

***The new digital
ecosystem reality:***
The new revenue
recognition standard—
Is your technology
company ready?

Technology Institute
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The new standard: It's not just about accounting

The deliberation is over: On May 28, 2014, the Financial Accounting Standards Board and the International Accounting Standards Board released their new standard for revenue recognition, to take effect in 2017 for public companies. The new guidance may constitute the biggest accounting change the world has seen in over a decade, because revenue recognition informs a wide array of business decisions. Technology companies that start preparing for the change now will be in the best position to seize the opportunities that will come with the change—while also surmounting the challenges.

The recently released new standard is a converged accounting standard, with the aim of fostering consistency and comparability throughout the global capital markets and across industries. It will replace substantially all existing US Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) literature on revenue recognition. Companies in all industries and countries will use the **new five-step model** for recognizing revenue from customer contracts.

The new standard may constitute the largest accounting change seen in years. After all, revenue recognition is a key metric for most companies—revenue being a number that all executives, managers, and investors care about. Arguably, revenue is the most important number in a company's financial statements, and it drives other major metrics—such as net income; earnings before interest, taxes, depreciation, and amortization (EBITDA); and earnings per share.

PwC's New Digital Ecosystem Reality series provides our perspectives on the trends and challenges that technology businesses should consider to remain competitive. To learn more about the trends, [click here](#).

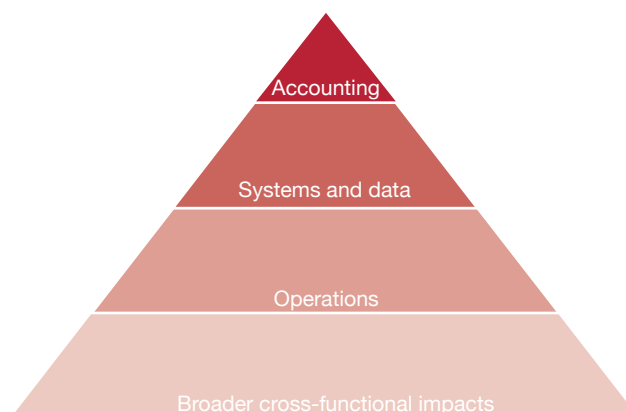
In this series, PwC has identified nine key technological, economic, and political trends for technology CEOs to consider. Revenue recognition resonates especially strongly with the trend focused on the changing political and regulatory landscape as well as the trend regarding the evolution of business models. The pace of evolution in business models in the technology space has put pressure on accounting and finance teams as they try to fit those models into the current GAAP framework. That pressure will only be exacerbated by the need to consider the implications of current and future GAAP as companies transition to the new guidance.

Finally, the new standard also ties directly into the need for technology companies to establish systems with which they can continue to adapt and thrive in the shifting landscape. For example, in addition to identifying and analyzing new business models, they will need to optimize their IT operations and infrastructure to foster agility and responsiveness.

The new standard for revenue recognition will affect all companies to some degree, because revenue recognition informs a broad range of business decisions—such as how companies bundle their offerings, how they go to market and

structure contracts, and how they compensate many of their people. Thus, it has implications for people, processes, and systems—exerting a broad, cross-functional impact far beyond accounting (see Figure 1).

Figure 1: Accounting is just the tip of the iceberg



Implications for technology companies

For technology companies currently following US GAAP—enterprises focused on software, computing hardware, semiconductors, networking, and internet services—the impact of the new standard will be especially notable. This is especially true for businesses in sub-sectors that have specialized guidance or industry practices, such as software and semiconductors.

Like many huge changes, the standard will bring both opportunity and challenge. On the opportunity side, the standard is far less prescriptive than current revenue recognition rules, which have sometimes put numerous constraints on how companies do business. Under the new standard, companies will have more flexibility and a wider range of choices regarding their business models, product offerings, pricing, and ways of setting up contracts and interacting with their customers. They will be able to do more estimating and make more judgment calls than they've been doing under current US GAAP. They will have a chance to rethink the areas of their business that are constrained today and where they may want to make modifications under the new standard.

For instance, software companies tend to follow strict rules today about not showing product roadmaps to customers, because doing so often causes a complete deferral of license revenue. Under the new standard, they'll have more flexibility to share that information with customers. They may still have a revenue deferral, but it will be much smaller than it is today and thus will not have such dire consequences for their bottom line. As a result, they may decide to give their salesforce more leeway in determining what kinds of information are shared with customers.

