

Case 23-4h2: ABC Software

Handout 2

The excerpt below is from ABC Inc.'s "Critical Accounting Policies and Estimates" in the "Management Discussion and Analysis" section of its Form 10-K.

Revenue Recognition

Some of our contracts with customers contain multiple performance obligations. Determining whether products and services are considered distinct performance obligations that should be accounted for separately versus together may require significant judgment. For these contracts, we account for individual performance obligations separately if they are distinct. The transaction price is allocated to the separate performance obligations on a relative stand-alone selling price (SSP) basis. For deliverables that we routinely sell separately, such as software entitlement and support subscriptions on our core offerings, we determine SSP by evaluating the stand-alone sales over the trailing 12 months. For those that are not sold routinely, we determine SSP on the basis of our overall pricing trends and objectives, taking into consideration market conditions and other factors, including the value of our contracts, the products sold, and geographic locations.

If the contract contains a single performance obligation, the entire transaction price is allocated to the single performance obligation. Contracts that contain multiple performance obligations require an allocation of the transaction price to each performance obligation based on a relative SSP. We determine SSP on the basis of the price at which the performance obligation is sold separately. If the SSP is not observable through past transactions, we estimate the SSP, taking into account available information such as market conditions and internally approved pricing guidelines related to the performance obligations.

An excerpt from Note 1 of ABC's Form 10-K is below.

Revenue Recognition

The core principle of ASC 606, *Revenue From Contracts With Customers*, is to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration the entity expects to be entitled to in exchange for those goods or services. This principle is achieved by applying the following five-step approach:

- *Identification of the contract, or contracts, with a customer* — A contract with a customer exists when (1) we enter into an enforceable contract with a customer that defines each party's rights regarding the goods or services to be transferred and identifies the payment terms related to these goods or services, (2) the contract has commercial substance, and (3) we determine that collection of substantially all consideration for goods or services that are transferred is probable based on the customer's intent and ability to pay the promised consideration. We apply judgment in determining the customer's ability and

intention to pay, which is based on a variety of factors, including the customer's historical payment experience or, in the case of a new customer, published credit and financial information pertaining to the customer.

- *Identification of the performance obligations in the contract* — Performance obligations promised in a contract are identified based on the goods or services that will be transferred to the customer that are both capable of being distinct, whereby the customer can benefit from the goods or services either on their own or together with other resources that are readily available from third parties or from us, and are distinct in the context of the contract, whereby the transfer of the goods or services is separately identifiable from other promises in the contract. To the extent a contract includes multiple promised goods or services, we apply judgment to determine whether promised goods or services are capable of being distinct and distinct in the context of the contract. If these criteria are not met, the promised goods or services are accounted for as a combined performance obligation.
- *Determination of the transaction price* — The transaction price is determined based on the consideration to which we will be entitled in exchange for transferring goods or services to the customer.
- *Allocation of the transaction price to the performance obligations in the contract* — If the contract contains a single performance obligation, the entire transaction price is allocated to the single performance obligation. Contracts that contain multiple performance obligations require an allocation of the transaction price to each performance obligation based on a relative stand-alone selling price (SSP). We determine SSP based on the price at which the performance obligation is sold separately. If the SSP is not observable through past transactions, we estimate the SSP, taking into account available information such as market conditions and internally approved pricing guidelines related to the performance obligations.
- *Recognition of revenue when, or as, performance obligations are satisfied* — We satisfy performance obligations either over time or at a point in time. Revenue is recognized at the time the related performance obligation is satisfied with the transfer of a promised good or service to a customer. For additional details on revenue recognition, refer to Note 2 of Notes to Consolidated Financial Statements.

Contracts With Multiple Performance Obligations

The majority of our contracts with customers contain multiple performance obligations. For these contracts, we account for individual performance obligations separately if they are distinct. The transaction price is allocated to the separate performance obligations on a relative stand-alone selling price (SSP) basis. For deliverables that we routinely sell separately, such as software entitlement and support subscriptions on our core offerings, we determine SSP by evaluating the stand-alone sales over the trailing 12 months. For those that are not sold routinely, we determine SSP based on our overall pricing trends

and objectives, taking into consideration market conditions and other factors, including the value of our contracts, the products sold and geographic locations.

Contract Balances

The timing of revenue recognition may differ from the timing of invoicing to customers. Accounts receivable are recorded at the invoiced amount, net of an allowance for credit losses. A receivable is recognized in the period we deliver goods or provide services, or when our right to consideration is unconditional. In situations in which revenue recognition occurs before invoicing, an unbilled receivable is created, which represents a contract asset. Unbilled accounts receivable, included in accounts receivable, net on the consolidated balance sheets, was not material for any of the periods presented.

Payment terms on invoiced amounts are typically 30 to 45 days. The balance of accounts receivable, net of allowance for credit losses, as of December 31, 20X0, is presented in the accompanying consolidated balance sheets.

Business Combinations

On March 1, the Company acquired a 100 percent ownership in another software company, XYZ Software (“XYZ”), which was accounted for as a business combination in accordance with Accounting Standards Codification (ASC) 805. XYZ was acquired for a total acquisition price of \$500 million. The Company used discounted expected future cash flow method to measure the fair value of the intangible assets. The significant estimate assumptions used to estimate fair value included revenue growth rates and discount rates.