

Revenue from Contracts with Customers – Software Industry

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REVENUE FROM CONTRACTS WITH CUSTOMERS – SOFTWARE INDUSTRY

OVERVIEW

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*.¹

The new revenue rules establish comprehensive accounting guidance for revenue recognition and will replace substantially all existing U.S. Generally Accepted Accounting Principles (GAAP) on this topic. The new guidelines are substantially merged with the International Financial Reporting Standards (IFRS) 15, the comparable new standard issued by the International Accounting Standards Board (IASB).

The revenue standard's core principle is built on the contract between a vendor and a customer for the provision of goods and services. It uses the transfer of control between the parties to determine the pattern of revenue recognition based on the consideration to which the vendor is entitled. To accomplish this objective, the standard requires five basic steps:

1. Identify the contract with the customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

Many entities adopting the new standard may experience a change in the timing and manner of revenue recognition. For some transactions, the changes can be significant and will require careful planning.

¹ Subsequently, the FASB has issued amendments to ASU 2014-09 based on operational issues raised by the FASB/IASB Joint Transition Resource Group and other practitioners. The amendments include:

- ASU 2015-14 (deferring the effective date of the new revenue rules by one year),
- ASU 2016-08 (gross versus net revenue presentation),
- ASU 2016-10 (identifying performance obligations and accounting for intellectual property licenses), and
- ASU 2016-12 (narrow scope improvements and practical expedients)
- ASU 2016-20 (technical corrections and improvements).

This publication, which was originally issued in 2014, has been updated to reflect FASB amendments issued through January 16, 2017.



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EFFECTIVE DATE

Public entities² must apply the new standard for annual periods beginning after December 15, 2017, including interim periods therein. Therefore, a calendar year-end public entity would reflect the new standard in its first quarterly report for the period ending March 31, 2018, as well as for the entire year ending December 31, 2018.

Nonpublic entities have an additional year to adopt – i.e., the new standard applies for annual periods beginning after December 15, 2018, and for interim periods within annual periods that begin one year later. Therefore, a calendar year-end nonpublic entity would first apply the new standard for the year ending December 31, 2019. If it also prepares interim financial statements, the new standard would first take effect for those interim periods in 2020.

All entities are allowed to early adopt the new standard for annual reporting periods beginning after December 15, 2016.

- ▶ Public companies that elect early adoption must also apply the new standard to interim periods within the year of adoption.
- ▶ Nonpublic companies electing early adoption would apply the new standard to interim periods beginning one year later. To demonstrate, calendar year-end nonpublic entities that early adopt the new standard could do so for the year ending December 31, 2017. Interim periods would first reflect the new standard in the following year (e.g., the first quarter ending March 31, 2018).

SOFTWARE INDUSTRY CONSIDERATIONS

The following examples demonstrate how the new guidelines may affect companies in the software industry. We encourage you to read these examples in connection with our publication [BDO Knows FASB: Topic 606 Revenue from Contracts with Customers](#), which describes the requirements of the new standard in more detail.

The interpretations contained within this publication could continue to evolve. As we continue to study the new standard and monitor implementation efforts at the FASB and American Institute of Certified Public Accountants (AICPA), we may update our guidance within this publication.

Distinct Performance Obligations within PCS

Under current U.S. GAAP, there is no accounting distinction between the various types of maintenance and support activities that software companies provide to customers. Services such as phone support, bug fixes, and delivery of when and if available (unspecified) updates and product enhancements are all combined into a single accounting unit known as post-contract customer support, or PCS. In general, the portion of the arrangement fee allocated to PCS is recognized ratably over the period that services are being rendered.

The new revenue rules require companies to more closely analyze the various activities that comprise maintenance and support. It is possible that some of these activities might be considered distinct and therefore change the pattern in which revenue is recognized relative to today's accounting guidelines.

To demonstrate, assume that Xlog Inc. sells perpetual software licenses bundled together with one year of PCS. Upon closer analysis, though, Xlog determines that the PCS is made up of two components:

- ▶ Offering 24/7 telephone or internet support for user questions and
- ▶ Unspecified software upgrades on a when and if available basis.

Historically, Xlog issues around one or two software upgrades per year, but the company has gone as long as 18 months without issuing any updates.

The new revenue guidance requires separate promises in the contract such as the license, installation, maintenance and support to be treated as distinct performance obligations if:

² A "public entity" is one that meets the definition of a "public business entity" in the ASC Master Glossary, as defined in ASU 2013-12. Under ASU 2014-09, "not-for-profit" entities that have issued (or are conduit bond obligors for) certain securities will apply the same effective date as public business entities. Employee benefit plans that file or furnish financial statements with the SEC are also considered public. All other entities are considered "non-public" under the new revenue recognition standard.

- ▶ The customer can benefit from the license, installation and support services either on their own or together with other resources that are readily available to the customer. A readily available resource includes a good or service that the entity will have already transferred to the customer under the contract.
- ▶ The performance obligations are distinct from one another within the context of the contract. Notably:
 - The nature of the promise to the customer is to provide individual goods and services, rather than a combined item,
 - The installation services (or the maintenance) are not a required input to produce a functional software license,
 - Neither the installation nor maintenance services significantly customize the software license, and
 - None of the performance obligations are highly interrelated with or interdependent on one another.

In this arrangement, there are likely three distinct performance obligations:

- ▶ The software license
- ▶ Telephone/internet support
- ▶ The provision of when and if available updates.