On the challenge side, the new flexibility brings complexity. Companies will need to ensure that they have the right front-end and back-end systems, processes, and people required to not only ensure compliance but also seize the opportunities offered by flexibility. Moreover, they will need to document the rationale behind the increased number of judgment calls and estimates they will be making. In addition, they will have to think through the various cross-functional business impacts for their company. For example:

- **Compensation and bonus plans.** Revenue recognition can trigger payments such as commissions and bonuses. Consider how timing changes for revenue recognition affect these and other internal arrangements.
- **Technology.** They may have to update their systems to capture new information that might not have been necessary before.
- **Taxes.** The timing of cash tax payments could be affected if, for example, they recognize revenue sooner than in the past. In addition, the new standard could raise new questions as to how revenue has traditionally been characterized for tax purposes which could impact items such as state apportionment factors, sales and property taxes, etc. In addition, the new standard could raise certain transfer pricing issues related to profits and revenue recognition. Furthermore, tax considerations related to the new standards must be taken into account in the development of any new financial reporting systems to ensure the necessary tax reporting information will be available to compute the additional book-tax adjustments that are likely to result from the implementation of the new GAAP revenue recognition changes.

- **Controls and processes.** The standard requires companies to make more estimates and disclosures. That calls for new controls and processes.
- **Investor relations.** Stakeholders will want to know how the revenue recognition will change and how the new standard affects the company's financial picture.

To see how such complexities may play out, take the time value of money. When a contract contains a significant financing component, the transaction price is affected by the time value of money. Technology companies that have contracts with a significant financing component may face operational challenges associated with measuring and tracking time value of money if they don't do this today. Determining whether a "significant" financing component exists could require considerable judgment. To illustrate, suppose your software company provides three years of customer support for \$300. A customer chooses to pay \$300 upfront, in lieu of paying \$100 per year annually. Is this a significant financing because the customer paid upfront? Or does the fact that the aggregate gross price was the same imply there is no financing? While the standard will provide relief in certain areas (such as payment terms less than 1 year), it might be difficult in other situations to determine if a significant financing element exists.

Although the 2017 effective date for the new standard may seem far off, companies most affected by the change should start preparing now. Revenue recognition is a critical accounting area, and your company can't afford to get it wrong. Your board, investors, and managers whose compensation hinges on company revenue all want to know what to expect—so get started today.

Leading and implementing the change: A three-step process

PwC recommends a three-step process for navigating the changes that will come with the new standard: (1) Assess, (2) Convert, and (3) Embed. In the sections that follow, we take a closer look at the activities involved in each step.

Step 1: Assess

Build a framework for change

In the Assess phase, start by building a solid framework for change—by establishing proper structures for governance, project management, and change management.

When it comes to *governance*, you'll want to identify an executive sponsor and a business owner to lead the implementation program and to drive it forward. In addition, appoint a steering committee that includes representatives from all functional areas that will be affected by the new standard—most likely heads of business units, operations, sales, legal, talent, finance, tax, and IT. Members of the steering committee will help to evaluate how revenue recognition currently affects their functions and what might change under the new standard.

As for *project management*, select an experienced project manager, and establish project management principles, processes, and practices—such as defining key milestones, establishing accountability, and deciding on a reporting cadence. Assign flexible, experienced staff to project management and other key activities, including people with the right mix of technical, accounting, and business knowledge. Align your project manager, executive sponsor, business owner, and steering committee around a clear vision, such as “should the project focus solely on compliance or is the company looking

to make operational improvements at the same time?”, and clear objectives; for example, the desired level of automation.

Regarding *change management*, evaluate your organization's current change management capabilities, structures, and tools, and identify gaps that need filling. Establish a clear process for decision making on key issues as the project progresses and establish a training and communication plan to key internal and external stakeholders throughout the project.

Gauge the broader impact of the new standard

Review your current accounting policies and practices, and figure out what the key accounting changes will be under the new standard versus current GAAP. In addition, inventory your current revenue arrangements, and review the current contracts you've established with customers. You can evaluate the financial impact with forecasting models to predict changes in key financial measures, significant sales transactions, or a sample of transaction types. Also consider assessing tax implications, as a change in timing of revenue recognition could accelerate your cash tax liabilities.

