Technology Companies and Revenue Recognition: Sorting Through the Complexities

Jim Steiner and Jill Nussbaum

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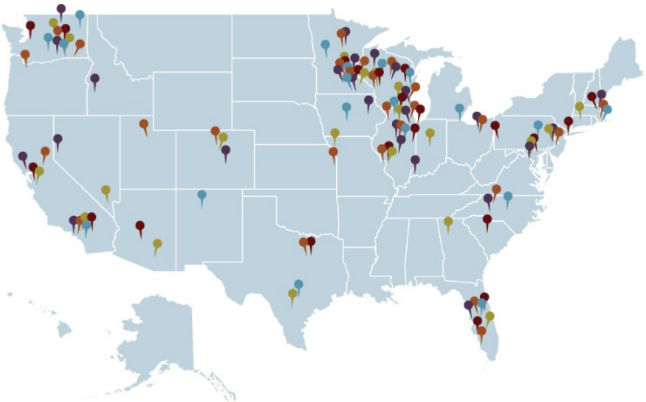

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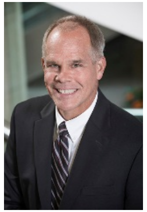
Speaker Introductions

Jill Nussbaum, CAST Director

Jill is an engagement director in the Consulting and Accounting Solutions Team with over 30 years of combined experience in public accounting and financial leadership roles with global technology and manufacturing companies. Jill possesses extensive knowledge in application of the new revenue recognition standard. She has worked as part of CLA's team to establish the tools and processes for implementing the new standard. Jill's ASC 606 implementation experience includes companies of all sizes and within various industries, including medical device, software, manufacturing, construction and media.



Jim Steiner, Principal

Jim is an assurance principal with more than 30 years of combined experience in public accounting and private industry. Jim works in CLA's National Assurance Technical Group where his focus is on the technology industry. In his role, Jim provides guidance and training to engagement teams and clients on a variety of technical issues.

Learning Objectives

- At the end of this session, you will be able to:
  - Identify key areas of potential change or emphasis for technology companies under ASC 606 vs. legacy guidance
  - Understand the necessary steps for implementing the updated revenue recognition standard
- Content in this presentation assumes participants have a base level knowledge of the ASC 606 five-step revenue model

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Part 1:
Key areas of potential change or emphasis for technology companies under ASC 606 vs. legacy guidance

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Key Areas of Potential Change – Overview

Legacy Guidance:	New Guidance under ASC 606:
VSOE required to separate deliverables	VSOE not required; separation dependent on meeting “distinct” criteria
Software and PCS in on-premise term-based license recognized together over term	Software recognized upfront; PCS over term
Set-up fees in SaaS contracts recognized over customer life	Absence of set-up fees on renewal may require deferral for a material right
No recognition of contingent revenue; price must be fixed and determinable	No similar prohibition; required to be estimated
Financing component not as likely to apply	More likely to include a “significant financing component”

Key Areas of Potential Change – Overview
(continued)

Legacy Guidance:	New Guidance under ASC 606:
Residual approach default method for valuing software license	Residual approach applicable only when price is "highly variable" or "uncertain"
No specific guidance re: allocation of discounts	Allocate proportionately to all performance obligations unless specific criteria are met
Fixed fee professional services -- varying interpretations applied in pattern of revenue recognition	If specific criteria met, recognized over time based on appropriate input/output method
Royalty revenue reported on a lag relative to timing of customer usage	Royalties applicable to usage period are to be estimated; no lag reporting
Capitalizing contract acquisition costs optional	Incremental contract acquisition costs required to be capitalized, subject to 1 year practical expedient

Determination of distinct performance obligations

VSOE is no longer required to separate revenue recognition between delivered software license and undelivered PCS and professional services:

- Ability to separate recognition of revenue between software license and undelivered PCS and professional services is dependent on whether each is considered a separate performance obligation based on meeting the "distinct" criteria (*under ASC 606-10-25)*.

- Absence of VSOE will not prevent separate recognition. However, if an observable standalone selling price or VSOE cannot be established, standalone selling price is required to be estimated.

