step in recognizing revenue is to determine whether a valid and genuine contract exists, for accounting purposes, between an entity and its customer. ASC 606-10-25-2 states that a contract is a legally binding “agreement between two or more parties that creates enforceable rights and obligations” and further indicates that contracts “can be written, oral, or implied by an entity’s customary business practices.” In accordance with ASC 606-10-25-1(a) through (e), a contract exists if the contract has commercial substance, collectibility is probable, each party has approved the contract and is committed to perform its obligations under the contract, the entity can identify each party’s rights, and the entity can identify payment terms. As discussed further below, a few considerations related to performing step 1 of revenue recognition may be unique to health tech companies.

As part of evaluating whether each party has approved the contract and is committed to perform its obligations under the contract and, in turn, whether each party’s rights are identifiable and enforceable, companies must consider the existence of any termination clauses or provisions within the contract. As noted in ASC 606-10-25-2, “[a] contract is an agreement between two or more parties that creates enforceable rights and obligations.” Termination provisions may affect the length of time over which the identifiable rights and obligations are enforceable and therefore may also have an impact on the determination of several factors (to be discussed in further detail below), such as the promises under the contract (“performance obligations”), the transaction price, and similarly the contract duration over which revenue may be recognized.

ASC 606-10

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.

Contracts may contain various termination provisions that are intended to protect one party or multiple parties to the contract. These terms may vary widely (e.g., whether they include a penalty for termination and, if so, the amount of and reason for this penalty). For example, consider a couple of potential scenarios for a telehealth company that contracts with its customers to provide real-time, remote access between patients and their health care providers via its proprietary SaaS platform. The contract contains a one-year stated term and the customer is billed in ratable increments on a monthly subscription basis.

In one potential scenario, the contract states that the customer may exit the arrangement at any time with one month’s notice and for no additional fee. Because there is no additional fee for leaving the contract, the telehealth company’s enforceable rights (to bill the customer for remote access to health care) actually extend for just one month since the customer is only required to provide a month’s worth of notice before any cancellation takes effect. In this case, despite the stated contract term of one year, the contract term would actually be seen as month to month in the evaluation of the contract under step 1 of ASC 606.

Consider another potential scenario involving the same contract whose termination provision states that the customer may still cancel the contract at any time with one month's notice but would then be required to pay the telehealth company a penalty. In this instance, since the customer must pay a penalty for canceling the contract early, the termination provision would need to be evaluated further to determine whether it is substantive. To be considered substantive, the provision would be weighed against factors such as (1) whether the terminating party is required to pay compensation, (2) the amount of such compensation, and (3) the reason for the compensation (i.e., whether the compensation is in addition to amounts due for goods and services already delivered). Substantive termination penalties suggest that the parties' rights and obligations extend for the duration of the contract term, because the counterparty would not be expected to terminate early. An entity must use judgment in making this determination, since the guidance does not specify what differentiates a substantive penalty from a nonsubstantive penalty. However, an incremental penalty of 10 percent or more of the total transaction price for early termination of a contract may be one factor indicating that the termination provision is substantive. Nevertheless, in evaluating such provisions, companies should consider any such provision in the context of the contract as a whole as well as their customary business practices.

Contracts may also include termination provisions intended to protect against a material breach of contractual obligations from either party. These types of provisions, which may also be known as "termination for cause" provisions, generally do not allow for a penalty-free or nonsubstantive termination because they are intended to address a breach of one's contractual rights rather than to limit such rights; therefore, such provisions typically would not affect the determination of the contract length. If the contract is determined to have commercial substance in step 1 (i.e., the risk, timing, or amount of an entity's future cash flows are expected to change as a result of the contract), the parties to the contract most likely intend to satisfy their obligations. In such cases, the termination provisions for material nonperformance generally do not indicate that any parties' rights or obligations are limited to any period less than the full contract term; rather, such provisions generally would stipulate that all parties expect their rights and obligations to extend throughout the entire duration of the contract.

In further determining whether a valid and genuine contract exists, an entity must evaluate whether it is probable that it will collect substantially all of the consideration to which it expects to be entitled under the contract. However, the consideration to which an entity is ultimately entitled may be less than the price stated in the contract if the customer is offered a price concession. Price concessions are a form of variable consideration and need to be analyzed when the transaction price is being determined (as part of step 3 of revenue recognition). However, in step 1, an entity would evaluate whether it is probable that it will collect the consideration to which it will be entitled for providing goods or services to a customer after considering any price concessions. As part of this evaluation, the entity must perform certain aspects of step 3 in conjunction with step 1. It may be difficult to differentiate between credit risk (i.e., the risk of collecting less consideration than the amount the entity legitimately expected to collect from the customer) and price concessions (i.e., entering into a contract with a customer with the expectation of accepting less than the contractual amount of consideration in exchange for goods or services). Entities will need to use significant judgment and consider all relevant facts and circumstances in determining whether they have provided an implicit price concession (variable consideration to be estimated in step 3, as discussed below) or have accepted a customer's credit risk (to be evaluated in step 1). This is particularly true of entities in highly regulated industries, such as health care, which may be required by law to provide certain goods and services to their customers regardless of the customers' ability to pay.

The following indicators may suggest that a health tech company has offered a price concession:

- The health tech company has a customary business practice of providing discounts or accepting as payment less than the contractually stated price, regardless of whether such a practice is explicitly stated at contract inception or specifically communicated or offered to the customer. This indicator may specifically apply to health tech companies that are in their start-up phase and want to incentivize potential customers to enter into an arrangement.
- The customer has a valid expectation that the health tech company will accept less than that contractually stated price. This could be due to customary business practices, published policies, or specific statements made by the company.
- The health tech company transfers the goods or services to the customer and continues to do so, even when historical experience indicates that it is not probable that the entity will collect the billed amount.
- Other facts and circumstances indicate that the customer intends to pay an amount that is less than the contractually stated price, and the entity nonetheless enters into a contract with the customer.
- The health tech company has a customary business practice of not performing a credit assessment before transferring goods or services to the customer (e.g., the entity is required by law or regulation to provide emergency medical services before assessing the customer's ability or intention to pay).

ASC 606 includes an example (reproduced below) illustrating an implicit price concession that could apply to health tech companies. Note that while health tech companies may not sell prescription drugs, the scenario in the below example may be relevant to health tech companies that sell, for example, software licenses or bundled hardware/software to clinics or physician groups that operate in economically depressed regions. Because health tech is a convergence of health care, life sciences, health plans, and technology, macroeconomic trends or legislative policy decisions can affect the health tech industry far more broadly than they would affect the general technology space.

ASC 606-10

Example 2 — Consideration Is Not the Stated Price — Implicit Price Concession

55-99 An entity sells 1,000 units of a prescription drug to a customer for promised consideration of \$1 million. This is the entity's first sale to a customer in a new region, which is experiencing significant economic difficulty. Thus, the entity expects that it will not be able to collect from the customer the full amount of the promised consideration. Despite the possibility of not collecting the full amount, the entity expects the region's economy to recover over the next two to three years and determines that a relationship with the customer could help it to forge relationships with other potential customers in the region.

55-100 When assessing whether the criterion in paragraph 606-10-25-1(e) is met, the entity also considers paragraphs 606-10-32-2 and 606-10-32-7(b). Based on the assessment of the facts and circumstances, the entity determines that it expects to provide a price concession and accept a lower amount of consideration from the customer. Accordingly, the entity concludes that the transaction price is not \$1 million and, therefore, the promised consideration is variable. The entity estimates the variable consideration and determines that it expects to be entitled to \$400,000.

ASC 606-10 (continued)

55-101 The entity considers the customer's ability and intention to pay the consideration and concludes that even though the region is experiencing economic difficulty it is probable that it will collect \$400,000 from the customer. Consequently, the entity concludes that the criterion in paragraph 606-10-25-1(e) is met based on an estimate of variable consideration of \$400,000. In addition, based on an evaluation of the contract terms and other facts and circumstances, the entity concludes that the other criteria in paragraph 606-10-25-1 are also met. Consequently, the entity accounts for the contract with the customer in accordance with the guidance in this Topic.

Note that in the above example, the entity concludes that the promised consideration is variable. Therefore, the entity may need to determine the transaction price in step 3 of the model (see [Section 3.1.3](#)), including any price concessions, before concluding on collectibility.

3.1.2 Step 2: Identify the Performance Obligations in the Contract

Once a contract is deemed to exist, an entity must identify the goods or services outlined in the contract, then determine which are separate performance obligations. Step 2 is one of the most critical steps of ASC 606's revenue framework since it establishes the unit of account for revenue recognition. Many health tech companies may bundle goods/services with the software solution, including PCS, training for software users, hardware, and hosting services. Some or all of these may exist in a health tech contract and may constitute separate performance obligations. These promises for goods or services can be explicit in the contract or implied by the health tech company's actions. Such actions may include statements or communications that are available to the customer outside of the contract and that could lead the customer to reasonably expect to receive goods or services upon entering into the contract.

To identify performance obligations, an entity needs to determine whether promised goods or services are distinct. ASC 606-10-25-14 states:

At contract inception, an entity shall assess the goods or services promised in a contract with a customer and shall identify as a performance obligation each promise to transfer to the customer either:

- a. A good or service (or a bundle of goods or services) that is distinct
- b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer (see paragraph 606-10-25-15).

The section below addresses the evaluation of whether a good or service is distinct under the series guidance in ASC 606-10-25-15.

3.1.2.1 Evaluating Whether a Good or Service Is Distinct

ASC 606-10-25-19 notes that the following criteria must be met before a promised good or service can be considered distinct:

- a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is *capable of being distinct*).
- b. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is *distinct within the context of the contract*). [Emphasis added]

In addition, ASC 606-10-25-20 addresses when a customer may benefit from a good or service and states:

A customer can benefit from a good or service in accordance with paragraph 606-10-25-19(a) if the good or service could be used, consumed, sold for an amount that is greater than scrap value, or otherwise held in a way that generates economic benefits. For some goods or services, a customer may be able to benefit from a good or service on its own. For other goods or services, a customer may be able to benefit from the good or service only in conjunction with other readily available resources. A readily available resource is a good or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained from the entity (including goods or services that the entity will have already transferred to the customer under the contract) or from other transactions or events. Various factors may provide evidence that the customer can benefit from a good or service either on its own or in conjunction with other readily available resources. For example, the fact that the entity regularly sells a good or service separately would indicate that a customer can benefit from the good or service on its own or with other readily available resources.

ASC 606-10-25-21 further states that the following factors may indicate that two or more promises to transfer goods or services to a customer are not separately identifiable:

- a. The entity provides a significant service of integrating goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer. A combined output or outputs might include more than one phase, element, or unit.
- b. One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, one or more of the other goods or services promised in the contract.
- c. The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfill its promise by transferring each of the goods or services independently.

Moreover, ASC 606-10-25-22 indicates that “[i]f a promised good or service is not distinct, an entity shall combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct. In some cases, that would result in the entity accounting for all the goods or services promised in a contract as a single performance obligation.”

The determination of whether a customer can benefit from the goods or services is based on the characteristics of the goods or services themselves rather than the customer’s specific plan. The following example from ASC 606-10 illustrates a scenario in which the goods or services are not distinct:

ASC 606-10

Example 10 — Goods and Services Are Not Distinct

Case C — Combined Item

55-140D An entity grants a customer a three-year term license to anti-virus software and promises to provide the customer with when-and-if available updates to that software during the license period. The entity frequently provides updates that are critical to the continued utility of the software. Without the updates, the customer’s ability to benefit from the software would decline significantly during the three-year arrangement.

55-140E The entity concludes that the software and the updates are each promised goods or services in the contract and are each capable of being distinct in accordance with paragraph 606-10-25-19(a). The software and the updates are capable of being distinct because the customer can derive economic benefit from the software on its own throughout the license period (that is, without the updates the software would still provide its original functionality to the customer), while the customer can benefit from the updates together with the software license transferred at the outset of the contract.

ASC 606-10 (continued)

55-140F The entity concludes that its promises to transfer the software license and to provide the updates, when-and-if available, are not separately identifiable (in accordance with paragraph 606-10-25-19(b)) because the license and the updates are, in effect, inputs to a combined item (anti-virus protection) in the contract. The updates significantly modify the functionality of the software (that is, they permit the software to protect the customer from a significant number of additional viruses that the software did not protect against previously) and are integral to maintaining the utility of the software license to the customer. Consequently, the license and updates fulfill a single promise to the customer in the contract (a promise to provide protection from computer viruses for three years). Therefore, in this Example, the entity accounts for the software license and the when-and-if available updates as a single performance obligation. In accordance with paragraph 606-10-25-33, the entity concludes that the nature of the combined good or service it promised to transfer to the customer in this Example is computer virus protection for three years. The entity considers the nature of the combined good or service (that is, to provide anti-virus protection for three years) in determining whether the performance obligation is satisfied over time or at a point in time in accordance with paragraphs 606-10-25-23 through 25-30 and in determining the appropriate method for measuring progress toward complete satisfaction of the performance obligation in accordance with paragraphs 606-10-25-31 through 25-37.

Health tech companies should be aware of the situations addressed in this example, which notes that ongoing updates to the customer-hosted software can be critical to its continued use. The nature of the updates can have a significant impact on the health tech company's determination of whether the updates are distinct; management must use significant judgment in making this determination.

For example, an implantable device that uses associated software for diagnostic purposes might not be useful if it is not paired with the software and thus might not be separately identifiable. On the other hand, off-the-shelf hardware, such as a server, monitor, or computer terminal that is sold together with on-premise software, could provide benefits to customers regardless of whether they intend to use such hardware. A key question to ask is whether a good or service transforms another good or service it is bundled with or whether it merely provides some incremental benefit. If the good or service is considered transformative, it is most likely not separately identifiable and therefore not distinct.

Example 10 illustrates a software update that significantly modifies the functionality of the software in such a way that the software and update are not distinct. Health tech companies often include multiple services in the same contract, such as delivering the software, installing the software on the customer's servers, performing training or maintenance services, and providing hardware such as monitors or diagnostic machines. A company must determine whether such goods or services are distinct. Example 11 below illustrates a scenario involving distinct goods or services.

ASC 606-10**Example 11 — Determining Whether Goods or Services Are Distinct****Case A — Distinct Goods or Services**

55-141 An entity, a software developer, enters into a contract with a customer to transfer a software license, perform an installation service, and provide unspecified software updates and technical support (online and telephone) for a two-year period. The entity sells the license, installation service, and technical support separately. The installation service includes changing the web screen for each type of user (for example, marketing, inventory management, and information technology). The installation service is routinely performed by other entities and does not significantly modify the software. The software remains functional without the updates and the technical support.

ASC 606-10 (continued)

55-142 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity observes that the software is delivered before the other goods and services and remains functional without the updates and the technical support. The customer can benefit from the updates together with the software license transferred at the outset of the contract. Thus, the entity concludes that the customer can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available and the criterion in paragraph 606-10-25-19(a) is met.

55-143 The entity also considers the principle and the factors in paragraph 606-10-25-21 and determines that the promise to transfer each good and service to the customer is separately identifiable from each of the other promises (thus, the criterion in paragraph 606-10-25-19(b) is met). In reaching this determination the entity considers that although it integrates the software into the customer's system, the installation services do not significantly affect the customer's ability to use and benefit from the software license because the installation services are routine and can be obtained from alternate providers. The software updates do not significantly affect the customer's ability to use and benefit from the software license because, in contrast with Example 10 (Case C), the software updates in this contract are not necessary to ensure that the software maintains a high level of utility to the customer during the license period. The entity further observes that none of the promised goods or services significantly modify or customize one another and the entity is not providing a significant service of integrating the software and the services into a combined output. Lastly, the entity concludes that the software and the services do not significantly affect each other and, therefore, are not highly interdependent or highly interrelated because the entity would be able to fulfill its promise to transfer the initial software license independent from its promise to subsequently provide the installation service, software updates, or technical support.

55-144 On the basis of this assessment, the entity identifies four performance obligations in the contract for the following goods or services:

- a. The software license
- b. An installation service
- c. Software updates
- d. Technical support.

55-145 The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether each of the performance obligations for the installation service, software updates, and technical support are satisfied at a point in time or over time. The entity also assesses the nature of the entity's promise to transfer the software license in accordance with paragraphs 606-10-55-59 through 55-60 and 606-10-55-62 through 55-64A (see Example 54 in paragraphs 606-10-55-362 through 55-363B).

Case B — Significant Customization

55-146 The promised goods and services are the same as in Case A, except that the contract specifies that, as part of the installation service, the software is to be substantially customized to add significant new functionality to enable the software to interface with other customized software applications used by the customer. The customized installation service can be provided by other entities.

ASC 606-10 (continued)

55-147 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity first assesses whether the criterion in paragraph 606-10-25-19(a) has been met. For the same reasons as in Case A, the entity determines that the software license, installation, software updates, and technical support each meet that criterion. The entity next assesses whether the criterion in paragraph 606-10-25-19(b) has been met by evaluating the principle and the factors in paragraph 606-10-25-21. The entity observes that the terms of the contract result in a promise to provide a significant service of integrating the licensed software into the existing software system by performing a customized installation service as specified in the contract. In other words, the entity is using the license and the customized installation service as inputs to produce the combined output (that is, a functional and integrated software system) specified in the contract (see paragraph 606-10-25-21(a)). The software is significantly modified and customized by the service (see paragraph 606-10-25-21(b)). Consequently, the entity determines that the promise to transfer the license is not separately identifiable from the customized installation service and, therefore, the criterion in paragraph 606-10-25-19(b) is not met. Thus, the software license and the customized installation service are not distinct.

55-148 On the basis of the same analysis as in Case A, the entity concludes that the software updates and technical support are distinct from the other promises in the contract.

55-149 On the basis of this assessment, the entity identifies three performance obligations in the contract for the following goods or services:

- a. Software customization which is comprised of the license to the software and the customized installation service
- b. Software updates
- c. Technical support.

55-150 The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether each performance obligation is satisfied at a point in time or over time and paragraphs 606-10-25-31 through 25-37 to measure progress toward complete satisfaction of those performance obligations determined to be satisfied over time. In applying those paragraphs to the software customization, the entity considers that the customized software to which the customer will have rights is functional intellectual property and that the functionality of that software will not change during the license period as a result of activities that do not transfer a good or service to the customer. Therefore, the entity is providing a right to use the customized software. Consequently, the software customization performance obligation is completely satisfied upon completion of the customized installation service. The entity considers the other specific facts and circumstances of the contract in the context of the guidance in paragraphs 606-10-25-23 through 25-30 in determining whether it should recognize revenue related to the single software customization performance obligation as it performs the customized installation service or at the point in time the customized software is transferred to the customer.

Example 56, Case A, in ASC 606-10-55-368 through 55-370 further illustrates use of the “capable of being distinct” criterion. In this example, an entity determines that a pharmaceutical patent license is not distinct from the entity’s promise to manufacture the drug for the customer because the customer cannot benefit from the license without the corresponding manufacturing service.

ASC 606-10**Example 56 — Identifying a Distinct License****Case A — License Is Not Distinct**

55-368 In this case, no other entity can manufacture this drug while the customer learns the manufacturing process and builds its own manufacturing capability because of the highly specialized nature of the manufacturing process. As a result, the license cannot be purchased separately from the manufacturing service.

55-369 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity determines that the customer cannot benefit from the license without the manufacturing service; therefore, the criterion in paragraph 606-10-25-19(a) is not met. Consequently, the license and the manufacturing service are not distinct, and the entity accounts for the license and the manufacturing service as a single performance obligation.

55-370 The nature of the combined good or service for which the customer contracted is a sole sourced supply of the drug for the first five years; the customer benefits from the license only as a result of having access to a supply of the drug. After the first five years, the customer retains solely the right to use the entity's functional intellectual property (see Case B, paragraph 606-10-55-373), and no further performance is required of the entity during Years 6–10. The entity applies paragraphs 606-10-25-23 through 25-30 to determine whether the single performance obligation (that is, the bundle of the license and the manufacturing service) is a performance obligation satisfied at a point in time or over time. Regardless of the determination reached in accordance with paragraphs 606-10-25-23 through 25-30, the entity's performance under the contract will be complete at the end of Year 5.

In addition, goods or services promised in the contract differ from activities that the entity needs to undertake to transfer the promised goods or services. Promised goods or services are goods or services that are transferred to the health tech company's customer in accordance with the contract (i.e., goods or services that result in the customer's obtaining control of an asset). A good or service promised in the contract must be evaluated so that the entity can determine whether the good or service represents a distinct performance obligation. In contrast, an activity typically represents something that the entity is required to undertake before or in connection with fulfilling an obligation to transfer a good or service to the customer.

Because the core principle of the revenue standard is for an entity to recognize revenue when it transfers control of a good or service to a customer, it would be inappropriate for an entity to recognize revenue for the completion of an activity. This is because completion of a fulfillment activity does not transfer a good or service to a customer. An entity must sometimes use significant judgment in distinguishing between fulfillment activities and promises to transfer goods or services to a customer. Consider the following example:

Example 3-1

Health Tech Company A enters into a contract with Customer B to provide access to A's software in a hosted environment. Customer B is unable to take possession of the software; rather, B can only access the software in A's hosted environment (i.e., A is providing the SaaS). The contract requires A to make modifications to the software at B's request; however, A will control any modifications to the software and can use the modified software to provide SaaS to customers other than B.

In this example, A's obligation to modify the software at B's request is not a promised good or service. Rather, that obligation is a fulfillment activity that A needs to undertake before it can transfer the specified service (i.e., SaaS) to B. This is because B does not obtain control of any asset resulting from the customization services since B is only able to access the modified software in A's hosted environment.

Once the distinct promised goods and services have been identified, the entity will then determine which goods or services constitute a performance obligation, which is the unit of account under ASC 606. ASC 606-10-25-14 defines a performance obligation as a promise in a contract with a customer to transfer to the customer either (1) a “good or service (or a bundle of goods or services) that is distinct” or (2) a “series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.”

