Working Draft:
Software Revenue Recognition Implementation Issue

Issue #14-7: Significant Financing Components in Software Arrangements

Expected Overall Level of Impact to Industry Accounting: Low

Wording to be Included in the Revenue Recognition Guide:

Assessing Significance

1. In accordance with FASB ASC 606-10-32-3, a software company should consider if each of their contractual arrangements with customers provide a significant benefit of financing to either party of the contract. The financing component may be explicitly identified in the contract or may be implied by the contractual payment terms of the contract. In accordance with FASB ASC 606-10-32-15, an entity should adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer.

2. An entity must first determine at what level significance is required to be assessed. BC234 of FASB ASU 2014-09 states:

    > The Boards clarified that an entity should only consider the significance of a financing component at a contract level rather than consider whether the financing is material at a portfolio level. The Boards decided that it would have been unduly burdensome to require an entity to account for a financing component if the effects of the financing component were not material to the individual contract, but the combined effects for a portfolio of similar contracts were material to the entity as a whole.

3. In accordance with FASB ASC 606-10-32-15 and BC 234 of FASB ASU 2014-09, the assessment of whether the financing component is significant should only be made at the contract level (i.e., not at the business level, portfolio level, segment level, or entity level, nor would any assessment be required at the performance obligation level). When the financing component is considered significant in relation to the contract, the

transaction price is required to be adjusted. At the March 2015 Transition Resource Group ("TRG") meeting[1], the TRG agreed that there is no guidance in the standard that would preclude an entity from accounting for a financing component that is not significant.

4. In accordance with FASB ASC 606-10-32-16, all relevant facts and circumstances should be considered in assessing whether a contract contains a financing component and whether the financing component is significant, including:
   a. The difference if any, between the amount of promised consideration and the cash selling price of the promised goods or services
   b. The combined effect of both of the following:
      i. The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services
      ii. The prevailing interest rate in the relevant market

5. The assessment of whether a financing component is significant requires judgment and will be based upon individual facts and circumstances. BC234 of FASB ASU 2014-09 states, that "for many contracts an entity will not need to adjust the promised amount of customer consideration because the effects of the financing component will not materially change the amount of revenue that should be recognized in relation to a contract with a customer". If an entity concludes the financing component is not significant, the entity does not need to apply the provisions of FASB ASC 606-10-32-15 through 32-30 and adjust the consideration promised in determining the transaction price.

6. At the March 2015 TRG meeting[1], the TRG discussed how to apply the significant financing component guidance when there is no difference between the amount of promised consideration and the cash selling price. In this situation, it was discussed that an entity should not automatically assume that there is no significant financing component. The difference, if any, between the amount of promised consideration and the cash selling price is only one consideration in determining whether a significant financing component exists. As a first step, an entity would evaluate whether the amount of promised consideration in fact equals the cash selling price versus the list price (if the cash selling price differs from the list price). If the amount of promised consideration is equal to the cash selling price, all relevant facts and circumstances should be considered; however, it might be an indicator that that the contract does not include a significant financing component or it may be possible a financing component exists but it is not significant.

7. The following examples are meant to be illustrative, and the actual determination of the existence of a significant financing component in the contract should be based on the facts and circumstances of an entity's specific situation. Assume the vendor considered the factors in FASB ASC 606-10-32-17 and concluded none of the factors exist.

   Example 1:

8. A software vendor enters into a contract with a customer to provide a software license for promised consideration of $100,000. The customer will remit 90% of the payment upon delivery of the license and 10% of the payment in 18 months. In order to defer a portion of the payment 18 months, the customer is paying a higher price. The vendor concludes a financing component exists. Based on an evaluation of the facts, including prevailing interest rates, the vendor calculates a $2,000 financing component over the 18 month term. The entity concludes that $2,000, or 2% of the contract price, is not significant and the entity does not need to adjust the consideration promised in determining the transaction price.

   Example 2:

[1] FASB/IASB TRG Agenda Ref 30 addresses questions related to Significant Financing Components. Question 2 specifically relates to whether a financing component exists if the promised consideration is equal to the cash selling price. Question 3 addresses whether the standard precludes accounting for financing components that are not significant. FASB/IASB TRG Agenda Ref 34, March 2015 Meeting – Summary of Issues Discussed and Next Steps, Topic 6, summarizes the TRG discussion on Significant Financing Components.

9. Consider the same facts as noted above, except that the customer remits 100% of the consideration in three years. The customer is paying a higher price in order to defer payment three years. The vendor concludes a financing component exists, which the vendor calculates to be $20,000. In this case, the entity concludes $20,000, or 20% of the contract price is significant (there are no other qualitative factors to suggest otherwise) and the entity should adjust the consideration promised in determining the transaction price.

