October 2017

Implementing the New Revenue Recognition Standard for Technology Companies

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The new revenue recognition rules can significantly change the timing and character of revenue recognized by technology companies. In some ways, the new rules represent a modernization of guidance, which technology companies will welcome. In other respects, the rules will introduce new issues and challenges for technology companies. This guide is intended to help financial executives understand some of the relevant changes that affect technology companies.

In May 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued their much-anticipated converged standard on revenue recognition. The FASB issued Accounting Standards Update (ASU) No. 2014-09, and the IASB issued International Financial Reporting Standard (IFRS) 15, both titled "Revenue From Contracts With Customers." With only minor differences, the joint standard represents a single, global, principles-based revenue recognition model. The new guidance will affect almost every entity that recognizes revenues from contracts with customers, so financial executives with technology companies likely will need to determine how to apply the new standard.

Since that date, the FASB has issued several ASUs that update or clarify the new rules. It is not common for the FASB to issue additional amendments on a standard prior to the date when the standard becomes effective, but in this case, the FASB issued the following ASUs that either change or clarify guidance from ASU 2014-09:

- ASU 2016-08, "Revenue From Contracts With Customers (Topic 606): Principal Versus Agent Considerations"
- ASU 2016-10, "Revenue From Contracts With Customers (Topic 606): Identifying Performance Obligations and Licensing"
- ASU 2016-12, "Revenue From Contracts With Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients"
- ASU 2016-20, "Technical Corrections and Improvements to Topic 606, Revenue From Contracts With Customers"

Because the new standard is less prescriptive than FASB Accounting Standard Codification (ASC) 605, "Revenue Recognition," or ASC 985-605, "Software – Revenue Recognition," technology companies will be required to use more of their own judgment than they do today. For many technology companies, the new standard might change the timing and character of revenue recognized. The effort required for a company to analyze and document revenue transactions is likely to increase, and the number of disclosures in the financial statements will grow as well.

The Crowe article "Revenue From Contracts With Customers: Understanding and Implementing the New Rules"[1] includes an overview of the new rules, presentation and disclosure requirements, transition and implementation considerations, and effective dates. That article also describes the new comprehensive framework's five steps for determining how much revenue to recognize and when it should be recognized.

Issues in Implementing Revenue Recognition Rules

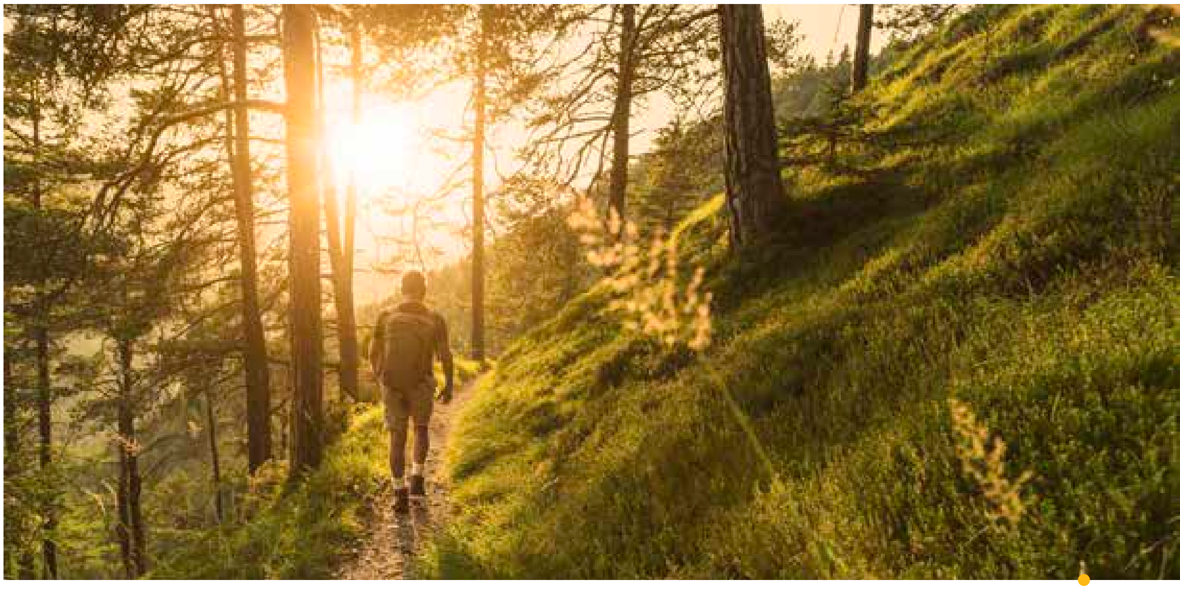
Following is a description of significant issues a technology company might face when applying the new revenue recognition approach. It is important for financial executives in the technology industry to keep these issues in mind when implementing the new rules.

