Flexible consumption models

Implications under the new revenue standard and beyond

Moving to a flexible consumption model for product and service offerings may require an evaluation of operational considerations and an analysis of revenue recognition especially given the new revenue standard (ASU2014-09)[1]

Background

Technology companies are currently in the midst of a fundamental shift to **flexible consumption**, in which customers are able to access, consume, and pay for offers and services on a need and usage basis. To make a successful **transition**, companies may not only have to change how they deliver their offerings but also determine what new capabilities, skills, and knowledge are needed to properly recognize revenue.

Flexible consumption can take a variety of forms, from subscriptions (with or without overages), to pure pay-per-use arrangements and other recurring revenue models. These models are different from traditional business models and require a different set of business know-how. As companies move to a new model, they need to look across the accounting and finance organization to identify where the capability gaps are and determine what adjustments should be made.

Depending on the specific type of flexible consumption-based model selected, companies may need a new set of capabilities to identify, track, and record revenue. Changes may impact existing business processes, organizational design, talent, and IT infrastructure. To further complicate the transition, there are a wide variety of possible arrangements for flexible consumption models that can differ in the timing of fulfillment, delivery, and payment structure (e.g., upfront payments, installments). The number of potential variations in flexible consumptions models coupled with ancillary services, such as implementation assistance, training and service maintenance, can result in significant challenges for the accounting and disclosure of revenue.

Adding to these operational challenges, the new revenue standard means that accounting and finance teams will need to perform a comprehensive review of their organizations when transitioning to a flexible consumption model.

[1] FASB Accounting Standards Update No. 2014-09, Revenue From Contracts With Customers (ASC 606)

Revenue recognition challenges

Some of the key accounting issues (under ASU2014-09[1]) and the related process and system questions organizations should consider when shifting to a flexible consumption model include:

Identifying a contract

Flexible consumption models can follow different contractual structures. A determination will need to be made on what represents an enforceable contract and when a contract with enforceable rights and obligations is in place. For subscription-based models that have "unlimited" use, identifying the contract may be fairly straightforward since a subscription agreement typically identifies the start and end dates as well as the price for that specific time period. Identifying the contract becomes more difficult and less explicit for pay-per-use type models in which the timing and quantity of services or goods to be consumer are uncertain.

Operational considerations

- Does your organization have processes and controls to identify contracts that could be impacted by ASC 606?

System considerations

- Do you have a system in place that has the capability to automate the creation and accounting treatment of a contract based on business defined criteria?

Identifying distinct performance obligations

Companies may need to use judgment when determining whether the goods or services in a contract are "distinct". More specifically, companies need to determinewhether the goods or services are, "highly dependent on, or highly interrelated with, other goods or services promised in the contract", or whether they "significantly modify or customize" other goods and services in the contract if goods and services do not represent distinct performance obligations, entities may need to account for a bundle of goods or services as a single performance obligation (formerly identified under 605 as an unit of account).
X-As-a-Service (XaaS) offerings are often bundled with other products or services, such as implementation or consulting services, in a single arrangement. Companies may find it challenging to determine whether the hosted software, hardware, and other software or services offered are distinctly identifiable, depending on the nature of each item and how the items interact with each other as part of the promises delivered to the customer. Under the new revenue standard, similar arrangements may have different perforance obligations based on how they are priced, bundled, and marketed and these factors may need to be considered in application of the "distinct in the context of the contract" guidance.

Operational considerations

- Do you have business processes in place to consistently identify and track distinct performance obligations?
- Do your contracts have considerable customization in terms of goods and services that could make this determination more complex?

System considerations

- Does your system have the flexibility to recognize revenue under different patterns for multiple performance obligations in one contract?
- Can your system handle contract modifications and automatically adjust the consideration to be recognized by performance obligation when an allocation adjustment needs to be processed?

Licensing contracts

When a flexible consumption model provides a combination of hardware, software, and/or services, companies may need to assess whether the contract is predominantly a licensing agreement (e.g., licensing of the software) or the sale of goods and services, regardless of it being a subscription model or not. Licensing agreements may have different revenue recognition patterns compared with typical goods and services arrangements due to the exception to the variable consideration constraint for sales-and usage-based royalties[2] and the requirement to assess whether the license is a "right to use" or "right to access".

Does your organization have a consistent process to differentiate licensing contracts from a typical contract for a good or service?

Operational considerations

- Have you determined the impacts to management controls in relation to the systems changes?

System considerations

- Does your system have the ability to track multiple performance obligations under one contract and recognize revenue accordingly?

Hosting arrangements

Software in a hosting arrangement is excluded from the scope of the licensing guidance in the new revenue standard when certain criteria are met. True XaaS arrangements typically occur when the customer does not have the contractual ability to take possession of the software, and therefore it may not represent a software license. If the customer has the contractual right to take possession of the software and can do so without significant penalty, the arrangement may represent a license with a hosting service.