Each of these performance obligations is distinct on its own. For instance, the software is delivered before the other services and remains functional without the updates and the technical support. In addition, each performance obligation is distinct within the context of the contract. For example, the software updates will modify the software but not significantly. Also, licensees can continue to use the software after the initial PCS period lapses at the end of one year without renewing the PCS arrangement.

Assuming that the software license is conveying the right to use Xlog's intellectual property (IP) as of a point in time, revenue allocated to software license would be recognized when control over the license is transferred to the customer. The support services would be recognized over time on a straight-line basis, as Xlog is providing a service of standing ready to answer questions every day as needed. Similarly, Xlog would likely recognize revenue related to providing software upgrades over time as well, as the nature of this performance obligation is similar to the telephone support – i.e., standing ready to perform.

Note that if the facts were changed slightly, the pattern of revenue recognition may be altered as well. For example, assume Xlog promised the customer additional functionality that would be included in its software upgrades during the PCS period. In this fact pattern, it may be that Xlog has provided the customer with both an unspecified upgrade right and a specified upgrade right. If Xlog has provided a specified upgrade right, it will have to allocate a portion of the transaction price to this performance obligation and defer recognition of those revenues until the specified upgrade is delivered.

Vendor-Specific Objective Evidence (VSOE)

It is quite common for software companies to sell multiple goods and services to a customer as part of a single transaction. For instance, a software developer may agree to provide a software license, installation services and one year of telephone support under a customer contract.

At present, there are special accounting rules for companies that sell bundled software and/or software-related deliverables. These rules prescribe when elements within a multiple-element, or bundled, software arrangement can be accounted for as separate accounting units. In summary, these rules state that:

- ▶ If an arrangement includes multiple elements, the total arrangement fee should be allocated to the various elements based on vendor-specific objective evidence of fair value, or VSOE, regardless of any separate prices stated in the contract for each element.
- ▶ However, if sufficient VSOE does not exist for the allocation of revenue to the various elements of the arrangement, they will be accounted for as a single unit, and all revenue from the arrangement shall be deferred.
- ▶ If the only undelivered element is PCS and VSOE does not exist for PCS, the entire transaction price should be recognized ratably over the support period.

The new revenue rules eliminate these guidelines. In particular, companies will no longer be required to have VSOE to separate elements in a bundled software arrangement, which will be a significant change in practice.

Instead, as previously discussed, software companies will consider whether various aspects of a customer contract represent distinct performance obligations.

Distinct performance obligations are treated as separate accounting units. The total transaction price is allocated to distinct performance obligations using a relative standalone selling price methodology, which will be discussed in more detail in the next section of this publication.

To demonstrate these concepts, assume that Vizzy LLC licenses enterprise software that helps businesses track network traffic. Nearly every license arrangement includes one year of PCS. The PCS comprises 24/7 telephone, online or email support. PCS is renewable for successive years at the discretion of the customer. Vizzy has also concluded that the license and PCS are distinct performance obligations in this example.

Vizzy has a wide range of transaction prices for both its software licenses and its PCS renewal rates. In particular, only about 40 percent of the actual prices Vizzy charged on PCS renewals falls within ± 15 percent of the median price (well short of the 80-85 percent threshold commonly looked to in practice to support having VSOE for the PCS).

Nonetheless, under the new revenue recognition rules, Vizzy would separate the license and PCS deliverables even though Vizzy does not have VSOE for the PCS. This is because the license and PCS are distinct individually, as well as in the context of the contract in this example. In other words, the customer can benefit from the software license and the PCS independently, and:

- ▶ The nature of the contract is to provide a license and separate PCS, rather than a combined item.
- ▶ The PCS is not a required input to produce a functional software.
- ▶ The PCS does not significantly modify or customize the software.
- ▶ The PCS and the software are not highly interrelated or interdependent, meaning that the customer could decide to not purchase PCS without significantly affecting the functionality of the software in any way.

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Note that Vizzy would also have to consider whether a particular contract contains a third performance obligation—a renewal option that provides a “material right.” For example, a customer could be transferred a material right if the PCS renewal price is at a lower price relative to what is typically offered to the same class of customer in a given geographical area or market.

If the option provides a material right to the customer, Vizzy would:

- ▶ Identify a third performance obligation in the arrangement.
- ▶ Allocate a portion of the arrangement consideration to this performance obligation using a relative standalone selling price approach. The new standard provides guidance and an example of how to estimate the standalone selling price of the option.
- ▶ Recognize the revenue related to this third performance obligation when the customer exercises the option or it expires.

Specified Upgrades and Product Roadmaps

Today's GAAP contains somewhat punitive rules when companies offer “specified upgrade rights” to customers. For example, a software company may deliver a license to v9.2 of a software product immediately and agree to deliver a v10.0 release when available that will include three or four additional features. Assume that the customer will be able to obtain a reasonable amount of utility from v9.2 of the software without the specified upgrades.

Chances are, the software company will not have VSOE for the specified features, as they are not even commercially available yet. Unfortunately, this means that the software company will have to fully defer all revenues under the arrangement until the upgraded software features are delivered to the customer.

This same accounting outcome might not occur under the new revenue guidelines. Instead, the software license and the specified upgrades would be viewed as distinct performance obligations, if:

- ▶ The customer can benefit from the license and the upgraded features individually.
- ▶ The performance obligations are distinct from one another within the context of the contract, as the nature of the promise to the customer comprises transfer of functional software and future updates, rather than a combined item. In other words, the customer does not need the upgraded feature set for the licensed software to function and provide utility to the customer.

