MOSSADAMS

Revenue Recognition

IMPLEMENTATION AND BEST PRACTICES
FOR TECHNOLOGY COMPANIES

IGNITING GROWTH

AN OVERVIEW

Since the initial release in 2014, the FASB has issued multiple amendments to the revenue guidelines based on operational issues raised by the Transition Resource Group and other practitioners.

These amendments include Accounting Standards Updates (ASUs):

- 2015-14—deferring the effective date of the new revenue rules by one year
- 2016-08—gross versus net revenue presentation
- 2016-10—identifying performance obligations and accounting for intellectual property licenses
- 2016-12—narrow scope improvements and practical expedients
- 2016-20—technical corrections and improvements to Topic 606, *Revenue from Contracts with Customers*

After years of deliberation, the FASB issued final revenue recognition guidelines.

These guidelines introduce a fundamentally different model for recognizing revenue versus legacy generally accepted accounting principals (GAAP). The revenue recognition model in ASC Topic 606 applies to nearly all types of revenue-generating transactions.

Once Topic 606 becomes effective, most of today's industry-specific revenue practices will be eliminated.

This includes the long-standing software revenue recognition guidelines in ASC Subtopic 985-605 as well as technical practice aids and other industry interpretations that have been developed and applied consistently over the past 20 years.

What the New Guidelines Mean for Tech Companies

In 2014, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) 2014-09, which introduced new Accounting Standards Codification® (ASC) Topic 606, *Revenue from Contracts with Customers*.

The main principle of Topic 606 is that a seller should recognize revenue when the customer obtains control of a good or service, in an amount the seller expects to be entitled in exchange for those goods or services.

The new guidelines will supersede long- standing, industry-specific rules. Familiar concepts such as persuasive evidence of an agreement, delivery, and fixed or determinable fees will be eliminated in favor of new, more principles-based rules.

Companies will have to apply significant judgment to determine the timing and amount of revenue recognition. This may be challenging for technology companies that have grown accustomed to today's rigid, rules-based revenue recognition requirements.

EFFECTIVE DATES

For **public entities**, the new rules become effective for annual reporting periods beginning on or after December 15, 2017, and related interim periods.

For **nonpublic entities**, the rules are effective for annual reporting periods beginning on or after December 15, 2018, and interim periods beginning after December 15, 2019.

All companies are permitted to **early adopt** the new rules for annual periods beginning on or after December 15, 2016.

The new revenue rules are long, complex, and involve judgment to apply. Waiting until just before the effective date to think about how the new rules may alter your company's financial statements is far too late.

Why the Urgency?

If the new revenue rules don't become effective for most companies until 2018 or 2019, why's it so important to begin analyzing the potential effects today?

It's a fair question. And it's easy to understand the natural inclination to wait until closer to the effective date of Topic 606 to begin working through the new rules.

However, in this case, the new revenue rules are long, complex, and involve judgment to apply. Waiting until just before the effective date to think about how the new rules may alter your company's financial statements is far too late, especially given the internal control and policy changes necessary to account for customer contracts that cross accounting periods.

PENALTIES

Current revenue rules can be extremely punitive when it comes to sharing product road maps with customers. In particular, any sort of commitment—express or implied—that future versions of a product will contain specific features is viewed as a performance obligation under today's GAAP. In most cases this commitment will cause a company to defer all revenue until the new product feature is introduced, which could be years following the delivery of an initial product or service. For this reason, many technology companies have put strict rules in place around discussing product road maps with customers.

The new revenue recognition guidelines don't contain severe penalties for committing to specified features in future product releases. Revenue will often be recognized upon transferring control of initial goods or services to a customer, with some portion of the arrangement fee deferred until the new feature is released. Your company may decide it's more appropriate to collaborate with customers around product road maps. Doing so will no longer risk delaying all revenue recognition until committed features are commercially available.

FIVE-STEP PROCESS

These required steps can help you determine when revenue from customer contracts should be recognized:

Step One:
Identify the contract with the customer.

A contract is in the scope of Topic 606 if all of the following conditions are met:

- The parties have approved the contract and are committed to performing their obligations. ✓
- Each party's rights regarding the goods and services to be transferred can be identified. ✓
- The payment terms are identifiable—and it's probable the seller will collect. ✓
- The arrangement has commercial substance. ✓

Step Two:
Identify the separate performance obligations in the contract.