Elimination of Vendor-Specific Objective Evidence Criteria for Software Companies

Currently, under the existing standard, elements of a software licensing arrangement can be accounted for separately only if vendor-specific objective evidence (VSOE) of fair value exists for the undelivered element or elements. If VSOE does not exist, entities must combine the elements into a single unit of accounting and recognize revenue when or as the delivery of the last element takes place or until the company has VSOE for the remaining undelivered elements.

Many software entities do not have VSOE for a software license and thus are not able to recognize revenue upon delivery of the software license under ASC 985-605. This is an example of the criticism of U.S. generally accepted accounting principles (GAAP) revenue recognition rules prior to this new standard. Most other industries would be required to make an estimate of the revenue to allocate to delivered items and are not held to the strict VSOE criteria, resulting in similar transactions having significantly different accounting implications.

Under the new revenue recognition rules, a software entity may be able to recognize revenue for a delivered software license even if the entity does not have VSOE. It is important to note that not all software delivered to a customer will qualify as a revenue recognition event. The crux of the matter is in the type of license and whether or not the license qualifies as a distinct performance obligation under the new rules.



Type of License

The new rules create a distinction between a license arrangement that is "functional" and one that is "symbolic." The distinction is important because contracts for functional licenses result in the entity recognizing revenue at a point in time (when control transfers to the customer), whereas symbolic licenses result in the entity recognizing revenue over time (the duration of the license). In functional license arrangements, the customer can benefit immediately from the asset that is transferred to the customer (for example, music or recipes). Symbolic license arrangements contain at least an implicit promise that the licensor will have continuing involvement in maintaining the value of the asset (for example, a brand name or right to use a sports team's logo). In general, most customers can benefit immediately from software they purchase, so many licensing arrangements involving software are expected to be characterized as functional licenses, though distinguishing between the two is a critical first step.

Distinct Performance Obligations

The new standard creates a concept of "performance obligations," which are the goods or services promised to a customer in a contract. A good or service (and therefore a performance obligation) is distinct if it meets both of the following criteria:

1. 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 (that is, the good or service is capable of being distinct).
2. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract).

Under the new rules, revenue is recognized when (or as) performance obligations are satisfied. Functional software licenses will result in revenue recognition when the license is considered a distinct performance obligation using the previously mentioned criteria. Not all software licenses are distinct performance obligations. An entity may build software that is so highly technical and customized that the customer cannot benefit from the software alone.

For example, an entity that builds satellites may create software used to control the satellites in space. Even if the entity licensed this software to its customer, the software might be so technical in nature that the customer cannot benefit from the software without the satellites (or without additional implementation service from the entity). Accordingly, this software would not meet the first criterion, it would not be considered a distinct performance obligation, and the entity could not recognize revenue under the new rules related to this software. In contrast, an entity that sells software under functional license arrangements where the software theoretically could be installed and used either by the customer or by another party could recognize revenue for delivery of this software even if the entity has no history of selling its software separate from installation services.

Many software entities will see this change in the rules as a positive development. The new rules are consistent with similar FASB guidance that has been in effect for many years for other industries. However, this change also might require software entities to make estimates and calculations that have not been required in the past. Software entities should assess the systems, processes, and internal controls in place to perform these calculations, and they periodically should refresh estimates and assumptions.

The new standard requires entities to use observable information, if available, to determine stand-alone selling prices for each distinct performance obligation. However, unlike the old standard, the new one requires entities to make estimates based on reasonably available information if stand-alone selling prices are not directly observable. Entities may use one method or a combination of appropriate methods to estimate the stand-alone value of a good or service. The new standard discusses three estimation methods that entities will be able to use when stand-alone selling prices are not readily observable: (1) an adjusted market assessment approach, (2) an expected cost plus a margin approach, and (3) a residual approach.