   Example 3:

10. A software vendor enters into a contract with a customer to provide a five-year term license for promised consideration of $100,000, which is equal to the list price of the software. The customer will make 60 equal payments on a monthly basis over the five year term; however, the software vendor will recognize revenue upon delivery of the license. The vendor concludes a financing component exists. In assessing whether the financing component is significant, the vendor considers the difference between the amount of promised consideration and the cash selling price of the promised goods or services. Although the amount of promised consideration equals the list price, the vendor notes that customers generally receive a 20% discount for paying for a license in full upon delivery. As such, the vendor concludes the cash selling price is $80,000, which is $20,000 less than the promised consideration. Based on this fact, and consideration of prevailing interest rates and the length of time between delivery of the license and payment, the entity concludes the contract contains a significant financing component and the entity should adjust the consideration promised in determining the transaction price.

11. In these examples, the entity's conclusions regarding whether a financing component is significant is a judgment based on the entity's facts and circumstances. An entity may reach a different conclusion based on its facts and circumstances, i.e., the thresholds (2% and 20%) used in these examples are not intended to be bright-lines.

When to Assess a Contract for a Significant Financing Component

12. FASB ASC 606-10-32-15 provides that an entity should adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing. The standard does not explicitly provide for when and how often an entity should assess whether a significant financing component is present. However, FASB ASC 606-10-32-19 does imply that it should be assessed at contract inception as it provides guidance that when adjusting the promised consideration for a significant financing component an entity should use the discount rate that would be reflected in a separate financing transaction with the entity and its customer at contract inception.

13. When a contract is modified, the terms and conditions of the revised contract could alter the timing of satisfaction of the performance obligations or payments in such a way that explicitly or implicitly provides for a significant financing component. Since a contract modification could change whether a contract contains a significant financing component, FinREC believes an entity should consider whether a significant financing component is present based on the terms and conditions of the newly modified contract, regardless of whether it is accounted for as a separate contract or as part of the same contract based on guidance within FASB ASC 606-10-25-12 through 25-13.

14. FASB ASC 606-10-32-19 also states, after contract inception, an entity should not update the discount rate for changes in interest rates or other circumstances (such as a change in the assessment of the customer's credit risk).

15. As a result, once an entity determines a significant financing component is present and adjusts the promised consideration, the entity would continue to use the same assumed discount rate for the specific contract assessed. However, in situations in which a contract modification results in the addition of a significant financing component or a change to an existing significant financing component, FinREC believes an entity will likely need to update the discount rate assumptions.

Applying the Practical Expedient

16. FASB ASC 606-10-32-18 also provides a practical expedient, whereby an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less. The practical expedient may be applied in instances where the contract is greater than one year, but within that contract the period between performance (transfer of a good or service) and payment is one year or less.

17. The following example is meant to be illustrative, and the actual determination of whether the practical expedient can be applied as stated in FASB ASC 606-10-32-18 should be based on the facts and circumstances of an entity's specific situation.

    Example 4:

18. Company H enters into a 2-year contract to develop customized software for Company C. Company H concludes that the goods and services in this contract constitute a single performance obligation (this conclusion is not the purpose of this example). Based on the terms of the contract, Company H determines that it transfers control over time, and recognizes revenue based on an input method best reflecting the transfer of control to Company C. Company C agrees to provide Company H progress payments on a monthly basis. In this case, Company H must assess whether any timing difference between the transfer of control of the software and payment from Company C is indicative of a significant financing component. Based on the expectation of the timing of costs to be incurred, Company H concludes that progress payments are being made such that the timing between the transfer of control and payment is never expected to exceed one year. Therefore, Company H concludes it will not need to further assess whether a significant financing component is present, and does not adjust the promised consideration in determining the transaction price, as they are applying the practical expedient under FASB ASC 606-10-32-18.

Applying the significant financing component guidance when there are multiple performance obligations

19. The standard does not provide explicit guidance regarding how to apply the significant financing component guidance when there are multiple performance obligations. As a result, questions regarding this issue were raised for discussion at the March 2015 TRG meeting. In TRG Agenda Ref 30, Question 6, the FASB staff explains that, in Step 3 of revenue model, the transaction price should be adjusted for the effect of financing, since the financing component is in exchange for financing rather than in exchange for promised goods or services. After determining the transaction price, adjusted for any financing components, an entity would allocate the transaction price to the performance obligations in Step 4 of the revenue model. For example, if the total consideration in a contract is $100 and an entity determines the interest component is $10, then the transaction price to be allocated to the performance obligations is $90.

