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Software CXO Highlights
Common Themes Related to Applying the New Revenue Standard

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The FASB's new standard on revenue recognition is effective for annual reporting periods beginning after December 15, 2017, for public entities. For all other entities, it is effective for annual reporting periods beginning after December 15, 2018. Early adoption is permitted for annual reporting periods beginning after December 15, 2016.

While the new standard will affect entities differently depending on their facts and circumstances, we have briefly summarized for corporate executives (CXOs) some of the common themes associated with its application by entities in the software sector.

Elimination of VSOE Requirement

Under current U.S. GAAP, software organizations must demonstrate vendor-specific objective evidence (VSOE) of the fair value for each undelivered element (a high hurdle). Failure to demonstrate VSOE, generally through stand-alone sales, can result in ratable revenue recognition or full revenue deferrals until certain conditions are met.

Under the new revenue standard, the VSOE requirement to separate elements is eliminated, and an organization must use judgment to determine the value (known as the "stand-alone selling price") of each performance obligation in an arrangement. As a result, revenue is generally accelerated.

The elimination of the VSOE requirement may put pressure on entities to maintain pricing discipline. The VSOE requirement under current guidance, although prescriptive, provided a built-in mechanism for maintaining pricing-related discipline. The new standard's framework, which is more judgment-driven, removes the built-in pricing boundaries that the VSOE requirement imposed on organizations.

Determining the Value of a License

Under current U.S. GAAP, an entity is not required to establish the fair value of a license that is delivered up front since it can use the residual method. Many organizations have not focused on pricing strategies for licenses. Under the new standard, they must evaluate the license value, either to demonstrate what the value is or, if the license value is highly variable or uncertain, that the residual method (which is expected to be used infrequently) is acceptable.

Hybrid Licenses

Software is no longer either on the premises or on the cloud — it can be located in either or both places depending on how it is introduced to the market and delivered to customers. In a hybrid arrangement, an entity must use significant judgment to determine whether the on-premises license and cloud-based solution are highly interrelated or interdependent and whether they should be accounted for separately or as one combined obligation. Depending on the outcome of this analysis, the associated revenue could differ significantly on the basis of the transfer of control (e.g., predominately upon delivery of the license, or ratably over time).

Hosting and Term-Based Licenses

Under current U.S. GAAP, organizations are not able to separate a software license from postcontract customer support (PCS) if the term of the license is one year or less and requires VSOE of the PCS for separate recognition of the license. Similarly, for hosted arrangements in which customers have the legal right to take possession of the software license during the contract, revenue is frequently recognized ratably under current U.S. GAAP because of the absence of VSOE for undelivered elements in the arrangement. Under the new standard, such requirements are eliminated, which generally results in the recognition of more revenue upon delivery.

Additional Users Versus Additional Usage

An arrangement may give the customer an option to obtain additional licenses for an incremental fee ("additional users") or may permit additional usage of a single license already controlled by the customer ("additional usage"). To distinguish between additional users and additional usage, an organization must use judgment that is based on the nature of the arrangement and software product. If the organization concludes that the rights represent additional users, it will evaluate the rights on the basis of the guidance on additional copies (discussed below). If it concludes that rights represent additional usage, it will generally recognize the rights when that usage occurs.

Additional Copies

Existing software guidance permits entities to use a practical expedient that lets them contractually discount additional copies of their software previously sold (including tiered volume-purchase discounts) without deferring any revenue from the initial transaction. Under the new revenue standard, entities must use judgment to determine whether such future discounts warrant deferral.

Royalty and Resellers

Currently, many organizations recognize royalty revenue once royalty reports are received (e.g., one month in arrears). Similarly, under current U.S. GAAP, arrangements with resellers may result in the recognition of revenue upon sell-through. Under the new standard, organizations are generally required to estimate royalty revenue in the period in which the activity occurs and to estimate the timing and price of reseller arrangements at the point of sell-in.

Contract Cost

Under current U.S. GAAP, the decision to capitalize commissions (and similar costs) is a policy election that can be made only if such costs are direct and incremental to obtaining the contract. Under the new standard, **direct and indirect** incremental costs attributable to the acquisition of a contract **must** be capitalized unless the amortization period is one year or less. An organization must also use judgment to determine the costs associated with renewals and an appropriate amortization period.

