Financial reporting developments

A comprehensive guide

Software — Revenue recognition

Accounting Standards Codification 985-605

Revised March 2018

Building a better working world

To our clients and other friends

Determining how and when to recognize revenue for software licensing arrangements continues to be challenging even though it has been more than a decade since the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA) issued Statement of Position 97-2, Software Revenue Recognition.[1] This guidance is codified in the Accounting Standards Codification (ASC) at 985-605, Software — Revenue Recognition. This publication has been updated to include the appropriate references from the ASC.

We have prepared this publication to help you understand and apply the software revenue recognition accounting literature. This publication presents each paragraph (or series of paragraphs) excerpted from the ASC verbatim. These excerpts are followed by a discussion of our current views and observations on the application of the guidance. These discussions utilize questions and responses, including illustrative examples, to highlight key concepts. Our views and observations are based on the relevant guidance, what we have seen in practice, consultations with the standards setters, interactions with other major accounting firms and our participation on the Software Revenue Recognition Task Force, a once-standing task force of AcSEC.[2]

We expect software revenue recognition to continue to present challenges for financial statement preparers. Ways of doing business continue to evolve as do the views of the standard setters and regulators. While these changes are inevitable, one thing is certain — it is imperative that any company required to apply the software revenue recognition standards be thoroughly knowledgeable of the guidance and have robust and effective processes and controls to facilitate and maintain compliance therewith.

Past and future modifications to the software guidance

In October 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2009-14, Certain Revenue Arrangements that Include Software Elements (ASU 2009-14), that will significantly affect how entities account for revenue arrangements containing both hardware and software elements. ASU 2009-14 revised the guidance regarding the types of arrangements that fall under the scope of the software revenue recognition guidance, providing a scope exception for many transactions that were previously within the scope of ASC 985-605.This publication has been updated to reflect the revised scope exceptions to the software revenue recognition guidance provided by ASU 2009-14, and it provides guidance on certain transition issues entities are likely to encounter.

In May 2014, the Financial Accounting Standards Board (FASB or Board) and the International Accounting Standards Board (IASB) (collectively, the Boards) issued largely converged revenue recognition standards. Once effective, this new guidance will replace virtually all current revenue recognition guidance, including the software — revenue recognition guidance in ASC 985-605. See our Financial reporting developments (FRD), *Revenue from contracts with customers (ASC 606)* for additional guidance on the new revenue standard.

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1 As amended by Statement of Position 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*

2 The Task Force commenced in 1998 and is now largely inactive.

Under US GAAP, the standard is effective for public entities for fiscal years beginning after 15 December 2017, and for interim periods therein. Nonpublic entities are required to adopt the new guidance for fiscal years beginning after 15 December 2018, and interim periods within fiscal years beginning after 15 December 2019. US GAAP public and nonpublic entities will be permitted to adopt the standard as early as annual reporting periods beginning after 15 December 2016, and interim periods therein. Early adoption prior to that date is not permitted.

We hope this publication will help you understand and successfully apply the provisions of ASC 985-605. Ernst & Young professionals are prepared to assist you in your understanding and are ready to discuss your particular concerns and questions.

Ernst + Young LLP

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Notice to readers:

This publication includes excerpts from and references to the FASB Accounting Standards Codification (the Codification or ASC). The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that in turn include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication references to guidance in the codification are shown using these reference numbers. References are also made to certain pre-codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification.

This publication has been carefully prepared but it necessarily contains information in summary form and is therefore intended for general guidance only; it is not intended to be a substitute for detailed research or the exercise of professional judgment. The information presented in this publication should not be construed as legal, tax, accounting, or any other professional advice or service. Ernst & Young LLP can accept no responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. You should consult with Ernst & Young LLP or other professional advisors familiar with your particular factual situation for advice concerning specific audit, tax or other matters before making any decisions.

1 Introduction and scope

1.1 Chapter summary

In October 1997, the AcSEC of the AICPA issued Statement of Position 97-2, *Software Revenue Recognition* (SOP 97-2). This guidance is codified in ASC 985-605, *Software — Revenue Recognition*.

The guidance in ASC 985-605 is applicable to transactions involving the licensing, selling, leasing or otherwise marketing of computer software and related elements. This guidance requires a determination of its applicability to revenue arrangements at an activity level versus an entity level (i.e., whether or not an entity is a software entity in the traditional vernacular is not determinative in assessing whether a transaction is or is not within the scope of ASC 985-605). In certain circumstances, the assessment as to whether an arrangement is within the scope of ASC 985-605 can be straightforward. However, this assessment can also be complex and require considerable professional judgment, especially when the software is bundled with products, services or both.

Additionally, if an entity offers discounts or other concessions relating to software products or other deliverables that are within the scope of ASC 985-605 that are determined to be "more-than-insignificant," an additional element is being offered in the arrangement, and that element also must be accounted for in accordance with ASC 985-605. However, insignificant discounts and discounts that are not incremental to discounts typically given in comparable transactions are not unique to software transactions and are not included in the scope of ASC 985-605. These types of discount offers are similar to coupons offered in a retail environment for mass marketing efforts. This guidance also applies to certain hosting arrangements and to the sale of services containing or utilizing software when the software content is more-than-incidental to the service and the service is essential to the functionality of the software.

However, the guidance also contains a number of scope exceptions for certain elements in an arrangement. Specifically, the following types of transactions have been excluded from the scope of this guidance:

- Arrangements in which the software is incidental to the products or services as a whole.
- Leases of software that include a tangible product, if the software is incidental to the tangible product as a whole or the software and nonsoftware components of the tangible product function together to deliver the tangible product's essential functionality.
- Nonsoftware components of tangible products.
- Software components of tangible products when the software components and nonsoftware components of the tangible product function together to deliver the tangible product's essential functionality. We also refer to these types of software components as "essential software" throughout this publication.
- Undelivered components that relate to the software that is essential to the above-described tangible product's functionality.

These concepts are discussed further below.

1.2 Introduction and scope

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Overview and Background

985-605-05-1

This Subtopic provides guidance on when revenue should be recognized and in what amounts for **licensing**, selling, leasing, or otherwise marketing computer software.

985-605-05-2

[Not used]

985-605-05-3

Software arrangements range from those that provide a license for a single software product to those that, in addition to the **delivery** of software or a software system, require significant production, modification, or customization of software.

985-605-05-4

Structurally, the form of a **hosting arrangement** may be split into two elements:

a. The right to use software

b. The hosting service.

The arrangement may or may not include a license right to the software and the customer may or may not have an option to take delivery of the software. The guidance beginning in paragraph 985-605-55-119 addresses the scope application of this Subtopic to a hosting arrangement.

Scope and Scope Exceptions

985-605-15-1

This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Topic, see Section 985-10-15, with specific qualifications and exceptions noted below.

985-605-15-2

The guidance in this Subtopic applies to all entities.

985-605-15-3

The guidance in this Subtopic applies to the following transactions and activities:

a. Licensing, selling, leasing, or otherwise marketing computer software.

b. [Subparagraph superseded by Accounting Standards Update No. 2009-14]

c. The software and software-related elements of arrangements that include software that is more-than-incidental to the products or services in the arrangement as a whole. Indicators that software is more-than-incidental to the products or services in an arrangement as a whole include (but are not limited to):

    1. The software is a significant focus of the marketing effort or is sold separately.

    2. The vendor is providing **postcontract customer support**.

3. The vendor incurs significant costs that are within the scope of Subtopic 985-20.

   In such arrangements, the guidance in this Subtopic applies to the software and software-related elements in the arrangement unless a scope exception in paragraph 985-605-15-4 is present. Software-related elements include software products and services such as those listed in paragraph 985-605-25-5. A service is within the scope of this Subtopic if software in the arrangement is essential to the functionality of that service.

d. More-than-insignificant discounts on future purchases that are offered by a vendor in a software arrangement. More-than-insignificant discounts have all of the following characteristics:

   1. Incremental to the range of discounts reflected in the pricing of the other elements of the arrangement

   2. Incremental to the range of discounts typically given in comparable transactions

   3. Significant.

      If the discount or other concessions in an arrangement are more than insignificant, a presumption is created that an additional element or elements (as defined in paragraph 985-605-25-5) are being offered in the arrangement. Judgment is required when assessing whether an incremental discount is significant.

e. Arrangements to deliver software or a software system, either alone or together with other products or services that require significant production, modification, or customization of software (see Subtopic 605-35). Paragraphs 985-605-25-88 through 25-107 provide guidance on applying contract accounting to certain arrangements involving software. If a software arrangement includes services that meet the criteria discussed in paragraph 985-605-25-78, those services should be accounted for separately.

The guidance beginning in paragraph 985-605-55-119 addresses the scope application of this Subtopic to a **hosting arrangement**.

Determining if an arrangement is within the scope of the software revenue recognition guidance included in ASC 985-605

Question 1-1 **What factors should be considered in assessing whether an arrangement is within the scope of the software revenue recognition guidance in ASC 985-605?**

ASC 985-605 requires a determination of its applicability to be made at an activity level versus an entity level (i.e., whether an entity is a software entity, as described by the entity itself or by others, is not determinative as to whether the provisions of this guidance should be applied). Accordingly, many entities that consider themselves hardware or equipment vendors may still have software components of their product offerings that need to be accounted for pursuant to this guidance.

Any transactions including the "licensing, selling, leasing, or otherwise marketing of computer software" must be assessed to determine whether those transactions, in whole or in part, fall under the guidance in ASC 985-605. In certain situations, this assessment will be straightforward; in others, it will be more complex. For example:

- If the arrangement contains only software, the assessment is straightforward; as such arrangements are pure software arrangements and, therefore, are always in the scope of the software revenue recognition guidance.

- If arrangements contain both software and tangible products, the assessment may be more complex. For such transactions, an entity may have to consider a number of factors, including the following:
  - The entity will have to determine whether the software and software-related elements are more than-incidental to the products or services as a whole. (See Question 1-2 for a further discussion of this concept.) If the software and software-related elements are not more-than-incidental to the products or services as a whole, then the transaction is not subject to the provisions of ASC 985-605.
  - If the software and software-related elements are more-than-incidental to the products or services in the arrangement as a whole, those software and software-related elements are within the scope of the ASC 985-605, unless any of the scope exceptions in ASC 985-605-15-4 apply. (See Question 1-5 for a further discussion of the scope exceptions.)
  - If the software and software-related elements are within the scope of ASC 985-605 (i.e., they are more-than-incidental, and none of the scope exceptions in ASC 985-605-15-4 apply), any services included in the arrangement will have to be assessed to determine if they also fall within the scope of ASC 985-605. If the software and software-related elements are essential to the functionality of the services, the services are within the scope of ASC 985-605.

Determination of more-than-incidental

Question 1-2 **What factors should be considered in determining whether the software and software-related elements in an arrangement including products or services are more-than-incidental to the arrangement as a whole?**

ASC 985-605 indicates that its provisions are applicable to the sale of software and software-related elements in arrangements when the software is more-than-incidental to the products or services in the arrangement as a whole. However, determining whether software content is more-than-incidental to the products or services in which the software is contained can be difficult and will require considerable judgment. In other situations, entities may not need to give much consideration as to whether the software is more-than-incidental because the product and related software will qualify for the scope exceptions provided in ASC 985-605-15-4, regardless of the result of the more-than-incidental determination. However, in situations in which the scope exceptions do not apply, an entity will have to assess whether or not the software included within an arrangement is more-than-incidental to the products or services as a whole.

ASC 985-605-15-3 provides the following indicators to consider when making the determination as to whether the software is more-than-incidental:

- Is the software a significant focus of the marketing effort or is the software sold separately?

  Evaluation of this factor seeks to determine if the focus of the company's marketing effort for the product or service is on the software component such that the customer's buying decision is significantly influenced by the software component of the product or service (e.g., the software component is a factor that differentiates the product or service from competitor's products). The greater the emphasis on the features and functionality of the software in the marketing of the product or service by the vendor, the more likely it is that the software is important to the customer's buying decision. In such cases, the software may be more-than-incidental.

For purposes of evaluating this factor, consideration should be given to the content of marketing collateral (e.g., advertisements, product brochures, vendor websites, tear sheets, proposals, sales personnel training and presentations). Additionally, consideration should also be given to whether the product or service is described and differentiated based on the software's features and capabilities or by features and capabilities of the product or service that are primarily driven by the functionality of the software. If the software's features are marketed, the relative significance of that focus to the overall marketing effort for the product or service must be evaluated.

We understand that when evaluating the focus of the marketing effort for a product or service, the SEC staff will read the company's discussion of its business, including the products and services that it offers, contained in any SEC filings. Additionally, our experience with the SEC staff indicates that they often will read the content of a company's website and other publicly available information to evaluate the focus of its marketing efforts.

When software is sold without the associated product or service, this generally is an indicator that the software is more-than-incidental to the products and services that are being marketed.

- Is the vendor providing postcontract customer support (PCS)?

  ASC 985-605 defines PCS, in part, as the right to receive services (other than those accounted for separately), or unspecified product upgrades/enhancements on a when-and-if-available basis, or both. PCS typically includes one or more of the following:

  - Telephone support
  - Bug fixes or debugging
  - Unspecified upgrades/enhancements on a when-and-if-available basis

  PCS may be provided by a software vendor even though not evidenced by a written contract. This is referred to as implied PCS. We believe that if a vendor provides PCS for software marketed in conjunction with, or as a part of, a product or service offered for sale (either as a condition of a written contract or through implied PCS), this is an indicator that the software is more-than-incidental.

  However, the services comprising PCS should be considered before concluding that the software is more-than-incidental. For example, assume a vendor provides periodic updates on a when-and-if-available basis, but 1) the updates are limited to bug fixes and no new functionality or features are provided to the customer and 2) the bug fixes are not provided on a regular basis. Although the definition of PCS provided by ASC 985-605 encompasses bug fixes, when bug fixes are the only item provided after delivery of the licensed software, and that is the vendor's continuing intent, the vendor is in essence providing services pursuant to a warranty. In such circumstances, the provision of bug fixes should be accounted for as a warranty obligation pursuant to ASC 450, *Contingencies*.

  While the presence of PCS may be an indicator that the software is more-than-incidental, the absence of PCS should not be presumed to indicate that the software is incidental. As illustrated by the excerpt of the illustrative guidance below, situations may exist in which the customer does not need PCS and, despite its absence, the provisions of ASC 985-605 are applicable.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Example 2: Scope–A Developer of Interactive Training Courses

985-605-55-130

This example illustrates the guidance in paragraphs 985-605-15-3 through 15-4 regarding the determination of whether the software is incidental to the products or services as a whole.

985-605-55-131

An entity develops interactive training courses for sale or licensing to customers. These courses are delivered on a compact disc, which is loaded onto a customer's computer. The courses are developed such that, based on the responses received to a particular question, different questions are generated and content of the course material that is displayed is determined in a manner that directs the user's learning experience in a more focused way. The course developer's costs for the development of the software content are within the scope of Subtopic 985-20 and are significant. The interactive nature of the courses is mentioned prominently in the marketing efforts.

985-605-55-132

The Subtopic is applicable because the software is not incidental to the product.

985-605-55-133

Although some might say that the product is educational services, the marketing of the product focuses on the software-reliant interactive features. In addition, the course developer incurs significant costs that are within the scope of Subtopic 985-20. The nature of the relationship between the vendor and the customer is not one in which the customer would have a need for postcontract services. Consequently, the absence of postcontract support is not presumptive that software is incidental to the product. Accordingly, a conclusion is reached that the software is not incidental to the product as a whole. Therefore, the provisions of this Subtopic apply.

- Does the vendor incur significant costs that are within the scope of ASC 985-20, *Software — Costs of Software to be Sold, Leased, or Marketed*?

  A cursory reading of this indicator might lead one to consider whether significant costs have been capitalized pursuant to the provisions of ASC 985-20. However, we believe that the indicator seeks to determine whether significant costs have been incurred, regardless of whether such costs have been capitalized. The scope of ASC 985-20 includes all the costs incurred in the development of the software component (which generally are expensed as research and development) and those that are production costs (which generally are capitalized).

  When evaluating the appropriate aggregate pool of costs of developing the product or service as a whole (i.e., ASC 985-20 costs and the hardware or equipment development costs), we believe a pure quantification of the ASC 985-20 or software costs is not necessarily determinative of the significance of the total development costs. For example, if internally generated development costs are incurred relating to software but a larger amount is incurred to acquire or develop a "box" that houses the software used to provide a service, the software development costs incurred may still indicate that the software is more-than-incidental. Additionally, when development costs relate to both hardware and software, it is important to analyze the components of the development costs. That is, consideration should be given to the relationship of the software development costs to the hardware development costs. When the software development costs are significant relative to the total development costs of the product, this is an indicator that the software is more-than-incidental. Of course, in both of these situations, if the transaction meets the scope exception guidance within ASC 985-605 (e.g., the entity determines that the hardware and software are working together to provide the essential functionality of the tangible product), the transaction would be excluded from the scope of ASC 985-605, even if the software is more-than-incidental (see Question 1-5). We believe that the scope exception pertaining to the hardware and software functioning together will apply in a large number of transactions for tangible products including both hardware and more-than-incidental software. However, if the scope exceptions do not apply, the vendor will have to account for any software components of the development costs in accordance with ASC 985-605.

If a vendor concludes the software component of its products or services is incidental to those products or services as a whole, that conclusion should be periodically reevaluated. This is particularly true for companies in technology-based industries because of the rapidly changing environment in which many of these companies operate and the evolution of software embedded in their products or used to provide their services.

When assessing whether changes in a company's products or services indicate that the software has become more-than-incidental to the arrangement, the SEC staff outlined in a speech at the December 2004 AICPA Conference on SEC Current Developments the following factors that should be considered.

- When evaluating whether the software is a significant focus of the marketing effort of the product or service, companies should focus on whether changes to the features and functionality of the product or service being promoted by advertisements directly result from the software.
- In some situations, hardware manufacturers or service providers find the underlying software works so well that it develops a market among their competitors. They then begin to license that software separately for sale so their competitors can use the software in their product and service offerings. That would represent a change in circumstances that may suggest that the embedded software is more-than-incidental.
- Changes in circumstances also may affect a company's accounting for software costs. Companies should carefully consider the interaction between ASC 985-20 and ASC 350-40, *Intangibles — Goodwill and Other — Internal Use Software,* as it relates to accounting for the costs of software-related to the product or service offerings. A determination that such costs are most appropriately accounted for pursuant to ASC 985-20 may indicate that the software is more-than-incidental to the products or services that it is included in or sold with.

The SEC staff also commented that companies that have software underlying products and services that they believe are nonsoftware centric should consider the following indicators of whether the software is more-than-incidental:

- Do the rights to use the software remain solely with the vendor, or are the rights transferred to the customer as part of the product or service offering? If the rights to use the software survive cessation of the service or sale of the product, this is an indicator that the software is more-than-incidental.
- Does the licensed software require the customer to provide dedicated information technology (IT) support? If the customer must maintain and troubleshoot the underlying software, it may be more-than-incidental.

This speech also emphasized the following matters:

- The factors identified in the software revenue recognition guidance as those to be considered when determining whether software is more-than-incidental are not determinative, presumptive or all inclusive. Further, the staff acknowledged that these factors can be difficult to apply to products or services not traditionally viewed as software-related. We believe this point emphasizes that the determination of whether software is more-than-incidental is a matter that requires professional judgment.
- A change in circumstances resulting in a company concluding that software is not incidental also would require the costs of developing the software be accounted for pursuant to ASC 985-20 rather than as internal use software.
- Because a company's determination in this area involves significant judgment and would likely have a material effect on a company's revenue recognition policy, a detailed discussion of these factors and the related conclusions within the Critical Accounting Policies section of MD&A may be appropriate. Note that the scope exception in ASC 985-605-15-4 regarding hardware and software that function together to deliver a tangible product's essential functionality arose after this SEC staff speech. Because the evaluation of that scope exception also involves judgment and could materially affect the financial statements, we believe the SEC staff would expect similar disclosures for that judgment.

It is difficult to consider one indicator more persuasive than another, so a careful evaluation of the facts and circumstances is required to determine whether the provisions of the software revenue recognition guidance are applicable to all of a company's activities, certain software product lines or individual transactions.

Applicability of ASC 985-605 when licensed software is hosted by the vendor

Question 1-3 **Are the provisions of the software revenue recognition guidance applicable to arrangements in which a vendor agrees to host licensed software, or should such arrangements be accounted for as service contracts?**

Some vendors enter into transactions to provide customers with software functionality without the customer having to install the licensed software on their own hardware. Instead, the vendor's software resides on its own servers, or those of third parties engaged by the vendor, and the customer accesses the software on an as-needed basis via a dedicated link or the Internet. Reasons for transactions of this nature might include the vendor's desired business model or the desire of a customer to avoid a dedicated in-house information systems infrastructure to support the licensed software.

Such transactions typically are referred to as "hosting," Application Service Provider (ASP) or Software as a Service (SaaS) arrangements. Regardless of the term used to describe such an arrangement, the form may be split into two elements: 1) the right to use the licensed software and 2) the hosting service. The arrangements may or may not include an explicit license of the software, and the customer may or may not have an option to take delivery of the software.

Although the vendor's software is undoubtedly key to its ability to meet its obligations to its customer in such arrangements, the arrangement itself may or may not be subject to the scope of the software revenue recognition guidance. To determine whether the scope of the software revenue recognition guidance is applicable, the substance of the arrangement must be evaluated to determine whether a service based on the software is being delivered to the customer. ASC 985-605 includes factors that must be considered in making such determination, as follows:

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Hosting Arrangement

985-605-55-119

This implementation guidance addresses the scope application of this Subtopic to a hosting arrangement.

985-605-55-120

[Paragraph not used]

985-605-55-121

A software element subject to this Subtopic is only present in a hosting arrangement if both of the following criteria are met:

a. The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.

b. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

Accordingly, a hosting arrangement in which the customer has an option as specified in this paragraph is within the scope of this Subtopic.

985-605-55-122

For purposes of item (b) in the preceding paragraph, the term significant penalty contains two distinct concepts:

a. The ability to take delivery of the software without incurring significant cost

b. The ability to use the software separately without a significant diminution in utility or value.

985-605-55-123

Therefore, arrangements that do not give the customer such an option are service contracts and are outside the scope of this Subtopic. Hosting arrangements that are service arrangements may include multiple elements that affect how revenue should be attributed.

985-605-55-124

For those hosting arrangements in which the customer has the option, as described in paragraph 985-605-55-122 to take possession of the software, delivery of the software occurs when the customer has the ability to take immediate possession of the software. If the software element is within the scope of this Subtopic, all of this Subtopic's requirements for recognizing revenue, including vendor-specific objective evidence of fair value and the requirement that the fee allocated to the software element not be subject to forfeiture, refund, or other concession, must be met to recognize revenue upon delivery for the portion of the fee allocated to the software element. The portion of the fee allocated to the hosting element should be recognized as the service is provided. Hosting arrangements that are within the scope of this Subtopic may also include other elements, such as specified or unspecified upgrade rights, in addition to the software product and the hosting service.

985-605-55-125

If the vendor never sells, leases, or licenses the software in an arrangement within the scope of this Subtopic, then the software is utilized in providing services and the development costs of the software should be accounted for in accordance with Subtopic 350-40.

The fact that an arrangement conveys to the customer a license to software hosted by the vendor is not in and of itself a sufficient basis to conclude that the arrangement is subject to the scope of the software revenue recognition guidance. ASC 985-605-55-121 specifies that an arrangement should only be deemed to include a software element that should be accounted for pursuant to the software revenue recognition guidance if the customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty, and it is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software. These factors are discussed in more detail below.

A vendor does not have to deliver licensed software included in an arrangement for a software element to exist in the arrangement. Conversely, a software element is not present in a transaction merely because the vendor delivers a copy of the licensed software to the customer. The key in determining whether a software element exists is whether the customer has a substantive right to take possession of the licensed software and use it for its intended purpose without further utilization of the hosting services offered by the vendor. In other words, for a software element to be deemed to exist in a hosting arrangement, the customer must be able to use the software in-house or engage a third party unrelated to the vendor to host the software on its behalf, and it must be able to do so without incurring a significant penalty.

ASC 985-605-55-122 defines a significant penalty using two distinct criteria: 1) the ability to take delivery of the software without incurring significant cost and 2) the ability to use the software separately without a significant diminution in utility or value. In order to conclude that a significant penalty does not exist, the vendor must be able to demonstrate that the customer can meet both of the conditions above. However, the guidance does not provide specific guidelines on how to apply these two criteria in practice.

We believe that the following factors should be considered in evaluating whether a customer has the ability to take delivery of software included in an arrangement without incurring significant cost:

- *Whether financial penalties or operational barriers act as a significant disincentive to the customer taking possession of the software*. An example of such a barrier is a contractual requirement that significant fees or penalties must be paid to the vendor in connection with taking possession of the software. Another form of penalty may be a requirement to pay or forfeit a significant amount of "unused" hosting fees on cancellation of the hosting contract. Accordingly, a hosting arrangement should be evaluated carefully to determine if the amount of hosting fees that the customer must either 1) pay on cancellation or 2) forfeit if prepaid, represents a "significant cost."

  Although a bright line does not exist to determine significance, if a penalty represents more than 10% of the overall arrangement fees (generally comprised of the software license fees, the initial bundled PCS period and non-cancelable hosting fees), we believe a rebuttable presumption exists that the penalty is significant. Additionally, a penalty of less than 10% may be significant based on the applicable facts and circumstances. The evaluation should be based on whether the amount of the penalty creates a sufficiently large disincentive such that it is not likely that the customer would incur the penalty to take possession of the software. In evaluating whether any fees or penalties are significant, we believe that the amount of the fees or penalties should be evaluated both in the context of the overall arrangement economics as well as the financial condition of the customer.

- *Whether there is an explicit, reasonable mechanism in the contractual arrangement by which the customer can exercise a right to take possession of the software.*

- *Whether other economic barriers or costs exist that act as a significant disincentive to the customer taking possession of the software*. For example, specialized hardware may be required to run the software, but the cost of obtaining that hardware is so high that a significant disincentive exists. Furthermore, if specialized technicians are needed to run the software, the cost to hire the technicians also may be a significant disincentive.

- *Whether there is an absence of an adequate number of qualified replacement service providers*. A lack of service providers that could host the licensed software due to 1) unique features, functionality or operating system requirements of the software, 2) the need to hire specialized technicians to run the software at a significant cost or 3) other factors may be a significant disincentive.

We believe the following factors should be considered in evaluating whether a customer has the ability to use software separately without a significant diminution in utility or value:

- *Whether the customer can utilize all of the functionality of the software if the software is not hosted by the vendor*. For example, if the software would not be able to process substantially the same number of transactions in approximately the same period if not hosted by the vendor, this may indicate that the customer cannot use the software separately from the vendor's hosting services without a significant diminution in utility or value.

- *Whether software upgrades are only available to customers for whom the vendor hosts the software*. If the functionality provided by upgrades to the software is important to customers, and such upgrades would not be made available if the software is not hosted by the vendor, the utility of the software to a customer is likely significantly diminished if the vendor's hosting services are discontinued.

If a software element is not deemed to be included in a hosting arrangement pursuant to the provisions of ASC 985-605, the entire arrangement should generally be accounted for as a service contract in accordance with the provisions of the multiple-element arrangements guidance in ASC 605-25 and the general revenue recognition guidance in SAB Topic 13. We generally expect that when a hosting arrangement does not have a software element pursuant to ASC 985-605 and is therefore in the scope of SAB Topic 13, the software would generally not have standalone value. Accordingly, if an arrangement is composed of only the right to use the software and the hosting service, the two elements should be accounted for as one unit of accounting pursuant to ASC 605-25. In this case, as the hosting service is the last element to be delivered, the entire arrangement fee should be recognized as revenue as the hosting service is performed.

If all elements of the arrangement, including hosting or any other services, are within the scope of the software revenue recognition guidance, the separation criteria in that guidance are applicable and must be evaluated. If VSOE of fair value exists for each element, the arrangement consideration should be allocated to the various elements using the relative-fair-value method such that each element of the arrangement is allocated a proportionate amount of consideration and any discount from the arrangement. If VSOE of fair value exists only for the undelivered elements of the arrangement, an amount of arrangement consideration equal to VSOE of fair value should be allocated to the undelivered elements and the remaining amount of arrangement consideration, if any, should be allocated to the delivered elements. If VSOE of fair value does not exist for the undelivered elements, the revenue should be recognized at the earlier of the following (assuming all of the basic criteria for revenue recognition of ASC 985-605 have been met):

- VSOE of fair value is developed for the undelivered elements

- All elements of the arrangement have been delivered

- If the last undelivered element of the arrangement is a service, such as a hosting service, that does not involve significant production, modification or customization of the licensed software, the entire fee should be recognized over the period that the services will be performed

If the elements of the arrangement are not within the scope of the software revenue recognition guidance, the arrangement should be accounted for as a service contract in accordance with the provisions of ASC 605-25 and SAB Topic 13 as discussed above. If a vendor is unable to separately account for a delivered software license, for example, due to a lack of standalone value, the delivered elements cannot be accounted for separately from the ongoing hosting services, and revenue for the arrangement generally should be recognized as the hosting services (i.e., the last element delivered) are performed. Additionally, as discussed further below, the vendor should consider whether the license fee is actually an up-front fee that should be accounted for over the estimated customer relationship period.

Certain hosting arrangements may require the customer to pay an amount at inception of the arrangement (an "up-front fee"). Generally, when such fees are not associated with the delivery of a product or service, they do not represent the culmination of the earnings process and, therefore, cannot be recognized at the onset of the arrangement. For example, we believe that a license fee in a hosting arrangement for which it is not feasible to use the license without the hosting (i.e., the arrangement is treated as a service contract) is analogous to a set-up fee. SAB Topic 13 provides guidance on the accounting for such fees, indicating that the receipt of such up-front fees is not a separate earnings process that should result in revenue being recognized for the following reasons:

- The terms, conditions and amounts of these fees typically are negotiated in conjunction with the pricing of all the elements of the arrangement.
- The customer would ascribe a significantly lower, and perhaps no, value to elements ostensibly associated with the up-front fee in the absence of the registrant's performance of other contract elements (e.g., the hosting service).
- The vendor does not sell the initial rights, products or services separately (i.e., without the vendor's continuing involvement).

In such situations, the fee should be deferred and recognized over the contractual term of the hosting service or the estimated customer relationship period (which is the assumed estimated period of benefit pursuant to SAB Topic 13), if longer than the hosting contractual period.

The following examples illustrate these concepts:

Illustration 1-1: All elements are subject to the software revenue recognition guidance, VSOE of fair value of hosting services exists

Facts

Vendor S enters into an arrangement with Customer C to license software Product and provide hosting services for one year for $1,500,000, which is paid at inception of the arrangement. The arrangement also states that Vendor S will perform implementation services that will allow Customer C to access the hosted software. The software is essential to the services included in the arrangement. The contract states that $1,000,000 is for the software license, $100,000 is for the implementation services and $400,000 is for the first year of hosting services. The hosting services are cancelable with thirty days' notice. If cancelled, the customer receives a pro-rata refund of the $400,000 hosting fee.

The customer has the contractual right to take possession of the software without incurring a significant penalty, and it is feasible for the customer to run the software on its existing hardware or engage other vendors to host the software. The costs to take possession of the software, or to transfer the hosting services to a third party, are $25,000. VSOE of fair value of the hosting services is $500,000 based on annual renewals of the services. VSOE of fair value of the implementation services does not exist.

Analysis

The costs to take possession of the software, or transfer hosting services to a third party, are not significant in relation to the overall arrangement. Because the customer has the right to take possession of the licensed software without significant penalty, and it is feasible for the customer to utilize its existing hardware to run the software, or to engage others to host the software, the licensed software is subject to the scope of the software revenue recognition guidance.

Additionally, because the software is essential to the services included in the arrangement, these services also are subject to the scope of the software revenue recognition guidance. Since VSOE of fair value exists only for the hosting services (undelivered element), revenue should be recognized once the hosting services are the only undelivered element (assuming the software license term has commenced and all of the basic revenue recognition criteria of the software revenue recognition guidance have been met). At the time the implementation services are complete, Vendor S should defer $500,000 for the hosting services (which represents VSOE of fair value of those services) and recognize such amount over the period that the hosting services will be delivered, and the residual arrangement consideration of $1,000,000 can also be recognized as revenue when the implementation services are complete (if all of the basic revenue recognition criteria of the software revenue recognition guidance have been met).

Note that in an arrangement involving hosting services, we do not believe application of the "Combined Services" approach at the onset of the contract is appropriate because the implementation services and the hosting services do not commence concurrently. As discussed in Question 3-16, under a Combined Services approach, the entire arrangement fee would be recognized ratably over the period during which the services are expected to be performed or the PCS period, whichever is longer, once the software has been delivered and the provision of both services has commenced, if all of the other basic revenue recognition criteria of ASC 985-605 have been met.

Illustration 1-2: Elements are not subject to the scope of the software revenue recognition guidance

Facts

Assume the same facts as in Illustration 1-1 above, except that if the customer elects to take possession of the software, it must pay an additional software licensing fee of $250,000. In the context of this arrangement, the requirement that the customer must pay an additional $250,000 to the vendor if it elects to take possession of the software represents a significant penalty that serves as a disincentive to the customer taking such action.

Analysis

Pursuant to the provisions of ASC 985-605-55-121, the licensed software is not subject to the scope of the software revenue recognition guidance because there is a significant disincentive to the customer taking possession of the software. We generally expect that when a hosting arrangement does not have a software element pursuant to ASC 985-605 and is therefore in the scope of SAB Topic 13, the software would generally not have standalone value. Instead, all elements of the arrangement should be accounted for as a service contract pursuant to the provisions of SAB Topic 13 and the multiple-element arrangements guidance in ASC 605-25, including determining if the initial payment reflects an up-front fee that must be recognized over the estimated customer relationship period.

Evaluating whether future discounts are more than insignificant

Question 1-4 **What factors should be considered to assess whether a future discount is more than insignificant? Should the right to the discount on a future purchase be accounted for separately?**

Pursuant to ASC 985-605-15-3(d), more-than-insignificant discounts on future purchases of software included in a software arrangement are within the scope of the software revenue recognition guidance. Contractual arrangement terms that give customers the right to future purchases of additional products or services from a vendor for an amount below their fair value, including the ability to renew PCS at rates below established VSOE of fair value, in addition to the current products and services being purchased, generally should be accounted for separately. A discount that is not more than insignificant generally requires no accounting recognition.

A discount on the purchase of future products or services provided to a customer in connection with a current arrangement is considered to be more than insignificant if it meets each of the following criteria:

- The future discount is significant in the context of the overall transaction. For example, if an arrangement for which the total consideration is $200,000 includes the right to buy an item that normally sells for $2,000 for $1,000, that discount is not significant in the context of the overall transaction. Determining when a discount is significant to the overall transaction will require the use of professional judgment and will be dependent on the relevant facts and circumstances.
- The future discount is incremental to the discounts, if any, inherent in the pricing of the other elements included in the arrangement. For example, if the customer were granted a discount of 20% on the elements included in the arrangement, a 20% discount on future purchases of additional products or services would generally not be considered incremental.
- The future discount is incremental to the discount typically provided to customers purchasing the same or similar products or services on a standalone basis. If the customer is not provided a discount that is incremental to that which other customers generally receive, no incremental value has been provided to the customer through the future discount.