Another important aspect of step 2 relevant to health tech companies and the evaluation of whether goods and services are distinct is understanding the nature of the goods or services in question — for this section, we refer to the discussion in [Chapter 2](#) related to on-premise or hosted software and the evaluation of the software under the criteria in ASC 350-40-15-4A, which are the same as those in ASC 985-20-15-5:

- a. The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.
- b. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

As noted above, many software hosting arrangements include a “license” to software but allow the customer to use the software only in the entity’s hosted environment (because of contractual or practical limitations or both). In these arrangements, the software is not even a promised good or service in the contract since ownership of the software is not transferred to the customer. Although these arrangements may include a contractual license, since the customer is unable to take possession of the software subject to the license without significant penalty, the customer is required to make a separate buying decision before control of any software is truly transferred to the customer (the separate buying decision would be the customer’s election to incur the penalty to take possession of the software). These transactions are accounted for as service transactions (rather than licensing transactions) and the underlying software license itself is not considered a distinct performance obligation; rather, it is an input to the service, since the entity is providing the functionality of the software through a hosting arrangement (service) rather than through an actual software license that is controlled by the customer. This determination is important, since it directly factors into the conclusions discussed later in step 5 regarding whether the revenue associated with the good or service (software license or hosted SaaS) may be recognized at a point in time (such as the delivery of the software license itself to the customer) or over time (such as over the period the customer has access to the hosted SaaS).

3.1.2.2 Identifying Performance Obligations in Arrangements That Include Smart Devices, Updates, and Cloud-Based Services

Many health tech entities offer solutions in which a customer purchases (1) a smart device with an embedded software component (e.g., firmware), (2) maintenance and support (i.e., PCS), and (3) a cloud-based service. In these offerings, the firmware allows the smart device to connect to the cloud-based application, which is physically hosted on the technology entity’s systems (or hosted by the entity’s cloud-computing vendor) and accessed by the customer over the Internet. For arrangements in which the software is always embedded in the smart device and the software is essential to the device’s core functionality, an entity will typically conclude that the embedded software (e.g., firmware) is not distinct from the smart device. This is because the software is a component of the tangible device and integral to the functionality of that device in accordance with ASC 606-10-55-56(a).

Because PCS and a cloud-based service typically are sold together, are coterminous, and have the same pattern of transfer (i.e., ratably over time as stand-ready obligations), they will be referred to collectively as “subscription services.” In some cases, the smart device and both the PCS and the cloud-based service may constitute a combined performance obligation. However, there may be instances in which the smart device and either the PCS (without the cloud-based service) or the cloud-based service (without the PCS) constitute a combined performance obligation.



Connecting the Dots

At the 2021 AICPA & CIMA Conference on Current SEC and PCAOB Developments, Jonathan Wiggins, senior associate chief accountant in the SEC’s Office of the Chief Accountant (OCA), noted that complex consultations on the identification of performance obligations have included fact patterns in which an entity promises to provide (1) a good or service up front, such as a software license or a smart device, and (2) a related service over time, such as PCS for the software license or a cloud-based service for the smart device. This topic was also addressed by then OCA Professional Accounting Fellow Sheri York in her speech at the 2018 AICPA Conference on Current SEC and PCAOB Developments. In that speech, Ms. York discussed a consultation with an SEC registrant regarding the identification of performance obligations with respect to a commercial security monitoring service. The registrant’s technology platform incorporated an element of AI to create a smart security monitoring service. As Ms. York observed, the registrant concluded that the promises in the contract were not distinct within the context of the contract because it “believed it was providing a significant service of integrating the goods and services in the contract into a bundle that represented the combined output for which the customer had contracted.” Ms. York noted that the SEC staff did not object to the registrant’s conclusion.

The functionality of smart devices and subscription services can vary between offerings to customers and between entities. When identifying performance obligations in these arrangements, an entity should consider the guidance in ASC 606-10-25-19 to determine whether the smart device and the subscription services are distinct (i.e., whether each promise is capable of being distinct and distinct within the context of the contract). While a smart device and related subscription services are each often capable of being distinct, determining whether they are distinct within the context of the contract is much more challenging. An entity should consider the guidance in ASC 606-10-25-21 in making such a determination.

We believe that an entity may consider the following indicators, which are not individually determinative or all-inclusive, in determining whether its smart device is distinct from its subscription services:

- *Whether the entity’s smart device and subscription services are ever sold separately* — The entity’s practice of selling the smart device and the subscription services separately typically indicates that there are two separate performance obligations (i.e., the promises should not be combined) since the customer may benefit from the smart device or the subscription services offering on its own.¹ In addition, separate sales also suggest that the smart device and the subscription services each have significant stand-alone functionality, which indicates that those items are distinct within the context of the contract.

¹ If an entity sells subscription services separately as renewals and does not sell subscription services to a party that did not acquire the smart device from the entity, the separate sales of the subscription services would not, in and of themselves, suggest that the smart device and the subscription services are distinct within the context of the contract.

- *Whether the customer can benefit from each product or service (i.e., the smart device or the subscription services) either on its own or together with other resources that are readily available to the customer* — For example, suppose that the customer has the ability to (1) obtain from a different vendor a smart device or subscription services offering that is the same as or similar to that sold by the entity, (2) use the alternative vendor's smart device with the entity's subscription services (or use the alternative vendor's subscription services with the entity's smart device), and (3) receive substantially the same functionality as that of the entity's combined offering. That ability may indicate that the entity's smart device and subscription services are each capable of being distinct and are distinct within the context of the contract since (1) the entity is not providing a significant integration service for the device and the subscription services and (2) it is less likely that the smart device and the subscription services are highly interdependent or highly interrelated.

Alternatively, suppose that the functionality of the smart device is significantly integrated with (rather than just improved by) the subscription services in such a way that the entity's combined offering provides significant additional capabilities that cannot be obtained from an alternative vendor providing the subscription services. In that case, the presence of an alternative vendor providing a portion of the same utility with its subscription services would indicate that the promises are capable of being distinct, but the integrated nature of the promises would indicate that the promises are not distinct within the context of the contract.

- *Whether the subscription services significantly modify the smart device* — The subscription services and the smart device may not be distinct within the context of the contract if rather than just enhancing the capabilities of the smart device, the subscription services modify and significantly affect the functionality of the smart device. For example, suppose that the subscription services (1) employ AI or machine learning that teaches and significantly affects the functionality of the smart device and (2) cannot employ the AI or machine learning without using the functionality of the smart device. This situation would indicate that the subscription services and the smart device are not distinct within the context of the contract because rather than just enhancing the capabilities of the smart device, the subscription services modify and significantly affect the functionality of the smart device.
- *Whether the absence of either the smart device or the subscription services significantly limits or diminishes the utility (i.e., the ability to provide benefit or value) of the other* — If the smart device's functionality is significantly limited or diminished without the use of the subscription services, and vice versa, that significantly limited or diminished functionality may indicate that the smart device and the subscription services (1) are highly interdependent or highly interrelated (i.e., they significantly affect each other) and (2) function together as inputs to a combined output. This, in turn, may indicate that the promises are not distinct within the context of the contract since the customer cannot obtain the intended benefit of the smart device or the subscription services without the other. That is, while the customer may be able to obtain some functionality from the smart device on a stand-alone basis, it would not obtain the intended outputs from the smart device if the smart device is not updated by or connected to the subscription services because the subscription services are critical to the customer's intended use of the combined solution. In this situation, the entity cannot fulfill its promise to the customer by transferring the smart device or the subscription services independently (i.e., the customer could not choose to purchase one good or service without significantly affecting the other good or service in the contract).

- *Whether the functionality of the combined smart device and subscription services is transformative rather than additive* — Transformative functionality should be assessed separately from added functionality. Transformative functionality comprises features that significantly affect the overall operation and interaction of the smart device and the subscription services (e.g., integrated data analytics, pushdown learning, customization). To be transformative, the smart device and the subscription services must significantly affect each other. That is, the smart device and the subscription services are inputs to a combined output such that the combined output has greater value than, or is substantively different from, the sum of the inputs. By contrast, added functionality comprises features that provide an added benefit to the customer without substantively altering (1) the manner in which the functionality is used and (2) the benefits derived from that functionality of the smart device or the subscription services on a stand-alone basis. Even if the added functionality is significant, it may not be transformative. It is more likely that the smart device and the subscription services are highly interdependent or highly interrelated when the functionality of the combined offering is transformative rather than additive.

When performing this assessment, the entity may need to consider proprietary software embedded in the smart device. For example, the entity may design customized embedded software that enhances the smart device's functionality when combined with the entity's subscription services. However, embedded software that limits the smart device's functionality to working only with the entity's subscription services would not represent a transformative relationship. This is because it would only establish a functional dependency.

- *Whether the entity's smart devices and subscription services are always sold on a one-to-one basis* — If the entity has a practice of selling smart devices without the subscription services, this may indicate that the customer can obtain its intended benefit from the smart devices separately. For example, if a customer purchases the entity's subscription services and 10 devices and has an option to subsequently purchase additional devices without additional subscription services, the entity is able to fulfill any promise to provide additional devices without any related subscription services. If the entity is able to fulfill its promise to provide a smart device independently from its promise to provide subscription services, the smart device and the subscription services may not be highly interdependent or highly interrelated. By contrast, if a customer is always required to purchase additional subscription services for each smart device purchased, this may indicate that the smart device and the subscription services are not distinct.
- *Whether the smart devices are sold on a stand-alone basis through a distribution channel or in an aftermarket* — If the entity's smart devices are sold on a stand-alone basis by other third parties and the entity will sell its subscription services separately to any customer that has purchased or obtained a smart device from a third party, the entity is able to fulfill its promise to provide subscription services independently from any promise to provide smart devices. This indicates that the smart device and the subscription services are not highly interdependent or highly interrelated. By contrast, if the entity will not sell its subscription services to a customer unless the customer has purchased a smart device directly from the entity, this may indicate that the smart device and the subscription services are not distinct.

- *Whether the entity's marketing materials support a conclusion that the arrangement is for a combined solution rather than separate products or service offerings* — The entity's marketing materials may help clarify what the entity has promised to deliver to its customer and may provide evidence of the customer's intended use of the smart device and the subscription services. Circumstances in which an entity markets its product as a "solution" (i.e., the materials discuss the functions, features, and benefits of the combined offering with little or no discussion of the smart device and the subscription services separately) may help support a conclusion that the entity's promise is a combined performance obligation. However, the entity should exercise caution when relying on its marketing materials since the manner in which the entity markets its combined offering would not, by itself, be sufficient to support a conclusion that the smart device and the subscription services represent a combined performance obligation.

Challenges arise when health tech companies need to identify performance obligations in arrangements that include promises to provide (1) hardware and embedded software (i.e., a smart device), (2) PCS, and (3) a cloud-based service. There are additional considerations when an entity leases the smart device with the related PCS and cloud-based service instead of selling it. The interpretive guidance below addresses factors that an entity may consider in identifying the performance obligations in these arrangements and discusses situations in which a smart device is subject to a lease accounted for under ASC 842.

When control of two or more goods or services, such as customer support and a cloud-based service, is transferred at exactly the same time, or on the same basis over the same period, and if those items do not need to be segregated for presentation or disclosure purposes, it will usually not be necessary to unbundle each of those concurrently delivered performance obligations because the amount and timing of revenue recognized and disclosed would not differ if the items were unbundled. The FASB acknowledges this in paragraph BC116 of [ASU 2014-09](#) and paragraph BC47 of [ASU 2016-10](#). In some cases, the smart device and both the PCS and the cloud-based service may constitute a combined performance obligation. However, there may be instances in which the smart device and either the PCS (without the cloud-based service) or the cloud-based service (without the PCS) constitute a combined performance obligation.

The functionality of smart devices and subscription services can vary between offerings to customers and between entities. When identifying performance obligations in these arrangements, a health tech company should consider the guidance in ASC 606-10-25-19 to determine whether the smart device and the subscription services are distinct (i.e., whether each promise is capable of being distinct and distinct within the context of the contract). While a smart device and related subscription services are each often capable of being distinct, determining whether they are distinct within the context of the contract is much more challenging. See [Section 3.1.2.1](#) for further discussion of the determination of whether a performance obligation is distinct within the context of a contract.

Example 55 below illustrates circumstances in which promised goods or services are not distinct from one another. While this example may not specifically apply to health tech companies, it is relevant to the appropriate application of this guidance.

ASC 606-10**Example 55 — License of Intellectual Property**

55-364 An entity enters into a contract with a customer to license (for a period of three years) intellectual property related to the design and production processes for a good. The contract also specifies that the customer will obtain any updates to that intellectual property for new designs or production processes that may be developed by the entity. The updates are integral to the customer's ability to derive benefit from the license during the license period because the intellectual property is used in an industry in which technologies change rapidly.

55-365 The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity determines that the customer can benefit from (a) the license on its own without the updates and (b) the updates together with the initial license. Although the benefit the customer can derive from the license on its own (that is, without the updates) is limited because the updates are integral to the customer's ability to continue to use the intellectual property in an industry in which technologies change rapidly, the license can be used in a way that generates some economic benefits. Therefore, the criterion in paragraph 606-10-25-19(a) is met for the license and the updates.

55-365A The fact that the benefit the customer can derive from the license on its own (that is, without the updates) is limited (because the updates are integral to the customer's ability to continue to use the license in the rapidly changing technological environment) also is considered in assessing whether the criterion in paragraph 606-10-25-19(b) is met. Because the benefit that the customer could obtain from the license over the three-year term without the updates would be significantly limited, the entity's promises to grant the license and to provide the expected updates are, in effect, inputs that, together fulfill a single promise to deliver a combined item to the customer. That is, the nature of the entity's promise in the contract is to provide ongoing access to the entity's intellectual property related to the design and production processes for a good for the three-year term of the contract. The promises within that combined item (that is, to grant the license and to provide when-and-if available updates) are therefore not separately identifiable in accordance with the criterion in paragraph 606-10-25-19(b).

55-366 The nature of the combined good or service that the entity promised to transfer to the customer is ongoing access to the entity's intellectual property related to the design and production processes for a good for the three-year term of the contract. Based on this conclusion, the entity applies paragraphs 606-10-25-23 through 25-30 to determine whether the single performance obligation is satisfied at a point in time or over time and paragraphs 606-10-25-31 through 25-37 to determine the appropriate method for measuring progress toward complete satisfaction of the performance obligation. The entity concludes that because the customer simultaneously receives and consumes the benefits of the entity's performance as it occurs, the performance obligation is satisfied over time in accordance with paragraph 606-10-25-27(a) and that a time-based input measure of progress is appropriate because the entity expects, on the basis of its relevant history with similar contracts, to expend efforts to develop and transfer updates to the customer on a generally even basis throughout the three-year term.

In addition, Example 9-2-3 in the AICPA Audit and Accounting Guide *Revenue Recognition* states, in part:

Many hybrid offerings will enable customers to perform some functions with the on-premise software even when they are not connected to the hosting service. An entity may determine that the on-premise software meets the criteria of FASB ASC 985-20-15-5 and is capable of being distinct. However, even when the software license is within the scope of FASB ASC 606-10-55-54a and is capable of being distinct, it may not be distinct in the context of the contract because it is, for example, highly interdependent or interrelated with the hosting service. In making this determination, the entity may consider indicators such as the following:

- a. Hosted functionality is limited to capabilities that are widely available from other vendors. For example, the entity offers online file storage and sharing with minimal integration to the on-premise software workflow. In such cases, a customer could gain substantially all of the benefits included in the offering by utilizing alternative vendor services. This would indicate that the software license likely is both capable of being distinct from the hosted service and distinct within the context of the contract because the entity is not providing unique and additional value from the integration of the software and the file storage.

- b. A portion of the hosted functionality is available from other vendors, but the entity provides significant additional utility from the manner in which it integrates the software with its own hosted functionality. For example, the online storage and sharing is integrated with the on-premise software in such a manner that the customer gains significant capabilities or workflow efficiencies that would not be available when using another vendor's hosted services. In such circumstances, the on-premise software is capable of being distinct, but the customer obtains a significant functional benefit by purchasing the complete hybrid offering from the entity. This may indicate that the software license and hosting service are highly interrelated to each other and are not distinct within the context of the contract.
- c. Hosted functionality is limited to functions that the customer may also perform locally with the on-premise software. For example, the customer has the option to perform computationally intensive tasks on its own computer or upload them to the entity's servers as part of the hosting service. In such circumstances, the customer can obtain the intended benefit of the offering with only the on-premise software. This may indicate that the software is not highly dependent on or interrelated with the hosting service and is therefore distinct within the context of the contract.
- d. The hybrid offering workflow involves ongoing interactions between the on-premise software and hosted services. As a result, the utility of the offering would be significantly diminished if the customer is not connected to the hosting service. For example, the utility of the offering would be significantly diminished if the customer is unable to perform computationally intensive tasks when not connected to the hosting services. In such circumstances, the software and hosted services are highly interdependent or interrelated because (1) the customer gains significant functionality from the software and hosting services functioning together and (2) the entity fulfills its overall promise to the customer only by both transferring the on-premise license and providing the hosting services. This would indicate that the software is not distinct within the context of the contract.

3.1.2.3 Evaluating Whether Goods or Services May Be Considered a Series

As previously mentioned, ASC 606-10-25-14 describes what a performance obligation is. ASC 606-10-25-14(b) explains that a performance obligation can be a series of goods or services; however, the performance obligation must meet certain requirements to qualify as a series and therefore be accounted for as a singular performance obligation rather than multiple individual distinct performance obligations. Specifically, the goods or services must be substantially the same and have the same pattern of transfer to the customer as though they were a single performance obligation. As explained in paragraph BC113 of [ASU 2014-09](#), the FASB and the International Accounting Standards Board (IASB®) decided to provide the series guidance to promote consistent application of the revenue standard to similar goods and services.

ASC 606-10-25-15 clarifies the meaning of “the same pattern of transfer.”

ASC 606-10

25-15 A series of distinct goods or services has the same pattern of transfer to the customer if both of the following criteria are met:

- a. Each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria in paragraph 606-10-25-27 to be a performance obligation satisfied over time [see [Section 3.1.5.1](#)].
- b. In accordance with paragraphs 606-10-25-31 through 25-32 [see [Section 3.1.5.1](#)], the same method would be used to measure the entity's progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

Entities that determine that the series guidance applies to their goods or services must account for them as a series. In other words, goods or services that meet the requirements of ASC 606-10-25-14(b) must be accounted for as a single performance obligation. (This guidance is similar to that on whether goods or services are distinct or must be “bundled” as a single account.)

An entity should use significant judgment in determining how series guidance may apply to health tech companies. Consider again a potential scenario involving a telehealth company that contracts with health care providers to provide patients with remote access via a proprietary SaaS platform. In this example, the contract is written in such a way that the patient is charged either per distinct telehealth visit or a flat monthly minimum fee for an indefinite number of visits (in this example, the customer may choose between the two pricing models before signing the contract). The customer has access to physicians via synchronous (i.e., in real time) or asynchronous (i.e., recorded exchange of medical information to be stored and forwarded on the platform between the patient and physician) visits.

In the former scenario in which the customer is charged per telehealth visit, the telehealth provider may, upon concluding that the performance obligation is the delivery of telehealth visits and that these visits qualify for revenue recognition over time (see [Section 3.1.5.1](#)), assess whether such visits qualify as *substantially the same*. For example, the customer may receive differing medical diagnoses or opinions during each visit in such a way that the underlying activities within each visit may differ; however, depending on the contract terms, the telehealth provider may conclude that its promise is to facilitate the visits themselves (not to provide medical diagnoses). In such circumstances, the nature of the visits would be the same regardless of the medical outcome; therefore, the measure of progress would be the same and the series guidance would apply.

This example is applicable both when telehealth visits are priced per visit, as discussed above, or when the customer can make unlimited visits in exchange for a flat monthly fee, in which case the telehealth provider agrees to make its platform and visits available over a specified period such that the promise to the customer may be determined to be daily access to its SaaS platform for messaging or real-time visiting with physicians as needed. The activities and level of service provided by the telehealth company may therefore differ each day but may still qualify for the series guidance if the days of access to the telehealth platform — the distinct obligations — can be recognized over time, are considered substantially the same, and are measured with the same measure of progress.

ASC 606-10-25-18 lists types of promises in a contract that an entity should assess to determine whether they are distinct performance obligations. For example, ASC 606-10-25-18(e) describes a service of “standing ready” to provide goods or services (“stand-ready obligation”). The example above introduces the concept of a “stand-ready” obligation. When an entity enters into a contract with a customer and agrees to make itself available to provide an unspecified number of goods and services to the customer over a specified period, such a promise is generally viewed as a stand-ready obligation. In this type of arrangement, a customer typically receives and consumes a benefit from a stand-ready obligation — namely, the assurance that a service is available to the customer when and if needed or called upon.

It may be complex to distinguish a performance obligation to deliver goods or services from a stand-ready obligation to deliver goods or services. In such cases, an entity will be required to consider the arrangement’s relevant facts and circumstances. However, an entity should begin by identifying the nature of the promise in the contract. For example, the determination of whether the promise is an obligation to provide one or more defined goods or services or is instead an obligation to provide an unknown type or quantity of goods or services **might** be a strong indicator of the nature of the entity’s promise in the contract. While in **either** case the entity might be required to “stand ready” to deliver the good(s) or service(s) whenever the customer calls for them or when a contingent event occurs (e.g., snowfall), the fact that the entity will not know when or how extensively the customer will receive the entity’s good(s) or service(s) during the contract term may be a strong indicator that the entity is standing ready to perform.