Consider the broader, downstream impact of the new standard—on your company's operations and cross-functional activities. Explore questions such as the following:

- Will you have to rethink customer negotiation or pricing strategy?
- What might your compensation and benefit plans look like?
- Should you rethink how you sell your products or services?
- What could lead you to unintentionally violate a debt covenant?
- What information do you need to communicate to your investors? When?
- Will the increased flexibility that the new standard will bring present your company with fresh business opportunities? If so, what are they? How might you change your business models to seize those opportunities?

Potential areas of difference are numerous for technology companies (see Figure 2).

Assign flexible, experienced staff to project management and other key activities, including people with the right mix of technical, accounting, and business knowledge.

Figure 2: Potential areas of difference

Volume discounts	Contingent revenues	"Cash cap" guidance	Service level agreements	Distributor revenues	Allocation of discounts	Extended payment terms
Sales commissions	Funded R&D arrangements	Certain subscriptions	Ratable revenue may change	Time value of money	Consignment arrangements	Bill and hold arrangements
Other contract costs	Term licenses	Customer loyalty programs	Vendor protection clauses	Contract modifications	Extended warranties	In-transit loss coverage
Discounted goods or services	No VSOE limitation	Roadmaps	Implied maintenance	Residual approach	Customization/implementation	Elimination of software guidance
Disclosures						

Transition alternatives

Consider the fact that when the new rules take effect in 2017, accounting for variable consideration and the time value of money, among other matters, could result in an increased use of estimates. Those estimates won't come easily if your company isn't accustomed to making them. Thus, you may need to collect, analyze, and report more data than you did in the past.

Ask whether your people, processes, and systems (including IT infrastructure and internal controls) are up to the task. Your current systems may not be ready to capture and process the data needed for forming and monitoring new estimates, and for tracking revenue differences for book and tax purposes. The new standard will also require significant new disclosures that your current systems may not be prepared to capture. And, you may need to review

existing processes to ensure that the applicable internal controls are in place to apply the new standard.

Step 2: Convert

Select an adoption method

Plan the approach you will take to adopt the new standard. Companies can choose from two adoption approaches, each of which offers its own pros and cons:

- **Full retrospective.** Using this approach, you recast previous-period financial statements as if the guidance had always existed, for a comparative two-year period prior to the adoption year (and four quarters prior to the adoption year). This approach may require extensive time and effort. It will involve a significant amount of data and customer contracts. Companies will

have the opportunity to start collecting data sooner by developing parallel processes to capture the necessary data points in 2015 and 2016.

- **Modified Retrospective.** Because redoing accounting for the prior comparable periods is a big undertaking for some preparers, the Boards agreed to offer another option: recording a cumulative effect of the change at the date of adoption for all open arrangements and taking your current-year numbers, in the year of adoption, and showing them under both the new and old model. To use this method, you'll need to present your 2017 financial statements under the new guidance but include a footnote disclosure of all financial statement line items and the amounts they would have been under legacy guidance for

2017. This method offers a simpler alternative. But it comes with its own challenges as well. For example, you will have to close the books twice for revenue recognition every quarter of 2017, which will put added pressure on the quarterly close cycle. It also may mean that some revenue is never recorded, if there is more revenue to record earlier under the new standard than under existing GAAP.

How to select an approach? Consider whether you have the resources at hand to implement one method more effectively than the other over the required timetables (see Figure 3). Ask whether your business could benefit from having comparability between the before-and-after periods. And factor in what your investors expect and what your competitors are doing.

