In depth

A look at current financial reporting issues

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What's inside:

New revenue guidance
Implementation in the software industry

At a glance

Public companies must adopt the new revenue standard in 2018. Almost every company will be affected to some extent by the new guidance, though the effect will vary depending on industry and current accounting practices. Although originally issued as a converged standard under US GAAP and IFRS, the FASB and IASB have made slightly different amendments so the ultimate application of the guidance could differ under US GAAP and IFRS.

The Revenue Recognition Transition Resource Group (TRG) and the AICPA's software revenue recognition task force have discussed various implementation issues impacting companies across many industries. The SEC expects registrants to consider these discussions in applying the new guidance as they may provide helpful insight.

This publication reflects the implementation developments since the guidance was issued and highlights certain challenges specific to the software industry. The content in this publication should be considered together with our Revenue guide, available at CFOdirect.com.

Overview

Revenue recognition within the software industry has historically been highly complex with much industry-specific guidance. The new revenue standards (ASC 606 and IFRS 15, *Revenue from Contracts with Customers*) replace industry-specific guidance with a single revenue recognition model. As such, the accounting for software products and services is expected to be one of the areas most impacted by the new standards. This publication summarizes the more significant impacts of the new guidance on the software industry, broken down by step of the model.

The effective date and transition guidance varies for companies reporting under each framework.

- Under US GAAP, public business entities must apply ASC 606 for annual reporting periods (including interim periods therein) beginning after December 15, 2017. Entities that are not public business entities reporting under US GAAP are required to apply ASC 606 for annual periods beginning after December 15, 2018. The standard permits early adoption for all companies for annual reporting periods beginning after December 15, 2016.
- Companies that report under IFRS are required to apply IFRS 15 for annual reporting periods beginning on or after January 1, 2018, and early adoption is permitted.

1. Identify the contract

Under the new revenue standards, a contract may be written, oral, or implied by the vendor's customary business practices. Generally, any agreement with a customer that creates legally enforceable rights and obligations meets the definition of a contract under the new guidance. Software companies should consider any side agreements, whether verbal or written, as these may create enforceable rights and obligations and have implications for revenue recognition.

In the software industry, a contract may take the form of formal signed contracts, purchase orders, electronic communications, or, in the case of consumer products, sales receipts. Master agreements often define all of the basic terms and conditions for transactions between the parties. A second communication in the form of a purchase order or electronic request that specifies the software products, quantities, and requested delivery dates often supplements the master agreement. In these cases, the master agreement and the additional communication constitute the contract with the customer because the quantities specified create enforceable rights and obligations between the two parties.

Collectibility

As part of identifying the contract, companies are required to assess whether collection of the consideration is probable, which is generally interpreted as a 75-80% likelihood in US GAAP and a greater than 50% likelihood in IFRS. This assessment is made after considering any price concessions expected to be provided to the customer. In other words, price concessions are variable consideration (which affect the transaction price), rather than a factor to consider in assessing collectibility. Further, the FASB clarified in an amendment of ASC 606 that companies should consider, as part of the collectibility assessment, their ability to mitigate their exposure to credit risk, for example by ceasing to provide goods or services in the event of nonpayment. The IASB did not amend IFRS 15 on this point, but did include additional discussion regarding credit risk in the Basis for Conclusions of their amendments to IFRS 15.

New guidance	Current US GAAP	Current IFRS
A company accounts for a contract with a customer when all of the following criteria are met: • Contract has been approved and the parties are committed • Each party's rights are identified • Payment terms are defined. • Contract has commercial substance • Collection is probable Management should reassess the arrangement at each reporting period to determine if	A company is generally prohibited from recognizing revenue from an arrangement until persuasive evidence of the arrangement exists, even if the software has been delivered and the other revenue recognition criteria have been met. Evidence of the arrangement should be consistent with the vendor's customary business practices. If the vendor customarily obtains a written contract, a contract signed by both parties is the only acceptable evidence that the agreement exists. If the vendor does not customarily obtain a	A company is required to consider the underlying substance and economics of an arrangement, not merely its legal form. A company must establish that it is probable that the economic benefits of the transaction will flow to it before revenue can be recognized. A provision for bad debts (incurred losses on financial assets, including accounts receivable) is recognized in a two-step process: (1) objective evidence of impairment must be present; then (2) the amount of

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<td rowspan="2">the criteria are met. If an arrangement does not meet all of the criteria, the arrangement is not accounted for using the five-step model. In that case, the company should recognize consideration received as revenue when one of the following events occurs:

• There are no remaining obligations to transfer goods or services to the customer, and substantially all of the consideration has been received and is nonrefundable.
• The contract has been terminated, and the consideration received is nonrefundable.
• The company transferred control of the goods or services, the company has stopped transferring goods or services to the customer (if applicable) and has no obligation to transfer additional goods or services, and the consideration received from the customer is nonrefundable. [US GAAP only]

IFRS 15 does not include the same implementation guidance and examples related to the collectibility assessment; however, the IASB included discussion in its Basis for Conclusions that describes similar principles as the ASC 606 implementation guidance.</td>
<td>signed contract, the vendor must have other forms of evidence documenting that an arrangement exists (such as a purchase order, online authorization, electronic communication, or credit card authorization).

Revenue is deferred in its entirety if a company cannot conclude that collection from the customer is reasonably assured.</td>
<td>the impairment is measured based on the present value of expected cash flows.</td>
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<td colspan="2">Expected impact

Today, software companies that customarily obtain a written contract from their customers are precluded from recognizing revenue under US GAAP until there is a written, final contract signed by both the company and customer. The assessment of whether a contract with a customer exists under the new revenue guidance is less driven by the form of the arrangement, but rather by whether an agreement between the parties (either written, oral, or implied) creates legally enforceable rights and obligations between them.

The purpose of the collectibility assessment under the new guidance is to determine whether there is a substantive contract between the company and the customer. This differs from current guidance in which collectibility is a constraint on revenue recognition.

We expect the application of the collectibility assessment to be similar under ASC 606 and IFRS 15, with the exception of the limited situations impacted by the difference in the definition of “probable”.

The new guidance also eliminates the cash-basis method of revenue recognition that is often applied today if collectibility is not reasonably assured (US GAAP) or probable (IFRS).

Companies that conclude collection is not probable under the new guidance cannot recognize revenue for cash received if (1) they have not collected substantially all of the consideration and (2) continue to transfer goods or services to the customer.</td>
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Example 1-1: Assessment of collectibility

Facts: Software Co. decides to expand into a new market, which is currently experiencing economic stagnation. On December 15, 20x6, Software Co. enters into an arrangement with Engineering Co. to license its software and provide post-contract customer support (PCS) for a two-year term beginning January 1, 20x7. The total consideration is $2.4 million.

Engineering Co. is a start-up company with limited cash, and thus, the parties agree that Engineering Co. will pay for the licensed software over two years in monthly installments of $100,000.

How should Software Co. evaluate whether collection is probable for this arrangement?

Analysis: In evaluating whether collection is probable, Software Co. should first assess whether it intends to provide a price concession. For example, if Software Co. were to determine that it is willing to accept a lower amount, if necessary, of up to $400,000, the amount to which it would be entitled is $2.0 million.

Thus, it would perform the collectibility assessment based on the $2.0 million rather than the contractually-stated consideration of $2.4 million.

If Software Co. concludes that it is not probable that it will collect the expected consideration of $2.0 million, it should initially account for any cash collected as a liability until one of the events (in the preceding table) occurs to recognize the cash as revenue.

Further, Software Co. should reassess whether the collectibility criterion is met each reporting period and recognize revenue on a cumulative catch-up basis if it concludes collection is probable in a future period or if the conditions described are met.

Software Co. should also assess whether there is a difference between the timing of the payment and performance, indicating a significant financing component exists in the arrangement. See further discussion of the existence of a significant financing component on page 18.

Contract modifications

It is common in the software industry to change the scope or price of the contract. For example, a vendor may license software and provide PCS to a customer in an initial transaction and then license additional software to the same customer at a later time. In general, any change to an existing contract is a modification per the guidance when the parties to the contract approve the modification either in writing, orally, or based on the parties' customary business practices. A new contract entered into with an existing customer could also be viewed as the modification of an existing contract, depending on the circumstances.

In determining whether a contract has been modified, among other factors, company might consider whether:

- the terms and conditions of the new contract were negotiated separately from the original contract, and
- the additional goods or services were subject to a competitive bid process, and
- any discount to the standalone selling price of the additional goods or services is attributable to the original contract.

Modifications are accounted for as either a separate contract or as part of the existing contract (either prospectively or through a cumulative catch-up adjustment). This assessment is driven by whether (1) the modification adds distinct goods and services and (2) the distinct goods and services are priced at their standalone selling prices.

Modification accounted for as a separate contract

A modification is accounted for as a separate contract if the additional goods or services are distinct and the contract price increases by an amount that reflects the standalone selling price of the additional goods or services. The guidance provides some flexibility to adjust the standalone selling price to reflect contract-specific circumstances. For example, a company might provide a discount to a recurring customer that it would not provide to a new customer because it does not incur the same selling-related costs.

Modification accounted for prospectively

The modification is accounted for as if it were a termination of the original contract and the creation of a new contract if the additional goods or services are distinct, but the price of the added goods or services does not reflect standalone selling price. Any unrecognized revenue from the original contract and the additional consideration from the modification is combined and allocated to all of the remaining performance obligations under the original contract and modification.

Modification accounted for through a cumulative catch-up adjustment

If the added goods or services are not distinct and are part of a single performance obligation that is only partially satisfied when the contract is modified, the modification is accounted for through a cumulative catch-up adjustment.

Example 1-2: Contract modifications

Facts: Cloud Co. enters into a three-year service contract with Customer for $450,000 ($150,000 per year). The standalone selling price for one year of service at inception of the contract is $150,000 per year. Cloud Co. concludes the contract is a series of distinct services.