Post-Contract Customer Support

Post-contract customer support (PCS), which is integrated into most software arrangements, generally includes items such as bug fixes, telephone and web-based support, software enhancements, and new software releases.

Some technology companies provide some level of PCS at no additional cost to the customer but have no written contractual obligation to provide PCS to customers. For example, periodic internet-based updates are included with some software applications. One update can serve a variety of functions. A single update might, for example, (1) make a particular application compatible with the latest features of other applications, (2) correct a bug in the system, and (3) add new functionality to the software. Under the current guidance, this type of PCS may not result in a separate allocation of consideration because the PCS is provided only when and if it is available.

However, the new standard requires entities to consider all arrangements in a contract, including those that are implied by past business practices. Many entities are likely to find that their past business practices imply that the customer will receive updates as well as other support, such as telephone- or web-based assistance with software installation.

This might be a significant and challenging change for technology companies, which will have to determine whether these types of services represent a separate performance obligation. Some of the challenges will include:

1. Evaluating whether the customer's right to PCS is enforceable
2. Predicting the volume and timing of updates and other types of PCS
3. Considering questions about the types of PCS – for example:
   a. If the update corrects core functionality of the software, is the update akin to a warranty service?
   b. If the update enhances the software, should the customer support be considered a separate performance obligation?
4. Determining the timing of revenue recognition for services such as telephone- and web-based support when there is no finite termination date for the support

Because of this change to PCS, technology companies might need to adjust internal systems or tracking mechanisms for any additional performance obligations identified under the new standard.

Complex Consideration Arrangements

Under the new standard, an entity will be required to determine the transaction price based on the amount of consideration to which it expects to be entitled. The amount to which the entity expects to be entitled may differ from the contract price. The transaction price may include variable consideration, such as contingent consideration due from the customer, consideration payable to the customer, and the time value of money for significant financing components.

Variable Consideration

Variable consideration includes arrangements that are relatively common such as rebates, price concessions, or discounts based on future actions. The new standard requires that any variable consideration be estimated at contract inception and that the amount of the consideration be included in the transaction price. Variable consideration can be estimated using either an expected value approach or the most likely amount. The method used to estimate variable consideration should be determined on a contract-by-contract basis and must be consistently applied.

The new standard requires an entity to estimate variable consideration and include this estimate within the transaction price used to measure revenue. However, the entity is allowed to recognize revenue only to the extent that it is probable that a future reversal of revenue is not probable. This provision from the new rules is commonly referred to as the variable consideration "constraint" and is intended to restrain entities from recognizing revenue prematurely. The new standard also provides a limited exception to this variable consideration guidance. The exception, which will apply to technology companies, is that variable consideration related to sales or usage-based royalties on licenses of intellectual property should not be included in the estimate of the transaction price.

Significant Financing Components

Companies also will be required to consider payment terms in the determination of the transaction price. Under the current guidance, entities may have to discount receivables from a customer when the customer is allowed to defer payment for more than one year from recording the receivable. However, the new guidance requires the entity to consider numerous factors in evaluating whether an arrangement includes a significant financing component. Significant financing components may exist even when a customer prepays for goods or services.

As a practical expedient, the new standard allows an entity to avoid assessing arrangements for significant financing components if, at the inception of the contract, the entity expects that the timing between the goods or services being provided and payment by the customer is one year or less. While this practical expedient is useful for many entities, any entity with contractual arrangements that are long term in nature (for example, multiyear subscriptions or projects expected to be serviced over more than one year) must carefully consider the guidance of the standard and may be required to recognize interest income (or expense) if the arrangement contains a significant financing component.

Options for Additional Goods or Services

Some technology entities may provide their customers with options for additional services (or goods) at a discounted price. An example would be a software entity that sells a software license for $100,000 with PCS services of $24,000 for one year of support. Included in the contract is a right for the customer to purchase an additional year of PCS for $12,000.