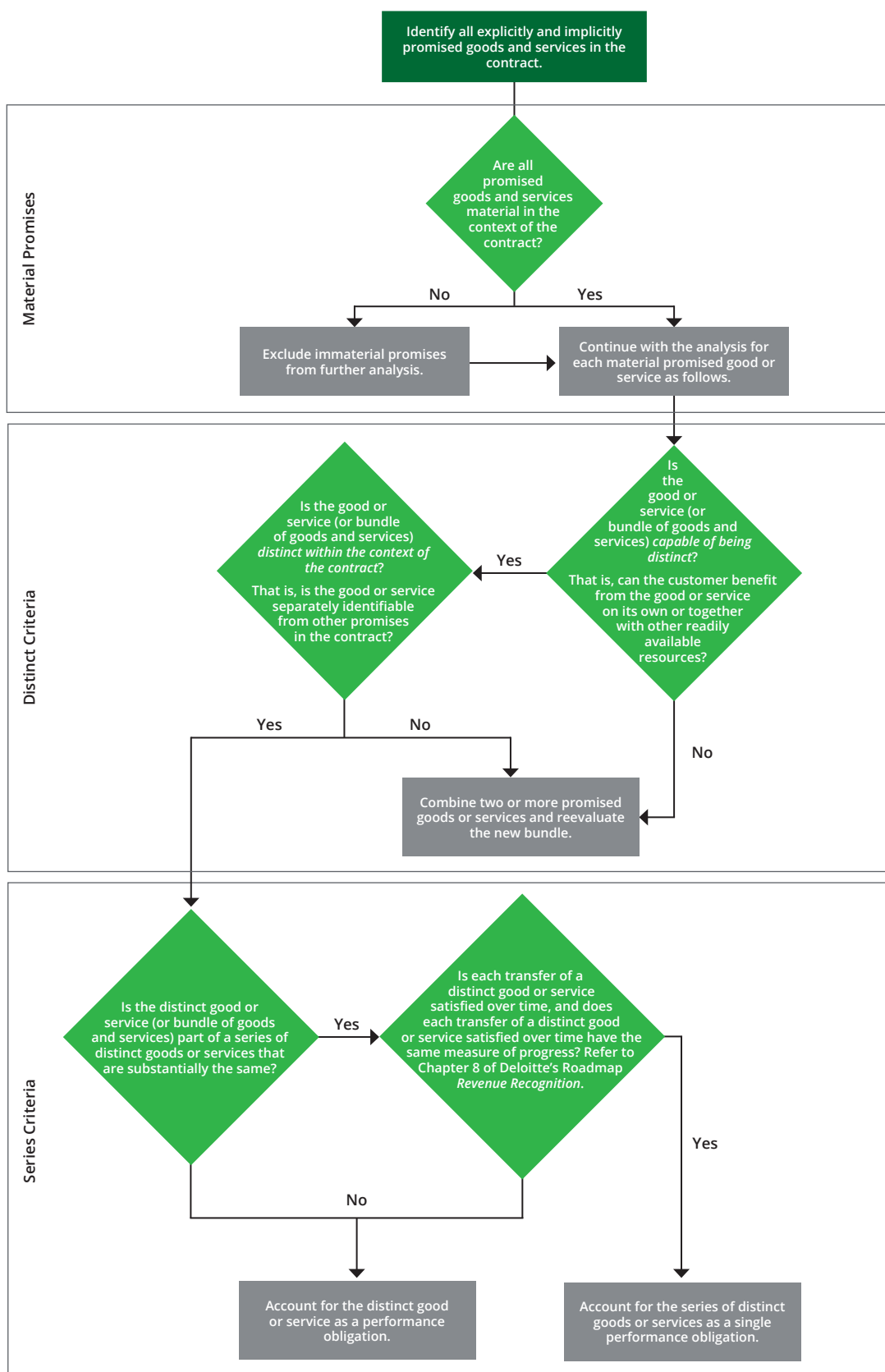
Example 18 in ASC 606-10-55-184 through 55-186 discusses stand-ready obligations in health club memberships. The example notes that the entity's promise is to provide a service of making the health clubs available because the extent to which a customer uses the health clubs does not affect the amount of the remaining goods and services to which the customer is entitled. This is consistent with the discussion in paragraph BC160 of ASU 2014-09.

Other examples of stand-ready performance obligations may include the following:

- *Snow removal services* — An entity promises to remove snow on an “as needed” basis. In this type of arrangement, the entity does not know and most likely cannot reasonably estimate whether, how often, and how much it will snow. This suggests that the entity's promise is to stand ready to provide these services on a when-and-if-needed basis.
- *Software upgrades* — An entity promises to make unspecified (i.e., when-and-if-available) software upgrades available to a customer, and the entity has no discernible pattern of providing updates. The nature of the entity's promise is fundamentally one of providing the customer with assurance that any upgrades or updates developed by the entity during the period will be made available because the entity stands ready to transfer updates or upgrades when and if they become available.
- *Extended warranty* — A customer purchases an extended product warranty for a good (e.g., equipment), and the entity promises to remediate **any** issues with the product when and if problems arise. That is, the entity is standing ready to make repairs when and if needed.

The telehealth provider referred to above is promising to deliver remote medical care through various means (per visit or standing ready to provide an unspecified number of visits) and perhaps through various types of care (e.g., general, urgent, or specialty). In all cases, however, the specific nature of the promise to the customer is important to the determination of whether the visits may qualify as one performance obligation or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer under ASC 606-10-25-14 and 25-15.

The following decision tree illustrates the process for identifying performance obligations in a contract:



In addition, when identifying a performance obligation, an entity should determine whether it is a principal or an agent in the transaction because that determination will affect how (and sometimes when) the entity reports the revenue earned. While step 2 is probably the best stage of the revenue recognition process for determining whether an entity is a principal or an agent, there are many considerations that go into that determination. Accordingly, principal-versus-agent considerations are discussed separately in [Chapter 10](#) of Deloitte's Roadmap *Revenue Recognition*.

3.1.3 Step 3: Determine the Transaction Price

Once the contract and performance obligations are identified, the entity must determine the transaction price. In accordance with ASC 606-10-32, the transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services, excluding amounts collected on behalf of third parties. To determine the transaction price, an entity considers (1) the terms of the contract and any amounts of fixed consideration; (2) the effects of variable consideration; (3) the constraint on variable consideration, if any; (4) the existence of a significant financing component in the contract; (5) noncash consideration; and (6) consideration payable to the customer. Note that an entity assumes that the goods or services will be transferred to the customer on the basis of the terms of the existing enforceable contract and does not take into consideration the possibility of a contract's cancellation, renewal, or modification. When determining the transaction price, it is common for health tech entities to evaluate nonrefundable up-front fees, variable consideration, and significant financing components.

3.1.3.1 Nonrefundable Up-Front Fees

Health tech contracts may include certain nonrefundable up-front fees that are paid in conjunction with the execution of the contract, such as set-up fees for SaaS contracts or hosting arrangements. These fees may (1) be related to a good or service (e.g., implementation fees for a software licensing arrangement or SaaS contract, which would need to be evaluated to determine whether they are distinct) or (2) not result in the transfer of a good or service to the customer (e.g., set-up activities in a SaaS arrangement). In both instances, the fees are not related to a distinct good or service; thus, the costs associated with such activities should be part of the transaction price allocated to the various performance obligations in the contract.

Paragraph BC190 of ASU 2014-09 indicates that consideration in a contract with a customer may vary as a result of many different factors, and variability may arise in many different circumstances. Variable consideration is easiest to identify in a contract when price, quantity, or both are not fixed and known at the contract's inception. Consider again the example of the telehealth company. When the contract is priced on a per-visit basis, the amount of consideration to which the telehealth provider expects to be entitled over any given period is variable because the specific quantity of visits that may be billed for is unknown at contract inception. If the contracts are priced by using a fixed fee for an undefined amount of visits over a set time frame, the consideration may not be deemed variable since the telehealth provider already knows the amount of consideration to which it expects to be entitled over the full term of the contract.

Regardless of the form of variability or its complexity, once variable consideration is identified, an entity must estimate the amount of variable consideration to determine the transaction price in a contract with a customer. Since revenue is one of the most important metrics to users of financial statements, the boards and their constituents agreed that estimates of variable consideration are only useful to the extent that an entity is confident that the revenue recognized as a result of those estimates will not be subsequently reversed. Accordingly, as noted in paragraph BC203 of ASU 2014-09, the FASB and IASB acknowledged that some estimates of variable consideration should not be included in the transaction price if the inherent uncertainty could prevent a faithful depiction of the consideration to which the entity expects to be entitled in exchange for delivering goods or services. Thus, the focus of the boards' deliberations on a mechanism to improve the usefulness of estimates in revenue as a predictor of future performance was to limit subsequent downward adjustments in revenue (i.e., reversals of revenue recognized). The result of those deliberations is commonly referred to as the "constraint."

ASC 606-10-32-11 further clarifies this point by stating, "[a]n entity shall include in the transaction price some or all of an amount of variable consideration estimated in accordance with paragraph 606-10-32-8 only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved." Inherent in the language of ASC 606-10-32-11 is a link between the measurement of variable consideration in the transaction price (step 3) and the recognition of an appropriate amount of revenue (step 5). That is, the constraint is naturally a measurement concept because it influences the amount of variable consideration included in the transaction price. However, its application is driven by a recognition concept and the avoidance of reversing the cumulative amount of revenue previously recognized.

3.1.3.2 Variable Consideration

Variable consideration is often found in health tech contracts in the form of discounts, rebates, refunds, credits, price concessions, incentives, usage-based fees in SaaS arrangements, and performance bonuses or penalties. ASC 606-10-32-8 states that either of the following methods should be used to estimate variable consideration, depending on which method the entity thinks will better predict the amount of consideration to which it will be entitled:

- a. The expected value — The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.
- b. The most likely amount — The most likely amount is the single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

To determine the expected value, health tech companies need to have a large number of similar transactions and must evaluate the similarity and volume of the contracts included in the assessment. The contracts used in the assessment do not need to be identical; rather, it is sufficient for them to be substantially similar. Therefore, it is critical for health tech companies to use judgment in making this determination. Note that ASC 606-10 contains numerous examples of constraining estimates of variable consideration, including sales with right of return considerations, price concessions, volume discount incentives, and management fees subject to constraint. As mentioned above, the term "constraint" resulted from the FASB's and IASB's deliberations when developing ASU 2014-09 (codified in ASC 606). The boards tried to create a mechanism to improve estimates in revenue related to variable consideration (e.g., by limiting revenue reversals in future fiscal periods). Essentially, the boards intended to create a downward bias in revenue recognition to limit future debits to revenue and thus make the financial statements more relevant to users of the financial statements.



Connecting the Dots

As stated in the first sentence of ASC 606-10-32-9, a single method of estimating variable consideration should be used *throughout* the term of the contract with the customer. That is, the method of estimating variable consideration should not be reassessed or changed once it is selected as the most appropriate.

In paragraph BC197 of ASU 2014-09, the boards briefly discuss “management’s best estimate” as a method of estimating variable consideration and acknowledge stakeholders who noted in deliberations that such a method “would provide management with the flexibility to estimate on the basis of its experience and available information without the documentation that would be required when a measurement model is specified.” However, as noted in paragraph BC201 of ASU 2014-09, the boards do not expect that either the most likely amount method or the expected value method of estimating variable consideration will be too costly or complex for entities to apply to contracts with customers. Specifically, the boards allow that an entity would *not* be expected to develop complex modeling techniques to identify all possible outcomes of variable consideration when determining the most likely outcome or a probability distribution of outcomes. Thus, the benefits of applying the most likely amount method or the expected value method to estimate variable consideration exceed the costs of doing so.

As previously noted, an entity is required to use one of two methods to estimate variable consideration, and management’s best estimate is not one of those methods. Although we think that it is appropriate for an entity to be pragmatic in deriving an estimate by using one of the required methods, we do *not* think that it is appropriate to use a method described as management’s best estimate as either the most likely amount or the expected value of variable consideration.

When evaluating whether there is a difference in timing between when goods and services are transferred and when the promised consideration is paid, health tech entities must evaluate whether a significant financing component is present. Specifically, ASC 606-10-32-15 states:

ASC 606-10

32-15 In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.

A significant financing component may exist in term software and SaaS contracts if there are significant timing differences between when a good or service is transferred and when cash (or other consideration) is exchanged so that the time value of money needs to be considered. ASC 606-10-55-244 through 55-246 provide a related example, which could apply to health tech companies:

ASC 606-10

Example 30 — Advance Payment

55-244 An entity, a technology product manufacturer, enters into a contract with a customer to provide global telephone technology support and repair coverage for three years along with its technology product. The customer purchases this support service at the time of buying the product. Consideration for the service is an additional \$300. Customers electing to buy this service must pay for it upfront (that is, a monthly payment option is not available).

ASC 606-10 (continued)

55-245 To determine whether there is a significant financing component in the contract, the entity considers the nature of the service being offered and the purpose of the payment terms. The entity charges a single upfront amount, not with the primary purpose of obtaining financing from the customer but, instead, to maximize profitability, taking into consideration the risks associated with providing the service. Specifically, if customers could pay monthly, they would be less likely to renew, and the population of customers that continue to use the support service in the later years may become smaller and less diverse over time (that is, customers that choose to renew historically are those that make greater use of the service, thereby increasing the entity's costs). In addition, customers tend to use services more if they pay monthly rather than making an upfront payment. Finally, the entity would incur higher administration costs such as the costs related to administering renewals and collection of monthly payments.

55-246 In assessing the guidance in paragraph 606-10-32-17(c), the entity determines that the payment terms were structured primarily for reasons other than the provision of finance to the entity. The entity charges a single upfront amount for the services because other payment terms (such as a monthly payment plan) would affect the nature of the risks assumed by the entity to provide the service and may make it uneconomical to provide the service. As a result of its analysis, the entity concludes that there is not a significant financing component.

The key consideration relevant to the above example (as it is to other health tech companies) is the business reason behind the contractual payment arrangement. To determine whether a significant financing component exists, an entity considers the amount of time between the transfer of goods or services and receipt of payment; an entity must use judgment in making this determination. If such a significant financing component does exist, the transaction price must be adjusted by the significant financing component in accordance with ASC 606-10-32-15.

3.1.4 Step 4: Allocate the Transaction Price to the Performance Obligations

In step 4 of ASC 606, an entity allocates the transaction price to each of the identified performance obligations. For a contract containing more than one performance obligation, the allocation is made on the basis of the relative SSP of each distinct good or service. As described earlier, health tech companies often bundle their software offerings with implementation services, training, hardware, maintenance, and PCS; each of these goods or services would most likely differ with respect to (1) the costs of providing the good or service to customers, (2) companies' margin targets, and (3) the revenue amounts to be recognized for each good or service. ASC 606-10-32-29 requires an entity to allocate the transaction price to each performance obligation on a relative SSP basis by using observable inputs to the greatest extent possible or, if no observable inputs are available, by estimating the SSP. The SSP is the price at which an entity would provide a good or service separately from the other bundled goods or services promised in a contract.

ASC 606-10-32-31 states, "To allocate the transaction price to each performance obligation on a relative standalone selling price basis, an entity shall determine the standalone selling price at contract inception of the distinct good or service underlying each performance obligation in the contract and allocate the transaction price in proportion to those standalone selling prices." While the SSP may be the stated contract price, the best evidence for a performance obligation's SSP is the price at which the company sold the good or service on a stand-alone basis to a similar customer, which is an observable input, as noted in ASC 606-10-32-32. The SSP must also be supported by other factors, such as consistency in contract prices for multiple contracts with various performance obligations. Further, the allocation that results from the determination of SSPs must meet the allocation objective (i.e., allocation of an amount of consideration that the entity would expect to be entitled to in exchange for the promised good or service).

While the concept of the SSP in ASC 606 replaces the related concepts under ASC 605, the approach is similar in that the best evidence is an observable price at which entities sell their good or service to similar customers. In accordance with ASC 606-10-32-33, if no such observable input exists, entities must estimate the selling price by considering “all information (including market conditions, entity-specific factors, and information about the customer or class of customer) that is reasonably available to the entity. In doing so, an entity shall maximize the use of observable inputs and apply estimation methods consistently in similar circumstances.”

ASC 606-10-32-34 indicates that suitable methods for estimating SSPs may include the following:

- a. Adjusted market assessment approach — An entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That approach also might include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.
- b. Expected cost plus a margin approach — An entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.
- c. Residual approach — An entity may estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract. However, an entity may use a residual approach to estimate, in accordance with paragraph 606-10-32-33, the standalone selling price of a good or service only if one of the following criteria is met:
 1. The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (that is, the selling price is highly variable because a representative standalone selling price is not discernible from past transactions or other observable evidence).
 2. The entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (that is, the selling price is uncertain).

Entities can assess various data points in estimating the SSP and may consider the costs of providing the goods or services to customers, their target margins for each good or service, competitor pricing, large versus small customers, and other entity-specific factors.

Note that SSPs are estimated at contract inception. Health tech companies may have contracts in which they are delivering a service over a multiyear contractual period. ASC 606-10-32-43 indicates that even if the SSP changes over time, the company should not reallocate the transaction price to reflect the changes in the SSP for ongoing contracts. Further, goods or services can be sold to many different types, or classes, of customers and, with respect to health tech contracts, these customers can be in multiple sectors within the life sciences and health care industry. These different classes of customers may have differing SSPs if, for example, each customer class would be willing to pay a different price for the good or service on the basis of the nature of the company's relationship with the customer or other specific circumstances unique to each customer. The SSPs are determined for each performance obligation, not the contract as a whole, so an entity may have to use a different estimation method for each performance obligation. It is important to apply such a method consistently to similar types of goods and services in different contracts, though it may not be necessary to do so for the different performance obligations within each contract.

A residual approach may be considered for health tech companies if the SSP of some of the goods or services is either highly variable or uncertain, as may be the case when contracts include software licenses along with professional services and PCS. An entity may have observable SSPs for the professional services and the PCS if they are regularly sold as separate performance obligations, but the SSPs of licenses in a contract may be highly variable or uncertain. In such a scenario, the entity might use the residual approach to determine the amount of the transaction price that should be allocated to the licenses in the aggregate (i.e., the transaction price minus the SSPs of the professional services and the PCS) and then use another method to further allocate the residual transaction price to each license. Note, however, that use of the residual approach is not expected to be common and will need to be thoroughly supported by health tech company management.

Two areas of complexity in allocation arise when the transaction price includes discounts or variable consideration. Both complexities may be present in health tech contracts, since services, PCS, or hardware may be discounted from their otherwise stated list price if a customer elects to purchase the entirety of the bundle. In accordance with the general allocation principle, the discounted transaction price is allocated proportionately to each distinct good and service on the basis of its relative SSP. However, there may be instances in which the result of this allocation approach does not faithfully depict the amount of consideration to which the entity expects to be entitled in exchange for the underlying goods or services. That is, the allocation approach may result in revenue recognition that is inconsistent with the core principle in the revenue standard. This may occur, for example, if certain goods or services are routinely sold at a very low margin while others are sold at a very high margin. An entity may routinely discount the high-margin goods or services but not discount the low-margin goods or services. Allocating a discount proportionately to these goods or services may result in an allocated amount that does not accurately depict the amount of consideration to which the entity expects to be entitled in exchange for the goods or services. ASC 606-10-32-37 states the following regarding the allocation of discounts:

An entity shall allocate a discount entirely to one or more, but not all, performance obligations in the contract if all of the following criteria are met:

- a. The entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a standalone basis.
- b. The entity also regularly sells on a standalone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the standalone selling prices of the goods or services in each bundle.
- c. The discount attributable to each bundle of goods or services described in (b) is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.

An entity does not need to sell each distinct good or service on a stand-alone basis to allocate a discount to one or some, but not all, goods or services. Although judgment is integral to making this allocation, generally for the criterion in ASC 606-10-32-37(a) to be met, the entity will regularly sell bundles of goods or services at the same discount that is inherent in the contract and have observable evidence that the discount in the contract is related to one or some (i.e., the bundle of goods or services routinely sold at a discount), but not all, performance obligations in the contract.

If a contract includes variable consideration, it may have to be allocated to one or more, but not all, of the performance obligations, depending on the specific requirements, as detailed below.

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32-39 Variable consideration that is promised in a contract may be attributable to the entire contract or to a specific part of the contract, such as either of the following:

- a. One or more, but not all, performance obligations in the contract (for example, a bonus may be contingent on an entity [implementing a software platform into a customer's enterprise resource planning system within a certain amount of time])
- b. One or more, but not all, distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) (for example, the consideration promised for the second year of a two-year [hardware maintenance contract] will increase on the basis of movements in a specified inflation index).

32-40 An entity shall allocate a variable amount (and subsequent changes to that amount) entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) if both of the following criteria are met:

- a. The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service).
- b. Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective in paragraph 606-10-32-28 when considering all of the performance obligations and payment terms in the contract.

Example 35 in ASC 606-10-55-270 through 55-279 further illustrates the allocation of variable consideration.

ASC 606-10**Example 35 — Allocation of Variable Consideration**

55-270 An entity enters into a contract with a customer for two intellectual property licenses (Licenses X and Y), which the entity determines to represent two performance obligations each satisfied at a point in time. The standalone selling prices of Licenses X and Y are \$800 and \$1,000, respectively.

Case A — Variable Consideration Allocated Entirely to One Performance Obligation

55-271 The price stated in the contract for License X is a fixed amount of \$800, and for License Y the consideration is 3 percent of the customer's future sales of products that use License Y. For purposes of allocation, the entity estimates its sales-based royalties (that is, the variable consideration) to be \$1,000, in accordance with paragraph 606-10-32-8.

55-272 To allocate the transaction price, the entity considers the criteria in paragraph 606-10-32-40 and concludes that the variable consideration (that is, the sales-based royalties) should be allocated entirely to License Y. The entity concludes that the criteria in paragraph 606-10-32-40 are met for the following reasons:

- a. The variable payment relates specifically to an outcome from the performance obligation to transfer License Y (that is, the customer's subsequent sales of products that use License Y).
- b. Allocating the expected royalty amounts of \$1,000 entirely to License Y is consistent with the allocation objective in paragraph 606-10-32-28. This is because the entity's estimate of the amount of sales-based royalties (\$1,000) approximates the standalone selling price of License Y and the fixed amount of \$800 approximates the standalone selling price of License X. The entity allocates \$800 to License X in accordance with paragraph 606-10-32-41. This is because, based on an assessment of the facts and circumstances relating to both licenses, allocating to License Y some of the fixed consideration in addition to all of the variable consideration would not meet the allocation objective in paragraph 606-10-32-28.

