



Technology Highlights

Challenges Associated With Applying the New Revenue Standard: Blend-and-Extend Modifications Related to a Cloud-Based or Hosted Software Arrangement

by Sandie Kim, Tyler Murakami, Michael Wraith, and Mohana Dissanayake, Deloitte & Touche LLP

For public entities, the new revenue standard (ASC 606¹) became effective for annual reporting periods beginning after December 15, 2017. The standard is effective for all other entities for annual reporting periods beginning after December 15, 2018. Early adoption is permitted for annual reporting periods beginning after December 15, 2016.

While ASC 606 will affect organizations differently depending on their facts and circumstances, we have identified certain aspects of its application that are especially challenging for technology companies. This *Technology Alert* is part of a [series](#) intended to help technology entities better understand the new guidance, particularly private organizations that are currently adopting the standard's requirements.

Executive Summary

ASC 606-10-25-10 specifies that a contract modification is "a change in the scope or price (or both) of a contract." Under ASC 606-10-25-12, such a modification must be accounted for as a separate contract when (1) the "scope of the contract increases because of the addition of promised goods or services that are distinct" and (2) the "price of the contract increases by an amount of consideration that reflects the entity's standalone selling prices of the additional promised goods or services" as adjusted to reflect the circumstances of the contract (e.g., a discount that the entity provides because it did not incur additional selling-related costs when modifying the contract). If the contract modification does not result in a separate contract, the entity must determine whether the modification constitutes (1) a termination of the

¹ For titles of FASB Accounting Standards Codification (ASC) references, see Deloitte's ["Titles of Topics and Subtopics in the FASB Accounting Standards Codification."](#)

existing contract and the creation of a new contract because the remaining goods or services are distinct, (2) a part of the existing contract because the remaining goods or services are not distinct, or (3) a combination of (1) and (2).

An entity that sells a cloud-based or hosted software solution (e.g., a software-as-a-service (SaaS) arrangement)² may modify its arrangements before the end of the initial contract term by renewing the initial contract and revising the pricing on a “blended” basis for the remaining term, particularly if prices have decreased (i.e., a “blend-and-extend modification”). In such circumstances, the entity and its customer agree to extend the contract term and “blend” the remaining original, higher contract rate with the lower rate of the extension period for the remainder of the combined term. Consequently, when navigating the contract modification guidance, the entity may find it difficult to determine the appropriate accounting treatment. In a typical blend-and-extend modification in the SaaS industry, the entity would account for such a modification as either (1) a separate contract for the added services under ASC 606-10-25-12 or (2) a termination of the existing contract and the creation of a new contract under ASC 606-10-25-13(a).³ The determination of which model to apply is based on whether the additional services are priced at their stand-alone selling prices (SSPs) (i.e., whether the conditions in ASC 606-10-25-12 are met).

The interpretive guidance below discusses three alternatives for an entity to consider in determining how to account for a blend-and-extend modification.

Interpretive Guidance

In accordance with ASC 606-10-25-12(b), to determine whether a modification results in a separate contract, an entity must assess whether the price of the contract increases by an amount that reflects the SSPs of the additional promised goods or services. We believe that if a modification is not just an increase in a contract’s scope (e.g., an extension of the SaaS arrangement) in exchange for an incremental fee because the pricing of the remaining goods or services in the original contract is also adjusted, it would be appropriate for the entity to account for the modification as a termination of an existing contract and the creation of a new contract. This is because the modification does not solely add goods or services for an incremental fee as described in ASC 606-10-25-12 (i.e., the modification also adjusts the pricing of the original goods or services). Under this view (hereafter referred to as “View A”), the entity does not need to perform an analysis of the SSPs of the additional promised goods or services.

However, an entity may also apply the two views below to blend-and-extend modifications. Under these views, an entity must carefully analyze whether the additional goods or services are actually priced at their SSPs to determine whether they should be accounted for as a separate contract:

- *View B* — This view focuses on the net increase in the contract consideration (i.e., the total increase in consideration that the entity expects to be entitled to under the modified contract, including any changes to the prices of the remaining goods or services in the original contract), compared with the SSPs of the additional promised goods or services. In determining how to account for the modification, the entity should compare the net increase in consideration with the SSP of the services added during the extension period.
- *View C* — This view focuses on the revised blended prices of the contract compared with the SSPs of the additional promised goods or services. Therefore, the analysis focuses solely on whether the stated blended price is consistent with the SSP of the additional services during the extension period.

An entity should consistently apply its elected method to similar contracts.

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

³ Cumulative adjustments to revenue under ASC 606-10-25-13(b) are not common for these types of modifications of SaaS arrangements because the services provided after the modification are typically distinct from those transferred before the modification. Therefore, this publication does not focus on modifications that would result in an adjustment to revenue.

