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ARE YOU READY FOR THE NEW REVENUE RECOGNITION STANDARD? TEN ILLUSTRATIONS[1]

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ARE YOU READY FOR THE NEW REVENUE RECOGNITION STANDARD? TEN ILLUSTRATIONS[1]

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The Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2014-09 (Topic 606), Revenue from Contracts with Customers, which is a principles-based standard on accounting for revenue from contracts with customers and replaces the preexisting rules-based guidance designed for specific industries. ASC 606, or the "New Standard," is effective for public companies with fiscal years beginning after December 15, 2017 and for nonpublic companies with fiscal years beginning after December 15, 2018. This article will refer to the pre-ASC 606 standards as the "Old Standard" or "Legacy GAAP."

ASC 606 impacts all companies that contracts with customers to provide goods or services. The New Standard will require organizations to re-evaluate not only how they recognize revenue related to promised goods or services they provide to their customers but how their customer contracts are structured.

The core of the New Standard provides for a five-part process for assessing how revenue should be recognized, which are as follows:

1. Identify the contract with a customer.

2. Identify the performance obligations (promises) in the contract.

3. Determine the transaction price.

4. Allocate the transaction price to the performance obligations.

5. Recognize the revenue when (or as) performance obligations are satisfied.

ASC 606 will have some form of impact on all industries but will arguably have the most significant impact on software and Software-as-a-Service ("SaaS") based companies (collectively referred to as "Tech Companies"). As a result, many Tech Companies will be

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required to modify their systems, processes, controls and documentation to meet the New Standard.

This article is organized around ten questions and answers that illustrate some of the likely impacts of the New Standard and give some brief practical considerations.

<u>First Question:</u> For every significant transaction, have you examined all written, electronic (e.g. emails, texts) and oral communications between the parties in order to accurately assess what your agreement is? Are there other promises made or standard procedures that must also be considered?

Under the Old Standard, a company could not recognize revenue until there was persuasive evidence of an arrangement. The New Standard focuses on whether a binding agreement exists.

Under the New Standard, the assessment of whether a contract with a customer exists is not based exclusively on the form of the arrangement but rather on whether an agreement between the parties (written, oral or even implied) creates legally enforceable rights and obligations between them. Under the New Standard, a contract may be written, oral or even implied by an entity's customary business practice—as long as it creates enforceable obligations. A company must account for a legally-enforceable contract with a customer when all of the following criteria are met:

- Contract has been approved and the parties are committed
- Each party's rights are identified
- Payment terms are defined
- Contract has commercial substance
- Collection is probable

Although the criteria noted above are similar to Legacy GAAP, it is important to emphasize that the most significant difference is a new focus on whether an arrangement with a customer is legally enforceable. Under the New Standard, a software company may determine that it has a contract earlier in the negotiating process or even multiple contracts as enforceable rights. Obligations may exist as soon as performance begins rather than when the contract is signed by both parties. Making this determination will be affected by laws and legal precedents involving enforceability in the customer's jurisdiction. To properly assess revenue under the New Standard, it is critical to understand all contractual obligations your company might have with a customer and when the obligations are enforceable.

Practical considerations: Software companies should review their customer arrangements to determine whether their contracts are legally enforceable, to understand the goods and services they have promised to deliver to their customers, and to ensure that they have good processes to evaluate future arrangements with their customers for proper revenue recognition.

Second Question: Do your contracts typically have amendments, side agreements or modifications?

Under the Old Standard, there was little discussion concerning the treatment of amendments or side agreements that were executed during or after the original agreement. Under the New Standard, amendments or side agreements must be assessed to determine whether they are a modification of the original contract or a separate contract for revenue recognition purposes. That assessment could significantly impact the proper recognition of revenue.

Under the New Standard, a contract modification is accounted for as a separate contractual obligation if (a) the modification adds "distinct" goods and services, and (b) the distinct goods and services are priced at their standalone selling prices. Conversely, if both of these conditions are not met under the New Standard, the modification is part of the original contract.

Goods or services are "distinct" if the following two conditions are met: (i) 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 (ii) the promise to transfer the good or service is separately identifiable from other promises in the contract.

Practical considerations: When evaluating contracts with customers, ensure that all amendments and side agreements are captured and evaluated for proper revenue recognition. Furthermore, all promises to the customer should be captured and evaluated, even if the promise to deliver a good or service is not in the contract (i.e. an implicit promise, one that creates a valid expectation with a customer to deliver a good or service. Implicit promises do not need to be legally enforceable).