Refer to Question 5-4 for guidance on the accounting for a future discount that it is deemed more than insignificant as an element in the arrangement.

1.3 Scope exceptions

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Scope and Scope Exceptions

985-605-15-4

The guidance in this Subtopic does not apply to the following transactions and activities:

a. Arrangements for products or services containing software that is incidental to the products or services as a whole

b. Leases of software that include a tangible product (such as property, plant, or equipment), if the software is incidental to the tangible product as a whole or the software and nonsoftware components of the tangible product function together to deliver the tangible product's essential functionality

c. Marketing and promotional activities not unique to software transactions, such as the following:

 1. Insignificant discounts on future purchases that are offered by a vendor in a software arrangement. For example, a vendor may offer a small discount (a coupon or other form of offer for 5 percent off) on additional licenses of the licensed product or other products that exist at the time of the offer but are not part of the arrangement.

 2. Discounts that are not incremental to discounts typically given in comparable transactions (for example, volume purchase discounts comparable to those generally provided in comparable transactions).

d. Nonsoftware components of tangible products

e. Software components of tangible products that are sold, licensed, or leased with tangible products when the software components and nonsoftware components of the tangible product function together to deliver the tangible product's essential functionality

f. Undelivered elements that relate to software that is essential to the tangible product's functionality in (e).

985-605-15-4A

In determining whether a tangible product is delivered with software components and nonsoftware components that function together to deliver the tangible product's essential functionality, a vendor shall consider all of the following:

a. If sales of the tangible product without the software elements are infrequent, a rebuttable presumption exists that software elements are essential to the functionality of the tangible product.

b. A vendor may sell products that provide similar functionality, such as different models of similar products. If the only significant difference between similar products is that one product includes software that the other product does not, the products shall be considered the same product for the purpose of evaluating (a).

c. A vendor may sell software on a standalone basis. The vendor may also sell a tangible product containing that same software. The separate sale of the software shall not cause a presumption that the software is not essential to the functionality of the tangible product.

d. Software elements do not need to be embedded within the tangible product to be considered essential to the tangible product's functionality.

e. The nonsoftware elements of the tangible product must substantively contribute to the tangible product's essential functionality. For example, the tangible product should not simply provide a mechanism to deliver the software to the customer.

Determining if software components are excluded from the scope of ASC 985-605

Question 1-5 **What factors should be considered to determine whether software and nonsoftware components function together to deliver the tangible product's essential functionality?**

When an arrangement contains both hardware and software components, the hardware is always outside the scope of the software revenue recognition guidance. Further, the entity must make a determination as to whether the hardware and software function together to deliver the product's essential functionality. If it is determined that the two function together to deliver the product's essential functionality, the essential software (i.e., software that functions together with the hardware to deliver the essential functionality) and any undelivered elements related to that essential software are excluded from the scope of the software revenue recognition guidance.

This scope exception originated in ASU 2009-14, which resulted from the EITF's consensus in Issue No. 09-3, "Applicability of SOP 97-2 to Certain Arrangements That Include Software Elements." During its deliberations, the EITF concluded that the determination of whether the software and nonsoftware components function together to deliver the product's essential functionality should be from the vendor's perspective, not the customer's. The EITF ultimately decided that a customer's buying decision may be affected by many factors, including price, functionality, aesthetics, brand and others. As a result, the EITF concluded that a model based on customer perspective would be very difficult, if not impossible, to apply in practice. Therefore, the guidance requires the determination of what is essential to the functionality of a product be from the standpoint of the vendor. Making the determination from the vendor's perspective also is consistent with the guidance regarding determination of VSOE of fair value and of estimating selling price in the software revenue recognition guidance and multiple-element arrangements guidance, respectively.

Because the determination of whether, from the standpoint of the vendor, the software and nonsoftware components function together to deliver the essential functionality of a product can be difficult and requires considerable professional judgment, the EITF developed indicators and examples to be considered in the analysis. Specifically, ASC 985-605-15-4A lists the following indicators:

- Does the entity sell the tangible product without the software element on more than an infrequent basis?

  The inclusion of the software with the tangible product on an optional basis implies that the vendor does not consider it essential to the product's functionality. Conversely, if the tangible product is normally combined with the software and sales of the tangible product without the software are infrequent, this in an indicator that the software elements are essential to the functionality of the tangible product. The guidance does not provide specific guidance as to what "infrequent" means, and all relevant facts and circumstances will need to be carefully considered in the analysis. For example, if a vendor sells the hardware without its own software only occasionally to customers that previously purchased the hardware with the software that now need to expand the hardware or replace non-nonfunctioning hardware, such sales would likely be considered infrequent.

The following examples from ASC 985-605 illustrate this concept:

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Example 13 — Arrangements That Include Tangible Products and Software Elements

Case A: Computer with Operating System Included

985-605-55-212

Vendor sells a personal computer that includes an operating system that, along with the hardware, provides the basic functionality of a personal computer including the ability to manage the computer and its hardware functions, the ability to manage and interact with a range of hardware peripherals, and the ability to communicate through a variety of types of computer networks. This arrangement has no undelivered elements. Vendor infrequently sells the personal computer without the operating system.

985-605-55-213

Because both the hardware and operating system are necessary to deliver the computer's essential functionality, the arrangement would be excluded from the scope of this Subtopic.

Case B: Computer with Operating System Excluded More Than Infrequently

985-605-55-214

Consider the same fact pattern as in Case A, except that Vendor sells the personal computer both with and without the operating system more than infrequently.

985-605-55-215

Because Vendor sells the personal computer without an operating system more than infrequently, the operating system is not considered essential to the functionality of the personal computer. Therefore, the computer would be excluded from the scope of this Subtopic, and the operating system would be considered a separate deliverable that is within the scope of this Subtopic.

Case C: Computer and Multiple Operating Systems

985-605-55-216

Consider the same fact pattern as in Case A, except that Vendor also sells the personal computer with a different operating system that provides essentially the same functionality as the operating system in Case A.

985-605-55-217

Vendor infrequently sells the personal computer without an operating system, which indicates that an operating system is essential to the functionality of Vendor's personal computer. All deliverables would be excluded from the scope of this Subtopic.

Case D: Computer with Additional Software Products Included

985-605-55-218

Consider the same fact pattern as in Case A, except that Vendor also includes a productivity software bundle with the personal computer that allows users to create, edit, and use documents, spreadsheets, and presentations. Vendor frequently sells the same computer both with and without the productivity software. When the productivity software is included with the software, the functionality of the productivity software is prominently displayed in the marketing materials and specifications of the computer. The productivity software is also sold separately.

985-605-55-219

The productivity software would not be considered necessary for the computer to provide its essential functionality. While the operating system is essential to deliver the personal computer's basic functionality, the productivity software is not. This is demonstrated by the fact that the computer is frequently sold both with and without the productivity software. The computer and operating system would be considered one deliverable that is excluded from the scope of this Subtopic. The productivity software would remain within the scope of this Subtopic.

- Does the entity sell products that provide similar functionality, such as different models of similar products?

  When an entity sells products that provide similar functionality (e.g., different models of similar products), and the only difference between the products is that one includes particular software and the other does not, the products should be considered the same product for purposes of evaluating this indicator. For example, if one model (Model 1) is sold with particular software and another model (Model 2) is sold without that same software, then that particular software element sold with Model 1 likely is not essential to the product's functionality. In that case, the incremental software on Model 1 would be within the scope of the software revenue recognition guidance (but the hardware and the balance of the software would not be subject to the software revenue recognition guidance). Conversely, if Model 1 also included different hardware features that the incremental software was designed to exploit, and Model 1 always included the incremental hardware features and incremental software, Model 1 would likely be considered a different product than Model 2 for purposes of this evaluation. Therefore, Model 1, including its incremental software, would be outside the scope of the software revenue recognition guidance. This concept is discussed further in Question 1-6.

The following example from ASC 985-605 illustrates this concept:

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Example 13 — Arrangements That Include Tangible Products and Software Elements

Case K: Similar Products

985-605-55-232

Vendor sells two models of personal digital assistant devices — Model 100 and Model 200. Model 100 (including the software delivered on Model 100) is considered to be a nonsoftware deliverable excluded from the scope of this Subtopic when applying this Subtopic. The difference between the two models is that Vendor infrequently sells the Model 200 without music player software. The music player software is not included on Model 100, but customers can separately purchase the software for use on Model 100. There is no substantive difference in the other hardware or software components of the two models.

985-605-55-233

Vendor would need to assess whether the two models are the same product or different products. If they are the same product, then the music player software would not be considered essential to the functionality of Model 200. Because there is no substantive difference between the two models other than the inclusion of the music player software, Vendor determines that the two models are the same product. When Vendor sells Model 200, it considers the music player software to be a software deliverable within the scope of this Subtopic when allocating the arrangement consideration.

- Does the vendor sell the software elements that are included with the tangible product separately in standalone sales?

  The separate sale of the software does not cause a presumption that the software is not essential to the functionality of the tangible product. For example, assume a vendor sells devices that require an operating system to function and the vendor only infrequently excludes the operating system from the device. The vendor also may sell the operating system separately as an upgrade to operating systems on devices previously purchased by customers. The vendor also may have configured the operating system to work on competitor's products. The vendor's decision to sell the software separately has no effect on the determination of whether or not the operating system is essential to the tangible product's functionality. The critical assessment is whether the device and the operating system when sold together are both necessary to provide the product's essential functionality.

The following examples from ASC 985-605 illustrate this concept:

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Example 13 — Arrangements That Include Tangible Products and Software Elements

Case E: Personal Digital Assistant

985-605-55-220

Vendor sells a personal digital assistant. The personal digital assistant provides several functions, such as phone, camera, and computing functionality, that allow the user to access and use various software programs, such as a music player and games. The personal digital assistant contains an operating system that allows the customer to access the functionality of the device, including the ability to utilize software that is necessary to provide the phone, camera, and other functionality. The phone and camera software are frequently included on the personal digital assistant, but the music player and game software are excluded more than infrequently. The phone, camera, and music player software are not sold separately, but the game software is sold separately.

985-605-55-221

The personal digital assistant hardware, operating system, phone, and camera software are essential to the functionality of the personal digital assistant and would be considered one deliverable that is outside the scope of this Subtopic. The music player and game software would be considered software deliverables within the scope of this Subtopic because the product also is sold more than infrequently without this software. Whether the software is sold separately does not affect the conclusion in this example.

Case F: Computer with Operating System Sold Separately

985-605-55-222

Vendor sells a personal computer that includes an operating system that, along with the hardware, provides the basic functionality of a personal computer, including the ability to manage the computer and its hardware functions, the ability to manage and interact with a range of hardware peripherals, and the ability to communicate through a variety of types of computer networks. The arrangement has no undelivered elements. Vendor never sells the personal computer without the operating system but does sell the operating system for the personal computer separately. The personal computer hardware cannot function without an operating system, and the operating system does not function without the computer hardware.

985-605-55-223

Vendor determines that the operating system is necessary to deliver the computer's essential functionality as evidenced by the fact that the vendor does not sell the computer without the operating system. Accordingly, the computer and operating system would be considered one deliverable that is excluded from the scope of this Subtopic. Whether the software is sold separately in a different transaction does not affect the conclusion in this example. The critical assessment is whether the computer and the operating system in one transaction are both necessary to provide the computer's essential functionality. See paragraph 985-605-55-227 for an illustration of how Vendor would account for the separate sale of the operating system without the computer.

- Are the hardware and software sold as an integrated package?

  The software does not need to be embedded in the tangible product in order for it to be considered essential to the tangible product's functionality. If the hardware and software are sold as an integrated package or solution and both are necessary to deliver the product's essential functionality, then both the hardware and software elements would be considered nonsoftware elements. The manner in which the vendor delivers the product should not affect this assessment. However, we believe the hardware and software should be sold within a reasonable period of time of one another in order for the vendor to demonstrate that the two are an integrated package.

The following example from ASC 985-605 illustrates this concept:

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Example 13 — Arrangements That Include Tangible Products and Software Elements

Case J: Networking Equipment

985-605-55-230

Vendor sells networking equipment that provides its energy company customers with the ability to remotely monitor and manage their customers' energy use. Vendor sells an integrated package of equipment and software that consists of a monitoring device that is placed at the energy company's customer location to collect data that it then relays back to the energy company's remote location and software that allows the energy company to analyze the data and interface with its billing system. The software is installed on the energy company's computer system, which is not purchased from Vendor. The equipment does not have functionality without the software, and the software does not have functionality without the equipment. Vendor's customers will initially purchase all of these components together; however, they also can separately purchase replacement or expansion equipment or updated versions of the software at a subsequent time.

985-605-55-231

The equipment and software would all be considered nonsoftware elements outside the scope of this Subtopic. The monitoring and relay equipment work together with the software (though not as a physically combined unit) to deliver the product's essential functionality and allow the energy company to access and analyze its customers' usage data. Vendor cannot access the functionality of the equipment without the software. Although Vendor does sell the equipment separately without the software, it only does so in replacement situations or as the customer base of the energy company expands. The customer would have needed to previously acquire the software for the replacement equipment to function.

- Do the nonsoftware elements substantively contribute to the tangible product's essential functionality?

  The tangible product should not simply provide a mechanism to deliver the software to the customer. For example, if a vendor decides to sell the software on a CD or another device but the software and hardware components do not function together to deliver the tangible product's essential functionality, the software would not be considered essential to the functionality of the tangible product and, therefore, the software would be within the scope of the software revenue recognition guidance.

Model versus product determination

Question 1-6 **If an entity sells multiple versions of a similar software-enabled tangible product with different functionalities, what factors should be considered to determine whether such versions are different products or different models of the same product?**

Many entities have extensive product offerings. In applying the scope exception guidance in ASC 985-605-15-4 and 15-4A, an entity likely will have to determine whether these different offerings are actually different products or different models of the same product. This is because the scope exception guidance within ASC 985-605 requires that the assessment of whether the tangible product and software elements function together to provide the essential functionality be done at the product level, not the model level. Pursuant to this guidance, if multiple tangible product offerings are considered the same product for purposes of this evaluation, any incremental software included on certain but not all of the models would not be considered essential to the functionality of that tangible product. This is because the tangible product is sold more than infrequently without such software. In such situations, the incremental software would remain within the scope of the software revenue recognition guidance.

The guidance in ASU 2009-14 does not specifically address how entities are to determine whether multiple product offerings are different products or different models. However, in many situations, the underlying hardware included on a tangible product will differ from other product offerings (e.g., in order to provide different functionality from one product to the next, the hardware (and software) on one tangible product differs from another tangible product). In such situations, those product offerings generally would be considered different products for purposes of this evaluation. For example, an entity may include additional hardware and software on a game player to include wireless technology to expand the capability of that game player from a single-user game to a multi-user game. As the hardware contained within the tangible product differs substantively from the hardware contained on a single-user game, we believe this would be considered a different product, rather than a different model.

However, in some situations the software may be the only difference between two different tangible product offerings, or the hardware difference may not be significant. In such situations, we believe entities should consider the characteristics of their product lines and how the software affects the products' characteristics and functionality. For example, an entity should consider the effect the incremental software has on the basic function of the products. Assume the products in question are fulfilling the same basic function, and the only differentiating features between the products are additional "bells and whistles" offered in certain products (e.g., the additional features may improve certain aspects of performance, such as speed, but do not change the basic function of the product). In such situations, it is likely that these items are actually different models of the same product for purposes of this analysis. Conversely, if the incremental software is actually modifying the basic functions of the tangible product, an entity likely would conclude that these items are different products, not different models of the same product.

The entity also should take into consideration the marketing of the different products (e.g., whether the price differences for the tangible products are significant). The more significant the price difference, the more likely the items are different products and not different models. Additionally, if the different products are marketed to distinctly different customers, or the entity has different marketing strategies for each of the products, this also likely would support a conclusion that the items are different products. Marketing efforts also may highlight differences in use of the product. For example, an entity may market differently a product that includes incremental software if such software significantly expands or changes the manner in which a tangible product is used (e.g., a digital music player offered with and without phone capabilities). In such situations, the entity likely will conclude these items are different products and not models of the same product.

The factors discussed above are not exhaustive. The entity's evaluation of its product offerings to determine which are different products or different models likely will be complex and require the use of judgment. Therefore, it is critical that entities carefully consider all facts and circumstances specific to their product offerings and have clear and consistent accounting policies with respect to how they will make such a determination.

The following example illustrates this concept:

Illustration 1-3: Model versus product determination

Facts

A vendor sells server products A, B and C. Each server is sold with embedded software that provides the basic functionality for the server such as file sharing and storage, printing services, application hosting, e-mail and web hosting. This family of products is targeted to medium-sized business customers. Server A typically only includes the basic software. Server B is sold with additional software that increases the processing speed. Server C is sold with additional software that allows the server to more efficiently host enterprise databases such as enterprise resource planning. Server B is sold at a slightly higher price than server A, and server C is sold at a substantially higher price than server B.

Analysis

The vendor would need to consider carefully whether the differences in each product are sufficiently significant to make them different products instead of different models of the same product. The vendor would have to consider all relevant facts and circumstances pertaining to its product lines, including targeted customers, price points and the relative significance of the additional software to the functionality of the product. In this situation, the entity is likely to conclude that it has two "products" for purposes of this guidance, server A and server C, and that server B is another model of server A. This is because the functionality and pricing between server A and server B are not significant. However, server C has expanded functionality from servers A and B, as evidenced by the higher price for server C.

Based on the above, when determining whether the tangible product and software elements function together to deliver the essential functionality, the vendor will consider server A and B to be one product and server C to be a second product. Therefore, it is likely that the vendor will conclude that the incremental software included on server B (as compared to server A) is not essential to the functionality of the tangible product, as the tangible product is sold without that software on more than an infrequent basis (as the incremental software is not included on server A).

Undelivered elements in arrangements that include both software and nonsoftware elements

Question 1-7 **How are undelivered elements accounted for in arrangements containing both software and nonsoftware elements?**

The accounting treatment for the undelivered elements depends on whether the undelivered elements relate to the delivered software or the nonsoftware elements. ASC 985-605 indicates that to the extent the undelivered elements (such as PCS) relate to the delivered nonsoftware elements (which include any essential software elements excluded from the scope of ASC 985-605), the undelivered elements are also excluded from the scope of ASC 985-605 even if those elements would be subject to the scope of ASC 985-605 if sold separately. However, if the undelivered elements relate to delivered nonessential software (e.g., the "software elements" of the arrangement), those undelivered elements would be in the scope of ASC 985-605. To the extent that the undelivered elements relate to *both* essential and nonessential software, the undelivered element(s) has (have) to be bifurcated into a software and nonsoftware element. The software element is within the scope of ASC 985-605, and the nonsoftware element is excluded from its scope.

The following examples from ASC 985-605 illustrate this concept:

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Example 13 — Arrangements That Include Tangible Products and Software Elements

Case G: Computer and Undelivered Software Elements

985-605-55-224

Consider the same fact pattern as in Case A,[3] except that Vendor also provides a specified upgrade right for the next version of its operating system along with postcontract customer support, including information about available upgrades of the operating system.

985-605-55-225

Because the computer and operating system are determined to be a single nonsoftware deliverable that is excluded from the scope of this Subtopic, all deliverables related to that nonsoftware deliverable are also considered nonsoftware deliverables and excluded from the scope of this Subtopic. Accordingly, the postcontract customer support and specified upgrade right for the operating system would be nonsoftware deliverables excluded from the scope of this Subtopic.

Case I: Computer with Nonessential Software and Postcontract Customer Support Included

985-605-55-228

Consider the same fact pattern as in Case D,[4] except that Vendor also provides postcontract customer support for both the computer (including the operating system) and productivity software.

985-605-55-229

The combined computer and operating system product is considered to be a single nonsoftware deliverable, and the productivity software is considered to be a software deliverable consistent with Case D. Because the postcontract customer support relates to deliverables within the scope of this Subtopic and deliverables outside the scope of this Subtopic, it must be bifurcated into software and nonsoftware related components. Postcontract customer support relating to the productivity software would be a deliverable within the scope of this Subtopic. Postcontract customer support relating to the computer (including the operating system) would be a nonsoftware deliverable that is outside the scope of this Subtopic.

Question 3-17 discusses how to allocate the arrangement consideration between the software and nonsoftware deliverables.

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[3] "Case A" is presented in ASC 985-605-55-212 and 55-213, and has been included in this publication as part of the response to Question 1-5.

[4] "Case D" is presented in ASC 985-605-55-218 and 55-219, and has been included in this publication as part of the response to Question 1-5.

Updates to assessment of tangible product's essential functionality

Question 1-8 **Once an entity has evaluated its product line to determine whether software and nonsoftware elements function together to deliver the tangible product's essential functionality, how frequently should that analysis be updated?**

Once an entity has analyzed its product line and determined the appropriate revenue recognition accounting policy, it only would have to update this analysis when changes to the products occur. For example, the introduction of new product lines or significant changes in the functionality of existing products likely would require an update to this analysis. Further, changes to business practices that affect the method the entity uses to market and deliver its software products may affect whether the software deliverables are within the scope of the ASC 985-605.

The following example from ASC 985-605 illustrates how a change in business practice may affect this analysis.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Example 13 — Arrangements That Include Tangible Products and Software Elements

Case L: Change in Business Practice

985-605-55-234

Vendor sells engineering software that it always sells with postcontract customer support. Vendor does not have vendor-specific objective evidence for postcontract customer support and applies this Subtopic when accounting for the arrangement, which results in the software and postcontract customer support being combined into one unit of accounting. The software can be used on various computer systems. As a result of technological developments, Vendor changes its business model such that its software is now included on an integrated workstation device. The device offers several advanced features including voice command and touch-screen design capabilities. Vendor does not sell the workstation device without the engineering software, and the software is not sold separately from the device because the workstation is needed for the software to function. Vendor continues to sell the previous version of its engineering software separately, but its market strategy is to transition customers to its new advanced technology.

985-605-55-235

Vendor determined that the hardware components of the workstation device along with the engineering software are necessary to provide the product's essential functionality. Both the device and the postcontract customer support relating to the engineering software are now considered nonsoftware deliverables and are excluded from the scope of this Subtopic.

985-605-55-236

When a vendor's business model changes, judgment will be necessary to determine whether the software provided with a tangible product is essential to the product's functionality. For example, if the device does not provide substantive functionality beyond that provided by the software, the software would likely not be essential to the functionality of the device. In that case, the software and postcontract customer support would continue to be included within the scope of this Subtopic.

Standalone sales of software elements

Question 1-9 **A vendor frequently sells a tangible product combined with software that it has determined to be essential to the functionality of that tangible product. Therefore, the software is excluded from the scope of ASC 985-605. If the vendor also has standalone or subsequent sales of those same software elements, are those standalone or subsequent sales excluded from the scope of ASC 985-605 as well?**

No. In standalone or subsequent sales of a software element that has been determined to be essential when sold in combination with a tangible product, the customer is only purchasing the software, and not any hardware. Arrangements that relate solely to the licensing, selling, leasing or otherwise marketing of computer software are always within the scope of ASC 985-605, unless scoped out for other reasons (e.g., the transaction is determined to be a hosting arrangement). While software deliverables can be excluded from the scope of ASC 985-605 when the arrangement includes hardware and software elements that function together to deliver the essential functionality of the tangible product, the guidance within ASC 985-605 requires that the determination of whether a software deliverable is within the scope of ASC 985-605 be done based on the facts and circumstances associated with the applicable transaction. In other words, a previous determination that a software deliverable was essential to a tangible product and, therefore, excluded from the scope of ASC 985-605 for that transaction, would not affect the determination of appropriate accounting treatment for that same software in a separate standalone or subsequent sale of that software.

Similarly, if a vendor sells an updated version of a software element in a standalone subsequent sale to a customer who had purchased a previous version of the same software, the sale of the updated version would be within the scope of the software revenue recognition guidance, even if the previous version of this software, when originally purchased by the customer, was considered a nonsoftware element outside the scope of ASC 985-605.

The following example from ASC 985-605 illustrates this concept.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Example 13 — Arrangements That Include Tangible Products and Software Elements

Case H: Standalone Sale of an Operating System

985-605-55-226

Vendor releases a new upgraded version of its computer operating system. Vendor sells the upgraded operating system in a standalone transaction to a customer that had previously purchased a computer that contained a prior version of Vendor's operating system. Vendor now includes the upgraded operating system on all of its computers. When sold with the personal computer, the operating system is combined with the personal computer as a single nonsoftware deliverable that is excluded from the scope of this Subtopic.

985-605-55-227

The separate sale of the operating system would be within the scope of this Subtopic. Even though this software would be considered a nonsoftware deliverable if it were sold with the computer, this Subtopic only provides a scope exception for the operating system when it is part of an arrangement that includes the sale of a tangible product.

2 Relationship to other pronouncements

2.1 Chapter summary

The software revenue recognition guidance included in ASC 985-605 is not intended to alter the requirements of any other authoritative guidance included in the ASC as it relates to the application of that guidance to software licensing arrangements. For example, ASC 985-605 states if an arrangement includes a lease of property, plant or equipment (e.g., computer hardware or other tangible property such as land or other depreciable assets) and software elements, the former should be accounted for as a lease pursuant to the provisions of ASC 840, *Leases*. (Further, to the extent that the software in the arrangement functions together with the hardware to deliver the essential functionality of the tangible leased product, the software also would be accounted for in accordance with ASC 840.)

This chapter discusses the interaction of the requirements of ASC 985-605 with the requirements of the lease accounting guidance, general revenue recognition guidance, multiple-element arrangements guidance and nonmonetary transactions guidance.

Interaction of the software revenue recognition guidance with the lease accounting guidance

Question 2-1 **How does the software revenue recognition guidance included in ASC 985-605 interact with the lease accounting guidance included in ASC 840? How should arrangement consideration be allocated to the elements of an arrangement subject to ASC 840 and those subject to ASC 985-605?**

FASB standard setting

In February 2016, the FASB issued a new leases standard (ASU 2016-02). ASU 2016-02 will supersede ASC 840 on the accounting for leases. Those pending changes have not been reflected herein.

ASU 2016-02 will be effective for annual periods beginning after 15 December 2018 (i.e., 1 January 2019 for a calendar-year public entity), and interim periods within those years, for public business entities and both of the following:

- Not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market
- Employee benefit plans that file or furnish financial statements with or to the SEC

For all other entities, ASU 2016-02 will be effective for annual periods beginning after 15 December 2019 (i.e., 1 January 2020 for a calendar-year entity), and interim periods beginning after 15 December 2020 (i.e., 1 January 2021 for a calendar-year entity). Early adoption is permitted for all entities.

ASC 840-10-15 provides guidance on how to determine whether an arrangement contains a lease that is within the scope of the lease guidance, based on the following model:

- The arrangement involves the use of property, plant or equipment (i.e., land or depreciable assets),
- The property, plant or equipment in the arrangement is either explicitly or implicitly identified, and

- The arrangement conveys to the purchaser/lessee the "right to use" the specified property, plant or equipment.

ASC 840-10-15 provides that if a multiple-element arrangement contains a lease, then the classification, recognition, measurement and disclosure provisions of the lease guidance must be applied to the lease elements of the arrangement. That is, ASC 840-10-15 requires that any lease in any arrangement be separated and accounted for pursuant to the lease guidance. Non-lease elements of the arrangement (e.g., elements that are in scope of the software guidance or other literature) are not within the scope of the lease guidance and should be accounted for in accordance with other literature. If the software in the arrangement is incidental to the property, plant and equipment as a whole (e.g., software embedded in an automobile), the entire arrangement should be accounted for as a lease (see Question 1-2 for the factors to consider to determine whether the software is incidental). If the software in the arrangement functions together with the hardware to deliver the essential functionality of the tangible leased product, we believe the hardware and the software should be treated as one unit of accounting under the lease guidance. The determination of whether the software and hardware function together to deliver the product's essential functionality requires the use of professional judgment (see Question 1-5). Finally, if a lease includes 1) a lease of property, plant or equipment (e.g., computer hardware) and 2) software elements (i.e., software that is not essential to the functionality of the tangible product included in the arrangement), the lease of the tangible property should be accounted for pursuant to the lease guidance and the software elements should be accounted for separately in accordance with the software revenue recognition guidance.

Although the software revenue recognition guidance does not address how to allocate the arrangement consideration when the arrangement involves a sale or license of software and a lease of hardware or other tangible property, ASC 840-10-15-19 provides that such allocation should be done on a relative-fair-value basis, consistent with the multiple-element arrangements guidance in ASC 605-25-15-3A(b) as follows:

Excerpt from Accounting Standards Codification

Revenue Recognition — Multiple-element Arrangements

Scope and Scope Exceptions

605-25-15-3A (b)

Other Topics address separation but not allocation. If another Topic provides guidance requiring separation of deliverables within the scope of that Topic from deliverables not within the scope that Topic, but does not specify how to allocate arrangement consideration to each separate unit of accounting, such allocation shall be based on the relative selling price of the deliverables within the scope of that Topic and the deliverables not within the scope of that Topic. For example, leased assets are required to be accounted for separately under the guidance in Subtopics 840-20 and 840-30. See paragraph 605-25-55-3. (For purposes of the allocation between deliverables within the scope of another Topic and deliverables not within the scope of that other Topic, the selling price shall be determined using the guidance as discussed in paragraphs 605-25-30-6A through 30-7.) Subsequent identification of separate units of accounting and allocation of arrangement consideration to the deliverables not subject to that other Topic would be governed by the provisions of this Subtopic.

Accordingly, if an arrangement includes software elements within the scope of the software guidance and nonsoftware elements subject to the scope of the lease guidance, the arrangement consideration (e.g., the minimum lease payments) should be allocated between the lease elements and the software elements on a relative-selling-price basis using the vendor's estimate of selling price in accordance with the provisions of ASC 605-25. Separating the lease elements from the software elements is not elective, even if VSOE of fair value of the software elements does not exist. If more than one element of the arrangement is subject to the scope of software guidance, any amounts allocated to the software elements included in the arrangement should be further evaluated to determine if VSOE of fair value exists such that they can be further separated into different units of accounting pursuant to the provisions of the software revenue recognition guidance.

Arrangements involving leases generally contain payment streams that occur over a period of time. Pursuant to the software revenue recognition guidance, a license fee should be presumed not to be fixed or determinable if a significant portion of the fee is due after the expiration of the license or more than twelve months after delivery. Accordingly, if the payments relating to a software licensing arrangement containing a lease extend beyond twelve months, the portion of the payments allocated to the software elements is presumed not to be fixed or determinable. The presumption that the software portion of the payments is not fixed or determinable may be overcome if the vendor has an established standard business practice of using long-term or installment (including long-term leasing) contracts and a history of successfully collecting under the original payment terms without making concessions. If it is determined that the software portion of the payments is not fixed or determinable, the revenue attributable to the software elements of a leasing arrangement should be recognized as each payment becomes due.

The following example illustrates these concepts:

Illustration 2-1: Interaction of the software revenue guidance with the lease accounting guidance

Facts

A vendor enters into a three-year time-based arrangement with a customer to provide a packaged solution that includes computer hardware, a software license and PCS of the software. For purposes of this example, assume the hardware and software do not function together to deliver the tangible product's essential functionality. The arrangement does not include significant production, modification or customization of the licensed software. Monthly payments of $5,000 ($180,000 in total) are due under the lease term. The vendor has historically offered three-year leases of computer hardware and software, and fully collected amounts due pursuant to the original terms of such arrangements without granting concessions to customers. The lease payments are probable of collection.

The vendor has determined its best estimate of selling price for the three-year lease of the hardware (without software) is $80,000. Management's best estimate of the selling price of the software and PCS included in the arrangement, were it to be sold on a standalone basis, is $120,000.

Analysis

Payments due pursuant to the arrangement should be allocated as follows:

	Management's best estimate of selling price	Allocation of selling price	Allocation of payments
Hardware	$ 80,000	40%	$ 72,000
Software and PCS	120,000	60%	108,000
Total	$ 200,000	100%	$ 180,000

Revenue should be recognized for the $72,000 allocated to the hardware pursuant to the provisions of the lease guidance in ASC 840. For example, if the lease of the hardware qualifies as a sales-type lease, the vendor may recognize the initial sale, and the related cost of sale, of the computer hardware on delivery and the related interest income over the lease term in accordance with the provisions of ASC 840. If the lease is determined to be an operating lease, the vendor would recognize the lease payments ratably over the lease term ($2,000 per month).

The $108,000 allocated to the software and PCS should be further evaluated pursuant to the software revenue recognition guidance to determine if the software can be accounted for separately from the PCS. If the vendor determines it has established VSOE of fair value for both the software and the PCS, it would allocate the arrangement consideration of $108,000 to both of those elements using the relative-fair-value approach. If the vendor determines it has established VSOE of fair value for only the PCS, it would defer an amount equal to that established VSOE of fair value and recognize the residual upon the delivery of the software. The deferred balance would be recognized ratably over the PCS period. Finally, if the vendor does not have VSOE of fair value for either the software or the PCS, the vendor would recognize the entire arrangement consideration allocated to these elements ($108,000) ratably over the PCS period.

Interaction of the software revenue recognition guidance with the multiple-element arrangements guidance

Question 2-2 **How does the software revenue recognition guidance included in ASC 985-605 interact with the multiple-element arrangements guidance included in ASC 605-25?**

ASC 985-605 provides guidance regarding the timing and amount of revenue recognition for licensing, selling, leasing or otherwise marketing computer software. ASC 985-605 also provides guidance relating to the separation of multiple deliverables included in a multiple-element software arrangement and for the allocation of arrangement consideration among units of accounting. Because ASC 985-605 provides guidance on both the separation of deliverables and the allocation of arrangement consideration, the guidance in ASC 985-605 should be applied to deliverables within its scope instead of the provisions of ASC 605-25.

However, tangible products that contain software and nonsoftware elements that function together to deliver the tangible product's essential functionality, as well as undelivered elements that relate to the software that is essential to the tangible product's functionality, are excluded from the scope of ASC 985-605. These arrangements are instead subject to general revenue recognition guidance, including the guidance in ASC 605-25.

If some, but not all, of the deliverables included in an arrangement involving the sale of software are determined to be outside the scope of ASC 985-605 (i.e., nonsoftware deliverables), the arrangement consideration should be allocated to the software deliverables as a group and to the individual nonsoftware deliverables in accordance with the multiple-element arrangements guidance in ASC 605-25-15-3A. After performing such allocation, the amount allocated to the software deliverables as a group will be accounted for pursuant to the software revenue recognition guidance in ASC 985-605.

The example included in Question 3-17 illustrates these concepts.