At the end of the second year, the parties agree to modify the contract as follows:

- The fee for the third year is reduced to $120,000
- Customer agrees to extend the contract for another three years for $300,000 ($100,000 per year)

The standalone selling price for one year of service at the time of modification is $120,000, taking into account the contract-specific circumstances.

How should Cloud Co. account for the modification?

Analysis: The modification would be accounted for as part of the existing contract on a prospective basis (as if the original arrangement was terminated and a new contract created) because the additional services to be provided are distinct, but the price of the contract did not increase by an amount of consideration that reflects the standalone selling price of the additional services.

Cloud Co. should reallocate the remaining consideration of $120,000 and the new consideration of $300,000 to all of the services to be provided (obligations remaining from the original contract and the new obligations). Cloud Co. will recognize a total of $420,000 ($120,000 + $300,000) over the remaining four-year service period (one year remaining under the original contract plus three additional years), or $105,000 per year.

Combining contracts

Multiple contracts need to be combined and accounted for as a single arrangement when the economics of the individual contracts cannot be understood without reference to the arrangement as a whole.

The determination of whether to combine two or more contracts is made at contract inception. Contracts must be entered into with the same customer (or related parties of the customer) at or near the same time to account for them as a single contract.

A software vendor should combine individual contracts entered into at or near the same time if they are negotiated as a package with a single commercial objective. Contracts might have a single commercial objective if a contract would be loss-making without the consideration received under another contract.

Contracts should also be combined if the price or performance under one contract affects the consideration to be paid under another contract. This would be the case when failure to perform under one contract affects the amount paid under another contract.

Lastly, contracts should be combined if the goods or services in the contracts are a single performance obligation. For example, a contract for the sale of software should not be accounted for separately from a second contract for significant customization and modification of the software.

2. Identify performance obligations

Software arrangements are typically comprised of:

- Multiple goods and services, such as software licenses
- Unspecified or specified future updates or upgrades / enhancements
- Specified or unspecified additional software products
- Exchange and platform transfer rights
- PCS
- Installation
- Other professional services

The goods or services promised in a contract with a customer may be explicitly stated in the arrangement or implied by the software vendor's customary business practices. The new revenue guidance requires companies to consider whether the customer has a valid expectation that the vendor will provide a good or service when it is not explicitly stated. If the customer has a valid expectation, the customer would view those promises as part of the goods or services in the contract.

A promised good or service must be distinct to be accounted for as a separate performance obligation when there are multiple promises in a contract. A good or service is distinct if (1) the customer can benefit from the good or service either on its own or together with other readily available sources (that is, it is capable of being distinct) and (2) if the good or service is separately identifiable from the other promises in the contract (that is, distinct in the context of the contract). Determining whether a good or service is distinct may require significant judgment.

Under the new guidance, how to identify separate performance obligations is a significant change for companies in the software industry. The new guidance eliminates current software industry-specific guidance under US GAAP (which was often applied by analogy under IFRS) and thus, vendor specific objective evidence (VSOE) of fair value is no longer required to separately account for elements in a software licensing arrangement. As a result, companies that couldn't separately account for elements due to a lack of VSOE may recognize revenue earlier.

Licenses of intellectual property

The new standards provide specific guidance on accounting for licenses of intellectual property. A license arrangement establishes a customer's rights related to a company's intellectual property (IP) and the obligations of the company to provide those rights. Licenses in the software industry come in many forms and can be term-based or perpetual, exclusive or nonexclusive.

Consideration received for licenses often includes upfront payments, over time payments, or some combination of the two. These arrangements also frequently include other licensor obligations such as PCS, including specified or unspecified upgrades or enhancements, telephone support, and professional services.

Management will first need to determine whether an arrangement includes a license of IP, particularly in arrangements that include cloud services or software as a service (SaaS). For US GAAP reporters, a software license included in a hosting arrangement that does not meet either of the criteria in ASC 985-20 (i.e., the customer can take possession of the software at any time without significant penalty and it's not feasible for the customer to run the software on its own hardware or use another vendor to host the software) is not a license of IP subject to the licensing guidance in ASC 606. Similar concepts would apply to IFRS reporters, although there is no specific guidance on this concept within IFRS.

Other arrangements may contain a license of IP that is not distinct and should be combined with the other goods or services in the arrangement. For example, a software license that solely enables a customer to access content delivered via an online service is not distinct from the online service. Many companies provide hybrid offerings that represent a combination of on-premise software and SaaS. Assessing whether the on-premise software license is distinct from the SaaS may require significant judgment. See Example 2-1 for an illustration of a hybrid offering.

License is not distinct

When a license is not distinct from the other goods or services, the company will need to determine whether the combined performance obligation is satisfied (1) over time or (2) at a point in time.

License is distinct

Under US GAAP, for licenses that are distinct, the licensor will need to determine if the license provides a right to use the IP or a right to access the IP, as this will determine whether revenue allocated to the license should be recognized at a point in time or over time. ASC 606 defines two categories of IP, functional and symbolic, for purposes of assessing whether a license is a right to use or a right to access IP.

Similarly, under IFRS, for licenses that are distinct, the licensor will need to determine whether the license is a right to use or a right to access IP. This assessment is based on whether the licensor's activities significantly change the IP to which the customer has rights.

We believe that the outcome of applying ASC 606 and IFRS 15 in determining the nature of a license will be similar; however, there may be limited instances when the conclusions could differ.

Sales- or usage-based royalties in exchange for IP will also impact revenue recognition under the new guidance for both US GAAP and IFRS reporters, as discussed on page 25.

Restrictions on time, geography, or use

All software licenses contain provisions that specify the licensee's rights with respect to the use of the IP. For example, a license could stipulate that the IP can only be used for a specified term or only to sell products in a specified geographical region. The new revenue guidance requires companies to distinguish between (1) contractual provisions that define the attributes of a license of IP and (2) provisions that represent additional promised goods or services to the customer.

Contractual provisions that are attributes of a single promised license define the scope of a customer's rights to IP and do not affect the number of performance obligations or whether a performance obligation is satisfied at a point in time or over time.

ASC 606 and IFRS 15 use different words to explain how contractual restrictions may impact the number of promises in a contract. The FASB included additional examples related to license restrictions. We believe the concepts in the two standards are similar; however, companies may reach different conclusions under the two standards given that US GAAP contains more specific guidance.

<table>
<tr><th>New guidance</th><th>Current US GAAP</th><th>Current IFRS</th></tr>
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<td rowspan="2">A performance obligation is a promise in a contract to transfer to a customer either:

• a good or service (or a bundle of goods or services) that is distinct, or
• a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer.

A good or service is distinct if both:

• 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.
• The good or service is separately identifiable from other goods or services in the contract.

Licenses
When a license is distinct, consider the nature of the license – (1) right to access IP or (2) right to use IP -- to determine when to recognize revenue.

Right to access IP
Licenses that provide a right to access IP are performance obligations satisfied over time.

Right to use IP
Licenses that provide a right to use IP are performance obligations satisfied at a point in time.

US GAAP
ASC 606 defines two categories of licenses: (1) functional and (2) symbolic.

Functional IP
Functional IP includes software, drug formulas or compounds, and completed media content. A</td>
<td>The criteria applied to transactions to determine if elements included in a multiple-element arrangement should be accounted for separately are:

• The delivered item has value to the customer on a standalone basis.
• If a general return right exists for the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the vendor.

Software-specific guidance
Contract consideration is allocated to the various elements of an arrangement based on VSOE of fair value, if such evidence exists for all elements in the arrangement.

When VSOE of fair value does not exist for delivered elements, but exists for all of the undelivered elements, the arrangement consideration is allocated using the residual method. Under this method the amount of consideration is first allocated to the undelivered elements (i.e., the elements for which fair value can be determined), and any remaining consideration is then allocated to the delivered elements.

Revenue is deferred when VSOE of fair value does not exist for undelivered elements until the earlier of: (a) when VSOE of fair value for the undelivered element does exist, or (b) all elements of the arrangement have been delivered.</td>
<td>Principles in IAS 18, Revenue, require revenue in respect of each separable element of a transaction to be allocated based on the fair value of the element. However, IFRS does not provide specific guidance on how to allocate the consideration for software arrangements.

Separating the components of a contract might be necessary to reflect the economic substance of an arrangement. IFRS does not define identifiable components of a single transaction. The assessment of components and future obligations is a matter of judgment (regardless of whether the obligation is specifically stated in the contract or implied).

However, due to lack of industry-specific guidance in IFRS, many companies in the software industry considered the guidance in US GAAP in their assessment.</td>
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<td colspan="2">Expected impact

Under the new guidance, software companies reporting under US GAAP are no longer required to have VSOE of fair value to separately account for the elements in a multiple element arrangement with a customer. Rather, they will need to determine</td>
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license to functional IP grants a right to use the company's IP as it exists at the point in time at which the license is granted unless both of the following criteria are met:

- The functionality of the IP is expected to substantively change during the license period as a result of activities of the company that do not transfer a promised good or service to the customer.
- The customer is contractually or practically required to use the updated IP.

Symbolic IP
Symbolic IP is anything that is not functional IP. It includes brands, logos, team names and franchise rights. Symbolic IP is a right to access IP because of the company's obligation to support or maintain the IP over time.

IFRS
Under IFRS, determining whether a company's promise to grant a license provides a customer with either a right to access IP or a right to use IP depends on whether a customer can direct the use of, and obtain substantially all of the remaining benefits from, a license at the point in time at which the license is granted.

The nature of a company's promise in granting a license is a right to access IP if all of the following criteria are met:

- The contract requires, or the customer reasonably expects, that the company will undertake activities that significantly affect the IP to which the customer has rights

whether a good or service (or bundle of goods or services) is distinct and then allocate the transaction to the separate performance obligations based on the relative standalone selling prices of the goods or services being provided.

Assessing whether goods and services are capable of being distinct is similar to determining if deliverables have standalone value under existing US GAAP or are separate components under existing IFRS, although the definitions are not identical. Under the new guidance, management will assess if the customer can benefit from the good or service with "resources that are readily available to the customer," which could be a good or service sold separately by the company or another company, or a good or service the customer has already obtained.