Determination of distinct performance obligations

Software license and maintenance/PCS bundled together in an on-premise term-based software license (non SaaS) will typically each be considered distinct performance obligations requiring different timing of revenue recognition:

- As the software license represents "right to use" functional IP, the transaction price allocated to the license is recognized when control to the software is transferred to the customer (upon providing access to the software and license term has begun).
- Maintenance/PCS is recognized over the contract term as the customer benefits from the service.
  - Additional complexities may arise in allocation of transaction price under certain circumstances.
- Bundled services under a core hosted SaaS arrangement will generally continue to be treated as a single combined performance obligation recognized ratably over contract term.

Determination of distinct performance obligations

Treatment of fees for set-up or activation activities that provide little or no value to the customer independent of the follow-on SaaS service:

- Under legacy GAAP, fees set-up or activation are deferred and recognized over estimated customer life.
- Under ASC 606, <u>if no material right is provided</u>, these types of fees are combined with related performance obligation(s) and recognized over the contract's noncancellable term.
- A material right may arise when the absence of another set-up fee upon renewal provides an incentive to the customer to renew. When this occurs, a portion of the transaction price is deferred for recognition over the period that the absence of the fee continues to provide an incentive to renew.

Determination of transaction price

Transaction price is no longer required to be "fixed and determinable" to recognize revenue:

- Under ASC 606, an entity is required to estimate the impact of uncertainties and other variable consideration and include in the transaction price at contract inception if it concludes that it is probable that the estimate is not subject to a risk of significant revenue reversal.
- May result in an acceleration in timing of revenue recognition compared to legacy GAAP.

Determination of transaction price

Transactions may be more likely to include a "significant financing component":

- Transactions may be more likely to require an adjustment of the transaction price for a financing component if deemed significant at the contract level.
  - Payments received from customers more than a year in advance of transferring good/service ==> increase transaction price and recognize interest expense.
    - *For example, a customer's upfront payment of a full three-year SaaS or PCS contract.*
  - Payments received from customers more than a year after transfer of good/service ==> reduce transaction price and recognize interest income.
    - *For example, customer's payment for software license is expected to be received more than a year from the transfer of the license.*
  - Certain exceptions apply when payment timing is not driven by financing considerations.

Allocation of transaction price

Transaction price is to be allocated to each performance obligation in proportion to estimated standalone selling price, potentially requiring a pricing analysis:

- A pricing analysis may be required to determine observable standalone selling price within customer class for each performance obligation.
  - Arrived at from an analysis of standalone sales, maximizing observable inputs, e.g., a potential method is a bell-shaped curve pricing analysis.
- If observable standalone selling prices are not available, the guidance requires entities to estimate the standalone selling price, maximizing the use of observable inputs.
  - 1) *Adjusted market assessment approach 2) Expected cost plus a margin approach 3) Residual approach*
- Standalone selling price is required in assessments of whether options for future products/services, including renewals, provide a material right to the customer.

Allocation of transaction price

The residual approach was the default method for estimating standalone selling price of a software license under legacy guidance. New guidance requires specific criteria be met to use the residual approach:

- Entities cannot default to the residual approach for allocating transaction price to the software license unless the license pricing is "highly variable" or "uncertain“ AND all other performance obligations in the transaction have observable standalone selling prices.

- For many software vendors, a perpetual software license is rarely, if ever, sold separately from PCS; as such, the standalone selling price could be deemed to be uncertain.

  - ➢ As a result, in the case of a software license, the residual approach may be the method that maximizes the use of observable inputs.

Allocation of transaction price

Use of the residual approach for estimating standalone selling price must meet specific criteria *(continued):*

- If criteria for use of residual approach are not met, entities are required to arrive at the estimated standalone selling price of the license (and other deliverables) maximizing the use of observable inputs and allocate the total transaction price between the software license and other performance obligations in proportion to the estimated standalone selling price for each.