A performance obligation represents a distinct product or service within a broader contract that the seller has promised to deliver to the customer.

Topic 606 indicates a product or service is distinct if both of the following criteria are met:

- The promised good or service is capable of being distinct because the customer can benefit from it either on its own or together with other resources that are readily available to the customer. ✓
- The promise to transfer a good or service is distinct within the context of the contract. ✓

Performance obligations can be both specified deliverables and implied or unspecified obligations based on the terms and conditions of the contract.

See more details on page eight and Post-Contract Support on page 9.

Step Three:
Determine the transaction price.

When calculating the transaction price, Topic 606 requires companies to consider:

- Potential discounts
- Concessions
- Rights of return
- Liquidated damages
- Performance bonuses
- Other forms of variable consideration

When estimating the amount of variable consideration to include in the transaction price, companies should look at the stated terms of the customer contract as well as any past business practices that provided refunds or concessions or may provide rebates or other credits to specific customers based on the seller's intentions.

Examples

Here are examples of variable consideration for a software company:

- A developer will grant concessions to the customer if the software doesn't perform as expected.
- A cloud provider agrees to provide 10 terabytes of storage for a fixed fee with additional storage charged at a monthly rate in 50 gigabyte increments.

See more details in the Time Value of Money, Residual Method, and Variable Revenue sections on pages eight through 11.

Step Four:

Allocate the transaction price to the separate performance obligations in the contract.

To perform the allocation, the business should first try to determine the stand-alone selling price of each distinct performance obligation.

If an entity doesn't sell a particular performance obligation on a stand-alone basis, it will have to estimate the stand-alone selling price. Techniques to make such estimates include:

TOP-DOWN APPROACH

A company can work with its sales team to develop a price it believes the market would be willing to pay for its goods or services.

BOTTOM-UP APPROACH

A company can also estimate the stand-alone selling price for a good or service based on a cost-plus methodology—estimating its costs to provide a good or service and adding a reasonable margin for its production and selling efforts.

A major change is the elimination of vendor-specific objective evidence (VSOE) as one of the requirements to recognize revenue in some arrangements involving software.

See details in the Residual Method section on page 9.

Step Five:

Recognize revenue when—or as—the entity satisfies a performance obligation.

Under ASC Topic 606, a company will recognize revenue each time as it satisfies a performance obligation. These principles may result in very different patterns of revenue recognition compared to legacy GAAP. As an example, the new revenue recognition guidance eliminates the sell-through method.

Other considerations in this step:

REFUND RIGHTS

When a good or service is sold together with a refund right, a company should record:

- Revenue for the transferred goods or services in the amount of consideration to which the company expects to be entitled.
- No revenue would be recognized for products expected to be returned or services expected to be refunded.
- A refund liability for any consideration received (or in some cases receivable) that's expected to be refunded.

As applicable, an asset—and corresponding adjustment to cost of goods sold (COGS)—for a company's right to recover products from customers upon settling the refund liability.

CONTROL TRANSFERS OVER TIME

In some situations, control over a good or service isn't transferred at a point in time but rather over time. When revenue is recognized over time, Topic 606 allows companies to measure performance using either input measures, such as those based on costs or labor hours incurred, or output measures, such as milestones or units produced.

LICENSES

Topic 606 specifies whether revenue from granting a license should be recognized at a point in time or over time. If a license represents a distinct performance obligation, revenue would be recognized one of two ways:

- If the underlying intellectual property (IP) to which the license relates is "functional," then revenue is recognized at a point in time—namely, when control of the license is transferred to the customer at the beginning of the license period.
- If the underlying IP is "symbolic," then revenue from the performance obligation will be recognized over time. The IP doesn't have significant standalone functional value; instead, it provides utility in the form of access to the entity's past or ongoing activities.

See more details in Sales to Distributors, In-Transit Loss Coverage, Bill-and-Hold Sales, and Contract Acquisition and Fulfillment Costs on pages 10 and 11.

What Will Change

Technology companies will likely account for transactions quite differently under the new revenue guidelines. The new rules will also require a significant application of judgment, even more so than under legacy GAAP.

