



# REVENUE RECOGNITION READINESS CHECKLIST

A Guide for Privately Held Tech Companies



On May 28, 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued converged guidance on recognizing revenue in contracts with customers. The new guidance—FASB ASC 606 or IFRS 15, the IASB’s comparable standard—replaces substantially all existing U.S. GAAP on this topic.

While the compliance deadline for public organizations has already passed, nonpublic organizations must apply the new revenue standard to annual reporting periods beginning after Dec. 15, 2018.

Use this checklist as a starting point to gauge your readiness and prioritize next steps ahead of the deadline. Remember to communicate regularly with your investors, lenders, analysts, and other stakeholders to set proper expectations.

# Revenue Recognition Readiness Checklist

## STEP 1: Understand, Scope and Plan

Understand the new standard's requirements. Confirm your understanding with your auditor.

Determine what, if any, new information needs to be gathered to comply with the standard.

Assess whether your organization's existing systems, internal controls, and processes are adequate or if new systems and tools are required.

Look beyond financial reporting to determine how the new standard may affect other aspects of your business, including marketing, sales, and pricing.

Assess the tax implications of the new standard. If your company uses U.S. GAAP to determine revenue recognition for income tax purposes, the changes in timing of revenue recognition may result in changes to your current taxable income. It may also impact your organization's deferred taxes.

Enlist the help of external experts, if necessary.

## STEP 2: Technical Analysis and Assessment

Divide your revenue into similar revenue streams and assess the impact of the standard on your revenue streams.

Perform a detailed analysis of the accounting impact of individual transactions in the revenue streams identified. This detailed analysis should include the costs capitalization rules and should confirm and/or further your initial assessment.

Decide on one of the available transition methods and consider discussing these approaches with your financial statement users and peer organizations, if relevant..

**Full Retrospective:** Under this approach, entities may avail themselves of certain practical expedients.

**Modified Retrospective Cumulative Effect:** If this method is selected, entities must disclose which results would have been under prior U.S. GAAP in the year of adoption.

Confirm your decisions with your auditor.

## STEP 3: Consider Changes to Existing Processes

If your assessment has determined that new information will be needed, determine the changes needed to ensure that that information is gathered accurately and on a timely basis.

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

Depending on your analysis of the standard's potential impact on your business, consider possible changes to your organization's standard contracts.

Consider discussing changes with lenders to revise debt covenants that are impacted by revenue, such as EBITDA and times-interest earned ratios.

Consider possible changes to compensation arrangements that are driven by revenue, if the timing or pattern of your organization's revenue recognition changes under the new guidance.

Revise your documented processes and controls to ensure they are sufficient to prevent or detect misstatements under the new guidance.

## STEP 4: Implementation and Testing

Run applicable historical transactions through new systems and business processes to calculate the effect on prior periods or the cumulative effect upon adoption date.

Allow time for your auditor to test your restated accounts or cumulative adjustment.

Prepare new disclosures and ensure auditor concurrence.

## STEP 5: Stay Up-to-Date with New Guidance

Monitor the activities of the American Institute of CPAs (AICPA) and the joint FASB/IASB Transition Resource Group.

Stay informed on SEC developments, including any amendments the Commission may make to its own staff interpretations on revenue recognition.

Tech companies should keep the following questions and considerations in mind when assessing the new standard's impact.



## SPECIAL CONSIDERATIONS FOR Software Companies

### Do you sell multiple goods and services to a customer as part of a single transaction?

For example, you may be a software developer that provides a software license, installation services, and one year of post-contract support (PCS) under a customer contract.

#### UNDER CURRENT U.S. GAAP

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. To separate and account for the elements at different times, companies are required to have VSOE<sup>1</sup> (vendor-specific objective evidence) of fair value for undelivered elements (such as PCS); without it, they cannot separate the elements.

#### UNDER ASC606

VSOE is no longer required to separate elements in a bundled software arrangement. Instead, SSP (standalone selling price) must typically be determined for each distinct performance obligation, and the transaction price will be allocated to each distinct performance obligation in proportion to those SSPs.

Not separating "distinct performance obligations" due to an absence of observable, consistently priced standalone transactions will not be an option. Rather, in that scenario, an entity will be required to estimate SSP.