Companies will also need to determine whether the nature of the promise within the context of the contract is to transfer each of those goods or services individually, or instead, to transfer a combined item(s) to which the promised goods or services are inputs. This will be a new assessment.

We believe that the vast majority of distinct software licenses are a right to use IP for which revenue will be recognized at the point in time the right is transferred to the customer (generally, at the beginning of the license period).

The categorization of software licenses as a right to use IP may significantly accelerate the timing of revenue recognition when revenue was previously recognized ratably over the license term.

Difference between US GAAP and IFRS
ASC 606 defines two categories of IP–functional and symbolic–for purposes of assessing whether a license is a right to access or a right to use IP.

Under IFRS 15, the nature of a license is determined based on whether the company's activities significantly change the IP to which the customer has rights. We expect that the outcome of applying the two standards will be similar; however, there will be fact patterns for which outcomes could differ.

• The rights granted by the license directly expose the customer to any positive or negative effects of the company's activities • Those activities do not result in the transfer of a good or a service to the customer as they occur	

Example 2-1 – License is distinct from service

Facts: Software Co. enters into a contract with its customer for on-premise data analytics software and cloud data storage. The on-premise software utilizes the customer's data stored on the cloud to provide data analysis. The on-premise software can also utilize data stored on the customer's premises or data stored by other vendors.

Is the software license distinct?

Analysis: Yes. Software Co. would likely conclude that the on-premise software license is distinct from the cloud data storage service. The cloud data storage could be provided by other vendors and is capable of being distinct. The software license and cloud data storage service are not highly interrelated or interdependent because a customer could gain substantially all of the benefits of the on-premise software when data is stored on the customer's premises or with another vendor.

Alternatively, if Software Co.'s on-premise software and cloud data storage function together in such a manner that the customer gains significant functionality that would not be available without the cloud data storage service, Software Co. might conclude that the license is not distinct from the storage service.

Hybrid cloud arrangements will require an understanding of the standalone functionality of each promised good or service in the arrangement and the degree to which each promised good or service affects the other in determining whether a license is distinct.

Example 2-2 – License bundled with other goods and services

Facts: Software Co. contracts with a customer for a perpetual software license, installation services, unspecified software updates, and technical support for two years. The installation services include significant customization of the software to interface with customer data sources. The updates and technical support are not critical to maintaining the ongoing utility of the software.

Is the software license distinct?

Analysis: No. Software Co. concludes that the software license is not distinct from the installation services because the installation services significantly customize the software. As such, the software license and the installation services are inputs into a combined output, which is a promise to deliver customized software.

Software Co. should assess whether the promise is satisfied at a point in time (once the software is completed) or over time (as the customization is performed), which will depend on the contract-specific facts and circumstances.

In this case, Software Co. concludes that the updates and support are distinct and should be recognized over time using an appropriate measure of progress.

Example 2-3 – License restrictions - contract with multiple licenses

Facts: On December 15, 20X6, Software Co. enters into a contract with a customer that permits the customer to embed the vendor's software in the customer's consumer products for five years beginning on January 1, 20X7. During the first year of the license period, the customer is permitted to embed the vendor's software only in products sold in the United States. Beginning January 1, 20X8, the customer is permitted to embed the vendor's software in products sold in Europe.

There are no other promised goods or services in the contract. Software Co. provides a copy of the software to the customer on December 31, 20X6.

What is the impact of the contractual provisions that restrict the use of software in this arrangement?

Analysis: Software Co. concludes that the contract includes two distinct licenses: (1) a right to use the software in the United States and (2) a right to use the software in Europe because each license is capable of being distinct and the promise to transfer each license is distinct within the context of the contract. Therefore, Software Co. should allocate the transaction price to each of the distinct licenses based on their relative standalone selling prices.

As discussed further in Step 5, Software Co. should recognize revenue when the customer has the ability to use and benefit from its right to use the software. This is the later of the date the license period commences and the date the license is transferred. For the license to use the software in the United States, Software Co. would recognize the revenue allocated to the license on January 1, 20X7. For the license to use the software in Europe, Software Co. would recognize the revenue allocated to the license on January 1, 20X8.

Example 2-4: License remix rights

Facts: Software Co. enters into an arrangement with a customer to allow the customer to change or alternate its use of multiple software products included in a license arrangement after all of the software has been delivered to the customer. The customer may use any mix of the software products as along as the cumulative value of all products used in a given time period does not exceed the license fee of $100,000.

Software Co. provides a copy of the software to the customer on January 1, 20X7, which is the date the license term commences.

Is the license remix right a separate performance obligation?

Analysis: No. The remix right is an attribute of the promised licenses that defines the scope of the customer's right to use the IP. The remix right does not represent a separate performance obligation because all of the software was delivered to the customer upfront, and Software Co. is not required to transfer any additional rights to use the IP. Software Co. would therefore recognize revenue on January 1, 20x7 because the software has been provided and the license term has commenced.

License renewals and cancellations / material rights

Software vendors often provide customers the option to renew or extend the term of or to cancel a license. Options to acquire additional goods and services, including options to renew or extend licenses, are not included in the initial contract term. However, an option is a separate performance obligation if it provides a material right to the customer that the customer would not receive without entering into the original contract. For example, an option to renew a contract at a discounted price may be a material right if the discount is incremental to the range of discounts typically given to other customers. A cancellation right that allows a customer to cancel a multi-year contract after each year without penalty should be accounted for the same as a one-year contract with a renewal option, since the customer makes a decision annually whether to continue under the contract. Other options to acquire additional goods and services are addressed on page 15.

The new US GAAP standard also specifies that revenue from the renewal or extension of a license cannot be recognized until the customer can use or benefit from the license renewal (that is, at the beginning of the renewal period). This is true even if the vendor provides a copy of the IP in advance of the renewal period or the customer has a copy of the IP from another transaction. This differs from current guidance in which revenue is generally recognized from a license renewal on the date the renewal is executed.

Therefore, companies may recognize revenue for renewals later under the new guidance as compared to today.

IFRS does not include specific guidance on license renewals. Companies applying IFRS should evaluate whether a renewal or extension should be accounted for as a new license or a modification of an existing license. This could result in recognition of revenue from renewals earlier under IFRS compared to US GAAP in some cases. See chapter 9 of PwC's Revenue guide for further guidance.

Example 2-5 – Renewal option for a license arrangement that represents a material right

Facts: On January 1, 20X6, Software Co. enters into an agreement to provide a customer a term license and PCS for three years for an upfront, non-refundable fee of $350,000. The customer has the option to extend the term of the license and renew PCS for an additional three years for a fee of $300,000. The rest of the terms and conditions of the original agreement remain unchanged.

Software Co. typically increases its prices by 5% each year, and the renewal price is lower than the standalone selling price for similar customers.

How should the software vendor account for the renewal option?

Analysis: The renewal option provides a material right to the customer as it will be charged a lower price for the software license and PCS than similar customers if the agreement is renewed. Software Co. will account for the option as a separate performance obligation and allocate a portion of the $350,000 transaction price to the renewal right based on its standalone selling price. However, as a practical alternative to estimating the standalone selling price of the option, Software Co. may determine the total consideration it expects to receive (including renewals) and allocate the estimated consideration to the goods and services it expects to provide.

Example 2-6 – Cancellation option on SaaS services

Facts: Cloud Co. enters into a five-year contract with a customer to provide SaaS services. The fee for SaaS services is $150,000 per year, payable at the beginning of each year. The contract includes a cancellation option that allows the customer to unilaterally cancel the contract after each year for any reason without penalty.

How should the software vendor account for the cancellation option?

Analysis: The contract only has enforceable rights and obligations for one year; therefore, Cloud Co. should account for the arrangement as a one-year contract with a renewal option. Cloud Co. should assess whether the renewal option provides a material right to the customer. The renewal option could provide a material right if prices for similar customers are expected to increase significantly over the five-year period.

Post-contract customer support

Post-contract customer support (PCS) is an element included in virtually every software arrangement; it represents the right to receive services or unspecified product upgrades/enhancements, or both. PCS is often explicitly promised in the contract, but could also be implied as a result of the vendor's past business practices.

Consideration for PCS may be included in the license fee or separately priced.

Software companies should assess individual services included in PCS to determine whether they are distinct. Generally, a software license and PCS will each be distinct, even when PCS is not optional, because the software remains functional without the PCS. In limited circumstances, however, a software license may not be distinct from the unspecified updates/upgrades if (1) those updates/upgrades are critical to the continued utility of the software, and (2) without the unspecified updates or upgrades, the customer's ability to benefit from the software would decline significantly. In such cases, the software license and the right to the unspecified product upgrades/enhancements are accounted for as a single performance obligation.

Reinstating inactive PCS

It is not uncommon for a customer to cancel or decline PCS renewal in a given period but subsequently decide to reinstate these services. At the time of reinstatement of inactive PCS, the customer typically receives the cumulative updates, upgrades, and enhancements released during the lapsed PCS periods, and the software vendor typically charges the customer for the lapsed periods. When PCS is reinstated, we believe a software company will generally recognize revenue immediately for the fee allocated to PCS provided during the lapsed period because control of the updates released during the lapsed PCS period transfers to the customer at reinstatement.

Example 2-7 – License with updates that are critical to maintaining utility

Facts: Software Co. contracts with customer for a time-based software license, unspecified software updates, and technical support for two years. The vendor frequently provides updates that are critical to the continued utility of the software such that the updates significantly modify the functionality of the software, and without the updates, the customer's ability to benefit from the software declines significantly.

Is the software license distinct from the updates? Is the technical support distinct?

Analysis: Software Co. concludes that the software and the updates are not distinct from each other, but are distinct from the technical support. Although the license and updates are capable of being distinct, the updates significantly modify the functionality of the software and are integral to maintaining the utility of the software.