Therefore, if the above conditions were met, the software company would be able to potentially recognize some revenue upon transferring control over the v9.2 software license to the customer and the rest when the v10.0 software (containing the additional features) is released.³

The new revenue rules may provide an opportunity for software companies to reconsider their policies around sharing product roadmaps with customers. At the moment, many software developers avoid specific discussions with customers around future version releases for fear of inadvertently introducing a performance obligation – for instance, by implicitly agreeing to develop a certain feature set that will not have VSOE. If the developer accidentally introduces a specified upgrade obligation, revenues from every current transaction with that customer would be deferred (under today's GAAP) until the feature set was delivered.

However, under the new revenue recognition rules, the future deliverables will typically be distinct from the current software license and other performance obligations. In other words, the performance obligations delivered today and the feature sets to be delivered in future releases usually won't be significantly interdependent or interrelated (or inputs to produce a combined output) and thus will be considered distinct under the new revenue guidelines.

Term Licenses

Software is typically provided to customers through either perpetual or time-based (term) licenses.

Under today's GAAP, revenues from perpetual software licenses may be recognized upon delivery, provided the license can be unbundled from other deliverables in the arrangement, such as PCS.

In contrast, revenues associated with time-based licenses are often recognized ratably over the license term because the current rules make it very difficult to establish VSOE for PCS bundled with a term license.

As indicated earlier, an absence of VSOE for undelivered elements in the arrangement does not preclude upfront revenue recognition for a software license under the new rules. Rather, under ASC 606, a licensor would evaluate whether the license is distinct from other performance obligations in the arrangement. If so, then the license and the PCS would be considered separate performance obligations, regardless of whether the license was time-based or perpetual.

The new accounting rules contain a different approach to determining whether revenues from any license agreement – term or perpetual – should be recognized over time or at a point in time. The new rules require the licensor to evaluate whether the license provides a right to:

- ▶ Use the licensor's intellectual property (IP) as it exists at the point in time at which the license is granted. This is known as a "functional license." A functional license allows the licensee to perform some sort of action or task based on underlying intellectual property to which the licensee will have usage rights. For instance, a functional license to software allows the licensee to process transactions, perform calculations or otherwise use the underlying functionality of the licensed software.
- ▶ Access the licensor's IP as it exists throughout the entire license period, including any changes or enhancements to that IP (referred to as a "symbolic license").

Revenue allocated to a symbolic license would be recognized over the term of the license period. Revenue attributable to a functional license is recognized at a point in time, when control over the license is transferred to the customer and the license term has commenced.

To demonstrate, assume that Wicky Ltd. licenses option pricing software under a two-year term license. Wicky has a historical practice of providing when and if available updates for bug fixes and of making general improvements to the interface or reports. Wicky will also occasionally issue updates when a new type of option instrument is introduced into the marketplace and gains popularity.

In evaluating the accounting for this arrangement, Wicky first determines whether the software license and the updating services are distinct performance obligations. Wicky might decide that both performance obligations are:

- ▶ Capable of being distinct – that is, the customer can benefit from each the two performance obligations individually.
- ▶ Distinct within the context of the contract.

³ For simplicity, assume there are no other performance obligations in the arrangement such as technical support.

Therefore, the term license, as well as the update services, are distinct performance obligations. Wicky would then evaluate whether the license grants the customer access to Wicky's intellectual property over the license period, or use of Wicky's IP as it existed when the license was granted.

Wicky would likely conclude that the license provides functional use of Wicky's IP as it existed at license inception, meaning that Wicky would recognize the revenue attributable to the term license at a point in time, when control over the license is transferred to the customer. Control is often granted via providing access to a website through which the customer may download the software, through provision of an access key or through physically installing the software on the customer's premises. Control typically coincides with commencement of the license term.

In reaching this accounting conclusion, Wicky would not consider that the IP underlying the license may be updated or enhanced over the two-year license term because it had previously concluded that this service represents a separate performance obligation.

A very different accounting outcome can occur if the promised updates are not considered to be distinct performance obligations. For example, assume that another company, Icky Co., grants one-year term licenses for its antivirus software. In addition, Icky updates the virus definitions daily for any new threats that are detected.

In this fact pattern, Icky might conclude that the service of providing the virus definitions is not distinct in the context of the contract from the one-year term license. Simply, a license to software that protects only against current, but not future, virus threats would provide a very limited benefit to a customer. Hence, the accounting unit would be the combined license and the virus definition updates service. Revenues from the combined unit would be recognized over time under the new revenue guidelines.

Professional Services

Many software providers offer professional services to their customers, including training, consultation, system integration, or software customization and implementation.

Current accounting standards require companies to distinguish between arrangements that involve:

- ▶ The significant production, modification or customization of software and
- ▶ All other services.

When the arrangement requires significant production, modification or customization of software, the software developer will apply contract accounting. Typically, this would result in revenues for the entire arrangement being recognized on a percentage of completion basis over the period the services are being provided (assuming all other revenue recognition criteria have been met). In practice, progress toward completion is typically estimated using input measures, such as costs incurred to date relative to total costs expected to fulfill the contract.

When the arrangement involves other types of professional services, the seller must determine whether there is VSOE for the fair value of those deliverables. In addition, the seller must conclude that the services are not essential to the functionality of any other elements of the transaction and that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services.

