Deloitte.

Deloitte & Touche LLP
695 East Main Street
Stamford, CT 06901-2150
USA

Tel: +1 203 708 4000
Fax: +1 203 705 5455
www.deloitte.com

April 9, 2019

Ms. Susan Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Agenda request – Accounting for contracts that include a conversion from an on-premise software license to SaaS

Dear Ms. Cosper,

Deloitte & Touche LLP appreciates the opportunity to submit an agenda request to the FASB. We request the FASB or Emerging Issues Task Force (EITF) address the application of Accounting Standards Codification (ASC) Topic 606 to contracts that include, whether from inception or by subsequent modification, a conversion from an on-premise functional software license[1] (hereafter referred to simply as a software license) to a hosted software solution[2] (a software-as-a-service subscription or SaaS for simplicity) that in accordance with ASC Topic 606 will be recognized over time.

We are making this request because we are aware of diversity in practice in the accounting for contracts that include a right provided by a vendor to a customer to switch from a software license to SaaS. In addition, we are seeing an increasing number and variety of these types of contracts and therefore believe there is an opportunity to increase consistency in this area by clarifying how ASC 606 should be applied to these types of transactions. For illustrative purposes we have provided three variations of this issue below:

(1) Contract modifications that result in the switch from a software license to SaaS.

(2) Contract modifications that add an option to switch from an existing software license to SaaS.

(3) Contracts that include an option to switch from a software license to SaaS.

For simplicity, assume for all cases that an annual payment is made at the beginning of each year over a three year contract term (equal installments).

(1) Contract modifications that result in the switch from a software license to SaaS

[1] This software license is intended to be a license that meets the criteria in ASC 606-10-55-54(a) and therefore would be treated as a functional license and recognized at a point in time.
[2] A SaaS service would allow the customer to access the software on the vendor's equipment but not obtain control of a software license in accordance with the requirements in ASC 985-20-15-5.

Companies that sell both software licenses and SaaS may modify existing contracts that include a functional software license and post-contract customer support ("PCS") by allowing the customer to switch from a software license (and PCS) to SaaS. This results in the customer relinquishing any remaining rights to use the software license and, in its place, receiving access to SaaS for the remainder of contract term. Assume that the modification is executed in year 2 and the payment terms remain unchanged. Application of ASC 606-10-55-58C to the contract prior to modification results in upfront recognition of the license revenue such that, at the time of modification, the remaining unrecognized revenue will relate solely to PCS.

ASC 606-10-25-12 and 25-13 provide guidance on accounting for contract modifications. ASC 606-10-25-12 indicates that the addition of a distinct good or service is accounted for as a separate contract, on a prospective basis, when the transaction price increases by an amount that represents the standalone selling price (SSP) of the added good or service. When the addition of a distinct good or service is not priced at SSP, ASC 606-10-25-13(a) indicates that any unrecognized revenue related to the original contract plus any additional consideration related to the new contract, must be allocated to the remaining goods and services in the new contract and any contract asset must be carried forward[3]. When considering the switch from the software license to SaaS, the company will likely conclude the SaaS is distinct from the software license. We have observed the following two interpretations of the guidance related to this fact pattern:

<u>View A</u> – Sale with a Right of Return Model
Proponents of this view note that the customer is surrendering certain rights (e.g., the right to determine where the software is hosted) and obtaining different rights. Under this view, a modification that results in the relinquishment of a software license is akin to the return of a tangible good. Therefore, on the date of the modification, the Company should record an immediate adjustment to the transaction price (and revenue) to account for the return of the software license. The remaining transaction price, inclusive of this reversal, will then be recognized over the period the SaaS is provided.

This view results in revenue that was previously recognized being deferred and re-recognized over a future period (aligned with the period of time the SaaS is transferred to the customer). For this reason, some view this approach as inappropriate. Additionally, opponents of this view observe that challenges may arise when applying this approach to implied rights or expected future rights to exchange (i.e., at what point should the entity estimate future return rights granted to its customers). On the other hand, proponents of this view believe this approach best aligns the accounting with the economic substance of the transaction and is therefore in line with the objective of modification guidance as noted in paragraph BC76 of the FASB's Basis for Conclusions to ASU 2014-09 which states, in part:

> … each approach was developed with the overall objective of faithfully depicting an entity's rights and obligations in the modified contract. …

<u>View B</u> – Prospective Modification Model

[3] In accordance with TRG 51 Contract Asset Treatment in Contract Modifications (April 2016) in which modifications accounted for under ASC 606-10-25-13(a) were discussed.