Third Question: Can I offer financing terms for my software licenses?

Payment terms in the technology industry often include up-front fees or extended payment terms. Under the Old Standard, the offer to pay an up-front software license fee over a period of years generally resulted in the deferral of revenue recognition as the fee is not fixed or determinable unless the entity has a history of collecting fees under the payment terms. Under the New Standard, extended payment terms no longer result in a deferral of all license revenue as was required under the Old Standard. For software companies this is a significant advantage.

Under the New Standard, if the financing term extends beyond one year and includes a significant financing component, the entity would need to adjust the transaction price (with certain limitations) by the time value of money and would not be precluded from recognizing revenue.

The same consideration should be made if the customer pays an upfront fee for a service to be provided over a period of time exceeding one year (or a software that is developed over a period of time exceeding one year).

Practical consideration: Tech companies need to evaluate the transaction price and underlying payment terms, including fees received in advance, to determine if there is an embedded finance component, which may result in an unintended consequence of the arrangement.

Fourth question: My software contracts currently include post-contract support (PCS). Under the New Standard, do I need to establish vendor specific objective evidence (VSOE) to determine when I can recognize revenue associated with PCS?

No. The FASB has explicitly eliminated VSOE and any references to PCS. The New Standard requires Tech Companies to determine if the promised goods or services that are bundled within PCS are separate performance obligations, as described below.

PCS generally includes multiple promises to deliver services such as telephone support, correction of errors such as bug fixes, and unspecified number of upgrades and enhancements. As a result, software companies will need to individually evaluate each service (vs. a bundle of services, as one) to determine if separate performance obligations exist which will impact the timing of revenue recognition. This may result in different patterns of revenue recognition as compared to the Old Standard and quite possibly could accelerate revenue recognition as a result of adopting the New Standard. For example, under the Old Standard, PCS was considered “one element” of the transaction. If the Tech Company did not have VSOE, it would be required to bundle the PCS with the software and defer the software and PCS revenue over the average customer life. Under the New Standard, the Tech Company will be required to assess the individual services included in the bundled PCS and determine appropriate revenue recognition for each performance obligation without having to assess VSOE.

Practical consideration: Eliminating VSOE is a major (and welcomed) change to determining revenue recognition. In general, Tech Companies may find that there is opportunity to accelerate revenue recognition for certain promised goods or services (that were previously bundled in PCS) when, in the past, they could not demonstrate VSOE.

Due to the constraints VSOE placed on Tech Companies in recognizing revenue, Tech Companies find themselves structuring contracts to ensure VSOE is established so a desired accounting outcome is achieved. As a result, the New Standard provides Tech Companies more flexibility when structuring their contracts.

<u>Fifth question:</u> I generally include a specified number of software upgrades in my contracts. Will revenue recognition change under the New Standard?

Software companies may have included a specified number of upgrades in their contracts. Under the Old Standard, companies that license software are often unable to separate the delivered elements from the specified upgrade because VSOE is generally unavailable for the specified upgrades. However, under the New Standard, software companies are likely to separate the specified upgrades as a separate performance obligation and recognize revenue earlier than under the Old Standard.

<u>Practical consideration:</u> As discussed in question number four, removing VSOE is a major change in accounting. Therefore, software companies will need to reevaluate their promises made to their customers when applying the new guidance, which could result in a significant change to revenue recognition.

<u>Sixth Question:</u> If your company provides (installed) software solutions to customers, do you typically offer a bundle of services with the software such as support, updates, etc.?

Principles often applied by software companies under the Old Standard were largely adopted in the New Standard.

Let's assume that your company provides the following solutions to your customers: a license to software (on-premise), installation services, periodic updates to the software, and online and telephonic technical support. Assume that these deliverables are sold to customers separately. Under the New Standard, in order to identify the performance obligations, you must determine which of these deliverables are "distinct," as defined under the New Standard. If the software functions without any of the other deliverables, then it is distinct. If the customer could obtain installation services from another entity and if the installation services do not significantly modify the software, then those services are distinct. Similarly, if the software functions without regard to whether the customer obtains updates or support services, then those services are also are distinct.