Allocation of transaction price

Allocation of discounts or variable consideration:

- Required to be allocated to all performance obligations in a contract in proportion to estimated standalone selling price unless:
  - The entity has observable evidence (as specified under ASC 606-10-32-37 and 606-10-32-40) that the entire discount or variable consideration relates to one or more, but not all, performance obligations in a contract.

Recognize revenue as performance obligations are satisfied

Determination of whether control is transferred to customer over time or at a point in time:

Over time satisfaction

Yes ← Customer receives benefits as entity performs/another entity would not need to re-perform
(e.g., SaaS services or T&M based professional services)

OR

Yes ← Create or enhance an asset the customer controls
(e.g., customization of an on-premise software license or website)

OR

Yes ← Does not create asset w/alternative use to the entity
AND
Enforceable right to payment* for work to date
(e.g., customized products / consulting services with report)

If none are met, then → **Point in time satisfaction**

* Cost plus a reasonable margin

Recognize revenue as performance obligations are satisfied

Professional services ("PS") typically meet one or more criteria for over time recognition. Recognized over time based on a measure of progress using an input or output method that best depicts timing of transfer of control to customer:

- Fixed fee PS that do not provide a significant customization service, i.e., are distinct from software, SaaS or other products/services:
  - Typically recognized using an input method such as cost to cost (costs incurred to date vs. total expected costs).

- Fixed fee PS that significantly customize the software or SaaS:
  - Software license – PS combined with software as a single performance obligation and combined fee recognized using a single measure of progress as service is performed, e.g., cost to cost may be appropriate.
  - SaaS – PS is combined with SaaS as a single performance obligation, PS fee is deferred and combined with SaaS fee for recognition over SaaS term; ratable recognition may be appropriate.

Recognize revenue as performance obligations are satisfied

Sales- or usage-based royalties/fees promised in exchange for a license of IP:

- Recognized at the later of when:
  - the customer's subsequent sales or usage to which the royalty relates occurs, or
  - the performance obligation is satisfied or partially satisfied

- Represents an exception to the variable consideration guidance of ASC 606 which would otherwise require the royalties to be estimated upfront and included in the transaction price for recognition when the performance obligations are satisfied.

- In a departure from legacy GAAP, reporting royalties on a lag is no longer acceptable.
  - If the royalty report has not been received before reporting deadline, an estimate of royalties earned is required.

Incremental costs of obtaining a contract with a customer

Incremental costs to obtain a contract (e.g., sales commissions) may be required to be recognized as an asset:

- Capitalized costs are recognized over the period the entity expects to recover those costs, i.e., the initial contract term plus anticipated renewal periods, unless a renewal period commission is commensurate with the initial year commission (i.e., at the same commission rate).

- As a practical expedient, an entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

- Under legacy GAAP, entities were allowed to make a policy election to either expense sales commissions when the liability was incurred or capitalize and recognize over the period that the deliverable was satisfied.

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Part 2:
Steps for implementing the new revenue standard

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What steps are required to implement ASC 606?

Phase 1
Project Establishment and Planning

- Establish a steering committee
- Establish a project team
- Establish a project plan

Phase 2
Current State Assessment

- Identify revenue streams
- Assess contract characteristics and customary business practices for providing goods/services to customers
- Document initial observations of potential areas of impact under ASC 606
- Develop contract sample selection from each homogeneous revenue stream

Phase 3
Contract Review

- Perform sample contract review
- Research and document application of 5-step revenue model to each contract
- Identify key findings:
  - ✓ Required changes in accounting treatment
  - ✓ Where current processes align with ASC 606
- Document findings and application of 5-step model in adoption memo
- Review with external auditors

What steps are required to implement ASC 606?