Proponents of this view believe a license does not lend itself to being returned in the same manner as a tangible asset. Accordingly, the modification should be recognized based on the guidance in ASC 606-10-25-12 through 25-13. Because the modification added distinct services (SaaS) and the transaction price did not "increase" by an amount equal to the SSP of the SaaS, ASC 606-10-25-12 does not apply. Instead, a distinct good or service (the SaaS) was added to the contract but not priced at SSP. Accordingly, the Company must account for the modification prospectively under ASC 606-10-25-13(a). Since the only remaining revenue to be recognized as of the modification date relates to PCS, this amount must now be allocated to the SaaS.

This view retains the recognition of revenue that occurred prior to the modification, thus resulting in the allocation of a smaller amount to the SaaS that will be provided for the remainder of the contract term. While it avoids the re-recognition of revenue, some may view this approach as incongruent with the economic substance of the transaction (i.e., the revenue recognized over the remaining term will be significantly less than what the SaaS is actually worth). In contrast, supporters view this outcome to be aligned with the modification guidance in ASC 606-10-25-13(a).

(2) Contract modifications that add an option to switch from an existing software license to SaaS

As an alternative to modifications that cause the customer to switch from a software license to SaaS, companies may, in negotiation with their customers, choose to modify existing licensing contracts by adding an *option* to convert the software license into SaaS (thereby, upon exercise of the option, also discontinuing any PCS subscription).

ASC 606-10-55-41 through 55-45 provide guidance on accounting for options for additional goods and services including how to determine whether such an option represents a material right. If an option is determined to represent a material right, it must be accounted for as a separate performance obligation which entails estimating SSP and determining when control of the material right transfers. ASC 606-10-55-43 indicates that an option to acquire goods or services at a price that reflects SSP is not a material right and should therefore only be accounted for if and when exercised. However, ASC 606-10-55-41 through 55-45 do not elaborate on what constitutes the "price" of the additional goods or services. For example, whether the price includes recurring annual fees that, prior to the modification, related entirely to the software license and PCS. This determination in turn affects the application of ASC 606-10-25-12 and 25-13 as the accounting for a modification will depend on whether the consideration in the modification reflects the SSP of the additional goods or services. Assuming the recurring annual payments remain the same each year pre and post modification and such annual payments represent the SSP of one year of SaaS, we have observed the following two interpretations of the guidance related to this fact pattern:

<u>View A</u>: No Material Right due to Sale with a Right of Return
Proponents of this view believe the license has been returned and future payments are credits received for that return that may be used to purchase the SaaS. Under this view, the option to acquire SaaS does not represent a material right because the option allows the customer to acquire SaaS by paying an annual amount equal to the SSP thereof. In concluding that the price of the SaaS is SSP, proponents of this view believe it is

appropriate to consider the credits for the returned license as part of the price of the SaaS. Consequently, the addition of the option to the contract requires a right of return to be estimated and accounted for at the time of modification. The associated reduction in revenue and refund liability would be subject to remeasurement each period. If and when the option is exercised, the vendor should account for the exchange of the software license as a return by reversing the refund liability and setting up a contract liability representing revenue to be recognized for the SaaS. The vendor would then recognize the contract liability over the SaaS term. In summary, under this view, previously recognized revenue for the software license would be reversed in conjunction with the modification due to the introduction, on that date, of a right of return, and the requirements to estimate variable consideration for that right of return could result in adjustments in subsequent periods.

View B: Prospective Modification Resulting in a Material Right
Under this view, the option to acquire SaaS does represent a material right. The initial contract required annual payments of the same amount each year in return for a software license and PCS. The addition of an option to acquire SaaS for no additional fee therefore represents a material right that must be accounted for as a separate performance obligation as it allows the customer to acquire the SaaS at an incremental discount that it would not have been able to obtain but for entering into the initial contract. Because of this, the modification results in the addition of a good or service that is not priced at SSP and must be accounted for as the termination of the old contract and the creation of a new contract (i.e. a modification in accordance with ASC 606-10-25-13(a)). Under this view, the amount of revenue not yet recognized and therefore allocable to the material right will likely equal the amount related to undelivered PCS in each year. If the option is exercised, this amount will be recognized ratably over the remaining term as the vendor provides the SaaS. In contrast to View A, because the option is accounted for as a separate performance obligation, the amount allocated to the material right on the date of modification will not be revisited (other than due to expiration or exercise) unless the contract is modified again.

