AN ALERT FROM THE BDO TECHNOLOGY & LIFE SCIENCES PRACTICE

BDO KNOWS: HARDWARE

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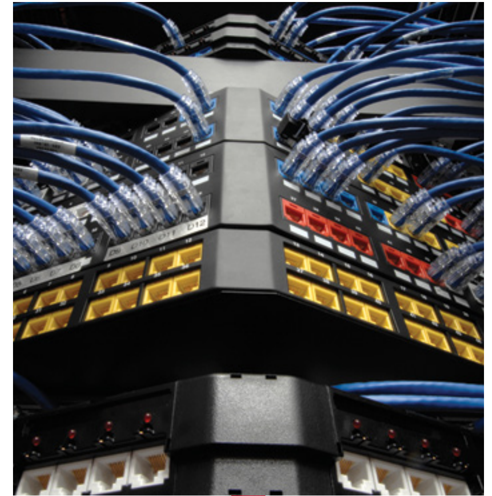

REVENUE FROM CONTRACTS WITH CUSTOMERS – HARDWARE INDUSTRY

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

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.

Contact:

ADAM BROWN
National Director of Accounting
214-665-0673 / abrown@bdo.com

KEN GEE
National Assurance Partner
415-490-3230 / kgee@bdo.com

Industry Contacts:

AFTAB JAMIL
Assurance Partner – Technology & Life Sciences
408-352-1999 / ajamil@bdo.com

SLADE FESTER
Assurance Partner – Hardware
408-352-1951 / sfester@bdo.com

HANK GALLIGAN
Assurance Director – Hardware
617-422-7521 / hgalligan@bdo.com

interim 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

HARDWARE INDUSTRY CONSIDERATIONS

The following examples demonstrate how the new guidelines may affect companies in the technology sector. 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 standard and monitor implementation efforts at the FASB and AICPA, we may update our guidance within this publication.

Rights of Return

Many technology companies offer their customers express or implied rights of return.

Under today's accounting rules, companies must defer revenue recognition until the right of return expires, unless they can reasonably estimate future returns (among other conditions). In other words, there are two possible accounting outcomes when a technology company offers a right of return to its customers:

- The seller will recognize revenue upon delivery of the products to the customer, net of an allowance for estimated returns, if it can make a reliable estimate of future returns and meet the other required conditions in U.S. GAAP.
- If the seller cannot make reliable estimates of future returns, all revenues are deferred. Moreover, revenues cannot be recognized until the right of return expires or a reliable estimate of future returns can be made.

The new revenue guidelines take a different approach towards return rights. As mentioned earlier in this publication, revenue will be recognized when control over a good or service is transferred to a customer, once the new rules are in place. Offering return rights may not affect whether control over a product passes to a customer, and hence may not preclude revenue from being recognized. Additionally, the new standard 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. For instance, a company may sell 3 products for $5 each. Each sale comes with a no questions asked, money-back guarantee, which is also known as a general right of return. Depending on how many products are returned (if any), the ultimate transaction price for this arrangement could be $15, $10, $5 or even $0.

- The new revenue rules require companies to estimate the variable consideration to be reflected in the transaction price. 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" [2] that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is subsequently resolved. This notion is referred to as the "constraint."

To demonstrate these concepts, assume that RIO Inc. sells control devices. The technology underlying these devices changes rapidly. As a result, RIO has a past practice of granting its customers, which are retail stores, stock rotation rights. Specifically, RIO will accept returns of goods that have remained unsold by the retail stores for six months or more, providing credits against future purchases.

Assume RIO sells a single control device to 50 different retail store customers and the selling price of each control device is $70. Each unit costs RIO $20 to produce.

Under the new revenue rules, RIO might first evaluate whether to group these 50 disparate transactions together as a portfolio. This is permitted under the new revenue guidelines as long as it would not result in a materially different outcome versus accounting for all 50 contracts individually. Presume RIO reaches that conclusion and adopts a portfolio approach to account for the 50 separate transactions.