The Timing of Revenue Recognition May Accelerate

For many technology companies, the new rules may accelerate the timing of revenue recognition compared to legacy GAAP guidelines.

VSOE of the fair value of post-contract support (PCS), for example, will no longer be required to unbundle a software license arrangement. This means the new rules may allow for a sizable portion of the license fee to be recognized upon delivery of the license to the customer, with the balance recognized over the PCS period.

In determining the amount of revenue to recognize, a licensor will have to apply judgment, estimating the stand-alone selling prices of the software license and the PCS, even if there's no history of selling either item separately.

Unbundling Integral Services May Be More Challenging

This applies to cloud and similar service providers when evaluating whether and how to unbundle integral services from license or software-as-a-service (SaaS) deliverables.

Management will also need to evaluate potential variable consideration—contractual provisions that can cause revenue to go up or down—throughout the life of the agreement. Things like downstream royalties or, conversely, potential liquidated damages will need to be estimated at the outset of an arrangement and potentially considered in the measurement of contract revenue from day one. Such estimates will be reevaluated each reporting period.

Legal Agreements May Require Modifications

Given the importance the new revenue rules place on identifying the customer contract, companies may need to consider whether legal agreements will need to be modified to better reflect current business practices.

It will be important to reevaluate whether such contracts remain legally enforceable in the jurisdictions in which the companies transact—especially internationally.

Policies, Systems, Processes, and Internal Controls Will Need to Be Updated

Audit committees and executives will have to review, approve, and monitor these changes. This is especially important at public companies where C-suite executives sign the quarterly Sarbanes-Oxley certifications.

There May Be Tax Implications

Beyond financial reporting, it will be important to consider the tax implications of the new guidelines because the tax rules are distinct from GAAP. This may include the acceleration of taxable income and tax payments due, new book-tax differences and changes to deferred taxes, and possible accounting method changes. Certain business practices could also change, which may have a tax consequence that should be evaluated.

There are sales and use tax considerations as well. The new rules may require arrangement consideration to be allocated to performance obligations differently from legacy GAAP. In fact, the allocations may be inconsistent with the breakdown on the customer invoice.

Companies should identify which taxing authorities follow GAAP allocation rules—there may be quite a few that do—and update tax compliance systems because some obligations may be subject to sales and use tax while others may not. This is especially important for providers of cloud services, where sales and use tax laws continue to evolve.

Other Implications

Here's a detailed look at how the new revenue rules will affect technology companies. In this section, we'll highlight what companies should do to prepare for the new revenue recognition rules and describe other ways revenue and expense recognition may change.

SALES TO DISTRIBUTORS

PREVIOUSLY

Many original equipment manufacturers or software developers use the sell-through method when recognizing revenue from sales to distributors. Under this method, revenue isn't recognized until the product is sold through the sales channel to the end customer.

This accounting policy is appropriate when distributors are afforded generous return rights, price protection privileges, or other entitlements that call into question whether the arrangement fee is fixed or determinable—a necessary condition for revenue recognition under today's GAAP.

NEW GUIDELINES

Revenue is recognized upon transferring control of a good or service to the distributor regardless of whether the arrangement fee is fixed or determinable. However, the amount of revenue reported may be constrained somewhat to reflect the variable pricing risk.

The new rules eliminate the sell-through method of revenue recognition and, instead, require more judgment in determining the amount of revenue to recognize upon transferring control of products to a distributor.

TIME VALUE OF MONEY

PREVIOUSLY

Legacy GAAP precludes immediate revenue recognition when a software licensor provides a customer with extended payment terms beyond 12 months or otherwise normal business practices.

NEW GUIDELINES

A company would have to consider whether there's implicit financing when extended payment terms are offered. If so, the financing element is accounted for separately from the rest of the contract.

To demonstrate, assume a software developer delivers a license to a customer and provides a three-year payment plan. Legacy GAAP would prohibit revenue recognition until payments become due and payable.

Conversely, the new rules would require the licensor to reduce the transaction price by an estimate of the implicit interest income embedded in the extended payment terms.

The licensor would recognize that discounted price as revenue upon license delivery when control of the software license is transferred to the customer. The interest income would be recorded over time.

RESIDUAL METHOD

PREVIOUSLY

Under legacy GAAP, software developers could use a residual method when there's VSOE of the fair value of undelivered elements such as PCS, but no similar evidence of the price at which delivered items are sold on a stand-alone basis.