(3) Contracts that include an option to switch from a software license to SaaS

Companies may also enter into contracts that, from inception, include both a software license and a right to exchange that software license for SaaS.

ASC 606 does not provide explicit guidance related to the switch from a software license to SaaS although it does address exchanges and returns in the implementation guidance in ASC 606-10-55-22 through 55-29 on sale with a right of return. However, that guidance refers to "products" and "assets" and is not explicitly relevant to transactions involving licenses to intellectual property or services. Further, the guidance in ASC 606-10-55-28 on an exchange of one product for another focuses on those two products being of the same type, quality, condition and price. In addition, ASC 606-10-55-66 through 55-78 contains guidance on repurchase agreements, including scenarios where a vendor is obligated to repurchase an asset at the customer's request. ASC 606-10-55-74 indicates that in situations where the repurchase price is greater than or equal to the original selling price, the sale should be accounted for as though it were a sale with a right of return or a financing. In other situations, the presence of a repurchase agreement results in the contract being accounted for as a lease. Notwithstanding these considerations, the guidance on repurchase agreements is premised on a notion that there is an asset that must or may be repurchased. As discussed previously, there are differing viewpoints on whether a software license may be viewed as akin to a tangible asset for purposes of applying ASC 606. Due to the lack of explicit guidance in this area, we are aware of at least three views on the accounting for contracts that include an option to exchange a software license for SaaS. Assume, for purposes of the views below, that exercise of the option to switch from the software license to SaaS results in the payment of an incremental fee, the amount of which is dependent on the number of remaining years in the contract:

> View A: Sale with a Right of Return Model
> Under this view, the inclusion of an option to switch from a software license to SaaS may be viewed as akin to a sale of a tangible good with a right of return. Therefore, at contract inception, the company should record an adjustment to the transaction price (and revenue) to account for the potential future return of the software license. If and when that return occurs, the value previously deferred as a refund liability should be recognized (or begin to be recognized) as SaaS revenue over the remaining term. Under this view, similar to application of the right of return guidance as variable consideration subject to the constraint, the estimate would be reassessed at each reporting period.
>
> Opponents of this view believe that a true right of return results in the recording of a product to be returned asset and a refund liability, the latter representing the payment to be made by the vendor to the customer upon return. In this fact pattern, no asset exists and no payment will be made by the vendor to the customer and therefore application of this guidance to these transactions may be viewed as inconsistent with ASC 606.
>
> View B: Enforceable Goods and Services Model
> Under this view, while the transaction price may be known and fixed (or estimable) the vendor's obligation to transfer goods and services is unknown and at the discretion of the customer, similar to a customer's rights under a gift card or voucher. The vendor should therefore only account for that portion of the contract for which it can identify its enforceable rights and obligations (the period for which the mix of goods and services is "known"). In other words, if the option to convert the software license to SaaS is exercisable on January 1st of each year after the first year, enforceable rights and obligations would only exist for the first full year of the contract, that is, the customer has only obtained a software license for one year and holds a right to purchase goods or services (either another software license or SaaS) in future years. We believe this view is similar to the concept discussed in paragraph BC364 of the FASB's Basis for Conclusions to ASU 2014-09 which states, in part:
>
>> In relation to performance obligations to provide customers with goods, **the Boards decided that, in effect, an entity has made an uncertain number of sales**. This is because it is only after the return right expires that the entity will know with certainty how many sales it has made (that is, how many sales did not fail). Consequently, the Boards decided that an entity should not recognize revenue for the sales that are expected to fail as a result of customers exercising their return rights. …

Supporters of this view believe that the rights and obligations of the two parties are only identifiable over the initial 'committed' period and, similar to the rights held under a gift card, voucher, or tokens, the transferred goods or services are only known to the vendor and therefore transferred to the customer when an election is made to either (1) purchase (retain) its software license or (2) switch to SaaS.