As a next step, RIO will have to estimate its refund liability based on estimates of how many controllers will ultimately be returned to the company. Let's assume that RIO has varying experience with product returns, depending on market conditions, the type of products involved, and other factors. Nonetheless, the new revenue guidelines require RIO to estimate the future returns associated with the portfolio of 50 transactions. RIO prepares the following table outlining its estimates:

Number of Returns	Individual Probability of Occurrence	Cumulative Probability of Occurrence	Extended Value
9+	0%	0%	
8	2%	2%	0.16
7	4%	6%	0.28
6	7%	13%	0.42
5	10%	23%	0.50
4	40%	63%	1.60
3	37%	100%	1.11
			4.07

Based on these estimates, RIO would record the following journal entries upon transferring control of the portfolio of 50 products to its customers:

Dr. Accounts receivable	$3,500		[50 units x $70]
Cr. Refund liability		285	[4.07 units x $70]
Cr. Sales		3215	[Difference]
Dr. Cost of goods sold	$1,000		[50 units x $20]
Cr. Inventory		1,000	[50 units x $20]

2 The definition of "probable" within ASC 606 is intended to be identical to the definition within ASC 450, Contingencies.

Under the new revenue guidelines, RIO would have to evaluate whether to recognize an asset for its right to recover products from a customer on settling a refund liability. RIO would establish an asset if it would be able to resell the returned products and recover their cost.

- The asset would initially be measured at the former carrying amount of the product, less than any expected costs to recover those products and would be evaluated each reporting period for recoverability.
- In this example, RIO has not recorded any asset as the products being returned are obsolete and likely could not be resold in the marketplace.

Note that RIO's estimate of product returns is consistent with the notion of the constraint. As shown in the table, there is a 77% likelihood [40% + 37%] that the number of returns will be four or less. This suggests that it is probable there will not be a significant revenue reversal when the uncertainty is resolved, since the likelihood of RIO experiencing five or more returns from the portfolio only has a cumulative probability of 23%.

Sales to Resellers and Distributors

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

There are a number of reasons why companies would apply a sell-through method of revenue recognition:

- When technology companies offer price protection clauses, generous product return rights, or other customer incentives, it may be difficult to determine the arrangement fee.
- Under today's accounting rules, revenue cannot be recognized until certain conditions are met, including that the arrangement fee is fixed or determinable.
- Accordingly, the seller will defer revenue recognition until the fee becomes fixed, which typically does not occur until the product has been transferred through the sales chain to the final consumer.

The new revenue standard does not contain a similar requirement that the arrangement fee be fixed or determinable to recognize revenue. Rather, a cornerstone principle of the new rules is that 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 concessions, accept returns, or grant other concessions.

To demonstrate, assume that SM Co. introduces a new 16GB network adapter and delivers (transfers control over) 100 units to its customer, a reseller. The transaction is not a consignment arrangement.

Historically, SM Co. has provided price protection to its reseller customers. Assuming that SM Co. sells each unit for $500, the cost of each unit is $200, and SM Co. estimates that the protection rebate after consideration of the constraint will be 1% for the current transaction, the company will record the following journal entries upon transferring control of the units to the customer:

Dr. Accounts receivable	$50,000		[100 units x $500]
Cr. Refund liability		$ 500	[100 units x $500 x 1%]
Cr. Sales		$49,500	[Difference]
Dr. Cost of goods sold	$20,000		[100 units x $200]
Cr. Inventory		$20,000	[100 units x $200]

Sale of Products with Services Agreements

Many technology companies sell products bundled together with maintenance and support services.

Under today's accounting rules, these transactions are known as multiple-element arrangements. There are a variety of different possible accounting outcomes, depending on the specifics of the arrangement:

1. If the services represent a separately-priced product maintenance or extended warranty within the scope of ASC Subtopic 605-20:
   - The services are considered a separate element.
   - The value of the services is their stated price in the contract with the customer. The remaining arrangement consideration is allocated to the products.
   - Revenue from the services is recognized on a straight-line basis, unless historical evidence indicates that the services will be performed on an other than straight-line basis. In this situation, revenue should be recognized as (and in proportion to) costs are incurred.
   - In the case of extended warranties, revenue recognition should only commence following the expiration of any standard warranty period (if any).

2. If the services are not within the scope of ASC Subtopic 605-20, the seller must evaluate whether the products and services should be divided into separate units of accounting under ASC Subtopic 605-25. If the criteria in ASC Subtopic 605-25 are met, the accounting would be as follows:
   - The total arrangement consideration should be allocated on a relative selling price basis to the products and services, irrespective of the stated prices contained in the contract – with one exception. The amount allocable to the delivered unit (in this case, the product) is limited to the amount that is not contingent upon the delivery of additional items or meeting other specified performance conditions.
   - Revenue allocated to the service element would typically be recognized using a proportional performance model.