- ▶ If all three of these conditions are met, then those services can be separated from other elements in the arrangement. Assuming the other elements in the arrangement qualify for separation as well (for example, there is VSOE for any bundled PCS), revenues allocated to those services are recognized as the services are performed or, if the pattern of delivery is not discernible, on a straight-line basis over the service period. Revenues associated with other elements in the arrangement would be recognized as those goods or services were delivered.
- ▶ If one or more of the aforementioned criteria are not met, there a number of possible accounting outcomes.
 - For instance, if VSOE does not exist for any of the elements, the arrangement will have one unit of accounting, and revenue will be recognized ratably over the longer of the service period or the PCS period. Varying practices exist as to when revenue recognition may commence.
 - In another permutation, assume there is VSOE for PCS but not for the other services. Also assume that PCS starts after the completion of the other services. In this particular fact pattern, revenues would be allocated to the PCS based on VSOE, with the residual arrangement consideration allocated to the combined license/other services element. Revenue from this combined license/

other services deliverable would be recognized upon completion of the other services, while revenue allocated to PCS would be recognized ratably over the PCS period.

As illustrated in earlier examples, under the new revenue recognition rules, the absence of VSOE does not require entities to bundle performance obligations. Rather, a software company will have to evaluate whether the professional services and any other performance obligations are distinct (i.e., should be accounted for separately) and whether revenues should be recognized at a point in time or over time.

To demonstrate, assume Great GL licenses accounting platforms and provides customers with installation services as well. The installation services involve significant customization of the software to properly work on the customer's existing computer systems. The installation itself is complex, and the underlying software code is not open source – hence, there are no other vendors besides Great GL who can implement its software.

Under the new revenue guidelines, Great GL must evaluate whether the following goods and services are distinct:

1. License to the software
2. Installation services

In making this evaluation, Great GL would consider not only whether each good or service is distinct in isolation but also within the context of the contract.

Based on the fact that the installation services involve significant customization that is required for the customer to derive a benefit from the software license, Great GL concludes that all promised goods and services would be combined into a single accounting unit.

Great GL would then have to evaluate whether the bundled performance obligation should be recognized over time or at a point in time. Great GL would recognize revenues over time – i.e., as installation services are being performed – in either of the following situations (presuming the facts are supported by enforceable contractual provisions):

1. The customer has obtained control over the underlying asset (i.e., the license term has commenced), as well as any enhancements Great GL has made to the licensed software and the customer's other systems through its customization and integration services.
2. The customer doesn't have control over either the software license or the enhancements, but:
 - Great GL's work to date creates an asset that doesn't have an alternative use to anyone besides the customer (i.e., the customized solution cannot be sold or licensed to someone else), and
 - Great GL has incorporated an enforceable right to payment into the contract for any performance completed to date. Such payment would not only cover Great GL's costs incurred at any point in time throughout the contract cycle but would allow the company to generate a reasonable profit margin as well.

If Great GL determines that it should recognize revenues over time, the new revenue rules require Great GL to select an appropriate method of measuring progress towards satisfying the performance obligation. Appropriate methods of measuring progress include:

- ▶ Output methods (e.g., achievement of defined milestones) and
- ▶ Input methods (e.g., labor hours incurred relative to total estimated labor hours to satisfy the performance obligation).

Selecting the measure of progress is not a free choice. The new standard requires that the measure of progress be based on the nature of the goods and services being transferred to the customer. For performance obligations such as installation, software companies might determine that input measures are the most appropriate measure of progress under the new accounting rules. This could be a change in practice for companies today that recognize revenue based on the achievement of certain milestones.

The new standard will require companies to critically review and inventory all stated and implied contractual rights and carefully apply professional judgment. Subtle changes in contractual provisions or business practices could result in very different accounting outcomes. For instance, if the installation services did not involve significant customization of the software and were routinely performed by other vendors, Great GL might have determined that the installation services were distinct from the software, and the revenue recognition pattern would have been very different than what was previously outlined. In this scenario, the revenues allocated to the installation services might still be recognized over time, assuming the contract provisions met the criteria for over-time recognition, but the revenues allocated to the license would be recognized when the customer obtained control, i.e. had the ability to use the license. If control does not transfer until after the installation services are complete, the license-related revenues would be recognized later in this scenario than in the previous example.

Extended Payment Terms

Under today's GAAP, there are four conditions that must be met before revenues can be recognized. Two of those four conditions indicate that:

- ▶ Collectibility of any amounts due from customers must be probable.
- ▶ The arrangement fee must be "fixed or determinable."

Today's rules provide further clarification around these two conditions, expressly requiring the deferral of revenue recognition if payment terms extend more than 12 months from the date of delivery of a software license. This is because historically in the software industry, providing extended payment terms increased the likelihood that customers sought (and obtained) future concession in the form of a price reduction or additional deliverables. Accordingly, the arrangement fee wasn't actually fixed or determinable. Also, the extended payment terms made it difficult to assert that collectibility was probable.

Under the new revenue guidelines, there will no longer be "bright-line" or prescriptive requirements like the 12-month extended payment restrictions in current GAAP. Instead, future price concessions are considered a type of variable payment. Potential variability in the transaction price may not preclude revenue recognition. Instead, the variability will be considered when estimating the transaction price as follows:

- ▶ First, companies will estimate the amount of variable consideration to which the entity is entitled. Depending on the nature of the variable consideration, the estimate may be based on a most likely amount or an expected value, considering probability-weighted assumptions.
- ▶ Companies will not necessarily include the full estimated amount of variable consideration as part of the transaction price. Instead, an entity will include in the transaction price some or all of an estimate of variable consideration only if it is "probable" that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is subsequently resolved. In this way, the amount of variable consideration included in the transaction price is "constrained" to an amount that is not likely to be reversed in the future.