<u>View C:</u> Prospective Accounting
The company has transferred control of a functional software license at contract inception and should recognize revenue accordingly. The option is priced at fair value and therefore is akin to a marketing offering and should be accounted for if and when exercised, at which point the incremental (and therefore variable) fee associated with it should begin to be recognized.

Proponents of this view believe that, despite the exchange right, the customer has received the right to use the term license for three years at contract inception. In accordance with ASC 606-10-55-58C, revenue for a three-year term license should therefore be recognized on that date.

Others agree with the initial accounting under View C, but would support a different outcome at the date the customer elects to make a change. Specifically, supporters of this view agree with the initial accounting in View C, in which the transfer of the software license and PCS are accounted for each period as if the option to switch to SaaS was not present. However, in contrast to View C, once the option is exercised, software license revenue is reversed (as if the license was returned, similar to View A).

We believe the diversity in viewpoints in each of the three issues above stems, in part, from differing views on whether the implementation guidance in ASC 606 on sale with a right of return can be applied to a software license. Based on the interpretative guidance on termination rights[4], practice has developed to conclude that the relinquishment of a software license upon termination of a contract does not constitute a substantive termination penalty because it does not involve the transfer of an asset to the vendor, as would occur with a tangible product or when a cash penalty exists[5]. Accordingly, some believe that software licenses cannot be viewed as assets that can be returned. Instead, proponents of the view that software licenses are not returnable assets believe that the accounting for the contract should be based on the enforceable rights and obligations. In contrast, others believe that the sale with a right of return guidance should apply to software licenses and therefore the relinquishment of a software license must be accompanied by a corresponding reduction in the transaction price[6] as would be the case when applying the sale with a right of return implementation guidance. These divergent views, coupled with the

---

[4] In accordance with TRG 10 Contract Enforceability and Terminations (October 2014) and TRG 48 Customer Options for Additional Goods and Services (November 2015).

[5] For example, when an entity provides a customer a software license for a three-year term and also allows the customer to cancel anytime with 90 days notice, the contract is accounted for using the enforceable 90-day term rather than considering the contract to be a three-year contract and accounting for the termination right as a sale with a right of return.

[6] This reduction would be estimated upfront in accordance with ASC 606-10-55-25 if the return of the license was anticipated at contract inception. In contrast, the reduction would be recognized at the time of the "return" if the contract was modified to replace the software license with SaaS.

switch from point-in-time revenue recognition (for the license) to over-time (for the SaaS) can result in significant differences in the amount and timing of revenue recognition. In short, we believe the root cause of all of these issues is lack of clarity regarding whether software licenses can be accounted for as returnable assets similar to tangible assets, as that determination impacts whether a switch from a point-in-time recognition model (for the license) to an over-time model (for the SaaS) is accounted for via a reversal of previously recognized revenue or prospectively.

We have provided examples in the Appendix to further illustrate some of the scenarios in which we think entities could benefit from the clarification of the application of ASC 606 to a customer's ability to switch from a software licenses to SaaS. While we believe these examples properly illustrate some of the challenges currently being faced in practice, we would advise the FASB that we are aware of a number of variations from these examples including options that are exercisable at any time during the contract term as well as options that are exercisable in both directions (i.e., to convert from a software license to SaaS and back) either a limited or unlimited number of times. In addition, we observe fact patterns with the sale of a multi-year license and only one year of PCS that may allow the customer to switch to SaaS.

In summary, it is unclear how an entity should account for a customer's ability to switch from a software license to SaaS. Given the diversity in practice and the increasing pervasiveness of these transactions, we believe that the FASB should add this issue to its agenda or the EITF's agenda to reduce diversity in practice.

If you have any questions, please contact Eric Knachel at 203-761-3625 or Bob Uhl at 203-761-3152.