Interaction of the software revenue recognition guidance with the guidance on accounting for construction-type and production-type contracts

Question 2-3 **How do the provisions of the software revenue recognition guidance included in ASC 985-605 interact with the accounting for construction-type and production-type contracts guidance in ASC 605-35 when the arrangement requires the significant production, modification or customization of the software?**

Prior to the FASB's codification of the accounting standards, SOP 97-2 included guidance that indicated that software arrangements requiring "significant production, modification, or customization of software" should be accounted for in conformity with the long-term construction accounting guidance, using the guidance included within SOP 97-2 and the guidance within SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. As part of the FASB's codification, this guidance was included directly within ASC 605-35, indicating that such arrangements should be accounted for in accordance with the guidance in ASC 605-35. Additionally, ASC 605-35 references the software revenue recognition guidance, specifically ASC 985-605-25-88 to 25-107, regarding the application of the contract accounting guidance to software arrangements.

We do not believe that the EITF intended to change the accounting for these types of arrangements with the issuance of ASU 2009-14. Therefore, even though ASU 2009-14 excludes from the scope of ASC 985-605 arrangements involving tangible products containing both hardware and essential software elements, we believe these arrangements should continue to be accounted for in accordance with the guidance within ASC 605-35 when the arrangement includes significant production, modification or customization of the essential software.

Interaction of the software revenue recognition guidance with the guidance for nonmonetary transactions

Question 2-4 **How do the provisions of the software revenue recognition guidance included in ASC 985-605 apply to nonmonetary exchanges of software?**

A software vendor may enter into a nonmonetary transaction whereby it provides a license to a product it markets in exchange for a license to a software product or technology of the counterparty. The vendor may sublicense the counterparty's product to other customers as a standalone product, utilize the counterparty's technology as a component of the software products it markets or use it internally.

ASC 845, *Nonmonetary Transactions*, provides relevant guidance relating to the accounting for nonmonetary transactions. Pursuant to that guidance, the accounting for nonmonetary transactions generally should be based on the fair value of the assets or services received or exchanged, whichever is more evident, unless one of the following conditions exists:

- The fair value of neither the asset(s) received nor the asset(s) relinquished is determinable within reasonable limits. For a nonmonetary exchange involving software, we believe VSOE of fair value of either the software received or relinquished must exist to conclude that fair value is determinable within reasonable limits. In practice, it would be rare for a vendor to demonstrate VSOE of fair value of software products (as such products are rarely sold individually and not along with other elements, such as PCS).
- The transaction is an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange.
- The exchange transaction lacks commercial substance. A nonmonetary exchange has commercial substance if an entity's future cash flows are expected to significantly change as a result of the exchange. An entity's future cash flows are expected to significantly change if either of the following criteria is met:
  - The risk, timing and amount of the future cash flows of the asset(s) received differs significantly from the configuration of the future cash flows of the asset(s) transferred.
  - The entity-specific value of the asset(s) received differs from the entity-specific value of the asset(s) transferred, and the difference is significant in relation to the fair values of the assets exchanged.

The application of the provisions of ASC 845 to nonmonetary exchanges of software for software that will be used as a component of the vendor's software or sublicensed or sold to other customers is addressed in ASC 985-845, *Software — Nonmonetary Transactions*.

Exchange transactions to facilitate sales to customers

Excerpt from Accounting Standards Codification

Software — Nonmonetary Transactions

Recognition

985-845-25-1

A software vendor may exchange a license of its software to a customer in exchange for a license to the customer's technology that permits the software vendor to sublicense the customer's technology to other customers as a component of the software vendor's products or as a standalone additional product.

985-845-25-2

Paragraph 845-10-30-3 states that, if certain conditions apply, a nonmonetary exchange shall be measured based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) of the nonmonetary asset relinquished, and not on the fair values of the exchanged assets. One of those conditions is an exchange to facilitate sales to customers, that is, an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange.

985-845-25-3

Therefore, if the technology or products received by the software vendor in the exchange are sold, licensed, or leased in the same line of business as the software vendor's technology or products delivered in the exchange, the software vendor shall measure the exchange based on the recorded (carryover) amount of the software issued in exchange.

985-845-25-4

However, if the technology or products received by the software vendor in the exchange are sold, licensed, or leased in a different line of business from the software vendor's technology or products delivered in the exchange, the exchange shall be measured based on the fair values of the exchanged technology or products, if both of the following conditions exist:

a. The fair value of the technology or products exchanged or received is determinable within reasonable limits (that is, vendor-specific objective evidence of fair value of the software given up, or the value of the technology or products received, as if the software vendor had received or paid cash)

b. The transaction has commercial substance, as described in paragraph 845-10-30-4, including that the technology or products received in the exchange are expected, at the time of the exchange, to be deployed and used by the software vendor and the value ascribed to the transaction reasonably reflects such expected use.

985-845-25-5

If neither the fair value of the technology or products exchanged nor the fair value of the technology or products received is determinable within reasonable limits, the exchange shall be measured based on the recorded (carryover) amount of the technology or products relinquished in exchange. Paragraph 845-10-30-8 indicates that if neither the fair value of a nonmonetary asset transferred nor the fair value of a nonmonetary asset received in exchange is determinable within reasonable limits, the recorded amount of the nonmonetary asset transferred from the entity may be the only available measure of the transaction.

Exchange transactions for software for internal use

Software vendors also may exchange a license to their software for a license to a counterparty's software that will be used for internal purposes. The application of the provisions of ASC 845 to such exchanges is as follows:

Excerpt from Accounting Standards Codification

Software — Nonmonetary Transactions

Recognition

985-845-25-6

A software vendor may also exchange a license of its software to a customer in exchange for a license to the customer's technology that the software vendor intends for internal use.

985-845-25-7

If the fair value of either of the nonmonetary assets involved in the transaction is determinable within reasonable limits, the software vendor shall measure the exchange based on the fair values of the assets exchanged, consistent with the guidance in paragraph 845-10-30-1.

The following table summarizes the guidance on nonmonetary exchanges of software:

Software — Nonmonetary Transactions

Implementation Guidance and Illustrations

985-845-55-1

The following table summarizes the guidance in this Subtopic.

Software Vendor's Technology Exchanged	Software Vendor's Use of Technology Received	Same Line of Business	Accounting Treatment
Software product held for sale in the ordinary course of business (that is, inventory)[(a)]	Technology to be held for sale in the ordinary course of business (that is, inventory)[(b)]	1. Yes 2. No	1. Record at historical cost 2. Record at fair value[(c)]
Software product held for sale in the ordinary course of business (that is, inventory)	Internal-use software[(d)]	N/A	Record at fair value[(c)]

(a) Licenses to software products, source code, and object code that the software vendor sells, licenses, or leases in the ordinary course of business would constitute inventory.

(b) A software vendor that receives any of the following would be receiving inventory:
- a. A product to resell, sublicense, or sublease
- b. A right to embed the technology received into a product
- c. A right to further develop the technology received into a product.

(c) Assumes that vendor-specific objective evidence of fair value exists and the transaction has commercial substance.

(d) A software vendor that receives any of the following would be receiving something other than inventory:
- a. A product or technology that can be used only internally (for example, a financial or management application)
- b. A product or technology that can be used only internally to make a product but which does not become part of the product.

The following example illustrates nonmonetary exchanges of software products:

Software — Nonmonetary Transactions

Implementation Guidance and Illustrations

Example 1: Exchange of Software Products

985-845-55-2

This Example illustrates the guidance in this Subtopic for both the software vendor (see Section 985-845-25) and the other party to the nonmonetary exchange.

985-845-55-3

Software Vendor A licenses Software Product 1 (a suite of financial accounting applications) to customers in the normal course of business. Software Vendor A has vendor-specific objective evidence of fair value of Product 1 resulting from prior cash transactions with its customers. Product 1 includes technology (Product 2) sublicensed by Software Vendor A from Entity B.

985-845-55-4

Software Vendor A agrees to exchange Product 1 with Entity B for licenses to Product 2. Software Vendor A intends to relicense Product 2 (as a separate product or embedded in Product 1) to its customers. Entity B intends to use Product 1 for internal use.

985-845-55-5

Software Vendor A would account for the transaction as follows.

985-845-55-6

Software Vendor A exchanged property held for sale (Product 1) for property to be sold in the same line of business (Product 2) to facilitate future sales to other customers. The exchange would be measured based on the recorded (carryover) amount of Product 1. No revenue would be recognized until Product 2 is sublicensed to other customers in subsequent transactions.

985-845-55-7

Entity B would account for the transaction as follows.

985-845-55-8

Entity B exchanged property held for sale (Product 2) for a productive asset (Product 1, which will be used by Entity B as an amortizable asset). The exchange would be measured based on fair value by Entity B, and revenue would be recognized on the exchange. Such accounting treatment is based on the fact that the fair value of the technology exchanged or received is reasonably determinable and that the exchange has commercial substance.

Based on the provisions of ASC 985-845 above, a vendor should recognize a nonmonetary exchange of software at fair value only if it can support culmination of the earnings process by demonstrating: 1) the software received is to be sold in a different line of business from the software provided in exchange, 2) VSOE of fair value of the product received or exchanged exists and 3) commercial substance. When evaluating commercial substance, an entity should also be able to demonstrate a substantive business purpose for structuring the transaction in such a manner, including a substantive need for the software product received. Pursuant to ASC 845 and ASC 985-845, VSOE of fair value of the software product received should be used if it is more evident than VSOE of fair value of the software product surrendered.

The table in ASC 985-845-55-1 above summarizes these provisions.

ASC 985-845 also states that fair value accounting is not permitted for a nonmonetary exchange that lacks commercial substance. Accordingly, a vendor also must consider whether the nonmonetary exchange has commercial substance as described in ASC 845.

Transactions involving boot

ASC 845 also addresses the accounting for nonmonetary exchanges including an amount of monetary consideration, or boot. A nonmonetary transaction that includes boot should be accounted for as a monetary exchange if the boot is equal to 25% or more of the fair value of the exchange. In such cases, the entire arrangement should be accounted for at fair value.

The inclusion of boot in a transaction involving the exchange of software products does not provide evidence of the fair value of the software products exchanged. In many such arrangements, a software vendor will be unable to evaluate the significance of boot included in a nonmonetary transaction because VSOE of fair value for neither the software given up nor the software received will exist. In such cases, the nonmonetary component and monetary component of the arrangement should each be accounted for separately. This accounting also should be applied if the fair value of an exchange is determinable (i.e., VSOE of fair value exists for the software products exchanged) but the amount of boot is less than 25% of the fair value of the exchange. If the nonmonetary component of such an arrangement 1) represents an exchange of software held for sale in the ordinary course of business, 2) lacks commercial substance or 3) does not meet any of the criteria specified in ASC 985-845 above, then the nonmonetary component of the arrangement should be measured at the recorded amount of the software given up. Boot received should be accounted for in accordance with the provisions of ASC 845-10-30-6. Boot paid should be accounted for as a purchase of inventory.

Transactions with the same counterparty

ASC 845-10 provides guidance with respect to purchases and sales of inventory with the same counterparty.

Excerpt from Accounting Standards Codification

Nonmonetary Transactions — Overall

Initial Measurement

845-10-30-15

A nonmonetary **exchange** whereby an entity transfers finished goods inventory in exchange for the receipt of raw materials or work-in-process inventory within the same line of business is not an exchange transaction to facilitate sales to customers for the entity transferring the finished goods, as described in paragraph 845-10-30-3(b), and, therefore, shall be recognized by that entity at fair value if both of the following conditions are met:

a. Fair value is determinable within reasonable limits.

b. The transaction has commercial substance (see paragraph 845-10-30-4).

845-10-30-16

All other nonmonetary exchanges of inventory within the same line of business shall be recognized at the carrying amount of the inventory transferred. That is, a nonmonetary exchange within the same line of business involving either of the following shall not be recognized at fair value:

a. The transfer of raw materials or work-in-process inventory in exchange for the receipt of raw materials, work-in-process, or finished goods inventory

b. The transfer of finished goods inventory for the receipt of finished goods inventory.

Based on the provisions of ASC 845-10, above, we believe that it will be rare that an exchange of a license to a vendor's software product for a license to the counterparty's software product that the vendor will then sublicense or sell to its customers will be accounted for at fair value. We believe that such exchanges generally are an exchange of finished goods for finished goods to be sold in the same line of business.

Further, we believe that an exchange by a vendor of a currently marketed software product for a right to embed the technology received into a product that will be licensed to other customers, or a right to further develop the technology received into such a product, is analogous to the exchange of a finished good for a raw material. Pursuant to the above guidance, such transactions should be accounted for at fair value, assuming that VSOE of fair value exists and the transaction has commercial substance.

Footnote (c) of ASC 985-845-55-1 indicates that a nonmonetary exchange of software must be recorded at carryover basis if the transaction does not have a valid business purpose. The assessment of whether a nonmonetary exchange has a valid business purpose is equivalent to the assessment of commercial substance and should be made pursuant to ASC 845.

Exchanges of software for a nonmonetary asset other than software

The guidance in ASC 985-845 refers and applies specifically to exchanges of software for software. If a software vendor exchanges software for a nonmonetary asset other than software (e.g., a computer monitor), the transaction should be accounted for pursuant to ASC 845.

The following example illustrates these concepts:

Illustration 2-2: Exchanges of software for a nonmonetary asset other than software

Facts

A software vendor, Softco, licenses Product A, a suite of financial accounting applications, to customers in the normal course of business. Softco does not have VSOE of fair value for the software. Softco agrees to exchange a stated number of perpetual licenses to Product A and one year of PCS with Autoco, an automobile manufacturer, for 10 automobiles. The automobiles will be utilized by Softco's sales personnel in the performance of their responsibilities. The transaction has commercial substance for each vendor.

Analysis

Softco should account for the exchange at fair value based on the fair value of the automobiles (fair value of the software is not determinable because Softco does not have VSOE of fair value for the software) because as Softco exchanged finished goods held for sale in the ordinary course of business (Product A) for productive assets to be used for internal purposes (the automobiles). The transaction does not meet any of the conditions, as discussed above, for an exception to the general requirement of ASC 845 that nonmonetary exchanges be recorded at fair value.

ASC 985-605-55-4 includes several factors that should be considered when determining whether a group of contracts should be accounted for as a single multiple-element arrangement. We believe those factors should be considered when determining if separate software licensing transactions between the same counterparties should be combined for purposes of accounting for the transactions as a nonmonetary exchange of software pursuant to the provisions of ASC 985-845. ASC 845-10-25-4 also provides factors for determining when two or more purchase and sales transactions with the same counterparty should be combined for purposes of applying ASC 845. We believe that these factors should be considered as well.

ASC 845 provides that if one transaction is legally contingent on the execution of another transaction with the same counterparty, the two transactions are deemed to have been entered into in contemplation of one another and should be considered a single nonmonetary exchange. The issuance of invoices and the exchange of offsetting cash payments is not a factor in determining whether two or more purchase and sales transactions with the same counterparty should be considered a single nonmonetary exchange transaction. However, if one transaction is not legally contingent on the execution of another transaction with the same counterparty, the following factors may indicate that a purchase transaction and a sales transaction were entered into in contemplation of one another and should be considered a single nonmonetary exchange:

- There is a specific legal right of offset of obligations between counterparties involved in inventory purchase and sales transactions. The ability to offset the payable(s) and receivable(s) related to the separately documented purchase and sales transactions indicates that there is a link between them, and therefore, it is an indicator that the separately documented transactions were entered into in contemplation of one another.
- Purchase and sales transactions were entered into at terms that were off-market when the arrangements were agreed to between counterparties. This indicator may be more relevant for transactions with products for which a vendor has established VSOE of fair value than for transactions with products that are subject to greater discretionary pricing.
- There is relative certainty that a reciprocal transaction with the same counterparty will occur.

The following example illustrates these concepts:

Illustration 2-3: Single nonmonetary exchange

Facts

On 25 June 20X9, a calendar year-end software vendor, Softco, licenses Product A bundled with one year of PCS to another software vendor, Vendor X, for $1,000,000. Payment is due from Vendor X to Softco on 31 July 20X9.

On 30 June 20X9, Softco agrees to license Product B, bundled with one year of PCS, from Vendor X for $1,150,000, payment due 31 July 20X9. The software licensing agreement stipulates that Softco may offset the amount due from Vendor X against the amount it is required to remit to Vendor X on 31 July 20X9.

Analysis

The fact that the software licensing arrangements were executed within a short time of each other and that the second arrangement allows Softco to offset the amounts it owes against the amounts due from Vendor X indicate that the separate arrangements were entered into in contemplation of one another and should be evaluated as a single nonmonetary exchange. Both Softco and Vendor X should apply the provisions of ASC 985-845 and the related factors discussed above to the arrangements to determine the appropriate accounting.

3 Basic principles

3.1 Chapter summary

The basic principles of ASC 985-605 provide that if an arrangement to deliver software or a software system does not require significant production, modification or customization of software, revenue should be recognized when all of the following criteria are met:

- Persuasive evidence of an arrangement exists
- Delivery has occurred
- The vendor's fee is fixed or determinable
- Collectibility is probable

If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification or customization of software, then the vendor should account for the arrangement in accordance with ASC 605-35, *Revenue Recognition — Construction-Type and Production-Type Contracts*; such accounting is commonly referred to as "contract accounting."

Software arrangements may consist of multiple deliverables, or elements, including software products, upgrades/enhancements, postcontract customer support (PCS) or services, including elements deliverable only on a when-and-if-available basis. If an arrangement within the scope of ASC 985-605 includes multiple elements, the vendor must allocate the revenue to the various elements based on vendor-specific objective evidence (VSOE) of fair value. If VSOE of fair value of at least the undelivered elements of an arrangement does not exist, all revenue from the arrangement should be deferred until sufficient evidence exists, or until all elements have been delivered. ASC 985-605 provides exceptions to this guidance for 1) undelivered PCS, 2) undelivered services that do not involve significant customization of the licensed software, 3) subscriptions and 4) arrangements in which the fee is based on the number of copies.

The portion of the fee allocated to an element should be recognized as revenue when all of the basic revenue recognition criteria have been met for that element. In applying the revenue recognition criteria of ASC 985-605, the delivery of an element is considered not to have occurred if there are undelivered elements that are essential to the functionality of any delivered elements.

3.2 Arrangements to customize licensed software

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-1

Software arrangements range from those that provide a license for a single software product to those that, in addition to the delivery of software or a software system, require significant production, modification, or customization of software.

985-605-25-2

If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the entire arrangement shall be accounted for in conformity with Subtopic 605-35, using the relevant guidance in paragraphs 985-605-25-88 through 25-107 on applying contract accounting to certain arrangements involving software.

If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification or customization of software, then the vendor should account for the arrangement in accordance with ASC 605-35, *Revenue Recognition — Construction-Type and Production-Type Contracts*. In fact, ASC 605-35-15-3(f) specifically indicates that arrangements "to deliver software or a software system, either alone or together with other products or services, requiring significant production, modification or customization of software" are within the scope of ASC 605-35. That guidance then refers to the guidance provided by ASC 985-605-25-88 through 25-107 regarding the application of ASC 605-35 to software contracts.

3.3 Basic revenue recognition criteria

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-3

If the arrangement does not require significant production, modification, or customization of software, revenue shall be recognized when all of the following criteria are met:

a. Persuasive evidence of an arrangement exists (see paragraphs 985-605-25-15 through 25-17).

b. Delivery has occurred (see paragraphs 985-605-25-18 through 25-29).

c. The vendor's fee is fixed or determinable (see paragraphs 985-605-25-30 through 25-40).

d. Collectability is probable (see paragraphs 985-605-25-13 through 25-14 and 985-605-25-30 through 25-40).

985-605-25-4

The term probable is used in this Subtopic with the same definition as used in Topic 450.

Chapter IV of this publication discusses considerations relating to the application of the criteria in the above paragraphs.

3.4 Multiple-element arrangements

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Multiple-Element Arrangements

985-605-25-5

Software arrangements may provide licenses for multiple software deliverables (for example, software products, upgrades or enhancements, **postcontract customer support**, or services), which are termed multiple elements. A number of the elements may be described in the arrangement as being deliverable only on a **when-and-if-available basis.** When-and-if-available deliverables shall be considered in determining whether an arrangement includes multiple elements. Accordingly, the requirements of this

Subtopic with respect to arrangements that consist of multiple elements shall be applied to all additional products and services specified in the arrangement, including those described as being deliverable only on a when-and-if-available basis.

Software license arrangements that convey rights to more than one deliverable, or element, complicate the application of the basic criteria for revenue recognition because the arrangement must be evaluated to determine if the fees can be allocated to each element. Elements, as described in ASC 985-605, include software products, specified upgrades and enhancements, postcontract customer support (PCS) and services, even if the elements are deliverable on a when-and-if-available basis. The discussion in Chapter IV on multiple-element arrangements addresses the factors that should be considered when determining the elements included in a software licensing arrangement.

3.5 Allocating fees based on VSOE of fair value

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Multiple-Element Arrangements

985-605-25-6

If an arrangement includes multiple elements, the fee shall be allocated to the various elements based on vendor-specific objective evidence of fair value, regardless of any separate prices stated in the contract for each element. Vendor-specific objective evidence of fair value is limited to the following:

a. The price charged when the same element is sold separately

b. For an element not yet being sold separately, the price established by management having the relevant authority; it must be probable that the price, once established, will not change before the separate introduction of the element into the marketplace.

985-605-25-7

The amount allocated to undelivered elements is not subject to later adjustment. (This does not apply to changes in the estimated percentage of customers not expected to exercise an **upgrade right**. See paragraph 985-605-25-45.) However, if it becomes probable that the amount allocated to an undelivered element will result in a loss on that element of the arrangement, the loss shall be recognized pursuant to Topic 450. When a vendor's pricing is based on multiple factors such as the number of products and the number of users, the amount allocated to the same element when sold separately shall consider all the factors of the vendor's pricing structure.

Once all of the elements in a software arrangement have been identified, a vendor must determine whether it can separately account for the elements (either in whole or in part). If the elements can be separated, the basic revenue recognition criteria of ASC 985-605 are applied separately to each element to determine when revenue should be recognized for that element. If elements cannot be separated, revenue is recognized in accordance with ASC 985-605-25-9 through 25-11 for the bundled unit of accounting.

In order to separately account for elements included in a software licensing arrangement, VSOE of fair value must exist for at least the undelivered elements of the arrangement. VSOE of the fair value of an element cannot be determined by reference to the sales price of a similar element sold by another vendor; a vendor must determine fair value of its software elements based on its own internal evidence. When the software revenue recognition guidance was originally issued, AcSEC believed that there are inherent differences in software products offered by different software vendors and that those differences preclude the use of surrogate prices to determine fair value of a particular vendor's software.

The following excerpt from the implementation guidance within ASC 985-605 illustrates these concepts:

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Example 7: Multiple-Element Arrangements — Right to New Product when Available

985-605-55-161

The following Cases illustrate the guidance in paragraphs 985-605-25-6 through 25-7:

a. Price not established at arrangement date (Case A)

b. Price established at arrangement date (Case B).

985-605- 55-162

In both Cases A and B, a vendor licenses version 1.0 of a software product to 100 customers for $300 per copy with a right to receive version 2.0 at no additional cost when it becomes available.

Case A: Price Not Established at Arrangement Date

985-605-55-163

In this Case, the pricing committee has not yet decided whether version 2.0 will be offered to users of version 1.0 for $100 or for $200.

985-605-55-164

The vendor would defer all revenue until the pricing committee makes its decision and it is probable that the price established will be the price charged upon introduction. Because the pricing committee has not yet decided whether version 2.0 will be offered at $100 or at $200, sufficient vendor-specific objective evidence does not yet exist supporting the price of the undelivered software. As discussed in paragraphs 985-605-25-9 through 25-11, if sufficient vendor-specific objective evidence does not exist to determine the allocation of revenue, all revenue would be deferred until sufficient vendor-specific objective evidence exists.

Case B: Price Established at Arrangement Date

985-605-55-165

In this Case, the pricing committee determines that version 2.0 will be offered to users of version 1.0 as a specified upgrade or **enhancement** at a price of $100. It is probable that such price will not change before introduction. Persuasive evidence exists indicating that the amount allocated to version 1.0 will not be subject to forfeiture, refund, or other concession. Also, the vendor's experience indicates that 40% of customers do not exercise upgrade rights.

985-605-55-166

The vendor would defer $6,000 (upgrade price of $100 multiplied by 100 copies, reduced by 40% to account for the customers expected not to exercise the **upgrade right**) until delivery of the upgrade or enhancement, and recognize the remaining $24,000 on delivery of version 1.0.

985-605-55-167

The portion of the arrangement fee allocated to the upgrade right is equal to the price for the upgrade or enhancement determined pursuant to paragraph 985-605-25-45. This amount would be deferred and recognized on the delivery of version 2.0. The amount deferred for the specific upgrade or enhancement would be reduced to reflect the percentage of customers that, based on experience, are not expected to exercise the upgrade right (see that paragraph). Accordingly, the $10,000 revenue allocated to the upgrade right would be reduced by $4,000 (40% of the allocated revenue).

985-605-55-168

If the vendor did not have information based on experience that indicates the percentage of customers that do not exercise the upgrade right, the vendor would defer the entire $10,000 of revenue allocated to the upgrade right, under the assumption that, in the absence of vendor-specific objective evidence to the contrary, 100% of customers will exercise the upgrade right.

Methods used to evaluate whether VSOE of fair value exists

Question 3-1 **What methods are commonly used by vendors to evaluate whether VSOE of fair value of an element (e.g., PCS or services such as training or installation) exists?**

Methods that are used to evaluate whether a vendor has established VSOE of fair value of elements commonly included in software licensing arrangements are presented in the table below. This table only provides general guidance; all relevant facts and circumstances should be considered carefully before concluding that VSOE of fair value exits for any particular element.

Element	Common source of VSOE of fair value
Initial PCS period bundled with the sale of a perpetual software license	Prices at which licensees subsequently renew PCS services. See ASC 985-605-25-67 through 25-69 for additional discussion of determining VSOE of fair value for PCS bundled with perpetual license sales.
PCS period bundled with the sale of a time-based license	Prices at which time-based licensees subsequently renew PCS services. See ASC 985-605-25-67 through 25-69 for additional discussion of determining VSOE of fair value for PCS bundled with time-based license sales.
Services not essential to the functionality of licensed software	Hourly rates or prices when sold separately. See ASC 985-605-25-78.
Services essential to the functionality of licensed software	Such services are accounted for using contract accounting. See ASC 985-605-25-88 through 25-107.
Specified upgrade rights	Fees charged to existing customers to separately license an upgrade, or the price to be charged when an upgrade is available (assuming that the vendor has a sufficient history of subsequently selling at prices established by management with the relevant authority — see Question 3-4). It is rare that a vendor can establish VSOE of fair value for a specified upgrade right. See ASC 985-605-25-44 through 25-46.
Specified additional software products	Price of the software products when sold separately or the price to be charged when products are made available (assuming that the vendor has a sufficient history of subsequently selling at prices established by management with the relevant authority). See ASC 985-605-25-47 through 25-57.

Some vendors may sell an element separately, but the price charged for the element may vary from customer to customer based on some or all of the following factors (among others):

- Customer size
- Product type included in the transaction
- Significance of the customer to the vendor's business (e.g., level of cumulative purchases made by the customer)
- Future sales potential of the customer
- Size of the sale
- Geographical location of customer

- Distribution channel
- Other competitive pressures

A vendor is not limited to determining whether VSOE of fair value exists for an element based on a company-wide population of sales transactions. Rather, it may stratify its transactions into different classes of customer based on meaningful and objective distinctions (e.g., customer size, geography or product line) and evaluate that customer class to determine if VSOE of fair value can be established for an element by customer class.

We believe that a limited amount of variability in the price charged for an element generally would not preclude a vendor from being able to establish VSOE of fair value for that element. However, the basic concepts of ASC 985-605-25-6 and 25-7 must be carefully considered when determining whether the amount of variability in pricing is of such an extent that one cannot conclude that VSOE of fair value exists. If the element is sold to similarly situated customers at widely varying prices, concluding that VSOE of fair value exists for that element will be difficult.

When the prices a vendor charges for an element when sold separately vary, we believe VSOE of fair value for that element would rarely exist when a substantial majority of a company's standalone sales transactions for the element are not priced within a relatively narrow range (after taking into account the effects of any acceptable stratification methodology as discussed below). For example, if a vendor can demonstrate that 80% of its PCS renewals fall within a range of plus or minus 15% from the midpoint of the range (relative percent, not percentage points, e.g., if 20% of the net software license fee is the midpoint, the range would be 17% — 23%, not 5% — 35%), we believe that the vendor would have a reasonable basis to support that VSOE of fair value of PCS exists (see Question 7-11). In such cases, we believe the range represents VSOE of fair value, not a single point within the range. While VSOE of fair value of an element may exist with a lower threshold of compliance than in the example above (e.g., a smaller number of transactions falling within the range of pricing consistency, but with a smaller amount of variance from the midpoint of those transactions falling within the range), we believe that such instances would be limited.

If a vendor's pricing structure considers factors such as the number of users granted access to the licensed software product or the number of products licensed, then the VSOE of fair value of an element should also consider those factors. Accordingly, when determining the VSOE of fair value of an element, if the vendor's pricing structure varies based on factors such as the number of users or number of products included within the arrangement, the vendor should determine the fair value of the element after giving effect to the number of copies or number of products included in the arrangement. In other words, to determine VSOE of fair value of an element, the underlying information on which the objective evidence is based must be relevant, reliable and comparable.

In addition, we believe vendors should consider whether more recent, actual sales prices are more relevant than older, actual sales prices because the fair value of software and related elements tends to fluctuate quickly. For example, all renewals over the last year are a more relevant population for determining whether VSOE of fair value of PCS exists than an average of all renewals occurring over the trailing three-year period. Trends in pricing may occur due to product obsolescence issues or competition. Prices may begin high and decrease over a period of time, depending on the specific product life-cycle. In other situations, the pricing for a product with a long life-cycle may increase over time as the product becomes more accepted in the marketplace or as upgrades increase its features and functions.

We believe that dollar-value weighting should not be used when performing such analyses. We believe the determination of whether VSOE of fair value exists should be based on the amount of variability of pricing for an element absent any impact of the dollar values associated with any individual transaction. Dollar-value weighting may appear to be advantageous in limiting the extent of a VSOE of fair value analysis or in determining the percentage of transactions falling within an acceptable range. However, the use of dollar-value weighting could mask information that would be relevant to an objective analysis. Dollar-value weighting generally should be considered to determine if stratifying a population by customer class would be appropriate.

When a substantial majority of a vendor's prices for an element when sold separately are within a reasonably narrow range, VSOE of fair value exists. Multiple-element arrangements containing contractually stated prices for elements that are not within the reasonably narrow range ("outliers") must be accounted for using VSOE of fair value. For example, software license arrangements that include an initial PCS period that is priced below the vendor's range of VSOE of fair value need to be adjusted — that is, one must use the VSOE of fair value of PCS to determine the amount of revenue that should be deferred and recognized over the PCS period (see discussion on PCS in Chapter VII).

When a range is used to establish VSOE of fair value of an element, the revenue allocated to the element can be based on either (1) the midpoint of the range, or (2) the lower limit of the range nearest to the stated price. Alternatively, use of the midpoint of the range would be acceptable, but not preferred. Regardless of the method selected, it should be consistently applied.

An undelivered element that has been priced above VSOE of fair value generally should not be adjusted (pursuant to the concepts in Questions 3-22 through 3-29), but rather the contract amount for the undelivered element should be deferred and recognized as the element is delivered (if all of the other basic revenue recognition criteria of ASC 985-605 have been met).

Software vendors should develop and document their methodology for determining VSOE of fair value of elements and apply that methodology consistently. Although the frequency and level of the analysis performed will vary based on the nature and complexity of a vendor's business and the level of flexibility a vendor grants to its sales personnel in terms of pricing, we believe that companies should perform analyses at least annually to determine whether VSOE of fair value exists for elements included in multiple-element software licensing arrangements. Such analyses may be performed on a "lag" basis (e.g., a trailing 12 months of PCS renewal data through the previous quarter). Analyses should be performed more often by any company that has or expects to have more than minimal variability in the pricing of the elements that it markets, such as those operating in highly competitive pricing environments, those whose products are subject to rapid technological obsolescence or those who have a practice of varying PCS renewal rates. Generally, analyses should be designed to encompass all separate sales of an element during the period analyzed. If a sampling approach is used, it is important to document and demonstrate how the sample is representative of the population being evaluated.

Determining whether VSOE of fair value for an element exists requires a careful analysis of the facts and circumstances and the use of professional judgment. Judgment must be used to evaluate the level of variability in pricing, the appropriateness of the stratification of an analysis, if any, by customer size, geography, product or other basis (see Question 7-13), and the reasons for prices outside of the vendor's range of VSOE of fair value (outliers). Judgment will also be required to assess the effect of other qualitative factors. Examples of such qualitative factors include:

- *Trends in pricing consistency over time.* For example, it may be relatively easier for a vendor whose pricing consistency has been improving over time to support an assertion that VSOE of fair value exists than one whose pricing consistency has been decreasing over time.

- *Age of the underlying software license to which PCS renewal relates.* We believe a VSOE of fair value analysis should consider all PCS renewals for a customer class regardless of the date the underlying software license was executed. However, a vendor should consider whether the analysis indicates a higher level of pricing consistency for more recently executed licenses. In such cases, it may be relatively easier to support an assertion that VSOE of fair value exists.

Is VSOE of fair value represented by one price?

Question 3-2 **Do the provisions of ASC 985-605 contemplate that one price must be charged to all customers in order to establish VSOE of fair value?**

Paragraph ASC 985-605-25-6 provides that VSOE of fair value is limited to the price charged when an element is sold separately or, for an element not yet being sold separately, the price established by management having the relevant authority. ASC 985-605-25-67 through 25-69, which specifically address VSOE of fair value of PCS, state that VSOE of fair value should be determined in conformity with ASC 985-605-25-6 and 25-7 and the fair value of the PCS should be determined by reference to the price the customer will be required to pay when it is sold separately (i.e., the renewal rate). Each of these phrases suggests that a single price was contemplated.

While these paragraphs and ASC 985-605-55-68 and 55-69 (which provide implementation guidance related to determining the fair value of PCS with consistent renewal percentages — see also Question 7-9) suggest a restrictive concept of pricing (i.e., a single price), we believe it is unrealistic to expect a vendor to restrict its pricing to a single price for all customers. Accordingly, we believe that a limited amount of variability in the price charged for a software element generally would not preclude a vendor from being able to establish VSOE of fair value. However, the basic concept of ASC 985-605-25-6 and 25-7 must be carefully considered when determining whether the amount of variability in pricing is of such an extent that one cannot conclude that VSOE of fair value exists.

Can VSOE of fair value be established by reference to a vendor's price list?