As a result, Software Co. would recognize revenue for the combined license and updates service over time using an appropriate measure of progress that reflects the transfer of control of the combined promise. Measures of progress might include time-based measures or measures based on costs of delivering the updates, among others. The technical support will also be recognized over time, which may or may not have the same measure of progress.

Although the updates are critical in this example, we expect that in many arrangements the updates will not be critical to maintaining the ongoing utility of the software.

Example 2-8: Sale of software and reinstated PCS – separate performance obligations

Facts: On January 1, 20X6, Software Co. enters into an arrangement with a customer to deliver a perpetual license to financial modeling software and to provide PCS for a period of one year once the software is activated. There is also an option to renew PCS for one more year based on its then standalone selling price. PCS includes telephone support and unspecified future updates.

On January 1, 20X7, the customer elects not to renew PCS for the licensed software. Subsequently, on June 30, 20X7, the customer decides to reinstate lapsed PCS and enters into a separate PCS reinstatement agreement. Software Co. agrees to reinstate lapsed PCS and deliver the cumulative updates released during the lapsed PCS periods at the time PCS is reinstated. In exchange, Software Co. requires the customer to pay an amount relating to the future PCS period and an additional amount relating to the lapsed PCS periods. The additional amount is equal to the cumulative amount of PCS in arrears and was calculated based on the standalone selling price for PCS.

How should Software Co. account for the fee paid by the customer to reinstate PCS?

Analysis: The fee paid to reinstate PCS should be allocated between the six months of PCS provided during the lapsed period and six months of future PCS based on their relative standalone selling prices.

When PCS is reinstated, we believe Software Co. should immediately recognize revenue for the fee allocated to PCS provided during the lapsed period because control of the updates released during the lapsed PCS period transfers to the customer at reinstatement.

The amount allocated to future PCS will be recognized over the remaining six months.

Professional services and customization of software offering

Arrangements involving software often include a promise to provide professional services. These services generally include training, installation, and consulting. Consulting services often include implementation support, data conversion, software design or development, and customization of the licensed software.

Current US GAAP guidance requires certain criteria to be met for professional services to be accounted for separately from the other elements of the arrangements. If the criteria are not met, the services do not qualify for separate accounting, and the entire arrangement is accounted for under contract accounting (ASC 605-35). Under IFRS, there are no specific criteria for separation of professional services from the other elements of the arrangement, and judgment is required to apply separation principles. Under the new standards, a company is required to determine whether the promised services are distinct, and thus represent separate performance obligations.

Example 2-9: Sale of software and services – separate performance obligations

Facts: Software Co. licenses enterprise resource planning (ERP) software to its customer. Software Co. also agrees to provide implementation support by performing setup activities for the customer. The customer can use Software Co. or another service provider for the implementation services. The implementation services do not significantly customize or modify the software.

How many performance obligations are in the arrangement?

Analysis: The license to the ERP software and the implementation services are separate performance obligations. The customer can benefit from the ERP software on its own or together with readily available resources because the customer has the ability to obtain the implementation services from another vendor. Further, the promise to deliver the license is separately identifiable from the promise to provide implementation services because the implementation services do not significantly customize or modify the software.

Specified upgrade rights and product roadmaps

Customers of software vendors may view the licensing of software as part of a long-term relationship with the software vendor, rather than as the purchase of a discrete product. As a result, it is common in the software industry to provide customers with the right to specified upgrades or enhancements as part of a software arrangement. These upgrade rights may be explicit in the arrangement and/or implied by the vendor’s customary business practices.

As part of its marketing efforts, a software vendor's plans for future software product releases and the strategic direction of software development initiatives, commonly referred to as product roadmaps, may be referenced or published in various forms. This could include product development plans, press releases, information on the vendor's website, marketing materials, and executive presentations. These communications may influence the customer's decision to select that particular vendor's software over the software of another vendor. In such cases, customers may believe that development efforts and strategies are part of what they are buying. Therefore, the vendor has created an expectation that there will be future deliverables and/or specified upgrades and enhancements, which may result in the arrangement being deemed to contain a specified upgrade right.

Software vendors should evaluate whether the customer’s rights (explicit or implicit through product roadmaps) to receive specified upgrades or enhancements are promised distinct goods or services, and therefore, separate performance obligations.

Example 2-10: Product development roadmap does not create specified upgrade right

Facts: Software Co. enters into a contract with a customer to provide ERP software. The transaction does not include the right to receive future when-and-if available updates. However, as part of its sales and marketing efforts, the vendor also communicates its product development roadmap to the customer. At the time of sale to the customer, neither the vendor nor the customer anticipates any updates related to the software purchased by the customer in the near future.

Does the discussion of the product development roadmap create a specified upgrade right?

Analysis: Probably not. Although the discussion of the product development roadmap may have influenced the customer's decision to purchase the software, the sharing of the product development roadmap would likely not give the customer an expectation that the vendor has promised to provide a specified upgrade right, and therefore, would not create a separate performance obligation. In other words, if Software Co. releases any updates to the ERP software, the customer would make an independent buying decision whether to purchase the updated product.

Example 2-11: Product development roadmap may create a specified upgrade right

Facts: Software Co. enters into a contract with a customer to provide general ledger software. The transaction also provides the customer with the right to receive future when-and-if available updates. As part of its sales and marketing efforts, Software Co. also communicates its product development roadmap to the customer.

Does the discussion of the product development roadmap create a specified update right?

Analysis: It depends. The inclusion of the product roadmap may result in a promise to the customer in the form of a specified update right since the customer is entitled to receive all future updates. It is a matter of professional judgment and Software Co. may consider the following indicators:

- Was the product roadmap customized for the customer's specific needs and requirements?
- Does the product roadmap contain a high degree of specificity, including features, functionality and the timing of the release, such that it is reasonably likely to have created an expectation by the customer that the customer will receive a specific upgrade?
- Does the arrangement contain explicit language stating that the customer will have to purchase items on the product roadmap separately in the future?
- Is the product roadmap generally made available to new and existing customers via the website, or other marketing material?

Unspecified additional software products

Many companies in the software industry promise to deliver unspecified additional software products in the future with the software license. A right to receive unspecified additional software as part of the arrangement typically is evidenced by the vendor's agreement to deliver new products it introduces within a specified time period without regard to the specific features and functionality of the new products. Such arrangements allow customers to obtain certain new products (e.g., within a family or suite of products) over a limited period.

A vendor may offer customers such a right under PCS arrangements to encourage them to maintain a current service arrangement or to help customers to maintain the latest available technology (e.g., a technology protection program).

A promise to deliver unspecified additional software products is generally distinct, and therefore represents a performance obligation that is separate from the initial software license. The vendor should also assess whether the promise to deliver unspecified additional software products: (1) is a stand-ready obligation to provide future products on a when-and-if available basis or (2) are individual promises to transfer specific software products.

Options to acquire additional goods and services in the future

Similar to license renewals and extensions discussed on page 11 companies in the software industry often provide their customers with options to purchase additional goods or services in the future at a discount as part of the initial arrangement. These options can come in many forms, including sales incentives, customer credits, options to acquire additional user access rights, contract renewal options or other discounts, and incentives on future purchases of goods or services.

Under the new guidance, options to acquire additional goods and services are separate performance obligations only if they provide a material right to the customer that the customer would not receive without entering into the original contract. An option to purchase additional goods or services at their standalone selling prices is a marketing offer and therefore not a material right. This is true regardless of whether the customer obtained the option only as a result of entering into the current transaction.

However, an option to purchase additional goods or services in the future at a current standalone selling price could be a material right, if prices are expected to increase. This is because the customer is being offered a discount on future goods compared to what others will have to pay as a result of entering into the current transaction.

Software arrangements may provide the customer with a contractual right to purchase additional copies of or allow additional users access to software previously granted to the customer. In general, transactions in which the vendor provides additional or incremental rights to software that the customer did not previously control should be accounted for as additional licenses.

When a vendor is entitled to additional consideration based on usage of software it already controls, without providing any additional or incremental rights, the vendor should account for it as a usage-based royalty. Significant judgment may be required to determine whether contract terms represent options to acquire goods or services in the future or a usage-based royalty (that is, a form of variable consideration).

Example 2-12: Option to purchase services does not provide a material right

Facts: On January 1, 20X6, Software Co. enters into a perpetual licensing arrangement to deliver a software license and provide PCS for a one-year period for an upfront, nonrefundable fee of $1 million. The license and PCS are distinct and accounted for as separate performance obligations.

As part of this arrangement, Software Co. also provided the customer with an option to purchase professional services at a 10% discount off the standalone selling price of these services if the customer exercises the option in the next 30 days.

Software Co. offers a 10% discount on professional services as part of a promotional campaign during the same period to a similar class of customers.

Does the option to purchase professional services provide a material right to the customer?

Analysis: No. The option does not provide a material right. The discount is not incremental to the discount offered to a similar class of customers that did not enter into a current transaction to purchase the perpetual license to the software. The option is a marketing offer that is not part of the current contract. The option is accounted for if and when it is exercised by the customer.

Example 2-13: Option to purchase services provides a material right

Facts: Assume the same facts as in *Example 2-13*, except the option to purchase professional services is offered at a 30% discount off the standalone selling price of these services if the customer exercises the option in the next 30 days. The discount on professional services offered as part of a promotional campaign during the same period to a similar class of customers is 10%.

Does the option to purchase professional services provide a material right to the customer?

Analysis: Yes. Because similar customers will receive a 10% discount on purchases during the next 30 days, the 30% discount provides the customer with a material right (the incremental 20% discount). The incremental discount is a performance obligation in the current contract (the perpetual licensing arrangement).

Software Co. allocates revenue to the right and recognizes it when the customer purchases the professional services or when the right expires.

