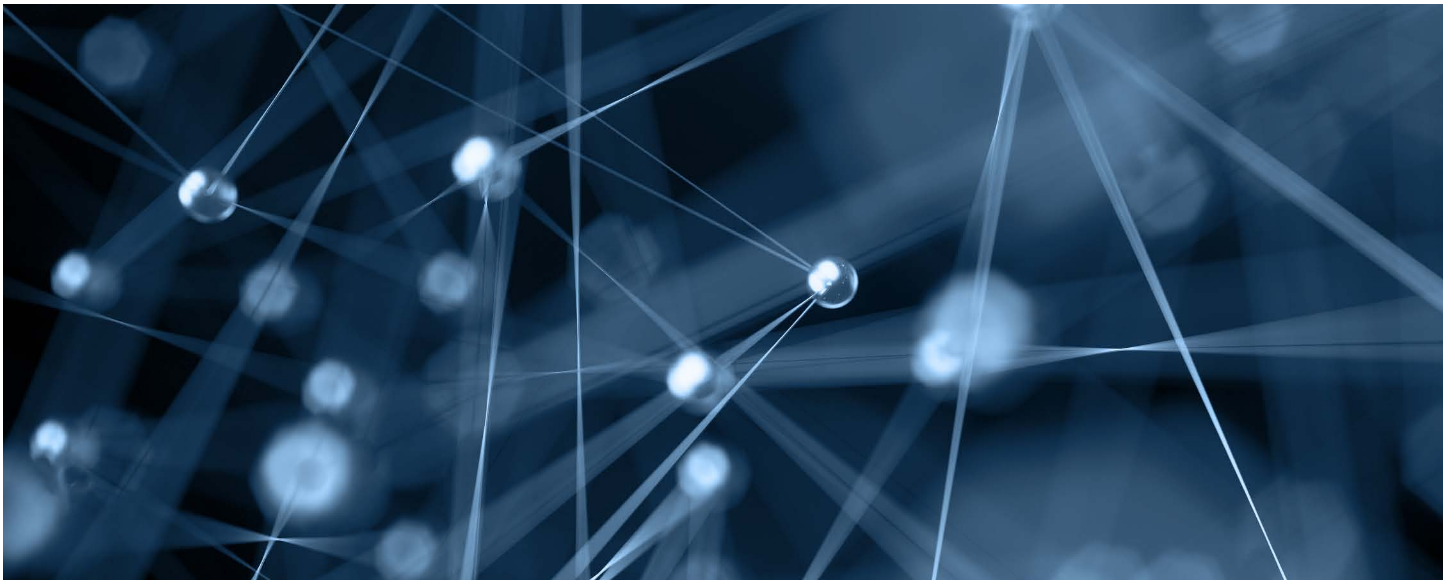

Technology Highlights
Challenges Associated With Applying the New Revenue Standard: Accounting for Implementation Services Related to a Cloud-Based or Hosted Software Arrangement

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

For public entities, the new revenue standard (ASC 606[1]) 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

Entities that sell a cloud-based or hosted software solution (e.g., a software-as-a-service (SaaS) arrangement)[2] often include implementation services. These services are performed either (1) at the outset of the customer arrangement or (2) during the SaaS term (in many cases because of added modules or features of the SaaS solution[3]). Depending on the facts and circumstances of the arrangement, an entity may need to use judgment to determine whether 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*."
2 In this publication, it is assumed that a 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 If a customer purchases additional implementation services after the SaaS term has commenced, the entity would generally apply the modification guidance in ASC 606 and perform the same analysis as if it were analyzing implementation services purchased up front.

implementation services represent (1) activities that do not transfer a good or service to the customer, (2) a promise that is not distinct from the SaaS, or (3) a distinct performance obligation. The questions and answers (Q&As) below discuss factors that an entity may consider in making that determination and applying the appropriate accounting.

Interpretive Guidance

Q&A 1 Identifying Whether Implementation Services Are a Promised Good or Service

ASC 606-10-25-17 states the following regarding the identification of promised goods or services in an arrangement:

> Promised goods or services do not include activities that an entity must undertake to fulfill a contract unless those activities transfer a good or service to a customer. For example, a services provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed. Therefore, those setup activities are not promised goods or services in the contract with the customer.

In addition, ASC 606-10-55-53 states the following:

> An entity may charge a nonrefundable fee in part as compensation for costs incurred in setting up a contract (or other administrative tasks as described in paragraph 606-10-25-17). If those setup activities do not satisfy a performance obligation, the entity should disregard those activities (and related costs) when measuring progress in accordance with paragraph 606-10-55-21. That is because the costs of setup activities do not depict the transfer of services to the customer. The entity should assess whether costs incurred in setting up a contract have resulted in an asset that should be recognized in accordance with paragraph 340-40-25-5.