ASC 606-10 (continued)

55-273 The entity transfers License Y at inception of the contract and transfers License X one month later. Upon the transfer of License Y, the entity does not recognize revenue because the consideration allocated to License Y is in the form of a sales-based royalty. Therefore, in accordance with paragraph 606-10-55-65, the entity recognizes revenue for the sales-based royalty when those subsequent sales occur.

55-274 When License X is transferred, the entity recognizes as revenue the \$800 allocated to License X.

Case B — Variable Consideration Allocated on the Basis of Standalone Selling Prices

55-275 The price stated in the contract for License X is a fixed amount of \$300, and for License Y the consideration is 5 percent of the customer's future sales of products that use License Y. The entity's estimate of the sales-based royalties (that is, the variable consideration) is \$1,500 in accordance with paragraph 606-10-32-8.

55-276 To allocate the transaction price, the entity applies the criteria in paragraph 606-10-32-40 to determine whether to allocate the variable consideration (that is, the sales-based royalties) entirely to License Y. In applying the criteria, the entity concludes that even though the variable payments relate specifically to an outcome from the performance obligation to transfer License Y (that is, the customer's subsequent sales of products that use License Y), allocating the variable consideration entirely to License Y would be inconsistent with the principle for allocating the transaction price. Allocating \$300 to License X and \$1,500 to License Y does not reflect a reasonable allocation of the transaction price on the basis of the standalone selling prices of Licenses X and Y of \$800 and \$1,000, respectively. Consequently, the entity applies the general allocation requirements in paragraphs 606-10-32-31 through 32-35.

55-277 The entity allocates the transaction price of \$300 to Licenses X and Y on the basis of relative standalone selling prices of \$800 and \$1,000, respectively. The entity also allocates the consideration related to the sales-based royalty on a relative standalone selling price basis. However, in accordance with paragraph 606-10-55-65, when an entity licenses intellectual property in which the consideration is in the form of a sales-based royalty, the entity cannot recognize revenue until the later of the following events: the subsequent sales occur or the performance obligation is satisfied (or partially satisfied).

55-278 License Y is transferred to the customer at the inception of the contract, and License X is transferred three months later. When License Y is transferred, the entity recognizes as revenue the \$167 ($\$1,000 \div \$1,800 \times \300) allocated to License Y. When License X is transferred, the entity recognizes as revenue the \$133 ($\$800 \div \$1,800 \times \300) allocated to License X.

55-279 In the first month, the royalty due from the customer's first month of sales is \$200. Consequently, in accordance with paragraph 606-10-55-65, the entity recognizes as revenue the \$111 ($\$1,000 \div \$1,800 \times \200) allocated to License Y (which has been transferred to the customer and is therefore a satisfied performance obligation). The entity recognizes a contract liability for the \$89 ($\$800 \div \$1,800 \times \200) allocated to License X. This is because although the subsequent sale by the entity's customer has occurred, the performance obligation to which the royalty has been allocated has not been satisfied.

If a contract includes both variable consideration and a discount, an entity would first apply the guidance in ASC 606-10-32-39 through 32-41 on allocation of variable consideration to determine whether the criteria for allocating the variable consideration to one or more (but not all) of the performance obligations are met. After considering the guidance on allocating variable consideration, the entity would look to the discount allocation guidance to determine how to allocate the discount. ASC 606-10-32-41 establishes a hierarchy that requires an entity to identify and allocate variable consideration to performance obligations before applying other guidance (e.g., the guidance on allocating a discount). Once the transaction price is allocated to the performance obligations in the contract, an entity can recognize revenue when it satisfies a performance obligation.

3.1.4.1 *Allocating Variable Consideration in Cloud-Based or Hosted Software Arrangements*

Entities that sell cloud-based or hosted software solutions (e.g., SaaS arrangements)² often require the customer to pay them a variable amount, usually based on the underlying usage of the SaaS technology. ASC 606 generally requires entities to estimate variable consideration subject to a constraint,³ but it also provides a practical expedient and a variable consideration allocation exception. In addition, while ASC 606 includes an exception to the general model for variable consideration in the form of a sales- or usage-based royalty related to licenses of intellectual property,⁴ SaaS arrangements often do not qualify for the exception because a license is typically not transferred to the customer in such cases (i.e., the contracts are often hosting arrangements that do not meet the criteria in ASC 985-20-15-5 to be considered a license and are therefore accounted for as a service).

The next sections provide interpretive guidance intended to help entities address certain challenges associated with applying the revenue model in ASC 606 to SaaS arrangements that include variable consideration. All of the examples assume that (1) SaaS is the only promise in the contract and (2) the SaaS performance obligation meets the requirements to be recognized over time because the customer “simultaneously receives and consumes the benefits provided by the entity’s performance as the entity performs,” in accordance with ASC 606-10-25-27(a).

3.1.4.1.1 *Applying the Invoice Practical Expedient to Stand-Ready SaaS Arrangements With Usage-Based Variable Consideration*

ASC 606-10-55-18 provides the following practical expedient (the “invoice practical expedient”), which can be applied to performance obligations that are satisfied over time:

As a practical expedient, if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity’s performance completed to date (for example, a service contract in which an entity bills a fixed amount for each hour of service provided), the entity may recognize revenue in the amount to which the entity has a right to invoice.

The invoice practical expedient allows an entity to recognize revenue in the amount of consideration to which the entity has the right to invoice if such amount corresponds directly to the value transferred to the customer. That is, the invoice practical expedient cannot be applied in all circumstances because the amount that an entity has the right to invoice does not always correspond to the value of the entity’s performance to date. Therefore, an entity should demonstrate its ability to apply the invoice practical expedient to performance obligations satisfied over time. In addition, because the use of the invoice practical expedient must faithfully depict the entity’s measure of progress toward completion, the expedient can only be applied to performance obligations satisfied over time (not at a point in time).

² In this section, it is assumed that a SaaS arrangement is accounted for as a service contract because the customer does not have the ability to take possession of the underlying software license on an on-premise basis.

³ In accordance with ASC 606-10-32-11, variable consideration can only be included in the transaction price “to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.”

⁴ When a sales- or usage-based royalty is related to only a license of intellectual property or to a license of intellectual property that is the predominant item in an arrangement, the royalty is recognized at the later of the date on which (1) the subsequent sale or usage occurs or (2) the performance obligation associated with the royalty is satisfied (or partially satisfied).

We believe that if a stand-ready SaaS arrangement (1) has a pricing structure that is solely variable on the basis of the customer's SaaS usage, (2) is priced at the same fixed rate per usage, and (3) gives the entity the right to invoice the customer for its usage as the usage occurs, the invoice practical expedient may be applied. In such cases, the amount of revenue for which the entity has the right to invoice may reflect the value the customer has obtained from the SaaS during the period because it is a fixed rate based on the volume of the customer's SaaS usage. Accordingly, an entity with this type of arrangement is not required to estimate the amount of variable consideration to which it would be entitled at contract inception and instead can recognize revenue as the customer's usage occurs (provided that it also has the right to invoice).

The conclusion above may not be appropriate when (1) there are fixed fees in addition to the usage-based fees, (2) there are substantive minimum usage requirements, (3) the usage price or rate varies during the contract period, or (4) up-front or back-end fees are charged. In those circumstances, it may be challenging to demonstrate that the amount the entity has the right to invoice corresponds to the value the customer has received to date. However, the invoice practical expedient may not necessarily be precluded in the following scenarios (not all-inclusive):

- The amount of fixed consideration the entity has a right to invoice does not change from period to period, and the customer's usage is expected to be consistent from period to period.
- The customer is expected to significantly exceed any minimum usage requirements.
- The usage rate changes solely on the basis of the Consumer Price Index or another metric that reflects an increase or decrease in value and directly correlates to the benefits received by the customer.
- The up-front or back-end fees are insignificant relative to the other expected consideration in the arrangement so that the amount the entity has the right to invoice is commensurate with the value the customer has received to date.

3.1.4.1.2 Applying the Variable Consideration Allocation Exception to Stand-Ready SaaS Arrangements With Usage-Based Variable Consideration

Generally, ASC 606 requires an entity to allocate the transaction price to each performance obligation on a relative stand-alone selling price (SSP) basis. However, the guidance provides an exception to the general allocation principle that applies specifically to variable consideration (the "variable consideration allocation exception"). Specifically, ASC 606-10-32-39(b) states that variable consideration may be attributable to "[o]ne or more, but not all, distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation." In addition, ASC 606-10-32-40 states the following:

An entity shall allocate a variable amount (and subsequent changes to that amount) entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b) if both of the following criteria are met:

- a. The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service).
- b. Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective in paragraph 606-10-32-28 when considering all of the performance obligations and payment terms in the contract.

If an entity elects not to apply the invoice practical expedient or is precluded from applying such expedient to its stand-ready SaaS arrangements, it may be required to apply the variable consideration allocation exception to usage-based fees depending on the facts and circumstances. Because a SaaS arrangement would typically be a series of distinct services that represent a single performance obligation, an entity that does not apply the invoice practical expedient would apply the variable consideration allocation exception if the conditions in ASC 606-10-32-40 are met. An entity that receives variable consideration based on usage would typically meet the condition in ASC 606-10-32-40(a) because the usage is usually associated with a specific outcome (e.g., the transaction is processed, or storage capacity is used). However, an entity must carefully evaluate its pricing structure to determine whether allocating variable consideration to a distinct service (e.g., each day that SaaS is provided) is consistent with the allocation objective.

3.1.5 Step 5: Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation

The final step of the revenue recognition process is to recognize revenue when or as control of the performance obligation is transferred to the customer. As noted previously, ASC 606-10-25-23 addresses this concept, stating that “[a]n entity shall recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (that is, an asset) to a customer” and that “[a]n asset is transferred when (or as) the customer obtains control of that asset.”

This guidance underscores the importance of determining when control of the underlying goods or services (i.e., the asset(s) the customer will receive) related to the performance obligation are transferred to the customer. ASC 606-10-25-25 defines such control as follows:

Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways

The key takeaway from this portion of the guidance is that the customer must be able to dictate the use of the asset and either obtain the remaining benefits of the asset or prevent others from obtaining the economic benefits before concluding that control of the asset has been transferred.

For example, assume that a vendor provides a highly customized on-premise software license to the customer and implementation of this software within the customer’s existing IT infrastructure. The software license itself may be delivered to the customer through mechanisms such as an online portal to download the software or e-mail. However, if it is determined that the performance obligation in step 2 includes the customization of the software, the customer cannot obtain the benefits of using the delivered software until it has been customized, which then affects the determination (discussed below) of when control of the performance obligation is transferred (and consequently, when revenue may be recognized). This illustrates the importance of properly defining the performance obligation.

Similarly, a customer may be provided with access to a software license for a definite period of time via a SaaS arrangement, but delivery of the specific access code to the SaaS or other means of providing the SaaS to the customer may not necessarily be aligned with when control of the service begins to be transferred. Companies must thoughtfully assess whether any other requirements are associated with their SaaS offerings that must be implemented or installed for the customer to both begin directing the use of and receiving the benefits of its SaaS subscription. That is, control of the SaaS itself may only begin to be transferred once any required implementation is complete.

Once definitions of the performance obligations and transfer of control are understood, an entity then applies the ASC 606 guidance to determine when control is transferred. ASC 606 notes that control may be transferred either over time or at a point in time and that this transfer affects the timing and pattern of revenue recognition. In accordance with ASC 606-10-25-27, the following criteria indicate that an entity satisfies a performance obligation over time:

- a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs 606-10-55-5 through 55-6).
- b. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced (see paragraph 606-10-55-7).
- c. The entity's performance does not create an asset with an alternative use to the entity (see paragraph 606-10-25-28), and the entity has an enforceable right to payment for performance completed to date (see paragraph 606-10-25-29).

If none of these three criteria are met, the performance obligation would be transferred at a specific point in time in accordance with ASC 606-10-25-30.

3.1.5.1 Revenue Recognized Over Time

Regarding the criterion in ASC 606-10-25-27(a), a performance obligation is satisfied over time if the customer simultaneously receives and consumes the benefits provided. A SaaS arrangement serves as a classic example illustrating when this criterion is met for health tech customers. Once the necessary steps have been taken to grant the customer functional access to the SaaS platform, the customer has use of the platform over the term of the arrangement; therefore, the realization of the benefits of this access coincides with the company's continual delivery of the access to the customer.

The second criterion in ASC 606-10-25-27(b) — that a customer controls an asset that is being created/enhanced as it is being built — is similar to the construction- or production-type contracts from legacy GAAP. This criterion specifically mentions work-in-process, which may be more applicable to companies in the construction space but would also be relevant to health tech companies. For example, when a performance obligation is the delivery of a customized, on-premise software license, the bundled software and implementation services constitute a single performance obligation that represents the combined good or service that is transferred to the customer (i.e., for which the customer obtains control) as progress toward complete implementation of the customized on-premise solution occurs.

The third and final criterion in ASC 606-10-25-27(c) was added to clarify situations in which it is unclear exactly which party controls the asset as it is being built or enhanced. For an entity to conclude that the performance obligation is satisfied over time in such situations, the asset must not have an alternative use to the entity and the entity must have an enforceable right to payment of cost plus a margin for the activity that has occurred to that point. For example, in a contract related to software implementation services, the nature of the implementation and the degree of customization required may lead the entity to develop a highly customized solution for that customer and the customer's IT infrastructure, regardless of whether the contract addresses who controls the software and the direction of the implementation service. In such instances, the time spent performing the implementation and the in-process implementation itself may not be able to be resold or delivered to another customer (since the time has already been spent and the software in question has been heavily modified to suit the

customer's particular needs). ASC 606-10-25-29 further addresses the determination of whether an enforceable right to payment exists (the second condition of this criterion) and states:

An entity shall consider the terms of the contract, as well as any laws that apply to the contract, when evaluating whether it has an enforceable right to payment for performance completed to date in accordance with paragraph 606-10-25-27(c). The right to payment for performance completed to date does not need to be for a fixed amount. However, at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity with a reasonable margin for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised.

This second criterion associated with the right to payment was included to emphasize that when the asset is highly customized and there is a right to payment for performance to date, the inclusion of such payment terms serves to indicate that the economics of the transaction are consistent with other performance obligations for which control is transferred over time. The reasoning behind this conclusion is that (1) the right to payment is a protection mechanism for the entity for its efforts incurred over time as it creates/enhances an asset or performs a service and (2) the customer is expected to receive some level of benefit over time given the agreed-to terms that require payment before completion of the asset/service.

When the performance obligation is satisfied over time because one of the criteria in ASC 606-10-25-27(a) through (c) is met, companies must measure their progress toward completion of this obligation to align the timing of the transfer of control with the timing of the associated revenue recognition. On this note, ASC 606-10-25-31 states that "[t]he objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (that is, the satisfaction of an entity's performance obligation)." ASC 606-10-25-32 then continues:

An entity shall apply a single method of measuring progress for each performance obligation satisfied over time, and the entity shall apply that method consistently to similar performance obligations and in similar circumstances. At the end of each reporting period, an entity shall remeasure its progress toward complete satisfaction of a performance obligation satisfied over time.

ASC 606-10-25-33 indicates that appropriate methods for companies to use in measuring their progress "include output methods and input methods." Output methods (e.g., appraisals of performance to date, milestones reached, time elapsed, and units produced/delivered) are related to the value received by the customer over time, while input methods (e.g., resources consumed, labor hours expended, costs incurred, or time elapsed) are related to the company's efforts taken to date.

For example, a SaaS arrangement may require a health tech company to give its customer access to software over a specified period in such a way that the number of days for which this access is provided may be an appropriate output-based measure of progress. Similarly, stand-ready performance obligations (see step 2 above), such as maintenance on software licenses, may be defined as occurring over a distinct set of days in such a way that the passage of days is used as an output method to measure progress and recognize revenue. Alternatively, companies may be able to reasonably estimate the total number of hours for an implementation or other professional service and therefore may track actual labor hours incurred against this total labor hour estimate to measure progress by using an input method.

The FASB has not explicitly stated whether it prefers an input or output method and acknowledges in paragraph BC164 of [ASU 2014-09](#) that there are advantages and disadvantages to both. Therefore, companies must determine which method most reasonably aligns with their particular facts and circumstances to best reflect the transfer of control and the progress toward complete satisfaction of the performance obligation.

3.1.5.2 *Practical Expedient for Measuring Progress*

While the measurement of progress for performance obligations satisfied over time may be complex, ASC 606-10-55-18 states that “[a]s a practical expedient, if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity’s performance completed to date (for example, a service contract in which an entity bills a fixed amount for each hour of service provided), the entity may recognize revenue in the amount to which the entity has a right to invoice.”

Most commonly referred to as the “invoice practical expedient,” this option allows an entity to recognize revenue in the amount of consideration that the entity has the right to invoice when this amount corresponds *directly* to the value transferred to the customer. That is, the invoice practical expedient cannot be applied in all circumstances because the right to invoice a certain amount does not always correspond to the progress toward satisfying the performance obligation. Therefore, an entity should demonstrate its ability to apply the invoice practical expedient to performance obligations satisfied over time. Because the purpose of the invoice practical expedient is to faithfully depict an entity’s measure of progress toward completion, the invoice practical expedient can only be applied to performance obligations satisfied over time (not at a point in time).

For example, a telehealth company that prices its contracts on a per-visit basis and therefore is subject to measurement requirements for variable consideration may, if the visits are determined to be a series accounted for as a single performance obligation satisfied over time, also conclude that it can use the invoice practical expedient if it can demonstrate that the value to the customer is commensurate with the amount to be billed (for this example, assume that the company bills on a monthly basis). Other factors that are important for an entity to consider in reaching this conclusion are the existence of up-front or back-end fees (which may affect whether the amounts presently billed align with the value received by the customer) or billing rates that may vary over the contract term and how those changes may or may not correspond to the value received by the customer.

The entity will need to use judgment in determining whether the amount invoiced for goods or services reasonably represents the value to the customer of the entity’s performance completed to date.

3.1.5.3 *Revenue Recognized at a Point in Time*

As mentioned above, ASC 606-10-25-30 stipulates that if none of the three criteria in ASC 606-10-25-27(a) through (c) are met, the transfer of control and recognition of the associated revenue are at a point in time. ASC 606-10-25-30 also lists the following indicators (not all-inclusive) of when a customer obtains control at a specific point in time:

- a. The entity has a present right to payment for the asset — If a customer presently is obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.
- b. The customer has legal title to the asset — Legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer’s failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.

- c. The entity has transferred physical possession of the asset — The customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls. Paragraphs 606-10-55-66 through 55-78, 606-10-55-79 through 55-80, and 606-10-55-81 through 55-84 provide guidance on accounting for repurchase agreements, consignment arrangements, and bill-and-hold arrangements, respectively.
- d. The customer has the significant risks and rewards of ownership of the asset — The transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.
- e. The customer has accepted the asset — The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. To evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred, an entity shall consider the guidance in paragraphs 606-10-55-85 through 55-88.

The above list demonstrates that while a present right to payment is one of the indicators of the transfer of control, it is not the sole indicator; companies therefore must evaluate the specific nature of their contracts in accordance with this guidance to determine when control has been transferred. Four of the five indicators above may occur before or after invoicing the customer; accordingly, in such cases, revenue may need to be recognized at a point in time *other* than when the invoice is sent to the customer.

Of note for health tech companies that may be delivering software, SaaS, telehealth visits, or any of the other multitude of performance obligations within the expanding health tech market, contracts may often allow for a period in which the customer tests or evaluates the good or service before deeming such a deliverable as "accepted." As stated in ASC 606-10-25-30(e), the guidance in ASC 606-10-55-85 through 55-88 would apply in such situations.

ASC 606-10

55-85 In accordance with paragraph 606-10-25-30(e), a customer's acceptance of an asset may indicate that the customer has obtained control of the asset. Customer acceptance clauses allow a customer to cancel a contract or require an entity to take remedial action if a good or service does not meet agreed-upon specifications. An entity should consider such clauses when evaluating when a customer obtains control of a good or service.