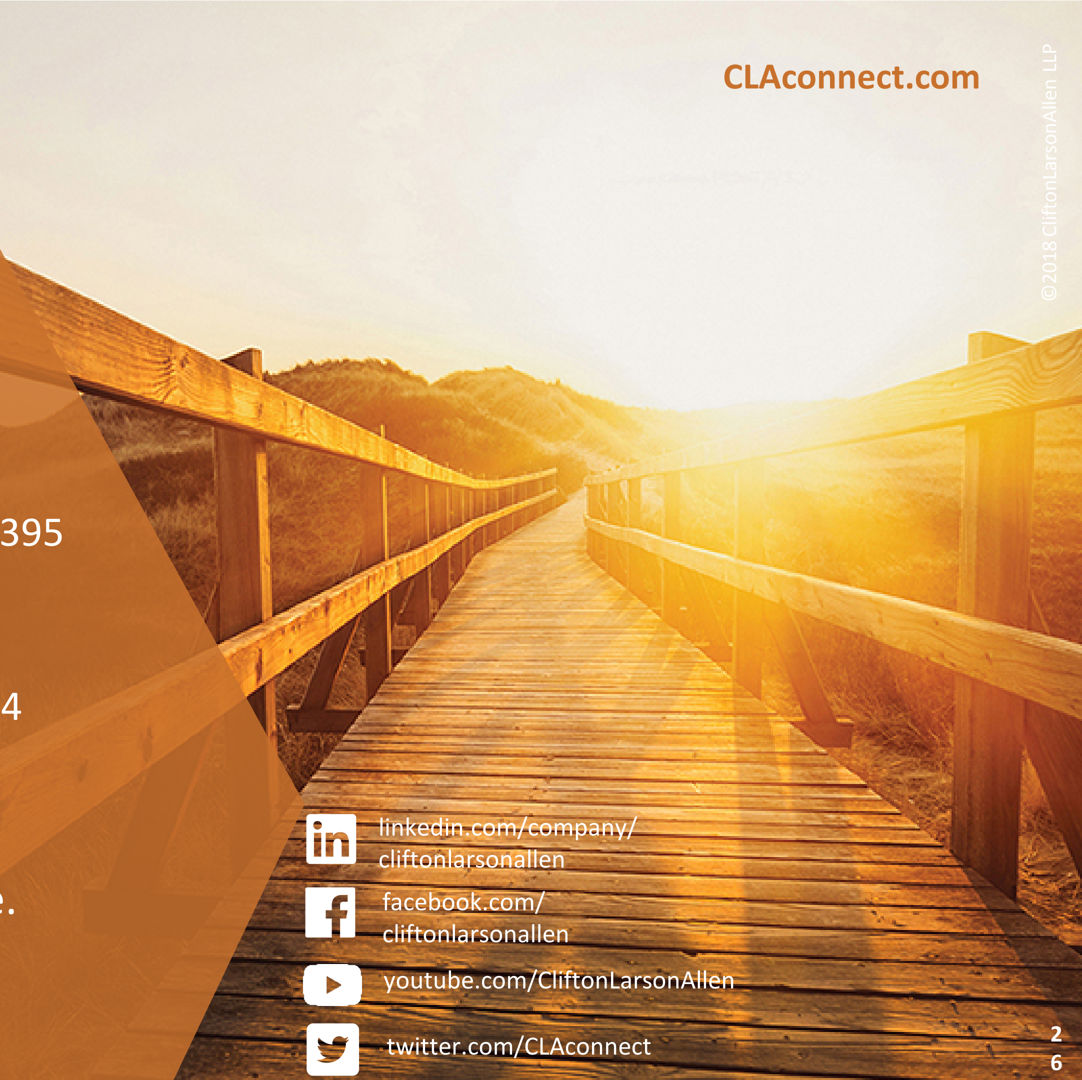
Phase 4
Functional Area Analysis

- Functional area impact analysis and training
- Identify required changes to business processes:
  - ✓ Accounting policies and procedures to record revenue
  - ✓ ERP and related system changes
  - ✓ Sales contract terms
  - ✓ Employee compensation plans
  - ✓ Tax impacts from changes in timing in book revenue recognition
- Functional area project plans

Phase 5
Implementation

Finalize adoption method

- Determine cumulative effect adjustment, if applicable
- Implement required changes to procedures and processes based on functional area reviews:
  - ✓ Revise existing accounting and reporting processes
  - ✓ Process documentation to comply with controls requirements
- Draft new expanded disclosures
- Deliver updates to key stakeholders



Questions?

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