Identify needed changes in people, processes, and systems

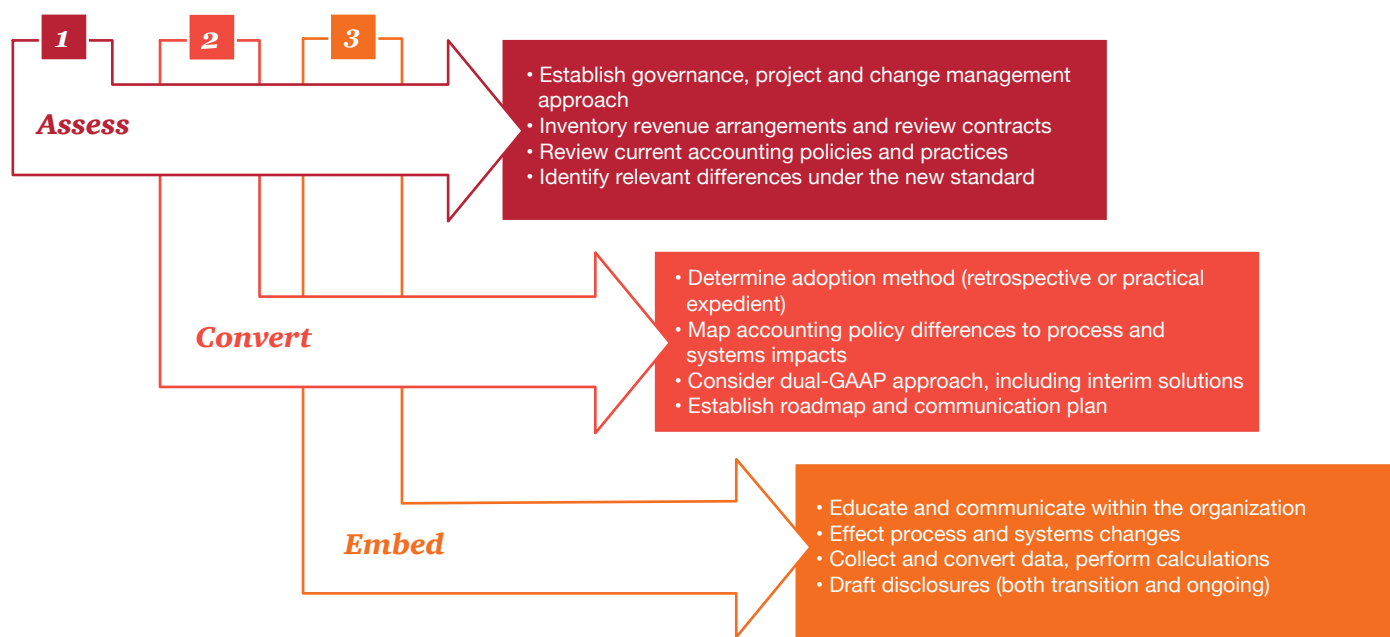
The accounting policy differences you identified during the Assess phase may have major implications for your people, processes, and systems. Take contingent revenue; in particular, allocation of variable consideration, such as rebates and discounts. Such allocation will require considerable judgment and estimates. Your people, processes, and systems will need to be agile enough to allocate discounts and variable consideration to respective performance obligations in your contracts. Moreover, as noted earlier, estimation processes have a higher level of inherent risk than routine data processes; thus they require rigorous internal controls and documentation of the assumptions behind your estimates.

Selling to distributors is another example. There is ongoing debate on the future of “sell-through” accounting, which

recognizes revenue after a product has been shipped from wholesalers. Shifting to sell-in accounting, which records revenue upon shipment to the wholesaler or distributor, requires estimates of price protection, rights of return, and other distributor reserves. It’s a complex data exercise that requires carefully thought out estimates and corresponding documentation of the assumptions behind the estimates. Moreover, there may be one-time “lost” revenue upon adoption of the standard for revenue accelerated from sell-through to sell-in.

Lack of vendor-specific objective evidence (VSOE) of fair value for software industry players presents an additional illustration. The new standard will likely bring an acceleration of revenue, as the high VSOE threshold has been eliminated and companies will now be able to use best estimates of stand-alone selling prices for each distinct performance obligation to allocate the overall contract price.

Figure 3: Roadmap for success





Systems used to record revenue may require modification to support the relative selling price allocation. You'll need to estimate the standalone selling price for software elements, including implied post-contract support, roadmaps, sunset clauses, and the software license itself, which software companies did not have to do previously. There's commercial opportunity in being able to offer more flexibility in these arrangements—but it comes with a heavier back-office burden. Plus, your company may experience “lost” revenue owing to acceleration of revenue previously deferred for lack of VSOE.

These and other issues—including identifying performance obligations, estimating variable consideration, measuring the time value of money, and evaluating options to purchase additional goods and services—all constitute important considerations for how the new standard will affect your people, processes, and systems. Because of the new complexities that arise regarding data gathering and analysis, you'll want to look for opportunities for automation during the Convert phase. Processes that may lend themselves to automation include:

- Ratable revenue recognition for service/maintenance

- Bundled stock-keeping units (SKUs) that contain more than one performance obligation
- Relative selling price calculation and allocation
- Stand-alone selling price establishment
- Simple deal/contract deferral (such as FOB shipping and partial shipments)

Reexamine your business models

Contract terms and strategies required for existing revenue accounting may no longer be advantageous to your company or necessary under the new standard. For example, some product offerings that lead to ratable revenue recognition under current GAAP may no longer be on a ratable model going forward. Applying the new model gives you the chance to take a fresh look at how you do business. Examine business practices that might have been influenced by the existing revenue rules. Identify contract terms included to address today's “bright-line” requirements that might not be needed under the new model.