Contract Modifications

The new standard establishes a framework for accounting for contract modifications that does not exist under current U.S. GAAP. An organization must use judgment to determine whether the modification, including changes to the transaction price, should be accounted for as a separate contract, as a modification with a prospective adjustment, as a modification with a retrospective adjustment (cumulative catch-up), or under a combination of these methods.

Limitation of Revenue (Contingent Revenue Guidance)

Under current U.S. GAAP, revenue on delivered items is limited if it is subject to refund for failure to provide future deliverables (referred to as "contingent revenue"). While the new standard does not require the deferral of contingent revenue, it introduces a new requirement to limit revenue (referred to as the "constraint") to the amount for which sufficient confidence exists that no reversal will be made at a later date. This change could result in earlier revenue recognition for certain contracts.

Billings

Current guidance generally limits the amount of revenue to be recognized under extended payment term arrangements, including in those contracts with increasing annual billings. There is no such limitation under the new standard. As a result, revenue can exceed billings, and the offset of this entry is recorded as an unbilled receivable. The new standard also requires an organization to evaluate the billing structures to determine whether implied financing is provided, which could result in the reclassification of a portion of the revenue as interest income or expense.

Termination Provisions

Certain software arrangements include termination provisions that allow the customer to end the contract before it expires. The treatment of termination provisions under the new standard can be complex. Such provisions may affect the transaction price allocated to the various elements in a contract as well as the financial statement disclosures. For example, disclosure of remaining performance obligations (discussed below) may only include amounts not subject to certain termination provisions.

Separation Criteria

The evaluation process under the new standard for determining whether elements in a contract should be accounted for separately from one another is different from that under current U.S. GAAP. As a result, conclusions an organization reaches under the new standard may be different from those it reached under current U.S. GAAP. For example, some software organizations may conclude that PCS should be separated into multiple obligations (e.g., updates, phone support). In addition, in limited circumstances, an organization may conclude that PCS and the software license should be combined for accounting purposes, which would cause the associated revenue to differ significantly (e.g., predominately upon delivery of the license, or ratably over time).

Fixed, Sales-Based, or Usage-Based fees

Some arrangements include fixed, sales-based, or usage-based license fees. Accounting for these arrangements requires the use of judgment. Fixed fees, even if paid over time, would generally need to be allocated to the license and PCS, which is likely to accelerate revenue recognition. Fees based on sales or usage are generally recognized when the sales or usage occurs.

Term License Renewals

Under current U.S. GAAP, an organization may recognize the license portion of a term license renewal at the time the renewal is signed, even if it is signed before the beginning of the renewal period, as long as all other recognition criteria were met. The new standard requires organizations to wait to recognize the license portion until the customer can use and benefit from the license, which is generally at the beginning of the license renewal period.

Concessions

Price concessions give customers an incentive to renew or upgrade and can be common in software arrangements. Under current U.S. GAAP, a history of price concession can lead to a significant deferral of revenue; under the new standard, such concessions are estimated at the onset of the arrangement and will generally result in revenue deferral that is less significant.

Disclosures

The new standard requires organizations to disclose much more information about revenue activities and related transactions than they do under current U.S. GAAP. For example, under the standard's new quantitative and qualitative disclosure requirements, software companies will need to provide information about (1) performance obligations (including disclosures commonly referred to as "backlog disclosures"), (2) significant judgments and estimates, (3) contract assets and liabilities (including rollforwards of these balances), and (4) revenue disaggregated to a degree that will be partially, if not entirely, new for many entities.

Internal Control

Because of the many changes made by the new standard as well as its complexity and requirements related to using judgment, organizations will generally need to make significant revisions to their internal controls and add new controls.

Exit Considerations for Private Companies

As a result of initial public offerings and other SEC filings, private company may be required to adopt the new standard in accordance with the adoption timeline for public companies or to present an additional year of recasted results because of the new standard's scope requirements related to recasting financial information.

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