If a developer licenses software, for example, together with one year of PCS, for $10,000 and the VSOE of the PCS is $2,400, the developer could recognize revenue of $7,600 upon delivery of the license to the customer using a residual approach.

NEW GUIDELINES

Although the residual method is technically permitted under the new revenue rules, its use will be far more limited and less common—it can only be used if the stand-alone price is highly variable or uncertain.

It will be required that companies estimate the price that each separate performance obligation in an arrangement would be sold on a stand-alone basis. If using the residual method is inconsistent with this principle, another estimation technique must be used to arrive at the estimated stand-alone selling price. Making this evaluation will involve significant judgment in practice.

POST-CONTRACT SUPPORT

PREVIOUSLY

Under legacy GAAP, all components of PCS—such as 24-7 telephone support, *when and if available* upgrades, and bug fixes—are typically viewed as a single accounting unit. The total transaction value attributed to the PCS accounting unit is recognized ratably over the PCS period.

NEW GUIDELINES

Each component of PCS may be viewed as a distinct performance obligation under the new revenue rules. This is because components' individual performance may not be interrelated or dependent on one another.

For example, telephone support is primarily geared toward helping address user issues related to the current software, whereas the unspecified product upgrades may be based on the software developer's internal product road map or discussions with customers about future feature enhancements.

Accordingly, companies may need to further break down amounts traditionally allocated, in aggregate, to PCS. As a result, the timing of revenue recognition for unspecified upgrades may change from the straight-line approach used today.

INTEGRATION & OTHER SERVICES

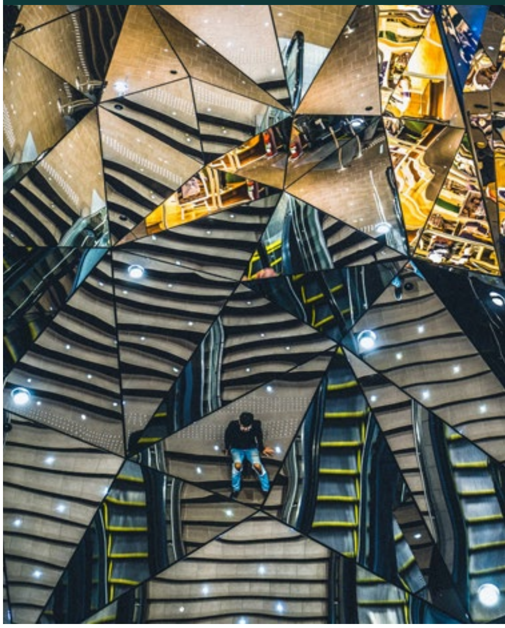
PREVIOUSLY

Under legacy GAAP, the accounting for bundled services can be complex. Companies first evaluate if services are within the scope of industry-specific guidelines. Then they determine if the services can be unbundled from other deliverables, and, if so, when they can be recorded as revenue. Revenue recognition is often delayed until the service is 100% complete based on strict rules-based standards.

NEW GUIDELINES

The new rules may allow for earlier recognition of service revenue for a few reasons. First, it will often be easier to unbundle services from other deliverables. The new standards also may permit more services revenue to be recognized over the period of time the benefits of the service are transferred to the customer.

This is especially true if the service enhances an asset the customer already controls or can benefit only that customer. The contract also must allow for the service provider to collect all costs incurred—plus a reasonable profit margin—if the contract is terminated early.



IN-TRANSIT LOSS COVERAGE

PREVIOUSLY

Technology companies will often ship physical products free-on-board shipping point or using similar terms. Legally, the risk of loss passes to the customer once the product leaves the seller's plant or warehouse.

However, to maintain strong customer relationships, some companies protect their customers from any risk of damage while the products are in transit, even though there's no obligation to do so.

In these circumstances, legacy GAAP prevents companies from recognizing revenue until the products arrive at the final customer location.

NEW GUIDELINES

A seller that provides in-transit loss coverage may have two performance obligations: delivering the units and insuring them while in transit. Revenue from the former would be recognized when control transfers to the customer, presumably at shipment. Revenue from the latter would be recognized once the de facto insurance services are provided. Judgment would be necessary to reach a formal conclusion.

