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BDO KNOWS: SOFTWARE

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REVENUE FROM CONTRACTS WITH CUSTOMERS – SOFTWARE INDUSTRY

OVERVIEW

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*. ASU 2014-09 establishes comprehensive accounting guidance for revenue recognition and will replace substantially all existing U.S. GAAP on this topic. ASU 2014-09 is converged with IFRS 15, the comparable new standard issued by the 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 utilizes 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, and
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 could be significant and will require careful planning.

▼ NOTE: THESE DATES MAY CHANGE ▼

EFFECTIVE DATE

Public entities[1] will apply the new standard for annual periods beginning after December 15, 2016, including interim periods therein. Early adoption is prohibited. Therefore, a calendar year-end public entity would reflect the new standard in its first quarter ended March 31, 2017, each subsequent quarter, and also in the year ended December 31, 2017.

Nonpublic entities have an additional year to adopt, i.e., the new standard applies for annual periods beginning after December 15, 2017. In addition, the new standard is effective for interim

1 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.

HOW DO I GET MORE INFORMATION?

Additional resources are available on BDO's Revenue Recognition Resource Center, including an in-depth publication with examples and practical considerations.

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periods within annual periods that begin after December 15, 2018. Therefore, a calendar year-end nonpublic entity would first apply the new standard for the year ended December 31, 2018. If it also prepares interim financial statements, the new standard would first take effect for those interim periods in 2019.

However, nonpublic entities are allowed to early adopt the new standard as follows, if they choose to do so:

- The new requirements may be applied no earlier than an annual reporting period beginning after December 15, 2016, including interim reporting periods within that period. This would mirror the effective date for public entities.
- They may be applied for annual reporting periods beginning after December 15, 2016 and interim periods within annual periods beginning after December 15, 2017. In other words, calendar year-end nonpublic entities would apply the new standard for the year ended December 31, 2017. Interim periods would first reflect the new standard in the following year, e.g., the first quarter ended March 31, 2018.
- They may be applied for an annual reporting period beginning after December 15, 2017, including interim periods within that period. In this scenario, calendar year-end nonpublic entities would apply the new standard to the year ended December 31, 2018. Interim periods in that year would also reflect the new standard, e.g., the first quarter ended March 31, 2018.

On April 1, 2015, the FASB decided to propose a one-year delay of the effective date for the new revenue recognition standard that it issued jointly with the IASB in 2014. If the proposal is finalized, the revenue recognition standard will take effect in 2018 for calendar year-end public entities. It would take effect for private entities in 2019.

The proposal will include an option for public and private entities to early adopt using the original effective dates, which is designed to provide flexibility for different companies in various stages of their implementation efforts.

For more information, read the full FASB Flash Report

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 are preliminary. As we continue to study the new standard and monitor implementation efforts at the FASB and 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. Things like phone support, bug fixes, and delivery of, when and if available, (unspecified) updates and product enhancements are all lumped into a single accounting unit known as 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 make a closer analysis of 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 24x7 telephone or internet support for user questions
- Unspecified software upgrades on a when and if available basis.

Historically, Xlog issues around 1-2 software upgrades per year, but the company has gone as long as 18 months without issuing any updates.

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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 utilize 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 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 each and 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 wait to record revenues from this performance obligation 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 postcontract customer support (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 big change in practice.

Instead, software companies will consider whether various aspects of a customer contract represent distinct performance obligations. For example, a software license, installation, and maintenance and support services would each be considered distinct performance obligations if:

- 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. For instance:
  - The integration services are not significant nor do they significantly customize the software license, and
  - None of the performance obligations are highly interrelated with or interdependent on one another.

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

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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 24x7 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% of the actual prices Vizzy charged on PCS renewals falls within ±15% of the median price (well short of the 80-85% 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 PCS is not:

- An integration-type service
- Significantly modifying or customizing the software license
- Highly interdependent on or interrelated with the software license, meaning that the customer could decide to not purchase PCS without significantly affecting the license in any way.

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 some of the arrangement consideration to this performance obligation using a relative selling price approach. The new standard provides guidance and an example on 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 develop three or four additional features that will be included in a v10.0 release that will be provided to the customer when available.

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 would not occur under the new revenue guidelines. Instead, the software license and the specified upgrades could be viewed as distinct performance obligations, as:

- 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 – for example, the customer does not need the upgraded feature set for the licensed software to function and provide utility to the customer.

Therefore, 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 customer's requested features) is released[2].

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 may 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.

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

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This same accounting outcome is not likely to result under the new revenue recognition rules, as 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 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:

- Access the licensor's intellectual property (IP) as it exists throughout the entire license period, including any changes or enhancements to that IP, or
- Simply use the licensor's intellectual property as it exists at the point in time at which the license is granted.

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 to make 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, in that the performance obligations are not highly interrelated or interdependent on one another.

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 is granted.

Wicky would likely conclude that that the license provides 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 (i.e., upon 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.

Note that during a February 18, 2015 Board meeting, the FASB tentatively decided to propose clarifying guidance indicating that licenses involving:

- *Functional* intellectual property, such as software, would typically result in revenue recognition at a point in time, whereas,
- *Symbolic* intellectual property, such as brand or trade names, would result in revenue recognition over time.

Hence, the conclusions reached in this example are likely consistent with the FASB's proposed clarifications.

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A very different accounting outcome can occur if there is a slight change in the facts. 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 customer may not purchase a license to software that protects only against current, but not future, virus threats. 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 towards 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 that 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 discernable, 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 account 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 that 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 would have to 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 as well.