Sunset clauses, exchange and platform transfer rights

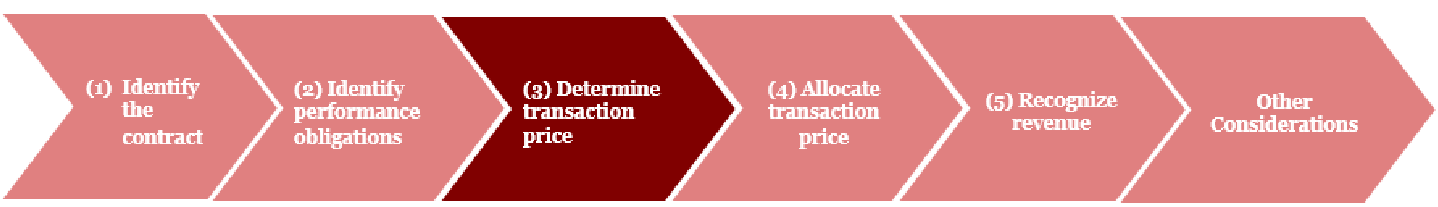
A licensing arrangement may provide the customer with the right to transfer software from one hardware platform or operating system to a different hardware platform or operating system. This is referred to as a platform-transfer right. Depending on the circumstances, the exercise of a platform-transfer right may represent an exchange, a return, or an additional software product.

To protect themselves against purchasing software products that the software vendor may subsequently discontinue, customers often negotiate and include rights to exchange a product in case the vendor discontinues the product and/or ceases providing support for it. These provisions are commonly referred to as sunset clauses. Sunset clauses are also negotiated by customers during or following a merger of companies that license competing products. Concerned that the surviving company will discontinue one of the competing products, customers of both the acquirer's and the target's products frequently include a sunset clause in the licensing agreements. The new product offered under the sunset clause may or may not have similar features and functionality than the discontinued product and may or may not be priced differently. Depending on the circumstances, the existence of the sunset clause may represent (1) an exchange right, (2) a right to receive unspecified upgrades/software products, (3) return right or (4) a right to receive a specified upgrade/additional software product. Refer to chapter 8 of PwC's Revenue guide for further guidance on return and exchange rights.

A software vendor should evaluate whether a promise to exchange a product or to transfer the software from one platform or operating system to another is distinct, and therefore represents a performance obligation. The following factors may indicate that a promise to exchange a product or to transfer platforms or operating systems is not a separate performance obligation:

- The license agreement does not contractually permit the customer to continue using the original platform software in addition to the new platform software.
- The platform transfer or exchange is for the same software product that currently exists. That is, there are no more than minimal differences in price, features, and functionalities between the software products being exchanged.
- The platform transfer or exchange is for specified existing or currently-unavailable new software, which is or would be marketed as the same product even though there may be differences due to environmental variables (operating systems, databases, user interfaces, and platform scales). Indicators of "marketed as the same product" include (1) the same product name (although version numbers may differ) and (2) a focus on the same features and functions.
- The platform transfer or exchange does not provide the customer an increased number of copies or concurrent users of the software product available under the license agreement.

These factors are not all-inclusive; other factors may be relevant based on the circumstances.



3. Determine transaction price

The transaction price in a contract reflects the amount of consideration to which the software vendor expects to be entitled in exchange for goods or services transferred. The transaction price includes only those amounts to which the company has enforceable rights under the present contract. Management must take into account consideration that is variable, noncash consideration, and amounts payable to a customer to determine the transaction price. Management also needs to assess whether a significant financing component exists.

Variable consideration

Determining the transaction price is more straightforward when the contract price is fixed, but is more complex when the arrangement includes a variable amount of consideration. Consideration that is variable includes, but is not limited to, discounts, rebates, price concessions, refunds, credits, incentives, performance bonuses, and royalties. Management must estimate the consideration to which it expects to be entitled to determine the transaction price and to allocate consideration to performance obligations. Under the new guidance, variable consideration is only included in the estimate of transaction price up to an amount that is probable (US GAAP) or highly probable (IFRS) of not resulting in a significant reversal of cumulative revenue in the future. While different terminology is used under IFRS, it is intended in this situation to have the same meaning as in US GAAP.

Extended payment terms

Software companies may offer payment terms that extend over a substantial portion of the period during which the customer is expected to use or market the software. Extended payment terms should be considered when assessing the customer's ability and intent to pay the consideration when due, and may impact the vendor's assessment of whether the collectibility criteria is met in Step 1 (discussed on page 2), and therefore, whether a contract exists. Software vendors should also determine if there is a possibility of a future price concession, which may lead to the conclusion that the transaction price is variable.

The new guidance differs from current US GAAP guidance in which payment terms beyond one year typically preclude revenue from being recognized because there is a presumption that the fee is not fixed or determinable. Although there is no similar guidance under current IFRS, companies are required to evaluate whether the inflow of benefits was probable. As a result, companies that provide extended payment terms might recognize revenue earlier under the new guidance.

Extended payment terms could also indicate that the arrangement includes a significant financing component that would need to be accounted for separately. A significant financing component does not exist, however, when the difference between the promised consideration and the cash selling price arises for reasons other than financing. This may occur, for example, when the intent of extended payment terms was to ensure that the vendor performs as specified under the arrangement rather than to provide financing to the customer.

Service level agreements

Service level agreements (SLAs) are a form of guarantee frequently found in contracts with customers. SLA is a generic description often used to describe promises by a vendor that could include a guarantee of a product's or service's performance or a guarantee of warranty service response rates. SLAs are commonly used by companies that sell products or services that are critical to the customer's operations in which the customer cannot afford to have product failures, service outages, or service interruptions. For example, a vendor might guarantee a certain level of "uptime" for a network, say 99.999%, or guarantee that service call response times will be within a defined time limit. SLAs might also include penalty clauses triggered by breach of the guarantees.

The terms and conditions of the SLA determine the accounting model. SLAs that are warranties should be accounted for under the warranty guidance discussed in chapter 8 of PwC's Revenue guide. SLAs that could result in payments to a customer (e.g., refunds or penalties) should generally be accounted for as variable consideration.

New guidance	Current US GAAP	Current IFRS
A company needs to determine the transaction price, including an estimate of variable consideration, based on the expected value or most likely	The seller's price must be fixed or determinable for revenue to be recognized. Revenue related to variable consideration generally is not recognized until the uncertainty	Revenue is measured at the fair value of the consideration received or receivable. Fair value is the amount for which an asset could be exchanged, or a liability settled, between

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<td rowspan="2">amount approach (whichever is more predictive).

Variable consideration included in the transaction price is subject to a constraint. The objective of the constraint is that a company should recognize revenue as performance obligations are satisfied to the extent that a significant revenue reversal will not occur. A company will meet this objective if it is probable (US GAAP) or highly probable (IFRS) that there will not be a significant downward adjustment of the cumulative amount of revenue recognized for that performance obligation.

Management needs to determine if there is a portion of the variable consideration (a “minimum amount”) that would not result in a significant revenue reversal and should be included in the transaction price.

Management should reassess its estimate of the transaction price each reporting period, including any estimated minimum amount of variable consideration it expects to receive.

The revenue standards also include a narrow exception that applies only to licenses of IP with consideration in the form of sales- and usage-based royalties. Revenue is recognized at the later of when (or as) the subsequent sale or usage occurs, or when the performance obligation to which some or all of the royalty has been allocated has been satisfied (or partially satisfied).</td>
<td>is resolved. For example, certain extended payment terms would not meet the fixed or determinable criterion, and therefore, revenue would be deferred. It is not appropriate to recognize revenue based on a probability assessment.</td>
<td>knowledgeable, willing parties in an arm's length transaction. Trade discounts, volume rebates, and other incentives (such as cash settlement discounts) are taken into account in measuring the fair value of the consideration to be received.

Revenue related to variable consideration is recognized when it is probable that the economic benefits will flow to the company, and the amount is reliably measurable, assuming all other revenue recognition criteria are met.</td>
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<td colspan="2">Expected impact

The new guidance on variable consideration may significantly affect the timing of recognition, especially for US GAAP reporters. Software companies often enter into arrangements with variable amounts, such as SLAs with penalties and/or refund rights, because of their focus on customer adoption of evolving technology. Under current US GAAP, the variable amount may result in a fee that is not fixed or determinable (e.g., extended payment terms) or a contingent fee that can’t be recognized until the contingency lapses (e.g., an SLA with penalties). Because the new guidance requires variable consideration to be estimated and included in the transaction price (subject to a constraint), software companies may recognize revenue earlier under ASC 606. This change may have less of an impact under IFRS because the contingent revenue limitation does not exist under current guidance.</td>
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Example 3-1 – Service level agreements

Facts: Software Co. enters into a one-year contract with Customer A to provide access to its SaaS platform. Included in the contract is a guarantee that the SaaS platform will maintain a 99.99% uptime during each month, or Customer A will be entitled to a 5% credit of that month's fees against the next month's payment.

How does the platform availability guarantee impacts determination of the transaction consideration?

Analysis: A portion of the arrangement is variable consideration because Customer A is entitled to a credit against the next month's payment if the platform availability guarantee is not met in any given month.

Software Co. should estimate the variable consideration it expects to receive using either the expected value or most likely amount approach, and include that amount in the transaction price, to the extent that it is probable (US GAAP) or highly probable (IFRS) that a significant reversal of the revenue recognized will not occur once the uncertainty is resolved. Management should revise its estimates of variable consideration at each reporting date throughout the contract period.

As a practical matter, Software Co. may not need to estimate the potential refund as the uncertainty will be resolved each month as Software Co. recognizes the related monthly revenue.

Additionally, US GAAP reporters are permitted to exclude quantitative, but not qualitative disclosures of variable consideration that is allocated entirely to a wholly-unsatisfied performance obligation or to a wholly-unsatisfied distinct good or service that forms part of a single performance obligation, and meets the variable allocation criteria in series guidance. No similar exemption is available under IFRS.

Example 3-2 – Reseller rebates

Facts: Software Co. enters into a master reseller agreement on January 1, 20x1 with Reseller Co. (a software distributor) to license software at a price of $100,000 per license for Product A and $50,000 per annual PCS contract for Product A.

