THE ARGON ADVISORS
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THE RUNDOWN
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Contents

The RunDown – Standard Setters Further Clarify Implementation Issues expected with New Revenue Guidance

The FASB-IASB Joint Transition Resource Group for Revenue Recognition (TRG) met for the sixth time on November 9, 2015 to discuss various issues related to implementation of the Accounting Standards Update No. (ASU) 2014-09, Revenue from Contracts with Customers (the new standard). We have included a few highlights from the meeting below.

During the meeting, the TRG summarized views expressed by the TRG and other FASB and IASB board members during the last TRG meeting in July 2015. As depicted in the table at the end of this letter, the FASB and IASB (the Boards) also discussed the status of other additional revenue-related projects.

These projects include upcoming revisions to the standard for licensing arrangements, updates for determining gross vs. net presentation of revenue in an entity's income statements, and narrow-scope improvements to the new standard. Narrow-scope improvements include guidance on non-cash consideration received for goods and services transferred to a customer, evaluation of completed contracts under the new standard, and certain contract modifications.

Licenses – Renewals, Restrictions and Options

The new revenue standard currently considers a right-to-use (i.e., point in time) license a "good" for which time and geographical restrictions are merely attributes of the license rather than separate incremental rights that require evaluation as potential performance obligations and that affect the timing of revenue recognition. This concept generally differs from current U.S. GAAP where time and geographical restriction may often affect and delay the timing of revenue recognition itself.

The TRG acknowledged the challenge some users face in distinguishing the accounting for an initial license from a renewal or extension of a current license. The new standard states that revenue from a license of intellectual property cannot be recognized (i.e., control does not transfer to the customer) before the license term begins. This conclusion is consistent with industry-specific guidance for revenue recognition under current U.S. GAAP.

Some users, however, questioned whether license revenue should be recognized upon the earlier date the renewal is purchased and not on the later date the renewal period begins. These users believe that in license renewals control transfers to customer upon purchase of the renewal because the customer already has access to the current licensed IP and the entity has already granted the license as part of the initial licensing term. The TRG did not reach a conclusion on this matter.

In answering this question, the TRG also considered scenarios where an initial license includes geographical restrictions which the contract gradually releases over time (so-called staggered rights such that the license rights may expand to further geographies over the term). Some users believe that in certain instances the release itself of a geographical restriction to a license is a distinct, incremental right, requiring evaluation as a new performance obligation. According to several members of the TRG, such thinking allegedly undermines the assertion that time and geography are mere attributes of a license and should not affect the number of performance obligations identified in a contract.

In this respect, the TRG did not reach a conclusion for determining the economic distinction between time and geography-based attributes when identifying separate performance obligations within a contract. The TRG asked the Boards to consider clarifying this point in its final upcoming licensing ASU scheduled for early 2016.

The TRG also touched on a practice issue arising from the removal of industry-specific guidance in U.S. GAAP for accounting for an option to purchase or use additional software licenses. The TRG acknowledged there may be challenges in practice for the software industry in accounting for the right to purchase additional licenses or users. The TRG reaffirmed that significant judgment is often required here. When an entity is offering a single license that is payable based on usage/number of users, the transaction price must be estimated as variable consideration, subject to the constraint. When multiple licenses are granted that are not part of the original contract, they must be evaluated as options and receive accounting only if the options are significantly in-the-money, representing a "material right" as defined in the new standard.

Accounting for Additional Goods and Services and Termination Penalties

The TRG is aware that some users of financial statements find it difficult to determine whether the purchase of additional goods or services in a contract represents an option that would be evaluated as a potential material right or, instead, merely a continuation of goods and services since the customer does not make a separate purchasing decision. In this case, the future goods or services should be included in variable consideration and evaluated in identifying performance obligations and estimated as part of the original transaction price. This distinction is important because the accounting differs significantly.

Under the new standard, an option to purchase or use additional goods or services is treated as a contract separate from the original contract and only receives accounting initially if the option provides a material right (i.e., represents an economic prepayment) for future goods or services. In contrast, if the goods or services underlying the option are really part of the original contract (for example, where an IT outsourcer or Transaction Processor stands ready to provide services and is paid based on usage), any additional usage of the services should be considered a continuation of performance of the obligated services under the initial contract, not new incremental rights. In this scenario, the fees arising from the additional usage should be included in the entity's Day 1 estimate of variable consideration.

It is important to note here that if fees for the underlying goods or services are estimated as variable consideration for the single purchase option (e.g., a series of distinct goods and services that are treated as a single performance obligation where additional invoices/user fees are estimated in the Day 1 transaction price), there are incremental disclosure requirements relative to current U.S. GAAP. For many companies, these disclosure requirements will involve significant changes in process, information being monitored, and periodic adjustments to its estimates at each reporting date.

The TRG noted in its discussions that one should often look to the legally enforceable rights and obligations in the contract, noting that some obligations may be legally enforceable even if not specifically stated in the contract. In evaluating whether a contract includes an option or an arrangement with variable consideration, it may be helpful to evaluate whether the customer makes a separate purchasing decision in the future upon exercise of the option. If the customer does, it is likely the contract contains an option. Conversely, if the customer's purchasing decision really occurs on Day 1 when the customer obligates the entity to stand ready and provide an indeterminate number of outputs, the contract for future goods or services may more appropriately be deemed to constitute a performance obligation with variable consideration. In making this distinction, some members of the TRG suggested variable consideration may include situations where significant upfront payments or effort are required and additional fees become due as control of the good is transferred or as the performance obligation is fulfilled (e.g. as additional usage occurs). The TRG acknowledged a significant level of judgment may be required to make this distinction.