Paragraph BC93 of ASU 2014-09[4] also specifies that even if an activity is "required to successfully transfer the goods or services for which the customer has contracted," that activity may not "directly transfer goods or services to the customer."

TRG Memo 41[5] contains an example in which the FASB staff discusses up-front implementation services that are provided with a SaaS solution. In the example, (1) the hosting period begins when the implementation services are complete and the customer cannot access or use the service until that time, (2) the vendor's solution is proprietary and no other vendors can provide the implementation services, (3) the customer cannot derive any benefit from the implementation services or the SaaS until implementation is complete, and (4) the implementation services are not capable of being distinct from the hosting services. While the example is intended to illustrate considerations related to whether the implementation services were relevant to an entity's measurement of progress toward completion of a performance obligation, it also addresses whether such implementation services would represent a performance obligation at all. According to the FASB staff, "the nature of the entity's overall promise is the hosting service and the implementation service does not transfer a service to a customer"; thus, the services would be disregarded in a manner similar to set-up activities described in ASC 606-10-25-17. This view is analogous to that discussed in Example 53 in ASC 606-10-55-358 through 55-360, in which set-up activities related to transaction processing services "do not transfer a good or service to the customer and, therefore, do not give rise to a performance obligation."

Question

How should an entity evaluate whether implementation services are a promised good or service in a SaaS arrangement?

Answer

We do not believe that the example in TRG Memo 41 was intended to address all types of implementation services, because the nature and composition of such services can vary in practice. Accordingly, an entity would have to carefully analyze the facts and circumstances of its SaaS arrangements and related implementation services to determine whether the activities a vendor performs for implementation services (1) transfer a good or service to the customer or (2) are akin to set-up activities. The entity's analysis would be based on whether

4 FASB Accounting Standards Update (ASU) No. 2014-09, *Revenue From Contracts With Customers*.
5 TRG Memo No. 41, *Measuring Progress When Multiple Goods or Services Are Included in a Single Performance Obligation*.

the customer obtains control of the implementation services as they are performed. In the determination of whether the customer obtains such control, we believe that it may be helpful for the entity to consider the following:

- Whose assets are being enhanced, improved, or customized by those activities. If the implementation activities are performed on the entity's internal infrastructure and applications (i.e., "behind the firewall"), the activities most likely do not transfer a good or service to the customer and the entity therefore would not consider the services in identifying performance obligations. This would be the case even if the customer benefits from the implementation activities. Because the activities are performed on the entity's assets, the entity retains control of any benefits those activities confer. By contrast, if the implementation activities are performed on the customer's infrastructure and applications, the activities may represent the transfer of a promised good or service to the customer. Paragraph BC129 of ASU 2014-09 discusses "situations in which an entity's performance creates or enhances an asset that a customer clearly controls as the asset is created or enhanced." It states, in part, the following:

    > In those cases, because the customer controls any work in process, the customer is obtaining the benefits of the goods or services that the entity is providing . . . . For example, in the case of a construction contract in which the entity is building on the customer's land, the customer generally controls any work in process arising from the entity's performance.

- Whether the services are provided directly to the customer (i.e., the services are simultaneously received and consumed by the customer; another entity would not need to substantially reperform the entity's performance to date). Paragraph BC125 of ASU 2014-09 states, in part:

    > In many typical "service" contracts, the entity's performance creates an asset only momentarily because that asset is simultaneously received and consumed by the customer. In those cases, the simultaneous receipt and consumption of the asset that has been created means that the customer obtains control of the entity's output as the entity performs . . . . For example, consider an entity that promises to process transactions on behalf of a customer. The customer simultaneously receives and consumes a benefit as each transaction is processed.

Example 1-1

Company S enters into a noncancelable SaaS arrangement with Customer T for a three-year term. As part of the arrangement, S has agreed to perform certain activities to add functionality to the SaaS before the commencement of the contract term (i.e., customization services) for an incremental fee. The added functionality is needed for the SaaS to work as intended by T. To perform the customization services, S must make modifications to its software applications that will be used to provide the SaaS. Customer T can only access the added functionality through the SaaS and has no other rights to the enhancements. That is, S continues to retain ownership of the improvements.

Question

Are the customization services a promised good or service to the customer?

Answer

No. Since the customization services will take place behind the firewall, the functionality is added only to S's assets, which S controls. The services will not enhance, improve, or customize a customer-controlled asset. Therefore, the arrangement does not result in a promise to transfer (i.e., does not transfer control of) services to the customer and would not be assessed as a promise under the contract. Rather, the customization services would be akin to set-up activities as described in ASC 606-10-25-17.