Example

On January 1, 20X8, Company S enters into a noncancelable contract with Customer T for a two-year term to provide a SaaS solution for a variable fee of \$50 per usage. The SSP of the SaaS ranges from \$45 to \$55 per usage. There are no other performance obligations in the contract. Company S determines that (1) it is providing a series of distinct services and (2) it is appropriate to recognize revenue by using a time-based measure of progress (i.e., ratably). In considering how much revenue to recognize in a distinct time period, S concludes that the contract meets the variable consideration allocation exception guidance in ASC 606-10-32-40, and therefore it recognizes revenue as usage occurs. In 20X8, T incurs usage-based fees for 1,000 transactions.

By January 1, 20X9, the SSP range of the SaaS has decreased to \$30 to \$40 per usage. During negotiations, T renews the contract for an additional year but requests a decrease in pricing. As a result of negotiations, S and T agree to apply a blended rate of \$43 per usage for the remaining two years of the modified contract. Customer T is expected to incur usage-based fees for 1,000 transactions per year for the remaining years.

Question

How should S account for the modification?

Answer

The following three views could be applied:

- *View A* — Company S accounts for the modification as a termination of the existing contract and the creation of a new contract. Therefore, it recognizes revenue at the blended transaction price of \$43 per usage in both 20X9 and 20Y0.
- *View B* — Company S computes the total increase in the contract consideration, which is \$36,000 or \$36 per usage, as follows:

Additional consideration for 20Y0 (\$43 per usage × 1,000 transactions)	\$ 43,000
Less: Decrease in consideration for 20X9 [(\$50 per usage – \$43 per usage) × 1,000 transactions]	<u>7,000</u>
Total increase in consideration	<u>\$36,000 or \$36 per usage*</u>

* (\$36,000 ÷ 1,000 transactions)

Company S would then compare the increase in the transaction price to the SSP range for the SaaS that will be provided during the extension period (i.e., 20Y0). Because \$36 per usage is within the SSP range of \$30 to \$40 per usage, S concludes that the extension period should be accounted for as a separate contract. Therefore, S will continue to recognize revenue in 20X9 at \$50 per usage, but it will recognize revenue in 20Y0 at \$36 per usage.

- *View C* — Company S compares the revised blended rate of \$43 per usage to the SSP range for the SaaS that will be provided during the extension period. Because \$43 per usage is outside the SSP range of \$30 to \$40 per usage, S concludes that the modification should be accounted for as a termination of the existing contract and the creation of a new contract. The accounting outcome would be similar to that in View A.

	Revenue Recognized		Revenue Recognized		Revenue Recognized		Total Revenue Recognized
	Jan. 1, 20X8– Dec. 31, 20X8		Jan. 1, 20X9– Dec. 31, 20X9		Jan. 1, 20Y0– Dec. 31, 20Y0		
View A	\$ 50,000	Modification occurs	\$ 43,000*	\$ 43,000*	\$ 43,000*		\$ 136,000
View B	50,000	Modification occurs	50,000**		36,000***		136,000
View C	50,000	Modification occurs	43,000*		43,000*		136,000

* Under Views A and C, the modification is treated as a termination of the existing contract and the creation of a new contract. Company S uses a blended rate of \$43 per usage, resulting in \$43,000 (\$43 per usage × 1,000 transactions) of revenue recognized in 20X9 and 20Y0.

** Under View B, because the extension period is treated as a separate contract, the initial contract is not affected. Company S recognizes revenue in the amount of \$50,000 (\$50 per usage × 1,000 transactions) in 20X9.

*** Under View B, the extension period (i.e., the separate contract) starts on January 1, 20Y0. Company S recognizes revenue in the amount of \$36,000 (\$36 per usage × 1,000 transactions) in 20Y0.

Contacts

Sandie Kim

Audit & Assurance Partner
National Office Accounting and Reporting Services
Deloitte & Touche LLP
sandkim@deloitte.com

Michael Wraith

Audit & Assurance Partner
U.S. Technology Industry Professional Practice Director
Deloitte & Touche LLP
mwraith@deloitte.com

Previn Waas

Audit & Assurance Partner
U.S. Software Industry Leader
Deloitte & Touche LLP
pwaas@deloitte.com

Tyler Murakami

Audit & Assurance Manager
National Office Accounting and Reporting Services
Deloitte & Touche LLP
tymurakami@deloitte.com

Mohana Dissanayake

Audit & Assurance Partner
U.S. Technology, Media & Telecommunications Industry Leader
Deloitte & Touche LLP
mdissanayake@deloitte.com

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