Question 3-3 **Many software vendors maintain a management-approved published price list for the products and services they sell. Is the use of such a price list a sufficient basis to establish VSOE of fair value of the vendor's products and services?**

In accordance with paragraph ASC 985-605-25-6 and 25-7, VSOE of fair value should be determined based on the actual amount charged to specific groups of customers when an element is sold separately or, if an element is not yet being sold separately, the price established by management having the relevant authority. For products or services currently sold by a vendor, VSOE of fair value only can be established by separate sales transactions (i.e., a single-element transaction or standalone transaction). If the vendor does not and will not sell a product or service in a standalone transaction, then by definition VSOE of fair value cannot and does not exist. For example, since software licenses are rarely sold without PCS, VSOE of fair value of software licenses rarely exists because of the lack of a standalone transaction.

Accordingly, a published price list, by itself, is not a sufficient basis to establish VSOE of fair value of any element included in a multiple-element software licensing arrangement unless the vendor has an established history of selling products and services on a standalone basis at list price.

Factors to consider when VSOE of fair value is established by management

Question 3-4 **What factors should be considered when evaluating if a vendor has established VSOE of the fair value of an item not yet sold separately by reference to a price established by management?**

When determining if VSOE of the fair value of an item that is not yet being sold separately can be established by reference to a price set by management, the following factors must be considered:

- Management that established the price must have the relevant authority to do so.
- The period of time until the element is expected to be sold separately should be short.

- It must be probable that the price established by management will not change once that element is introduced into the marketplace. It is often very difficult to assess the likelihood that a price established by management will not change, particularly when any of the following conditions are present:
  - The vendor operates in a highly competitive market that may require a change in pricing to match the actions of a competitor.
  - The product will not be introduced into the marketplace within a relatively short timeframe (when deliberating the software revenue recognition guidance, some AcSEC members stated a belief that the time period between establishment of a price by management and the release of the element into the marketplace should not exceed 30 days).
  - The product does not have proven acceptance in the marketplace.
  - The product has (or is anticipated to have) a long sales cycle.
  - The vendor does not have a history of successfully selling new products into the marketplace at prices set by management.
- Does VSOE of fair value exist for similar products? If a vendor is not able to support that VSOE of fair value exists for a similar product that is currently sold, it will be difficult for management to support an assertion that VSOE of fair value exists for a product not yet being sold.

We believe this guidance is only applicable to 1) an element a vendor is developing but has not introduced into the marketplace or 2) an element a vendor has introduced but has not sold separately (i.e., an element that has only been sold as part of a multiple-element arrangement). This guidance is not applicable to elements that are currently being sold separately by a vendor. Rather, one of the methods described in Question 3-1 should be applied to such elements to determine if VSOE of fair value exists. For guidance regarding establishing VSOE of fair value for PCS prior to the occurrence of actual renewals see Question 7-30.

If a vendor concludes that VSOE of fair value exists for an element not yet sold separately based on a price established by management having the relevant authority and no separate sales of the element are made within a reasonable period of time, or subsequent actual sales prices are inconsistent with the price established by management, we believe there is a rebuttable presumption that VSOE of fair value was never established for the element. In such cases, any arrangements previously accounted for as if VSOE of fair value did exist for the element generally should be evaluated as errors. Material errors included in previously issued financial statements should be reported as prior-period adjustments by restating the prior period financial statements in accordance with the guidance provided by ASC 250, *Accounting Changes and Error Corrections*.

Can VSOE of fair value exist for a group of elements?

Question 3-5 **Can VSOE of fair value be established for a group of elements when the elements are sold together on a separate basis but are not individually sold separately?**

Although a vendor may not separately sell all of the individual elements included in a multiple-element arrangement, it may routinely sell two or more of the elements together on a separate basis (e.g., a vendor may always sell software bundled with PCS). In such cases, a vendor may establish VSOE of fair value for two or more elements (a "combined element") for purposes of allocating arrangement consideration to elements included in a multiple-element arrangement. When determining when revenue may be recognized for the arrangement consideration allocated to a combined element, the revenue recognition provisions of ASC 985-605 should be applied as if the elements included in the combined element were a single element (e.g., the delivery criterion cannot be met until all elements included in the combined element have been delivered).

The following example illustrates these concepts:

Illustration 3-1 VSOE of fair value exists for a group of elements

Facts

A vendor routinely sells a software product in multiple-element arrangements that include a time-based license to software product A and co-terminus PCS for amounts ranging from $19,000 to $21,000, with $20,000 being the midpoint of the range. Due to the co-terminus nature of the license and PCS terms in these contracts, VSOE of fair value for the PCS and software does not exist on a separate basis (see Question 7-20). However, the vendor has determined that the range of prices of the software and PCS combined element is within a reasonably narrow range and that VSOE of fair value exists for the combined element.

The vendor enters into a licensing arrangement that also includes non-complex implementation services in exchange for $20,000. The implementation services do not involve significant production, modification or customization of the software, they are not essential to the functionality of the delivered product and they are included as an optional and incremental element of the contract such that the total price of the arrangement would vary as the result of their inclusion or exclusion. The vendor has determined that VSOE of fair value of the implementation services is $5,000, as equivalent services are frequently sold separately on a time-and-materials basis and it can make reasonably dependable estimates of the time required to complete such services when sold in connection with software license arrangements.

Analysis

The vendor should account for the combined software and PCS separately from the implementation services. Using the midpoint of the vendor's range of prices for the combined software and PCS element, the arrangement consideration of $20,000 should be allocated to the combined software and PCS element and the services based on their relative fair values, as follows (see Question 3-12):

	VSOE of fair value	% of relative fair value	Allocated discount	Allocated arrangement consideration
Software and PCS	$ 20,000	80%	$ (4,000)	$ 16,000
Implementation services	5,000	20%	(1,000)	4,000
Total	$ 25,000		$ (5,000)	$ 20,000

The vendor should account for each element separately — that is, the license and PCS should be accounted for as a separate unit of accounting, with revenue for that bundled element being recognized ratably over the PCS period (see ASC 985-605-25-9 through 25-11), and the implementation services accounted for as a second unit of accounting, with revenue being recognized as the services are performed (see ASC 985-605-25-77 through 25-85).

VSOE of fair value established by subsequent events

Question 3-6 **If VSOE of fair value of an element included in a multiple-element arrangement does not exist at the end of an accounting period, but is established prior to the issuance of the financial statements, can it be used for purposes of applying the provisions of ASC 985-605 to arrangements that existed as of the balance sheet date?**

No. The establishment of VSOE of fair value subsequent to the balance sheet date is an event that provides evidence with respect to conditions that did not exist at the balance sheet date. Pursuant to ASC 855, *Subsequent Events*, such events do not result in adjustment of the financial statements. However, if analyses are prepared subsequent to the balance sheet date of evidence that existed as of that date, that evidence can and should be used when applying the provisions of ASC 985-605 to transactions executed on or before the balance sheet date.

This topic is specifically addressed in the subsequent event guidance within ASC 855; see the excerpt of that guidance below. Additionally, the illustrative guidance within ASC 985-605 excerpted below also addresses this topic.

Excerpt from Accounting Standards Codification

Subsequent Events — Overall

Relationships

855-10-60-4

For guidance on the effect on the timing of revenue recognition when vendor-specific objective evidence of fair value is established by management after the balance sheet date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25), see paragraphs 985-605-55-93 through 55-95.

Software — Revenue Recognition

Implementation Guidance and Illustrations

Subsequent Event Related to Vendor-Specific Objective Evidence of Fair Value

985-605-55-93

The following provides implementation guidance as to the effect of subsequent events on the timing of the establishment of vendor-specific evidence of fair value (see paragraphs 985-605-25-6 through 25-7).

985-605-55-94

Vendor-specific objective evidence of fair value may be established by management after the balance sheet date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25), either by separate sales or by establishment of a price by a pricing committee. However, an entity may not use such evidence to recognize revenue at the balance sheet date in accordance with this Subtopic.

985-605-55-95

Establishment of vendor-specific objective evidence after the balance sheet date is a nonrecognized subsequent event, as discussed in Topic 855 — Subsequent Events. As a result, revenue should be deferred at the balance sheet date in accordance with paragraphs 985-605-25-9 through 25-11. However, if, after the balance sheet date, management merely compiles evidence that existed at the balance sheet date, that evidence should be used to assess whether there is sufficient vendor-specific objective evidence (in accordance with paragraphs 985-605-25-6 through 25-7) to recognize revenue at the balance sheet date.

VSOE of fair value established by reference to single, or limited, standalone sales

Question 3-7 **Can a vendor establish VSOE of fair value for an element included in a multiple-element arrangement solely by reference to the price at which the item has been sold separately if the item has only been sold separately once or on a limited basis?**

No. When a vendor attempts to establish VSOE of fair value by reference to an element's price when it is sold on a standalone basis, we believe it must be able to demonstrate that a substantial majority of the recent standalone sales of the element are priced within a relatively narrow range. Inherent in this concept is that the number of transactions is sufficiently large and reasonably current to allow a conclusion to be reached as to whether VSOE of fair value does or does not exist. Accordingly, we believe that VSOE of fair value generally cannot be established solely by reference to the price at which an element has been sold separately if the vendor does not or will not customarily sell the element separately, if it has been sold on a standalone basis only once, or only is sold separately on a limited basis, particularly when such transactions are not reasonably current.

Determining when the number of transactions is sufficiently large to provide a basis to conclude whether a vendor has established VSOE of fair value for an element, or determining the relevancy of transactions that occurred other than in recent periods, will be dependent on the applicable facts and circumstances and may require the use of professional judgment.

Inappropriate measures of fair value

Question 3-8 **May a vendor look to sources other than VSOE of fair value to establish fair value for an element for purposes of applying the provisions of ASC 985-605?**

No. ASC 985-605 provides that evidence of fair value may be established by reference to VSOE of fair value. It would be inappropriate to look to other sources to establish fair value, including the following:

- Contractually stated prices. Paragraph 99 of the Basis for Conclusions of the pre-codification guidance in SOP 97-2 stated that "AcSEC concluded that the revenue from an arrangement should be allocated to the separate elements based on vendor-specific objective evidence of fair value, regardless of any separate prices stated in the contract for each element. AcSEC believes that separate prices stated in a contract may not represent fair value and, accordingly, might result in an unreasonable allocation of revenue."
- Published price lists, unless the elements are being, or will be, sold in accordance with the price list terms.
- The vendor's cost of an item, including measures based on the time or amount of effort involved in delivering an element to a customer.
- The vendor's cost plus a "normal" profit margin. Cost plus a normal profit margin is not an acceptable mechanism for determining the fair value of an element included in a multiple-element arrangement because of the inherent difficulties and subjectivity involved in determining what a vendor's "normal" profit margin is.
- Competitor prices for similar products or industry averages. As stated in paragraph 100 of the Basis for Conclusions of the pre-codification guidance in SOP 97-2 "AcSEC considered allowing the use of surrogate prices such as competitor prices for similar products or industry averages to determine fair value. However, AcSEC believes that inherent differences exist between elements offered by different vendors. These inherent differences led AcSEC to conclude that only vendor-specific evidence of fair value can be considered sufficiently objective to allow the allocation of the revenue to the various elements of the arrangement."
- Liquidated damages payable to a customer or similar contractual features that reduce the price of elements included in an arrangement should a vendor fail to deliver an element. Additionally, when an arrangement contains liquidated damages or other penalties that are effective if an undelivered

element of the arrangement is not delivered, the guidance in ASC 985-605-25-13 and 25-14 should be considered. These paragraphs provide that amounts otherwise allocable to delivered elements do not meet the collectibility criterion if a portion of the arrangement consideration otherwise allocable is subject to forfeiture, refund, or other concession if any of the undelivered elements are not delivered.

Can VSOE of fair value of an element change?

Question 3-9 **Can VSOE of fair value for an element change over time?**

Yes. As discussed in Question 3-1, a vendor generally will establish VSOE of fair value by demonstrating that a substantial majority of recent standalone sales of an element are priced within a relatively narrow range. If changes in a vendor's business practices or pricing policies result in a substantial majority of all standalone sales of an element being priced within a range that is different from a range previously identified as constituting VSOE of fair value for the element, the new range should now be considered VSOE of fair value. However, we expect that such changes will occur infrequently.

Allocation of arrangement consideration when an arrangement to extend or renew an existing time-based license includes additional elements

Question 3-10 **If a software vendor enters into an arrangement to extend or renew an existing time-based license, and the arrangement also includes other elements, how should the arrangement fee be allocated to the different elements?**

As with all software arrangements, the arrangement consideration should be allocated based on VSOE of fair value pursuant to paragraph ASC 985-605-25-6 and 25-7.

This is further discussed in the implementation guidance in ASC 985-605, see applicable excerpt below.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Effect of Additional Products in an Extension or Renewal of License Term

985-605-55-110

Paragraphs 985-605-55-105 through 55-109[5] address the effect of commencement of an extension or renewal license term if the extension or renewal arrangement includes only a product or products already included in the existing, currently active arrangement. If the extension or renewal arrangement includes additional product or products, the extension or renewal arrangement fee should be allocated to the different products.

985-605-55-111

For example, consider the arrangement described in paragraphs 985-605-55-105 through 55-109, including that vendor-specific objective evidence of fair value exists for postcontract customer support. The license term of Product A commenced on January 3, 20X1, and ends on January 2, 20X4. In September 20X3, the customer decides it wants to continue to use Product A beyond January 2,20X4, and also to include in the arrangement a license to Product B, which will commence upon the delivery of Product B. The software vendor and customer execute an arrangement on September 20, 20X3, to extend or renew the terms of the existing, currently active license of Product A through December 31, 20X5, and also to license Product B. The software vendor has vendor-specific objective evidence of fair value for Products A and B, and Product B is expected to be delivered in the first quarter of 20X4.

985-605-55-112

[5] These paragraphs are included in this publication as part of the response to the Question 4-23.

The software vendor would allocate the extension or renewal arrangement fee using vendor-specific objective evidence of fair value consistent with paragraphs 985-605-25-6 through 25-7.

985-605-55-113

Consistent with paragraphs 985-605-55-105 through 55-109, the software vendor would recognize the portion of the extension or renewal arrangement fee allocated to Product A as revenue on September 20, 20X3 (if all other revenue recognition criteria are met), because the customer already has possession of and the right to use the software to which the extension or renewal applies. The portion of the extension or renewal arrangement fee allocated to Product B would be recognized when the criteria of paragraph 985-605-25-3 are met and the license period for Product B has commenced.

985-605-55-114

In considering the guidance in paragraphs 985-605-25-34 through 25-35 on determining whether the extension or renewal fee is fixed or determinable, the date that the extension or renewal arrangement is executed as it relates to the portion of the arrangement fee allocated to Product A and the date Product B is delivered as it relates to the portion of the arrangement fee allocated to Product B would be used to determine whether the extension or renewal arrangement payment terms are extended.

Subsequent adjustment of amounts allocated to undelivered elements

Question 3-11 **Can amounts of arrangement consideration allocated to an undelivered element at the outset of a software licensing arrangement be subsequently adjusted if VSOE of fair value of the element changes (or for other factors)? Should projected losses relating to undelivered elements be recognized by a vendor?**

Amounts of arrangement consideration allocated to an undelivered element at the outset of a software licensing arrangement may not be subsequently adjusted, even if VSOE of fair value for that element is subsequently revised, unless that element is a specified upgrade right (see also the discussion in Chapter IV on specified upgrade rights).

However, if it becomes probable that the amount of arrangement consideration allocated to an undelivered element will result in the recognition of a loss on that element once it is delivered and the allocated arrangement consideration is recognized, ASC 985-605-25-7 requires the loss be recognized when it is probable and can be reasonably estimated in accordance with ASC 450, *Contingencies*.

3.6 Allocating discounts

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-8

If a discount is offered in a multiple-element arrangement, a proportionate amount of that discount shall be applied to each element included in the arrangement based on each element's fair value without regard to the discount. However, as discussed in paragraph 985-605-25-45, no portion of the discount shall be allocated to any upgrade rights. Moreover, to the extent that a discount exists, the residual method described in paragraphs 985-605-25-10 through 25-11 attributes that discount entirely to the delivered elements.

ASC 985-605 recognizes when customers purchase software products or services in a multiple-element arrangement, they may receive a discount from the sum of the fair values of such products or services when purchased separately. The allocation of this discount differs depending on whether VSOE of fair value exists for all elements included in the arrangement or only for the undelivered elements.

If VSOE of fair value exists for each element included in a multiple-element arrangement, the total arrangement consideration is allocated to the elements based on their fair values. This method results in a pro-rata allocation of any discount among all of the elements in an arrangement.

When evidence of fair value does not exist for delivered elements, but does exist for all of the undelivered elements, the arrangement consideration is allocated using the residual method. The residual method allocates an amount of arrangement consideration to the elements for which fair value can be determined (i.e., the undelivered elements), and any remaining arrangement consideration (the residual) is then allocated to the delivered element(s). The residual method allocates any discount included in the arrangement to the delivered element(s) in its entirety.

Discounts from fair value should not be confused with discounts from list prices (e.g., 30% off vendor's list price) that are generally used to determine the amount to be received under an arrangement (i.e., a list price discount).

Regardless of the allocation method used, arrangement consideration allocated to an element should be recognized as revenue only when the revenue recognition criteria of ASC 985-605 have been met with respect to that element (see Chapter IV).

Arrangement consideration allocation methodologies

Question 3-12 **ASC 985-605-25-8 through 25-11 describe the relative-fair-value method and the residual methods of allocating arrangement consideration among elements included in a multiple-element arrangement. What are the differences in these methods?**

The method used to allocate arrangement consideration pursuant to ASC 985-605 differs depending on whether VSOE of fair value exists for all elements included in the arrangement or only for the undelivered elements (if VSOE of fair value for at least the undelivered elements does not exist, no allocation of arrangement consideration can be made and the elements should be accounted for as one unit of accounting). The main difference between the two methods relates to whether any discount included in an arrangement is allocated proportionately to all elements of the arrangement or allocated in its entirety to the delivered items.

The preferred method of allocating arrangement consideration pursuant to ASC 985-605 is the relative-fair-value method because the discount, if any, included in the arrangement is allocated proportionately to each element. This method should be used when the fair values of all the units of accounting in an arrangement are known (i.e., fair value is known for both the delivered and undelivered elements). Pursuant to this method, the total arrangement consideration is allocated to each element based on its relative percentage of the total fair value of all of the elements included in the arrangement. In practice, the relative-fair-value method is rarely used because software vendors generally cannot establish VSOE of fair value for software licenses that are almost always sold in conjunction with PCS.

The following example illustrates these concepts:

Illustration 3-2: Allocation of the considerations using the relative fair value approach

Facts

A software vendor enters into an arrangement to license Product A and to provide one year of PCS and installation services for $90,000. The software is delivered at inception of the arrangement. Based on sales of each of the elements on a separate basis, VSOE of fair value for the software, PCS and installation services is $75,000, $15,000 and $10,000 respectively.

Analysis

Because VSOE of fair value exists for each element included in the arrangement, the arrangement consideration of $90,000 should be allocated using the relative-fair-value method as follows:

	VSOE of fair value	% of Relative fair value	Allocated discount	Allocated arrangement consideration
Software Product A	$ 75,000	75%	$ (7,500)	$ 67,500
PCS	15,000	15%	(1,500)	13,500
Installation services	10,000	10%	(1,000)	9,000
Total	$ 100,000		$ (10,000)	$ 90,000

The residual method is used when VSOE of the fair values of all undelivered elements are known but the fair values of delivered elements are not. When arrangement consideration is allocated using the residual method, the entire fair value of the undelivered element(s) is allocated to those elements. The remaining arrangement consideration (the residual) is allocated to the delivered element(s). The use of this method results in any discount embedded in the arrangement being allocated, in its entirety, to the delivered element(s).

The following example illustrates these concepts:

Illustration 3-3: Allocation of the considerations using the residual approach

Facts

Assume the same facts as in the example above, except that the vendor never sells Product A without PCS. Accordingly, it is unable to determine VSOE of fair value for Product A. However, based on PCS renewals and sales of services on a separate basis, it has determined that VSOE of fair value for PCS and installation services is $15,000 and $10,000, respectively.

Analysis

Because VSOE of fair value exists for the undelivered elements included in the arrangement, the arrangement consideration of $90,000 should be allocated using the residual method as follows:

Total arrangement consideration	$ 90,000
Less amounts allocated to undelivered elements based on VSOE of fair value:	
VSOE of fair value of PCS	15,000
VSOE of fair value of installation services	10,000
Amount allocated to the delivered element (Product A)	$ 65,000

Use of residual method to allocate arrangement consideration when VSOE of fair value exists for all elements

Question 3-13 **If VSOE of fair value exists for all elements included in a multiple-element arrangement, may the residual method be used to allocate arrangement consideration?**

No. Arrangement consideration should be allocated using the relative-fair-value method when VSOE of fair value exists for all of the elements included in a multiple-element arrangement. However, our experience is that the relative-fair-value method is rarely used in practice because, aside from certain vendors of shrink-wrap products, software vendors generally cannot establish VSOE of fair value for software products because products are almost always sold in conjunction with PCS.

Alternative arrangement consideration allocation methodologies

Question 3-14 **Is it acceptable for a vendor to allocate arrangement consideration based on a method other than the relative-fair-value method or the residual method?**

No. ASC 985-605 only provides for the allocation of arrangement consideration to elements contained in a multiple-element arrangement using either the relative-fair-value method or the residual method, depending on whether VSOE of fair value exists for all elements included in the arrangement or for at least the undelivered elements. If VSOE of fair value for the undelivered elements does not exist, no allocation of arrangement consideration can be made and the elements should be accounted for as one unit of accounting.

3.7 Revenue recognition for bundled units of accounting

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-9

Except as provided in the following paragraph, if sufficient vendor-specific objective evidence does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement shall be deferred until the earlier of the point at which:

a. Such sufficient vendor-specific objective evidence does exist.

b. All elements of the arrangement have been delivered.

985-605-25-10

The following are exceptions to the guidance in the preceding paragraph:

a. If the only undelivered element is postcontract customer support, the entire fee shall be recognized ratably (see paragraphs 985-605-25-66 through 25-75).

b. If the only undelivered element is services that do not involve significant production, modification, or customization of software (for example, training or installation), the entire fee shall be recognized over the period during which the services are expected to be performed (see paragraphs 985-605-25-76 through 25-85).

c. If the arrangement is in substance a subscription, the entire fee shall be recognized ratably (see paragraphs 985-605-25-58 through 25-59).

d. If the fee is based on the number of copies, the arrangement shall be accounted for in conformity with paragraphs 985-605-25-52 through 25-57.

e. There may be instances in which there is vendor-specific objective evidence of the fair values of all undelivered elements in an arrangement but vendor-specific objective evidence of fair value does not exist for one or more of the delivered elements in the arrangement. In such instances, if both of the conditions in the following paragraph are met, the fee shall be recognized using the residual method as follows:

   1. The total fair value of the undelivered elements, as indicated by vendor-specific objective evidence, is deferred.

   2. The difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

f. If an arrangement includes deliverables that are within the scope of this Subtopic (software deliverables) and deliverables that are not within the scope of this Subtopic (nonsoftware deliverables), a vendor shall allocate arrangement consideration to the nonsoftware deliverables, and to the software deliverables as a group, in accordance with paragraph 605-25-15-3A. The nonsoftware deliverables may include software deliverables that are considered essential to the functionality of a tangible product. If the arrangement includes more than one software deliverable, the portion of the arrangement consideration allocated to the software deliverables as a group in accordance with the guidance in paragraph 605-25-15-3A would be further subject to the separation and allocation guidance of this Subtopic. If a tangible product contains software that is not essential to the product's functionality, that nonessential software and any other deliverables within the arrangement (other than the nonsoftware components of the tangible product) that relate to that nonessential software are within the scope of this Subtopic. If an undelivered element relates to a deliverable within the scope of this Subtopic and a deliverable excluded from the scope of this Subtopic, the undelivered element shall be bifurcated into a software deliverable and a nonsoftware deliverable. The software deliverable is within the scope of this Subtopic and the nonsoftware deliverable is not within the scope of this Subtopic.

985-605-25-11

The residual method described in (e) in the preceding paragraph shall be applied only if both of the following conditions are met:

a. All other applicable revenue recognition criteria in this Subtopic are met.

b. The fair value of all of the undelivered elements is less than the arrangement fee.

Allocating arrangement consideration when VSOE of fair value exists for undelivered elements

Question 3-15 **How should a vendor allocate arrangement consideration when VSOE of fair value does not exist for the delivered elements included in a multiple-element arrangement but does exist for the undelivered elements?**

In such cases, the residual method should be used to allocate the arrangement fees between the delivered and undelivered elements.

PCS and services are the only undelivered elements and VSOE of fair value does not exist for one or both

Question 3-16 **Software vendors may enter into arrangements with customers to license software, provide an initial period of PCS and provide services that do not involve significant production, modification or customization of the software. If a vendor that enters into such an arrangement has not established VSOE of fair value for both the PCS element and the service element, how should revenue be recognized for the arrangement?**

ASC 985-605-25-78 states that if an arrangement includes software and services, the services should be accounted for separately if:

- Sufficient VSOE of fair value exists to permit allocation of the arrangement consideration to the various elements of the arrangement.
- The services "are not essential to the functionality of any other element of the transaction." In practice, we believe that this phrase has generally been interpreted to mean that the services are of the type described in ASC 985-605-25-80 as not involving "significant production, modification, or customization of the software" (e.g., training or installation — see Question 8-3).
- The services are described in the contract "such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services."

ASC 985-605-25-77 states that if these criteria are not met, "contract accounting shall be applied to both the software and service elements included in the arrangement." Accordingly, it appears from these paragraphs that software licensing arrangements that include both PCS and other services that are not essential to the functionality of the licensed software should be accounted for using contract accounting if VSOE of fair value does not exist such that the arrangement consideration can be allocated to each element included in the arrangement.

However, we believe that such arrangements should not be accounted for using contract accounting. Rather, we believe that ASC 985-605-25-88 through 25-107 contemplates a "customized solution sale" situation very different from arrangements including services that are not essential to the functionality of the licensed software. This belief is supported by ASC 985-605-25-80 which states that "(i)f vendor-specific objective evidence of the fair value does not exist to allocate a portion of the fee to the service element, and the only undelivered element is services that do not involve significant production, modification, or customization of the software (for example, training or installation), the entire arrangement fee shall be recognized on a straight-line basis over the period during which the services are performed."

ASC 985-605-25-9 through 25-11 addresses situations in which "sufficient vendor-specific objective evidence does not exist for the allocation of revenue to the various elements of the arrangement," noting that in such situations, "all revenue from the arrangement should be deferred until the earlier of the point at which: (a) such sufficient vendor-specific objective evidence does exist; (b) all elements of the arrangement have been delivered." However, it provides exceptions to this guidance, including the following:

- If the only undelivered element is PCS, the entire fee should be recognized ratably.
- If the only undelivered element is services that do not involve significant production, modification or customization of software (e.g., training or installation), the entire fee should be recognized over the period during which the services are expected to be performed.

A literal read of this guidance would indicate that if VSOE of fair value does not exist for both undelivered elements, no revenue should be recognized for an arrangement including a software license, PCS and services that are not essential to the licensed software until either VSOE of fair value is developed, all elements have been delivered, or only one undelivered element (either PCS or services) remains.

However, we believe when arrangements include both PCS and services that otherwise qualify for separate accounting under ASC 985-605 but for which VSOE of fair value does not exist, the following accounting policies are acceptable alternatives. Because the following represents an accounting policy election, the policy selected by a vendor should be consistently applied and, if material, disclosed in the footnotes to the financial statements.

- The "Combined Services" approach. Using this approach, the entire arrangement fee would be recognized ratably over the period during which the services are expected to be performed or the PCS period, whichever is longer, once the software has been delivered and the provision of both services has commenced, if all of the other basic revenue recognition criteria of ASC 985-605 have been met.

  In such situations, the remaining undelivered elements of PCS and non-essential services are all services in the broader usage of that term. Accordingly, we believe that recognizing the revenue over the longest period that services will be provided to the customer is consistent with the provisions of ASC 985-605-25-70 and 25-80.

  ASC 985-605-25-70 addresses the accounting for arrangements when sufficient VSOE of fair value does not exist to allocate consideration to the elements included in the arrangement and the only undelivered element is PCS, concluding that the entire arrangement fee should be recognized ratably over the period that PCS services will be provided to the customer.

  Similarly, ASC 985-605-25-80 addresses the accounting for arrangements when sufficient VSOE of fair value does not exist to allocate consideration to the elements included in the arrangement and the only undelivered element is services that are not essential to licensed software, concluding that the entire arrangement fee should be recognized as the services are performed. If no pattern of performance is discernible, the entire arrangement fee should be recognized on a straight-line basis over the period during which the services are performed.

  We believe the guidance in these paragraphs clearly indicates that the intent of the guidance was that if VSOE of fair value does not exist such that the multiple elements included in an arrangement cannot be accounted for separately, and the remaining undelivered items are services, revenue should be recognized over the period the services will be delivered.

  Further, ASC 985-605 recognizes that when multiple elements are included in a software licensing arrangement, the customer may receive a discount from the total price that would be paid if each of the elements were purchased separately. We believe the methods provided by ASC 985-605 for the allocation of arrangement consideration are meant to ensure that if revenue is recognized for a delivered element, the discount inherent in the arrangement is either allocated in its entirety to the delivered item (if VSOE of fair value of only the undelivered item(s) exists) or pro-rata among all of the elements (if VSOE of fair value of all of the elements exists). In either case, these methods prevent revenue from being "front-loaded."

  Accordingly, we believe that the intent of the guidance within ASC 985-605-25-9 through 25-11 with respect to the accounting for arrangements for which sufficient VSOE of fair value does not exist for the allocation of consideration to all of the elements of the arrangement, or exists only for undelivered elements, is to prevent the inappropriate "front-loading" of revenue by generally not allowing revenue recognition until either VSOE of fair value is developed by the vendor or all of the elements included in the arrangement have been delivered. The exceptions to this general rule when either services or PCS are the only remaining undelivered items recognize that, in such cases, revenue cannot be front-loaded if the revenue (and thus any discount included in the arrangement) is recognized over the service period.

We also believe that this accounting is analogous to a service contract (not subject to the scope of ASC 985-605) comprised of multiple services that do not meet the separation criteria of ASC 605-25. The prescribed accounting for such an arrangement under the multiple-element arrangements guidance is to account for the entire arrangement as a single unit. If the multiple services included in such an arrangement commence concurrently, revenue for the single unit of accounting generally would be recognized over the longest service period.

The following example illustrates these concepts:

Illustration 3-4: Combined services approach when VSOE of fair value does not exist

Facts

A calendar year-end software vendor enters into an arrangement on 30 June 20X5 to license Product A on a perpetual basis and to provide one year of PCS and installation services for $110,000. The installation services do not involve significant production, modification or customization of the software, are not essential to the functionality of Product A and are described in the arrangement such that the total price would vary as the result of their inclusion or exclusion.

Product A is delivered at inception of the arrangement. PCS services commence with delivery of the software. Installation services commence on 1 August 20X5, and are completed on 30 September 20X5.

The vendor has not established VSOE of fair value for any of the elements included in the arrangement.

The vendor's accounting policy is to begin to recognize revenue from such arrangements ratably over the period during which the services are expected to be performed or the PCS period, whichever is longer, once the software has been delivered and both services have commenced. All of the basic revenue recognition criteria of ASC 985-605 have been met.

Analysis

Due to the lack of VSOE of the fair value of the elements included in the arrangement, and based on the vendor's selected accounting policy, the revenue from the arrangement should be recognized ratably over the PCS period (the longer of two service periods), once the delivery of both services has commenced. Accordingly, the vendor may recognize $10,000 of revenue per month for the arrangement, commencing 1 August 20X5 (computed as the arrangement fee of $110,000 divided by the 11 months remaining in the PCS period once the installation services commence).

If an arrangement includes PCS and services that are not essential to the licensed software and the vendor has established VSOE of fair value for either the PCS or the services, but not both, this accounting may also be applied. If in such cases the services for which VSOE of fair value does not exist are completed prior to the completion of the services for which VSOE of fair value does exist, the difference between the VSOE of fair value for the remaining service period and the remaining unrecognized portion of the arrangement fee should be recognized as revenue on completion of the services for which VSOE does not exist (i.e., the residual method should be applied to determine the amount of revenue which should remain deferred at the date of completion of the services for which VSOE of fair value does not exist). The remaining deferred revenue should be recognized ratably over the period during which the service for which VSOE of fair value does exist will be completed, if all of the basic revenue recognition criteria of ASC 985-605 have been met.

The following example illustrates these concepts:

Illustration 3-5: VSOE of fair value does not exist for installation services

Facts

Assume the same facts as in Illustration 3-4 above, except that the vendor has established that VSOE of fair value of PCS is $18,000, based on PCS renewals.

Analysis

As in the example above, the vendor may begin to recognize revenue of $10,000 per month for the arrangement commencing 1 August 20X5. On 30 September 20X5, when the installation services are completed, $20,000 of revenue would have been recognized, and $90,000 remains to be recognized. On that date, the fair value of the remaining PCS period is $13,500 ($18,000 per year, or $1,500 per month, multiplied by the remaining 9 months of service to be provided). Accordingly, $76,500 ($110,000 less $20,000 recognized to date minus $13,500 for the undelivered PCS services) should be recognized as revenue on 30 September 20X5.

The Combined Services approach may be used when delivery of the services is front-loaded or occurs ratably over the service period. However, it generally should not be used if a substantial portion of the services (based relative value and effort) are provided to the customer towards the end of the arrangement (i.e., if the services are back-loaded), or if there are significant time delays between when a vendor commences delivery of a service and the majority of the service is provided.

- The "Full Deferral" approach. Using this approach, all revenue is deferred until either the services or the PCS is the only undelivered element. The entire arrangement fee is then recognized over the period during which the undelivered services will be completed, if all of the other basic revenue recognition criteria of ASC 985-605 have been met. This accounting is consistent with a literal read of the provisions of ASC 985-605-25-9 through 25-11.

The following example illustrates these concepts:

Illustration 3-6: Full deferral approach

Facts

Assume the same facts as in Illustration 3-4 above, except that the vendor's accounting policy is to defer all revenue recognition until only one undelivered service remains, and then recognize all revenue from the arrangement ratably over the period during which the undelivered service will be completed.

Analysis

On 30 September 20X5 when the installation services are completed, the vendor should begin to recognize revenue ratably over the remaining nine-month PCS period. Accordingly, it may recognize revenue of $12,222 per month ($110,000 divided by the remaining 9 months of PCS to be provided) during the period 1 October 20X5 to 30 June 20X6.

As in the first bullet above, an arrangement may have the following characteristics:

- It includes PCS and services that are not essential to the licensed software
- The vendor has established VSOE of fair value for either the PCS or the services, but not both
- The services for which VSOE of fair value does not exist are completed prior to the completion of the services for which VSOE of fair value does exist

In such cases, the difference between 1) VSOE of fair value for the remaining service period and 2) the remaining unrecognized portion of the arrangement fee should be recognized as revenue on completion of the services for which VSOE does not exist (i.e., the residual method should be applied to determine the amount of revenue which should remain deferred at the date of completion of the services for which VSOE of fair value does not exist). The remaining deferred revenue should be recognized ratably over the period during which the service for which VSOE of fair value does exist will be completed, if all of the other basic revenue recognition criteria of ASC 985-605 have been met.