Example 1-2

Assume the same facts as in Example 1-1 except that in this case, S has also agreed to perform other implementation activities before the commencement of the contract term (i.e., implementation services) for an incremental fee. These activities, which are performed on T's assets, include adapting and configuring T's infrastructure and T's in-place systems for communication with S's infrastructure. In addition, S will convert and migrate T's data in a format that is compatible with the SaaS platform and train T's employees in the SaaS's optimal use.

Question

Are the additional implementation services a promised good or service to the customer?

Answer

Yes. Most of the activities enhance, improve, or customize T-controlled assets (i.e., T's infrastructure, in-place systems, and data). In addition, the training is provided directly to T's employees (as opposed to S's employees), which permits T to simultaneously receive and consume the benefit conferred by the training. Therefore, the implementation services represent promises to transfer services to the customer and should be assessed as such under the contract.

Q&A 2 Identifying Whether Implementation Services Are a Distinct Performance Obligation

If an entity has determined that implementation services represent promised goods or services to the customer, it would next assess whether such services and the SaaS are (1) each a distinct performance obligation or (2) a combined performance obligation. Under ASC 606-15-10-25-19, for a promised good or service to be a separate performance obligation, the promise must be both (1) capable of being distinct (i.e., 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) and (2) distinct within the context of the contract (i.e., the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract).

We believe that the following factors (not all-inclusive) may be helpful in an entity's determination of whether implementation services are a distinct performance obligation (the analysis may in some circumstances need to be performed separately for each promise because implementation services often consist of multiple activities that represent separate promises):

- Whether the entity or other entities (e.g., consulting firms, SaaS competitors) provide the implementation services on a stand-alone basis. We believe that this is a key consideration in the entity's assessment of whether the implementation services are distinct. For example, if the entity has a number of partnerships or alliances with other organizations that enable those other businesses to provide the implementation services to the entity's customers, the implementation services are likely to be distinct.
- Whether the implementation services will provide an asset or incremental benefit to the customer without the SaaS arrangement (i.e., alternative use). An entity would evaluate whether the implementation services (1) are specific to the SaaS arrangement or (2) can be leveraged by the customer for use in other SaaS arrangements or circumstances. For example, an entity may provide professional services that enable the customer to use the SaaS to more efficiently analyze data. If those same professional services can be applied to other competitors' SaaS solutions, the services may be distinct.
- Whether the customer must obtain the implementation services to use and benefit from the SaaS arrangement (i.e., whether the SaaS is functional without the implementation services). An entity would evaluate whether the customer can maintain a reasonable degree of utility of the SaaS without the implementation services. For example, a SaaS that has no utility or value without the entity's implementation services may be an indicator that the implementation services are not distinct.
- Whether there are instances in which the SaaS was provided to customers without implementation services. Customers' frequent purchasing of the entity's SaaS without purchasing its implementation service may be an indicator that the implementation services are distinct.

- Whether the implementation services significantly alter any features or functionality of the SaaS. For example, the implementation services may include significant customization of the customer's infrastructure and applications to enable the SaaS to process transactions it could not process otherwise. Such customization may be an indicator that the implementation services are not distinct; however, if the customization's benefits could be applied to another SaaS platform (i.e., another readily available resource), the implementation services may be distinct.
- Whether the implementation services and the SaaS are so significantly integrated, interrelated, or interdependent that the entity could not fulfill its promises to transfer the implementation services and the SaaS independently. For example, to enable the SaaS to perform unique functions that are critical to the customer's intended use of the SaaS, the implementation services may require significant customization of both the entity's and customer's systems. In such cases, the implementation services may not be distinct because there is likely to be an interdependency between the implementation services and the SaaS (i.e., as a result of the services, there is an enhancement to the combined functionality of the SaaS and the customer's systems). In addition, as discussed in Q&A 1, the customization of the entity's systems is not likely to be a promised good or service in the arrangement.
- Whether using the SaaS or providing implementation services requires a highly specialized or complex skillset that neither the customer nor third parties possess. For example, an entity may provide to a governmental agency a highly customized and complex SaaS solution that requires the entity to employ scientists. If there is significant risk associated with the entity's ability to provide the implementation services and the level of effort and time needed to complete them is extensive, the implementation services may not be distinct. By contrast, if it is not difficult to configure or set up the customer's systems and interfaces, the implementation services may be distinct.
- Whether the entity markets the implementation services and the SaaS as a combined solution. While marketing the services and SaaS in such a manner is not a determinative factor, it may support a conclusion that the implementation services are not distinct.

Contacts

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

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

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

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

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