ASC 606-10 (continued)

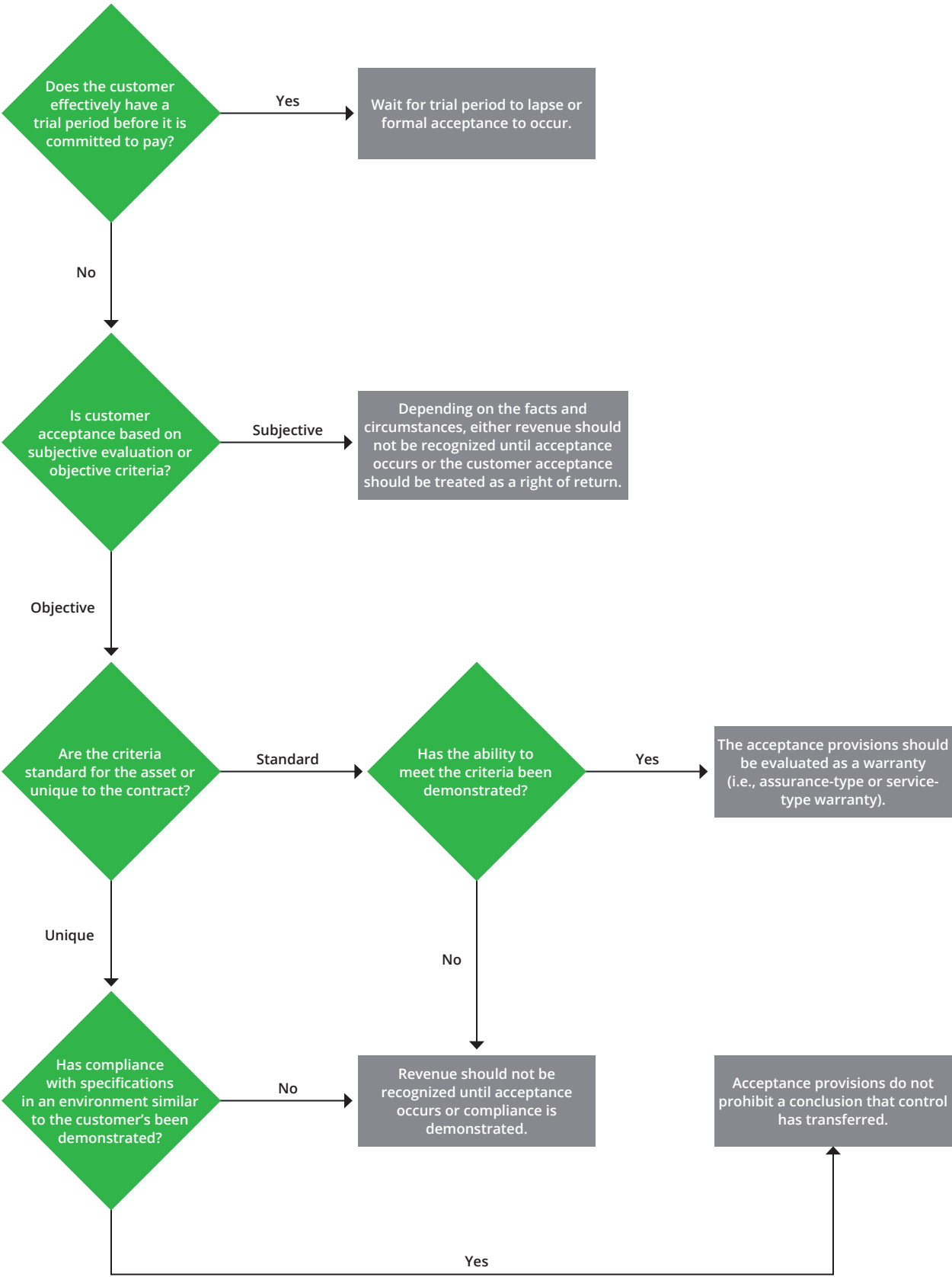
55-86 If an entity can objectively determine that control of a good or service has been transferred to the customer in accordance with the agreed-upon specifications in the contract, then customer acceptance is a formality that would not affect the entity's determination of when the customer has obtained control of the good or service. For example, if the customer acceptance clause is based on meeting specified size and weight characteristics, an entity would be able to determine whether those criteria have been met before receiving confirmation of the customer's acceptance. The entity's experience with contracts for similar goods or services may provide evidence that a good or service provided to the customer is in accordance with the agreed-upon specifications in the contract. If revenue is recognized before customer acceptance, the entity still must consider whether there are any remaining performance obligations (for example, installation of equipment) and evaluate whether to account for them separately.

55-87 However, if an entity cannot objectively determine that the good or service provided to the customer is in accordance with the agreed-upon specifications in the contract, then the entity would not be able to conclude that the customer has obtained control until the entity receives the customer's acceptance. That is because, in that circumstance the entity cannot determine that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service.

55-88 If an entity delivers products to a customer for trial or evaluation purposes and the customer is not committed to pay any consideration until the trial period lapses, control of the product is not transferred to the customer until either the customer accepts the product or the trial period lapses.

The significance of a customer acceptance clause in a health tech contract can vary. For example, some health tech contracts may include a substantive customer acceptance clause in which it is clear (perhaps even determinative) that without such acceptance, control of the asset has not been transferred to the customer. In such cases, the customer may be allowed to (1) cancel the contract and the remaining performance obligations and enforceable rights if a good or service does not have the agreed-upon specifications or functionality, (2) delay the provision of consideration for the good or service, or (3) otherwise request the entity to remedy the good or service until such specifications are achieved. Transfer of control most likely has not occurred in this case until the customer has accepted the good or service. An entity should evaluate the facts and circumstances of the arrangement in such situations.

The decision tree below illustrates the considerations relevant to customer acceptance provisions.



3.1.6 Contract Modifications

Health tech companies may enter into long-term contracts with their customers. During the term of these contracts, a health tech company may enter into a new agreement with its customers that may modify the terms of the original agreement. Whenever a health tech company and its customer agree to change what the entity promises to deliver (i.e., the contract's scope) or the amount of consideration the customer will pay (i.e., the contractual price), there is a contract modification. ASC 606-10-25-10 notes that a contract modification exists if "the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract." Consequently, whenever the enforceable rights and obligations in a contract with a customer change, a contract modification is present and the modification framework should be applied.

If a change in an entity's contract with a customer qualifies as a contract modification, the entity must assess the goods and services and their selling prices. Depending on whether those goods and services are distinct or are sold at their SSPs, a modification can be accounted for as:

- A separate contract.
- One of the following (if the modification is not accounted for as a separate contract):
 - A termination of the old contract and the creation of a new contract (with no adjustment to the historical accounting).
 - A cumulative catch-up adjustment to revenue under the original contract combined with the modification.
 - A combination of the two sub-bullet points above that faithfully reflects the economics of the transaction.

These different treatments that might be required by a health tech company are outlined below.

3.1.6.1 *Contract Modification Accounted for as a Separate Contract*

When an entity determines that its contract has been modified, it should first determine whether the modification should be accounted for as a separate contract. ASC 606-10-25-12 specifies that an entity should account for a contract modification as a separate contract if both of the following criteria are met:

- The modification adds distinct goods or services to the contract.
- The price of the contract increases by an amount equal to the SSPs of the additional distinct goods or services.

When a health tech company accounts for a contract modification as a separate contract, the health tech company's accounting for the original contract is not affected by the modification. Any revenue recognized through the date of the modification is not adjusted, and remaining performance obligations will continue to be accounted for under the original contract. The new contract is accounted for separately from the original contract on a prospective basis.

A contract modification that changes only the price of the contract (and not the contract's scope) would not be accounted for as a separate contract because the modification does not add distinct goods or services to the contract. For example, a modification that only decreases the price a customer is obligated to pay for goods or services to be transferred in the future would not be accounted for as a separate contract.

3.1.6.2 Contract Modification Not Accounted for as a Separate Contract

If a contract modification does not meet the criteria in ASC 606-10-25-12 to be accounted for as a separate contract, the accounting for the contract modification depends on whether the remaining goods or services are distinct from the goods and services already transferred under the contract. To meet this condition, the remaining goods or services do not need to be accounted for as a performance obligation that is separate from the goods or services already delivered; the key factor is whether the remaining goods or services are distinct. Therefore, if a contract contains a single performance obligation that meets the criteria to be accounted for as a series under ASC 606-10-25-15, a modification to the contract could qualify for prospective accounting treatment because each good or service in the series is distinct.

3.1.6.3 Contract Modification Accounted for Prospectively

In accordance with ASC 606-10-25-13(a), if the remaining goods or services are distinct from the goods or services already provided under the original arrangement, the health tech company would, in effect, terminate the original contract and establish a “new” contract that includes only the remaining goods or services. In this situation, the entity would allocate the following to the remaining performance obligations in the contract:

- Consideration from the original contract that has not yet been recognized as revenue.
- Any additional consideration from the modification.

The health tech company would not typically reallocate consideration to goods or services that were transferred to the customer before the modification (see [Section 3.1.6.7](#)). That is, the contract modification is accounted for prospectively.

3.1.6.4 Contract Modification Accounted for on a Cumulative Catch-Up Basis

In contrast to the guidance in ASC 606-10-25-13(a) on prospective contract modifications, the guidance in ASC 606-10-25-13(b) indicates that if the remaining promised goods and services at the time of the contract modification are not distinct, the health tech company should account for the modification as though any additional goods and services were an addition to an incomplete performance obligation. This may be the case when the health tech company and its customer modify the terms of a construction-type contract (for which revenue is recognized over time) as the construction progresses to change certain requested features of the complex the entity is building for the customer and change the price accordingly, though a price change is not necessary to be within the scope of ASC 606-10-25-13(b). In this instance, the health tech company would update both the transaction price and the measure of progress after considering the enforceable rights and obligations under the modified contract. As a result of the modification, the health tech company would calculate an updated revenue amount on the basis of the revised contract and record a cumulative catch-up adjustment to revenue.

3.1.6.5 Combination of Contract Modification Types

There may be modified contracts in which some performance obligations include remaining goods or services that are distinct from the goods or services already provided under the original arrangement but other performance obligations include remaining goods and services that are not (e.g., a change in scope of a partially satisfied performance obligation). In those circumstances, it may be appropriate for a health tech company to apply both the ASC 606-10-25-13(a) model and the ASC 606-10-25-13(b) model to a single contract in the manner described in ASC 606-10-25-13(c).

3.1.6.6 Accounting for Contract Assets as Part of a Contract Modification

ASC 606 requires recognition of a contract asset in certain circumstances, such as when a health tech company has a contract with a customer for which revenue has been recognized (i.e., goods or services have been transferred to the customer) but customer payment is contingent on something other than the passage of time, such as the satisfaction of additional performance obligations. A contract asset may exist at the time of a contract modification. Upon a contract modification, existing contract assets should be carried forward to the new contract. That is, the contract assets should not be impaired or reversed unless (1) their impairment or reversal is otherwise required by ASC 310 or (2) the customer was provided with a price concession.

3.1.6.7 Contract Modifications Versus Price Concessions

While contract modifications often result in a change in the transaction price, not all changes in the transaction price should be accounted for as a contract modification. This is because a contract modification results in a change to enforceable rights and obligations in a contract.

Some changes in the transaction price may result from new information that confirms what could be enforced under an existing contract. This could be case when a price concession is granted for goods or services already delivered (even if the price concession is granted through a prospective price adjustment). When determining whether a price concession should be accounted for as a contract modification, a health tech company should consider whether the price concession is due to (1) the resolution of variability that existed at contract inception or (2) a modification that changes the parties' rights and obligations after contract inception. This distinction is important because the resolution of variability that existed at contract inception (even if not initially identified as a form of variable consideration) is accounted for in accordance with ASC 606-10-32-43 and 32-44, whereas ASC 606-10-32-45 states that changes in the transaction price that are related to a contract modification are accounted for in accordance with the contract modification guidance in ASC 606-10-25-10 through 25-13.

Price concessions may be provided solely as a result of current economic conditions. If such conditions did not exist at contract inception (e.g., an unexpected economic downturn), a price concession most likely represents a contract modification. However, if a health tech company's customer has a valid expectation that it could be entitled to a price concession (e.g., because of past business practices or statements made by the health tech company), the health tech company should consider whether a price concession ultimately granted should be accounted for as a change in the transaction price (related to variability that existed at contract inception) rather than as a contract modification. Accounting for the price concession as a contract modification would be appropriate if the price concession resulted from a change to the enforceable rights and obligations in the contract. An entity may need to use significant judgment in making this distinction.

3.2 Gross Versus Net Revenue Recognition

A health tech company may encounter challenges in determining whether to recognize revenue and the associated cost of services as a gross amount or whether the revenue and cost should be recorded net. In making this determination, the entity must assess whether it is acting as a principal or as an agent. When a revenue transaction involves a third party in providing goods or services to a customer, the entity must evaluate whether the nature of its promise to the customer is to provide the underlying goods or services itself (i.e., the entity is the principal in the transaction) or to arrange for the third party to provide the underlying goods or services directly to the customer (i.e., the entity is the agent in the transaction). Examples of health tech companies that operate in environments in which third parties may be involved include, but are not limited to, those that process claims on behalf of payors or providers; transact prescriptions or other medical data between providers and pharmacies; or

transfer coupons or vouchers to patients on behalf of pharmaceutical manufacturers. To determine the nature of its promise to the customer, the entity must first identify each specified good or service that is distinct (or a bundle of goods or services that is distinct) to be provided to the customer and then assess whether the entity obtains control of each specified good or service (or a right to a good or service) before it is transferred to the customer. In arrangements involving more than one distinct good or service, an entity could be a principal for certain aspects of a contract with a customer and an agent for others.

When an entity controls the specified good or service before it is transferred to the customer, the entity is acting as a principal and recognizes revenue on a gross basis. If the entity does not control the specified good or service before it is transferred to the customer, the nature of the entity's promise is to arrange for another party to provide the specified good or service to the customer and the entity is acting as an agent and must recognize revenue on a net basis.

The meaning of "control" under the principal-versus-agent guidance is consistent with its meaning under ASC 606-10-25-25. Therefore, an entity controls a specified good or service if it has the ability to direct (or prevent another party from directing) the use of, and obtain substantially all of the remaining benefits from, the specified good or service. ASC 606-10-25-25 notes that there are many ways in which an entity can directly or indirectly obtain benefits (i.e., potential cash inflows or savings in cash outflows) from an asset (i.e., a good or service), including the following:

- "Using the asset to produce goods or provide services (including public services)."
- "Using the asset to enhance the value of other assets."
- "Using the asset to settle liabilities or reduce expenses."
- "Selling or exchanging the asset."
- "Pledging the asset to secure a loan."
- "Holding the asset."

There are three indicators codified in ASC 606-10-55-39 that an entity can use to support its conclusion that the entity does or does not obtain control of the specified good or service before control is transferred to a customer:

- *"The entity is primarily responsible for fulfilling the promise to provide the specified good or service to the customer (including responsibility for determining whether a third party's good or service is acceptable)"* — The entity that has primary responsibility for fulfilling the obligation to the customer is often the entity that is most visible to the customer and the entity from which the customer believes it is acquiring goods or services. Often, the entity that has primary responsibility for fulfilling the promise to transfer goods or services to the customer will assume fulfillment risk (i.e., risk that the performance obligation will not be satisfied) and risks related to the acceptability of specified goods or services. That is, such an entity will typically address customer complaints, rectify service issues, and be primarily responsible for exchanges or refunds.
- *"The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (for example, if the customer has a right of return)"* — Although holding inventory is not typically relevant to health tech companies, inventory as described herein can be related to both goods and services. When an entity has inventory risk, it is exposed to economic risk associated with either (1) holding the inventory before a customer is identified or (2) accepting product returns and being required to mitigate any resulting losses by reselling the product or negotiating returns with the vendor. While holding the inventory,

the entity bears the risk of loss as a result of obsolescence or destruction of inventory. This risk is generally referred to as front-end inventory risk. In the case of a service, the entity may commit to pay for a service before it identifies a customer for the service, which is also a form of inventory risk. Another type of inventory risk is back-end inventory risk, which is economic risk assumed upon product return (when there is a general right of return). If an entity is willing to assume economic risk upon product return (and there is a general right of return), it is assuming some risk that is typically borne by a principal in a transaction.

- *“The entity has discretion in establishing the price for the specified good or service,” which may indicate that it has “the ability to direct the use of that good or service and obtain substantially all of the remaining benefits”* — When an entity has control over the establishment of pricing, it generally assumes substantial risks and rewards related to the demand of the specified product or service, especially when the price it is required to pay a third party for the specified good or service is fixed. While this indicator is helpful, the FASB cautioned that an agent may also have discretion in setting prices (e.g., “to generate additional revenue from its service of arranging for goods or services to be provided by other parties to customers”).

While these indicators are intended to help an entity determine whether it is acting as a principal or as an agent, in accordance with [ASU 2016-08](#), they “do not override the assessment of control, should not be viewed in isolation, do not constitute a separate or additional evaluation, and should not be considered a checklist of criteria to be met in all scenarios.” Further, no one indicator is weighted more heavily than any other, and no indicator is considered to be individually determinative of whether an entity controls a specified good or service before it is transferred to a customer. An entity should use judgment to determine which indicators are more relevant depending on the facts and circumstances of the specific transaction.

3.3 U.S. Federal Income Tax Considerations

Under the general rules for revenue recognition, an accrual method taxpayer must recognize revenue when all events have occurred that fix the taxpayer’s right to revenue and the amount of the revenue can be determined with reasonable accuracy. Accordingly, revenue is typically recognized at the earliest of when that revenue is earned, due, or received. In addition, an accrual method taxpayer generally may not recognize revenue any later than when it is recognized as revenue in its applicable financial statements (i.e., generally audited financial statements based on GAAP or IFRS® Accounting Standards).

Taxpayers have the option of deferring the recognition of certain advance payments. Under this option, a taxpayer recognizes revenue in the year the payment is received, to the extent that this amount is recognized in revenue in its financial statements, and recognizes any unrecognized amounts in the tax year after the year in which the payment is received. There are exceptions and special rules that may shorten or lengthen the deferral period. Because taxpayers are only permitted to defer up-front payments to the next taxable year after receipt, there may be a book/tax difference in cases in which a taxpayer defers the recognition of up-front payments for financial statement purposes into revenue over a period longer than one year.

3.4 Considerations Related to Accounting for Income Taxes

ASC 740-10-25-19 acknowledges that “because tax laws and financial accounting standards differ in their recognition and measurement of assets, liabilities, equity, revenues, expenses, gains, and losses, differences arise between:

- a. The amount of taxable income and pretax financial income for a year.
- b. The tax bases of assets or liabilities and their reported amounts in financial statements.”

Because of the potential differences in timing of recognition of revenue, deferred taxes may result. For more information, see [Chapter 3](#) of Deloitte’s Roadmap *Income Taxes*.

3.5 Cloud Conversion or Switching Rights

As discussed in [Chapter 2](#) of this guide, a health tech company must use judgment in determining the appropriate model to use in accounting for the capitalized software costs it incurs. Some software is internally developed or modified solely to meet the company’s needs, while other software is marketed and sold to the company’s customers. In addition, some health tech companies may develop software that is sold both as a licensed product (on-premise license) and as a hosted solution (e.g., SaaS). Further, some health tech companies enter into contracts that include (or are subsequently 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 (e.g., SaaS). This issue has become more prevalent because customers of health tech companies and other software entities frequently migrate from on-premise software solutions to cloud-based platforms. Often, when a customer converts from an on-premise software arrangement to a SaaS arrangement, the customer will lose or forfeit its rights to the on-premise version of the software. Views differ on how to account for the revocation of the initial licensing rights and the conversion to a hosted solution.

From inception or after modification, a health tech company’s software arrangement may include a feature that allows a customer to convert a nonexclusive on-premise term-based software license to a cloud-based or hosted software solution (e.g., a SaaS arrangement) for the same software (i.e., software with the same functionality and features). A health tech entity may also modify a nonexclusive on-premise term-based software arrangement to immediately convert it to a SaaS arrangement. Further, an entity’s software arrangement may allow a customer to (1) deploy a certain number of licenses to software (e.g., 1,000 seats) and (2) use discretion to determine how many licenses to deploy on an on-premise basis or as SaaS at any point in time or at discrete points in time during the arrangement term. Cloud conversion or switching rights vary widely in practice, and the determination of the appropriate accounting for an arrangement that provides for such rights will depend on the particular complexities involved.

In accordance with the guidance in ASC 606 as well as that in [Section 3.1.5](#) of this guide (where the appropriate pattern of revenue recognition is discussed), revenue from on-premise software licenses is typically recognized at the point in time when both (1) the entity provides (or otherwise makes available) a copy of the software to the customer and (2) 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, particularly if the SaaS is a stand-ready obligation. SaaS arrangements typically qualify to be treated as a series (see [Section 3.1.2](#)) and thus are recognized over time, as discussed in Section 3.1.5. While ASC 606 includes guidance on contract modifications, material rights, and sales with a right of return, it does not directly address transactions in which a nonexclusive software license is revoked or converted to a SaaS arrangement. Views therefore differ on the accounting for such arrangements, particularly those in which a nonexclusive on-premise software license for which revenue is recognized at a point in time is converted to a SaaS arrangement for the same underlying software product for which revenue is recognized over time.

In the absence of additional standard setting, there could be more than one acceptable accounting model for certain types of cloud conversion or switching arrangements. The sections below contain examples illustrating such arrangements and discuss views on how entities may account for them. However, neither the examples nor the views discussed are all-inclusive, and entities should carefully consider their specific facts and circumstances in determining the appropriate accounting model.

3.5.1 Initial Contract Includes a Cloud Conversion Right

The example below illustrates an initial nonexclusive on-premise term-based software license contract that includes the right to convert the on-premise software license to a SaaS arrangement.

Example 3-2

On January 1, 20X0, Entity A enters into a noncancelable two-year contract with a customer for an up-front fee of \$1 million to provide a nonexclusive on-premise software license with maintenance or PCS for 100 seats and a right to convert any of the on-premise license seats to a SaaS arrangement at the beginning of the second year (i.e., January 1, 20X1). The SaaS has the same functionality and features as the on-premise software but would be hosted by A instead of being provided on an on-premise basis. Upon exercise of the conversion right, the customer would be required to forfeit the on-premise software license seats and related PCS, and the conversion is irrevocable (i.e., the customer cannot convert back to an on-premise software license). Upon conversion, the customer would be required to pay an incremental fee of \$500 per seat and would receive a credit for a pro rata portion of the “unused” on-premise software license and related PCS to apply to the price the customer would pay (based on the SSP) for the SaaS.

Entity A has similar arrangements with other customers and expects the customer to convert 50 seats at the beginning of the second year. The SSPs are as follows:

Performance Obligation	SSP
On-premise software license	\$4,000 per seat per year
PCS	\$1,000 per seat per year
SaaS	\$5,500 per seat per year

3.5.1.1 *Alternative 1A — Material Right Model (Preferred View)*

Under this alternative, an entity should determine whether the conversion right represents a material right. ASC 606-10-55-42 through 55-44 state the following:

ASC 606-10

55-42 If, in a contract, an entity grants a customer the option to acquire additional goods or services, that option gives rise to a performance obligation in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services, and the entity recognizes revenue when those future goods or services are transferred or when the option expires.

55-43 If a customer has the option to acquire an additional good or service at a price that would reflect the standalone selling price for that good or service, that option does not provide the customer with a material right even if the option can be exercised only by entering into a previous contract. In those cases, the entity has made a marketing offer that it should account for in accordance with the guidance in this Topic only when the customer exercises the option to purchase the additional goods or services.

55-44 Paragraph 606-10-32-29 requires an entity to allocate the transaction price to performance obligations on a relative standalone selling price basis. If the standalone selling price for a customer's option to acquire additional goods or services is not directly observable, an entity should estimate it. That estimate should reflect the discount that the customer would obtain when exercising the option, adjusted for both of the following:

- a. Any discount that the customer could receive without exercising the option
- b. The likelihood that the option will be exercised.