The following example illustrates these concepts:

Illustration 3-7: Deferral of revenue until only one undelivered service remains

Facts

Assume the same facts as in Illustration 3-4 above, except that the vendor's accounting policy is to defer all revenue recognition until only one undelivered service remains, and then recognize all revenue from the arrangement ratably over the period during which the undelivered service will be completed. The vendor has established that VSOE of fair value of PCS is $18,000, based on PCS renewals.

Analysis

The vendor should recognize no revenue relating to the agreement prior to the completion of the installation services on 30 September 20X5. On that date, $96,500 of revenue should be recognized ($110,000 minus the fair value of the remaining PCS period is $13,500 ($18,000 per year, or $1,500 per month, multiplied by the remaining 9 months of service to be provided)).

- The "Cumulative Catch-Up" approach. If VSOE of fair value does not exist for any of the undelivered elements included in a multiple-element arrangement and undelivered services have been and will be delivered ratably over the service period, all revenue can be deferred until either the services or PCS is the only undelivered element, and then an amount of revenue equal to the total arrangement consideration less the pro-rata portion applicable to the remaining service period can be recognized. The remaining amount is then recognized over the remaining service period. This accounting "trues up" the amount of deferred revenue relating to the arrangement on the balance sheet as of that date by recognizing a "cumulative catch up" of revenue.

The following example illustrates these concepts:

Illustration 3-8: Cumulative catch-up approach

Facts

Assume the same facts as in Illustration 3-4 above, except that the vendor's accounting policy is to defer all revenue recognition until only one undelivered service remains. At that point, it recognizes as revenue an amount equal to the total arrangement consideration less the pro-rata portion applicable to the remaining service period. The latter amount is then recognized over the remaining service period.

Analysis

On 30 September 20X5 when the installation services are completed, the vendor should recognize $27,500 of revenue ($110,000 divided by 12 months multiplied by 3 months of service rendered to date). The remaining $82,500 ($110,000 less the $27,500 recognized) should be recognized at a rate of $9,167 per month ($82,500 divided by the remaining 9 months of PCS to be provided) during the period 1 October 20X5 to 30 June 20X6.

Allocation of arrangement consideration between software and nonsoftware deliverables

Question 3-17 **If an arrangement contains both software and nonsoftware deliverables (i.e., deliverables both within and outside of the scope of ASC 985-605), how should the arrangement consideration be allocated to each separate unit of accounting?**

ASC 985-605-25-10 provides the following guidance on allocating the arrangement consideration between software and nonsoftware deliverables:

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-10

f. If an arrangement includes deliverables that are within the scope of this Subtopic (software deliverables) and deliverables that are not within the scope of this Subtopic (nonsoftware deliverables), a vendor shall allocate arrangement consideration to the nonsoftware deliverables, and to the software deliverables as a group, in accordance with paragraph 605-25-15-3A. The nonsoftware deliverables may include software deliverables that are considered essential to the functionality of a tangible product. If the arrangement includes more than one software deliverable, the portion of the arrangement consideration allocated to the software deliverables as a group in accordance with the guidance in paragraph 605-25-15-3A would be further subject to the separation and allocation guidance of this Subtopic. If a tangible product contains software that is not essential to the product's functionality, that nonessential software and any other deliverables within the arrangement (other than the nonsoftware components of the tangible product) that relate to that nonessential software are within the scope of this Subtopic. If an undelivered element relates to a deliverable within the scope of this Subtopic and a deliverable excluded from the scope of this Subtopic, the undelivered element shall be bifurcated into a software deliverable and a nonsoftware deliverable. The software deliverable is within the scope of this Subtopic and the nonsoftware deliverable is not within the scope of this Subtopic.

If the arrangement contains deliverables within the scope of the software revenue recognition guidance (software deliverables) and deliverables not within the scope of the software revenue recognition guidance (nonsoftware deliverables, which include any software essential to the functionality of the tangible product and related elements), the arrangement consideration must be allocated between the software and nonsoftware deliverables. The arrangement consideration is allocated to each separate unit of accounting of the nonsoftware deliverables and to the software deliverables as a group using the relative-selling-price method pursuant to the multiple-element arrangements guidance in ASC 605-25. ASC 985-605 requires that an entity use the allocation methodology within ASC 605-25 for all deliverables in the arrangement — including the software deliverables — in order to determine the total arrangement consideration to be applied to the nonsoftware and to the software deliverables.

ASC 605-25 requires an entity to use the relative-selling-price method to allocate arrangement consideration for all arrangements. This may represent a different allocation methodology than that provided in ASC 985-605 to allocate arrangement consideration (e.g., while the relative-selling-price method is allowed in situations in which VSOE exists for all deliverables within an arrangement, ASC 985-605 requires the use of the residual method when VSOE does not exist for all of the deliverables). Further, in allocating the arrangement consideration, ASC 605-25 requires an entity to use VSOE, if available, or third-party evidence (TPE) of selling price for the separate units of accounting. If neither VSOE nor TPE is available, the entity must use its best estimate of selling price. Conversely, ASC 985-605 does not allow the use of TPE or a best estimate of selling price when VSOE does not exist to allocate arrangement consideration. Entities may wish to refer to our separate publication, Financial Reporting Developments, *Revenue recognition — Multiple element arrangements*, *Accounting Standards Codification 605-25* (Revised March 2018, SCORE No. BB1843), for further discussion of TPE and best estimate of selling price, including factors to be considered in making such estimates.

If the arrangement includes multiple software deliverables, the amount allocated to the software deliverables as a group is then accounted for in accordance with the software revenue recognition guidance in ASC 985-605. Additionally, if an undelivered element relates to both software and nonsoftware deliverables, the consideration related to the undelivered element is bifurcated and accounted for pursuant to the appropriate guidance.

The following example illustrates this concept:

Illustration 3-9: Allocation of consideration between software and nonsoftware deliverables

Facts

A vendor sells a personal computer that includes an operating system, productivity software and PCS on the operating system and the productivity software. The operating system provides the essential functionality of the personal computer including the ability to manage the computer and its hardware functions, the ability to manage and interact with a range of hardware peripherals and the ability to communicate through a variety of computer networks. The vendor rarely sells the personal computer without the operating system. The vendor regularly sells the same computer with and without the productivity software and sells the productivity software separately.

Total arrangement consideration is $2,000. The vendor has determined that its best estimate of selling price is $1,400 for the personal computer, $400 for the operating system and $400 for the productivity software. The entity has established VSOE of fair value of $160 for the PCS, which covers both the operating system and the productivity software. (VSOE of fair value does not exist separately for the productivity software.) For purposes of this example, assume that the PCS would not meet the requirements of ASC 605-20-25-1 through 25-6 to be accounted for as a separately priced extended product maintenance agreement.

Analysis

The vendor likely would conclude that the personal computer and operating system function together to deliver the essential functionality of the personal computer. As a result, those elements would not be subject to the provisions of the software revenue recognition guidance; rather, they would be subject to multiple-element arrangements guidance. However, the productivity software would not be considered essential to the functionality of the personal computer because the computer is sold more than infrequently without the productivity software. Therefore, that element would be subject to the software revenue recognition guidance in ASC 985-605. The PCS relates to both essential software (i.e., the operating system, which for accounting purposes is considered a nonsoftware deliverable) and non-essential software (i.e., the productivity software, which for accounting purposes is considered a software deliverable). As a result, the arrangement consideration for the PCS must be bifurcated between the nonsoftware and software deliverables for purposes of revenue recognition. (In this scenario, the vendor determined that the estimated selling price of the PCS for the operating system and the productivity software is $80 each, based on its best estimate of selling price for each of the items.)

	Best estimate of selling price	% of relative selling price	Allocated discount	Allocated arrangement consideration
Personal computer	$ 1,400	60%	$ (214)	$ 1,186
Operating system	400	17%	(61)	339
PCS on operating system	80	3%	(12)	68*
Software deliverables (productivity software and related PCS)	480	20%	(73)	407
Total	$ 2,360		$ (360)	$ 2,000

Since the arrangement contains both software and nonsoftware deliverables, the arrangement consideration should be allocated individually to each separate unit of accounting for the nonsoftware deliverables (the personal computer, the operating system and PCS on the operating system) and to the software elements as a group (the productivity software and related PCS) based on the relative selling prices pursuant to the multiple-element arrangements guidance in ASC 605-25 as follows:

The consideration allocated to the nonsoftware separate units of accounting (the personal computer, operating system and PCS on the operating system) should be recognized as revenue in accordance with the appropriate revenue recognition guidance, including general revenue recognition criteria included in SAB Topic 13 and the multiple-element arrangements guidance in ASC 605-25.

The $407 allocated to the software components (the productivity software and the related PCS) should be recognized as revenue in accordance with the software revenue recognition guidance in ASC 985-605. As the entity has not established VSOE of fair value for all of the software elements, the entity would use the residual method to recognize the revenue for the productivity software and related PCS. As a result, the entity would allocate $80 (of the total $407 allocated to the software components) to the PCS, based on the VSOE of fair value of the PCS, and $327 ($407 less $80) to the productivity software, based on the residual method of allocating arrangement consideration.

(*) Note — this fact pattern and relative-selling-price allocation assumes that the revenue associated with these services is not contingent revenue.

In-substance subscriptions

Question 3-18 **ASC 985-605-25-10 provides that if an arrangement "is in substance a subscription, the entire fee shall be recognized ratably." Does that guidance define what is meant by "in substance a subscription"?**

In addition to the statement quoted in the question above, ASC 985-605-25-10 refers readers to ASC 985-605-25-58 and 25-59, which provide an example of an arrangement that should be accounted for as a subscription because a vendor has granted a customer rights to receive unspecified additional software products in the future (see Questions 5-27 through 5-30) or has provided unspecified future platform transfer rights that do not qualify for exchange accounting (see Chapter VI). One could interpret the reference to ASC 985-605-25-58 and 25-59 as denoting the only circumstances to which subscription accounting applies. However, we do not believe that this is the intent of the guidance, as it seems that the reference in ASC 985-605-25-10 , or the discussion in ASC 985-605-25-58 and 25-59, likely would have stated if that were the case.

While paragraph 120 of the Basis for Conclusions of the pre-codification guidance in SOP 97-2 discusses the rationale for the application of subscription accounting to the types of arrangements discussed in ASC 985-605-25-58 and 25-59, there is no discussion as to what other arrangements might be "in substance a subscription," or whether AcSEC's intent was to limit the application of subscription accounting to the types of arrangements explicitly discussed in paragraphs 25-58 and 25-59. Accordingly, determining when an arrangement is "in substance a subscription" will depend on the facts and circumstances and require the use of professional judgment. However, we believe that if a vendor routinely provides numerous updates to licensed software within a short period of time, consideration should be given to whether the arrangement should be accounted for as an in-substance subscription.

The following example illustrates these concepts:

Illustration 3-10: In-substance subscriptions

Facts

A software vendor enters into an arrangement to license spam prevention software to a customer. As part of the arrangement, the vendor also agrees to provide updates to the product for newly identified sources of spam during the term of the software license. These updates occur frequently, often on an hourly basis.

Analysis

Because the agreement includes numerous updates to the software within a short period of time over the term of the arrangement, the arrangement should be accounted for as an in-substance subscription. Revenue for the arrangement should be recognized ratably over the subscription period in accordance with ASC 985-605-25-59 beginning with the delivery of the software (if all of the other basic revenue recognition criteria have been met).

An additional type of arrangement that we believe may be accounted for as an in-substance subscription is discussed in Question 6-5.

Establishment of VSOE of fair value of PCS or other services subsequent to the outset of the arrangement

Question 3-19

Software vendors may enter into arrangements with customers to license software, provide an initial period of PCS or provide services that do not involve significant production, modification or customization of the software (e.g., training or installation — see Chapter VIII). If a vendor lacks VSOE of fair value of the undelivered PCS or services at the outset of the arrangement, it is unable to separately account for the elements of the arrangement. In such cases, revenue is generally recognized ratably over the period that the undelivered services will be rendered, based on the provisions of ASC 985-605-25-9 through 25-11.

However, ASC 985-605 is unclear as to how a vendor's subsequent establishment of VSOE of fair value of undelivered PCS or services affects the accounting for previously executed but uncompleted arrangements that include such elements. That is, how should a vendor account for deferred revenue related to delivered elements of arrangements when VSOE of fair value of PCS or other undelivered services is established subsequent to the onset of the arrangement, assuming that all other revenue recognition criteria are met?

ASC 985-605-25-9 states, "if sufficient vendor-specific objective evidence does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement should be deferred until the earlier of the point at which: (a) such sufficient vendor-specific objective evidence does exist; (b) all elements of the arrangement have been delivered." However, it provides the following exceptions to this guidance when undelivered elements of the arrangements are services:

- If the only undelivered element is PCS, the entire fee should be recognized ratably.
- If the only undelivered element is services that do not involve significant production, modification or customization of software (e.g., training or installation), the entire fee should be recognized over the period during which the services are expected to be performed.

ASC 985-605 is unclear as to how these provisions interact when (1) one of the exceptions to the general guidance in ASC 985-605-25-9 is applied to an arrangement and (2) VSOE of fair value of the undelivered service is later developed before all of the associated revenue has been recognized. In such cases, we are aware of at least two different views as to the appropriate accounting:

- One view is that the ASC 985-605-25-9 should be followed and the remaining amount of arrangement consideration recorded as deferred revenue should be allocated (most likely using the residual method) as of the date the vendor subsequently establishes VSOE of fair value of the undelivered services. That is, the amount of deferred revenue on the vendor's balance sheet is "trued up" to the VSOE of fair value of the remaining undelivered services. Any amount of deferred revenue recorded on the balance sheet in excess of the VSOE of fair value of the remaining undelivered services on that date is recognized as revenue.
- A second view is that once one of the exceptions to the general guidance in ASC 985-605-25-9 is applied that exception remains applicable to the accounting for the related arrangement through its anticipated term — even if VSOE of fair of the undelivered services is later established by the vendor. Pursuant to this view, once a vendor has determined to apply the guidance of the exceptions to ASC 985-605-25-9 to an arrangement, the subsequent establishment of VSOE of fair value has no effect on the accounting for the arrangement. Any amount of arrangement consideration not previously recognized as revenue remains deferred and is recognized over the related PCS or service period.

The selection of one of the alternatives above should be based on the facts and circumstances of the software arrangement. Once selected, the selected estimation approach should be applied consistently to arrangements with similar attributes and disclosed in the financial statements, if material.

The following example illustrates these concepts:

Illustration 3-11: VSOE of fair value established after the onset of the arrangement

Facts

A software vendor begins licensing its product in China. As it begins operations there, it is unable to establish VSOE of fair value for PCS sold in China due to such factors as a lack of a substantial population of agreements and a lack of any significant renewal activity (see Question 3-7). PCS is the only undelivered element following delivery of the licensed product. Accordingly, the Company recognizes software license and PCS revenues ratably over the one-year PCS contractual period, in accordance with ASC 985-605-25-10 (a), for software licensing arrangements in China.

After a period of time, the Company is able to establish VSOE of fair value for PCS sold in China based on the development of a significant population of PCS renewals consistently priced within a reasonable range. On establishing VSOE of fair value, the vendor will recognize revenue for any new software licensing arrangements in China using the residual basis.

Analysis

On establishing VSOE of fair value, the vendor has an accounting policy choice to make with regards to the remaining deferred revenue on uncompleted software licensing agreements in China that were bundled with an initial year of PCS. The deferred revenue (minus the VSOE of fair value of the undelivered PCS) could be recognized in full at that time, or the vendor could continue to recognize the remaining deferred revenue over the contractual PCS period.

Presentation of recognized revenue when services and products are included in a combined unit of accounting

Question 3-20 **Regulation S-X, Rule 5-03(b), requires that public registrants separately present in the income statement revenues from the sale of products and revenues from providing services. If products and services included in an arrangement cannot be separated into differing units of accounting, how should a vendor apply the provisions of this requirement (i.e., how should revenue be allocated between products and services for income statement presentation once recognized)?**

How a vendor should apply the provisions of Regulation S-X, Rule 5-03(b) when products and services are included in one unit of accounting has been the subject of comments made by the SEC staff in a speech, excerpted below. (Note: the speech was made prior to the FASB's codification of the accounting standards and therefore contains pre-codification references.)

Excerpts of Speech by Mr. Mark Barrysmith

December 2007

AICPA National Conference on Current SEC and PCAOB Developments

(footnote references omitted)

Rule 5-03(b) of Regulation S-X requires, among other categories, that product and service revenue be displayed separately on the income statement. We realize that the question often arises as to how a vendor might adhere to the requirements of Rule 5-03(b) when the vendor is unable to separate its multiple element arrangement under the applicable revenue recognition guidance, such as EITF 00-21 or SOP 97-2.

In recognizing the importance that investors may place on the ability to distinguish between product and service revenue and the added transparency this breakout can provide, we do not believe that a vendor should be precluded from separately displaying product and service revenue solely because they are unable to separate the deliverables for recognition purposes. I focus on product and service revenue, but our views may be applicable to other categories of revenue.

Accordingly, we would not object to the separate presentation of product and service revenue stemming from an arrangement that could not be separated for recognition purposes, when a vendor has a reasonable basis for developing a separation methodology, so long as the method of separating is consistently applied, clearly disclosed and not misleading.

When determining how to separate product and service revenue, we would expect registrants to apply reasonable judgment. Purely a systematic allocation with no basis other than consistency or one based on contractually stated amounts would seem insufficient. However, rational and systematic estimates may result in a reasonable allocation of product and service revenue. For example, estimates based on verifiable inputs used to derive a reasonable approximation of fair value of the deliverables. Likewise, for arrangements within the scope of SOP 97-2, a comparison to peers (i.e., third-party evidence of fair value) with sufficiently comparable product and/or service offerings or the use of the residual method when a vendor customizes its core product may result in a reasonable allocation of product and service revenue.

In summary, we believe that a vendor's basis for separately presenting product and service revenue will be a matter of judgment, dependent on the vendor's specific facts and circumstances, including consideration of which form of presentation would be most meaningful to investors. And once again, we are willing to accept the use of judgment, so long as the vendor's basis is reasonably grounded, consistently applied and clearly disclosed.

3.8 Undelivered elements essential to functionality of delivered elements

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-12

The portion of the fee allocated to an element shall be recognized as revenue when the criteria in paragraph 985-605-25-3 are met with respect to the element. In applying those criteria, the delivery of an element is considered not to have occurred if there are undelivered elements that are essential to the functionality of the delivered element, because the customer would not have the full use of the delivered element.

The portion of an arrangement's fee allocated to an element should be recognized as revenue when all of the basic revenue recognition criteria of ASC 985-605 have been met for that element. However, in applying the basic revenue recognition criteria, if undelivered elements are essential to the functionality of any delivered element, delivery should not be deemed to have occurred for the delivered element until the undelivered elements also are delivered.

Factors to consider when determining if an undelivered element is essential to the functionality of a delivered element

Question 3-21 **ASC 985-605-25-12 states that the basic revenue recognition criteria of delivery have not been satisfied for a delivered element included in a multiple-element arrangement if undelivered elements are essential to the functionality of the delivered element. What factors should be considered in determining whether an undelivered element is essential to the functionality of a delivered element?**

We believe that an undelivered element is essential to the functionality of a delivered element if the delivered element cannot be used separately (i.e., use of the delivered element is dependent on the vendor's delivery of the undelivered element). Although such a determination must be based on the applicable facts and circumstances, the following factors, although not all inclusive, should be considered:

- Are the delivered and undelivered elements sold on a standalone basis? If so, this would indicate that the undelivered element is not essential to the functionality of the delivered element.
- Does the timing of the payment for the delivered element coincide with the delivery of the undelivered element? When the timing of payments coincides with the delivery of undelivered elements, there is a presumption that the undelivered elements are essential to the functionality of the delivered elements.
- Is the undelivered product or service available from other vendors? If so, the fact that the customer can obtain the undelivered products or services from another source may indicate that the undelivered elements are not essential to the functionality of the delivered element.
- Can the delivered element function as intended if the undelivered element is not delivered? If the delivered element cannot fully function without the undelivered elements, or if the customer does not have the ability to use the delivered element prior to delivery of the undelivered element, the undelivered element is essential to the functionality of the delivered element.

The following example illustrates these concepts:

Illustration 3-12: Undelievered element is essential to the functionality of a delivered element

Facts

A calendar year-end vendor of financial accounting software enters into an arrangement with a customer to perpetually license its general ledger and financial reporting software products and to provide one year of PCS for both products on 30 June 20X5. The financial reporting product is delivered on execution of the arrangement. The general ledger product is delivered one week later on 7 July 20X5. The financial reporting software product cannot be used by the customer until the general ledger product is delivered, because it is designed to use the information produced by the general ledger product to function as intended.

Analysis

Because the undelivered general ledger product is essential to the functionality of the delivered financial reporting product, delivery of the financial reporting product should not be deemed to have occurred until the general ledger product is delivered on 7 July 20X5.

The following excerpt from ASC 985-605-55 provides further illustration of these concepts:

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Example 6: Multiple-Element Arrangements — Products

985-605-55-152

The following Cases illustrate the guidance in paragraph 985-605-25-12:

a. Undelivered product not essential to functionality of delivered products (Case A)

b. Undelivered product essential to functionality of delivered products (Case B).

985-605-55-153

Cases A and B share the following assumptions.

985-605-55-154

A vendor licenses to a user one license covering a single copy of Products A, B, C, and D for a nonrefundable fixed fee of $80, with no stated price per product. Products A, B, and C are deliverable. Product D is not deliverable. The vendor has a history of sales prices for Products A, B, and C of $25 each. The vendor's pricing committee has established a price for Product D of $25. It is probable that the price established by the pricing committee for Product D will not change before introduction. Therefore, the vendor is able to derive its specific price for the undelivered software.

Case A: Undelivered Product Not Essential to Functionality of Delivered Products

985-605-55-155

Product D is not essential to the functionality of Products A, B, or C. Persuasive evidence exists that indicates that the revenue related to Products A, B, or C is not subject to refund, forfeiture, other concessions if Product D is not delivered.

985-605-55-156

Revenue allocated to each product based on the existing prices for Products A, B, and C and the probable price for Product D would be recognized when each individual product is delivered. The revenue allocated to each of the products would be $20.

985-605-55-157

Revenue allocated to each product would be recognized upon the delivery of that product if the criteria in paragraphs 985-605-25-3 through 25-14 have been met.

985-605-55-158

The allocation of revenue to each product is based on the relative fair value of each product. As discussed in paragraphs 985-605-25-9 through 25-11, sufficient vendor-specific objective evidence must exist to determine allocation. In this Case, sufficient vendor-specific objective evidence exists to determine that the fair value of each product on a standalone basis is $25. Therefore, in accordance with paragraphs 985-605-25-49 through 25-50, the discount should be allocated evenly to each product, and revenue of $20 per product would be recognized when each product is delivered.

Case B: Undelivered Product Essential to Functionality of Delivered Products

985-605-55-159

In this Case, the contract is silent about penalties for the nondelivery of Product D, but the proposal and other communications indicate that it is a required capability of the offering and that the user does not want any of the vendor's products unless Product D is delivered.

985-605-55-160

The vendor would defer all revenue until delivery of Product D. Because revenue allocable to the delivered software is subject to forfeiture, refund, or other concession if Product D is not delivered, all revenue under the agreement would be deferred until Product D is delivered, in accordance with paragraph 985-605-25-12.

3.9 Fees subject to forfeiture, refund or concession

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-13

No portion of the fee (including amounts otherwise allocated to delivered elements) meets the criterion of collectibility if the portion of the fee allocable to delivered elements is subject to forfeiture, refund, or other concession if any of the undelivered elements are not delivered. For the revenue related to an arrangement to be considered not subject to forfeiture, refund, or other concession, management must intend not to provide refunds or concessions that are not required under the provisions of the arrangement. All available evidence shall be considered to determine whether the evidence persuasively indicates that the revenue is not subject to forfeiture, refund, or other concession. Although no single item of evidence may be persuasive, all of the following additional items shall be considered:

a. Acknowledgment in the arrangement of products not currently available or not to be delivered currently

b. Separate prices stipulated in the arrangement for each deliverable element

c. Default and damage provisions as defined in the arrangement

d. Enforceable payment obligations and due dates for the delivered elements that are not dependent on the delivery of the future deliverable elements, coupled with the intent of the vendor to enforce rights of payment

e. Installation and use of the delivered software

f. Support services, such as telephone support, related to the delivered software being provided currently by the vendor.

985-605-25-14

Regardless of the guidance in the preceding paragraph, the vendor's historical pattern of making refunds or other concessions that were not required under the original provisions (contractual or other) of other arrangements shall be considered more persuasive than terms included in the arrangement that indicate that no concessions are required.

If any portion of an arrangement's fee that is otherwise allocable to a delivered element is subject to forfeiture, refund or other concession if an undelivered element is not delivered by the vendor, the basic revenue recognition criterion of collectibility is not met. Recognition of amounts subject to forfeiture, refund or other concession as revenue, whether otherwise allocable to either delivered or undelivered elements, should be deferred until the forfeiture, refund or other concession provisions of the arrangement are resolved.

Meeting the collectibility criterion when a contract does not specify penalties if the vendor does not successfully deliver undelivered elements

Question 3-22 **Is the collectibility criterion met if a contract does not contain an explicit provision stating that a portion of the arrangement's consideration is subject to forfeiture, refund or other concession if the vendor does not successfully deliver undelivered elements included in a multiple-element arrangement and management represents that they do not intend to grant concessions?**

All of the relevant facts and circumstances must be evaluated to determine whether there is any evidence to suggest that if the vendor does not successfully deliver the undelivered elements it will provide a concession to the customer — even if it is not contractually required to do so. In making this evaluation, the historical business practices of the vendor must be considered. If a vendor has a history of granting concessions that are not contractually required if undelivered elements are not successfully delivered, we believe it generally would not be appropriate to conclude that this history is overcome by a lack of a specific contractual provision requiring such concessions, even if coupled with management's representation. See Question 4-47 for additional information on what is considered a concession.

Furthermore, the nature of an arrangement also must be considered when evaluating the likelihood of granting concessions. For example, a sale that is much larger relative to a vendor's typical sales transactions or an arrangement including a newly introduced product may increase the likelihood that a vendor will grant a future concession if undelivered elements are not successfully delivered.

Additionally, the likelihood of granting concessions not otherwise contractually required may increase if a vendor has provided extended payment terms in connection with a software licensing arrangement (see also our discussion on extended payment terms in Chapter IV).

Lastly, a vendor should evaluate rights afforded to its customer pursuant to the applicable laws (e.g., the Uniform Commercial Code or other applicable contract law) of the jurisdiction governing the arrangement to determine if statutory provisions exist that may limit the amount of arrangement consideration that is otherwise allocable to a delivered item. Consultation with legal counsel may be required in making this evaluation.

Should VSOE of fair value of an undelivered element or the amount of a potential refund be deferred?

Question 3-23 **If the elements included in a multiple-element arrangement can be accounted for separately, and the amount of arrangement consideration that is subject to forfeiture, refund or other concession if an undelivered element is not successfully delivered is greater or less than the VSOE of fair value of the undelivered element, what amount should be deferred for the undelivered element — VSOE of fair value or the amount of potential refund or forfeiture?**

If a portion of an arrangement's fee is subject to forfeiture, refund or other concession when an undelivered element included in a multiple-element arrangement is not successfully delivered, and VSOE of fair value of at least the undelivered elements of the arrangement exists, the amount of arrangement consideration allocated to the undelivered elements should be the greater of 1) the potential forfeiture, refund or other concession or 2) VSOE of fair value of the undelivered elements. Accordingly, if the amount of potential forfeiture or refund is greater than the VSOE of fair value of the undelivered elements, the amount of the potential forfeiture or refund should be deferred.

However, if VSOE of fair value is not determinable for an undelivered element, deferral of the amount of potential forfeiture, refund or other concession is not a sufficient basis to permit revenue recognition for the delivered elements (i.e., VSOE of fair value must be determinable for at least all of the undelivered elements included in a multiple-element arrangement in order to account for the delivered and undelivered elements as separate units of accounting).

The following example illustrates these concepts:

Illustration 3-13: Refund exceeds the VSOE of fair value of the undelivered element

Facts

A software vendor enters into an arrangement to license Product A and to provide installation services for $100,000. VSOE of fair value of the installation services, which are not essential to the functionality of the licensed software, is $20,000. The arrangement specifies that if the vendor does not successfully complete installation of the licensed software within sixty days of the execution of the arrangement, it will refund $25,000 to the customer.

Analysis

Because the amount of the potential refund exceeds the VSOE of fair value of the installation services, $25,000 should be deferred. This amount should not be recognized prior to successful completion of the installation services within the specified time frame. If all of the other basic revenue recognition criteria of ASC 985-605 have been met, the vendor may recognize revenue of $75,000 ($100,000 less the $25,000 stipulated refund amount) using the residual method on delivery of the licensed software.

Accounting for "Most–Favored-Nation" clauses

Question 3-24 **Certain software licensing arrangements may contain "Most-Favored-Nation" clauses such that the vendor guarantees the price of any software or services sold to the customer will be at least equal to the lowest price offered to any other customer. What is the accounting for such clauses?**

How such clauses should be accounted for is dependent on the terms of the clause. Many such clauses require a vendor to prospectively provide a customer with its best prices on any purchases of software or services subsequent to the execution of an arrangement that contains such a provision. In such cases, unless the vendor's past history suggests lower prices granted to other customers will be applied retroactively to the customer's past purchases as discussed below, we believe the inclusion of such a clause has no effect on the revenue recognition for the current arrangement.

However, if a vendor is required to apply retroactively any lower prices to previous purchases made by a customer (or has a past business practice of doing so), we believe the clause represents a form of price protection that may prevent a conclusion the fees associated with an arrangement are fixed or determinable.

These provisions are seen frequently in arrangements entered into with governmental agencies through the General Services Administration ("GSA" arrangements) whereby the GSA requires that the financial terms of their procurement contain a price reduction provision. This provision requires a vendor to monitor discounts given to comparable customers during the contract period and refund the difference between what was paid by the federal government versus pricing granted to comparable commercial customers. A software vendor that conducts a material volume of transactions under GSA terms should have a sufficiently robust system in place to ensure its compliance with GSA terms, by for example 1) tracking the subsequent pricing of all "qualifying" commercial arrangements and 2) monitoring all amendments to the GSA terms for newly qualifying products and changes in terms. In the absence of a sufficient monitoring system, it may be difficult for a software vendor to demonstrate that fees due pursuant to arrangements with the GSA are fixed or determinable.

Should the probability of granting a refund be considered?

Question 3-25 **If a portion of an arrangement's consideration is subject to forfeiture, refund or other concession if a vendor does not successfully deliver undelivered elements included in a multiple-element arrangement, should the likelihood that the vendor will successfully deliver the undelivered elements be considered in determining the amount of the arrangement consideration to be deferred?**

No. The probability of granting a refund or other concession should not be evaluated when determining the amount of revenue to be deferred due to a provision that subjects a portion of an arrangement's fees to forfeiture, refund or other concession if a vendor does not successfully deliver undelivered elements included in a multiple-element arrangement (even if the vendor can demonstrate a history of successful performance). ASC 985-605-25-13 specifies that no portion of an arrangement's fee otherwise allocable to delivered elements meets the criterion of collectibility if it is subject to forfeiture, refund or other concession.

Income statement classification of contingent revenue

Question 3-26 **The amount of an arrangement's fees otherwise allocable to a delivered item may be limited because a portion of it may be subject to forfeiture, refund or other concession if an undelivered element included in a multiple-element arrangement is not successfully delivered. In such cases, how should arrangement consideration that otherwise would be allocated to the delivered item be classified in the income statement as the vendor's remaining performance obligations are completed and revenue is recognized — that is, should the revenue classification be consistent with that of either 1) the initially delivered element or 2) the undelivered element(s)?**

This classification issue is not addressed by ASC 985-605. Absent authoritative guidance, vendors should determine the appropriate classification of the arrangement consideration once recognized as revenue based on an evaluation of the applicable facts and circumstances. Once determined, that classification should be consistently applied to all similar arrangements.

When material amounts of arrangement consideration otherwise allocable to delivered items are limited because a portion of it may be subject to forfeiture, refund or other concession if an undelivered element included in a multiple-element arrangement is not successfully delivered, a vendor should disclose how the amounts have been classified when recognized as revenue on the successful delivery of the undelivered items.

Recording deferred revenue when contingent revenue exists

Question 3-27 **When the amount of arrangement consideration allocable to a delivered item that is a separate unit of accounting is limited because some portion is subject to forfeiture, refund or other concession if the vendor does not successfully deliver undelivered elements included in a multiple-element arrangement, should the vendor record a receivable and an offsetting amount of deferred revenue for the excess of the arrangement consideration that would otherwise be allocated to the delivered item?**

No. A vendor should not record a receivable for the difference between 1) the amount of arrangement consideration otherwise allocable to a delivered item pursuant to the relative-fair-value method or the residual method and 2) the amount allocated when limited by a feature of the arrangement that links payment for the delivered item, in whole or in part, to the future delivery of the undelivered items included in the arrangement. Because receipt of the additional amount is contingent on the vendor's future satisfaction of the remaining terms of the contractual arrangement (i.e., delivery of additional products or services has not occurred), it is not appropriate to record a receivable and deferred revenue.

However, if a vendor receives amounts in connection with the delivery of an item that are forfeitable if its remaining obligations are not successfully completed, such amounts should be recorded as deferred revenue.

Because the vendor's performance obligations remain until all the contingencies have been met, any transfer of rights to the contingent revenue by a vendor to a third party would be subject to the provisions of ASC 470-10-25, *Debt — Overall — Sale of Future Revenues or Various Other Measures of Income*, and would not be a transfer of a financial instrument within the scope of ASC 860, *Transfers and Servicing*.

Specified damages for non-delivery of products or services included in multiple-element arrangements

Question 3-28 **Is the collectibility criterion violated if a vendor includes a provision in a multiple-element arrangement that limits damages for failure to deliver elements of the arrangement to a specified or limited amount?**

If an agreement specifies the amount of damages that a vendor would be obligated to pay to a customer in the event it fails to deliver one or more of undelivered elements included in a multiple-element arrangement, and the amount of damages specified does not exceed the amount of arrangement consideration otherwise allocable to the undelivered elements, we believe that the collectibility criterion would be met with respect to the delivered elements provided that the vendor has a history of not paying damages or providing concessions in excess of the amounts specified in arrangements with its customers.

However, if the amount of specified damages for undelivered elements exceeds the amount of arrangement consideration otherwise allocable to the undelivered elements, the vendor should defer the portion of the arrangement's fee attributable to the delivered elements that is subject to refund or forfeiture if the undelivered elements are not delivered (see Question 3-23).