Sincerely

Deloitte & Touche LLP

Appendix - Illustrations

**Red* indicates a decrease*

Revenue	Illustration 1					
	View A			View B		
	20X1	20X2	20X3	20X1	20X2	20X3
License	24,000	(16,000)		24,000		
PCS	2,000			2,000		
SaaS		10,000	10,000		2,000	2,000
Annual total	26,000	(6,000)	10,000	26,000	2,000	2,000
Cumulative total	26,000	20,000	30,000	26,000	28,000	30,000

Revenue	Illustration 2					
	View A			View B		
	20X1	20X2	20X3	20X1	20X2	20X3
License	24,000	(8,000)		24,000		
PCS	2,000	2,000		2,000	500	
SaaS			10,000			3,500
Annual total	26,000	(6,000)	10,000	26,000	500	3,500
Cumulative total	26,000	20,000	30,000	26,000	26,500	30,000

Revenue	Illustration 3								
	View A			View B			View C		
	20X1	20X2	20X3	20X1	20X2	20X3	20X1	20X2	20X3
License	16,000			8,000	8,000		24,000		
PCS	2,000	2,000		2,000	2,000		2,000	2,000	
SaaS			15,000			15,000			7,000
Annual total	18,000	2,000	15,000	10,000	10,000	15,000	26,000	2,000	7,000
Cumulative total	18,000	20,000	35,000	10,000	20,000	35,000	26,000	28,000	35,000

Illustration 1

On January 1, 20X1, entity J enters into a non-cancellable contract to provide a three-year functional software license and PCS for a total fee of $30,000. The total fee will be billed in three annual increments of $10,000 each on January 1 of each year. The software license is distinct from the PCS and the SSPs of the software license and PCS are $24,000 and $6,000 respectively.

Based on the above, in 20X1 entity J receives cash of $10,000 and recognizes $24,000 upfront as revenue for the software license as well as $2,000 ratably as revenue during 20X1 for the PCS. The difference between the amount of revenue recognized and the total cash received in 20X1 ($16,000) is recorded as a contract asset as follows:

Cash	$10,000	
Contract asset	$16,000	
Revenue – license		$24,000
Revenue – PCS		$2,000

On January 1, 20X2, the customer and entity J agree to modify the contract by switching the software license and PCS subscription to entity J's SaaS platform that provides the same or substantially similar functionality in a hosted environment. This results in the customer relinquishing the right to use the software license for years two and three. Consequently, the PCS is also removed from the contract. As such, after the modification, the contract includes only the promise to provide the SaaS. Further, the customer is able to use the remaining $20,000 in unpaid license and PCS fees as a "credit". This credit will be applied toward the price of the SaaS which is $10,000 in 20X2 and 20X3 for a total of $20,000. This annual fee is consistent with the SSP of one year of SaaS.

We are aware of at least two views on how this modification should be accounted for under ASC 606:

View A: Sale with a Right of Return Model
Under this view, the relinquishment of the software license is akin to a product return and should therefore be accounted for as a reduction of the contract's transaction price by immediately reducing the amount of revenue recognized. Since the SaaS is priced at SSP ($10,000 per year) the contract asset balance as of the end of 20X1 relates entirely to the relinquished license. That is, since the remaining consideration in the original contract is "rolled forward" to the new contract, it is considered in determining whether the goods or services added via the modification are priced at SSP and, if so, would indicate that the contract asset from the original contract relates entirely to that original contract. Accordingly, entity J records the following entry on January 1, 20X2 to reflect the return of the software license in exchange for the SaaS:

Revenue – license	$16,000	
Contract asset		$16,000

The annual SaaS fee of $10,000 will be recognized ratably over each of the next two years (20X2 and 20X3) as entity J provides access to the SaaS.

View B: Prospective Modification Model
Under this view, the modification is the termination of an old contract and creation of a new contract because the transaction price did not increase by an amount equal to the SSP of the SaaS. Accordingly, entity J allocates the amount of revenue not yet recognized to the remaining goods and services (the SaaS). This will result the recognition of $2,000[7] in SaaS revenue each year in 20X2 and 20X3:

20X2

Cash	$10,000	
Contract asset		$8,000
Revenue – SaaS		$2,000

20X3

[7] In this example, we have presumed it was appropriate to recognize the unrecognized $4,000 of revenue ratably over the remaining two-year period. However, an alternative view could be that the Year 2 payment of $10,000 first must fund the outstanding $16,000 contract asset resulting in no revenue in Year 2 and $4,000 recognized in Year 3.