Operational considerations

- Has your organization defined whether goods or services are truly distinct to assess hosting arrangements?

System considerations

- Does your system track multiple performance obligations under a hosting arrangement?

Variable consideration

Companies with pay-per-use models (and other pay-per-consumption models) may need to evaluate whether usage is considered variable consideration. Variable consideration is included in the transaction price to the extent that it is probable that subsequent changes in the estimate would not result in a "material reversal" of cumulative revenue. When the transaction price includes a variable amount, an entity may need to estimate the variable consideration by using either an "expected value" (probability-weighted) approach or a "most likely amount" approach based on whichever is expected to be more predictive of the amount to which the entity can be entitled[3].
Price concessions may be offered as an incentive to renew or upgrade arrangements. These concessions may represent variable consideration and would need to be estimated as described above. Companies with a history of offering price concessions or

Flexible consumption may change the pattern of revenue recognition within an organization and can result in even greater complexity to revenue recognition and further may require organizations to assess a new set of capabilities to identify, track, and record multiple revenue streams under ASU2014-09[1]

[1] FASB Accounting Standards Update No. 2014-09, Revenue From Contracts With Customers (ASC 606)

[2] See paragraph "Sales-based or usage-based royalties" for further information

[3] Variable consideration may not need to be estimated and included in transaction price if it is considered a sales-or usage-based royalty, see paragraph "Sales-based or usage-based royalties"

other incentives that represent variable consideration may need to establish a robust set of internal controls and processes for incorporating the impact of variable terms in estimating transaction price and determining the probability of any future revenue reversals.

These controls and processes would also need to take into account the requirement to update these estimates as of each reporting period. Additionally, if there are contractual price concessions or discounted renewal options, they might also need to be accounted for as material rights instead of a variable consideration if the discounts are considered material at contract inception. Companies may also need to consider tax implications around variable consideration. Tax will need to understand how and where variable consideration amounts are recorded, whether in new general ledger accounts or through modified journal entries. Variable consideration is typically not recognized for tax purposes until the amounts are fixed and determinable, thus a book to tax difference can exist.

Tax preparers will need to have a thorough understanding of the changes in accounting principles generally accepted in the United States, especially relating to variable consideration, in order to make these determinations.

Operational considerations

- Does your accounting function have the ability to determine the probable outcome of variable consideration and a process for measuring this amount?
- Do you have business processes and controls in place to continually update estimates at the end of each reporting period.
- If you have determined that variable consideration exists, have you communicated this to tax, as variable consideration is not typically recognized for tax purposes until amounts are fixed and determinable?

System considerations

- Does your system have the capability to track variable consideration accruals based on estimates to actuals?
- Does your system have the ability to estimate variable consideration based on probable outcomes?

Sales-based or usage-based royalties

For contracts within the scope of the licensing guidance, companies need to evaluate whether those contracts are subject to the sales-and usage-based royalty exception; as such a determination can impact the recognition of variable consideration. The requirement to estimate variable consideration does not apply to sales or usage-based royalties derived from the licensing of intellectual property; rather, consideration from such royalties underlying licenses of intellectual property is only recognized as revenue at the later of when the sales or usage occurs and the performance obligation with the allocated sales or usage royalty is satisfied (e.g., the uncertainty is resolved). However, in circumstances with guaranteed minimums, the sales- or usage-based royalties exception may only apply to the portion of the transaction price that is not fixed.

Operational considerations

- Does your organization have the ability to identify which contracts are predominately a service or a license?

System considerations

- Does your system have the capability to differentiate sales or usage-based royalties from other variable consideration based on business defined criteria and recognize revenue accordingly?

Material rights and renewal options

Flexible consumption models often provide an option to a customer to acquire additional goods or services. This may represent a performance obligation if it provides a "material right" to the customer that it otherwise would not have received without entering into the contract. If an option is deemed to be a performance obligation, an entity would allocate a portion of the transaction price to the option and recognize revenue when control of the goods or services underlying the option is transferred to the customer or when the option expires.

A material right may be represented by a discounted renewal rate that is incremental to the range of discounts offered to a customer of a certain classification. In this case, a portion of the transaction price of the original contract would need to be allocated to the renewal option.

Operational considerations

- Are renewal options currently identified and tracked?
- Is your organization able to estimate and allocate a portion of the transaction price to the material right?

System considerations

- Can your system automatically distinguish if renewals are a material right in which an allocation will need to take place?