To demonstrate these principles, assume that RTX sells software licenses to resellers. Historically, RTX has never allowed its customers to return any transferred licenses. However, the resellers tend to delay payments to RTX, especially when market demand for the software is low. In addition, RTX has often agreed to grant price concessions or provide credits against future purchases when RTX customers have had difficulty reselling the licenses to end users.

Because of these practices, RTX currently applies a "sell through" method of revenue recognition, meaning that RTX does not recognize revenue until its customers (the resellers) sell through the software licenses to end customers. This practice is appropriate because the de facto extended payment terms and price concessions make the arrangement fee variable—and not fixed or determinable.

Under the new revenue guidelines, RTX should first ensure that it has an enforceable contract with the customer (and that it is not a consignment arrangement, meaning that control over the licenses has transferred to the customer). To be within the scope of the new revenue standard, it must be "probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer." If this condition is not met, a valid customer contract does not exist. This means that revenue will not be recognized until one of the following events occurs:

- ▶ The software company has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable.
- ▶ The contract has been terminated, and the consideration received from the customer is nonrefundable.
- ▶ The software company has transferred control of the goods or services to which the consideration that has been received relates; it has stopped transferring goods or services to the customer (if applicable) and has no obligation under the contract to transfer additional goods or services; and the consideration received from the customer is nonrefundable.

Therefore, companies should carefully distinguish between:

- ▶ Adjustments to the transaction price for concessions or other variable consideration, versus
- ▶ Situations in which the customer doesn't have the wherewithal to pay the amounts to which the seller is entitled, which may lead to an outcome similar to today's deposit method of accounting.

If RTX concludes that it has a valid contract, it should then estimate the transaction price, the amount it believes it is entitled to in exchange for transferring goods and services to the customer.

Assume that for a given reseller arrangement, the stated contract price is \$1,000 per license. RTX transfers control of 200 licenses to this reseller. Although it will take up to 13 months, RTX believes that it will be paid for all 200 licenses. However, the following table outlines RTX's expected estimate of the ultimate price it will receive after considering concessions that it may grant. In practice, making estimates of the price concessions and other forms of variable consideration will involve judgment.

Consideration for all 200 licenses	Individual Probability of Occurrence	Cumulative Probability of Occurrence	Extended Value
\$200,000	5%	5%	\$ 10,000
\$190,000	10%	15%	19,000
\$180,000	15%	30%	27,000
\$170,000	20%	50%	34,000
\$160,000	30%	80%	48,000
\$150,000	15%	95%	22,500
\$140,000	5%	100%	<u>7,000</u>
			\$167,500

The table indicates that the weighted-average expected transaction price, considering variable consideration, would be \$167,500. However, RTX would limit the amount of revenue recognized to \$160,000. This is because this level of revenue is 80 percent likely to occur on a cumulative probability basis, and RTX is constrained to only recognizing revenue that is probable of not being reversed in future periods.

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Because payment is expected to extend beyond one year, RTX should consider whether the arrangement price includes an explicit or implicit element of financing. If so, the transaction price should be adjusted accordingly.

For instance, assume that if RTX were to be paid with normal 30-day terms, the company would only be entitled to \$750 per license. This suggests that of the expected \$800 per license transaction price (\$160,000 / 200 licenses), \$50 relates to implicit financing. Moreover, RTX believes that the implicit interest rate of 6.67 percent (\$50 on a "principal" balance of \$750, paid over one year) is consistent with the discount rate that would be reflected in a separate financing transaction involving RTX and its customer.

Accordingly:

- ▶ RTX would estimate its transaction price to be \$750 per license, or \$150,000.
- ▶ Over the expected 13-month payment period, RTX would accrete interest income of \$50 per license.

Under the new revenue guidelines, companies should consider whether there might be an implicit element of financing any time there is more than a one-year difference between the receipt of payment and the transfer of goods and services. For instance, software companies may need to consider whether there is an implicit significant element of financing when customers prepay for multiple years of maintenance and support.

Variable Consideration, Including Royalties and Usage-Based Fees

As mentioned in the previous section, the new revenue guidelines require companies to include an estimate of variable consideration in the transaction price to the extent that such amounts are not likely to be subject to a significant reversal.

There is one exception to this principle. Under no circumstance should an entity include an estimate of sales-based or usage-based royalties associated with an IP license in the transaction price. Royalty revenues should only be recognized once the related sales or usage occur.

Consider this example: QTI sells software licenses to a reseller. Key terms of the customer arrangement are as follows:

- ▶ Each license is priced at \$500. In addition, QTI will receive a five percent royalty on every sale from the reseller to the end user (i.e., the reseller's customer).
- ▶ If the reseller purchases 1,000 or more licenses within a six-month period, QTI will provide a three percent cumulative rebate on all purchases.

In estimating the transaction price, QTI should not reflect any amounts relating to the five percent royalty because the new revenue recognition rules fully constrain estimates of sales-based or usage-based royalties associated with an IP license. These royalties should not be recognized as revenues until the subsequent sale or usage occurs.

Conversely, QTI should consider whether to include an estimate of the three percent rebate in the transaction price based on historical experience with similar incentive programs as well as the current sales forecast and other relevant information.

It is important to realize that the limitation related to sales and usage-based royalties only applies to IP licenses and not other types of contractual arrangements. For instance, assume that Server Hosts offers cloud-based storage services to its customers. Before providing these services, Server Hosts requires its customers to "click to agree" to a standard online licensing agreement. The agreement does not allow the customer to use the software without the hosting services and has a one-year duration. It is renewable at the end of the contract term based on current market rates at that time.