Under the current revenue recognition rules, options available to the customer are not recognized until the customer has elected to use the additional goods or services or has otherwise become contractually obligated for payment of them. In our example, the entity would be prohibited from recognizing revenue for any portion of the second year of the PCS services, prior to the customer electing such an option. Similarly, the entity would not recognize amounts related to the option until the customer has elected the option or the option expires.

The new revenue recognition rules require an entity to recognize a separate performance obligation for customer options if those options give the customer a material right. The entity may do this in either of two possible ways. The entity can either (1) recognize the option as a separate performance obligation or (2) "look through" the optionality of the arrangement and recognize a performance obligation for the goods and services to be delivered in the option. The primary difference between these two methods is that recognizing the option in the contract requires an entity to consider the probability that a customer will exercise the option, whereas the alternative "look through" approach ignores the probability of the customer's election and treats the contract as an arrangement that includes all goods and services within the option.

Using either approach, the calculations required to recognize customer options that are a separate performance obligation can be highly complex. These calculations require the entity to make estimates related to (1) potentially, the probability of customers electing to purchase the additional goods and services and (2) the stand-alone selling price of the option or the additional goods and services provided by the option. In subsequent periods, customers may elect to not purchase the additional goods and services (or may do so at rates different from those estimated). These calculations can be further complicated if the option terms include a variable consideration component, a financing component, or nonstandardized terms.

Entities that grant customers options that are considered separate performance obligations may be required to allocate revenue to the customer option, potentially deferring revenue related to consideration received early in the contract and recognizing it at the point in time (or over the period) when optional goods and services are delivered.

Unexercised Rights

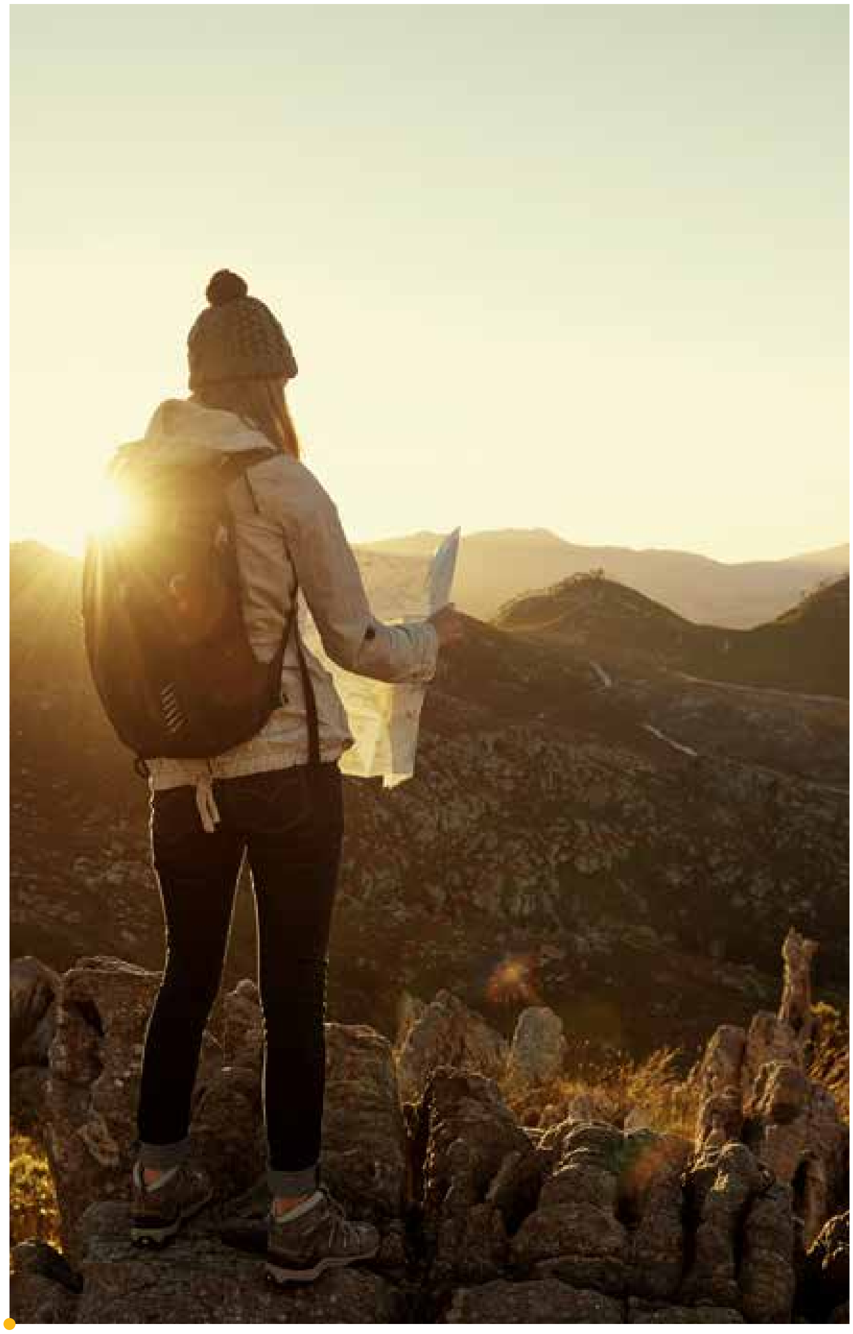
Another issue that may affect technology companies and other industries (such as retail) is unexercised rights. Some entities may provide their customers with rights to products and services in exchange for a nonrefundable advance fee. With respect to technology companies, products may be distributed to consumers digitally. A common example is gift cards for an entity that distributes digital content (for example, a music and video distribution platform, which distributes digital music and other content). An entity might sell $100,000 of gift cards for the platform, and historical results would suggest that less than $100,000 of gift cards actually will be redeemed. The portion of gift cards that is not expected to be redeemed is often called "breakage."