In the above situation, under the New Standard, there are four separate performance obligations (software license, installation services, updates, support). You would recognize revenue as each one of the four obligations is fulfilled. Assume, however, that the installation services involve customization of the software in order to make the software interface properly with other software applications of the customer. Assume further that the customization service can only be provided by your company. In this case, the first and the second deliverable (license of software, installation services) are interdependent and not distinct. In this scenario, ASC 606 regards this as your entity using the software license and the customized installation services as inputs to produce the combined output (i.e. a functional and integrated software system). Under this second scenario, there are only three performance obligations: customized installation services (that include a software license), software updates, and technical support.

<u>Practical consideration:</u> Tech Companies will need to reevaluate their customer contracts to determine how many performance obligations (referred to as "elements" or "accounting units" under the Old Standard) are within the context of the contract. For example, if under the Old Standard a contract contains only one deliverable, under the New Standard, one might find that a contract now has multiple deliverables.

<u>Seventh Question:</u> Do you pay commissions to your sales personnel?

Under the Old Standard, sales commissions could be (and generally were) expensed. Under the New Standard sales commissions that relate to revenue recognized over a period of time must be recorded as assets to be amortized over the revenue recognition period rather than expensed immediately. The amortization is over the expected length of the relationship, even if it is longer than the initial term of the agreement. Legal fees and travel expenses associated with a revenue transaction should be expensed, rather than amortized, because they would have been incurred whether or not the parties entered into the agreement.

<u>Practical consideration:</u> The requirement to capitalize expenses associated with obtaining a contract is a significant change in accounting under the New Standard. Tech Companies may find this burdensome to adopt; therefore, appropriate processes and controls should be implemented to capture and report this information in their financial statements. This includes determining the appropriate life to amortize the underlying expenses over for each arrangement.

<u>Eighth Question:</u> Does your company give customers the right to extend the term of a software license?

Under the Old Standard, a software licensor recognized revenue from the extension of an active term-based license when the renewal agreement is executed (assuming all other revenue recognition criteria are met and VSOE of fair value of the undelivered elements (e.g., PCS)) exists. This is because the customer already has possession of the software and the right to use the software license to which the extension applies. Under the New Standard, the customer does not have the right to use the software license under the renewal agreement earlier than the beginning of the extension period, even though it already possesses the software. Therefore, under the New Standard, entities have to wait until the beginning of the extension period to recognize revenue for renewals of software licenses.

<u>Practical consideration:</u> Software companies will need to evaluate their license agreements for renewal options and potentially adjust the pattern of revenue recognition.

<u>Ninth Question:</u> My customer insisted, in the contract, that certain functionality be made available in the next release. Can I still book the revenue?

Under the Old Standard, you could not book the revenue until the new functionality was delivered.

Under the New Standard, you may be able to book part of the revenue. If the obligation to deliver the new functionality is distinct and if you can determine or appropriately estimate the standalone selling price of the new functionality, then you can book the revenue for the software delivered to the customer less the standalone selling price for the new functionality that will be delivered at a later point in time.

Practical consideration: Allocating the transaction price under the New Standard is similar to the Old Standard. However, Tech Companies that do not have to allocate the transaction price in its contracts with customers, as the arrangements only contain one deliverable, may find it burdensome to do so if they determine that there are multiple performance obligations in their contracts with customers, as a result of applying the New Standard. Therefore, some Tech Companies may find themselves having to develop processes to capture standalone selling price in order to properly allocate the transaction price in its contracts with customers.

Tenth Question: Do your customer contracts have any forms of variable consideration in them?

Variable consideration includes, among other things, discounts, rebates, credits, performance bonuses and royalties.

Under the Old Standard, a seller's price must be fixed or determinable for revenue to be recognized. Therefore, revenue related to variable consideration is not typically recognized until the underlying uncertainty is resolved.

Under the New Standard, variable consideration is to be estimated and included in the transaction price, subject to a "constraint." This means that an entity shall include in the transaction price some or all of an amount of variable consideration only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

Practical consideration: Most contracts with customers contain some form of variable consideration, which can take many forms such as rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items. Requiring a company to estimate variable consideration is a significant change for entities that did not attempt to estimate variable consideration under the Old Standard. Under the Old Standard, generally companies simply recognized such amounts when cash was received. The New Standard requires an entity to estimate variable consideration, apply a constraint, and include in the transaction price. Estimating variable consideration will require a significant amount of judgment.