The pricing for Server Hosts' platform depends on the amount of data a user uploads to the site. For instance:

- ▶ <5 gigabytes (GB): Free
- ▶ 5-50 GB: \$100 per month
- ▶ >50 GB: \$175 per month + \$50 for each incremental 100 GB of storage utilized

In this example, Server Hosts concludes that it is providing Software-as-a-Service (SaaS) and not a license to intellectual property as that term is described in ASC 606-10-55-54. Therefore, the sales-based or usage-based royalties exception would not apply.

BDO OBSERVATION

In this Server Hosts example, it has been presumed that the nature of the arrangement involves a single performance obligation that contains a variable fee based on usage.

In practice, it may be difficult to differentiate whether a contract includes a usage-based fee that should be treated as variable consideration, or optional goods and services that may or may not represent a material right.

For example, assume that Server Hosts has a second SaaS offering that allows users to hold meetings and collaborate online. Server Hosts charges a fixed annual fee of \$10,000 for this service, which permits up to 10 persons to join a collaboration session at a given moment. If the customer decides to have more than 10 persons participate at a time, the customer will be charged an incremental usage fee of \$0.10 per minute per additional user.

Some practitioners may view the additional usage charges as a usage-based fee, which should be accounted for as variable consideration – i.e., estimated as part of the transaction price and subject to the constraint. Other practitioners might instead view the additional usage charges as optional goods and services, which would be given no initial accounting consideration unless the pricing was at a significant discount, giving rise to a material right (as discussed earlier in this publication).

A similar issue was discussed by the Transition Resource Group (TRG). TRG members agreed that judgment will be necessary in determining whether similar contractual provisions should be viewed as variable consideration (usage-based fees) or optional goods and services. Companies can consider the following factors in making that determination:

- ▶ ***The nature of the promise to the customer.*** A company likely has a usage-based fee arrangement if the contract contains a single site-wide access right, but the fees vary based on the number of users consuming the SaaS offering or the amount of information processed through the SaaS offering. In contrast, if the arrangement contains a price per end user, and the customer can select how many end users need access, the arrangement appears to contain optional goods and services rather than a usage-based fee.
- ▶ ***Whether the customer has to make a separate purchasing decision.*** If a customer has to select whether to acquire a good or service, it is likely that the arrangement contains optional goods and services. Said another way, the contract likely contains an optional good or service if the seller has no obligation to provide those items (and no right to receive consideration) until and unless the customer makes a separate purchasing decision.
- ▶ ***How the pricing in the arrangement is structured.*** In many but not all cases, arrangements in which there is a fixed fee for the basic service and additional fees for "add-on services" would contain optional goods and services. Again, the seller would need to consider whether the optional services represent a material right; if not, then no accounting recognition is given to the optional goods and services until and unless the customer elects to purchase those additional items. On the other hand, if the contract pricing varies after the goods and services have been transferred to the customer, the contract is more likely to contain variable consideration. For example, if the arrangement fee automatically adjusts based on parameters such as the number of page views a piece of software generates or the "stickiness" of a web page, the arrangement contains variable consideration rather than optional goods and services.

Cost of Contracts with Customers

Existing GAAP does not contain explicit guidance on the accounting for costs of obtaining and fulfilling a customer contract. As a result, there is disparity in practice around how companies record these types of costs – that is, as a:

- ▶ Period expense, or
- ▶ Deferred charge amortized over the life of the customer contract.

The new revenue requirements provide specific guidelines on the accounting for both the incremental costs of obtaining and the costs incurred in fulfilling a contract:

- ▶ *Incremental costs of obtaining a contract* should be deferred and amortized on a systematic basis consistent with the pattern in which revenue related to the contract is being recognized. As a practical expedient, an entity may recognize the incremental costs of obtaining a contract as a period expense if the amortization period would have been one year or less.
- ▶ *Costs incurred in fulfilling a contract* should be accounted for similarly, except there is no practical expedient to immediately expense these costs, even if the related contract will conclude in one year or less.

To demonstrate, assume Service Shop Ltd. uses external agents to sell its services in the marketplace. Each time a deal is closed, Service Shop remits a one percent commission to the external agent. In addition, Service Shop typically incurs \$50 of legal costs in drafting contracts for each customer arrangement and \$25 in performing credit checks of new customers.

Service Shop recently closed a \$10,000 transaction with a new customer to deliver hosting services over a two-year period. For the sake of simplicity, assume that external agent will be entitled to the same commission if the customer elects to renew the arrangement after the initial two-year period. Because the maintenance and support services to be performed under the contract will extend beyond one year, Service Shop has no choice but to defer the incremental costs of obtaining a contract.

- ▶ In this example, Service Shop would defer \$100 of cost related to the external commissions (1 percent x \$10,000). These costs would not have been incurred except for the fact that Service Shop obtained a new contract. The costs would be amortized proportionally in the same pattern that revenues from the contract will be recognized.

- ▶ Note that the legal and credit review costs would not be deferred, as they are not incremental costs of obtaining a contract. To clarify, both of these costs still would have been incurred if, at the last possible moment, the customer decided not to move forward with the deal. As a result, these costs were not incurred only due to obtaining the customer contract.