Under the new revenue standard, the accounting for bundled product and services agreements will be more standardized and have fewer possible variations. The same five-step process described earlier in this publication will be applied to all transactions in a consistent manner. Of note, the new standard eliminates the guidance in existing U.S. GAAP (ASC 605-20) for separately priced product maintenance or extended warranty contracts.

Here is an example to demonstrate the new guidelines. Assume that Kelly Inc. sells a piece of robotic equipment bundled together with a five-year maintenance and support agreement. The contract calls for Kelly Inc. to invoice $50,000 upon delivery of the equipment and $10,000 per annum, payable in advance, for each year of service. Other customers of Kelly Inc. often purchase the robotic equipment without also purchasing a maintenance and support agreement.

Under the new revenue guidelines, Kelly Inc. would evaluate whether the robotic equipment and the maintenance and support services represent distinct performance obligations. The answer is likely yes, as long as both of the following conditions are met:

- The customer can benefit from each of the equipment and services individually on their own.
- The two performance obligations are distinct from one another within the context of the contract. In other words, the equipment and services are not inputs in creating a larger good or service, nor are the performance obligations highly interdependent on one another.

Based on the facts presented, the transaction price would be $100,000 [$50,000 + ($10,000 x 5)]. This price would be allocated to the equipment and services based on their relative estimated standalone selling prices. For example, if the estimated standalone selling prices of the equipment and the services were $90,000 and $60,000 respectively:

- $60,000 of the transaction price would be allocated to the equipment [$100,000 x ($90,000 / ($90,000 + $60,000))]
- $40,000 would be allocated to the services [$100,000 x ($60,000 / ($90,000 + $60,000))]

Note: Under the new standard, allocating $60,000 of the transaction price to the equipment is appropriate even though Kelly Inc. is only contractually permitted to invoice $50,000 upon its delivery. This represents another change from current U.S. GAAP, which as indicated previously, limits the revenue allocable to a delivered element to the amount that is not contingent upon satisfaction of the undelivered element in an arrangement.

For some technology companies, there may be substantial judgment involved in estimating the standalone selling prices for distinct performance obligations, especially when a good or service is never actually sold separately in the marketplace. Significant changes to internal controls and processes may be necessary to make these estimates.

A brief note on warranties…

The new revenue standard differentiates between a warranty that a customer has an option to purchase separately and a warranty that a customer cannot purchase separately.

As noted earlier, a warranty that is sold separately is accounted for as a separate performance obligation for which revenue is recognized over the warranty period, similar to existing guidance. However, the arrangement consideration in separately-priced warranty contracts is allocated based on its relative stand-alone selling price under the new guidance rather than its contractual price, as is the case under current U.S. GAAP.

Under the new standard, a warranty that is not sold separately could still represent a separate performance obligation if there is a service component to the arrangement in addition to the assurance that the product will perform according to specifications.

- In assessing whether a contract contains a service element (in addition to assurance that the product complies with agreed-upon specifications), a technology company should consider factors such as the length of the warranty coverage period and the nature of the tasks that the vendor promises to perform.
- Warranties that only provide a customer with the assurance that the product will function in accordance with agreed-upon specifications are accounted for in accordance with existing guidance on product warranties.

Extended Payment Terms

Under today's accounting rules, collectibility of any amounts due from customers must be reasonably assured before revenue can be recognized.

A similar tenet is incorporated into the new revenue guidelines. Specifically, to pass Step 1 of the five-step revenue recognition process, 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."

Having said this, current ASC Subtopic 985-605 expressly precludes immediate revenue recognition if a company offers extended payment terms from the date of delivery of a software license. This is not only because the lengthy payment terms call into question whether collectibility is probable but also cast doubt on whether the arrangement fee is fixed or determinable. ASC 985-605 indicates that extended payment terms increase the likelihood that the customer will ultimately be granted a concession in the form of a price reduction or additional deliverables.