Based on an evaluation of these facts, assume that Great GL concludes that all performance obligations would be combined into a single accounting unit.

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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 free choice. The new standard requires that the measure of progress be based on the nature of the goods and services that are 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 those companies that today 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.

Extended Payment Terms

Under today's industry-specific GAAP for software, 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.

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, though. 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.

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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 drag out payments to RTX, especially when market demand for the software is low. In addition, RTX has often agreed to make 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). If so, RTX should then estimate the transaction price, the amount that 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%	7,000
			$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% 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.

On another note, 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, then 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% ($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. So software companies may need to consider whether there is an implicit element of financing when customers prepay for multiple years of maintenance and support.

There is one other nuance around extended payment terms under the new revenue guidelines.

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To even 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, there is not a valid customer contract. This means that revenue cannot be recognized until all goods and services are provided, the entity has collected the amounts to which it's entitled, and the amounts received are 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.

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 intellectual property (IP) license in the transaction price. Royalty revenues should only be recognized once the related sales or usage occur.

Here is a quick example: QTI sells software licenses to a reseller. Key terms of the customer arrangement are as follows:

- Each license price is priced at $500. In addition, QTI will receive a 1% 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 3% cumulative rebate on all purchases.

In estimating the transaction price, QTI should not reflect any amounts relating to the 1% royalty because the new revenue recognition rules fully constrain estimates of sales-based or usage-based royalties associated with an intellectual property (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 3% 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 this limitation only applies to sales and usage-based royalties associated with IP licenses and not from 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 in described in ASC 606-10-55-54. Therefore, the sales-based or usage-based royalties exception would not apply, and Server Hosts would estimate variable consideration when determining the transaction price. Specifically, the company would have to predict the level of usage customers will consume and include this estimate in the transaction price, subject to the constraint discussed in the previous section of this publication.

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During a February 18, 2015 Board meeting, the FASB decided to clarify the scope and applicability of the implementation guidance on sales-based or usage-based royalties promised in exchange for a license of intellectual property as follows:

1. An entity should not split a single royalty into a portion subject to the sales-based and usage-based royalties exception and a portion that is not subject to the royalties constraint (and, therefore, would be subject to the general guidance on variable consideration, including the constraint on variable consideration).
2. The sales-based and usage-based royalties exception should apply whenever the predominant item to which the royalty relates is a license of intellectual property.

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 that Service Shop Ltd. uses external agents to sell its services in the marketplace. Each time a deal is closed, Service Shop remits a 1% 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 the customer (if a new buyer).

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% 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.

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.

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The new revenue guidelines don't allow for this sort of policy selection. Instead, the new rules 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.

Companies that currently present sales taxes on a gross basis could potentially be most affected. The new revenue guidelines might require that amounts billed to customers on behalf of many taxing authorities be netted against the related costs.

Of note, the FASB and IASB have formed a joint transition resource group to help analyze issues arising from implementation of the new revenue recognition standard. One of the first topics the group examined involved the presentation of amounts billed to customers on behalf of others. The group reached no conclusions, but reaffirmed that application of the principle requires a case-by-case examination of each and every amount billed on behalf of others to customers.

Additionally, in March 2015, the FASB agreed to propose a practical expedient to allow an election for net reporting for all in-scope sales taxes with disclosure of the policy.

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 Topic 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 up to three forms of practical relief. That is, entities can choose to use one, two or all three of the following accommodations:
   (i) Contracts that begin and end in the same annual reporting period would not need to be restated under the new revenue recognition standard.
   (ii) Contracts that contain variable consideration can use hindsight. 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 adoption.

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, 2017 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.

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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, 2017 for a calendar year-end public company). For companies with longer-term contracts – such as enterprises that offer multi-year maintenance and support contacts – calculating the adjustment to opening retained earnings may require substantial effort, including analysis spanning back many reporting periods.
– **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, 2016. The license provides the customer the right to use the software as it exists on that date.

Developer Co. also agrees to provide one year of maintenance and support services, commencing from January 1, 2017. Both the license and the services are considered distinct performance obligations under the new revenue guidelines. Based on a relative standalone 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 the 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 software license in 2016.

However, assume that 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 2016, 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 2017.

If Developer applies a cumulative effect transition approach, $800,000 revenues associated with the license would never appear in any financial statements! This is because prior periods are not restated under the cumulative effect method of transition. Hence, the 2016 comparative financial statements 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 2017 financial statements because they would have been recognized on December 31, 2016, 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, 2017.

In sum, 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 begin evaluating 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 begin considering the available transition methods. Conversations with the company's financial statement users and also peer companies may be useful for this purpose. Note that the SEC staff has announced that it would provide relief for 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 that are 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.

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Develop SAB 74 disclosures – Public entities will need to begin drafting SAB 74 disclosures about the anticipated effect of the new pronouncement. While these disclosures will become more specific over time, the SEC staff has informally indicated it expects entities to disclose their chosen method of transition in the period that a decision is reached, which will vary across entities. See our SAB 74 Flash Report for an example. Likewise, SEC registrants should remain alert for any changes to SAB 104, including a possible rescission. The SEC staff has not yet indicated what its plans are on this point.

Investor communications – Management and boards will need to anticipate the effect on earnings in order to set expectations for investors, lenders, analysts, and other stakeholders.

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

Contract terms – Management may consider possible changes to its standard contracts.

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.

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. Further, public entities must report changes in the entity's internal controls in the period they occur.

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 joint FASB/IASB 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. Also, management should stay informed on SEC developments, including any amendments the Commission may make to its own staff interpretations on revenue recognition.

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.