Several users, including those from the telecommunications industry, have pointed out the need for clarity in defining the contract period in contracts where a customer may unilaterally cancel its contract. In consideration of the TRG's prior discussions on contract termination penalties, the TRG broadly agreed that contracts in which the customer has a unilateral right to cancel the contract with a termination penalty, the contract term should be the longest period included in the original contract term if the termination fee is substantive (a term not defined term in the standard, requiring judgment of specific facts and circumstances). This is consistent with the standard's overall position that in determining the transaction price an entity should not include the probability of cancellations or additional optional purchases.

In contrast, any cancellation point by the customer that does not provide for a substantive termination fee may be evaluated as a renewal option, thus curtailing the term of the contract for purposes of applying the new standard. The effect of this curtailment would be to shorten the performance period and the period of transaction price estimation, treating the remaining periods in the contract as renewal periods that must be evaluated as potential material rights.

Finally the TRG considered arrangements where an entity sells a good to a customer but expects the customer to be economically compelled to purchase additional goods/services. "Optional" future goods or services, if viewed as economically compelling to the customer, must be included as current elements/purchase obligations of the initial contract under current U.S. GAAP. In contrast, the TRG concluded that the concept of economic compulsion is inconsistent with the standard's notion to disregard the probability of renewal and cancellations in identifying the nature of the promises and enforceable rights within the contract (see 606-10-32-4). We expect this change to result in fewer performance obligations being identified under the new standard.

Pre-Production Activities

The determination as to whether pre-production activities are a promised good or service impacts timing of revenue recognition under the new standard.

The new standard states that performance obligations do not include fulfillment activities (such as set up activities) or administrative tasks where control of a good or service is being transferred to the customer. In other words, pre-production activities that do transfer promised goods or services do affect the measure of progress in satisfying performance obligations and thus drive revenue recognition. Administrative tasks do not.

In a helpful nod to users of the financial statements, the TRG suggested that users may analogize to the guidance in the standard related to transfer of control over time (see 606-10-25-27). In particular, the standard provides for three criteria necessary to demonstrate that transfers of a good or service occur over time. The TRG agreed that if an activity eventually results in the transfer of control of a good or service to the customer, this may not be a fulfillment activity or administrative task, and therefore, could affect the timing of revenue recognition.

For example, assume a service is provided to the customer and that service, by analogy to the transfer over time guidance, would qualify as transfer of control to a customer over time because the customer uses and benefits at the same time (such that another entity taking over the work midstream would not need to substantially reperform work completed to date). In this case, the entity might conclude that these services should be included in measurement of progress of revenue recognition and not dismissed as a mere fulfillment activity or administrative task. One potential example of these activities might be integration services performed under an IT outsourcing arrangement.

To elaborate further on this point, some members of the TRG suggested that progress reports provided throughout the service period to a customer (such as pre-production non-recurring expenditures) might help support this claim, since these progress reports may suggest that the customer simultaneously receives and consumes the benefits of the services (606-10-55-5 and 606-10-55-6). Such a reading may be a departure for some users who might conclude non-recurring expenditures around tooling, engineering and design are always fulfillment activities which do not depict the transfer of value to a customer. This evaluation will require judgment.

Participants of the November 9th meeting stressed that transfer of legal title is an indicator that there may be transfer of control taking place; however, it is not necessarily the definitive factor and should be evaluated amongst all other facts and circumstances.

Accounting for the Cost of Pre-Production Activities

The TRG, along with the Boards, noted that certain industry specialized guidance in U.S. GAAP (Subtopic 340-10, Other Assets and Deferred Costs, formerly EITF Issue 99-5) should not be broadly applied to arrangements not specifically captured in the EITF issue. In fact, the TRG suggested that revenue accounting should be independently evaluated from cost accounting, reiterating that revenue recognition and the determination of when costs should be expensed or capitalized are largely unrelated evaluations under the standard.

The existing governing guidance for these activities, Subtopic 340-10, Other Assets and Deferred Costs, is narrowly scoped for a specific industry (largely automotive) and did not change with the new revenue standard. However, the TRG clarified that all other industries, in the absence of other GAAP, should look to the new revenue standard for determine accounting for costs (including contracts formerly captured under Subtopic 605-35, Revenue Recognition - Construction-Type and Production-Type Contracts (formerly Statement of Position 81-1).

During the meeting, some TRG members suggested deleting Subtopic 340-10 to further align revenue and cost guidance with the principles of the new revenue standard.

Fixed Odds Wagering Contracts

The TRG discussed fixed odds wagering arrangements, often found in the gaming industry, involving games of chance, and where the payout on placed wagers is typically known at the time the wager is placed. Examples include table games, slot machines, and sports betting.

Unlike current US GAAP, the new revenue standard does not include explicit guidance related to fixed odds wagering. Questions have arisen as to whether fixed odds wagering should be included within the scope of the new revenue standard, or whether these arrangements are better suited for accounting as derivative contracts under ASC Topic 815.

During the meeting, the TRG and the FASB members agreed that fixed odds wagering contracts should be scoped within the new revenue standard; however, further clarity regarding scope may be needed, particularly if the Boards ultimately decide that these arrangements are better suited to the derivatives guidance in ASC Topic 815.

Issue Date	Accounting Standard Update	Comment Deadline	Comment Letter	Status
9/30/2015	Proposed Accounting Standards Update—Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients	11/16/2015	2015-320	Still Receiving Comments
8/31/2015	Proposed Accounting Standards Update, Revenue from Contracts with Customers (Topic 606): Principal versus Agent (Reporting Revenue Gross versus Net)	10/15/2015	2015-290	Comment Period Closed; TRG is Considering Comments Made
5/12/2015	Proposed Accounting Standards Update—Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing	6/30/2015	2015-250	Board is Drafting Final ASU for Vote by Written Ballot

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