Additional users versus additional usage

The flexible consumption model may allow the customer the option or right for additional users or alternatively may provide additional usage of a single license. A company in a right-to-use license arrangement may need to use judgement to determine whether the nature of the arrangement is one that provides an option to obtain additional rights or requires incremental fees to be paid for additional usage of rights already controlled by the customer.

An arrangement in which a company provides an option to the customer to obtain rights for additional users effectively promises to provide additional licenses for an incremental fee. Those optional additional purchases would not initially be included in the contract; however, they should be evaluated for favorable terms that may give rise to a material right. Alternatively, in a licensing arrangement in which an entity provides additional usage of a single license for a fee that represents standalone selling price, the fee could be considered a sales-or usage-based royalty[3]. If the license is subject to the sales- or usage-based royalty exception[2], the consideration may be recognized when the subsequent sales or usage occurs.

Operational considerations

- Does your organization have clearly defined criteria around when additional consideration needs to be applied to an existing license?

System considerations

- Is your system able to recognize additional consideration for additional usage or users?
- Does your system enable business defined rules to be applied to automatically differentiate what constitutes as additional users or additional usage?

Tiered pricing structures

Flexible consumption models can have a variety of pricing structures where prices change based on volume and/or functionality. Companies may need to assess whether their promises represent optional purchases and if these options represent material rights or whether the transaction price is simply variable. Further, if a transaction is subject to the sales- and usage-based exception[2] for licenses of intellectual property, a company should determine that revenue recognition does not occur ahead of usage. The use of a tiered pricing structure will complicate these analyses.

[2] See paragraph "Sales-based or usage-based royalties" for further information

[3] Variable consideration may not need to be estimated and included in transaction price if it is considered a sales-or usage-based royalty, see paragraph "Sales-based or usage-based royalties"

Revenue recognition challenges

Additionally, under a sales-or usage-based royalty[3] model for a license agreement, tiered pricing on usage or sales can result in a deferral of royalty revenue if the additional sales or usage does not relate to additional value. For such contracts, companies may need to consider whether the declining royalties per-usage or sales actually reflect a decline in value of the usage or sales.

Operational considerations

- Has your organization defined standalone prices for tiered pricing product offerings?
- Does your organization know how to measure the standalone value of material rights on multiple levels of tiered pricing discounts?

System considerations

- Can you system accommodate deferrals for tiered pricing licensing contracts?

Timing of revenue recognition

There may be challenges around when control has transferred to the customer given that fulfillment or delivery from contract to contract can differ in a flexible consumption model due to a mix of hardware, software, and services. If a contract contains multiple performance obligations, companies might need to have the flexibility to recognize revenue differently for each element along with the ability to track the amount of revenue recognized and the remaining amount of revenue to be recognized. A single contract could also have both point in time recognition (e.g., for the delivery of hardware) and over time recognition (e.g., for a subscription of software). Companies that have flexible consumption models may need robust systems or tools along with new processes to support the appropriate revenue recognition under ASC 606.

Operational considerations

- Has your organization considered how revenue can be recognized for contracts with a mix of hardware, software, and services?

System considerations

- Can your system manage revenue recognition for bundled contracts under one performance obligation?
- Are your systems able to differentiate point-in-time versus over- time recognition for different performance obligations?

Financial statement disclosures

The disclosure requirements within ASC606 are more comprehensive than those within the existing standard due to increased complexity which may result in additional information needing to be disclosed under the flexible consumption model. Although many companies may benefit from the disclosure relief provided by the practical expedients under ASC 606 and further clarified under ASU2016-20[4], the required disclosure assessment may be complicated for XaaS arrangements in which companies charge a fixed fee in addition to a variable fee (e.g., as usage fee).