An amendment to Topic 606 permits companies to elect an accounting policy to treat the in-transit loss coverage, which is included in the contract with a customer, as a cost of fulfilling the contract.

Electing this policy would result in a tech company recognizing 100% of the product revenue when control passes at shipment, while simultaneously recording an accrual for the expected costs of the insurance services.

VARIABLE REVENUE

PREVIOUSLY

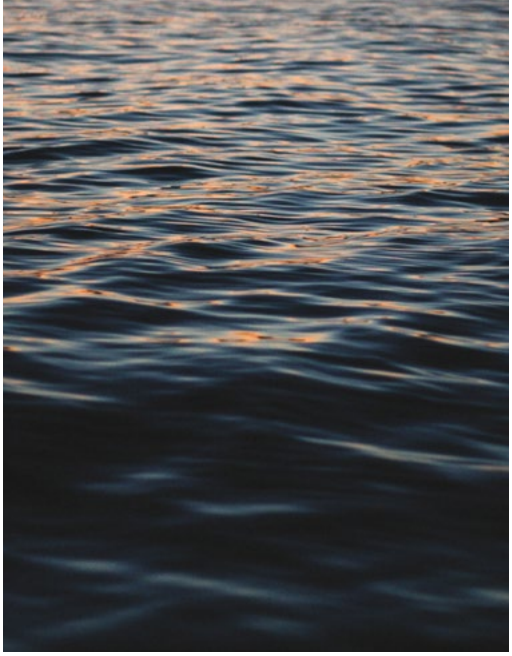
Some contracts call for fixed and variable consideration. For instance, if a company delivers 10,000 licenses to a reseller for an up-front payment plus a potential royalty each time the customer meets certain sales milestone targets when it resells the licenses to end users.

Legacy GAAP generally doesn't allow a company to recognize variable or downstream revenue until the milestones are achieved or other contingencies are resolved.

NEW GUIDELINES

The new guidelines require all revenue, including contingent or variable consideration, be considered at the onset of the agreement. So it's possible that estimates of variable consideration would be recorded as revenue upon delivery of a product or service well in advance of meeting the conditions that trigger payment of the contingent revenue.

One exception relates to sales royalties on licensed intellectual property—Topic 606 specifically prohibits revenue recognition until the underlying sale has occurred, similar to today's accounting requirements.



BILL-AND-HOLD SALES

PREVIOUSLY

Many technology companies and their customers find it cost effective to produce large batches of products, such as chips. In some cases, a customer may want to purchase the entire production output but not take physical delivery of all of the units until a later point in time. This is referred to as a bill-and-hold arrangement.

Under legacy GAAP, revenue typically can't be recognized from bill-and-hold sales until the units are physically delivered to the final customer location.

NEW GUIDELINES

The new revenue rules, however, may view a bill-and-hold arrangement as having two performance obligations—producing units and storing them. Revenue from the former would be recognized when control transfers to the customer, such as when the units are completed, the buyer has inspected them, and title to the goods has legally passed to the purchaser. Revenue from the storage services would be recognized over time.

Again, evaluating the proper accounting for this and similar fact patterns will involve judgment. In fairness, though, the accounting for most bill-and-hold sales under Topic 606 is expected to be the same as legacy GAAP requirements.

CONTRACT ACQUISITION & FULFILLMENT COSTS

PREVIOUSLY

Legacy GAAP provides limited guidance on the accounting for contract acquisition and fulfillment costs. Such costs can include sales commissions, which can be significant in some instances.

Consequently, there's diversity in practice. Some companies expense these costs as incurred, while others defer and amortize.

NEW GUIDELINES

Under the new rules, contract acquisition costs, such as sales commissions, must be deferred and amortized on a systematic basis—consistent with the pattern in which revenue is being recognized—if the contract will be fulfilled over more than a year. If the contract will be completed in 12 months or less, contract acquisition costs may be expensed as incurred at the seller's election.

Contract fulfillment costs necessary to complete performance obligations—such as expenditures to reconfigure a plant to manufacture a product to customer specifications—must be deferred and amortized on systematic basis, consistent with how revenue is recognized.

Contract fulfillment costs don't include items addressed in other ASC topics, such as software capitalization or inventory.