20. As noted in paragraph 38 of TRG Agenda Ref 34, March 2015 Meeting – Summary of Issues Discussed and Next Steps:

    > As it relates to Issue 6, the standard is clear that when determining the transaction price, the effect of financing is excluded from the transaction price prior to the allocation of the transaction price to performance obligations. TRG members agreed with the staff view that it may be reasonable in some circumstances to attribute a significant financing component to one or more, but not all, of the performance obligations in the contract. Some TRG members agreed that, practically, this might be in a manner analogous to the guidance on allocating variable consideration or allocating a discount.

Determining Whether the Transaction Price Contains a Significant Financing Component

Advance Payments

21. In certain software arrangements, entities receive consideration in advance of the transfer of goods to the customer. For example, the following scenarios include payments in advance:
    - A software vendor enters into a contract with a customer to provide three years of postcontract customer support ("PCS"). Revenue is recognized over time. The customer remits full payment for the three year term at the inception of the arrangement.
    - A software vendor enters into a contract with a customer to provide software as a service ("SaaS") over a five year term. Revenue is recognized over time. The customer remits full payment for the five year term at the inception of the arrangement.
    - A software vendor enters into a contract with a customer to provide a three year term license, including PCS. As the license and PCS are considered distinct, revenue for the license is recognized upon delivery and revenue for the PCS is recognized over time. The customer remits full payment for the entire arrangement upon delivery of the license; therefore, the customer is paying in advance for the PCS.

    An entity should consider all facts and circumstances in assessing whether the advance payment from the customer represents a significant financing component.

22. BC232 of FASB ASU 2014-09 states that one of the factors to consider in evaluating whether a contract includes a significant financing component is:

    > The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services. If the entity (or another entity) sells the same good or service for a different amount of consideration depending on the timing of the payment terms, this generally provides observable data that the parties are aware that there is a financing component in the contract. This factor is presented as an indicator because in some cases the difference between the cash selling price and the consideration promised by the customer is due to factors other than financing.

23. BC233 of FASB ASU 2014-09 describes circumstances in which a contract does not provide the customer or the entity with a significant benefit of financing, including when:
    a. a customer pays for goods or services in advance and, the timing of the transfer of those goods is at the discretion of the customer,
    b. a substantial amount of the consideration promised by the customer is variable and that consideration varies on the basis of factors that are outside the control of the customer or the entity, or
    c. the difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of financing to either the customer or the entity.

    The examples in BC 233 illustrate when a payment in advance or in arrears of the typical payment terms may have a primary purpose other than financing. A software arrangement may require customers to pay in advance for reasons other than to secure financing, such as to mitigate risk of nonpayment or to commit a customer to a longer term.

24. BC 237 and BC 238 of FASB ASU 2014-09 explain that FASB ASC 606 does not include an exemption for advance payments, as there may be situations where a significant financing component is present, and to ignore the impact would skew the amount and pattern of revenue recognition. This point was also discussed in the March 2015 TRG meeting.[2] TRG members agreed that there is no presumption as to whether advance payments do or do not contain significant financing components and that advance payments should be assessed under the new revenue standard. However, they did discuss that an advance payment arrangement may be more likely to contain the factor

[2] FASB/IASB TRG Agenda Ref 34, March 2015 Meeting – Summary of Issues Discussed and Next Steps, Topic 6, summarizes the TRG discussion on Significant Financing Components. Paragraph 32 discusses TRG Agenda Ref 30: Significant Financing Components, Question 1: How should the factor in paragraph 606-10-32-17(c) [62(c)] be applied in determining when the difference between promised consideration and cash selling price is not related to a significant financing component?

described in ASC 606-10-32-17(c), i.e., the difference in promised consideration and cash selling price is for a reason other than financing.

25. The following examples are meant to be illustrative, and the actual determination of the existence of a significant financing component in a contract should be based on the facts and circumstances of an entity's specific situation.

Example 5:

26. A software vendor enters into a contract with a customer whereby the customer commits to spend $100,000 on software products over a two year arrangement. The customer prepays $100,000 at the inception of the arrangement into a flexible spending account, which may be applied to software purchases under the arrangement, the timing of which is at the discretion of the customer. Although the customer will pay in advance of the transfer of the software, because the timing of the transfer of the software is at the discretion of the customer, the vendor concludes the contract does not provide the customer or the entity with a significant benefit of financing based on FASB ASC 606-10-32-17(a).