BDO OBSERVATION

In November 2016, the TRG concluded that:

- ▶ All commissions paid should be considered incremental costs to obtain a contract if they would not have been incurred absent the contract. For example, assume that if a new contract is signed, the salesperson directly involved in the sales efforts will receive a five percent commission, and her manager will receive a three percent commission. Both commission payments should be considered incremental costs of obtaining a contract because neither amount would have been paid absent signing the contract.
- ▶ When an entity pays commissions at both contract signing and at any renewal periods, it should consider whether it qualifies for the practical expedient of immediately recording the incremental payments as a period expense. The only way the practical expedient would apply is if (a) the commissions paid at contract renewal are **commensurate** with (b) the commissions paid at contract signing.
 - For example, assume Crestfallen enters into a one-year, renewable contract with a customer. Crestfallen pays a five percent commission on contract signing to its sales lead and will pay that same individual a smaller one percent commission upon contract renewal. The difference in the renewal rates stems from Crestfallen's belief that the level of effort necessary to obtain a renewal is far less than initially entering into a new deal.
 - The FASB staff indicated that the "level of effort" to obtain a contract or renewal should not factor into determining whether the commission paid on a contract renewal is commensurate with the initial commission. Instead, a renewal commission is commensurate with an initial commission if the two commissions are reasonably proportionate to the respective contract values (e.g., both are two percent of the amounts invoiced to customers). Therefore, if a contract does not contain commensurate commissions, the initial commission would relate to a contract period beyond the initial term. In our example, Crestfallen would not qualify for the practical expedient and instead would defer and amortize the initial commissions over a period that considers both the initial contract term and any expected renewals.

Amounts Billed to Customers

Sometimes, existing U.S. GAAP contains prescriptive guidelines on whether certain amounts billed to customers should be reported on a gross or net basis. For example, reimbursement of out-of-pocket expenses that are billed to customers must be presented as revenues in the income statement.

In other circumstances, current GAAP allows companies to make an accounting policy election on how to present amounts billed to customer on behalf of others. In particular, companies can elect to present sales tax and similar items, such as goods and services tax (GST) and value added tax (VAT):

- ▶ On a gross basis, in which the billings are included in revenues and any amounts due to governmental authorities presented as costs, or
- ▶ On a net basis, with both the amounts billed to customers and owed to the taxing authorities netted in a single line on the income statement.

The new revenue guidelines state that "amounts collected on behalf of third parties" – such as some taxes – should be excluded from revenue. Unfortunately, the new rules contain no other details or examples on how to apply this principle.

The new revenue rules do permit companies, as a practical expedient and an accounting policy election, to exclude amounts collected from customers for all sales (and other similar) taxes from the transaction price – that is, to present such transactions on a net basis. If a company does not elect this practical expedient, it must assess each tax collected under the principal versus agent guidance in ASC 606-10-55-36 through 55-40 in order to determine whether a transaction should be presented gross or net of taxes.

TRANSITION METHODS

For both public and nonpublic entities, a full retrospective approach is available, under which entities may avail themselves of certain practical expedients. If a retrospective approach is not applied, then entities will use a cumulative effect approach. More specifically:

1. A full retrospective approach would apply the default method of adopting new accounting standards in ASC 250. Each prior period presented would follow the guidance in paragraphs 250-10-45-5 through 45-10.
2. Similarly, a retrospective approach can be used in conjunction with various types of practical relief. That is, entities can choose any of the following accommodations:
 - (i) Contracts that are completed before initial application and begin and end in the same annual reporting period would not need to be restated under the new revenue recognition standard.
 - (ii) Hindsight may be used in assessing contracts that contain variable consideration. That is, entities are allowed to use the final transaction price at the date the contract was actually completed, rather than estimating the variable consideration at inception.
 - (iii) Entities are not required to disclose the amount of a contract's transaction price that was allocated to the remaining performance obligations or an explanation of when those obligations are expected to be recognized as revenue for reporting periods presented before the date of initial application.
 - (iv) Entities can elect to reflect the aggregate effect of all modifications that occur before the beginning of the earliest period presented when identifying the satisfied and unsatisfied performance obligations, determining the transaction price, and allocating the transaction price to the satisfied and unsatisfied performance obligations.

Under the cumulative effect approach, an entity would apply the new revenue standard only to contracts that are incomplete under legacy U.S. GAAP at the date of initial application (e.g., January 1, 2018 for a calendar year-end public company) and recognize the cumulative effect of the new standard as an adjustment to the opening balance of retained earnings. That is, prior years would not be restated. However, additional disclosures would be required to enable users of the financial statements to understand the impact of adopting the new standard in the current year compared to prior years that are presented under legacy U.S. GAAP.

BDO OBSERVATION

Many companies might assume that the cumulative effect transition approach would be easiest to implement. This may not be the case, however, for some types of organizations, including:

- ▶ **Companies that have longer-term contracts.** The cumulative effect transition approach applies to contracts that are incomplete at the date of initial application (e.g., January 1, 2018 for a calendar year-end public company). For companies with longer-term contracts – such as enterprises that offer multi-year maintenance and support contracts – calculating the adjustment to opening retained earnings may require substantial effort, including analysis spanning back many reporting periods. The requirement to defer contract costs and amortize them over the expected period of benefit, which may extend beyond the contract term, may further complicate the analysis.
- ▶ **SEC registrants.** Under the cumulative effect transition approach, companies will not restate prior periods. Therefore, it may be challenging for public companies to craft Management's Discussion and Analysis (MD&A) in their SEC filings, especially when comparing the results of operations for periods immediately before and after the adoption of the new revenue guidelines.
- ▶ **Companies whose financial systems are limited.** In the year of adoption, companies electing the cumulative effect transition approach must disclose how their financial statements would have looked had existing accounting rules continued to be applied. Such companies will need to keep two sets of accounting records in the initial year of adoption, which may be difficult for businesses whose financial systems are not equipped to do so.