In practice, this guidance on extended payment terms has been analogized beyond software licenses to the sale of other goods and services in the technology sector where similar risks of concession exist. In fact, SEC Staff Accounting Bulletin Topic 13A expressly states that analogizing to the extended payment terms requirements in ASC Subtopic 985-605 "should be considered in other sales transactions in which the risk of technological obsolescence is high."

The new revenue guidelines do not contain an explicit prohibition from recognizing revenues when offering extended payment terms. Instead, companies will apply the standard five-step revenue process in accounting for such arrangements. In particular:

- The seller should first ensure that it has a legally enforceable contract with the customer, and conclude that collectibility of amounts to which the seller is entitled is probable.
- Assuming the customer contract passes Step 1 of the revenue recognition process, the seller would estimate the transaction price, considering any potential variable consideration (and the related constraint) as discussed previously in this publication. In addition, the seller would evaluate whether the arrangement contains an implicit element of financing and, if so, would exclude this amount from the transaction price.

To demonstrate these concepts, assume SLZ Co. transfers control of 1,000 semiconductors to a customer. The stated contract price for the semiconductors is $112.59 per unit. Payment is due 13 months from delivery. Assume that SLZ has concluded that collectibility is probable, and the arrangement represents a contract with a customer.

Typically, SLZ would charge $100.00 per unit when selling the same semiconductors to similar customers. However, those other customers typically pay within 30 days of taking delivery of the products.

Accordingly, SLZ concludes that the transaction price for this arrangement should be $100 per unit, as the $112.59 per unit contract price includes an implicit element of financing. SLZ believes that the implicit interest rate of 11% ($12.59 of "interest" on a "principal" balance of $100, paid over

13 months) is consistent with the discount rate that would be reflected in a separate financing transaction involving SLZ and its customer. Upon transferring control of the semiconductors to the customer, SLZ would record the following journal entries, assuming the cost of each unit is $10.

Dr. Contract Asset	$100,000		[1,000 units x $100 per unit]
Cr. Sales		$100,000	[1,000 units x $100 per unit]

Dr. Cost of goods sold	$10,000		[1,000 units x $10 per unit]
Cr. Inventory		$10,000	[1,000 units x $10 per unit]

Over the thirteen month payment terms, SLZ would accrete the contract asset from $100,000 to $112,590 (the aggregate contract price) using an effective interest method. The first monthly entry would be as follows:

Dr. Contract Asset	$917		[$100,000 x implied interest of 11% / 1 mo.]
Cr. Interest income		$917	[$100,000 x implied interest of 11% / 1 mo.]

The second monthly entry would be:

Dr. Contract Asset	$925		[$100,917 x implied interest of 11% / 1 mo.]
Cr. Interest income		$925	[$100,917 x implied interest of 11% / 1 mo.]

Cost of Contracts with Customers

Existing U.S. 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, such as:

- 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 be 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, let's assume that Servepro sells an extended warranty contract. The agreement provides the customer with protection on their purchases for the three-year period beginning 12 months after purchase (once the standard warranty period expires).

Before entering into the extended warranty contract, Servepro incurred a $200 charge to perform a credit check on the customer. In addition, a Servepro sales manager received a $1,000 commission upon closing the transaction.

Under the new revenue guidelines, the $200 credit check fees would not be considered an *incremental* cost of obtaining a contract. Such costs would have been incurred even if the customer – at the 11th hour – decided not to sign the sales contact. As a result, these costs would be expensed as incurred as a period cost.

However, the $1,000 commission does represent an incremental cost of obtaining a contract. This payment was only triggered because the contract was entered into by the customer, and hence is an incremental cost of obtaining the contract.

Because the services to be performed under the contracts will extend beyond one year, Servepro has no choice but to defer the $1,000 incremental costs of obtaining the contract. The costs would be amortized on a straight-line basis – that is, in a similar pattern to how the revenues from the extended warranty contracts will be recognized. To be clear, neither the revenues nor the costs associated with the contract would be recorded in the first twelve months following the transfer of the related product, during the standard warranty period. Instead, both revenue and cost recognition would begin at the start of Year 2.

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 U.S. 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.

The new revenue guidelines simply state that "amounts collected on behalf of third parties" should be excluded from revenue. In some cases, it may be operationally challenging to apply this principle. For example, assume that Hifi Industries sells server equipment across the globe. In certain countries, Hifi may have to pay sales tax, value-added tax (VAT), or excise taxes on product sales. Accordingly, Hifi may have to evaluate in each of these jurisdictions whether or not it is collecting the tax on behalf of the local government authorities as a component of the selling price.