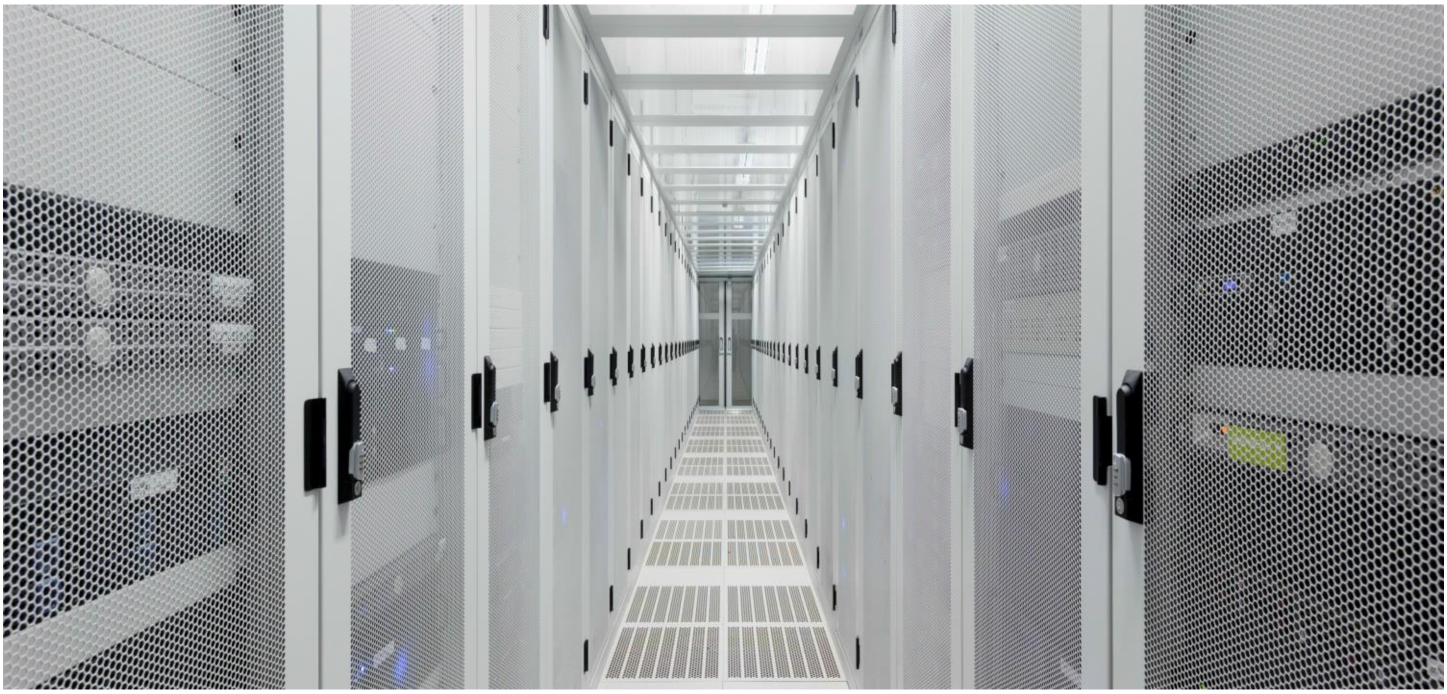
Companies with flexible consumption models may need to create disclosures related to contracts with performance obligations spanning multiple reporting periods and revenue from previously satisfied performance obligations. As an example, for a subscription agreement that spans over multiple fiscal periods, companies may need to track how much revenue has been recognized over the period of the performance obligation and disclose revenue related to the performance obligations in future periods. Additionally, if a contract has satisfied performance obligations but continues to generate revenue (e.g., in the case of licensing agreement with royalties), the revenue generated after the relevant performance obligation has been satisfied may need to be disclosed.

Operational considerations

- Does your accounting function have information needed to report disclosures?
- Does your organization have processes and controls to identify and track contracts with multiple performance obligations spanning multiple reporting periods?
- Can your organization segregate revenue derived from ongoing performance obligations from revenue on previously satisfied performance obligations?

System considerations

- Does your system have the capability and data to support the requirements related to financial disclosures?
- Do you have the necessary contract reporting tools that allow you to prepare the appropriate disclosures?
- Can your system segregate financial reporting data for contract revenue from financial reporting data for non-contract revenue?



[2] See paragraph "Sales-based or usage-based royalties" for further information
[3] Variable consideration may not need to be estimated and included in transaction price if it is considered a sales-or usage-based royalty, see paragraph "Sales-based or usage-based royalties"
[4] FASB Accounting Standards Update No. 2016-20, Technical Corrections and Improvements to Topic 606, Revenue From Contracts With Customers

Getting started

Some effective first steps to consider as you begin to evaluate the implications of the flexible consumption product offerings may include:

- Working closely with internal organization teams (e.g., contract, pricing, products, etc.,) to identify the proper contract structure to ensure alignment on revenue recognition impact is achieved in relation to the new product offerings.
- Reviewing and evaluating key contracts to identify the specific revenue recognition changes required and the specific business units where these changes may have the greatest impact.
- Assessing business readiness to handle the impact and changes to the existing operational process and system infrastructure.

How Deloitte Risk and Financial Advisory can help

We have an experienced team of professionals in the United States, and access to a team of specialists globally across the member firms of Deloitte Touche Tohmatsu Limited, who can assist in developing an action plan to help you implement the changes associated with new flexible consumption product offerings.

These capabilities includes the full breadth of services and competencies needed to help clients address these issues, and would include accounting assistance, help with process revisions, support in making system changes (including development of system business requirements), tax and other matters.

As the #1 global risk and financial advisory service provider, Deloitte is helping organizations lead with confidence, navigate risks and opportunities, and become disrupters. Using analytics and innovative methods, we advise on critical business issues and help clients accelerate performance.

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