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# Software

## Implementing the New Revenue Recognition Standard

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# REVENUE RECOGNITION

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The far-reaching impact of the new revenue recognition accounting standard, which will affect different industries in different ways, will bring about some important changes for software companies. Financial executives in the software industry need to understand the issues they could face when using the five-step approach of the new comprehensive framework to implement the guidance in their organizations.

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 software companies likely will need to determine how to apply the new standard.

Because the new standard is less prescriptive than FASB Accounting Standard Codification (ASC) 985-605, "Software – Revenue Recognition," software companies will be required to use more of their own judgment than they do today. For many software companies, the new standard might change the value and timing 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 revenue recognition over time or at a particular point in time, a summary of contract costs, presentation and disclosure requirements, and transition and implementation considerations; and effective dates – which the FASB has proposed postponing one year for both public and private entities.[2] That article also describes the new comprehensive framework's five steps for determining how much revenue to recognize and when it should be recognized.

## Five Steps to Revenue Recognition

Following is a description of key issues a software company might face when applying the new five-step approach. It is important for financial executives in the software industry to keep these issues in mind when considering the impact the standard is likely to have on their organizations.

### Step One: Identify the Contract With a Customer

Identifying the contract or contracts with a customer is the first step in the new framework for determining revenue recognition. Under current guidance, persuasive evidence of an arrangement typically does not exist until both parties have signed a contract. The new standard indicates that contracts may be written, oral, or implied by an entity's customary business practices as long as they are enforceable by law.

This change could significantly affect any software company that currently delivers software to customers before the contract has been signed by both parties. Without an agreement signed by both parties, revenue recognition is generally prohibited under current guidance even if all other general revenue recognition criteria have been met. The new standard eliminates this distinction. As a result, companies will need to exercise more judgment when determining whether a contract with a customer is legally binding.

## Step Two: Identify Each Performance Obligation in the Contract

Identifying performance obligations in a contract, the second step in the new framework, is a significant change for software companies. Two new elements important to software companies are the elimination of “vendor-specific objective evidence” criteria and the need to account for certain types of post-contract customer support as separate performance obligations.

### Elimination of Vendor-Specific Objective Evidence Criteria

Currently, 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.

Under the new standard, promised goods or services represent separate performance obligations if they are distinct. A good or service 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).

When a promised good or service is determined not to be distinct, entities will combine it with other goods or services until a distinct performance obligation can be identified.

### 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 software companies provide some level of PCS at no additional cost to the customer but have no 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 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 clearly 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 software companies, which will have to determine whether these types of services represent a separate performance obligation. Some of the challenges will include:

1. Predicting the volume and timing of updates and other types of PCS
2. 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 just enhances the software, should the customer support be considered a separate performance obligation?
3. 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, software companies might need to adjust internal systems or tracking mechanisms for any additional performance obligations identified under the new standard.

## Step Three: Determine the Transaction Price

*The change in how the transaction price is determined could be significant for software companies that currently defer recognizing revenue for contracts with extended payment terms until the cash is collected.*

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 also 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. Under some contracts, the transaction price includes variable consideration 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.

The new standard provides a limited exception to this variable consideration guidance. The exception, which will apply to software 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.

Companies will also be required to consider extended payment terms (payment terms greater than one year) in the determination of the transaction price. Under current guidance, there is a presumption that the transaction price is not fixed or determinable if extended payment terms exist in the contract, and an entity cannot

recognize revenue for contracts with extended payment terms unless the presumption is overcome. The presumption may be overcome if an entity demonstrates that it has a history of successful collections without making concessions to the customer.

Under the new standard, however, extended payment terms in a contract are considered variable consideration. The guidance provides a practical expedient that indicates that an entity will be required to assess whether a contract contains a significant financing component only when the period between the customer's payment and the entity's transfer of goods or services is longer than one year.

This change in how the transaction price is determined might prove to be significant for software companies that currently defer the recognition of revenue for contracts with extended payment terms until cash is collected. In addition, software companies will need to see that variable consideration is included in the transaction price only if a significant reversal of revenue is not probable.