Transition Checklist

It's critical to begin evaluating how the new rules will affect your business; from an accounting and operational perspective. A number of steps ideally should be completed before the end of 2017, or else it will be difficult to make the proper transition when the rules do become effective.

Step 1

Read the new guidelines if you're on the finance team. At 1,000 pages, it will take time to familiarize yourself with the new guidance.

Step 2

Run current revenue transactions through the new five-step revenue model. In some cases, contractual arrangements will be accounted for in the same way as legacy GAAP, albeit for different reasons. In other instances, the timing or amount of revenue recognition will change, sometimes dramatically.

Step 3

Discuss any gray areas with your accounting advisor and consult your tax advisor. In perhaps more than a few cases, it will be unclear how to apply the principles in the new revenue guidance to a given transaction.

Step 4

Communicate. Discuss the expected effects of adopting the new guidelines to key stakeholders, including management, investors, and creditors.

Step 5

Draft disclosure of the potential effects of adopting the new guidelines. This disclosure will be included in SEC filings or other financial statements.

Step 6

Identify whether the new rules will negatively affect debt covenants. If so, begin negotiating amendments or waivers with lenders.

Step 7

Consider whether any commercial practices should change.

Step 8

Begin planning for other operational changes.

CHOOSE YOUR TRANSITION METHOD

This is an important transition decision that companies should think about one, two, or even three years prior to adoption because it will drive the nature, timing, and extent of any necessary systems and process changes.

Companies may adopt the new rules one of two ways:

- Full retrospective basis
- Modified retrospective basis

Either way, data for at least some contracts will need to be tracked for periods prior to the adoption date—that is, from 2016 or even earlier depending upon the inception date of the contract.

This means every company should decide as soon as possible which method it will use to transition to the new rules so that it can properly assess transactions that may be impacted by adoption of the new guidelines.

The selection of a transition method is also important because it can affect reported trends, perhaps in surprising ways.

FULL RETROSPECTIVE

Companies that elect full retrospective adoption will almost certainly want systems in place well before ASC Topic 606 becomes effective to track how revenue will be recognized under the new rules for all outstanding contracts, even while continuing to report under legacy GAAP rules until the date of adoption.

MODIFIED RETROSPECTIVE

Even companies that will transition using the modified retrospective basis should begin the arduous process of updating systems to track new performance obligations, estimates of variable consideration, and other data necessary to comply with the extensive disclosures required under the new rules.

SOFTWARE REVENUE TRANSITION CASE STUDY

On December 31, 2017, a calendar-year-end publicly traded software developer delivers a software license, together with three years of PCS, for $12 million. On a relative stand-alone selling price basis, the license would be allocated $9 million of the arrangement price and the PCS would be allocated $3 million. Assume there's no VSOE of the fair value of the PCS.

Under legacy GAAP, no revenue would be recognized during 2017 and the entire license fee would be recorded over the three-year PCS period, or $4 million per year beginning in 2018.

Under the new revenue rules, $9 million in revenue would be recognized in 2017 upon delivery of the software license and the balance would be spread over the PCS period.

What It Means

If the software developer adopts Topic 606 on January 1, 2018, using a modified retrospective adoption approach, $9 million of revenue would disappear.

Why? For starters, under a modified retrospective transition approach, past periods aren't restated. Hence, even in the 2018 financial statements, the comparative 2017 accounting period wouldn't show any revenue related to this software license because this is reflective of how legacy GAAP would account for the transaction.

Upon adoption of the new rules, the software developer will book a catch-up entry to January 1, 2018, retained earnings for the difference between the revenue that would've been recognized under the new rules in 2017 ($9 million) versus what had been reported previously ($0).

In this case, the software developer would book a $9 million adjustment to opening retained earnings, removing this amount from deferred revenue upon transition. Accordingly, $9 million of revenue never gets reported in any accounting period, leading to some difficult trends to explain to shareholders and other financial statement users.

We’re Here to Help

Adopting the new revenue recognition guidelines is a significant undertaking that will involve more than just your company’s finance and controllership teams. There are important tax, legal, and commercial considerations as well.

If you’d like to learn more, contact your Moss Adams professional or visit **mossadams.com/technology**.

You can also subscribe to have relevant articles, news, and event notifications sent to you via email.

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