As a result of such evaluations, some technology companies may decide to introduce more flexibility into their

business model; for example, moving from selling products to selling solutions, or from selling software to selling services. These changes will create an added layer of back-office complexity. Be sure to identify the people, process, and systems modifications needed to manage the complexity—so you can boost the odds that your new business model will deliver the promised benefits.

Establish a roadmap and communications plan

Now that the standard has been issued, many internal and external constituents will be asking what it means for the company. Given the significant areas of judgment and policy decisions that will have to be made, companies will have to be thoughtful about the timing and nature of communications to ensure that there is consistency of messaging and to ensure that no one jumps to conclusions too quickly in complex areas. Additionally, training will need to be rolled out to impacted functional groups regarding the upcoming changes' impact on their functional areas and the timing of such changes. Lastly, the finance and tax teams, FP&A and investor relations will all need to understand the key areas of difference and expected financial impacts prior to the implementation date in order to give guidance to the street for 2017.

What are companies doing now?

Many companies are taking a phased, measured approach to evaluate people, process, and system impacts of the new revenue recognition standard and to create an adoption roadmap that they can deploy depending on the progress of ongoing business change initiatives. This approach comprises activities such as the following:

- **Training.** Provide training for all business departments, with a primary focus on accounting, tax, and IT functions—to ensure that each understands the changes and impacts that will come with the new standard.
- **Impact analysis.** Identify and validate expected impacts of the new standard within key revenue streams/contracts and assess potential impacts on people, processes, and systems. Use your findings to define a roadmap and budget for the eventual implementation of needed changes.
- **Contract reviews.** For key revenue streams, review a sample of representative contracts to understand the potential changes to revenue recognition under the new standard.
- **Illustrative disclosures.** Examine your existing revenue disclosures, and propose incremental disclosures and evaluate additional resulting data needs on the basis of the new standard.
- **Policy development.** Evaluate your existing policy documents, and identify areas for incremental updates based on requirements of the new standard.

Step 3: Embed

Execute your plan

You've assessed the implications of the new standard for many different aspects of your business beyond just accounting procedures. And you've developed a conversion plan for seizing the opportunities presented by the new standard while managing the corresponding challenges. Now it's time to put your conversion plan into action. That means implementing the people, process, and systems changes outlined in your plan so you can begin collecting and converting the new data required by the standard and performing the new types of calculations and being ready to process transactions under the new standard from the implementation date.

Start drafting the disclosures the new standard calls for, and explain their meaning to your investors. Such disclosures may cover the following:

- How you've disaggregated revenue by category
- Costs to obtain and fulfill contracts
- Remaining performance obligations
- The assumptions behind your judgments and estimates

Maintain momentum

As you implement your plan, you'll almost certainly experience bumps in the road, such as unexpected differences as judgmental areas of the standard are clarified or new business models you hadn't previously contemplated. To maintain momentum in the face of the inevitable setbacks, provide needed training and continue communicating about the change program with stakeholders throughout your organization.

Some companies may question the wisdom of investing time now to adapt to the new revenue recognition standard, when it won't be effective until 2017. But because the change will exert a widespread, complex impact on technology companies, we maintain that taking time now to craft your response will pay big dividends. Seizing the opportunities presented by the new guidance, while managing the corresponding challenges, will require careful thought and planning. Start preparing today—by assessing the new standard's implications for your company; building a plan for converting your people, processes, and systems to the new guidance; and embedding needed changes throughout your organization. This is particularly important for companies that might be considering the full retrospective approach, which may need to collect data and make judgments contemporaneously in 2015 and 2016.

Seizing the opportunities presented by the new guidance, while managing the corresponding challenges, will require careful thought and planning.

PwC can help

For a deeper discussion on the new revenue recognition standard, please contact one of our leaders:

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Let's talk

Please reach out to any of our technology leaders to discuss this or other challenges. We're here to help.

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