### Is your software provided to your customers through a perpetual or time-based (term) license?

#### UNDER CURRENT U.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 post-contract customer support (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.

#### UNDER ASC606

A licensor needs to evaluate whether the license is distinct from other performance obligations in the arrangement. If so, the license and PCS would be considered separate performance obligations, regardless of whether the license was time-based or perpetual. As a result, the license portion of many term license agreements will now be recognized at a point in time.

### Do you offer your customers extended payment terms from the date of delivery of a software license?

#### UNDER CURRENT U.S. GAAP

The price must be fixed or determinable before revenue can be recognized. Today's rules often require the deferral of revenue recognition if payment terms extend more than 12 months from the date of delivery of a software license because such extended payment terms often indicate that the price is not fixed or determinable.

#### UNDER ASC606

The fixed or determinable criterion is no longer a prerequisite to revenue recognition. Instead, future price concessions are considered a type of variable payment, and significant financing components must be identified and accounted for. Potential variability in the transaction price may not preclude revenue recognition.

### Do you offer "specified upgrade rights" to your customers?

#### UNDER CURRENT U.S. GAAP

Today's GAAP contains somewhat punitive rules when companies offer "specified upgrade rights" to customers, which typically results in the revenue being deferred until the upgrade is delivered because VSOE of fair value usually cannot be established for the specified upgrade rights.

#### UNDER ASC606

The software license and the specified upgrades could be viewed as distinct performance obligations if certain conditions are met.

<sup>1</sup> VSOE of fair value is frequently established by demonstrating that representative standalone transactions are priced consistently. For example, under current U.S. GAAP, entities might conclude that VSOE of fair value exists for PCS if at least 80 percent of its PCS renewals are priced within a range of plus or minus 15 percent from the midpoint of the range.



## SPECIAL CONSIDERATIONS FOR Hardware Companies

### Do you offer your customers express or implied rights of return?

#### UNDER CURRENT U.S. GAAP

Companies must defer revenue recognition until the right of return expires, unless they can reasonably estimate future returns (among other conditions).

#### UNDER ASC606

Revenue is recognized when control over a good or service is transferred to a customer. Offering return rights may not affect whether control over a product passes to a customer, and hence may not preclude revenue from being recognized. The new standard also specifically states that a return right is not a separate performance obligation. Instead, return rights cause the transaction price to have an element of variability.

### Do you sell your products to resellers or distributors?

#### UNDER CURRENT U.S. GAAP

When selling products to resellers or distributors, some tech companies currently apply the so-called "sell-through method" of revenue recognition. Under this accounting approach, they do not recognize revenue upon delivery of a product to the reseller/distributor customer. Instead, they will wait to record revenue in their financial statements until the product has been sold through the distribution channel to the end user.

#### UNDER ASC606

There is no requirement that the arrangement fee be fixed or determinable to recognize revenue. Rather, revenue should be recognized when control over a good or service has been transferred to the customer. The amount of revenue recognized will consider the risk that the seller may grant price or other concessions or accept returns.

### Do you deliver your manufactured products to your customers at a point in time or over time?

#### UNDER CURRENT U.S. GAAP

Some contract manufacturers produce goods for their customers over time but do not deliver the manufactured product until a later point in time. Currently, revenue is recognized only after the manufactured items are delivered to the customer.

#### UNDER ASC606

Subject to certain criteria being met<sup>2</sup>, revenue could be recognized over time, rather than at a point in time such as product delivery. If revenue is recognized over time, an appropriate measure of progress must be identified, which would often result in the recognition of revenue as the goods are produced.

<sup>2</sup> Under ASC 606-10-25-27c, if the entity's performance does not create an asset with alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date, revenue must be recognized over time. In a contract manufacturing arrangement, these conditions might be met because i) the contract prohibits the entity from directing the asset in its completed state for another use, and ii) in the event of the customer cancelling the contract for reasons other than the entity's breach, the contract provides the entity with compensation for performance completed to date (cost plus a reasonable margin).

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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A group of business professionals are gathered around a table in a meeting. A woman with curly hair is leaning over a laptop, pointing at the screen. A man in a blue blazer is looking at the screen and talking. There are glasses of water and a tablet on the table.

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