In addition, using a cumulative effect transition approach may result in unusual trends for some companies, including revenues that may seemingly disappear. To demonstrate, assume Developer Co., a calendar year-end public business entity, transfers control of a software license to a customer on December 31, 2017. The license provides the customer the right to use the software as it exists on that date.

BDO OBSERVATION

Developer Co. also agrees to provide one year of maintenance and support services, commencing January 1, 2018. Both the license and the services are considered distinct performance obligations under the new revenue guidelines. Based on a relative stand-alone selling price allocation approach:

- ▶ \$800,000 of the total transaction price is allocated to the license, and
- ▶ \$200,000 of the total transaction price is allocated to maintenance and support services.

Had the new revenue guidelines been in effect, Developer would have recognized \$800,000 of revenues from the transfer of the functional software license in 2017.

However, assume Developer does not have VSOE for the maintenance and support services. Under today's GAAP, Developer would not be able to recognize any revenue for this transaction in 2017, when the license was transferred. Instead, Developer would recognize the entire \$1,000,000 arrangement fee ratably over the one-year maintenance and support period in 2018.

If Developer applies a cumulative effect transition approach, \$800,000 revenues associated with the license would never appear in the income statement. This is because prior periods are not restated under the cumulative effect method of transition. Hence, the 2017 comparative income statement would not reflect the revenues from transferring the software license based on the accounting rules in place at that time. Similarly, these revenues would not be reported in the 2018 income statement because they would have been recognized on December 31, 2017 under the new revenue guidelines. In effect, the \$800,000 of license revenues disappear, ending up as part of the adjustment to opening retained earnings on January 1, 2018.

In summary, management should carefully evaluate which method of adopting the new standard is appropriate for its circumstances. It will not always be the case that applying the cumulative effect transition approach will involve the least effort or best reflect a company's financial trends across all periods presented in the financial statements.

NEXT STEPS FOR MANAGEMENT

Assess the impact – Management should continue to assess the potential impact of the new standard on each specific revenue stream of the entity. To initiate this process, financial reporting professionals should be trained in the new standard.

Select a transition method – Management should continue to assess the available transition methods. Conversations with the company's financial statement users and peer companies may be useful for this purpose. Note that the SEC staff has provided relief to companies that apply a retrospective transition approach. Specifically, the SEC staff would not object if a registrant only restates the five-year selected financial data table for the same periods included in the audited financial statements. Earlier periods would not need to be recast. However, disclosure of this election would be required to highlight the inconsistency.

Maintain and update Staff Accounting Bulletin (SAB) 74 disclosures – Public entities should continue to include SAB 74 disclosures about the anticipated effect of the new pronouncement. These disclosures will become more specific over time. At the 2016 AICPA Conference on Current SEC and Public Company Accounting Oversight Board (PCAOB) Developments, the SEC staff noted that SAB Topic 13, Revenue Recognition, applies prior to the adoption of the new revenue recognition standards. Thereafter, registrants should evaluate revenue arrangements under ASC 606. The staff also indicated that it will assess any implementation-related consultations under ASC 606 similarly (i.e., without regard to SAB Topic 13). See our [SEC Year in Review](#) publication for further discussion regarding the conference and other SEC developments and example SAB 74 disclosures.

Revise internal controls – Management, particularly of public companies, will likely need to revise documented processes and controls to ensure they are sufficient to prevent or detect misstatements under the new guidance, and during the implementation process. Furthermore, public entities must report changes in the entity's internal controls in the period they occur. The SEC's Chief Accountant recently reminded registrants that "companies will need to design and implement internal controls to evaluate the application of the standard to a company's specific facts and circumstances." In addition, the Chief Accountant noted that "the preparation of the transition disclosures [under SAB 74] should be subject to effective ICFR and disclosure controls and procedures."

Stay on top of investor communications – Management and boards will need to anticipate the effect on earnings to set expectations for investors, lenders, analysts and other stakeholders.

Revise debt covenants – Management may need to discuss similar changes with lenders to revise debt covenants impacted by revenue, such as EBITDA and times-interest earned ratios.

Assess current contract terms – Management may consider possible changes to its standard contracts.

Determine implications on income taxes – The changes in timing of revenue recognition may result in changes in current taxable income since many entities use U.S. GAAP to determine revenue recognition for income tax purposes. The new standard may also impact an entity's deferred taxes. Since an entity's income tax accounting depends on specific facts and circumstances, consultation with a tax advisor may be useful. See our [Flash Report](#) on tax implications of the new standard.

Consider changes to compensation and other revenue-based metrics – Management may consider possible changes to compensation arrangements that are driven by revenue, if the timing or pattern of the entity's revenue recognition changes under the new guidance.

Follow developments on the new standard – Companies should monitor the activities of the AICPA and the FASB Transition Resource Group. This may be particularly relevant for matters involving a high degree of judgment, where previous U.S. GAAP may have been more prescriptive. In addition, management should stay informed on SEC developments, including any amendments the Commission may make to its own staff interpretations on revenue recognition.

Prepare to make judgments and estimates – In some situations, management will be required to make more estimates and use more judgment than under current guidance, such as estimates related to variable consideration discussed above. Those matters will be highlighted for users through increased disclosure requirements.

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