If Reseller Co. reaches total annual purchases of $5,000,000 of license and annual PCS contracts (in any combination), Reseller Co. will receive a 10% cash rebate on total annual purchases. Software Co. expects Reseller Co. to reach the $5,000,000 purchase target.

On January 31, 20x1, Reseller Co. places an order to purchase five licenses of Product A and an annual PCS contract for the five licenses. Total consideration is $750,000.

Management has concluded the order meets the definition of a contract and that the license of Product A and the annual PCS contract are separate performance obligations.

How will the rebate impact the transaction price?

Analysis: Payments to customers are considered a reduction of the transaction price unless the payment is in exchange for a distinct good or service. In this case, there is not a distinct good or service being provided by Reseller Co.; therefore, the estimated transaction price should be reduced by the expected rebate.

As discussed in Step 4, the expected rebate should then be allocated to all of the performance obligations in the arrangement based on their relative standalone selling prices. However, it may be appropriate in some instances to allocate the expected rebate to only one or more performance obligations in the arrangement, rather than to all performance obligations, if the specific criteria for allocating variable consideration are met.

4. Allocate transaction price

Many contracts involve the sale of more than one good or service. For example, they might involve the sale of multiple goods, goods followed by related services, or multiple services. The transaction price in an arrangement must be allocated to each separate performance obligation based on the relative standalone selling prices (SSP) of the goods or services being provided to the customer. The allocation could be affected by variable consideration or discounts.

The best evidence of SSP is the price a company charges for that good or service when the company sells it separately in similar circumstances to similar customers. However, goods or services are not always sold separately. The SSP needs to be estimated or derived by other means if the good or service is not sold separately. This estimate often requires judgment, such as when specialized goods or services are sold only as part of a bundled arrangement.

The new standards do not prescribe or prohibit any method for estimating SSP as long as the method results in an estimate that faithfully represents the price a company would charge for good or services sold separately. The standards provide three examples of methods a company might use to estimate SSP: (1) adjusted market assessment approach, (2) expected cost plus a margin approach, and (3) residual approach.

Companies who do not separately account for elements in a software arrangement due to a lack of VSOE of fair value under current US GAAP software guidance may need to develop new processes for estimating SSP under the new standards.

Standalone selling price for software licenses and PCS

SSP for certain software products or services may not be directly observable and may need to be estimated because it is common practice in the software industry for vendors to bundle their software licenses together with other products and services. For example, some vendors may often, or even always, license software bundled together with PCS, professional services, or hosting.

There is no hierarchy for how to estimate SSP for goods or services that are not sold separately. A vendor should not presume that a contract price or list price for a product or service represents SSP although these prices may be a factor to consider in determining SSP. See PwC's Revenue guide (RR 5.3) for additional factors to consider when estimating SSP that is not directly observable.

Both term licenses and perpetual licenses are typically bundled with PCS. To determine the SSP of PCS bundled with a term license, a company should consider all observable evidence, which may include the SSP of PCS related to a perpetual license (i.e., the renewal price for PCS in a perpetual license arrangement). The company should consider whether any adjustments are required to reflect the differences between the pricing of PCS with term licenses versus perpetual licenses. We also believe that SSP could be based on a percentage of the license fee rather than a dollar amount, if the use of a percentage best reflects the company's pricing practices.

Range of prices for determining SSP

Consistent with practice today, we believe a company may use a range of prices when determining SSP, provided that the range reflects reasonable pricing of each product or service as if it were priced on a standalone basis for similar customers. When the contractual price of a good or service falls outside of the range, companies should apply a consistent method to determine the standalone selling price within that range for that good or service (e.g., the midpoint of the range or the outer limit closest to the stated contractual price), as illustrated in Example 5-2 in PwC's Revenue guide.

Residual approach

The residual approach involves deducting from the total transaction price the sum of the observable SSPs of other goods and services in the contract to estimate SSP for the remaining goods and services. This approach is an estimation methodology, not an allocation methodology like the residual method applied under current US GAAP and IFRS guidance.

Under the new guidance, the residual approach is only permitted if the selling price of a good or service is highly variable or uncertain. Before utilizing this approach, management should first consider the overall principle that a company should maximize the use of observable data and should assess whether another method provides a reasonable method for estimating SSP.

Even when the residual approach is used, management still needs to consider whether the results achieve the objective of allocating the transaction price based on standalone selling prices. For example, if the residual method results in allocating little or no consideration to a performance obligation, this method would not be appropriate.

Allocating discounts and variable consideration

The transaction price should be allocated to each performance obligation based on the relative standalone selling prices of the goods or services provided to the customer. Discounts and variable consideration are typically allocated to all of the performance obligations in an arrangement based on their relative standalone selling prices. However, if certain criteria are met, a discount or variable consideration is allocated to only one or more performance obligations in the contract rather than to all performance obligations.

New guidance	Current US GAAP	Current IFRS
The transaction price is allocated to separate performance obligations based on their relative standalone selling prices, as determined at contract inception. Management should estimate the standalone selling price if it does not separately sell a good or service on a standalone basis. Companies should maximize the use of observable inputs to estimate standalone selling price. The standards provide three examples of methods that a company may use to estimate standalone selling price: • Adjusted market assessment approach • Expected cost plus a margin approach • Residual approach (if certain criteria are met) Discounts and variable consideration should be	Under software revenue recognition rules, contract consideration is allocated to the various software elements of an arrangement based on VSOE of fair value, if such evidence exists for all elements in the arrangement. When VSOE of fair value does not exist for delivered elements, but exists for all of the undelivered elements, the arrangement consideration is allocated using the residual method. Under this method the amount of arrangement consideration is first allocated to the undelivered elements (i.e. the elements for which fair value can be determined), and any remaining arrangement consideration is then allocated to the delivered elements. Revenue is deferred when VSOE of fair value does not exist for	While the application of IFRS implies that revenue should be allocated to individual components of a transaction, it does not provide any specific guidance on how that allocation should be determined, except that revenue should be measured at the fair value of the consideration received or receivable. In this context, as it relates to individual elements of a contract, the price regularly charged when an item is sold separately is typically the best evidence of the item's fair value. Other approaches to estimating fair value and allocating the total arrangement consideration to the individual elements may be appropriate, including cost plus a reasonable margin, the residual method, and under rare circumstances, the reverse residual method.

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<td rowspan="2">allocated to some, but not all, of the performance obligations in a contract if certain criteria are met.

The transaction price is not reallocated after contract inception to reflect subsequent changes in standalone selling prices.</td>
<td>undelivered elements until the earlier of: (a) when VSOE of fair value for the undelivered element does exist, or (b) all elements of the arrangement have been delivered.

If the software is considered not essential to the functionality of non-software deliverables, those non-software deliverables should be separated from the software deliverables. Arrangement consideration related to non-software deliverables is then allocated to each deliverable on the basis of their relative selling prices.</td>
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<td colspan="2">Expected impact

US GAAP
VSOE of fair value, which is a high hurdle, will no longer be required for undelivered items to separate and allocate contract consideration to the various promises in a contract under US GAAP. The elimination of the VSOE requirement for software might significantly accelerate the timing of revenue recognition when revenue was previously deferred due to a lack of VSOE of fair value. These changes could also result in the need for significant modifications to the information systems currently used to record revenue.

IFRS
The principles in the new standard are similar to current IFRS guidance. However, the new standard includes specific requirements related to the separation, allocation, and recognition of multiple element transactions that management will need to consider in applying those principles.</td>
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Example 4-1 – Determining SSP of PCS for term and perpetual software licenses

Facts: Software Co. only enters into agreements for one-year term software licenses with bundled PCS. Software Co. also bundles perpetual software licenses with the first year of PCS, with subsequent annual PCS renewals sold on a standalone basis at 20% of the initial license fee. The software license and PCS are separate performance obligations.

What is the SSP of PCS associated with the term license?

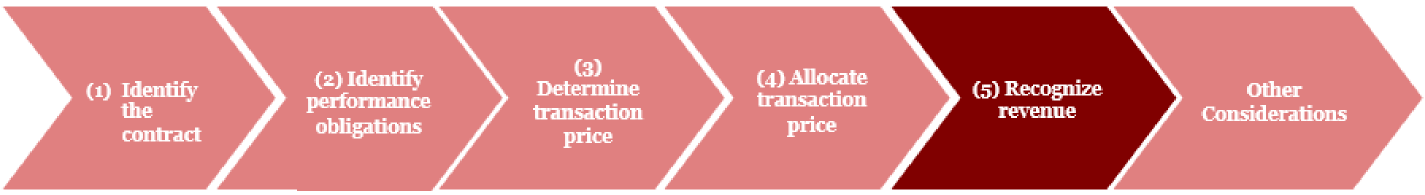
Analysis: Software Co. would likely utilize the renewal rate of 20% of the initial license fee for the PCS associated with the perpetual license as an observable input in its estimate of the SSP of the PCS associated with the term license. However, Software Co. should consider whether adjustments to that rate are necessary to reflect its pricing of term licenses.

Example 4-2 – Use of the residual approach is not appropriate

Facts: Software Co. enters into a contract with a customer to license software and provide PCS for a total transaction price of $10,000. Software Co. regularly sells PCS for $10,000 on a standalone basis. The software vendor also regularly licenses software on a standalone basis for $10,000 to $50,000, which the vendor determines to be highly variable.

Can Software Co. use the residual approach to determine the SSP of software license?

Analysis: No. Because the seller has observable evidence that PCS sells for $10,000, the residual approach results in an estimated standalone selling price of $0 for the software license. As such, the allocation objective is not met because no amount would be allocated to the software license. Therefore, Software Co. should use another method to estimate SSP of the license.



5. Recognize revenue

A performance obligation is satisfied and revenue recognized when control of the promised good or service is transferred to the customer. A customer obtains control of a good or service if it has the ability to (1) direct the use of and (2) obtain substantially all of the remaining benefits from that good or service.