In March 2015, the FASB tentatively approved a practical expedient that would allow companies to elect a policy to always report revenues net of sales, value-added, excise or similar taxes. Companies that adopt this practical expedient must disclose this accounting policy election.

Companies that present revenues on a gross (i.e., inclusive of taxes charged to customers) would only be able to continue this presentation if they are primarily obligated to pay the tax. To demonstrate, assume Firely Ltd. sells key fobs in a tropical island nation. This nation charges Firely an excise tax on every unit sold. Firely has discretion on whether to pass this charge along to customers and, if so, whether to collect the exact amount of the tax, or something more or less. If the customer fails to remit payment on the transferred goods, Firely is still liable to pay the excise tax to the government. Given these facts, Firely would present revenues on a gross basis, and would record the excise taxes payable as an expense, unless the company elects the previously discussed practical expedient.

Revenue Recognition Over Time Versus at a Point in Time

Some contract manufacturers produce goods for their customers over time but do not deliver the manufactured product until a later point in time. Under today's U.S. GAAP, revenue would be recognized only after the manufactured items are delivered to the customer.

Under the new standard, it is possible that revenues may be recognized earlier in some cases. Specifically, the new rules require that revenue be recognized over time, rather than at a point in time such as product delivery when certain criteria are met.

For example, assume Windy Inc. receives an order to produce 100 portable CT scanners that are significantly customized for this specific customer. The contract indicates that legal title to the scanners passes at the moment they are loaded on the freight carrier's truck and depart Windy's warehouse.

Under the new standard, revenue may need to be recognized over time as the scanners are being produced, even though title of the product or equipment does not transfer until the end of the contract period. For instance, this outcome would be appropriate if:

- The asset Windy is building has no alternative use – i.e., it can't be sold to any other customers, and
- Windy has an enforceable right to recover its cost, plus a reasonable profit margin, at any time throughout the contract in the event that the order is cancelled.

If Windy is required under the new standard to recognize revenues over time, it must select an appropriate way of measuring progress towards completion of its performance obligation. Likely, Windy would use input measures, such as comparing actual costs incurred to date relative to total expected costs to fulfill the contract.

More on the Notion of Over Time vs. at a Point in Time…

Hardware companies sometimes license their intellectual property (IP) to a customer. Notwithstanding industry-specific guidance for *software* licenses, current U.S. GAAP is unclear as to when revenue for other types of IP licenses should be recognized—either at a point in time or over time.

Under the new revenue guidelines, assuming that the license is distinct from other performance obligations in the arrangement, revenue from license transactions should be recognized over time if the hardware company is determined to provide access to its IP as it exists throughout the license period (a dynamic license).

Conversely, license revenue should be recognized at a point in time if the licensor is providing its customer with the right to use its IP as it exists at the time the license is granted (a static license).

The FASB has 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.

Readers should continue to monitor this area for additional developments.

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.

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 an 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 Tech Co., a calendar year-end public business entity, transfers control of equipment to a customer on December 31, 2016. Tech Co. believes that it will be entitled to $1 million in exchange for the equipment.

Under existing U.S. GAAP, Tech Co. uses the “sell-through method” for recognizing revenues because it has historically offered generous return rights and price protection provisions to its customers. Accordingly, Tech Co. did not recognize revenue for this transaction in 2016 under its existing accounting policies.

Under the new accounting guidelines, assume that after estimating the transaction price using the expected value method and consideration of the constraint, Tech Co. concluded that it would have been able to recognize $600,000 of revenue from the transaction in 2016.

If Tech Co. applies a cumulative effect transition approach, revenues from this transaction would never appear in any financial statements! This is because prior periods are not restated under this method of transition. Hence, the 2016 comparative financial statements would not reflect any revenue from the equipment sale based on the accounting rules in place at that time. Similarly, transaction revenues of $600,000 would not be reported in the 2017 financial statements because they would have been recognized on December 31, 2016 under the new revenue guidelines. The revenues from this transaction 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 their 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 announced that it would provide some 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.

Develop SAB 74[3] 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

3 Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period

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.

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