Example 6:

27. A software vendor enters into a three year arrangement with a customer to provide PCS. For customers with low credit ratings, the vendor requires the customer to pay for the entire arrangement in advance of the provision of service. Other customers pay over time. Due to this customer's credit rating, the customer pays in advance for the three year term. Since there is no difference between the amount of promised consideration and the cash selling price (i.e., the customer does not receive a discount for paying in advance), the vendor only requires payment in advance to protect against customer nonpayment, and no other factors exist to suggest the arrangement contains a financing, the vendor concludes this contract does not provide the customer or the entity with a significant benefit of financing.

Example 7:

28. A software vendor enters into a contract with a customer to provide a three year term license, including PCS, for promised consideration of $100,000, which includes a discount for paying at the beginning of the three year term. In these facts and circumstances, the vendor is unable to determine that the difference between the promised consideration and the cash selling price is for a reason other than financing. Therefore, the vendor concludes the transaction price contains a financing component and, based on all relevant facts and circumstances, concludes the financing component is significant to the contract.

29. As the license and PCS are considered distinct, revenue for the license is recognized upon delivery and revenue for the PCS is recognized ratably over the term of the arrangement. Since there is no difference between when the customer pays for the license and the vendor transfers the license to the customer, the vendor concludes the significant financing component relates solely to the PCS, for which payment is made in advance of delivery. In order to determine the transaction price to be allocated between the license and PCS, the vendor first must calculate the financing component.

30. Since FASB ASC 606 does not provide explicit guidance regarding how to calculate the financing component when there are multiple performance obligations, there may be more than one allowable methodology. One reasonable approach requires first allocating the $100,000 in promised consideration between the license and PCS. Although the transaction price should be adjusted for the financing component prior to allocating the transaction price, FinREC believes it is appropriate under this approach to first allocate the promised consideration of $100,000 between the license and PCS on a relative standalone selling price basis, solely for purposes of calculating the financing component. Under this approach, assuming the standalone selling price for the license is $80,000 and the standalone selling price for the PCS is $30,000, the vendor determines $72,700 of promised consideration relates to the license (($80,000/$110,000)*$100,000 = $72,700) and $27,300 of promised consideration relates to the PCS (($30,000/$110,000)*$100,000 = $27,300).

31. Based on an advance payment of $27,300 for the PCS, and using a discount rate that would be used in a separate financing transaction between the vendor and the customer, the vendor concludes that $6,000 in interest expense should be recognized related to the financing component (assume for purposes of this example that the amount is considered significant to the contract). As such, the vendor determines the total transaction price for the arrangement is $106,000 ($100,000 promised consideration plus the financing component). However, since the financing component relates solely to the PCS, the vendor determines that $72,700 of the transaction price should be allocated to the license and $33,300 should be allocated to the PCS. Note that other approaches to calculate the financing component may also be reasonable.

Payments in Arrears

32. In some software arrangements, entities may receive payment after the transfer of goods or services to the customer. In certain cases, the financing is explicitly stated in the contract and may already be appropriately accounted for under the significant financing component guidance. In other cases, the financing may be implicit and the entity may need to evaluate whether a significant financing component exists and, if so, adjust the consideration promised for the effects of the time value of money in determining the transaction price.

33. The following examples are meant to be illustrative, and the actual determination of the existence of a significant financing component in a contract should be based on the facts and circumstances of an entity's specific situation.

Example 8:

34. A software vendor enters into a contract with a customer to provide a license solely in exchange for a sales-based royalty. Although the payment will be made in arrears, since the total consideration varies based on the occurrence or non-occurrence of a future event that is not within the control of the customer or the entity, the software vendor concludes the contract does not provide the customer or the entity with a significant benefit of financing based on FASB ASC 606-10-32-17(b).

Example 9:

35. A software vendor enters into a 2-year contract to develop customized software for a customer. The vendor concludes that the goods and services in this contract constitute a single performance obligation (this conclusion is not the purpose of this example). Based on the terms of the contract, the vendor determines that it transfers control over time, and recognizes revenue based on an input method best reflecting the transfer of control to the customer. The customer agrees to provide the vendor progress payments on a monthly basis, with the final 25% payment (the "holdback payment") due upon contract completion. As a result of the holdback payment, there is a difference between when control transfers and when consideration is received, creating a financing component. However, since there is no difference between the amount of promised consideration and the cash selling price (i.e., the customer did not pay a premium for paying a portion of the consideration in arrears), the payment terms included a holdback payment only to ensure successful completion of the project, and no other factors exist to suggest the arrangement contains a financing, the vendor concludes this contract does not provide the customer or the vendor with a significant benefit of financing.

Comments should be received by April 3, 2017, and sent by electronic mail to Kim Kushmerick at kkushmerick@aicpa.org, or you can send them by mail to Kim Kushmerick, Accounting Standards, AICPA, 1211 Avenue of the Americas, NY 10036.