Directing the use of an asset refers to a customer's right to deploy that asset, allows another company to deploy it, or restrict another company from using it.

Management should evaluate transfer of control primarily from the customer's perspective, which reduces the risk that revenue is recognized for activities that do not transfer control of a good or service to the customer.

As discussed, a software license generally represents a right to use IP for which revenue is recognized at the point in time that control of the license transfers to the customer. This occurs when a customer is able to use and benefit from the license, but not before the beginning of the stated license period. There are various ways a customer may take control of a software license. Control may transfer when the customer takes possession of the software by physical receipt, download, or receipt of an access code or license key that provides the customer the ability to immediately take possession of the software.

Temporary keys

Sometimes vendors deliver temporary keys that can be turned off by the vendor or that automatically expire if the customer does not pay the vendor.

The vendor would likely be able to recognize revenue when the temporary key is provided if the vendor has a customary business practice of using temporary keys for this purpose; however, selective issuance of temporary keys might indicate software is being used only for demonstration purposes or on a trial basis. In these cases, the customer does not have control over the software and revenue recognition would be precluded.

Software license combined with other goods or services

When a software license is not distinct and is combined with other goods or services (such as implementation services or PCS) in a contract, the company needs to assess whether control of the combined performance obligation transfers to the customer at a point in time or over time.

If the combined performance obligation qualifies for over time recognition, the company will measure its progress toward completion by selecting a single input or output method that best reflects the transfer of control of the goods or services.

Sell-through approach

Under current guidance, many software companies that sell to distributors use the sell-through approach, in which revenue is not recognized until the product is sold to the end customer. This approach might be used because the distributor is thinly capitalized, does not have a high-grade credit rating, or has the ability to return the unsold product, rotate older stock, or receive price concessions, or because the company cannot reasonably estimate returns or concessions.

The effect of the new standard on the sell-through approach will depend on the terms of the arrangement and why sell-through accounting was applied historically. The standards require management to determine when control transfers to the customer.

If the distributor has control of the product, control transfers when the product is delivered to the distributor. Any amounts related to expected sales returns or price concessions affect the amount of revenue recognized (that is, the estimate of transaction price), but not when revenue is recognized.

A company that is not able to estimate returns, but is able to estimate a minimum amount of revenue that is not probable of being reversed should recognize this minimum amount at the time of sell-in, provided that control has transferred.

When revenue is deferred until sell-through to the end customer, management should re-evaluate the appropriateness of the deferral each reporting period rather than defaulting to recognition upon sell-through of the product to the end customer.

Sales or usage-based royalties

The standards provide an exception relating to the recognition of variable consideration for sales- or usage-based royalties received in exchange for licenses of IP. Under this exception, royalties should be recognized as the underlying sales or usages occur, as long as this approach does not result in the acceleration of revenue ahead of the company's performance. This means that, in many cases, the accounting treatment of contingent royalty transactions will remain consistent with current practice under both US GAAP and IFRS. The application of this exception is not optional; therefore, companies should review their contracts for any in-substance royalties promised in exchange for a license of IP. For example, an arrangement with an upfront payment that is subject to clawback if the licensee does not meet certain sales or usage targets is effectively a sales- or usage-based royalty.

Companies that sell, rather than license, IP cannot apply the royalty exception. Additionally, when applying this exception to an arrangement, it is not appropriate to recognize revenue in the period that the sales or usages are reported by the customer (i.e., recognize on a "lag" basis). Instead, revenue is recognized when the sales or usage occurs. As a result, it may be necessary to estimate sales or usages prior to receiving reporting from the customer.

Additional complexities may arise when a sales- or usage-based royalty relates to both a license of IP and other goods or services. The royalty exception should only be applied when the license of IP is the predominant item to which the royalty relates. Because the standards do not provide a specific definition of "predominant," judgment will be required to determine whether the predominant item to which a royalty relates is the license component. If a customer would ascribe significantly more value to the license component, it would likely be predominant.

Minimum royalty guarantees are common in arrangements with sales- or usage-based royalties. In some cases, the minimum guarantee is negotiated due to uncertainty about the customer's performance and its ability to successfully exploit the IP. In other cases, the minimum guarantee is established as a cash flow management tool to provide the licensor with predictable timing of some of the cash flows under the contract. A minimum royalty guarantee is fixed consideration and is not subject to the sales- and usage-based royalty exception. Therefore, minimum royalty guarantees should be recognized when the licensor transfers control of the IP to the licensee. The variable consideration (the amount above the fixed minimum) should be recognized in accordance with the sales- or usage-based royalty exception.

Customer acceptance

A customer acceptance clause provides protection to a customer by allowing it to either cancel a contract or force the vendor to take corrective actions if the software or services do not meet the requirements in the contract.

An acceptance clause that is contingent upon the software meeting certain objective specifications could be a formality if the vendor has performed tests to ensure those specifications are met before the software has been delivered to the customer. Customer acceptance that is only a formality does not affect the assessment of whether control has transferred. An acceptance clause that relates primarily to subjective specifications is not likely to be a formality because the vendor cannot ensure the specifications are met prior to delivery.

Customer acceptance, as with all indicators of transfer of control, should be viewed from the customer's perspective. Management should consider not only whether it believes the acceptance is a formality, but also whether the customer views the acceptance as a formality.

New guidance	Current US GAAP	Current IFRS
Over time A company transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if one of the following criteria is met: ● The customer simultaneously receives and consumes the benefits as the company performs ● The company's performance creates or enhances an asset that the customer controls as the asset is created or enhanced ● The company's performance does not create an asset with an alternative use to the company and the company has an enforceable right to partial payment *Point in time* A performance obligation is satisfied at a point in time if none of the criteria for satisfying a performance obligation over time are met. If the performance obligation is satisfied at a point in time, indicators of the transfer of control include: ● The company has a right to payment for the asset	Revenue is generally recognized when all of the following criteria are met: ● Persuasive evidence of an arrangement exists ● Delivery has occurred or services have been rendered ● The seller's price to the buyer is fixed or determinable ● Collectibility is reasonably assured For services arrangements not within the scope of guidance for construction or certain production-type contracts, revenue is recognized using the proportional performance method. For services arrangements in the scope of guidance for construction or certain production-type contracts, revenue is recognized using the percentage-of-completion method when reliable estimates are available.	Revenue recognition occurs at the time of delivery when the following conditions are satisfied: ● The risks and rewards of ownership have transferred ● The seller does not retain managerial involvement to the extent normally associated with ownership nor retain effective control ● The amount of revenue can be reliably measured ● It is probable that the economic benefit will flow to the customer ● The costs incurred can be measured reliably If these criteria are not met, revenue is recognized once the risks and rewards of ownership have transferred, which may be upon sale to an end consumer. For revenue arising from the rendering of services, provided that all of the following criteria are met, revenue should be recognized by reference to the stage of completion of the transaction at the balance sheet date (the percentage-of-completion method): • The amount of revenue can be measured reliably

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The customer has legal title to the asset
The company transferred physical possession of the asset
The customer has significant risks and rewards of ownership
The customer has accepted the asset

Licenses of IP
The revenue standards include specific guidance to determine whether revenue from licenses of IP should be recognized at a point in time or over time. Refer to discussion in Step 2 beginning on page 6.
The revenue standards also include a narrow exception that applies only to licenses of IP with consideration in the form of sales- and usage-based royalties. Revenue is recognized at the later of when (or as) the subsequent sale or usage occurs, or when the performance obligation to which some or all of the royalty has been allocated is satisfied (or partially satisfied).
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It is probable that the economic benefits will flow to the seller
The stage of completion at the balance sheet date can be measured reliably
The costs incurred, or to be incurred, in respect of the transaction can be measured reliably

When these criteria are not met, revenue arising from the rendering of services should be recognized only to the extent of the expenses recognized that are recoverable (a "cost-recovery approach").
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Expected impact
The timing of revenue recognition could change (and be accelerated) for some companies compared to current guidance, which is more focused on the transfer of risks and rewards than the transfer of control. The transfer of risks and rewards is an indicator of whether control has transferred under the new standards, but companies will need to consider additional indicators.
Revenue from a distinct license that is a right to use IP is recognized at a point in time under the new standards. Whether the license is a perpetual license or a term license does not impact the conclusion. Thus, the analysis under the new standards could result in a different timing of revenue recognition as compared to today, depending on the company’s current accounting conclusions.
For licenses of IP with fees in the form of sales- or usage-based royalties, the exception provided in the guidance may result in a similar accounting outcome as today since companies typically do not recognize revenue until royalties are received. However, the new guidance specifies that the period of recognition should be the period in which the sales or usage occurs. As a result, if information from customers is received on a “lag” basis, companies may need to estimate sales or usage to recognize revenue at the time the sale or usage occurs.
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Example 5-1 – License to IP with a sales-based royalty

Facts: Software Co. licenses its patented technology to a customer to be used in a handheld device for no upfront fee and 1% of the customer’s future product sales. The license term is equal to the remaining patent term of three years. Technology in this area is changing rapidly so the possible consideration ranges from $10 million to $50 million, depending on whether new technology is developed.

How should Software Co. recognize revenue for this arrangement?

Analysis: The sales- or usage-based royalty exception applies to this arrangement because the vendor is promised a sales-based royalty in exchange for a license of IP. The royalty is not recognized until the customer’s future product sales occur.

Example 5-2 – License of IP is predominant

Facts: Software Co. licenses helpdesk software on an annual basis to its customers and promises to provide training on the use of the software. In exchange for the software license and training, the customer promises to pay Software Co. $1 per helpdesk ticket processed. Software Co. concludes that the software license and training are each distinct.

Does the sales- or usage-based royalty exception apply to this arrangement?

Analysis: Yes. The exception applies because the license of IP is predominant in the arrangement because the customer would ascribe significantly more value to the software license than to the training. In accordance with the exception, Software Co. will recognize revenue as the usage occurs, assuming this approach does not accelerate revenue ahead of performance.