Cash	$10,000	
Contract asset		$8,000
Revenue – SaaS		$2,000

Illustration 2

Assume the same facts as in Illustration 1 except instead of exchanging the software license for SaaS, entity J and the customer agree on January 1, 20X2, to add an *option* into the contract whereby, if exercised, the customer, in return for relinquishing any remaining rights to the software license (as well as the associated PCS), will receive SaaS for the remainder of the contract term. The option may only be exercised once and the decision to exercise must be made upon an anniversary of the contract effective date (January 1, 20X2 or January 1, 20X3). No incremental fee is due upon exercise of the option but the customer, consistent with the pre modification terms, must pay $10,000 per year. As in Illustration 1, the SSP of one year of SaaS is $10,000. Assume the customer decides to exercise the option on January 1, 20X3. The following entry was made in 20X1 to recognize revenue associated with the software license and PCS:

20X1

Cash	$10,000	
Contract asset	$16,000	
Revenue – license		$24,000
Revenue – PCS		$2,000

<u>View A:</u> Sale with a Right of Return – No Material Right
Under this view, there is no material right as a result of the modification because the pricing of the optional future purchase is at SSP. Therefore, on the date of modification, entity J makes the following entries to account for the receipt of the annual payment and the addition of a right of return to the contract. Assume entity J estimates the right of return will be utilized on January 1, 20X3 to exchange the software license for SaaS, causing entity J to relinquish control of the remaining one-year software license worth $8,000 ($24,000 divided by three years = $8,000 x one year of remaining license term as of the estimated exercise date of January 1, 20X3 = $8,000):

20X2

To account for the annual payment of $10,000:

Cash	$10,000	
Contract asset		$8,000
Revenue – PCS		$2,000

To account for the addition of the right of return:

Contra revenue[8]	$8,000	
Refund liability		$8,000

On January 1, 20X3, entity J records the following entry to account for the exercise of the option and return of the software license (for which one year remained in the term):

January 1, 20X3

Refund liability	$8,000	
Contract asset[9]		$8,000
Cash	$10,000	
Contract liability		$10,000

The following entry will be made to recognize the SaaS revenue throughout 20X3:

20X3

Contract liability	$10,000	
Revenue – SaaS		$10,000

<u>View B:</u> Prospective Modification Model with a Material Right
Under this view, the modification results in the addition of a material right because the option to exchange the software license for SaaS is not priced at SSP; instead it provides the customer with an incremental discount. Because of this, the modification is accounted for as the termination of the old contract and the creation of a new contract.

Consistent with above Illustration, the following was the journal entry as of January 1, 20X1

Cash	$10,000	
Contract asset	$16,000	
Revenue – license		$24,000
Revenue – PCS		$2,000

Therefore, on January 1, 20X2, the date of modification, entity J allocates its consideration between the PCS to be provided either over one or two years and the right to SaaS (SSP of $10,000 per year). As a result, presume the outcome of the allocation is $1,000 to PCS and $3,000 to the material right ($500 and $1,500 to PCS and SaaS in 20X2 and 20X3, respectively). The total amount allocated to the remaining two performance obligations is the amount of the consideration not yet recognized as revenue, $4,000 from the original contract as there was no

[8] Because a right of return is accounted for like variable consideration, entity J will is required to update its estimate each reporting period. However, for simplicity of the illustration, we have assumed the initial estimate remains accurate and no revisions are required between contract inception and the date of exercise.
[9] For balance sheet presentation purposes, any contract asset and contract liability would be presented net.

additional consideration added in the modification. As a result J records the following on January 1, 20X2 and for the annual period 20X2:

January 1, 20X2

Cash	$10,000	
Contract asset		$8,000
Contract liability – material right		$1,500
Contract liability – PCS		$500

20X2

Contract liability – PCS	$500	
Revenue – PCS		$500

In 20X3, when the option is exercised, entity J makes the following entries:

January 1, 20X3

Cash	$10,000	
Contract asset		$8,000
Contract liability – material right		$2,000

20X3

Contract liability – mat. right	$3,500	
Revenue – SaaS		$3,500

If the customer had chosen not to exercise the option on January 1, 20X3, entity J would have recognized $1,500 as of that date due to the expiration of the option, unexercised.

Illustration 3

On January 1, 20X1, entity K enters into a non-cancellable contract to provide a three-year functional software license and PCS for a total fee of $30,000. The total fee will be billed in three annual increments of $10,000 each. The software license is distinct from the PCS and the SSPs of the software license and PCS are $24,000 and $6,000 respectively. In addition, the contract includes an option, at the customer's discretion, to exchange the software license for SaaS (which also terminates the PCS subscription). This option may be exercised by the customer on each of the annual anniversaries of the contract effective date (January 1, 20X2 and January 1, 20X3) but may only be exercised once. If exercised, the customer will be required to pay an incremental $5,000 each year in addition to the recurring payments of $10,000 for the SaaS. Assume that the combined fee of $15,000 per year represents the SSP of one year of SaaS. Assume that the customer exercises the option on January 1, 20X3 (at which time one year of software license term and PCS remains).