Under the material right guidance, a health tech company provides a material right if its customer has the option of purchasing the SaaS at a discount that is incremental to the range of discounts typically provided for the SaaS to that class of customer in similar circumstances. Any incremental fee the customer is required to pay to exercise the conversion right is compared with the SSP of the SaaS. (See [Section 3.1.4](#) for further discussion of the determination of a performance obligation's SSP.) While the customer may receive a credit for the "unused" portion of the on-premise term-based software license and related PCS, only the incremental fee to exercise the right is considered. This is because under Alternative 1A, a nonexclusive on-premise term-based software license is not subject to the right of return guidance since the entity does not receive an asset back when the right is exercised (i.e., there is no return of an asset). This alternative view is consistent with the accounting for on-premise term-based software licenses that enable the customer to terminate the license agreement without penalty. For example, if a customer paid for a one-year on-premise term-based software license but had the ability to cancel the arrangement for a pro rata refund with 30 days' notice, the term of the initial arrangement would be 30 days, with optional renewals thereafter. In those circumstances, the right of return guidance would not be applied. Specifically, the health tech company is not compensated with an asset of any value as a result of the conversion since it can replicate a nonexclusive software license for sale to any of its customers for a nominal cost. If the incremental fee that the customer is required to pay to convert to the SaaS reflects the SSP of the SaaS, no material right exists under ASC 606-10-55-43, as discussed above. Instead, the conversion right is accounted for only if and when it is exercised.

On the other hand, if the conversion right represents a material right because the incremental fee is less than the SSP of the SaaS, that material right would be accounted for as a separate performance obligation. In accordance with ASC 606-10-55-44, as discussed above, the health tech company would estimate the SSP of the material right as the discount the customer would obtain when exercising the material right, adjusted for any discount the customer could receive without exercising the option and the likelihood that the option will be exercised. If the conversion option is exercised, the amount allocated to the material right plus any incremental fee paid would generally be recognized over the remaining term of the SaaS (and the PCS if not all licenses are converted).

In [Example 3-2](#), Entity A would need to assess whether the option to receive the SaaS at a discount represents a material right in line with the guidance outlined above. Because the incremental fee to be paid by the customer of \$500 per seat per year is significantly less than the SSP for the SaaS of \$5,500 per seat per year, A would conclude that a material right exists at contract inception. Entity A could estimate the material right's SSP as the \$5,000 per seat per year discount (\$5,500 SaaS SSP – \$500 incremental fee to be paid), adjusted for the likelihood that the option will be exercised. We believe that it would also be acceptable for A to estimate the SSPs of the on-premise software license and the PCS by applying a similar adjustment for the likelihood that the option will be exercised (which could truncate the term of the on-premise software license and the PCS). For example, A might estimate the SSPs of the on-premise software license and the PCS under the assumption that 50 seats of the license and related PCS will have only a one-year term if customers are expected to convert half the seats of the license to SaaS after one year. While the material right's SSP could be adjusted for any discount the customer could receive without exercising the option, in this example it is assumed that the customer could not receive a discount without exercising the option.

Assume that A determines that the relative SSP allocation of the transaction price results in allocations to the on-premise software license, PCS for 20X0, PCS for 20X1, and the material right of \$600,000, \$100,000, \$50,000, and \$250,000, respectively.⁵ Entity A will recognize \$600,000 of revenue on January 1, 20X0, for the on-premise software license and \$100,000 for PCS ratably over 20X0. Revenue is deferred for the \$50,000 allocated to PCS for 20X1 and the \$250,000 allocated to the material right, and those amounts are recognized as contract liabilities. If the customer elects to exercise the conversion right on 100 seats on January 1, 20X1, A would assess its policy for accounting for the exercise of an option that includes a material right and apply either of the following:

- *Separate contract model* — The remaining unrecognized revenue of \$50,000 related to PCS is recognized immediately since PCS for all 100 seats is forfeited and therefore will not be provided in 20X1. Revenue of \$300,000, which is calculated by adding the material right allocation of \$250,000 and the incremental fee of \$50,000 (\$500 incremental fee × 100 seats), is recognized over the remaining one-year SaaS term.
- *Contract modification model* — Revenue of \$350,000, which is calculated by adding the remaining unrecognized revenue of \$50,000 related to PCS, the material right allocation of \$250,000, and the incremental fee of \$50,000, is recognized over the remaining one-year SaaS term.

Alternative 1A may be less costly to implement than Alternative 1B (discussed below) because the SSP of the material right is estimated only at contract inception and is not subsequently revised. In addition, because the right of return model is not applied, the variable consideration constraint would likewise not be applicable. (See [Section 3.1.3.1](#) for more information about the variable consideration constraint.) Therefore, revenue recognition could potentially be less volatile under the material right model than under the right of return model discussed below.

⁵ The allocation of the transaction price based on relative SSP is included for illustrative purposes only and uses simplistic assumptions; judgment will be required to determine SSPs in this and similar fact patterns.

3.5.1.2 **Alternative 1B — Right of Return Model (Acceptable View)**

Under this alternative, a health tech company applies the right of return guidance when accounting for the potential that a nonexclusive on-premise term-based software license will be converted to a SaaS arrangement. ASC 606-10-55-22 through 55-26 state the following:

ASC 606-10

55-22 In some contracts, an entity transfers control of a product to a customer and also grants the customer the right to return the product for various reasons (such as dissatisfaction with the product) and receive any combination of the following:

- a. A full or partial refund of any consideration paid
- b. A credit that can be applied against amounts owed, or that will be owed, to the entity
- c. Another product in exchange.

55-23 To account for the transfer of products with a right of return (and for some services that are provided subject to a refund), an entity should recognize all of the following:

- a. Revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (therefore, revenue would not be recognized for the products expected to be returned)
- b. A refund liability
- c. An asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.

55-24 An entity's promise to stand ready to accept a returned product during the return period should not be accounted for as a performance obligation in addition to the obligation to provide a refund.

55-25 An entity should apply the guidance in paragraphs 606-10-32-2 through 32-27 (including the guidance on constraining estimates of variable consideration in paragraphs 606-10-32-11 through 32-13) to determine the amount of consideration to which the entity expects to be entitled (that is, excluding the products expected to be returned). For any amounts received (or receivable) for which an entity does not expect to be entitled, the entity should not recognize revenue when it transfers products to customers but should recognize those amounts received (or receivable) as a refund liability. Subsequently, at the end of each reporting period, the entity should update its assessment of amounts for which it expects to be entitled in exchange for the transferred products and make a corresponding change to the transaction price and, therefore, in the amount of revenue recognized.

55-26 An entity should update the measurement of the refund liability at the end of each reporting period for changes in expectations about the amount of refunds. An entity should recognize corresponding adjustments as revenue (or reductions of revenue).

Under Alternative 1B, an on-premise software license is generally treated as a tangible product, and the right of return guidance applies to the exchange of a product for another product in accordance with ASC 606-10-55-22(c), as outlined above. However, while an entity would generally record an asset for its right to recover a tangible product, an entity would not record an asset for its right to recover a nonexclusive software license in accordance with ASC 606-10-55-23(c) above, since the returned license has no value to the entity. Therefore, in applying the right of return guidance, the health tech company would estimate and recognize an adjustment to the transaction price (and reduce revenue) at contract inception to account for the potential conversion.⁶ The right of return would be accounted

⁶ The variable consideration resulting from the right of return would generally be estimated on the basis of the transaction price allocated to the on-premise software and related PCS and the amount of that allocated transaction price that is expected to be refunded as a credit to the SaaS arrangement (i.e., the pro rata portion of the on-premise software and related PCS that is "unused"). If the credit plus any incremental fee required to convert to the SaaS arrangement is less than the SSP of the SaaS, the entity may need to consider whether a material right has also been granted.

for as variable consideration, subject to the constraint in ASC 606-10-32-11 and 32-12.⁷ See [Section 3.1.3.1](#) for further discussion of the variable consideration constraint. The estimate of the variable consideration associated with the right of return would be reassessed at the end of each reporting period in accordance with ASC 606-10-55-25 and 55-26, with changes in the estimate recognized as an adjustment to revenue. If the conversion right is exercised, the amount previously deferred as a liability⁸ plus the incremental fee paid would generally be recognized as revenue over the remaining term of the SaaS (and the PCS for any licenses that are not converted).

Applying this alternative to [Example 3-2](#), Entity A would need to determine its estimate of how much of the \$1 million up-front payment should be constrained (i.e., how many seat licenses and corresponding rights to PCS will be “returned” in exchange for a credit for the SaaS). On the basis of the assumptions in Example 3-2, A determines that \$250,000 of the \$1 million should be constrained. This is because A expects 50 seats to be converted (i.e., returned in exchange for a credit for the SaaS) on January 1, 20X1. Accordingly, when applying the guidance in ASC 606-10-55-22 through 55-26, A records a liability for the amount of consideration that is expected to be refunded to the customer upon conversion (i.e., the amount of credit that will be applied toward the SaaS). Therefore, A will recognize revenue of \$600,000, or $(\$4,000 \text{ on-premise software license SSP} \times 100 \text{ seats} \times 1 \text{ year}) + (\$4,000 \text{ on-premise software license SSP} \times 50 \text{ seats} \times 1 \text{ year})$, on January 1, 20X0, for the on-premise software license and \$100,000, or $(\$1,000 \text{ PCS SSP} \times 100 \text{ seats} \times 1 \text{ year})$, for PCS ratably over 20X0. In addition, A will recognize (1) a liability of \$250,000, or $(\$4,000 \text{ on-premise software license SSP} + \$1,000 \text{ PCS SSP}) \times 50 \text{ seats} \times 1 \text{ year}$, for the credit that the customer is expected to receive for the on-premise software license and PCS that are expected to be forfeited and (2) a PCS contract liability of \$50,000 (which is to be recognized as revenue in 20X1). Entity A will reassess its estimate of variable consideration at the end of each reporting period.

Assume that on December 31, 20X0, A revises its estimate of the liability associated with the right of return to \$500,000 because it now expects that the customer will convert all 100 seats to a SaaS arrangement. Entity A will reverse \$200,000 of revenue for the incremental 50 seats of on-premise software expected to be forfeited $(\$4,000 \text{ on-premise software license SSP} \times 50 \text{ seats} \times 1 \text{ year})$ and reclassify the \$50,000 PCS contract liability for the incremental PCS expected to be forfeited $(\$1,000 \text{ PCS SSP} \times 50 \text{ seats} \times 1 \text{ year})$ for a total increase in liability of \$250,000 related to the credit expected to be granted to the customer. If the customer elects to exercise the conversion right on 100 seats on January 1, 20X1, revenue of \$550,000, which is calculated by adding the liability of \$500,000 and the incremental fee of \$50,000 $(\$500 \text{ incremental fee} \times 100 \text{ seats} \times 1 \text{ year})$, is recognized over the remaining one-year SaaS term.

Because A's initial estimate of the liability for the credit expected to be granted to the customer was not sufficient, a significant amount of revenue ultimately had to be reversed in a subsequent reporting period. This example highlights the importance of critically evaluating how much revenue should be constrained to ensure that it is probable that a significant reversal in cumulative revenue recognized will not occur. Given the risk of overestimating the amount of variable consideration to which an entity can expect to be entitled for the on-premise software license and PCS, we believe that many software entities, particularly those that do not have sufficient historical data on conversion rates, may find it challenging to determine an appropriate estimate of variable consideration and constraint as required under Alternative 1B.

⁷ Under ASC 606-10-32-11, an entity includes variable consideration in the transaction price “only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.”

⁸ A liability of a return right is typically recognized as a refund liability in accordance with ASC 606-10-55-23(b). However, we believe that if an entity's contract with a customer is noncancelable and consideration therefore would not be refunded to the customer, it would be acceptable to recognize the liability as a contract liability (e.g., deferred revenue) for the entity's expected performance associated with a SaaS arrangement.

3.5.1.3 Tabular Summary of Alternatives 1A and 1B

The following table summarizes the timing of revenue recognition under Alternatives 1A and 1B:

	Alternative 1A (Material Right Model)		Alternative 1B (Right of Return Model)
	Separate Contract	Contract Modification	
Revenue recognized on January 1, 20X0	\$ 600,000	\$ 600,000	\$ 600,000
Revenue recognized (reversed) from January 1 through December 31, 20X0	100,000	100,000	(100,000)*
Revenue recognized on January 1, 20X1	50,000	—	—
Revenue recognized from January 1 through December 31, 20X1	<u>300,000</u>	<u>350,000</u>	<u>550,000</u>
Total revenue recognized	<u>\$ 1,050,000</u>	<u>\$ 1,050,000</u>	<u>\$ 1,050,000</u>

* This amount represents the \$100,000 of revenue recognized for PCS less the \$200,000 reversal of revenue for the change in the estimate of variable consideration.

3.5.2 Initial Contract Is Modified to Convert a Term-Based License to SaaS

The example below illustrates a situation in which a nonexclusive on-premise term-based software license contract (1) initially *does not* include the right to convert the on-premise software license to a SaaS arrangement but (2) is subsequently modified to immediately convert the on-premise software license to a SaaS arrangement.

Example 3-3

On January 1, 20X0, Entity B enters into a noncancelable two-year contract with a customer for an up-front fee of \$1 million to provide a nonexclusive on-premise software license with PCS for 100 seats. At contract inception, there is no explicit or implied right to convert any of the on-premise license seats to a SaaS arrangement.⁹

On January 1, 20X1, B and the customer modify the contract to convert 50 seats of the on-premise software license to a SaaS arrangement for the remaining term. The SaaS has the same functionality and features as the licensed software but would be hosted by B instead of being provided on an on-premise basis. The customer is required to forfeit the 50 on-premise software license seats and related PCS (but will retain the other 50 seats on an on-premise basis with the related PCS for the remaining term), and the conversion is irrevocable (i.e., the customer cannot convert back to an on-premise software license). Upon contract modification and conversion, the customer is required to pay an incremental fee of \$500 per seat and receives a credit for the pro rata portion of the “unused” term-based license and related PCS to apply to the price the customer will pay for the SaaS.

⁹ Note that if an entity's contract does not contain a cloud conversion right at contract inception, a practice of allowing customers to convert their on-premise software license to a SaaS arrangement may create an implied right that is similar to the explicit right provided to the customer in [Example 3-2](#). Significant judgment will be required to determine when an implied right is created in these circumstances.

Example 3-3 (continued)

The SSPs are as follows:

Performance Obligation	SSP
On-premise software license	\$4,000 per seat per year
PCS	\$1,000 per seat per year
SaaS	\$5,500 per seat per year

3.5.2.1 Alternative 2A — Prospective Model (Preferred View)

Under this alternative, a health tech company should evaluate the contract modification guidance since the contract has been modified (i.e., there is a change in the scope and price). Contract modifications are further discussed in [Section 3.1.6](#) of this guide. Specifically, ASC 606-10-25-12 and 25-13 state the following:

ASC 606-10

25-12 An entity shall account for a contract modification as a separate contract if both of the following conditions are present:

- a. The scope of the contract increases because of the addition of promised goods or services that are distinct (in accordance with paragraphs 606-10-25-18 through 25-22).
- b. The price of the contract increases by an amount of consideration that reflects the entity's standalone selling prices of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract. For example, an entity may adjust the standalone selling price of an additional good or service for a discount that the customer receives, because it is not necessary for the entity to incur the selling-related costs that it would incur when selling a similar good or service to a new customer.

ASC 606-10 (continued)

25-13 If a contract modification is not accounted for as a separate contract in accordance with paragraph 606-10-25-12, an entity shall account for the promised goods or services not yet transferred at the date of the contract modification (that is, the remaining promised goods or services) in whichever of the following ways is applicable:

- a. An entity shall account for the contract modification as if it were a termination of the existing contract, and the creation of a new contract, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification. The amount of consideration to be allocated to the remaining performance obligations (or to the remaining distinct goods or services in a single performance obligation identified in accordance with paragraph 606-10-25-14(b)) is the sum of:
 1. The consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognized as revenue and
 2. The consideration promised as part of the contract modification.
- b. An entity shall account for the contract modification as if it were a part of the existing contract if the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification. The effect that the contract modification has on the transaction price, and on the entity's measure of progress toward complete satisfaction of the performance obligation, is recognized as an adjustment to revenue (either as an increase in or a reduction of revenue) at the date of the contract modification (that is, the adjustment to revenue is made on a cumulative catch-up basis).
- c. If the remaining goods or services are a combination of items (a) and (b), then the entity shall account for the effects of the modification on the unsatisfied (including partially unsatisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of this paragraph.

The contract modification is accounted for as a termination of the existing contract and the creation of a new contract in accordance with ASC 606-10-25-13(a), as discussed above, because the modification does not solely add goods or services at their SSPs (i.e., goods and services are also forfeited, and any incremental fee paid for the SaaS is not at its SSP) and the remaining SaaS (and PCS for any licenses that are not converted) is distinct. See [Section 3.1.4](#) of this guide for more information about the determination of a performance obligation's SSP. The contract modification is accounted for prospectively, and any unrecognized revenue that was included in the transaction price from the original contract plus any additional consideration paid as part of the contract modification is recognized over the remaining term of the SaaS (and the PCS for any licenses that are not converted). There is no adjustment to or reversal of revenue for the "unused" portion of the on-premise software license since the modification is accounted for prospectively (i.e., revenue is not "recycled"). Further, the entity does not receive a "returned" asset since, as similarly noted in the discussion of Alternative 1A, the entity does not receive an asset of any value back. Therefore, none of the pro rata credit provided for the "unused" portion of the on-premise software license that has been forfeited would be included as part of the consideration allocated to the SaaS (and PCS for any licenses that are not converted).

In [Example 3-3](#), Entity B will recognize revenue of \$800,000 ($\$4,000 \text{ on-premise software license SSP} \times 100 \text{ seats} \times 2 \text{ years}$) on January 1, 20X0, for the on-premise software license and \$100,000 ($\$1,000 \text{ PCS SSP} \times 100 \text{ seats} \times 1 \text{ year}$) for PCS ratably over 20X0. When the contract is modified on January 1, 20X1, B has a PCS-related contract liability of \$100,000 and receives incremental consideration of \$25,000 ($\$500 \text{ incremental fee} \times 50 \text{ seats}$). Entity B will therefore recognize \$125,000 ($\$100,000 + \$25,000$) for both PCS and the SaaS over the remaining one-year term.¹⁰

3.5.2.2 *Alternative 2B — Return Model (Acceptable View)*

Under this alternative, in a manner similar to that in Alternative 2A, the contract modification is accounted for as a termination of the existing contract and the creation of a new contract because the modification does not solely add goods or services at their SSPs (i.e., goods and services are also forfeited, and any incremental fee paid for the SaaS is not at its SSP) and the remaining SaaS (and PCS if not all licenses are converted) is distinct. However, unlike Alternative 2A, Alternative 2B treats the “unused” portion of the on-premise software license as being effectively returned for a credit that can be applied toward the purchase of the SaaS. Therefore, revenue associated with the unused portion of the returned on-premise software license is reversed. The amount of revenue reversed (i.e., the credit associated with the unused portion of the returned on-premise software license), together with any unrecognized revenue that was included in the transaction price from the original contract and any additional consideration paid as part of the contract modification, is recognized over the remaining term of the SaaS (and the PCS for any licenses that are not converted).

In [Example 3-3](#), Entity B will recognize revenue of \$800,000 ($\$4,000 \text{ on-premise software license SSP} \times 100 \text{ seats} \times 2 \text{ years}$) on January 1, 20X0, for the on-premise software license and \$100,000 ($\$1,000 \text{ PCS SSP} \times 100 \text{ seats} \times 1 \text{ year}$) for PCS ratably over 20X0. When the contract is modified on January 1, 20X1, B will reverse revenue of \$200,000 ($\$4,000 \text{ on-premise software license SSP} \times 50 \text{ seats} \times 1 \text{ year}$) for the returned portion of the on-premise software license. Entity B also has a PCS-related contract liability of \$100,000 and receives incremental consideration of \$25,000 ($\$500 \text{ incremental fee} \times 50 \text{ seats}$). Entity B will therefore recognize revenue of \$325,000 ($\$200,000 + \$100,000 + \$25,000$) for both PCS and the SaaS over the remaining one-year term.¹¹

¹⁰ Entity B would generally allocate the \$125,000 between PCS and the SaaS on the basis of their relative SSPs if required to do so for presentation or disclosure purposes. However, because both PCS and the SaaS are stand-ready obligations that are recognized ratably over the same period, the \$125,000 was not allocated between the two services for purposes of this illustration.

¹¹ Entity B would generally allocate the \$325,000 between PCS and the SaaS on the basis of their relative SSPs if required to do so for presentation or disclosure purposes. However, because both PCS and the SaaS are stand-ready obligations that are recognized ratably over the same period, the \$325,000 was not allocated between the two services for purposes of this illustration.

3.5.2.3 Tabular Summary of Alternatives 2A and 2B

The following table summarizes the timing of revenue recognition under Alternatives 2A and 2B:

	Alternative 2A (Prospective Model)	Alternative 2B (Return Model)
Revenue recognized on January 1, 20X0	\$ 800,000	\$ 800,000
Revenue recognized from January 1 through December 31, 20X0	100,000	100,000
Revenue reversed on January 1, 20X1	—	(200,000)
Revenue recognized from January 1 through December 31, 20X1	<u>125,000</u>	<u>325,000</u>
Total revenue recognized	<u>\$ 1,025,000</u>	<u>\$ 1,025,000</u>

3.5.3 Initial Contract Is Modified to Add a Cloud Conversion Right

The example below illustrates a situation in which a nonexclusive on-premise term-based software license contract (1) initially *does not* include the right to convert the on-premise software license to a SaaS arrangement but (2) is subsequently modified to add a right to convert the on-premise software license to a SaaS arrangement.

Example 3-4

On January 1, 20X0, Entity C enters into a noncancelable three-year contract with a customer for an up-front fee of \$3 million to provide a nonexclusive on-premise software license with PCS for 100 seats. At contract inception, there is no explicit or implied right to convert any of the on-premise license seats to a SaaS arrangement.¹²

On January 1, 20X1, C and the customer modify the contract to add a right to convert any of the on-premise license seats to a SaaS arrangement at the beginning of the third year (i.e., January 1, 20X2). The SaaS has the same functionality and features as the on-premise software but would be hosted by C instead of being provided on an on-premise basis. As in [Example 3-2](#), the customer would be required to forfeit the on-premise software license seats and related PCS upon exercise of the conversion right, and the conversion is irrevocable (i.e., the customer cannot convert back to an on-premise software license). Upon conversion, the customer would be required to pay an incremental fee of \$1,000 per seat and would receive a credit for a pro rata portion of the “unused” on-premise software license and related PCS to apply to the price the customer would pay for the SaaS.