Example 5-3 – License to IP with a sales-based royalty and guaranteed minimum

Facts: Software Co. licenses patented technology in a handheld device for no upfront fee and 1% of future product sales. The non-cancellable license term is equal to the remaining patent term of three years. Technology in this area is changing rapidly so the possible consideration from product sales ranges from $0 to $50 million, depending on whether new technology is developed. However, Software Co. is entitled to at least $5 million at the end of each year, regardless of the actual sales.

Management has concluded that the license transfers at a point in time when the license period commences. Management has also concluded that it is probable it will collect the consideration to which it is entitled, and there are no further obligations remaining after the license is transferred.

How should Software Co. account for the transaction?

Analysis: Software Co. will recognize royalty revenue when the future product sales occur. However, since Software Co. is entitled to at least $5 million at the end of each year, this amount of consideration is not variable. Therefore, Software Co. should recognize as revenue the fixed amount (the minimum payment of $15 million) at license inception. Any consideration from royalties in excess of $5 million in any given year will be recognized as those sales occur.

Software Co. should also consider whether this arrangement contains a significant financing component.

Software-as-a-Service

A software-as-a-service (SaaS) arrangement that does not include a license of IP is accounted for as a service. We expect that most SaaS arrangements will meet the criteria to be accounted for as a series of distinct service periods (e.g., daily or monthly service periods) because each distinct service period is substantially the same, meets the criteria for over time recognition, and the same method would be used to measure progress over each distinct service period.

As such, revenue from SaaS arrangements will generally be accounted for as a single performance obligation, except when accounting for contract modifications and allocating variable consideration. In these two areas, the model is applied to the distinct good or service within the series.

Example 5-4 – Allocating variable consideration to a series

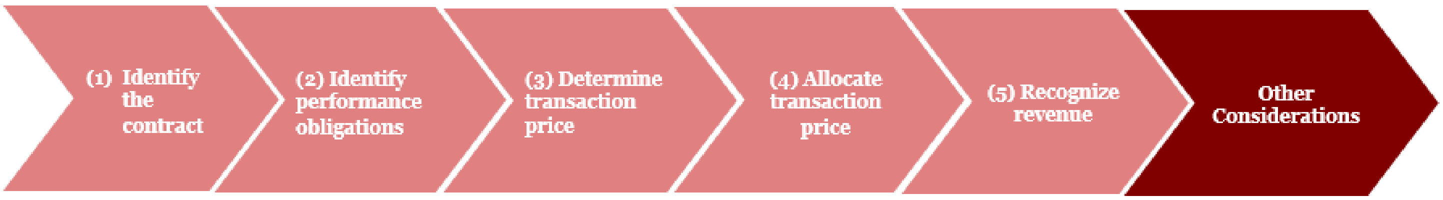
Facts: Cloud Co. enters into a contract to provide a customer with a cloud-based solution to process payroll over an annual period. The customer cannot take possession of the software at any time during the hosting period. Cloud Co. charges the customer an upfront fee of $10,000 and a $2 fee for each employee's payroll that is processed through the cloud-based solution, payable on a monthly basis throughout the term of the arrangement. If the customer renews the contract, it will have to pay a similar upfront fee.

How should Cloud Co. recognize revenue from this arrangement?

Analysis: Cloud Co. is providing a series of distinct services that represent a single performance obligation satisfied over time. Cloud Co. should determine an appropriate measure of progress for recognition of the $10,000 upfront fee, which would likely be ratable recognition over the contract term.

Cloud Co. should allocate the variable monthly fee to the distinct monthly service to which it relates. The allocation objective is met because fees are priced consistently through the contract.

If the rates were not consistent throughout the contract (e.g., the variable fee ranged from $2 to $8 for each employee's payroll processed during the contract term), the vendor would need to assess whether allocating the variable monthly fee to the month it relates meets the allocation objective. Cloud Co. would assess whether the changes in the rates are linked to changes in value provided to the customer.



Contract costs

Incremental costs of obtaining a contract

A company may incur costs to obtain a contract with a customer, such as selling and marketing costs, bid and proposal costs, sales commissions, and legal fees. The company should capitalize as an asset incremental costs of obtaining a contract with a customer if the company expects to recover them. Incremental costs of obtaining a contract are those costs the company would not have incurred if the contract had not been obtained. Bid, proposal, selling and marketing costs are not incremental because the company would have incurred those costs even if it did not obtain the contract. Similarly, an employee's annual salary and legal and travel costs incurred in the process of trying to obtain a contract are not incremental costs because these costs would have been incurred regardless of whether the contract was executed.

Sales commissions represent incremental costs to obtain a contract and should be capitalized as an asset. Expensing these costs as incurred is not allowed under the new standards unless the costs qualify for the practical expedient that permits a company to expense incremental costs to obtain a contract when the expected amortization period is one year or less. This represents a difference from current guidance that allows a company to make a policy choice regarding whether to expense or defer sales commissions.

Companies may be required to capitalize more commissions under the new standards because the new standards focus on costs that are incremental; they do not consider whether the costs are "direct." Commission payments made to multiple individuals (e.g., salesperson, manager, and regional manager) for the same contract could all qualify as incremental costs. Additionally, the timing of a commission payment does not, on its own, determine whether it is incremental. Commissions paid based on a pool of contracts could also qualify as incremental costs.

Companies may need to apply judgment to determine whether there are factors (other than whether a contract is obtained) affecting the amount of the payment, which could indicate the payment is not an incremental cost. For example, a discretionary bonus that is based both on obtaining new contracts and other performance targets is not an incremental cost because there are other factors impacting whether the company will pay the bonus and the amount of the bonus.

Costs to fulfill a contract

A software company may incur costs, such as setup costs, to fulfill their obligations under a contract once it is obtained, but before transferring goods or services to the customer. Management is first required to determine whether the accounting for these costs is addressed by other standards (PP&E, intangible assets, etc.). If not, the costs to fulfill a contract are eligible for capitalization if all of the following criteria are met.

- The costs relate directly to a contract or a specifically-anticipated contract
- The costs generate or enhance company resources that will be used in satisfying future performance obligations
- The costs are expected to be recovered

See Example 11-4 in PwC's Revenue guide on setup costs in the technology industry.

Amortization of capitalized contract costs

Software companies should amortize assets recognized from capitalizing costs to obtain or fulfill a contract on a systematic basis, consistent with the pattern of transfer of the goods or services to which the asset relates. Capitalized costs could relate to an entire contract, specific performance obligations within a contract, or anticipated renewals.

The amortization period should not include anticipated renewals if the company also incurs a commensurate cost for them. For example, if a company pays its employees a 2% sales commission for the initial annual contract and also pays 2% commission for each annual renewal, the company should amortize the initial commission over the term of the initial contract and amortize each renewal commission over the renewal term because the renewal commission is commensurate with the initial commission.

Often, the renewal commission is a lesser amount than the initial commission. In these circumstances, the level of effort to obtain a contract or renewal should not be a factor in determining whether the commission paid on a contract renewal is commensurate with the initial commission. As a result, when the respective contract values are equal and the renewal commission is a lesser amount than the initial commission, the renewal commission is likely not commensurate with the initial commission. Therefore, the asset recognized from the cost to obtain the initial contract will be amortized over a period longer than the initial contract term, such as over the average customer life, which is based on the period of expected future cash flows to be received from the customer. There may be circumstances when the asset should be amortized over a period shorter than the average customer life, such as when the life cycle of the goods or services to which the asset relates is shorter than the average customer life.

Example 6-1 – Incremental costs to obtain a contract

Facts: A company's vice president of sales receives a quarterly bonus based on meeting a specified revenue target that is established at the beginning of each quarter.

Is the quarterly bonus considered an incremental cost to obtain a contract?

Analysis: It depends. The company should consider if the revenue target includes factors other than obtaining new contracts. If so, the payment would not be incremental.

If the bonus payment was based solely on achieving a cumulative target of new contracts obtained during the quarter, it would likely be an incremental cost as it is essentially a delayed commission payment.

Example 6-2 – Amortization of initial commission

Facts: A sales employee is paid a $500 commission for each initial annual SaaS contract obtained with a customer and $250 for each annual renewal. The services provided under the initial and renewal contracts are substantially the same. The company expects the customer to renew the contract. The average customer life is five years.

What is the amortization period for the initial commission and renewal commission?

Analysis: Since the renewal commission is not commensurate with the initial commission, the initial commission should be amortized over a period longer than the initial contract term. The average customer life of five years could be a reasonable amortization period in this example. The asset should be amortized on a systematic basis that is consistent with the transfer of the related services. To comply with this objective, the company could amortize the initial $500 commission over the average customer life of five years, or it could separate the initial commission of $500 into two components and amortize $250 over the initial annual contract term and the remaining $250 over five years.

About PwC's Technology, Media, and Telecommunications (TMT) Practice:

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For more information about the TMT practice or PwC, please contact:

Raman Chitkara
Global Technology Industry Leader
raman.chitkara@pwc.com

Mark McCaffrey
US Technology, Media and Telecom Sector Leader
mark.mccaffrey@pwc.com

Kevin Healy
US Technology, Media and Telecom Assurance Leader
kevin.healy@pwc.com

Chris Smith
Partner, Capital Markets and Accounting Advisory Services
christopher.j.smith@pwc.com

To have a deeper discussion, contact:

Michael Coleman
Partner
michael.coleman@pwc.com

Steve Mack
Partner
steve.mack@pwc.com

Stig Haavardtun
Partner
stig.haavardtun@pwc.com

Alisher Zokhidov
Director
alisher.zokhidov@pwc.com

Angela Fergason
Partner
angela.fergason@pwc.com

Roxanne Fattahi
Senior Manager
roxanne.fattahi@pwc.com

Patrick Young
Senior Manager
patrick.d.young@pwc.com

Jeff Mollenhauer
Partner
jeff.mollenhauer@pwc.com

Follow @CFOdirect on Twitter.