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Revenue Recognition: Technology Companies

January 24, 2018

Glenn Richards

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Today's Presenter

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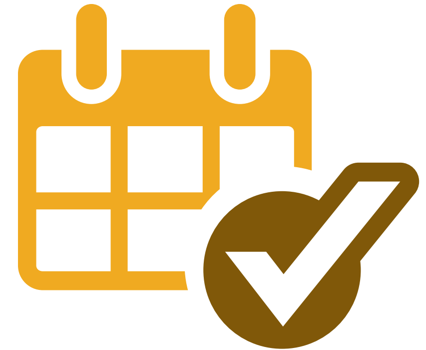
Agenda

What we'll cover today:



- Issue 1: Elimination of VSOE
- Issue 2: Material Rights
- Issue 3: Licenses
- Issue 4: Significant Financing Components
- Issue 5: Unexercised Rights
- Issue 6: Incremental Costs to Obtaining a Contract

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Issue 1: Elimination of VSOE

- Existing rules (Topic 605) contain a requirement that an entity may only recognize revenue related to the delivery of a software license if the entity has vendor-specific objective evidence (VSOE) to support the value of the delivered software. VSOE is a significant threshold of evidence, and many software entities may never sell their software license independent of PCS. As a result, some software entities may have never allocated any revenue to the delivery of its software.
- Under the new rules (Topic 606), software entities may be required to recognize revenue upon delivery of their software license (assuming that delivery of the license is considered a distinct performance obligation).

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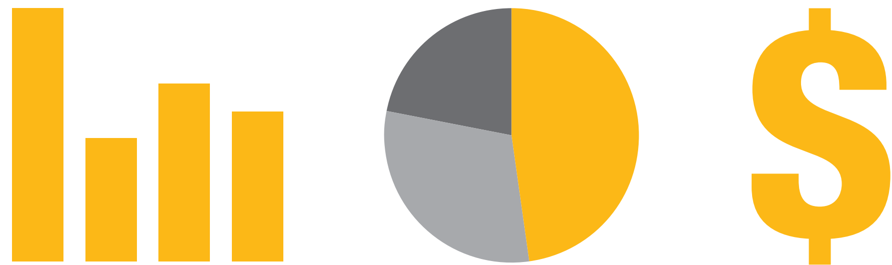
Allocating Price to Performance Obligations

- It is common in the software industry for the individual values of licenses and various forms of PCS included in bundled packages to not be directly observable.
- Thus, management of software companies may be challenged with the task of determining the stand-alone selling price of a software license for the first time in their history (and developing appropriate controls around assumptions/estimates).



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Polling Question #1

What is your view of the impact of the elimination of the VSOE criteria on the quality of financial reporting for tech companies?

A. Significant improvement; for example, this increases the consistency of financial reporting with other entities
B. Moderate improvement
C. Neutral
D. Moderate deterioration
E. Significant deterioration; for example, the increased complexity of determining the stand-alone selling price of software licenses outweighs other benefits
F. Don’t know; wait and see

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Issue 2: Material Rights

Some entities may grant their customers options for additional goods and services, and these options could be considered a "material right."

Example:

- Buy a machine for $1,000,000, and a service package for year 1 of $100,000.
- Second year of service is $100,000

OR

- Second year of service is $25,000

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Issue 2: Material Rights

Current Practice: Under the current revenue recognition rules, the company providing the option is not required to consider the option as a revenue element, the (incremental cost method).

New Guidance: Under the new standard, material rights can be a separate performance obligation.

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Issue 2: Material Rights

Current Practice

Contract price:

Machinery:	$1,000,000
Year 1 service:	100,000
Option for year 2:	-
	$1,100,000

New Rules

Contract price:

Machinery:	$ 937,500*
Year 1 service:	93,750*
Option for year 2:	93,750*
	$1,125,000*

(Stand alone selling price allocation required - $1M machine, $100K for each year of service, allocated over the total contract price of $1,125,000)

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Issue 2: Material Rights

- Notice that at the end of year 1, there are only two possibilities:
  - Customer exercises their right, and the Company records $93,750 of revenue over year 2, but collects $25,000 of cash.

    OR
  - Customer elects not to exercise their rights, and entity recognizes $68,750 ($1,100,000 collected from the customer less $937,500 and $93,750 previously recognized) in revenue upon expiration of the right.

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Issue 2: Material Rights

- This can get complicated for due diligence teams to unwind if:
  - More elements of variable or contingent consideration.
  - Erratic payment terms (i.e. the customer was billed for $25,000 prior to its election, but never paid it, resulting in additional amounts in accounts receivable and deferred revenue).
  - Offsets or other claims (i.e. other arrangements with the customer that reduce deferred revenue or AR may “hide” the full scale of this contract).