The SSPs are as follows:

Performance Obligation	SSP
On-premise software license	\$8,000 per seat per year
PCS	\$2,000 per seat per year
SaaS	\$11,000 per seat per year

3.5.3.1 Alternative 3A — Prospective Material Right Model (Preferred View)

Under this alternative, in a manner similar to that under Alternative 2A, the contract modification is accounted for as a termination of the existing contract and the creation of a new contract because the

¹² See [footnote 9](#).

modification does not solely add goods or services at their SSPs (i.e., a conversion right is added for no additional consideration, and any incremental fee to be paid for the SaaS is not at its SSP) and the remaining performance obligations (PCS and a material right) are distinct. The contract modification is accounted for prospectively, and any unrecognized revenue that was included in the transaction price from the original contract is allocated to the remaining performance obligations (PCS and a material right). If the conversion option is exercised, the amount allocated to the material right plus any incremental fee paid would generally be recognized over the remaining term of the SaaS (and the PCS for any licenses that are not converted).

In [Example 3-4](#), Entity C will recognize revenue of \$2.4 million (\$8,000 on-premise software license SSP × 100 seats × 3 years) on January 1, 20X0, for the software license and \$200,000 (\$2,000 PCS SSP × 100 seats × 1 year) for PCS ratably over 20X0. When the contract is modified on January 1, 20X1, C has a PCS-related contract liability of \$400,000. Entity C will allocate that amount to the remaining PCS and the material right on the basis of their relative SSPs. The material right's SSP would be estimated as the \$10,000 per seat per year discount (\$11,000 SaaS SSP – \$1,000 incremental fee to be paid), adjusted for the likelihood that the option will be exercised. We believe that it would also be acceptable for C to estimate the SSP of the PCS by applying a similar adjustment for the likelihood that the option will be exercised (which could truncate the term of the PCS).

Assume that C determines that the relative SSP allocation of the transaction price results in allocations to the PCS for 20X1, the PCS for 20X2, and the material right of \$100,000, \$50,000, and \$250,000, respectively.¹³ Entity C will recognize \$100,000 for PCS ratably over 20X1. If the customer elects to exercise the conversion right on 100 seats on January 1, 20X2, C would assess its policy related to accounting for the exercise of an option that includes a material right and would apply either of the following:

- *Separate contract model* — The remaining unrecognized revenue of \$50,000 related to PCS is recognized immediately since PCS for all 100 seats is forfeited and therefore will not be provided in 20X2. Revenue of \$350,000, which is calculated by adding the material right allocation of \$250,000 and the incremental fee of \$100,000 (\$1,000 incremental fee × 100 seats), is recognized over the remaining one-year SaaS term.
- *Contract modification model* — Revenue of \$400,000, which is calculated by adding the remaining unrecognized revenue of \$50,000 related to PCS, the material right allocation of \$250,000, and the incremental fee of \$100,000, is recognized over the remaining one-year SaaS term.

Alternative 3A may be less costly to implement than Alternative 3B below because the SSP of the material right is estimated only upon contract modification and is not subsequently revised. In addition, because the right of return model is not applied, the variable consideration constraint would likewise not be applicable. Therefore, revenue recognition could potentially be less volatile under the prospective material right model than under the right of return model discussed below.

¹³ See [footnote 5](#).

3.5.3.2 **Alternative 3B — Right of Return Model (Acceptable View)**

Under this alternative, in a manner similar to that under Alternative 3A, the contract modification is accounted for as a termination of the existing contract and the creation of a new contract because the modification does not solely add goods or services at their SSPs (i.e., a conversion right is added for no additional consideration, which could result in the forfeiture of goods and services, and any incremental fee to be paid for the SaaS is not at its SSP) and the remaining PCS is distinct. However, unlike Alternative 3A, Alternative 3B treats any “unused” portion of the on-premise software license as being effectively returned for a credit that can be applied toward the purchase of the SaaS. Therefore, revenue associated with the expected unused portion of the returned on-premise software license is reversed. The amount of revenue reversed (i.e., the credit associated with the potential unused portion of the returned on-premise software license), together with any unrecognized revenue that was included in the transaction price from the original contract, is accounted for prospectively over the remaining two-year term. In applying the right of return guidance, the entity would estimate and recognize an adjustment to the transaction price (and reduce revenue) upon contract modification to account for the potential conversion.¹⁴ The right of return would be accounted for as variable consideration, subject to the constraint in ASC 606-10-32-11 and 32-12.¹⁵ The estimate of variable consideration associated with the right of return would be reassessed at the end of each reporting period in accordance with ASC 606-10-55-25 and 55-26, with changes in the estimate recognized as an adjustment to revenue. If the conversion right is exercised, the amount previously deferred as a liability,¹⁶ plus the incremental fee paid, would generally be recognized as revenue over the remaining term of the SaaS (and the PCS for any licenses that are not converted).

In [Example 3-4](#), Entity C will recognize revenue of \$2.4 million ($\$8,000 \text{ on-premise software license SSP} \times 100 \text{ seats} \times 3 \text{ years}$) on January 1, 20X0, for the software license and \$200,000 ($\$2,000 \text{ PCS SSP} \times 100 \text{ seats} \times 1 \text{ year}$) for PCS ratably over 20X0. When the contract is modified on January 1, 20X1, C would need to determine its estimate of variable consideration and how much of that consideration, if any, should be constrained. Assume that C determines that \$1 million of the original transaction price of \$3 million is variable consideration, which is calculated as $(\$8,000 \text{ on-premise software license SSP} + \$2,000 \text{ PCS SSP}) \times 100 \text{ seats} \times 1 \text{ year}$. In addition, assume that C estimates variable consideration of \$500,000 — calculated as $(\$8,000 \text{ on-premise software license SSP} + \$2,000 \text{ PCS SSP}) \times 50 \text{ seats} \times 1 \text{ year}$ — and concludes that none of the estimated variable consideration should be constrained.¹⁷ Therefore, C will reverse revenue of \$400,000 ($\$8,000 \text{ on-premise software license} \times 50 \text{ seats} \times 1 \text{ year}$) and reclassify \$100,000 of the PCS contract liability for the PCS expected to be forfeited ($\$2,000 \text{ PCS SSP} \times 50 \text{ seats} \times 1 \text{ year}$) for a total liability of \$500,000 for the credit the customer is expected to receive. Entity C also has a remaining PCS-related contract liability of \$300,000 and recognizes \$200,000 ($\$2,000 \text{ PCS SSP} \times 100 \text{ seats} \times 1 \text{ year}$) for PCS ratably over 20X1.

Assume that on December 31, 20X1, C revises its estimate of the liability associated with the right of return to \$1 million because it now expects that the customer will convert all 100 seats to a SaaS arrangement. Entity C will reverse an additional \$400,000 of revenue for the incremental 50 seats of on-premise software expected to be forfeited ($\$8,000 \text{ software license SSP} \times 50 \text{ seats} \times 1 \text{ year}$) and reclassify \$100,000 of the remaining PCS contract liability for the incremental PCS expected to be forfeited ($\$2,000 \text{ PCS SSP} \times 50 \text{ seats} \times 1 \text{ year}$) for a total increase in liability of \$500,000 related to the credit expected to be granted to the customer. If the customer elects to exercise the conversion right on 100 seats on January 1, 20X2, revenue of \$1.1 million, which is calculated by adding the liability of \$1 million and the incremental fee of \$100,000 ($\$1,000 \text{ incremental fee} \times 100 \text{ seats} \times 1 \text{ year}$), is recognized over the remaining one-year SaaS term.

¹⁴ See [footnote 6](#).

¹⁵ See [footnote 7](#).

¹⁶ See [footnote 8](#).

¹⁷ See [footnote 9](#).

Because C's initial estimate of the liability for the credit expected to be granted to the customer was not sufficient, a significant amount of revenue ultimately had to be reversed in a subsequent reporting period. This example highlights the importance of critically evaluating how much revenue should be constrained, as discussed in [Section 3.1.3.1](#), to ensure that it is probable that a significant reversal in cumulative revenue recognized will not occur. Given the risk of overestimating the amount of variable consideration to which an entity can expect to be entitled for the on-premise software license and PCS, we believe that many software entities, particularly those that do not have sufficient historical data on conversion rates, may find it challenging to determine an appropriate estimate of variable consideration and constraint as required under Alternative 3B.

3.5.3.3 Tabular Summary of Alternatives 3A and 3B

The following table summarizes the timing of revenue recognition under Alternatives 3A and 3B:

	Alternative 3A (Prospective Material Right Model)		Alternative 3B (Right of Return Model)
	Separate Contract	Contract Modification	
Revenue recognized on January 1, 20X0	\$ 2,400,000	\$ 2,400,000	\$ 2,400,000
Revenue recognized from January 1 through December 31, 20X0	200,000	200,000	200,000
Revenue reversed on January 1, 20X1	—	—	(400,000)
Revenue recognized (reversed) from January 1 through December 31, 20X1	100,000	100,000	(200,000)*
Revenue recognized on January 1, 20X2	50,000	—	—
Revenue recognized from January 1 through December 31, 20X2	<u>350,000</u>	<u>400,000</u>	<u>1,100,000</u>
Total revenue recognized	<u>\$ 3,100,000</u>	<u>\$ 3,100,000</u>	<u>\$ 3,100,000</u>

* This amount represents the \$200,000 of revenue recognized for PCS less the \$400,000 reversal of revenue for the change in the estimate of variable consideration.

3.5.4 Initial Contract Includes Cloud Mixing Rights With a Cap

The example below illustrates an initial contract that gives the customer the right to use nonexclusive licensed software on both an on-premise basis and a cloud basis, subject to a cap on the total number of seats.

Example 3-5

On January 1, 20X0, Entity D enters into a noncancelable two-year contract with a customer for an up-front fee of \$1 million to provide 1,000 nonexclusive software licenses. Under the terms of the contract, the customer has an option to deploy each of the 1,000 licenses as either on-premise software or SaaS throughout the two-year license term. That is, the customer can use any mix of on-premise software and SaaS at any point during the license term as long as the number of licenses used does not exceed 1,000 seats. The on-premise software license and the SaaS (1) are each fully functional on their own and (2) provide the same functionality and features (other than D's hosting of the SaaS). At contract inception, the customer decides to use 600 licenses as on-premise software and 400 licenses as SaaS. Six months later, the customer decides to use 500 licenses as on-premise software and 500 licenses as SaaS.

Example 3-5 (continued)

We believe that D may reasonably conclude that it has promised to (1) provide the right to use on-premise software and (2) stand ready to provide SaaS (i.e., to host the software license). Since each of the promises is likely to be distinct, there are two performance obligations to which the \$1 million fee should be allocated on a relative SSP basis. We believe that it would be acceptable for D to estimate the SSP of each performance obligation by considering the expected mix of on-premise software and SaaS. The SSPs are determined at contract inception and should not be subsequently revised regardless of whether the mix of on-premise software and SaaS changes after the initial estimate. Consideration allocated to the on-premise software would be recognized once control of the license is transferred to the customer. In addition, since the performance obligation to provide SaaS is satisfied over time, consideration allocated to this performance obligation would be recognized as revenue over the two-year contract term (i.e., the period over which D is required to stand ready to provide SaaS).

3.6 Conversion of Perpetual Software Licenses to Term-Based Software Licenses

Certain entities that provide perpetual software licenses in contracts with customers may modify those contracts to convert the licenses from perpetual to term-based. Such modification is common for entities that intend to convert customers from an on-premise license arrangement to a cloud-based arrangement under which the software is hosted (e.g., SaaS). Converting a perpetual license to a term-based license is considered an intermediary step in this process.

The example below illustrates the accounting for conversion from perpetual software licenses to term-based software licenses.

Example 3-6

On January 1, 20X1, Entity B enters into a contract with Customer C to transfer a perpetual license for 100 seats of Software X and one year of PCS for a total price of \$1.2 million. The license is distinct from the PCS; therefore, there are two performance obligations. Customer C can renew PCS for \$200,000. The software has an estimated economic life of five years. Control of the perpetual license is transferred to C on January 1, 20X1.

Customer C renews PCS and receives regular updates in calendar years 20X2 and 20X3.

After calendar year 20X3, B no longer sells perpetual licenses and undertakes initiatives to transition its customers to its cloud-based offerings. In connection with this undertaking, B announces that it will no longer sell PCS renewals to existing perpetual license holders but instead will sell a one-year term license bundled with one year of PCS for the same amount at which a PCS renewal was sold. Accordingly, on January 1, 20X4, rather than renew the PCS under the existing terms, B and C enter into a contract under which C pays B \$200,000 for a bundle consisting of a one-year term license for 100 seats of Software X and one year of PCS. Under this new contract, C forfeits its rights to the perpetual license. As a result, in the absence of any additional term license renewals, C will lose its right to use Software X as of January 1, 20X5.

The substance of the transaction is that, for the initial term license purchase, C is renewing the PCS for license rights it already controls. This is because the exchange of a nonexclusive software license (i.e., the exchange of a perpetual license for a term-based license) is not considered a return. Although C lost its rights to the perpetual license, it retains the right to use the software for the duration of the term license, which is not a newly granted right. As a result, B will record the \$200,000 ratably as PCS (service) revenue in 20X4. That is, B does not treat the conversion as a return and does not recognize any software license (product) revenue in 20X4. This is because C already had rights to use the software and did not obtain any incremental rights upon conversion.

If B and C separately negotiate a renewal of the term license and PCS contract bundle for an additional year (i.e., beginning January 1, 20X6), the renewal will be treated the same as any other sale of a term license with associated PCS, if applicable.

Chapter 4 — Costs of Obtaining a Contract

4.1 Introduction

ASC 340-40 introduces comprehensive guidance on accounting for the costs of obtaining a contract within the scope of ASC 606. Under U.S. GAAP, there is separate cost guidance in ASC 340-40 but not in ASC 606.

Specifically, ASC 340-40 provides the following guidance on recognizing the incremental costs of obtaining a contract with a customer:

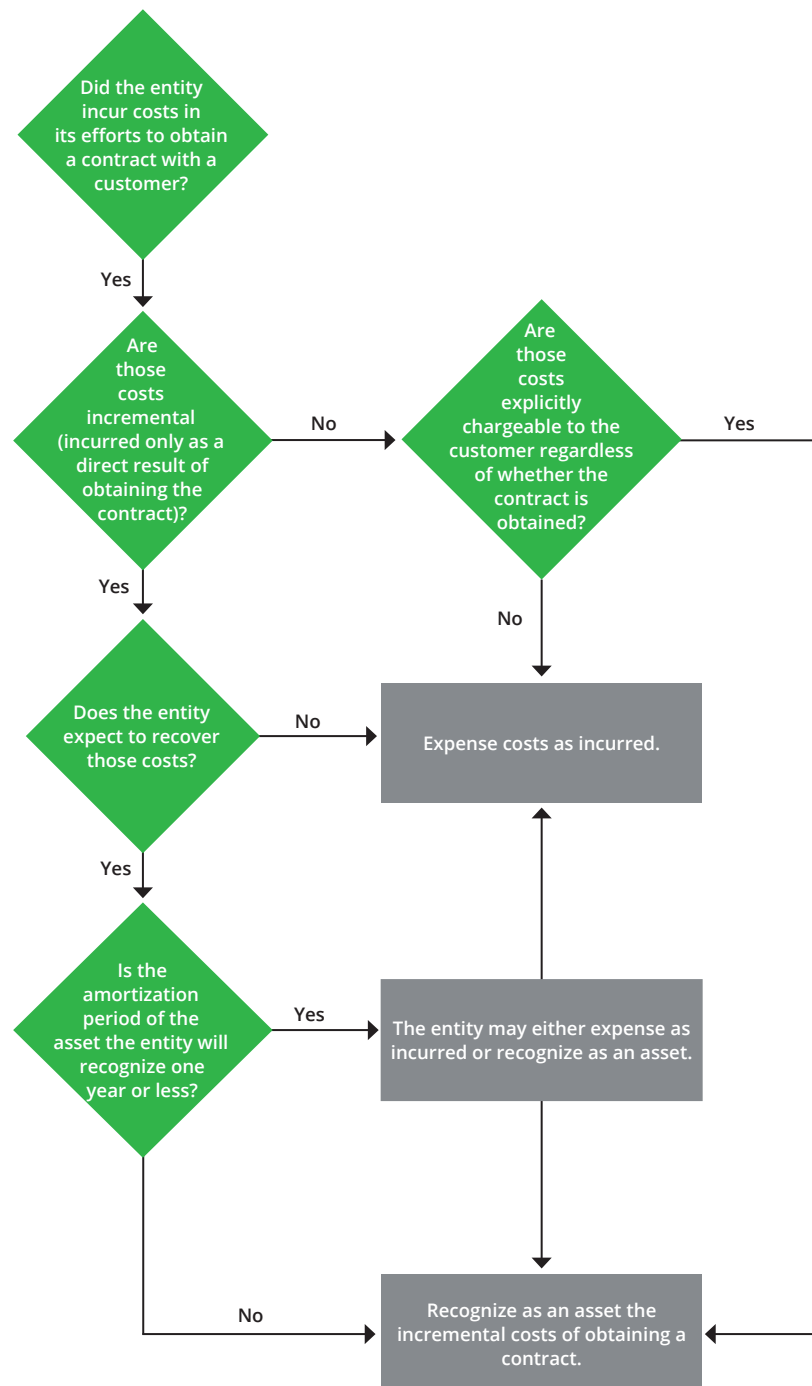
ASC 340-40

25-1 An entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs.

25-2 The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).

25-3 Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained shall be recognized as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.

The flowchart below illustrates the process that entities should use in applying the guidance in ASC 340-40-25-1 through 25-3 to determine the treatment of costs of obtaining a contract with a customer.



Under ASC 340-40-25-1, an entity must capitalize the incremental costs of obtaining a contract with a customer if the entity expects to recover them.¹ ASC 340-40-25-2 defines such incremental costs as those that the entity “would not have incurred if the contract had not been obtained (for example, a sales commission).” Questions have arisen about the types of costs that would qualify for capitalization under the revenue standard.

In [TRG Agenda Paper 57](#) and Q&A 78 of the FASB staff’s *Revenue Recognition Implementation Q&As*, which the FASB staff drafted in preparation for the revenue transition resource group’s (TRG’s) November 2016 meeting,² the staff noted that an entity should consider whether costs would have been incurred if the customer (or the entity) had decided that it would not enter into the contract just as the parties were about to sign the contract. If the costs (e.g., the legal costs of drafting the contract) would have been incurred even if the contract had not been executed, they would not be incremental costs of obtaining a contract.

At the TRG’s November 2016 meeting, TRG members generally agreed with the FASB staff’s views on which costs of obtaining a contract are incremental and the framework for analyzing whether costs are incremental. In a manner consistent with prior discussions of the timing of revenue recognition, TRG members confirmed their general agreement that entities should continue to refer to legacy U.S. GAAP on liability recognition to determine whether and, if so, when a liability needs to be recorded in connection with a contract with a customer. Therefore, an entity should initially apply the specific guidance on determining the recognition and measurement of the liability (e.g., commissions, payroll taxes, 401(k) match). If the entity recognizes a liability, only then should the entity determine whether to record the related debit as an asset or as an expense.

One TRG member highlighted a difference between the revenue standard’s guidance on capitalizing costs to obtain a contract and the accounting under legacy practice. The revenue standard requires that costs be incremental rather than both direct and incremental as they were under legacy U.S. GAAP (e.g., on loan origination and insurance policy acquisition). Accordingly, the TRG generally acknowledged that this difference may lead to a broader pool of costs that are subject to capitalization (i.e., entities may be required to capitalize certain costs in accordance with the revenue standard that they would not have capitalized under legacy U.S. GAAP if they had elected a capitalization policy).

However, the TRG cautioned that entities would need to use judgment to determine whether certain costs, such as commissions paid to multiple employees for the signing of a contract, are truly incremental. The FASB staff encouraged entities to apply additional skepticism to understand whether an employee’s compensation (i.e., commissions or bonus) — particularly for individuals in different positions in the organization and employees who are ranked higher in an organization — is related solely to executed contracts or is also influenced by other factors or metrics (e.g., employee general performance or customer satisfaction ratings). TRG members emphasized that only those costs that are incremental (e.g., costs that resulted from obtaining the contract) may be capitalized (as long as other asset recognition criteria are met).

¹ However, the practical expedient in ASC 340-40-25-4 allows an entity to “recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.”

² For more information about the TRG’s November 2016 meeting, see [TRG Agenda Paper 60](#) and Deloitte’s November 2016 [TRG Snapshot](#).

The table below outlines the views discussed at the TRG meeting on the examples in TRG Agenda Paper 57 and the views selected by the FASB staff. Quoted text is from TRG Agenda Paper 57.