## Step Four: Allocate the Transaction Price to Each Performance Obligation

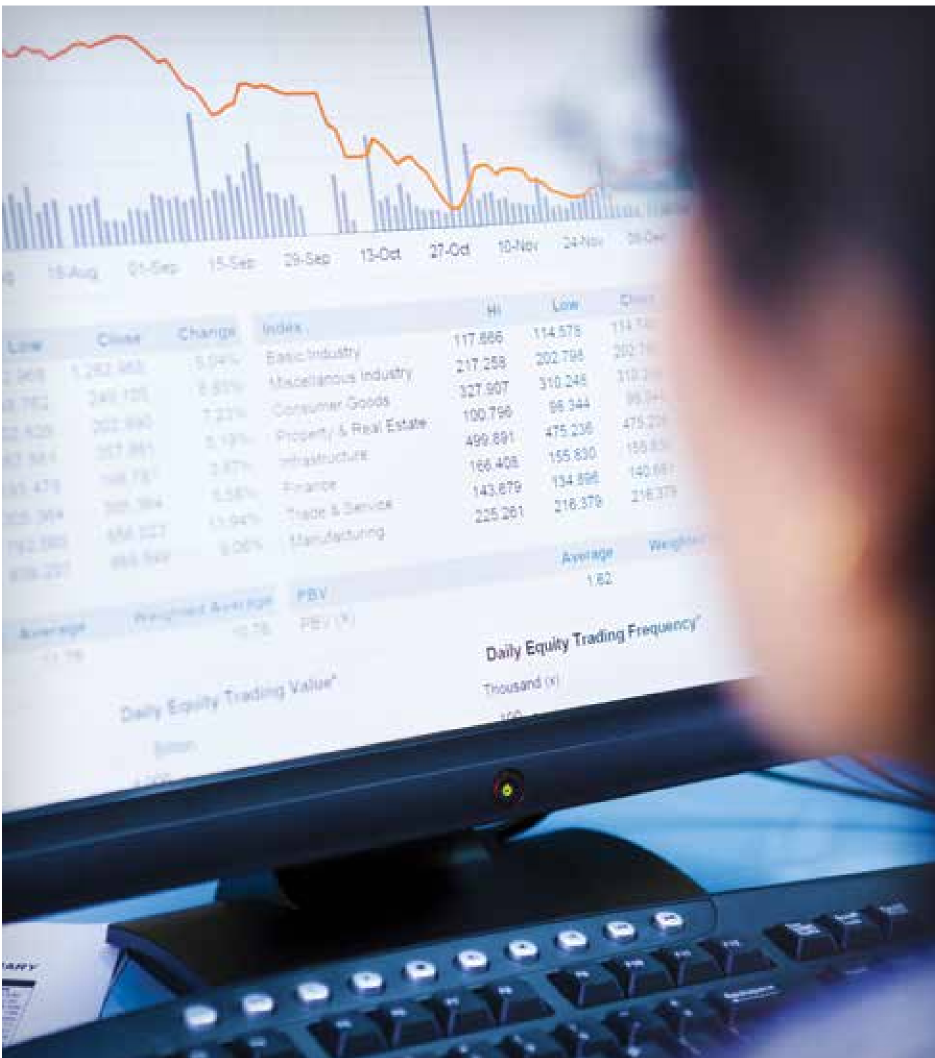
Software arrangements typically include various performance obligations. As a result, the allocation of the transaction price to these separate performance obligations is important. Under current guidance, companies use a relative selling price method to allocate the transaction price to separate elements only when VSOE of fair value exists for all of the elements in the arrangements. This allocation is complicated by the requirement to have VSOE for all undelivered items.

The new standard changes the transaction price allocation process and indicates that the transaction price should be allocated to each separate performance obligation, generally in proportion to its stand-alone selling price. The stand-alone selling price is the price at which an entity would sell a good or service on a stand-alone basis at contract inception. Software companies will need to take into account variable consideration, discussed in step three, and allocate any variable consideration to one or more of the performance obligations.

The new standard requires entities to use observable information, if available, to determine stand-alone selling prices. 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 will be permitted to use one 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. The requirement to estimate a stand-alone selling price could prove to be a big change for software companies, for the current standard requires observable evidence and does not permit the use of management estimates.

## Step Five: Recognize Revenue When or As Each Performance Obligation Is Satisfied

Satisfying the performance obligations is the final step in the new revenue recognition framework. Under the new standard, revenue is recognized when an entity satisfies a performance obligation by transferring a promised good or service to the customer. That is established when the customer obtains control. The new standard provides specific guidance to determine when control of distinct licenses of intellectual property transfer to customers.




For software companies, the standard indicates that companies provide their customers with either right-to-use licenses or right-to-access licenses. A right-to-use license provides the right to use intellectual property as it exists at the point in time the license is granted, and, generally, revenue should be recognized at a point in time. A right-to-use software license should not be recognized at a point in time if, during the license period, the company has explicit or implicit contractual obligations to carry out activities that would significantly affect the software license.

A right-to-access license provides the right to access intellectual property as it exists throughout a licensing period, and as it is changed during that period. Revenue should be recognized over the determined access period, and it should be recognized using an input or output method that best depicts the pattern of the transfer of control.

## Moving Forward

Financial executives in the software industry should consider monitoring the activities 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.

The FASB has issued for public comment a proposal to delay the ASU's effective dates. Although the proposal would give organizations an additional year to evaluate the impact of the revenue recognition standard and put in place the systems and processes necessary for compliance, software entities should not postpone or slow down the development and execution of their implementation plans.

Based on an initial understanding of the provisions of the standard, the views offered in this article are preliminary and do not necessarily reflect all of the implementation issues that have been identified or are yet to be identified. As more entities implement the standard, both the TRG and the AICPA no doubt will identify new issues related to how the guidance is to be applied in specific situations. The FASB or the IASB could issue additional guidance in the future.

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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/

[2] See Alex J. Wodka, "FASB Proposes a One-Year Deferral of the New Revenue Recognition Standard," Crowe, April 3, 2015, http://www.crowe.com/insights/new-revenue-recognition-standard.aspx




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