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Polling Question #2

How often does your organization include options in a contract that may include material rights?

A. Always
B. Frequently
C. Sometimes
D. Never

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Issue 3: Licenses

An entity selling a 7-year license under the new rules might be able to recognize 100% of the revenue upon delivery of the IP. This depends on the type of license.

- Functional license – The customer can benefit from the license without further performance of the entity (recipes, software, music/videos, etc… Recognize revenue at a point in time)
- Symbolic license – Expressed or implied maintenance by the entity (brand name, team sports logo, etc… Recognize revenue over time)

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Issue 3: Licenses

Note

Most software licenses (that are delivered “on prem”) are expected to be functional licenses

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Issue 3: Licenses

Example

Entity A sells a license to a customer. The term of the license is three years. The customer is required to pay $1,000,000 per year, in advance of each year.

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Issue 3: Licenses

Current Practice / Symbolic License

	Revenue	Interest
Year 1:	$1,000,000	-
Year 2:	1,000,000	-
Year 3:	1,000,000	-
	$3,000,000	-

Functional License

	Revenue	Interest
Year 1:	$2,550,000	150,000
Year 2:	-	150,000
Year 3:	-	150,000
	$2,550,000	$450,000

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Polling Question #3

Do you believe that recognizing revenue from certain license arrangements at a point in time better represents the economic substance of the arrangement?

A. Yes, and the division of functional versus symbolic licenses is an appropriate division of licenses
B. Yes, but the criteria for recognizing revenue at a point in time under license arrangement should be something other than functional versus symbolic
C. No, license revenue should be recognized over time, for all license arrangements

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Issue 4: Significant Financing Components

- The new rules require an entity to consider whether an arrangement with a customer has an implicit or explicit financing component. As a practical expedient, this only applies to contracts where the difference between payment and delivery of services is more than one year.
- Many software entities may provide multi-year arrangements, including the acceptance of an up-front fee (e.g. pay $300, for a three-year subscription)
- In these circumstances, a significant financing component may exist…. Or may not.

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Issue 4: Significant Financing Components

- For example, if the Company offers annual subscription plans of $100, but a three year plan may be purchased for $250, this suggests that there is an implicit financing component (with a rate equal to $50 over three years).
- Alternatively, consider an entity that only offers 3-year subscriptions (for $250).

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Issue 4: Significant Financing Components

If the entity charges a single upfront amount, not with the primary purpose of obtaining financing from the customer but, instead, to maximize profitability, taking into consideration the risks associated with providing the service, this could have no financing component.

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Issue 4: Significant Financing Components

Specific examples provided by the standard:

- If customers could pay monthly, they would be less likely to renew, and the population of customers that continue to use the support service in the later years may become smaller and less diverse over time (that is, customers that choose to renew historically are those that make greater use of the service, thereby increasing the entity's costs).
- In addition, customers tend to use services more if they pay monthly rather than making an upfront payment
- Finally, the entity would incur higher administration costs such as the costs related to administering renewals and collection of monthly payments

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Issue 5: Unexercised Rights

- Topic 606 includes guidance on addressing unexercised rights that is different than current US GAAP rules (Topic 605).
- Unexercised rights are frequently called “breakage” and are most commonly illustrated with gift cards (e.g., if a merchant sells $100,000 in gift cards, some of that amount will never be redeemed by customers, and the issue is what to do with the “breakage” or the portion that is deferred but never used).

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Issue 5: Unexercised Rights

This is new, and very different:

- Current U.S. GAAP would prohibit the company from recognizing such revenue until the customers' legal rights expire.
- Topic 606 requires the entity to recognize revenue in proportion to the pattern of rights exercised by the customer.
- The entity must continue to recognize contract liability for prepayments.

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Issue 5: Unexercised Rights

Unexercised rights can result in an entity recognizing revenue on an accelerated basis (to the extent of estimated breakage), except that such recognition is limited by what is commonly referred to as either the "variable consideration constraint." Here is the exact language from the standard:

606-10-32-11 An entity shall include in the transaction price some or all of an amount of variable consideration estimated [in step 3] 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.

In plain English, you can make estimates, just don't be materially wrong.

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Issue 5: Unexercised Rights

- Some entities may have a long history of being able to estimate the amount of breakage. For example, assume a telecom company sells prepaid mobile cards – the rights to use 600 minutes of airtime, for $600, over the course of a year. Historically, most customers use $400 in minutes, and let $200 in minutes expire at the end of the year.
- Current GAAP would have the entity recognize revenue of $1.00 per minute ($600/600 minutes allowed), and $200 at the contract expiration.
- Topic 606 would have the entity recognize revenue of $1.50 per minute ($600/400 minutes expected to be used), with – theoretically – $0 at expiration.
- The company would have to monitor this estimate through the life of the contract. The company could be required to adjust the estimated breakage at some point during the contract. This could be a highly complex calculation.