Topic	Example/Question	Views Discussed	View Selected by FASB Staff
Fixed employee salaries	“Example 1: An entity pays an employee an annual salary of \$100,000. The employee’s salary is based upon the employee’s prior-year signed contracts and the employee’s projected signed contracts for the current year. The employee’s salary will not change based on the current year’s actual signed contracts; however, salary in future years likely will be impacted by the current year’s actual signed contracts. What amount, if any, should the entity record as an asset for incremental costs to obtain a contract during the year?”	<p>View A: “Determine what portion of the employee’s salary is related to sales projections and allocate that portion of the salary as an incremental cost to obtain a contract.”</p> <p>View B: “Do not capitalize any portion of the employee’s salary as an incremental cost to obtain a contract. The costs are not incremental costs to any contract because the costs would have been incurred regardless of the employee’s signed contracts in the current year.”</p>	<p>View B. “[N]one of the employee’s salary should be capitalized as an incremental cost to obtain a contract. . . . Whether the employee sells 100 contracts, 10 contracts, or no contracts, the employee is still only entitled to a fixed salary.”</p> <p>“[T]he objective of the requirements in [ASC] 340-40-25-1 is not to allocate costs that are associated in some manner with an entity’s marketing and sales activity. The objective is to identify the incremental costs that an entity would not have incurred if the contract had not been obtained.”</p>
Some, but not all, costs are incremental	“Example 2: An entity pays a 5% sales commission to its employees when they obtain a contract with a customer. An employee begins negotiating a contract with a prospective customer and the entity incurs \$5,000 of legal and travel costs in the process of trying to obtain the contract. The customer ultimately enters into a \$500,000 contract and, as a result, the employee receives a \$25,000 sales commission. What amount should the entity capitalize as an incremental cost to obtain the contract?”	<p>View A: “The entity should capitalize only \$25,000 for the sales commission. Those costs are the only costs that are incremental costs to obtain the contract because the entity would not have incurred the costs if the contract had not been obtained.”</p> <p>View B: “The entity should capitalize \$30,000, which includes the sales commission, legal expenses, and travel expenses. The entity would not have been able to obtain the contract without incurring those expenses.”</p>	<p>View A. “[T]he sales commission is the only cost that the entity would not have incurred if the contract had not been obtained. While the entity incurs other costs that are necessary to facilitate a sale (such as legal, travel and many others), those costs would have been incurred even if the customer decided at the last moment not to execute the contract.”</p> <p>If an entity “incurs the same type of legal and travel expenses to negotiate a contract, but the customer decides not to enter into the contract right before the contract was to be signed by both parties . . . , the travel and legal expenses would still have been incurred even though the contract was not obtained. However, the commission would not have been incurred.”</p>

(Table continued)

Topic	Example/Question	Views Discussed	View Selected by FASB Staff
Timing of commission payments	<p>Example 3: An entity pays an employee a 4% sales commission on all of the employee's signed contracts with customers. For cash flow management, the entity pays the employee half of the commission (2% of the total contract value) upon completion of the sale, and the remaining half of the commission (2% of the total contract value) in six months. The employee is entitled to the unpaid commission, even if the employee is no longer employed by the entity when payment is due. An employee makes a sale of \$50,000 at the beginning of year one. What amount should the entity capitalize as an incremental cost to obtain the contract?"</p>	<p>View A: "Capitalize half of the commission (\$1,000) and expense the other half of the commission (\$1,000)."</p> <p>View B: "Capitalize the entire commission (\$2,000)."</p>	<p>View B. "The commission is an incremental cost that relates specifically to the signed contract and the employee is entitled to the unpaid commission. [T]he timing of payment does not impact whether the costs would have been incurred if the contract had not been obtained."</p> <p>"In this fact pattern, only the passage of time needs to occur for the entity to pay the second half of the commission. However, . . . there could be other fact patterns in which additional factors might impact the payment of a commission to an employee." For example, an entity could make the second half of the commission contingent upon the employee's selling additional services to the customer or upon the customer's "completing a favorable satisfaction survey about its first six months of working with the entity." Therefore, an "entity will need to assess its specific compensation plans to determine the appropriate accounting for incremental costs of obtaining a contract."</p>

(Table continued)

Topic	Example/Question	Views Discussed	View Selected by FASB Staff
Commissions paid to different levels of employees	Example 4: An entity's salesperson receives a 10% sales commission on each contract that he or she obtains. In addition, the following employees of the entity receive sales commissions on each signed contract negotiated by the salesperson: 5% to the manager and 3% to the regional manager. Which commissions are incremental costs of obtaining a contract?"	<p>View A: "Only the commission paid to the salesperson is considered incremental because the salesperson obtained the contract."</p> <p>View B: "Only the commissions paid to the salesperson and the manager are considered incremental because the other employee likely would have had no direct contact with the customer."</p> <p>View C: "All of the commissions are incremental because the commissions would not have been incurred if the contract had not been obtained."</p>	<p>View C. "The new revenue standard does not make a differentiation based on the function or title of the employee that receives the commission. It is the entity that decides which employee(s) are entitled to a commission directly as a result of entering into a contract."</p> <p>"[I]t is possible that several commissions payments are incremental costs of obtaining the same contract. However, [stakeholders are encouraged] to ensure that each of the commissions are incremental costs of obtaining a contract with a customer, rather than variable compensation (for example, a bonus)" that would not be incremental because it also relies on factors other than sales.</p>

(Table continued)

Topic	Example/Question	Views Discussed	View Selected by FASB Staff
Commission payments subject to a threshold	<p>Example 5: An entity has a commission program that increases the amount of commission a salesperson receives based on how many contracts the salesperson has obtained during an annual period. The breakdown is as follows:</p> <ul style="list-style-type: none"> • 0–9 contracts . . . 0% commission • 10–19 contracts . . . 2% of value of contracts 1–19 • 20+ contracts . . . 5% of value of contracts 1–20+ <p>Which commissions are incremental costs of obtaining a contract?"</p>	<p>View A: "No amounts should be capitalized because the commission is not directly attributable to a specific contract."</p> <p>View B: "The costs are incremental costs of obtaining a contract with a customer and, therefore, the costs should be capitalized."</p>	<p>View B. Both the 2 percent commission and the 5 percent commission are incremental costs of obtaining a contract. "The entity would apply other GAAP to determine whether a liability for the commission payments should be recognized. When a liability is recognized, the entity would recognize a corresponding asset for the commissions. This is because the commissions are incremental costs of obtaining a contract with a customer. The entity has an obligation to pay commissions as a direct result of entering into contracts with customers. The fact that the entity's program is based on a pool of contracts (versus a program in which the entity pays 3% for all contracts) does not change the fact that the commissions would not have been incurred if the entity did not obtain the contracts with those customers."</p>

4.2 Using the Portfolio Approach for Contract Costs

The guidance in ASC 340-40 was developed contemporaneously with that in ASC 606. ASC 340-40-05-1 expressly indicates that ASC 340-40 is aligned with ASC 606, stating that "[t]his Subtopic provides accounting guidance for the following costs related to a contract with a customer within the scope of Topic 606 on revenue from contracts with customers."

ASC 606 is applied at the individual contract level (or to a combination of contracts accounted for under ASC 606-10-25-9). In addition, ASC 606-10-10-4 allows an entity to apply, as a practical expedient, the revenue recognition guidance to a portfolio of contracts rather than an individual contract. The practical expedient can only be used "if the entity reasonably expects that the effects on the financial statements of applying [the revenue recognition guidance] to the portfolio would not differ materially from applying [the revenue recognition guidance] to the individual contracts (or performance obligations) within that portfolio." In addition, ASC 606-10-10-3 states that an "entity shall apply this guidance, including the use of any practical expedients, consistently to contracts with similar characteristics and in similar circumstances."

If an entity reasonably expects that contract costs recorded under a portfolio approach would not differ materially from contract costs that would be recorded individually, an entity may apply a portfolio approach to account for the costs. The entity would use judgment in determining the characteristics of the portfolio in a manner similar to its assessment of whether a portfolio satisfies the requirements in ASC 606-10-10-4.

In applying the portfolio approach, an entity should consider paragraph BC69 of [ASU 2014-09](#), which states, in part, that the FASB and IASB “did not intend for an entity to quantitatively evaluate each outcome and, instead, the entity should be able to take a reasonable approach to determine the portfolios that would be appropriate for its types of contracts.” In determining the characteristics and composition of the portfolio, an entity should consider the nature and timing of costs incurred and the pattern of transferring control of the related good or service to the customer (e.g., amortization of the capitalized costs).

An entity may have a policy of matching 401(k) contributions on the basis of salaries paid to sales representatives, including sales commissions. These sales commissions may be determined to meet the definition of incremental costs of obtaining contracts with customers in ASC 340-40-25-2 and would therefore be capitalized in accordance with ASC 340-40-25-1.

ASC 340-40-25-1 requires an entity to “recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs.” The incremental costs of obtaining a contract are defined in ASC 340-40-25-2 as “those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).”

When 401(k) match contributions (along with other fringe benefits) are attributed directly to sales commissions that are determined to be incremental costs of obtaining contracts with customers, the 401(k) match contributions also qualify as incremental costs of obtaining the contracts since such costs would not have been incurred if the contracts had not been obtained. However, incremental costs of obtaining contracts with customers would not include fringe benefits constituting an allocation of costs that would have been incurred regardless of whether a contract with a customer had been obtained.

Arrangements for the payment of some incremental costs of obtaining a contract may be complex. For example, payment of a sales commission may be (1) contingent on a future event, (2) subject to clawback, or (3) based on achieving cumulative targets.

The revenue standard does not address when to recognize the incremental costs of obtaining a contract. Other Codification topics (e.g., ASC 275, ASC 710, ASC 712, ASC 715, and ASC 718) specify when a liability for costs should be recognized and how that liability should be measured.

If an entity concludes that a liability for incremental costs of obtaining a contract should be recognized under the relevant Codification topic, the guidance in ASC 340-40-25-1 should be applied to determine whether those recognized costs should be capitalized as an asset or recognized immediately as an expense.



Connecting the Dots

ASC 340-40-25-2 states that the “incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).” Application of this guidance requires an entity to identify those costs that are incurred (i.e., accrued) as a direct result of obtaining a contract with a customer. An entity should apply existing guidance outside of the revenue standard to determine whether a liability should be recognized as a result of obtaining a contract with a customer. Upon determining that a liability needs to be recorded, the entity should determine whether the related costs were incurred because, and only because, a contract with a customer was obtained.

In many circumstances, it may be clear whether particular costs are costs that an entity incurs *to obtain* a contract. For example, if an entity incurs a commission liability solely as a result of obtaining a contract with a customer, the commission would be an incremental cost incurred to obtain such a contract. However, in other circumstances, an entity may need to exercise judgment and consider existing accounting policies for liability accruals when determining whether a cost is incurred in connection with obtaining a contract with a customer. As also noted in TRG Agenda Paper 57, when the determination of whether a cost has been incurred is affected by other factors (i.e., factors in addition to obtaining a contract with a customer), an entity will need to take additional considerations into account when assessing whether a cost is an incremental cost associated with obtaining a contract with a customer.

For example, some commission plans include substantive service conditions that need to be met before a commission associated with a contract (or group of contracts) is actually earned by the salesperson. In such cases, some or all of the sales commission may not be incremental costs incurred to obtain a contract with the customer since the costs were not actually incurred solely as a result of obtaining a contract with a customer. Rather, the costs were incurred as a result of obtaining a contract with a customer *and* the salesperson’s providing ongoing services to the entity for a substantive period.

Some commission structures could have a service condition that is determined to be nonsubstantive. In such cases, the commission is likely to be an incremental cost incurred to obtain a contract with a customer. In other cases, a commission plan could include a service condition, but the reporting entity determines on the basis of the amount and structure of the commission payments that part of the entity’s commission obligation is an incremental cost incurred to obtain a contract with a customer (because it is not tied to a substantive service condition) while the rest of the commission is associated with ongoing services provided by the salesperson.

Sometimes, there may be other factors that affect the commission obligation but the ultimate costs are still incremental costs incurred to obtain the contract. For example, a commission may be payable to a salesperson if a customer’s total purchases exceed a certain threshold regardless of whether the salesperson is employed when the threshold is met (i.e., there is no service condition). In these cases, although no liability may be recorded when the contract with the customer is obtained (because of the entity’s assessment of the customer’s likely purchases), if the customer’s purchases ultimately exceed the threshold and the commission is paid, the commission is an incremental cost of obtaining the contract. That is, the commission is a cost that the entity would not have incurred if the contract had not been obtained. This situation is economically similar to one involving a paid commission that is subject to clawback if the customer does not purchase a minimum quantity of goods or services.

Entities will need to carefully evaluate the facts and circumstances when factors other than just obtaining a contract with a customer affect the amount of a commission or other incurred costs. Entities should consider their existing policies on accruing costs when determining which costs are incremental costs incurred to obtain a contract with a customer.

Example 4-1

Entity A's internal salespeople earn a commission based on a fixed percentage (4 percent) of sales invoiced to a customer. Half of the commission is paid when a contract with a customer is signed; the other half is paid after 12 months but only if the salesperson is still employed by A. Entity A concludes that a substantive service period is associated with the second commission payment, and A's accounting policy is to accrue the remaining commission obligation ratably as the salesperson provides ongoing services to A.

Entity A enters into a three-year noncancelable service contract with a customer on January 1, 20X7. The total transaction price of \$3 million is invoiced on January 1, 20X7. The salesperson receives a commission payment of 2 percent of the invoice amount (\$60,000) when the contract is signed; the other half of the 4 percent commission will be paid after 12 months if the salesperson continues to be employed by A at that time. That is, if the salesperson is not employed by A on January 1, 20X8, the second commission payment will not be made. Entity A records a commission liability of \$60,000 on January 1, 20X7, and accrues the second \$60,000 commission obligation ratably over the 12-month period from January 1, 20X7, through December 31, 20X7.

Entity A concludes that only the first \$60,000 is an incremental cost incurred to obtain a contract with a customer. Because there is a substantive service condition associated with the second \$60,000 commission, A concludes that the additional cost is a compensation cost incurred in connection with the salesperson's ongoing service to A. That is, the second \$60,000 commission obligation was not incurred solely to obtain a contract with a customer but was incurred in connection with ongoing services provided by the salesperson.

If the salesperson would be paid the commission even if no longer employed, or if A otherwise concluded that the service condition was not substantive, the entire \$120,000 would be an incremental cost incurred to obtain a contract and would be capitalized in accordance with ASC 340-40-25-1. Entities will need to exercise professional judgment when determining whether a service condition is substantive.

Because commission and compensation structures can vary significantly between entities, an entity should evaluate its specific facts and circumstances when determining which costs are incremental costs incurred to obtain a contract with a customer. It is important for entities to consider whether an obligation to make a payment is solely a result of obtaining a contract with a customer. Further, entities will need to refer to U.S. GAAP outside of the revenue standard to determine when a liability has been incurred. Upon recognizing a liability, an entity needs to consider whether the corresponding amount should be recognized as an asset in accordance with ASC 340-40-25-1.

4.3 Disclosure Requirements

ASC 340-40-50 provides the disclosure requirements for costs of obtaining contracts with customers. The table below summarizes these disclosure requirements, including both the disclosures that a nonpublic entity may elect not to apply and required interim disclosures.

Category	Disclosure Requirements	Election Available to Nonpublic Entities	Interim Requirement (ASC 270)
Contract costs	Qualitative information about:		
	<ul style="list-style-type: none"> Judgments the entity used in determining the amount of the costs incurred to obtain or fulfill a contract. 	Yes	No
	<ul style="list-style-type: none"> The method the entity uses to determine the amortization for each reporting period. 	Yes	No
	Quantitative information about:		
	<ul style="list-style-type: none"> The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract, by main category of asset. 	Yes	No
	<ul style="list-style-type: none"> The amount of amortization and any impairment losses recognized in the reporting period. 	Yes	No

Entities are required to disclose significant judgments related to contract costs to help financial statement users understand the types of costs that the entity has recognized as assets and how those assets are subsequently amortized or impaired.

ASC 340-40

50-1 Consistent with the overall disclosure objective in paragraph 606-10-50-1 and the guidance in paragraphs 606-10-50-2 through 50-3, an entity shall provide the following disclosures of assets recognized from the costs to obtain or fulfill a contract with a customer in accordance with paragraphs 340-40-25-1 or 340-40-25-5.

50-2 An entity shall describe both of the following:

- The judgments made in determining the amount of the costs incurred to obtain or fulfill a contract with a customer (in accordance with paragraph 340-40-25-1 or 340-40-25-5)
- The method it uses to determine the amortization for each reporting period.

50-3 An entity shall disclose all of the following:

- The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract with a customer (in accordance with paragraph 340-40-25-1 or 340-40-25-5), by main category of asset (for example, costs to obtain contracts with customers, precontract costs, and setup costs)
- The amount of amortization and any impairment losses recognized in the reporting period.

ASC 340-40 (continued)

50-4 An entity, except for a public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements with or to the Securities and Exchange Commission, may elect not to provide the disclosures in paragraphs 340-40-50-2 through 50-3.

The illustrative disclosure below shows how an entity may disclose the qualitative and quantitative information required under ASC 340-40-50-1 through 50-4.

Illustrative Disclosure — Qualitative and Quantitative Information About Contract Costs**Assets Recognized From the Costs Incurred to Obtain or Fulfill a Contract With a Customer**

For business units C and D, the incentive portions of the Company's sales commission plans qualify for capitalization since these payments are directly related to sales achieved during a time period. The amortization period for the capitalized asset is the original contract term because commensurate commissions are paid for all renewals. For these capitalized sales commissions, the Company amortizes the capitalized costs and allocates them on a relative basis to the products and services sold. When the Company recognizes revenue related to goods and services at a point in time, the commission costs related to those goods and services are recognized when control of those goods and services is transferred to the customer. When the Company recognizes revenue related to goods and services over time by using the time-elapsed output method, the commission costs related to those goods and services are amortized ratably over the same period. The capitalized costs of the remaining goods and services for which revenue is recognized over time are amortized in the periods in which the goods and services are invoiced because the amount the Company has invoiced corresponds to the value to the customer of the Company's performance completed to date.

For business unit A, the incentive portions of the Company's sales commission plans qualify for capitalization. These commissions are earned on the basis of the total purchase order value of new bookings, which does not include sales related to renewals. Since there are not commensurate commissions earned on renewal of the Type B services, the capitalized asset is related to Type B services provided under both the initial contract and renewal periods. Therefore, the amortization period for the asset is the customer life, which is determined to be five years. Since the asset is related to services that are transferred over the customer's life, the Company amortizes the asset on a straight-line basis over the customer life of five years.

The Company's total capitalized costs incurred to obtain customer contracts (i.e., capitalized sales commissions) as of December 31, 20X2, and December 31, 20X1, were \$30 million and \$24 million, respectively. During the years ended December 31 of 20X2, 20X1, and 20X0, the Company amortized \$14 million, \$10 million, and \$8 million, respectively, of costs incurred to obtain customer contracts.

None of the Company's fulfillment costs incurred meet the capitalization criteria for costs of fulfilling a contract because they do not generate or enhance resources used to satisfy promises to provide future goods or services.

Appendix A — Titles of Standards and Other Literature

AICPA Literature

Accounting and Valuation Guide

Assets Acquired to Be Used in Research and Development Activities

Audit and Accounting Guide

Revenue Recognition

FASB Literature

ASC Topics

ASC 105, *Generally Accepted Accounting Principles*

ASC 250, *Accounting Changes and Error Corrections*

ASC 270, *Interim Reporting*

ASC 275, *Risks and Uncertainties*

ASC 310, *Receivables*

ASC 340, *Other Assets and Deferred Costs*

ASC 350, *Intangibles — Goodwill and Other*

ASC 360, *Property, Plant, and Equipment*

ASC 605, *Revenue Recognition*

ASC 606, *Revenue From Contracts With Customers*

ASC 610, *Other Income*

ASC 710, *Compensation — General*

ASC 712, *Compensation — Nonretirement Postemployment Benefits*

ASC 715, *Compensation — Retirement Benefits*

ASC 718, *Compensation — Stock Compensation*

ASC 720, *Other Expenses*

ASC 730, *Research and Development*

ASC 740, *Income Taxes*

ASC 805, *Business Combinations*

ASC 835, *Financial Instruments*

ASC 842, *Leases*

ASC 928, *Entertainment — Music*

ASC 985, *Software*

ASUs

ASU 2014-09, *Revenue From Contracts With Customers (Topic 606)*

ASU 2016-08, *Revenue From Contracts With Customers (Topic 606): Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net)*

ASU 2016-10, *Revenue From Contracts With Customers (Topic 606): Identifying Performance Obligations And Licensing*

ASU 2018-15, *Intangibles — Goodwill and Other — Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract* — a consensus of the FASB Emerging Issues Task Force

ASU 2023-05, *Business Combinations — Joint Venture Formations (Subtopic 805-60): Recognition and Initial Measurement*

ASU 2024-02, *Codification Improvements — Amendments to Remove References to the Concepts Statements*

Proposed ASU

No. 2024-ED400, *Intangibles — Goodwill and Other — Internal-Use Software (Subtopic 350-40): Targeted Improvements to the Accounting for Internal-Use Software*

Concepts Statement

No. 8, *Conceptual Framework for Financial Reporting*

IRC

Section 250, "Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income"

TRG Agenda Papers

TRG Agenda Paper 57, *Capitalization and Amortization of Incremental Costs of Obtaining a Contract*

TRG Agenda Paper 60, *November 2016 Meeting — Summary of Issues Discussed and Next Steps*

Superseded Literature

AICPA Statements of Position

SOP 93-7, *Reporting on Advertising Costs*

SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*

FASB Concepts Statement

No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*

FASB Statement

No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases* — an amendment of FASB Statements No. 13, 60, and 65 and a rescission of FASB Statement No. 17

Appendix B — Abbreviations

Abbreviation	Description
AcSEC	Accounting Standards Executive Committee
AI	artificial intelligence
AICPA	American Institute of Certified Public Accountants
ASC	FASB Accounting Standards Codification
ASU	FASB Accounting Standards Update
BC	Basis for Conclusions
CCA	cloud computing arrangement
CIMA	Chartered Institute of Management Accountants
CPU	central processing unit
DTC	direct-to-consumer
ERP	enterprise resource planning
FASB	Financial Accounting Standards Board
FDII	foreign-derived intangible income
GAAP	generally accepted accounting principles
GPU	graphics processing unit
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standard

Abbreviation	Description
IP	intangible property
IRC	Internal Revenue Code
IT	information technology
LLM	large language model
MHW	mental health and wellness
NLP	natural language processing
OCA	SEC's Office of the Chief Accountant
PCAOB	Public Company Accounting Oversight Board
PCS	postcontract customer support
PE	private equity
Q&A	question and answer
R&D	research and development
RAM	random-access memory
SaaS	software as a service
SEC	U.S. Securities and Exchange Commission
SOP	AICPA Statement of Position
SSP	stand-alone selling price
SUD	substance use disorder
TRG	transition resource group
VC	venture capital



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