If all of the other basic revenue recognition criteria of ASC 985-605 have been met, the vendor may recognize revenue for the portion of the fee that is attributable to the delivered elements and is not subject to refund or forfeiture.

The following examples illustrate these concepts:

Illustration 3-14: Specified damages less than fees allocable to undelivered elements

Facts

A software vendor enters into an arrangement with a customer to perpetually license Product A and to provide installation services, which are not essential to the functionality of Product A and can be accounted for separately by the vendor. Total fees of $1,000,000 are received at inception of the arrangement. VSOE of fair value of the installation services is $200,000. Using the residual method, the vendor allocates arrangement consideration of $800,000 to the delivered software.

The arrangement includes a provision stipulating that if the vendor does not complete installation of the delivered software product within 180 days, it will pay liquidated damages not exceeding $150,000 to the customer.

Analysis

Because the specified damages for failure to deliver the installation services are less than the amount of arrangement consideration otherwise allocable to such services, the collectibility criterion would be met with respect to Product A (i.e., no portion of the arrangement consideration allocable to Product A is subject to refund or forfeiture if the installation services are not successfully delivered). If all of the other basic revenue recognition criteria of ASC 985-605 have been met, the vendor may recognize revenue of $800,000 on delivery of Product A to the customer.

Illustration 3-15: Specified damages more than fees allocable to undelivered elements
Facts Assume the same facts as in Illustration 3-14 above, except that the agreement includes a provision stipulating that if the vendor does not complete installation of the delivered software product within 180 days, it will pay liquidated damages to the customer not exceeding $300,000. **Analysis** In this case, the specified damages for failure to deliver the installation services are more than the amount of arrangement consideration otherwise allocable to such services ($200,000). Accordingly, the amount of arrangement consideration that may be allocated to Product A is limited to $700,000 ($1,000,000 less the $300,000 which is subject to refund or forfeiture if the installation services are not successfully delivered by the vendor). If all of the other basic revenue recognition criteria of ASC 985-605 have been met, the vendor may recognize revenue of $700,000 on delivery of Product A to the customer.

Payments to customers if vendor is acquired and support of licensed products is discontinued

Question 3-29 **A vendor may include a clause in its software licensing arrangements that entitles the customer to a refund of all or a portion of the arrangement fee, or a cash payment from the vendor in excess of the arrangement fee, if 1) the vendor is acquired within a specified time period and 2) after the acquisition, the acquiring company will no longer support the product(s) licensed to the customer. Do such provisions violate the collectibility criterion?**

We believe such provisions do not violate the collectibility criterion if at the time the arrangement is entered into with a customer it is not probable that 1) the software vendor will be acquired within the specified time period and 2) support of the licensed product(s) will cease. That is, we believe that if it is not probable amounts will be refunded to the customer as a result of such a provision at the date the software licensing arrangement is executed, the arrangement fees should be considered nonrefundable. For purposes of applying this provision, the term probable should be interpreted to have the meaning specified in ASC 450, *Contingencies*.

However, if it is probable both of these events will occur at the inception of a software licensing arrangement, we believe revenue recognition is precluded until the contingency is resolved or the likelihood subsequently is assessed as remote. In such cases, we would be skeptical that any software licensing arrangement is substantive, as we believe it would be unlikely that a customer would agree to license software that they expect will not be supported within a short period of time by a likely acquirer.

If a software vendor includes such a provision in an arrangement and concludes at inception of the arrangement both of these events are not probable but they subsequently become probable, previously recognized revenue should not be adjusted. However, contingent obligations to remit a payment to customers pursuant to arrangements containing such provisions and for which revenue has been previously recognized must be accounted for as a contingent loss pursuant to the provisions of ASC 450.

A vendor that enters into software licensing arrangements containing such provisions should consider disclosing that it has done so and quantifying the amount of potential payments to customers pursuant to the provisions.

4 Basic principles recognition criteria

4.1 Chapter summary

If an arrangement to deliver software or a software system does not require significant production, modification or customization, revenue should be recognized for each element of the arrangement when *all* of the following criteria are met (the "Basic Criteria") for that element:

- Persuasive evidence of an arrangement exists
- Delivery has occurred
- The vendor's fee is fixed or determinable
- Collectibility is probable

This chapter provides guidance on each of these requirements.

4.2 Persuasive evidence of an arrangement

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-15

Practice varies with respect to the use of written contracts. Although a number of sectors of the industry rely upon signed contracts to document arrangements, other sectors of the industry that license software (notably the packaged software sector) do not.

985-605-25-16

If the vendor operates in a manner that does not rely on signed contracts to document the elements and obligations of an arrangement, the vendor should have other forms of evidence to document the transaction (for example, a purchase order from a third party or online authorization). If the vendor has a customary business practice of using written contracts, evidence of the arrangement is provided only by a contract signed by both parties.

985-605-25-17

Even if all other requirements set forth in this Subtopic for the recognition of revenue are met (including delivery), revenue shall not be recognized on any element of the arrangement unless persuasive evidence of an arrangement exists.

One of the Basic Criteria of ASC 985-605 is that persuasive evidence of an arrangement must exist before revenue from a software licensing arrangement is recognized.

If a vendor's customary practice is to obtain signed contracts to evidence an arrangement, revenue recognition is precluded if a contract signed by both parties is not in hand at the end of an accounting period, even if the contract is executed soon thereafter and management believes that execution of the contract is merely perfunctory. Letters of intent, memoranda of understanding and similar documents are not acceptable evidence of the arrangement.

Vendors should not recognize any revenue from a licensing arrangement until persuasive evidence of the arrangement exists, even if the software has been delivered and the other Basic Criteria are met. This provision of ASC 985-605 is meant to ensure that all terms of the customer's acquisition and use of the license, and all obligations of the vendor, are mutually agreed on and that all necessary approvals are obtained.

If a vendor's customary business practices do not rely on signed contracts, persuasive evidence may be provided by an appropriately approved, non-cancelable purchase order, an on-line authorization from the customer or substantially similar evidence. In these situations, the persuasive evidence must set forth all relevant terms of the arrangement and must not be followed up with the execution of a subsequent agreement, even if the terms are the same (i.e., regardless of form, the final evidence of the agreement should be obtained prior to revenue recognition).

In some cases, legal assistance may be necessary to determine whether persuasive evidence of an arrangement exists if the vendor does not have a practice of obtaining signed contracts.

What constitutes persuasive evidence of an arrangement?

Question 4-1 **What form of documentation constitutes persuasive evidence of an arrangement?**

SAB Topic 13 defines an arrangement as "the final understanding between the parties as to the specific nature and terms of the agreed-on transaction" (SAB Topic 13.A.1, Footnote 3).

We believe that persuasive evidence of an arrangement should include a description of all the following terms and conditions:

- Identification of all the products and services included in the arrangement
- A description of the type of software license (i.e., perpetual or time-based license)
- Scope of rights provided to the customer (e.g., internal use vs. right to resell, geographical restrictions)
- Fees and the payment terms
- Delivery terms
- Rights of return, price protection or cancellation provisions
- Warranties, rights, obligations and termination provisions
- Other pertinent contractual provisions

ASC 985-605-25-16 explicitly states that if a vendor "has a customary business practice of using written contracts, evidence of the arrangement is provided only by a contract signed by both parties." Accordingly, persuasive evidence of an arrangement does not exist until the final agreement has been executed by both the customer and the vendor demonstrating that the parties mutually agree on the terms and conditions of the arrangement. Additionally, the individuals executing the agreement must have the authority to act on behalf of their respective companies.

Original documents or contracts generally should be used when evaluating if persuasive evidence of an arrangement exists. As electronic signatures, copies of documents and electronic document ("paperless") retention become increasingly common, vendors should consult with legal counsel on the validity and enforceability of scanned documents or contracts with only electronic or fax signatures.

If a vendor does not have a standard or customary business practice of relying on written contracts to document a sales arrangement, it usually has other forms of written or electronic evidence to document the transaction. A vendor should document what constitutes persuasive evidence of an arrangement for each line of business or class of customer as there may be differing forms of persuasive evidence of an arrangement for each. However, regardless of the form of documentation that constitutes persuasive evidence of an arrangement, the evidence must be final and include (or reference) all of the relevant terms and conditions of the arrangement.

Persuasive evidence of an arrangement establishes the final terms and conditions of the arrangement, including all elements in the arrangement. The arrangement is not final if it 1) is subject to contingencies (such as a final review), 2) is in a preliminary or draft form (such as a letter of intent) or 3) requires additional negotiations and a subsequent amendment. In SAB Topic 13, the SEC staff has stated that "if an arrangement is subject to subsequent approval (e.g., by the management committee or board of directors) or execution of another agreement, revenue recognition would be inappropriate until that subsequent approval or agreement is complete" (SAB Topic 13.A.2, Question 1). If the contingency is not resolved prior to the balance sheet date (i.e., approval or final agreement is not obtained), persuasive evidence of an arrangement does not exist until the contingencies are resolved, even if management considers the ability of the company to obtain the necessary approvals probable or obtaining the necessary signatures perfunctory.

The following examples illustrate these concepts:

Illustration 4-1: License agreement executed after end of financial reporting period

Facts

A calendar year-end software vendor's customary business practice is to utilize written license agreements. On December 28, the vendor receives a purchase order from a customer. On December 30, the vendor delivers the requested software product, a license agreement signed by its authorized representative and an invoice to the customer. The customer signs and returns the license agreement to the vendor on January 2. The vendor, after consultation with legal counsel, determines that a valid contractual arrangement existed as of December 31, because a legally binding offer had been made and accepted by the parties.

Analysis

Because the vendor's customary business practice is to evidence arrangements with customers using written license arrangements, persuasive evidence of the arrangement does not exist until it receives the final license agreement signed by both parties on January 2. Revenue should not be recognized prior to that date, even if all of the other basic revenue recognition criteria of ASC 985-605 have been met.

Illustration 4-2: License agreement subject to final review

Facts

A calendar year-end software vendor's customary business practice is to utilize written license agreements. It enters into an arrangement to license one of its software products to a customer on March 31 and delivers the software. The customer signs the contract, but indicates that the signature is "subject to legal review" because its procurement policies require all contracts to be reviewed and approved by its legal department. This legal review is not complete as of March 31. On April 3, prior to the vendor closing its books for its fiscal quarter ended March 31, the customer informs the vendor that the legal review process is complete. The other basic revenue recognition criteria of ASC 985-605 were met prior to the end of the quarter.

Analysis

Although a written license agreement signed by both parties was obtained prior to the end of the fiscal quarter ended March 31, the vendor was informed by the customer that the contract remained subject to review, thereby introducing a contingency relating to whether the contract represented the final arrangement between the parties. Accordingly, persuasive evidence of an arrangement did not exist prior to the end of the vendor's fiscal quarter ended March 31, and revenue should not be recognized during that quarter. The fact that subsequent legal approval was received without a change to the license agreement does not change the analysis. Persuasive evidence of an arrangement was obtained on April 3, on completion of the legal review.

Persuasive evidence of an arrangement for different segments of a business or classes of customers

Question 4-2 **Can the form of persuasive evidence of an arrangement vary by a vendor's line of business or by class of customer?**

It is not uncommon for a vendor to utilize signed license agreements for one line of its business or class of customer, but utilize purchase orders or other forms of persuasive evidence of an arrangement for another line or class of customer. ASC 985-605-25-15 and 25-16 recognize this fact.

The form of evidence of an arrangement may vary by type of product, class of customer or geography. The form of documentation that constitutes persuasive evidence of an agreement may be a signed license agreement, a non-cancelable purchase order or an on-line authorization (commonly used for on-line credit card purchasing of software for download).

For example:

- A vendor may sell its software product to both business customers and individual consumers via its website. The vendor's customary business practice for arrangements with business customers is to obtain a signed license agreement whereas its customary business practice with individual consumers is to obtain an on-line authorization referencing standard terms and conditions on the vendor's website.
- A vendor may license its software product as both an enterprise-wide application and a single-user personal-computer-based application. The vendor's customary business practice for an enterprise-wide application is to obtain a signed license agreement whereas its customary business practice for a single-user, personal-computer-based application is to obtain a non-cancelable purchase order.
- A vendor may sell its software product to both domestic and international customers. The vendor's customary business practice for arrangements with international customers is to obtain a signed license agreement whereas its customary business practice for arrangements with domestic customers is to obtain a non-cancelable purchase order.

The key in determining whether persuasive evidence of an arrangement exists is whether the evidence obtained is consistent with the vendor's customary business practices for the type of transaction under evaluation.

We believe that a software vendor should document its revenue recognition practices, based on objective and verifiable criteria, to ensure these practices are applied consistently. This documentation should include a definition of the line(s) of the business or the class(es) of customers and the form of documentation that constitutes persuasive evidence of an arrangement for each line or class of customer. The establishment of a line of business or class of customer and the form of documentation that is considered persuasive evidence of an arrangement should be based on a substantive level of activity to provide reasonable evidence of a consistent practice. In other words, one customer, or a very limited number of customers, should not be considered a separate class of customer.

The documentation prepared should allow the vendor to:

- Clearly delineate line(s) of the business or class(es) of customer
- Objectively determine the form of documentation required to establish that persuasive evidence of an arrangement exists for transactions with each line of the business or with each class of customer

Establishing persuasive evidence of an arrangement for a new class of customer or line of business

Question 4-3 **How can a vendor establish persuasive evidence of an arrangement for a new line of business or class of customer?**

A vendor may establish a new line of business or class of customer by sales into a new region, an introduction of a new software product or other actions. If the vendor intends to utilize a form of documentation of the arrangement with its customers in a new business line or customer class that differs from its established business practices, we believe that the vendor should document the form of agreement that will constitute persuasive evidence of an arrangement for this new line of business or class of customer prior to any sales activity. The form of agreement to be used should be authorized by vendor personnel with the relevant authority to do so.

Identification of a new line of business or class of customer should not be arbitrary or opportunistic. Rather, the characteristics of a new line of business or class of customer should be sufficiently unique in comparison to the vendor's existing business lines or classes of customers, based on objective and verifiable criteria, to require change to a vendor's revenue recognition practices. Additionally, when establishing a new line of business or class of customer, there should be a reasonable expectation that a substantive level of activity within that line of business or customer class will occur to provide reasonable evidence of the customary business practices followed to evidence an arrangement with customers of the new segment or class.

Contracts signed by only one party before the end of a reporting period

Question 4-4 **If a vendor's customary business practice is the use of written license agreements, and it delivers software prior to the end of the reporting period pursuant to a license signed by one party (either the vendor or the customer), with the understanding that terms and conditions have been agreed to with the customer and that obtaining the remaining signature is perfunctory, when should revenue be recognized for the arrangement (assuming the other basic criteria have been met)?**

ASC 985-605-25-16 explicitly states that if a vendor "has a customary business practice of utilizing written contracts, persuasive evidence of the arrangement is provided only by a contract signed by both parties." Accordingly, in such situations, persuasive evidence of an arrangement would not exist until the final license agreement has been executed by those individuals with the authority to act on behalf of their respective companies.

If both of the necessary signatures have not been obtained by the end of a financial reporting period, persuasive evidence of the arrangement does not exist and revenue should not be recognized during that period. The reason the signatures were not obtained (e.g., the person with signature authority is out of town or sick) or the belief that obtaining the necessary signatures is probable and perfunctory does not affect this conclusion.

The following example illustrates these concepts:

Illustration 4-3: License agreement signed by one party

Facts

A calendar year-end software vendor's customary business practice is to utilize written license agreements. The vendor receives a signed license agreement from a customer on March 31. The license agreement is reviewed and approved by the vendor's finance and legal departments. However, the vendor's officer with signature authority does not sign the license agreement until April 1. The effective date of the contract is March 31. The vendor, after consultation with legal counsel, determines that the license agreement can be enforced as a legally binding agreement once signed by the customer (i.e., March 31). The other basic revenue recognition criteria of ASC 985-605 were met prior to the end of the quarter ended March 31.

Analysis

Because the license agreement was not signed by both parties prior to the end of the quarter ended March 31, persuasive evidence of an arrangement did not exist and revenue should not be recognized during that quarter. The fact that the vendor's internal review processes were complete at the end of the financial reporting period does not eliminate the signature requirement. Persuasive evidence of an arrangement exists on April 1, the date the agreement is signed by both parties.

In certain circumstances a customer may never sign a license agreement although the vendor has signed it. After consultation with legal counsel, the vendor may determine that such license agreement can be enforced as a legally binding agreement without the customer's signature. In such situations, we believe that persuasive evidence of an arrangement may be deemed to exist once cash is received from the customer (absent any facts contradicting such a conclusion, such as the customer signing the contract at a different date), based on paragraph 116 of the Basis for Conclusions section of the pre-codification guidance in SOP 97-2, which states that "AcSEC believes it is unlikely that a customer would pay for an element that had not been ordered."

Revenue recognition based on preliminary evidence of an arrangement

Question 4-5 **If a vendor receives preliminary evidence of an arrangement that includes all pertinent terms and conditions of the arrangement with the customer, can revenue be recognized based on the preliminary evidence?**

Persuasive evidence of an arrangement must be the final form of documentation of the transaction between the two parties. If a vendor's customary business practices are to use written license agreements to evidence an arrangement, preliminary evidence such as a letter of intent, a commitment letter, purchase orders, etc., received by the vendor prior to execution of the final written agreement does not constitute persuasive evidence of an arrangement and should not be used as a basis to recognize revenue prior to the receipt of the final written agreement — even if the preliminary evidence contains the pertinent terms and conditions of the arrangement and the other basic revenue recognition criteria of ASC 985-605 are met at the time the preliminary evidence is obtained.

The following example illustrates these concepts:

Illustration 4-4: Commitment letters utilized by vendor

Facts

A calendar year-end software vendor's customary business practice is to use commitment letters to agree to the pertinent terms and conditions of an arrangement with its customers (including product(s) licensed, other elements to be included in the arrangement such as post-contract customer support, the type of license and payment terms), which are later finalized with written license agreements. The commitment letters specify all substantive terms and conditions of the agreements with the customers and are signed by authorized representatives of the vendor and the customer.

The vendor receives a signed commitment letter from a customer on March 31 and delivers the agreed-on software product to the customer. On April 9, the vendor obtains a signed written license agreement. The other basic revenue recognition criteria of ASC 985-605 were met prior to the end of the quarter ended March 31. In consultation with legal counsel, the vendor determines that the commitment letter can be enforced as a legally binding contract prior to obtainment of the written license agreement.

Analysis

Because the commitment letter is not the final form of the agreement with the customer, persuasive evidence of an arrangement does not exist, and revenue should not be recognized by the vendor until the written license agreement is obtained. Persuasive evidence of an arrangement exists on April 9, the date the signed agreement is received by the vendor (even if there are no changes from the commitment letter to the final form of the agreement).

Illustration 4-5: Statement of work to be finalized after software licensed

Facts

A calendar year-end software vendor enters into a master purchasing agreement with a customer. On March 31, the customer provides a purchase order pursuant to the terms of the master purchasing agreement to license 100 seats of Product A and for the vendor to provide 1) an initial bundled one-year PCS period and 2) implementation services. The purchase order specifies that the scope, nature and timing of the implementation services are to be clarified subsequently by a "statement of work." The statement of work is received by the vendor on May 9.

Analysis

Because the scope, nature and timing of the implementation services referenced in the purchase order are to be clarified by a subsequent "statement of work," all of the terms and conditions of the arrangement are not known on March 31. Persuasive evidence of an arrangement does not exist until May 9.

If a vendor's customary practice is an approved, non-cancelable purchase order, but a customer specifically requires a different form of documentation, such as a signed license agreement, persuasive evidence of an arrangement does not exist until the final license agreement is executed by both parties.

Effective date versus signature date of a contract

Question 4-6 **If a software license agreement specifies an effective date earlier than the date the agreement is executed by representatives of the vendor and customer, may that date be referenced when determining when revenue can be recognized?**

If a software vendor has a customary business practice of using written software licenses to evidence an arrangement, persuasive evidence does not exist until such a license has been executed by authorized representatives of both the customer and the company — regardless of any effective date included in the arrangement. For example, if a contract was physically signed on July 1 but dated "as of" June 30, persuasive evidence of an arrangement does not exist until July 1.

The following example illustrates these concepts:

Illustration 4-6: Persuasive evidence of the arrangement exists after the effective date

Facts

A calendar year-end software vendor's customary business practice is to utilize written license agreements. The vendor receives a signed license agreement from a customer on March 31. The license agreement was reviewed and approved by the vendor's finance and legal departments. However, the vendor's officer with signature authority did not sign the license agreement until April 1. The agreement specifies that the software license has an effective date of March 31. The vendor, after consultation with legal counsel, determines that the license agreement can be enforced as a legally binding agreement once signed by the customer. The other basic revenue recognition criteria of ASC 985-605 were met prior to the end of the quarter.

Analysis

Although the license agreement specifies that the software license is effective March 31, persuasive evidence of the arrangement does not exist until the license agreement has been signed by both parties. Persuasive evidence of an arrangement exists on April 1, the date the agreement is signed by both parties. No revenue relating to the arrangement should be recognized by the software vendor during the quarter ended March 31.

Considerations relating to operations in multiple time zones

Question 4-7 **When determining if persuasive evidence of an arrangement has been obtained (and if the other basic revenue recognition of criteria of ASC 985-605 have been met) before the end of a financial reporting period, should the time zone at the vendor's corporate headquarters, the location of the vendor's subsidiary that enters into the arrangement or the customer's location be considered?**

We believe that for purposes of determining whether persuasive evidence of an arrangement exists prior to the end of a vendor's financial reporting period, the time zone in which the personnel that are authorized to execute the arrangement on behalf of the vendor are located should be used. If those personnel are located at the vendor's corporate headquarters, the time zone of that location should be used to assess if persuasive evidence existed prior to the end of a financial reporting period. Conversely, if contracts are executed by personnel at subsidiary locations, the time zone of those locations should be used.

The following examples illustrate these concepts:

Illustration 4-7: Execution authority at corporate headquarters

Facts

A multi-national calendar year-end software vendor maintains its corporate headquarters in San Francisco. In accordance with the vendor's revenue recognition practices, all software license arrangements (including international software license arrangements) must be executed by the CFO or General Counsel, who are located at corporate headquarters.

A subsidiary of the vendor located in Sydney, Australia negotiates a license arrangement with an Australian customer. The vendor's chief financial officer signs the license arrangement on June 29. The contract is sent to Australia, where it is executed by the customer and received in the vendor's Australian offices by 11 a.m. on July 1 (6 p.m. June 30 in San Francisco).

Analysis

Personnel with authority to execute arrangements on behalf of the vendor are located in San Francisco. Persuasive evidence of an arrangement exists once the software license agreement was executed by the customer, which occurred before the end of the day (midnight) in San Francisco. If all of the other basic revenue recognition criteria of ASC 985-605 have been met, the software vendor may recognize revenue for this transaction during the quarter ended June 30.

Illustration 4-8: Execution authority at local subsidiary

Facts

A multi-national, calendar year-end software vendor maintains its corporate headquarters in Boston. In accordance with the vendor's revenue recognition practices, software license arrangements are executed by authorized management of local subsidiaries.

At 2 a.m. on October 1 in Berlin (8 p.m. September 30 in Boston), the vendor's German subsidiary receives a written license agreement executed by the customer. Authorized management of the subsidiary signs the agreement at that time.

Analysis

The agreement was executed by the end of the financial reporting period if determined based on the time zone of the vendor's corporate headquarters. However, local management of the subsidiary has the authority to execute arrangements on behalf of the vendor. Because the agreement was not executed by local management by the end of the financial reporting period in Germany, persuasive evidence of an arrangement did not exist by the end of the vendor's quarter ended September 30. Even if all of the other basic revenue recognition criteria of ASC 985-605 have been met, the software vendor should not recognize revenue for this transaction during the quarter ended September 30.

Master agreements

Question 4-8 **Vendors may use master agreements to govern the overall relevant terms and conditions of the business arrangement between the parties (e.g., scope of services, pricing, payment terms, warranties and other rights and obligations). Do such agreements constitute persuasive evidence of an arrangement?**

Typically, when a vendor and a customer enter into a master agreement, purchases are made by the customer issuing a non-cancelable purchase order or an approved on-line authorization that explicitly references the master agreement and specifies the products and quantities to be delivered. In such cases, we believe that the master agreement and the purchase order or approved on-line authorizations, taken together, constitute persuasive evidence of an arrangement.

However, if 1) the vendor has a customary business practice of executing a supplemental contract or addendum to the master agreement on the receipt of purchase orders or on-line authorizations, 2) a modification to a master agreement is required because the order received from the customer is not in accordance with the terms of the existing master agreement or 3) the vendor intends to execute a modification to the master agreement for its own reasons or at the request of the customer, revenue should not be recognized until the subsequent agreement has been executed by authorized personnel of both parties.

Software vendors should specify for purposes of revenue recognition practices what documentation constitutes persuasive evidence of an arrangement when master agreements are utilized.

The following examples illustrate these concepts:

Illustration 4-9: Receipt of purchase order referencing master agreement

Facts

A calendar year-end software vendor and a customer enter into a master agreement that includes a description of the relevant terms and conditions of the business arrangement between the two parties. The vendor's customary business practices indicate both a master license agreement and a purchase order that references the master agreement are required to establish persuasive evidence of an arrangement with the customer. On June 30, the vendor receives an e-mail from the customer requesting a license for 1,000 seats of product A. The vendor delivers the software on June 30. On July 5, the vendor receives a purchase order dated July 1 confirming the order contained in the e-mail. The other basic revenue recognition criteria of ASC 985-605 were met prior to the end of the quarter.

Analysis

In accordance with the vendor's customary business practices when utilizing master license agreements with a customer, persuasive evidence of an arrangement exists on receipt of a purchase order that references the master agreement. An e-mail does not constitute a purchase order. Therefore, persuasive evidence of an arrangement does not exist at June 30. Even though all of the other basic revenue recognition criteria of ASC 985-605 have been met and the actual purchase order, once received, confirmed the request made in the e-mail, the software vendor should not recognize revenue for this transaction during the quarter ended June 30.

Illustration 4-10: Master agreement contains a maximum order quantity

Facts

Assume the same facts as Illustration 4-9 above, except the master agreement with the customer specifies a maximum number of units that may be requested by the customer pursuant to the arrangement. Additional units would necessitate an amendment to the master agreement. On June 30, the vendor receives a purchase order for a quantity exceeding the maximum number of units provided in the master agreement. The other basic revenue recognition criteria of ASC 985-605 were met prior to the end of the quarter.

Analysis

The vendor should only recognize revenue for units up to the maximum number of units in the master agreement. Because an amendment to the master agreement will be required to reflect the orders in excess of the amounts originally agreed to, persuasive evidence of an arrangement with the customer for the number of units in excess of the maximum number of units specified in the arrangement did not exist at June 30. Even though all of the other basic revenue recognition criteria of ASC 985-605 have been met, the software vendor should not recognize revenue for the orders in excess of the amounts originally agreed to during the quarter ended June 30.

However, if the terms of the master agreement contained a provision that automatically provided authorization for additional units to be purchased under the arrangement if accompanied by an appropriate purchase order, persuasive evidence of an arrangement would exist prior to the end of the vendor's quarter ended June 30, and revenue could be recognized for all units during that quarter.

Subsequent amendments to a contract

Question 4-9 Can a subsequent amendment have an impact on past revenue recognition practices?

Yes. It is important to understand and evaluate the business reason(s) for a contract amendment or other changes to an arrangement throughout a customer relationship. An amendment may be a bona fide modification to the initial arrangement to provide additional products or services for the appropriate consideration. This type of amendment generally would not affect past revenue recognition practices.

An amendment may constitute the final evidence of an arrangement or it may reflect a change in the original arrangement that constitutes a concession (see Question 4-47). If the amendment represents the execution of the final arrangement with the customer (including the effect of concessions granted), then persuasive evidence of an arrangement likely did not exist previously. We believe that all amendments should be evaluated to determine if there is any effect on past revenue recognition.

An amendment may serve to clarify a term of the initial agreement, without in substance amending it or adding any elements to the arrangement, or to remove clear typographical or other errors that would be reasonably understood by both parties to be errors. Such clarifications generally do not affect past revenue recognition practices. In such cases, consultation with legal counsel may be necessary to determine that an amendment represents a clarification of a reasonable interpretation of the original terms.

Finally, for arrangements that are being accounted for in accordance with the guidance in ASC 985-605 subsequent to the adoption of ASU 2009-14, contract amendments should be analyzed to determine if they represent "material modifications" to the original contract (see Question A-3 in Appendix A). To the extent that such amendments are a material modification, the software vendor would have to apply the guidance in ASU 2009-14 to that arrangement, which may or may not affect the revenue recognition for that arrangement.

Multiple arrangements with a customer

Question 4-10 **How should a vendor evaluate customer relationships with multiple arrangements?**

It is common for a vendor to have an ongoing customer relationship that consists of multiple arrangements. In such cases, it is important to understand and evaluate the business reasons for multiple arrangements, and whether the multiple arrangements should be accounted for separately, or as one overall arrangement. To recognize revenue on a separate basis for an arrangement entered into with an existing customer, the vendor must demonstrate the subsequent agreement is not linked to the earlier agreement(s) and it must meet the basic revenue recognition criteria.

As discussed in Question 5-2, the criteria used to determine if the arrangements are linked are outlined in ASC 985-605-55-4.

Side agreements

Question 4-11 **What are side agreements? How do side agreements affect revenue recognition for an arrangement?**

Side agreements are amendments to a contract that are either undocumented or documented in agreements separate from the main contract. In essence, a side agreement is an element of the arrangement that is documented outside the base contract. The potential for side agreements is greater for complex or material transactions or when complex arrangements or relationships exist between a vendor and its customers.

Side agreements may be communicated in many forms, including verbal agreements, e-mail, letters or contract amendments and may be entered into for a variety of reasons. Side agreements may provide an incentive to a customer to enter into a contract near the end of a financial reporting period or to enter into a contract that it would not enter into in the normal course of business. Side agreements may entice a customer to accept delivery of goods and services earlier than required or may provide the customer additional rights. For example, a side agreement may extend contractual payment terms, expand the contractually stated license rights, provide a right of return or commit the vendor to provide future products or functionality not contained in the contract or to assist resellers in selling licensed product.

In some instances, management and auditors may be unaware of the existence of side agreements due to the fact only a few individuals within the organization are aware these "agreements" exist. In such cases, the side agreements occur outside the vendor's standard contract procedures and may not be subject to controls that require the information to be reported to the appropriate finance and legal personnel.

When side agreements exist, there is a greater risk that accounting personnel will be unaware of such agreements or will fail to understand all of the terms of the transaction, which may result in improper revenue recognition — particularly when side agreements are 1) unauthorized by management, 2) not made available to finance and accounting personnel or 3) alter the terms and conditions of the original arrangement.

If a software vendor's executive management and Board of Directors agree to a policy that allows the alteration of the terms of an executed agreement by side agreements, the vendor must develop a series of controls to ensure that such agreements are appropriately authorized, identified and forwarded to those who have the expertise to evaluate the effects on the accounting for the transaction as a part of the standard contracting process. However, because of the potential for abuse, we believe that generally it is difficult to design effective internal controls relating to the use of side agreements and that it is preferable to adopt a policy prohibiting their use.

Regardless of whether a vendor decides to adopt a policy that allows or prohibits the use of side agreements, management should satisfy itself that it has the appropriate controls in place to monitor and approve all communications that may amend or alter an arrangement. Additionally, vendors should implement and enforce a policy that includes a suitable penalty (e.g., up to and including the termination of employment) for any employee who does not adhere to the policy adopted, circumvents controls to enter into unauthorized side agreements with customers or does not provide all aspects of an agreement, including side agreements, to management and accounting personnel.

The following example illustrates these concepts:

Illustration 4-11: Side agreements

Facts

On December 26, a calendar year-end software vendor enters into an agreement to provide a perpetual license to Product A to a customer for $50,000, payable within 30 days. The vendor does not have a history of providing a right of return to its customers, and no such right is specified in the contractual arrangement. The vendor determines that the basic criteria for revenue recognition were met and recognizes $50,000 in revenue in the financial reporting period ended December 31.

Subsequent to the vendor's year-end, the customer does not pay the amount due in accordance with the contractual payment terms. When the accounts receivable manager follows up on the delinquent payment, he is notified that the salesperson promised the customer it had the ability to return the software for any reason through March 31 and that no payment was required prior to that date.

The salesperson was not authorized to make such promises to the customer, and the contractual arrangement with the customer contains an "entire arrangement" clause specifying the contract represents all of the pertinent terms and conditions of the arrangement. Further, the vendor's legal counsel has opined that the salesperson's promise is not enforceable by the customer.

Analysis

Because the side arrangement provided by the salesperson led the customer to believe it had a right of return that did not exist in the written agreement, it is difficult to know 1) if this right was important to the customer when making its purchasing decision and 2) whether the vendor would honor the salesperson's commitment to the customer by accepting any return made prior to March 31 as a customer accommodation. Accordingly, the salesperson's promise should be accounted for as if the arrangement with the customer includes a right of return.

Because the vendor does not have a history of providing a right of return to its customers, it does not have the ability to estimate the effect of potential returns in accordance with the provisions of ASC 605-15-25-1 through 25-4, *Revenue Recognition — Products — Sales of Product when Right of Return Exists* (see Question 6-3). Accordingly, the fee is not fixed or determinable prior to the expiration of the return period. No revenue relating to the arrangement should be recognized until March 31, when the right of return expires.

The vendor's recognition of revenue for the arrangement during the reporting period ended December 31 should be evaluated as an error. Material errors included in previously issued financial statements should be reported as prior-period adjustments by restating the prior period financial statements in accordance with the guidance provided by ASC 250, *Accounting Changes and Error Corrections*.

Considerations relating to arrangements with resellers

Question 4-12 **Are there any special considerations when evaluating whether persuasive evidence of an arrangement exists for transactions with resellers?**

There are no significant differences in evaluating whether persuasive evidence exists for a vendor's arrangement with a reseller beyond those applicable to a transaction with an end user. That is, in order for revenue to be recognized for a transaction with a reseller, the vendor must have obtained evidence consistent with its customary business practices relating to transactions with resellers. Questions 4-62 through 4-64 discuss other considerations specific to arrangements with resellers.

4.3 Delivery has occurred

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-18

The second criterion in paragraph 985-605-25-3 for revenue recognition is delivery. The principle of not recognizing revenue before delivery applies whether the customer is a user or a reseller. Except for arrangements in which the fee is a function of the number of copies, delivery is considered to have occurred upon the transfer of the product master or, if the product master is not to be delivered, upon the transfer of the first copy. For software that is delivered electronically, the delivery criterion in that paragraph is considered to have been met when either of the following has occurred:

a. The customer has taken possession of the software via a download (that is, when the customer takes possession of the electronic data on its hardware).

b. The customer has been provided with access codes that allow the customer to take immediate possession of the software on its hardware pursuant to an agreement or purchase order for the software.