Under the old revenue recognition rules, an entity is permitted to recognize revenue only when the customer receives the underlying goods or services (among other criteria) or the underlying right expires. This means that revenue related to breakage is recognized only when or if the customer's rights to acquire the underlying goods or services expire.

Under the new revenue recognition rules, if an entity expects to be entitled to breakage, the entity should recognize the expected breakage amount as revenue in proportion to the pattern of rights exercised by the customer. As an example, if an entity sold $100,000 of gift cards but expected only $80,000 to be redeemed, the entity would recognize $1.25 for every $1.00 that the customer redeemed ($100,000 divided by $80,000), so that at the point in time when the customer redeemed the expected $80,000, the entity would have recognized all $100,000 of revenue. Note that this assumes the entity would be entitled to the breakage amount. Certain legal jurisdictions require such funds to be remitted to a legal authority as unclaimed property, and in that case, the entity would not be entitled to any breakage.

The amount of breakage that the company can recognize is limited by the variable consideration "constraint." As a result, the entity is required to be able to reliably make estimates with respect to variable consideration; therefore, the entity's estimates with respect to breakage also must be reliable.

The new rules require an entity to consider breakage in its contracts with customers. While these rules address an issue that currently exists (especially with respect to items such as gift cards that in some jurisdictions may be legally prohibited from having expiration dates), this creates a requirement for the entity to generate and monitor complex estimates regarding the amount of goods and services that ultimately will be redeemed by the customer. The entity may be required to make different estimates depending on the unclaimed property laws of each jurisdiction in which it operates.



Moving Forward

Financial executives in the technology industry should consider reviewing the issue papers of the Joint Transition Resource Group (TRG) for Revenue Recognition established by the FASB and the IASB. The boards created the TRG to consider implementation issues raised by constituents. The TRG will not issue any guidance; rather, it will inform the boards about potential issues related to implementing the new standard, and the boards will determine what, if any, action might be needed as a result. Further action by the FASB and the IASB could include issuing additional implementation guidance or proposing amendments to the standard. Gaining an understanding of the issues under TRG discussion will help preparers anticipate and handle implementation issues.

In addition, the American Institute of Certified Public Accountants (AICPA) has formed 16 industry task forces, including one for the software industry, to help develop a new accounting guide on revenue recognition and assist industry stakeholders. Views and guidance issued by the AICPA are not authoritative.

Learn More

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[1] Scott Lehman and Alex J. Wodka, "Revenue From Contracts With Customers: Understanding and Implementing the New Rules," Crowe, October 2014, http://www.crowe.com/lp/revenue-recognition-standard/

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Text created in and current as of October 2016; Cover and artwork updated in May 2018.

DI-18100-027A