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Issue 6: Incremental Costs to Obtaining a Contract

- Under historical GAAP, both revenue and any deferred direct and incremental contract acquisition activities were recognized over a period not to exceed the expected customer relationship period.
- Under Topic 606, acquisition costs must be incremental and recoverable to receive this treatment.
- Acquisition costs to consider include but are not limited to:
  - Commissions to internal sales agents and third-party dealers
  - Discounted devices
  - General administrative costs
  - Costs to connect service network

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Issue 6: Incremental Costs to Obtaining a Contract

- Entities should consider whether commission costs that are paid over the term of a customer contract should qualify for deferred expense treatment.
  - Generally applicable to customer-facing sales agents because they are directly involved in obtaining the contract and an incremental cost

- Discounts on devices may be offered to a customer as an enticement to enter a service contract. The associated cost may not be deferred, as devices generally are treated as inventory and are accounted for as a separate performance obligation. But what happens when the inventory is sold at a “loss”?

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Issue 6: Incremental Costs to Obtaining a Contract

For example: A vendor offers a cellular phone plan for $100 per month, as long as the customer signs a two-year contract. The vendor normally sells a certain phone for $300. The vendor runs a promotion in which a customer can sign up for the two-year plan and get a “free” phone. This would allocate $267 of revenue to the phone ($300/$2,700 X $2,400).

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Polling Question #4

What type of incremental direct costs do you expect to be required to capitalize under the new revenue recognition rules?

A. Sales commissions
B. Legal costs
C. Engineering or other professional fees
D. Other
E. None of the above

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Other Matters

This is not a comprehensive list of the issues that entities face in applying the new rules. However, hopefully you can see the complexity in accounting for revenue under the new rules. There are numerous issues outside of “just” the accounting:

- Internal control issues
- Audit issues, especially around subjective assessments and assumptions
- Impact on compensation arrangements
- Impact on other contracts (such as debt covenants)
- Income tax issues
- System issues (whether and how the data captured is necessary to address these calculations)
- Expanded disclosure requirements

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Revenue Risks – Process Level

What are some of the revenue risks that need to be considered?

- Contract with customer is not identified, or not properly authorized
- All separate, or distinct, performance obligations are not identified
- Transaction price is not determined
- Data used in estimates is not complete and accurate, or is not available
- Assumptions used in estimates are not correct
- Revenue is not collectible
- Transaction price is not correct
- Transaction price not correctly allocated to performance obligations
- Performance obligations are not identified as satisfied, or revenue is recognized when performance obligations are not satisfied

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Internal Control Considerations

Implementation controls

- Grouping of revenue streams
- Review of contracts
- System controls may need to be changed (new data or new processing, for example)

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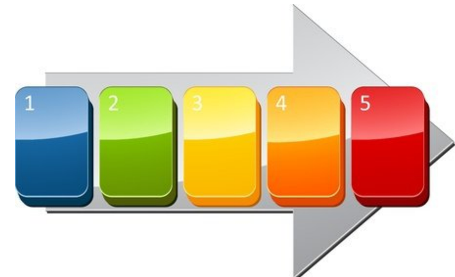
Internal Control Considerations

Contract review controls (i.e. criteria for which contracts should be elevated to 606 experts versus standard terms and conditions)



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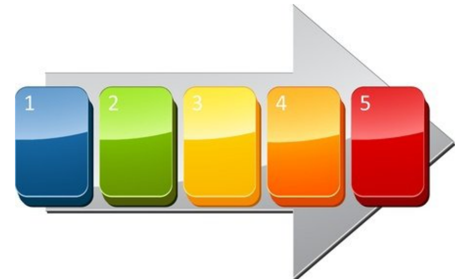
Internal Control Considerations

- Estimating the stand-alone selling price, including the maximizing of observable inputs in that process
- Making sure you don’t skip to management estimates



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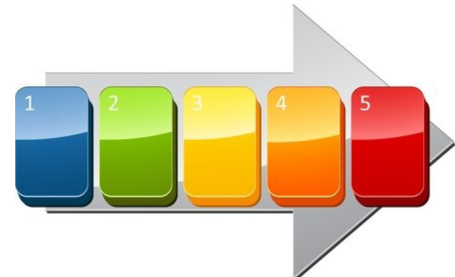
Internal Control Considerations

Determining the appropriate transaction price allocation, including variable consideration and discounts



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Internal Control Considerations

Refreshing estimates or assumptions (i.e. what happens if a product or service has not historically had objective evidence available, but subsequently, such information becomes available)

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Thank you!

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