985-605-25-19

In cases of electronic delivery such as described in the preceding paragraph, revenue shall be recognized if the other criteria in paragraph 985-605-25-3 have been satisfied.

985-605-25-20

The following guidance addresses various considerations related to delivery, specifically:

a. Customer acceptance (see paragraph 985-605-25-21)

b. Multiple copies of software products versus multiple licenses (see paragraphs 985-605-25-22 through 25-24)

c. Delivery other than to the customer (see paragraph 985-605-25-25)

d. Delivery agents (see paragraph 985-605-25-26)

e. Authorization codes (see paragraphs 985-605-25-27 through 25-29)

The second basic criterion is that revenue from a software licensing arrangement should not be recognized until the software is delivered to the customer. Delivery is considered to have occurred on the transfer of the product master or, if the product master is not to be delivered, on the transfer of the first copy. An exception to this is when the arrangement fee is variable based on the number of copies delivered (see Question 4-31). Software may be delivered electronically, such as through electronic mail or the Internet, or physically, such as on diskettes, compact discs or tape.

Effect of delivery terms on revenue recognition

Question 4-13 **Does the nature of delivery terms (e.g., FOB Destination and FOB Shipping Point terms) affect the determination of when revenue can be recognized for a software licensing arrangement that requires the vendor to physically deliver the licensed software?**

When a software vendor is obligated to physically deliver a copy of the licensed software to a customer, the nature of the shipping terms specified in the arrangement can affect when revenue should be recognized. Revenue should not be recognized prior to delivery of the software to the customer. Physical delivery is achieved when transfer of the risks and rewards of the rights conveyed by the license agreement occurs. Therefore, shipping terms affect the timing of revenue recognition.

If an arrangement specifies FOB Destination shipping terms, delivery is not achieved until the shipment has reached its destination, even if a common carrier assumes the risk of loss in transit. The vendor retains title to the shipment until it is delivered. The common carrier is merely acting as an agent on behalf of the vendor.

Conversely, if the arrangement specifies FOB Shipping Point terms, delivery is deemed to have occurred when title passes, and risk of loss is assumed by the customer on transfer of the software to the shipping agent.

As an alternative to FOB Destination or Shipping Point terms, a vendor may utilize International Commerce Terms (INCOTERMS) in software licensing arrangements to clarify when delivery occurs. INCOTERMS are internationally accepted commercial terms defining when the risk of ownership of goods transfers. Regardless of the terms used, delivery should not be deemed to have occurred prior to transfer of the risks and rewards of the rights conveyed by the license agreement.

The following paragraphs of the implementation guidance in ASC 985-605 provide relevant guidance for assessing when software can be deemed to have been delivered.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Delivery Terms if Arrangement Requires Physical Delivery of Software

985-605-55-97

Delivery is one of the basic criteria for revenue recognition in this Subtopic. In an arrangement that requires physical delivery of software, delivery terms that indicate when the customer assumes the risks and rewards of its licensing rights (for example, free on board [FOB] destination and FOB shipping point terms) are relevant in the assessment of whether software has been delivered.

985-605-55-98

This guidance also applies to arrangements in which a software vendor licenses a software product and retains title to the product. For example, software arrangements that include FOB destination terms do not meet the delivery criterion until the customer receives the software.

International delivery considerations

Question 4-14 **Are there any special considerations relating to determining when delivery has occurred for transactions outside the United States?**

The determination of when delivery occurs for transactions entered into in foreign jurisdictions should be based on the shipping terms agreed to by the parties. If shipping terms are not included explicitly in the agreement, delivery should be evaluated pursuant to the governing law specified in the arrangement. To the extent the arrangement is silent or unclear as to the governing law, the commercial law in the customer's local jurisdiction is generally applicable. A determination of the seller's and customer's rights, and how these affect the determination of whether delivery has occurred, may require an understanding of the law in the customer's local jurisdiction.

Regardless of the governing law, delivery generally should not be deemed to have occurred prior to transfer of the risks and rewards of the rights conveyed by the license agreement. Determining when this occurs in certain jurisdictions may require consultation with legal counsel knowledgeable of local law and customs.

The following examples illustrate these concepts:

Illustration 4-12: Governing law and shipping terms not specified by licensing agreement

Facts

A vendor located in the United States licenses and ships a software product to a customer in a foreign jurisdiction. The license arrangement does not specify the governing law or the delivery terms. The local commercial law indicates title and risk of loss transfer when the product arrives at the customer location (FOB Destination).

Analysis

The license arrangement did not state explicitly the governing law and the delivery terms. Therefore, the local commercial laws would govern the transaction. The default shipping term under the local commercial law is FOB Destination. Accordingly, the delivery criterion is met when the customer receives the software.

However, if the contract had explicitly stated the contract is governed by U.S. law and the delivery terms are FOB Shipping Point, the delivery criteria is achieved on shipment, regardless of the local commercial law.

Illustration 4-13: Governing law and shipping terms specified by licensing agreement

Facts

A vendor located in the United States licenses and ships a software product to a customer in a foreign jurisdiction. The agreement specifies that the parties have agreed to FOB Shipping Point terms. The agreement also specifies that the governing law is the commercial law in the local jurisdiction, which indicates that absent agreement between a vendor and a customer to the contrary, title and risk of loss transfer when the product arrives at the customer location (FOB Destination).

Analysis

Because the license agreement specifies that the parties have agreed contractually that the shipping terms are FOB Shipping Point, delivery should be deemed to have occurred when the vendor delivers the software to the common carrier.

The laws of some countries do not allow a seller to retain a security interest in the shipped goods as established in the U.S. Uniform Commercial Code (UCC). In these countries, it is common for a seller to retain a form of title to goods delivered to customers until the customer makes payment so that the seller can recover the goods in the event of customer default on payment.

SAB Topic 13 indicates that if all other revenue recognition criteria have been met, the staff would not object to revenue recognition at the time of delivery if the only rights that a seller retains with respect to the title are those enabling recovery of the goods in the event of customer default on payment. This limited form of ownership may exist in some foreign jurisdictions where, despite technically holding title, the seller is not entitled to direct the disposition of the goods, cannot rescind the transaction, cannot prohibit its customer from moving, selling, or otherwise using the goods in the ordinary course of business, and has no other rights that rest with a titleholder of property that is subject to a lien under the U.S. UCC. Vendors in the United Kingdom regularly include a "Romalpa Clause" in arrangements that gives such rights. Germany provides a similar right to sellers, referred to as "Eigentumsvorbehalt" (translated as "retention of title").

On the other hand, if retaining title results in the seller retaining rights normally held by an owner of goods, the situation is not significantly different from a delivery of goods on consignment. In such cases, revenue should not be recognized until payment is received. In some cases, consultation with legal counsel knowledgeable of the local law and customs outside the U.S. may be necessary to determine the seller's rights (SAB Topic 13.A.2, Question 3).

If the contract specifically indicates that United States law is the governing law, then United States law should be applied to determine when delivery occurs, irrespective of the local commercial law.

FOB Destination shipping terms with risk of loss insured

Question 4-15 **A vendor ships licensed software products to a customer via a common carrier. The terms of the agreement with the customer specify FOB Destination shipping terms, but the common carrier assumes the risk of loss during shipment. Alternatively, the vendor may obtain insurance from a third party for the shipment. In such cases, may delivery be deemed to have occurred on transfer of the licensed products to the common carrier?**

In such cases, the vendor's delivery obligation still exists prior to the customer's receipt of the licensed software as the vendor has merely outsourced the fulfillment of its delivery obligation to the common carrier as its delivery agent. Delivery is achieved when the delivery agent, acting on behalf of the vendor, delivers the software to the customer. Delivery should not be deemed to have occurred prior to transfer of the risks and rewards of the rights conveyed by the license agreement to the customer. When an agreement specifies FOB Destination shipping terms, the vendor and the customer have agreed transfer of the risks and rewards of the rights conveyed by the license agreement does not occur until receipt of the licensed product by the customer.

Delivery of software on malfunctioning media

Question 4-16 **A software vendor physically delivers a copy of a licensed software product on a CD to a customer before the end of its financial reporting period. On receipt of the software, the customer determines the CD has a malfunction that prevents access to or use of the licensed software. Subsequent to the end of its reporting period, the software vendor ships a replacement CD. Was the delivery criterion met at the end of the reporting period?**

Software arrangements in which software is physically delivered (e.g., CD) often contain warranties for defective media, such as a malfunctioning CD. These and other warranties generally should be accounted for in conformity with ASC 450, *Contingencies*. We believe that performance pursuant to such a warranty should not be regarded as indicating that the delivery criterion had not been previously met.

However, the delivery criterion would not be met if the vendor shipped the wrong software product (even if unintentionally), shipped an incomplete or partial shipment, shipped a substitute software product or consciously delivered product using a malfunctioning media at the end of the financial reporting period.

Electronic delivery of software

Question 4-17 **Many software vendors deliver licensed products electronically. In such cases, when is the delivery criterion met?**

ASC 985-605-25-18 states that "for software that is delivered electronically, the delivery criterion … is considered to have been met when of the following has occurred: (a) the customer takes possession of the software via a download (that is, when the customer takes possession of the electronic data on its hardware); (b) the customer has been provided with access codes that allow the customer to take immediate possession of the software on its hardware pursuant to an agreement or purchase order for the software."

While it generally is clear that delivery occurs once a customer completes the download of the licensed software from a vendor's servers, practice issues have arisen relating to whether delivery has occurred when a customer has been provided with access codes for licensed software but has not commenced or completed download.

If software is to be delivered electronically, we believe that the delivery criterion for revenue recognition is met when the customer has the reasonable ability to access the licensed software. This condition is generally met when the vendor provides the necessary access codes to the customer that allows the customer to commence downloading of the licensed software, and the vendor's server is functioning. We believe that the download does not have to be completed in order for the delivery criterion to be met, just that the customer must be able to commence downloading, if desired.

In the case of physical delivery, the delivery criterion is met for software that is delivered physically if it is shipped FOB Shipping Point prior to the end of the reporting period, even though the software may not arrive at the customer's location until several days after shipment. In the case of electronic delivery, if a customer elects not to commence a download of the licensed software on the last day of a vendor's reporting period, or commences the download but is unable to complete it because of either the time required to complete the download or a technical problem not caused by the vendor, the customer will still have access to the software faster than a physical shipment. Accordingly, we do not believe that this should preclude revenue recognition by the vendor (assuming all of the other basic criteria of ASC 985-605 have been satisfied).

When assessing whether a vendor has provided its customers with the reasonable ability to commence downloading of the licensed product(s), we do not believe that a vendor must maintain a level of server capacity so that all products licensed on a given day or all products that have yet to be downloaded can be simultaneously downloaded by all licensees before the end of the reporting period. Rather, we believe that the delivery criterion is met if the vendor can demonstrate that each customer was provided with the reasonable ability to commence a download prior to the end of the reporting period, if so desired. Determining whether a server's capacity is reasonable may require judgment; however, this assessment is not intended to be overly complex or highly subjective. Rather, it is intended to be a high level assessment so that one can determine whether it is feasible for the customer to download the software.

The following examples illustrate these concepts:

Illustration 4-14: Placing software on a server accessible on a website

Facts

A vendor sells 100 licenses on December 31, the end of its financial reporting period. At noon on December 31, the licensed software products were available for download from an accessible server. Access codes also were provided to the customers at the same time. The software requires an average of 15 minutes to download, based on the download capacity of a typical customer. The vendor's server is functional throughout the day. Server capacity is reasonable, and it is feasible for the customers to download the software.

Analysis

The delivery criterion has been met because each customer has the reasonable ability to access the software.

Illustration 4-15: Complex downloads

Facts

A vendor provides its customer with the means to download software electronically. The end of the vendor's financial reporting period is December 31. The software vendor provides the access code for a customer to commence download at noon on December 31. Server capacity is reasonable, and it is feasible for a customer to download the software. The software vendor's product offering is highly complex and comprises many separate modules, all of which have been licensed to this customer, and all of which are made available for downloading. Many of these modules function autonomously and several of the modules are unlikely to be downloaded for days, weeks or even months after the consummation of the license arrangement. The software vendor knows that it would take approximately 24 hours for this customer (or any other customer — i.e., it is not merely an issue of the customer's hardware/bandwidth constraints that limits the download in this case) to complete the electronic download of all of the many available software modules.

Analysis

The delivery criterion has been met because it is feasible for the customer to commence the download of any of the licensed products before the end of the vendor's financial reporting period.

Illustration 4-16: Reasonable ability to take possession

Facts

XYZ Software Company has a calendar year-end and sells 1,000 licenses on December 31. At 11:55 p.m. on December 31, XYZ placed the software on one server accessible to its 1,000 customers through its website, and all such customers had the access codes to retrieve the software. The download requires an average of 10 minutes based on the download capacity of a typical customer. Server capacity is reasonable, and it is feasible for the customer to commence downloading.

Analysis

Assuming that the vendor's server is technologically accessible, the delivery criterion has been met because each customer has the reasonable ability to commence downloading the software before year-end.

Illustration 4-17: Accessibility

Facts

A vendor sells 100 licenses on December 31, the end of its financial reporting period. The contract specifically requires electronic delivery. In connection with the contract execution, the vendor e-mails Company A the access codes to retrieve the software. The vendor has the software on a server accessible to its customers through its website; however, technical issues with its servers make it impossible to download software on December 31.

Analysis

We believe this situation is analogous to missing the shipping cutoff on physical delivery. The delivery criterion has not been met because the vendor's server was not accessible. Therefore, it is not feasible for a customer to access the software before year-end. Furthermore, it does not matter that a customer may not have tried to download the software. The customer must have the reasonable ability to access the software at the cutoff date.

Illustration 4-18: Both electronic delivery and physical delivery specified in the contract

Facts

A vendor enters into a contract stating that both electronic delivery and physical delivery are the stated means of delivery (e.g., the customer likes to have the physical disks and manuals for ease of reference or for other reasons). The software vendor's servers are functioning, and the electronic delivery capability is assured before quarter-end, but the hard copy is not shipped until the day after the quarter-end.

Analysis

In this contract, the customer specifically has requested that the software be delivered both electronically and physically. Therefore, the delivery criterion will not be satisfied until the vendor satisfies its contractual obligation (i.e., when the software has been delivered both electronically and physically). Contrast this fact pattern (i.e., where both physical and electronic delivery are required) with a contract that states that 1) delivery is satisfied either by electronic or physical delivery and 2) the licensing fees are payable on the first delivery. In this scenario, we believe that the delivery criterion would be met on providing the electronic access as the contract only requires one means of delivery.

Illustration 4-19: Electronic delivery specified in the contract and later physical delivery requested

Facts

A vendor enters into a contract for which electronic delivery is the stated means of delivery. At the end of the vendor's financial reporting period (December 31), all of the criteria for revenue recognition were achieved. On January 15, the customer asks the vendor to also physically deliver a copy of the licensed software, which the vendor agrees to do.

Analysis

The delivery criterion has been met on December 31 because the contract was explicit that electronic delivery was the stated delivery mechanism. This was met before the end of the reporting period. The license fee is payable even if no additional copies are requested by the customer. The customer, at its option, subsequently requested that the software be delivered physically, but this was not a contractual requirement. The physical delivery of the disk in this situation is considered an additional copy as discussed in ASC 985-605-25-22 through 25-24 (i.e., duplication of a license is considered incidental and the delivery criterion is met when the first copy of a software product is delivered) and is not considered to be a separate element pursuant to ASC 985-605-25-6 and 25-7.

Remaining obligations are inconsequential or perfunctory

Question 4-18 **In SAB Topic 13, the SEC staff has stated that even if a vendor has not yet completed all activities related to a delivered item, delivery may be deemed to have occurred and revenue for that item recognized (assuming all other recognition criteria have been met for the delivered item) if the vendor's remaining obligation(s) are inconsequential or perfunctory (SAB Topic 13.A.3.c, Question 1). If remaining obligations in an arrangement accounted for pursuant to ASC 985-605 are inconsequential or perfunctory, and all other revenue recognition criteria have been met, may delivery be deemed to have occurred and revenue recognized?**

No. The concept of delivery being effectively complete if a vendor's remaining obligations are inconsequential or perfunctory is not applicable to transactions accounted for pursuant to ASC 985-605. Accordingly, when applying the provisions of ASC 985-605, delivery should not be deemed to have occurred until all of the vendor's obligations relating to the delivered item have been completed.

This issue was specifically addressed in paragraph 98 of the Basis for Conclusions in the pre-codification of SOP 97-2:

> "In SOP 91-1, the accounting for vendor obligations remaining after delivery of the software was dependent on whether the obligation was significant or insignificant. However, these determinations were not being made in a consistent manner, leading to diversity in practice. AcSEC believes that all obligations should be accounted for and that revenue from an arrangement should be allocated to each element of the arrangement, based on vendor-specific objective evidence of the fair values of the elements. Further, AcSEC concluded that revenue related to a particular element should not be recognized until the revenue-recognition conditions in paragraphs .08 through .14 of this SOP are met, because the earnings process related to that particular element is not considered complete until that time."

Delivery of software not available for general release

Question 4-19 **Software vendors may enter into arrangements to provide versions of a software product to their customers that are not the final version of the product. For example, a software vendor may entice the customer to purchase a beta version of its software in exchange for a significant discount. Does delivery of a software product that is not available for general release meet the delivery requirements under ASC 985-605?**

Delivery generally should not be deemed to have occurred until the final version of the software to be utilized by the customer has been delivered. A software product that is not available for general release is not the final version of the product licensed by the customer, but is rather a beta version, a limited release version or a version for which the quality assurance review has not been completed. The customer may agree to accept a beta version of the licensed software because that may allow it to expedite the implementation of the software. Accordingly, we believe it would be rare to deem delivery to have occurred when the software product provided to the customer is not available for general release.

In those rare cases where delivery may be deemed to have occurred (e.g., if the license agreement explicitly states the customer is licensing the beta version of the software "as-is" and the vendor is not required to deliver the generally available version of the software), consideration should be given to whether the arrangement contains at least an implied (if not explicit) specified upgrade right to the version of the software product that becomes available for general release (see Questions 5-13 through 5-17), even if such rights are provided as a part of a PCS arrangement.

Delivery of an earlier version of a licensed product

Question 4-20 **A customer enters into a license arrangement for version 4.0 of software product X. The vendor delivers version 3.5 of product X. Does the delivery of version 3.5 of Product X satisfy the delivery criterion of ASC 985-605?**

No. Delivery is achieved when the vendor delivers the version of software licensed by the customer, which in this case is version 4.0 (even if the vendor has VSOE of fair value for the upgrade to version 4.0).

Delivery of a substitute product

Question 4-21 **A software vendor may enter into an agreement to license a product (Product B) that is not currently available to a customer. The vendor delivers a substitute product (Product A) and provides the customer with the right to exchange Product A for Product B once available. Product A has no more than minimal differences in price, functionality or features from Product B. Is delivery achieved on the delivery of Product A?**

No. Delivery should not be deemed to have occurred prior to delivery of the software licensed by the customer. The delivery criterion is not achieved when a substitute product is delivered as the substitute product is merely an accommodation to the customer until the product the customer ordered is delivered.

Even if Product A and Product B have similar features and functionality, we believe that delivery should not be deemed to have occurred with the right to receive Product B accounted for as an exchange (see Chapter VI) because the customer has not received the software product licensed. Evaluating whether Product A and Product B qualify for exchange accounting is irrelevant as the customer never intended to purchase Product A.

The following example illustrates these concepts:

Illustration 4-20: Delivery of a substitute product

Facts

A vendor enters into an arrangement with a customer in Germany to deliver software Product A. The customer requests the vendor to deliver the software with German language user interfaces. However, because development of the German language user interfaces is not complete, the vendor delivers the software version with English language user interfaces and offers the customer the right to exchange the delivered software for the German language version when available. Assume 1) there are no more than minimal differences between the English version and the German version of the software product, 2) the costs to complete the development of the German version are not significant, 3) the fee is fixed or determinable and 4) the vendor does not have a history of granting concessions.

Analysis

The vendor has not delivered the software product licensed by the customer when the English version of the software product is delivered. Delivery should not be deemed to have occurred until the German version of the software is released by the vendor and delivered.

Delivery prior to commencement of an initial license term

Question 4-22 **Software vendors may enter into license agreements that specify a beginning date for the license period. In such cases, the vendor may provide the licensed software products to the customer in advance of the date at which the license commences. In such cases, has delivery occurred when the customer is provided with the software product, or does it occur when the customer has the right to use the software (i.e., on commencement of the initial license term)?**

The delivery criterion is not met if the end user does not have the legal right to use the software. Revenue may be recognized only when the license term has legally commenced, assuming all of the other basic revenue recognition criteria of ASC 985-605 have been met.

The following paragraphs of the implementation guidance provide relevant guidance in such situations:

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Effect of Commencement of Initial License Term

985-605-55-101

Revenue recognition in software arrangements that do not require significant production, modification, or customization of the software should occur when all four basic revenue recognition criteria (persuasive evidence of an arrangement, delivery, fixed or determinable fee, and probable collectibility) of this Subtopic are met. However, none of the four basic criteria specifically addresses whether the license term also must commence.

985-605-55-102

For example, on December 20,20X0, a software vendor enters into an arrangement with a first-time customer for the license of Product A and postcontract customer support. Vendor-specific objective evidence of fair value exists for postcontract customer support. For reasons that may or may not be known by the software vendor, the customer wants the license to terminate on January 2, 20X4. The software vendor accepts the customer's terms and structures the arrangement as a three-year term beginning January 3, 20X1, and ending January 2, 20X4. On December 20, 20X0, the software vendor ships the software and collects the fee.

985-605-55-103

Revenue should not be recognized before the commencement of the initial license term. Deferring recognition of revenue until the initial license term commences is consistent with paragraphs 985-605-55-99 through 55-100, which include a right-to-use concept, and the overall concept of delivery addressed in this Subtopic.

985-605-55-104

If the software arrangement were structured as a 3-year and 14-day license commencing on December 20, 20X0, and ending January 2, 20X4, the software vendor would recognize revenue in December20X0 if all other revenue recognition criteria had been met.

The following further example illustrates concepts discussed above:

Illustration 4-21: Delivery prior to commencement of an initial license term

Facts

On 30 December 20X3, a calendar year-end software company executes a license agreement with a customer for Product A. The agreement stipulates that the license agreement commences 1 January 20X4. The vendor delivers the product to the customer on 31 December 20X3.

Analysis

Although the vendor has physically delivered the licensed software to the customer on 31 December 20X3, the customer's right to use the software does not begin until the next day. Delivery should not be deemed to have occurred until the customer has the right to use the software. Accordingly, no revenue relating to the agreement should be recognized by the vendor during its year ended 31 December 20X3, even if all of the other basic revenue recognition criteria of ASC 985-605 have been met.

Extensions or renewals of time-based software licenses

Question 4-23 **As discussed in Question 4-22, delivery of software should not be deemed to have occurred prior to the commencement of the license term. How should delivery be evaluated in an arrangement to extend or renew an existing time-based software license?**

The following factors must be considered when evaluating extensions or renewals of time-based software license arrangements:

- *Has the term of the original license arrangement expired?* If an agreement is entered into to reinstate a previously expired time-based license, it should be accounted for as a new arrangement.
- *Are the elements included in the agreement to extend the license the same as those included in the current agreement?* If the products included in the extension are the same as the products currently licensed, delivery has been achieved as the customer already has possession of and the right to use the software to which the extension/renewal applies. If not, then the vendor must evaluate the additional elements in the arrangement in accordance with the provisions of ASC 985-605-55-110 through 55-114 (see Question 3-10.
- *Are the fees associated with the extension or renewal agreement fixed or determinable?* If the agreement contains extended payment terms, the fees may not be fixed or determinable (see Questions 4-45 through 4-61). The length of the payment terms should be measured from the date the extension/renewal agreement is executed to the receipt of the associated consideration and not from the date of the extended or renewed license period commences.
- *Is the extension/renewal period greater or less than one year?* The term of the extension or renewal must be evaluated on a standalone basis. It is not appropriate to evaluate the extension/renewal based on the term of the original arrangement plus the term of the extension/renewal. The extension/renewal should be accounted for in accordance with the implementation guidance relating to time-based licenses (see Questions 7-19 and 7-20). For example, a one year extension/renewal would be recognized ratably over the one-year renewal period as VSOE of fair value for PCS does not exist for renewal of PCS in a one-year time-based license.

The following excerpt from the implementation guidance within ASC 985-605 provides relevant guidance in such situations.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Effect of Commencement of Extension or Renewal of License Term

985-605-55-105

Paragraphs 985-605-55-101 through 55-104 address the effect of commencement of an initial license term on software revenue recognition, and indicate that revenue should not be recognized before the license term commences even if all other criteria for revenue recognition have been met. However, if the license is an extension or renewal of a preexisting, currently active license for the same product(s), commencement of the extension or renewal term should not also be a prerequisite for revenue recognition.

985-605-55-106

For example, consider the arrangement described in paragraphs 985-605-55-101 through 55-104, including that vendor-specific objective evidence of fair value exists for postcontract customer support. The license term commenced on January 3, 20X1 and ends on January 2, 20X4. Now assume that in September 20X3, the customer decides it wants to be able to continue to use Product A beyond January 2, 20X4. The software vendor and customer execute an arrangement on September 20, 20X3 to extend or renew the terms of the existing license through December 31, 20X5. The extension or renewal arrangement includes only product or products already included in the existing, currently active arrangement.

985-605-55-107

If all other revenue recognition criteria are met, the software vendor should recognize the portion of the extension or renewal arrangement fee allocated to the license of Product A as revenue on September 20, 20X3. In the case of an extension or renewal of a preexisting, currently active license for the same product(s), the customer already has possession of and the right to use the software to which the extension or renewal applies.

985-605-55-108

However, if the customer's preexisting license for the product(s) had lapsed (that is, was not currently active), a new arrangement including the same software product(s) would be accounted for as an initial arrangement and not as an extension or renewal.

985-605-55-109

In considering the guidance in paragraphs 985-605-25-34 through 25-35 on determining whether the extension or renewal fee is fixed or determinable, the date that the extension or renewal arrangement is executed should be used to determine whether the extension or renewal payment terms are extended.

The following examples illustrate these concepts:

Illustration 4-22: Renewal of an expired time-based arrangement

Facts

On 30 December 20X3, a customer entered into a two-year time-based license arrangement. On 31 December 20X5, the customer renewed the license arrangement for an additional three years, commencing 1 January 2006. The time-based license arrangement includes the first year PCS with optional PCS for years 2 and 3 priced at VSOE of fair value.

Analysis

It would not be appropriate for the vendor to recognize the extension/renewal fees in December 20X5, as the delivery criterion was not achieved. The original two year time-based arrangement expired on 30 December 20X5. Therefore, the renewal must be evaluated as a new arrangement. Although the customer had possession of the software on 31 December 20X5, it did not have the legal right to use the software until 1 January 20X6 (i.e., it did not have the legal right to use the software on 31 December 20X5).

Illustration 4-23: Extension of an existing time-based license

Facts

On 30 December 20X3, a calendar year-end software vendor enters into an agreement with a customer to license Product A and to provide PCS on such product for a three-year term. On 31 December 20X5, the customer and the vendor agree to extend the expiration date of the license and PCS by two years. Payment is due from the customer within thirty days, and the vendor has VSOE of fair value of PCS bundled with time-based licenses.

Analysis

Because the agreement extends an effective license for products already in the customer's possession, the vendor may recognize revenue relating to the agreement (with an appropriate deferral of amounts for the additional two years of PCS bundled with the extension of the license) during its year ended 31 December 20X5.

License remix rights

Question 4-24 **Software arrangements may allow a customer to use a number of the vendor's products (i.e., the customer may change the license mix) as long as the cumulative value of all products in use does not exceed the total license fee. Certain of these arrangements may not limit usage of a product or products, but rather, they may limit the number of users that simultaneously can use the products (referred to as concurrent user pricing). When should a vendor recognize revenue for these kinds of arrangements?**

This issue is addressed in the implementation guidance within ASC 985-605 and excerpted below.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Effect of Change in License Mix

985-605-55-99

Software arrangements may allow a user to change or alternate its use of multiple products or licenses (license mix) included in a license arrangement after those products have been delivered by the software vendor. The user has the right under the arrangement to deploy and use at least one copy of each licensed product (that is, the user has a license to use each delivered product). The products may or may not be similar in functionality. These arrangements may limit the customer's use at any time to any mix or combination of the products as long as the cumulative value of all products in use does not exceed the total license fee. Certain of these arrangements may not limit use of a product or products, but may limit the number of users that simultaneously can use the products (referred to as concurrent user pricing).

985-605-55-100

If the other criteria in this Subtopic for revenue recognition are met, revenue would be recognized on delivery of the first copy or product master for all of the products within the license mix. Subsequent remixing is not an exchange or a return of software because the master or first copy of all products has been licensed and delivered, and the customer has the right to use them.

In addition to the considerations outlined in the paragraphs above, if the arrangement includes a remix right that allows the customer to exchange the currently licensed products for software products released in the future by the vendor, consideration should be given as to whether the agreement contains an upgrade right for a specified upgrade/enhancement (see Questions 5-13 through 5-17), rights to undelivered additional software products (see Questions 5-21 and 5-22) or a right to unspecified additional software products to be delivered in the future (see Questions 5-27 through 5-30).

The following examples illustrate these concepts:

Illustration 4-24: Rights to remix only include software products currently licensed

Facts

On December 30, a calendar year-end software vendor enters into a three-year time-based license agreement that provides the customer the right to use up to $5,000 (list price) of any combination of the vendor's software products A, B and C, all of which are currently available. There are no contractual rights to return the software. The rights to remix are limited to the licensed software. The customer has no right to remix the licensed software for any future products released by the vendor or any other currently available products.

The per user list price of A, B and C are $250, $100 and $90, respectively. The three-year time-based license arrangement includes the first year PCS with optional PCS for years 2 and 3 priced at VSOE of fair value. The vendor delivers a master copy of Products A, B and C on December 31.

The license fee is payable net 30 days.

Analysis

Delivery is complete on December 31 when the vendor delivers the first copy of the licensed software products A, B and C because the right to remix was limited to the software products licensed and delivered at the inception of the arrangement. If all of the other basic revenue recognition criteria of ASC 985-605 have been met, the vendor may recognize revenue for the transaction on delivery.

Illustration 4-25: Rights to remix include the right to undelivered additional software products

Facts

A calendar year-end software company enters into a three-year time-based license agreement that provides the customer with the right to use up to $5,000 (list price) of any combination of its then currently available software products A, B and C, plus Product D, E and F, which are not available for general release.

The per user list price of the currently available software products A, B and C are $250, $100 and $90, respectively, and the pricing committee, which consists of management with the relevant authority, has approved the per user list price for Products D, E and F at $200, $100 and $125, respectively. The vendor has determined that these amounts represent VSOE of fair value for these products.

There are no contractual rights to return any of the software and the rights to remix are limited to the licensed software and to the specified future products. The license arrangement includes first year PCS with optional PCS for years 2 and 3 priced at VSOE of fair value. The vendor delivers a master copy of Products A, B and C on December 31. Products D, E and F are expected to be available for general release within a year. The license fee is payable net 30 days.

Analysis

Delivery has not occurred on December 31 when the vendor delivers the first copy of the licensed software products A, B and C. The customer licensed products A through F. Delivery will occur when products D, E and F are also delivered to the customer.

No revenue may be recognized until at least one copy of each product has been delivered. The fact that the vendor has established VSOE of fair value for the undelivered products D, E and F does not change this conclusion as the customer has an unlimited right to remix all the products.

Illustration 4-26: Subsequent amendment to time-based arrangement with right to remix

Facts

A calendar year-end software company enters into a three-year time-based license agreement that provides the customer with the right to use up to $5,000 (list price) of any combination of currently available products A, B and C. There are no contractual rights to return the licensed software and the rights to remix are limited to the licensed software products. The per user list prices of products A, B and C are $250, $100 and $90, respectively.

The vendor delivers a master copy of Product A, B and C on December 31. The time-based license arrangement includes first year PCS with optional PCS for years 2 and 3 priced at VSOE of fair value. The license fee is payable net 30 days.

On June 30 of the next year, the vendor and customer enter into an amendment of the license agreement, which provides the customer the right to use up to an additional $2,000 (list price) of any combination of products A, B, C and D for the remaining license period of two and one-half years. The vendor delivers a master copy of Product D on June 30. The per-user list price for Product D is $100. The license fee is payable net 30 days.

Analysis

For purposes of accounting for the amendment to the original agreement, delivery is complete when the vendor licenses and delivers the master copy of Product D on June 30. If all of the other basic revenue recognition criteria of ASC 985-605 have been met, the vendor may recognize the $2,000 relating to the amendment of the license agreement on that date.

Bill-and-hold transactions

Question 4-25 **Is it possible to recognize revenue on a "bill-and-hold" software licensing arrangement before delivery to the customer is complete?**

Bill-and-hold transactions are arrangements in which, at the customer's request, a vendor may bill the customer for licensed software but will hold delivery of the software to the customer's ultimate destination. While ASC 985-605 does not specifically address bill-and-hold transactions, the SEC staff's views regarding such transactions are summarized in Accounting and Auditing Enforcement Release (AAER) 108 and in SAB Topic 13.A.3.a.

The SEC staff believes that recognizing revenue on bill-and-hold transactions is a departure from the general principles of revenue recognition and that to do so the underlying facts must provide significant evidence to support revenue recognition at the time the transaction is recorded. This must include evidence that the customer, not the seller, has requested a transaction be on a bill-and-hold basis for a valid business reason.

Generally, when a customer requests that a transaction be on a bill-and-hold basis, the business reason is because it does not have space to store the goods purchased from the vendor prior to their use in its operations. However, because software typically occupies little or no physical space, a customer's ability to store the software generally should not be an issue. Accordingly, we believe that it will be rare that a software vendor will be able to establish that a customer has a valid business reason for requesting that a transaction be on a bill-and-hold basis.

Even if a valid business reason can be established for the customer requesting a transaction be executed on a bill-and-hold basis, vendors executing such arrangements must still meet all of the conditions included in SAB Topic 13.A.3.a to recognize revenue prior to delivery of the software:

1. The risks of ownership must have passed to the buyer.
2. The buyer must have made a fixed commitment to purchase the goods, preferably reflected in written documentation.
3. The buyer, not the seller, must request that the transaction be on a bill-and-hold basis. The buyer must have a substantial business purpose for ordering the goods on a bill-and-hold basis.
4. There must be a fixed schedule for delivery of the goods. The date for delivery must be reasonable and must be consistent with the buyer's business practices (e.g., storage periods are customary in the industry).
5. The seller must not have retained any specific performance obligations such that the earnings process is not complete.
6. The ordered goods must have been segregated from the seller's inventory and must not be subject to being used to fill other orders.
7. The goods must be complete and ready for shipment.