View A: Sale with a Right of Return Model
Under this view, the contract is accounted for as though it included a right of return. Entity K estimates that the option will be exercised on January 1, 20X3 at which time the software license will be "returned" and entity K will be providing SaaS. Accordingly, license revenue is reduced at contract inception by the value of the software license at that time ($24,000 divided by three years = $8,000 x one year of remaining license term as of the estimated exercise date of January 1, 20X3 = $8,000). Accordingly, entity K records the following entries in 20X1 and 20X2:

20X1

To record revenue for the three-year software license, one year of PCS, and the related cash received and contract asset:

Cash	$10,000	
Contract asset	$16,000	
Revenue – license		$24,000
Revenue – PCS		$2,000

To record the impact of the right of return assuming it will be exercised on January 1, 20X3, resulting in the return of a software license with one year of remaining term:

Contra revenue[10]	$8,000	
Refund liability		$8,000

20X2

Cash	$10,000	
Contract asset		$8,000
Revenue – PCS		$2,000

In 20X3 when the option is exercised, assuming no adjustment to entity K's initial estimate related to the right of return was required, entity K records the following:

January 1, 20X3

Cash	$15,000	
Refund liability	$8,000	
Contract liability		$15,000
Contract asset		$8,000

20X3

Contract liability	$15,000	
Revenue - SaaS		$15,000

[10] Because a right of return is accounted for like variable consideration, entity K will is required to update its estimate each reporting period. However, for simplicity of the illustration, we have assumed the initial estimate remains accurate and no revisions are required between contract inception and the date of exercise.

View B: the contract should be treated as a right to purchase a mix of goods and services, some known and others unknown. The vendor should therefore only account for that portion of the contract for which it can identify its enforceable rights and obligations (the period for which the mix of goods and services is "known"). Accordingly, since the option is exercisable starting on January 1, 20X2, entity K can identify its rights and obligations for the entirety of 20X1 (but no future years) and records the following entry in 20X1:

20X1

Cash	$10,000	
Revenue – license		$8,000
Revenue – PCS		$2,000

As of January 1, 20X2, once entity K learns the customer will not exercise the option, it can again identify its rights and obligations for 20X2 and records the following entry:

20X2

Cash	$10,000	
Revenue – license		$8,000
Revenue – PCS		$2,000

On January 1, 20X3, once entity K learns the customer will exercise the option, it records the following entry as again, it has identified its rights and obligations:

January 1, 20X3

Cash	$15,000	
Contract liability		$15,000

The contract liability is recognized as revenue throughout 20X3 as entity K provides the SaaS:

20X3

Contract liability	$15,000	
Revenue - SaaS		$15,000

View C: the customer has the right to use and benefit from a three-year term license as of January 1, 20X1. The option will be accounted for if and when exercised. That is, the presence of the option will be ignored until it is exercised. Accordingly, entity K records the following entry in 20X1:

20X1

Cash	$10,000	
Contract asset	$16,000	
Revenue – license		$24,000
Revenue – PCS		$2,000

Since the customer does not exercise its option in 20X2, the Company records the following entry for 20X2:

20X2

Cash	$10,000	
Contract asset		$8,000
Revenue – PCS		$2,000

On January 1, 20X3, because the customer has now exercised its option, entity K records the following entries on January 1, 20X3 and for 20X3:

January 1, 20X3

Cash	$15,000	
Contract asset		$8,000
Contract liability		$7,000*

**$5,000 in incremental cash received due to the option exercise plus $2,000 in consideration for PCS that has not yet been recognized as of the date the option is exercised.*

20X3

Contract liability	$7,000	
Revenue – SaaS		$7,000

An alternative to the subsequent recognition model under View C is an approach whereby at the date of exercise of the option (January 1, 20X3) a reversal of license revenue of $8,000 (and corresponding contract asset) is recognized such that $15,000 will be recognized as SaaS revenue during the year 20X3.

******