The SEC staff have emphasized that the above criteria should not be used as a checklist. That is, the SEC staff believes circumstances may exist in which a transaction would meet all of the above conditions but not meet the requirements for revenue recognition (because the above conditions might affect the substance of a particular transaction differently).

In applying the above criteria to a bill-and-hold transaction, the SEC staff stated that the following factors also should be considered:

1. The date by which the seller expects payment and whether it has modified its normal billing and credit terms for this buyer.
2. The seller's past experiences with, and pattern of, bill-and-hold transactions (e.g., have bill-and-hold transactions accounted for as sales been subsequently reversed, or have transactions typically occurred at the end of the reporting period).
3. Whether the buyer has the expected risk of loss in the event of a decline in the market value of the goods.
4. Whether the seller's custodial risks are insurable and insured.
5. Whether extended procedures are necessary to assure that there are no exceptions to the buyer's commitment to accept and pay for the goods sold (i.e., that the business reasons for the bill-and-hold have not introduced a contingency to the buyer's commitment). For example, if a payment is conditioned on the customer obtaining a production contract or financing, a contingency has been introduced.

Because of the strict requirements of the criteria that must be met to recognize revenue on a bill-and-hold basis, we believe that it will be rare that a software vendor should conclude that the recognition of revenue on such a basis is appropriate. Although the requirements of SAB Topic 13 are applicable to public companies, we believe all companies should consider these criteria when determining if it is appropriate to recognize revenue for a bill-and-hold transaction.

Considerations relating to arrangements with resellers

Question 4-26 **Are there any special considerations relating to the delivery criterion when evaluating arrangements with resellers?**

The delivery criterion of ASC 985-605 applies to both end users and resellers. Generally, arrangements with resellers do not include unique complexities in assessing whether the delivery criterion has been met. However, even if software has been delivered to a reseller, consideration should be given as to whether the arrangement is in substance a consignment because the obligation of the reseller to pay the amounts due pursuant to the arrangement is contingent on the reseller successfully selling the licensed software products to end customers. Revenue should not be recognized for such arrangements until the product is sold to end customers because the reseller has not assumed the risks of ownership for the product (see Question 4-62).

4.4 Customer acceptance

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-21

After delivery, if uncertainty exists about customer acceptance of the software, license revenue shall not be recognized until acceptance occurs.

Many software arrangements include contractual acceptance provisions that allow the customer to accept or reject delivered software, hardware or services during a specified period following delivery. If acceptance terms or other circumstances initially make it uncertain whether the customer will accept the software after it is delivered, revenue recognition should be deferred until the uncertainty is resolved and the software is accepted.

ASC 985-605 states that delivery of software is not achieved if there are undelivered elements (e.g., installation services, another software module or training) that are essential to the functionality of the delivered software. Accordingly, arrangements with acceptance terms that coincide with the delivery of another element may indicate that the undelivered element is essential to the functionality of the delivered software, thus requiring deferral of the arrangement fee. Even if another element is determined not to be essential to the functionality of the delivered software, the customer acceptance provisions may be substantive and require deferral of the arrangement fee.

Evaluating whether customer acceptance is substantive or merely perfunctory is a matter of judgment and requires a careful analysis of the facts and circumstances. If acceptance terms are determined to be substantive, no revenue should be recognized until acceptance occurs.

When formal acceptance is required from the customer under the bargained-for terms of the arrangement, the provisions should be presumed substantive, and revenue generally should not be recognized until customer acceptance is obtained. Conversely, standard acceptance provisions that do not require formal acceptance from the customer but lapse simply by the passage of time may be perfunctory, provided that the time period is relatively short and the software is not for demonstration or evaluation purposes.

Types of acceptance clauses

Question 4-27 **Do different types of acceptance clauses exist? If so, how does the type of acceptance clause included in an arrangement generally affect the accounting for the arrangement? Can a software vendor ever recognize revenue before formal customer acceptance occurs when an arrangement contains a customer acceptance provision?**

In SAB Topic 13, the SEC staff states that "customer acceptance provisions may be included in a contract as a means to enforce a customer's rights to 1) test the delivered product, 2) require the seller to perform additional services subsequent to delivery of an initial product or performance of an initial service (e.g., implementation services), or 3) identify other work necessary to be done before accepting the product" (SAB Topic 13.A.3.b). When such clauses exist in arrangements, they should be presumed to be substantive, bargained-for terms, and the seller generally should not recognize revenue until formal acceptance occurs (generally through formal customer sign-off that they have accepted the delivered products or services) or the provisions lapse.

The SEC staff also has provided guidance on common types of acceptance clauses, as described in the excerpt from SAB Topic 13 below. As noted in this excerpt, formal customer sign-off is not required in all cases before revenue can be recognized when an arrangement includes a customer acceptance clause.

SAB Topic 13.A.3.b, Question 1 (footnote references deleted)

Question

Do circumstances exist in which formal customer sign-off (that a contractual customer acceptance provision is met) is unnecessary to meet the requirements to recognize revenue?

Interpretive Response

Yes. Formal customer sign-off is not always necessary to recognize revenue provided that the seller objectively demonstrates that the criteria specified in the acceptance provisions are satisfied. Customer acceptance provisions generally allow the customer to cancel the arrangement when a seller delivers a product that the customer has not yet agreed to purchase or delivers a product that does not meet the specifications of the customer's order. In those cases, revenue should not be recognized because a sale has not occurred. In applying this concept, the staff observes that customer acceptance provisions normally take one of four general forms. Those forms, and how the staff generally assesses whether customer acceptance provisions should result in revenue deferral, are described below:

(a) *Acceptance provisions in arrangements that purport to be for trial or evaluation purposes*. In these arrangements, the seller delivers a product to a customer, and the customer agrees to receive the product, solely to give the customer the ability to evaluate the delivered product prior to acceptance. The customer does not agree to purchase the delivered product until it accepts the product. In some cases, the acceptance provisions lapse by the passage of time without the customer rejecting the delivered product, and in other cases affirmative acceptance from the customer is necessary to trigger a sales transaction. Frequently, the title to the product does not transfer and payment terms are not established prior to customer acceptance. These arrangements are, in substance, consignment arrangements until the customer accepts the product as set forth in the contract with the seller. Accordingly, in arrangements where products are delivered for trial or evaluation purposes, revenue should not be recognized until the earlier of when acceptance occurs or the acceptance provisions lapse.

In contrast, other arrangements do not purport to be for trial or evaluation purposes. In these instances, the seller delivers a specified product pursuant to a customer's order, establishes payment terms, and transfers title to the delivered product to the customer. However, customer acceptance provisions may be included in the arrangement to give the purchaser the ability to ensure the delivered product meets the criteria set forth in its order. The staff evaluates these provisions as follows:

(b) *Acceptance provisions that grant a right of return or exchange on the basis of subjective matters*. An example of such a provision is one that allows the customer to return a product if the customer is dissatisfied with the product. The staff believes these provisions are not different from general rights of return and should be accounted for in accordance with Statement 48. Statement 48 requires that the amount of future returns must be reasonably estimable in order for revenue to be recognized prior to the expiration of return rights. That estimate may not be made in the absence of a large volume of homogeneous transactions or if customer acceptance is likely to depend on conditions for which sufficient historical experience is absent. Satisfaction of these requirements may vary from product-to-product, location-to-location, customer-to-customer, and vendor-to-vendor.

(c) *Acceptance provisions based on seller-specified objective criteria*. An example of such a provision is one that gives the customer a right of return or replacement if the delivered product is defective or fails to meet the vendor's published specifications for the product. Such rights are generally identical to those granted to all others within the same class of customer and for which satisfaction can be generally assured without consideration of conditions specific to the customer. Provided the seller has previously demonstrated that the product meets the specified criteria, the staff believes that these provisions are not different from general or specific warranties and should be accounted for as warranties in accordance with Statement 5. In this case, the cost of potentially defective goods must be reliably estimable based on a demonstrated history of substantially similar transactions. However, if the seller has not previously demonstrated that the delivered product meets the seller's specifications, the staff believes that revenue should be deferred until the specifications have been objectively achieved.

(d) *Acceptance provisions based on customer-specified objective criteria*. These provisions are referred to in this document as "customer-specific acceptance provisions" against which substantial completion and contract fulfillment must be evaluated. While formal customer sign-off provides the best evidence that these acceptance criteria have been met, revenue recognition also would be appropriate, presuming all other revenue recognition criteria have been met, if the seller reliably demonstrates that the delivered products or services meet all of the specified criteria prior to customer acceptance. For example, if a seller reliably demonstrates that a delivered product meets the customer-specified objective criteria set forth in the arrangement, the delivery criterion would generally be satisfied when title and the risks and rewards of ownership transfers unless product performance may reasonably be different under the customer's testing conditions specified by the acceptance provisions. Further, the seller should consider whether it would be successful in enforcing a claim for payment even in the absence of formal signoff. Whether the vendor has fulfilled the terms of the contract before customer acceptance is a matter of contract law, and depending on the facts and circumstances, an opinion of counsel may be necessary to reach a conclusion.

The following excerpt from the implementation guidance within ASC 985-605 makes clear that public registrants should consider the guidance included in SAB Topic 13 when evaluating customer acceptance clauses included in arrangements. We believe that private companies should as well.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Effect of Customer Acceptance Provisions

985-605-55-79

The following provides implementation guidance as to the effect of customer acceptance provisions on determining whether a software arrangement meets the delivery criterion for revenue recognition (see paragraphs 985-605-25-18 through 25-21)

985-605-55-80

Customer acceptance provisions in a software arrangement may affect whether a software vendor may recognize revenue (provided all of the other revenue recognition criteria of this Subtopic have been met) before formal customer acceptance occurs.

985-605-55-81

Paragraph 985-605-25-21 is not intended to suggest that the mere existence of a customer acceptance provision precludes revenue recognition until formal acceptance has occurred. Items to consider in evaluating the effect of customer acceptance on revenue recognition include the following:

a. Historical experience with similar types of arrangements or products

b. Whether the acceptance provisions are specific to the customer or are included in all arrangements

c. The length of the acceptance term

d. Historical experience with the specific customer.

Some acceptance provisions may be straightforward and provide a customer the ability to accept or reject delivered software products based on standard, objective criteria. Other acceptance clauses may be subjective or appear in parts of the contract that do not typically address acceptance matters, such as warranty provisions or indemnification clauses. Professional judgment may be required to determine the effect of the latter types of acceptance clauses on revenue recognition.

As discussed above, acceptance clauses that create uncertainty about the customer's acceptance of software should be presumed to be substantive elements of an arrangement that generally will preclude revenue recognition until formal customer sign-off is obtained, or the acceptance provisions lapse. We believe that one or more of the following would indicate that the customer acceptance provisions are substantive:

- The customer's payment or vendor's billing of a significant portion of the fee coincides with customer acceptance.
- The time for acceptance is long relative to the estimated life of the software.
- The acceptance provisions indicate the software is to be used for demonstration or evaluation purposes.
- The acceptance provisions are unique or "nonstandard." Indicators of nonstandard acceptance terms are:
  - The duration of the acceptance period is long as compared to standard contracts.
  - The absence of similar acceptance terms in the majority of the software vendor's contracts.
  - Explicit customer-specified requirements that must be met.
- A contractual requirement for explicit notification of acceptance versus deemed acceptance (see Question 4-29).
- A history of customers failing to accept the software or services or failing to accept unless the vendor provides additional products or services beyond those in the initial arrangement (i.e., unless the vendor provides a concession).

However, if none of the above factors are present, the presumption that a customer acceptance clause is substantive may be rebutted in certain circumstances, such as when customer acceptance is perfunctory. In assessing whether customer acceptance is perfunctory, the following criteria should be considered:

- Whether the acceptance criteria is a standard clause in arrangements entered into by the vendor. Customer acceptance clauses based on unique or non-standard acceptance terms should not be deemed perfunctory.
- Whether the acceptance is based on the product performing to standard published specifications and whether the vendor can demonstrate that the software has an established history of functioning in accordance with those specifications.
- Whether the vendor is required to perform additional services for customer acceptance to occur.

Even if an arrangement includes a standard acceptance clause, if the clause relates to a new product or one that has only been sold on a limited basis previously, a vendor may be required to initially defer revenue recognition for the product until it establishes a history of successfully obtaining acceptance.

The following examples illustrate these concepts:

Illustration 4-27: Acceptance clause based on seller-specified criteria

Facts

A software vendor enters into an arrangement with a customer to deliver Product A. The customer is not obligated to remit payment for the licensed software product until it determines whether the product performs to the vendor's published specifications. Pursuant to the arrangement, if the customer has not indicated acceptance of the product by a formal sign-off within 90 days after the origination of the agreement, or indicated that it does not accept the software, acceptance is deemed to have occurred.

The vendor has demonstrated in test environments that the software performs to its published specifications, and it has a history of customers accepting the software in licensing arrangements containing similar provisions.

Analysis

This is an acceptance provision based on seller-specified objective criteria. As the vendor has previously demonstrated that Product A meets the specified criteria, the acceptance clause should be accounted for as a warranty pursuant to the provisions of ASC 450, Contingencies.

If the vendor had not previously demonstrated that the Product A performs to the published specifications, revenue should be deferred until it can be demonstrated such performance has been attained, customer acceptance is received or the acceptance period lapses.

Illustration 4-28: Acceptance clause based on customer-specified criteria

Facts

A software vendor licenses order processing software bundled with one year of PCS to a customer for $10 million. The arrangement fees are due at contract origination. The customer specifies that the software must be able to process at least 50,000 transactions per hour, or it can return the software for a full refund. Pursuant to the terms of the arrangement, if the customer has not indicated acceptance of the product by a formal sign-off within 90 days after the origination of the agreement, or indicated that it does not accept the software, acceptance is deemed to have occurred.

The vendor has not sold the software to customers that have utilized it to process a similar number of transactions per hour in the past.

Analysis

This is an acceptance provision based on an objectively determinable customer-specified criterion. Because the vendor has not sold the software in the past to customers that have utilized it to process a similar number of transactions per hour, revenue should not be recognized prior to customer acceptance (provided either by customer sign-off or expiration of the acceptance period).

Alternatively, revenue recognition for the software license may be appropriate at inception of the arrangement (provided that the vendor has VSOE of the fair value of PCS and all of the other basic revenue recognition criteria of ASC 985-605 have been met) if the vendor can reliably demonstrate that the software is able to process the requisite number of transactions in a test environment similar to the customer's processing environment.

If, based on the previous excerpt from SAB Topic 13, an acceptance provision should be evaluated as a right of return, the vendor must apply the provisions of the rights of returns guidance in ASC 605-10, in addition to those of ASC 985-605. (See Chapter VI for a discussion of the application of the provisions of rights of returns guidance to software licensing arrangements). If a reasonable estimate of future returns can be made pursuant to the rights of return guidance, revenue generally would be recognized when all of the basic revenue recognition criteria of ASC 985-605 have been met, with a reserve established for the estimated amount of any returns associated with the customers who will not accept the software.

However, if the amount of returns for a licensed product is expected to be substantial, this may be indicative that there is a pervasive problem with customer acceptance. In such cases, the vendor should evaluate if revenue recognition is appropriate even if all of the criteria in the rights of return guidance have been met.

If a reasonable estimate of future returns cannot be made, revenue should not be recognized until the revenue recognition criteria of ASC 985-605 are met and the earlier of the following occurs:

- The criteria of the rights of return guidance (ASC 605-10) are met
- The customer formally accepts the software
- The acceptance period lapses

Customer–specified acceptance criteria

Question 4-28 **When an arrangement includes acceptance provisions based on customer-specified criteria, can revenue be recognized prior to formal notification of customer acceptance?**

In such cases, revenue may be recognized prior to formal notification of customer acceptance based on specific facts and circumstances. Although formal notification is always the best evidence of acceptance, other objective evidence that the product has met the customer-specified criteria may demonstrate acceptance.

The SEC staff has addressed this question in SAB Topic 13, as excerpted below, in the context of customer-specified acceptance criteria relating to equipment. We believe that the concepts discussed in this question are also relevant to sales of software pursuant to arrangements including customer-specified acceptance criteria.

SAB Topic 13.A.3.b, Question 2 (footnote references deleted)

Facts
Consider an arrangement that calls for the transfer of title to equipment upon delivery to a customer's site. However, customer-specific acceptance provisions permit the customer to return the equipment unless the equipment satisfies certain performance tests. The arrangement calls for the vendor to perform the installation. Assume the equipment and the installation are separate units of accounting under EITF Issue 00-21.

Question
Must revenue allocated to the equipment always be deferred until installation and on-site testing are successfully completed?

Interpretive Response
No. The staff would not object to revenue recognition for the equipment upon delivery (presuming all other revenue recognition criteria have been met for the equipment) if the seller demonstrates that, at the time of delivery, the equipment already meets all of the criteria and specifications in the customer-specific acceptance provisions. This may be demonstrated if conditions under which the customer intends to operate the equipment are replicated in pre-shipment testing, unless the performance of the equipment, once installed and operated at the customer's facility, may reasonably be different from that tested prior to shipment.

Determining whether the delivered equipment meets all of a product's criteria and specifications is a matter of judgment that must be evaluated in light of the facts and circumstances of a particular transaction. Consultation with knowledgeable project managers or engineers may be necessary in such circumstances.

For example, if the customer acceptance provisions were based on meeting certain size and weight characteristics, it should be possible to determine whether those criteria have been met before shipment. Historical experience with the same specifications and functionality of a particular machine that demonstrates that the equipment meets the customer's specifications also may provide sufficient evidence that the currently shipped equipment satisfies the customer-specific acceptance provisions.

If an arrangement includes customer acceptance criteria or specifications that cannot be effectively tested before delivery or installation at the customer's site, the staff believes that revenue recognition should be deferred until it can be demonstrated that the criteria are met. This situation usually will exist when equipment performance can vary based on how the equipment works in combination with the customer's other equipment, software, or environmental conditions. In these situations, testing to determine whether the criteria are met cannot be reasonably performed until the products are installed or integrated at the customer's facility.

… the determination of when customer-specific acceptance provisions of an arrangement are met in the absence of the customer's formal notification of acceptance depends on the weight of the evidence in the particular circumstances. Different conclusions could be reached in similar circumstances that vary only with respect to a single variable, such as complexity of the equipment, nature of the interface with the customer's environment, extent of the seller's experience with the same type of transactions, or a particular clause in the agreement. The staff believes management and auditors are uniquely positioned to evaluate the facts and arrive at a reasoned conclusion. The staff will not object to a determination that is well reasoned on the basis of this guidance.

Deemed acceptance clauses

Question 4-29

Contracts may include provisions used to limit the time period the customer has to reject licensed software. Such clauses may require the customer to provide, in writing, the reasons for the rejection of delivered software by the end of a specified period. When such clauses exist, can acceptance be deemed to have occurred at the end of the specified time period if notification of rejection has not been received from the customer?

Yes. In such cases, acceptance may be deemed to have occurred at the end of a stipulated period without formal customer notification, as long as the customer has not indicated it will reject the software.

The following example illustrates these concepts:

Illustration 4-29: Deemed acceptance clauses

Facts

A software vendor licenses order processing software bundled with one year of PCS to a customer for $10 million. The arrangement fees are due at contract origination. The customer specifies that the software must be able to process at least 50,000 transactions per hour, or it can return the software for a full refund. Pursuant to the terms of the arrangement, if the customer has not indicated, in writing, that it does not accept the software and the reasons for the rejection within 90 days after the origination of the agreement, acceptance is deemed to have occurred. VSOE of fair value of the bundled PCS exists.

No indication of rejection of the licensed software is received by the vendor from the customer prior to expiration of the contractual acceptance period.

Analysis

This is an acceptance provision based on objectively determinable customer-specified criteria (see Question 4-27). Because the vendor has not sold the software in the past to customers that have utilized it to process a similar number of transactions per hour, revenue should not be recognized prior to customer acceptance. Because the arrangement includes a provision that acceptance is deemed to have occurred if the customer does not reject the software, in writing, within 90 days of origination of the arrangement, the vendor may recognize revenue for the arrangement (if all of the other basic revenue recognition criteria of ASC 985-605 have been met) on expiration of the 90 day period.

Acceptance clauses in arrangements including vendor services

Question 4-30 **If customer acceptance of licensed software is linked to the vendor's provision of services (e.g., training or installation) that are not essential to the functionality of the software, and that would otherwise be accounted for as a separate element of the arrangement (see Chapter VIII), how should the customer acceptance provisions affect the accounting?**

We believe customer acceptance provisions that are linked to the vendor's provisions of other contracted-for services generally should be accounted for as a right of return pursuant to the provisions of ASC 605-10 because whether the customer believes that the future services provided are acceptable is generally viewed as a subjective right of return.

However, if payment of a significant portion of the license fee coincides with the provision of the services, and thus the acceptance of the software, this is a strong indicator the services are essential to the functionality of the software in the customer's environment. In such cases, the arrangement should be accounted for using contract accounting (see Chapter IX).

Additionally, if the customer has more than a relatively short period of time subsequent to completion of the services to accept the software, this may indicate that the software has been provided to the customer for demonstration or evaluation purposes. In such cases, no revenue should be recognized until the earlier of the formal acceptance of the software by the customer or expiration of the acceptance period.

If customer acceptance of licensed software is affected by a service element, we recommend that the vendor obtain customer acceptance of the software, exclusive of the service element, on delivery of the software. This will help to clarify that any extended acceptance period is related to the vendor's successful performance of services that are not essential to the functionality of the software.

4.5 Multiple copies of software products versus multiple licenses

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-22

Arrangements to use multiple copies of a software product under site licenses with users and to market multiple copies of a software product under similar arrangements with resellers shall be distinguished from arrangements to use or market multiple single licenses of the same software.

985-605-25-23

In a multiple copy arrangement, duplication is incidental to the arrangement and the delivery criterion is met upon the delivery of the first copy or product master. The vendor may be obligated to furnish up to a specified number of copies of the software, but only if the copies are requested by the user. The licensing fee is payable even if no additional copies are requested by the user or reseller. If the other criteria in this Subtopic for revenue recognition are met, revenue shall be recognized upon delivery of the first copy or product master. The estimated costs of duplication shall be accrued at that time.

985-605-25-24

In a multiple license arrangement, the licensing fee is a function of the number of copies delivered to, made by, or deployed by the user or reseller. Delivery occurs and revenue shall be recognized as the copies are made by the user or sold by the reseller if the other criteria in this Subtopic for revenue recognition are met.

When a customer licenses multiple copies of a software product (e.g., under a site license) for a fixed fee, the delivery criterion is satisfied when the product master is transferred. If a product master is not to be transferred, the transfer of the first copy satisfies the delivery criterion.

ASC 985-605 uses transfer of the first copy as the indicator that the delivery criterion has been met to accommodate situations where the vendor duplicates the software to maintain quality control, as a convenience to the customer, or for similar reasons. In these situations, duplication is incidental to the arrangement and does not preclude revenue recognition because the fee is payable even if no additional copies are requested by the customer. However, the estimated costs of duplicating the software should be accrued when the revenue is recognized.

Conversely, if the total license fee is not fixed but rather varies based on the delivery of each licensed copy (e.g., arrangements to use multiple single licenses), delivery is only accomplished by the delivery of each copy to the customer or duplication of each copy by the customer, and license fees are recognized as each copy is delivered.

Multiple-copy arrangements and multiple-license arrangements

Question 4-31 **What is the difference between a multiple-copy license arrangement and a multiple-license arrangement?**

The difference between a multiple-copy license arrangement and a multiple-license arrangement is whether the duplication of the software is incidental to the arrangement. Duplication of the software is not incidental to the arrangement if the amount and payment of the arrangement's fee is based on the duplication of the software. In multiple-copy arrangements, the amount of the arrangement fee and the payment terms are not linked to delivery of each license copy. Rather, payment of the arrangement consideration typically is due on the delivery of the master or first copy of the licensed software. In such arrangements, delivery should be deemed to occur when the master or first copy is provided to the customer, and revenue can be recognized (if all of the other basic revenue recognition criteria of ASC 985-605 have been met).

In contrast, multiple-license arrangements link the total amount and payment of the arrangement consideration to delivery of each copy of the software. In such arrangements, fees are not fixed or determinable, and revenue is not recognized, until each copy of the licensed software product is delivered (if all of the other basic revenue recognition criteria of ASC 985-605 have been met).

The following examples illustrate these concepts:

Illustration 4-30: Multiple-copy arrangement

Facts

A vendor enters into an agreement to license 1,000 copies of Product A for $1 million. The vendor delivers 100 copies of Product A. The customer may duplicate or request the vendor to deliver an additional 900 copies of Product A. Payment terms are net 30 days from the delivery of the initial 100 copies. The vendor's cost to duplicate is $1 per copy of Product A.

Analysis

This arrangement is a multiple-copy arrangement. Delivery is achieved on the provision of the initial 100 copies of Product A to the customer. The conditional obligation to deliver the remaining 900 copies at the customer's request does not affect the amount or payment of the license fee. If all of the other basic revenue recognition criteria of ASC 985-605 have been met, the vendor should recognize $1 million in revenue and accrue $900 (the costs associated with duplicating the remaining copies of Product A) when it delivers the initial 100 copies.

Illustration 4-31: Multiple-license arrangement

Facts

A customer enters into an agreement to license 100 copies of Product A for $100,000. The customer may, at its option, license up to an additional 900 copies of Product A at $1,000 per copy licensed. Payment terms are net 30 days from the delivery of each copy of Product A. The vendor's cost to duplicate is $1 per copy of Product A.

Analysis

This arrangement is a multiple-license arrangement as the amount of fees due from the customer and payment terms are linked to the delivery of each copy of the software. Revenue should be recognized as the copies are delivered, if all of the other basic revenue recognition criteria of ASC 985-605 have been met. On delivery of the initial 100 copies of the licensed product, the vendor may recognize $100,000 (100 delivered copies, at a price of $1,000 per copy) in revenue (if all of the other basic revenue recognition criteria of ASC 985-605 have been met). No accrual of the cost to deliver the remaining 900 copies is necessary, as no revenue related to these copies has been recognized.

Site licenses

Question 4-32 **What is a site license? What factors should be considered when assessing if delivery has occurred pursuant to a site license?**

Site licenses are defined in ASC 985-605-20 as "a license that permits a customer to use either specified or unlimited numbers of copies of a software product either throughout a company or at a specified location."

Site licenses typically specify that licensing fees are payable regardless of the number of copies requested by the customer. In such situations, duplication of the software is incidental to the arrangement and delivery occurs when the first copy of the licensed software, or the product master, is delivered to the customer.

If all of the other basic revenue recognition criteria of ASC 985-605 have been met and revenue is recognized on delivery of the licensed software or the product master, the estimated costs of any vendor duplication obligations should be accrued at the same time.

4.6 Delivery other than to the customer

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-25

Delivery shall not be considered complete unless the destination to which the software is shipped is the customer's place of business or another site specified by the customer. In addition, if a customer specifies an intermediate site but a substantial portion of the fee is not payable until the delivery by the vendor to another site specified by the customer, revenue shall not be recognized until the delivery is made to that other site.

ASC 985-605 requires that the licensed software be delivered to either the customer's place of business or another site specified by the customer before revenue is recognized. We believe that in ordinary circumstances involving physical delivery, delivery is accomplished by physical shipment via a third party (generally a common carrier) to the specified site, depending on the agreed-on shipping terms (see Question 4-13).

Delivery to an intermediate site

Question 4-33 **If all of the other basic revenue recognition criteria of ASC 985-605 have been met, can revenue be recognized before licensed software is delivered to the ultimate destination specified by customer?**

In certain circumstances, a customer may instruct a vendor to deliver licensed software to an intermediate site. When this occurs, the vendor must evaluate if 1) the arrangement is in substance a bill-and-hold transaction or 2) the payment of a substantial portion of the fees is linked to delivery at the customer's ultimate destination. If the arrangement is in substance a bill-and-hold transaction, it will be rare that revenue should be recognized prior to delivery to the customer's ultimate destination because of the strict criteria that must be met to recognize revenue on a bill-and-hold basis (see Question 4-25). Similarly, if the payment of a substantial portion of the fees is linked to delivery at the customer's ultimate destination, revenue should be deferred until delivery to that destination takes place. Amounts in excess of 10% of the fee generally should be presumed to be a substantial portion of the fee. However, each case should be evaluated based on the specific facts and circumstances and judgment may be required.

Hosting arrangements

Question 4-34 **A customer may purchase a software product that is to be hosted by the vendor or by an unrelated third party. If hosted by a third party, the software may not be delivered to the customer's location but to an alternative location where the software product will be hosted. If a hosting arrangement is accounted for in accordance with ASC 985-605, when should delivery be deemed to have occurred?**

Pursuant to the provisions of ASC 985-605-55-121, software included in an arrangement that also obligates the software vendor to host the licensed software is within the scope of the software revenue recognition guidance if the customer has the contractual right to take possession of the software at any time during the arrangement without significant penalty and it is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software (see Question 1-3). Accordingly, we believe that when licensed software to be hosted by the vendor or by a third party is accounted for pursuant to ASC 985-605, the delivery criterion is satisfied when the customer has the ability to take immediate possession of the software and the license term commences.

4.7 Delivery agents

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-26

Vendors may engage agents, often referred to as fulfillment houses, either to duplicate and deliver or only to deliver software products to customers. Revenue from transactions involving delivery agents shall be recognized when the software is delivered to the customer. Transferring the fulfillment obligation to an agent of the vendor does not relieve the vendor of the responsibility for delivery. This is the case even if the vendor has no direct involvement in the actual delivery of the software product to the customer.

Delivery agents

Question 4-35 **A vendor utilizes a delivery agent (e.g., a fulfillment house) to either duplicate and deliver, or only deliver, software to its customers. Assuming all of the criteria for revenue recognition are met, can the vendor recognize revenue on shipment of the product master to the delivery agent?**

The vendor should not recognize revenue on delivery of the software to the delivery agent. In such cases, the vendor's delivery obligation still exists as the vendor has merely outsourced the fulfillment of its delivery obligation to the delivery agent. Delivery is achieved when the delivery agent, acting on behalf of the vendor, delivers the software to the customer. Failure of the delivery agent to act in accordance with the software vendor's instructions does not relieve the software vendor from its own delivery obligations. In other words, if the delivery agent does not deliver the software, delivery is not achieved.

Delivery also should not be deemed to have occurred until the delivery agent delivers the software if a vendor instructs a customer to send orders directly to a delivery agent, and the agent has the authority to duplicate and deliver copies of the vendor's software. As above, the provision of the instructions to the customer does not relieve the software vendor from its delivery obligations. Delivery does not occur until the licensed software is provided to the customer — not when instructions relating to how to obtain such software are provided.

This conclusion would be the same if the license agreement included a third party product. If the third party product is delivered directly to the customer by the third party, delivery would not occur until the third party delivers its product to the customer.

4.8 Authorization codes

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-27

In a number of software arrangements, vendors use authorization codes, commonly referred to as keys, to permit customer access to software that otherwise would be restricted. Keys are used in a variety of ways and may serve different purposes. For example, permanent keys may be used to control access to the software, or additional permanent keys may be necessary for the duplication of the software. Temporary keys may be used for the same purposes and also may be used to enhance the vendor's ability to collect payment or to control the use of software for demonstration purposes.

985-605-25-28

In software arrangements involving the use of keys, delivery of a key is not necessarily required to satisfy the vendor's delivery responsibility. The software vendor shall recognize revenue on delivery of the software if all other requirements for revenue recognition under this Subtopic and all of the following conditions are met:

a. The customer has licensed the software and the vendor has delivered a version of the software that is fully functional except for the permanent key or the additional keys (if additional keys are used to control the reproduction of the software).

b. The customer's obligation to pay for the software and the terms of payment, including the timing of payment, are not contingent on delivery of the permanent key or additional keys (if additional keys are used to control the reproduction of the software).

c. The vendor will enforce and does not have a history of failing to enforce its right to collect payment under the terms of the original arrangement.

985-605-25-29

In addition, if a temporary key is used to enhance the vendor's ability to collect payment, the delivery of additional keys, whether temporary or permanent, is not required to satisfy the vendor's delivery responsibility if both of the following conditions are met:

a. The conditions in the preceding paragraph are met.

b. The use of a temporary key in such circumstances is a customary practice of the vendor.

Selective issuance of temporary keys may indicate that collectibility is not probable or that the software is being used only for demonstration purposes.

Keys serve a variety of purposes that may or may not be important to satisfying the delivery criterion. Permanent keys are often used to control access to or duplication of the licensed software. Temporary keys are often used for those same functions but also may be provided to a potential customer during a demonstration period or provided to a customer instead of a permanent key to facilitate collection of the arrangement fee. Delivery of authorization codes, or keys, to permit the customer to use the software may be required to complete delivery and permit revenue recognition.

Effect of keys or authorization codes on determining whether delivery has occurred

Question 4-36 **How does a vendor's use of keys or authorization codes affect the determination of whether the delivery criterion has been satisfied?**

Vendors may use keys, or authorization codes, for a variety of reasons. These may include controlling access to or duplication of licensed software, to ensure registration for warranty or other services, or to enhance collectibility. In accordance with ASC 985-605-25-28, if a vendor utilizes keys or authorization codes and has not yet delivered the key to the customer, delivery may still be deemed to have occurred if the following conditions are met:

- The customer has licensed the software and the vendor has delivered a fully functional version of the software.
- The customer's obligation to pay for the software and the terms of payment, including the timing of payment, are not contingent on the subsequent delivery of a key.
- The vendor intends to enforce and does not have a history of failing to enforce its right to collect payment under the terms of the original arrangement.
- The vendor has a standard business practice of utilizing keys to enhance collectibility.

For example, a software vendor customarily may utilize temporary keys to enhance collectibility. In these situations, the delivered authorization code will expire at a certain point in time and will disable the licensed software. The use of such temporary keys will not adversely affect revenue recognition as long as the first three conditions stated above are met, and the vendor has a customary practice of using temporary keys for collection purposes. Revenue recognition would not be appropriate if any of the first three criteria were not met.

However, the use of keys cannot act as a substitute for determining that sales have been made to a creditworthy customer. A vendor must have processes in place to make such a determination. We do not believe that a vendor lacking such processes can satisfy the basic revenue recognition criterion that collectibility of amounts due pursuant to a software licensing arrangement is probable solely through the use of keys.

If a vendor provides a temporary key when its customary practice is to provide a permanent key, the use of the temporary key may indicate that the vendor is concerned about collectibility, the customer is not obligated to pay until a permanent key is delivered or the delivered software is for demonstration purposes only, any of which may preclude revenue recognition.

The following examples illustrate these concepts:

Illustration 4-32: Delay in sending an authorization key

Facts

A software vendor licenses and delivers a fully functional version of its software to a customer with a temporary key. The vendor will provide the permanent key when the customer provides the serial number of the hardware on which the software is installed. The customer has not received the hardware, which it has purchased from an independent third party. Payment terms are standard and are not dependent on the delivery of the key. Post-contract customer support (PCS) commences on the date of shipment. The vendor intends to enforce, and does not have a history of failing to enforce, its right to collect payment under the terms of the original arrangement.

Analysis

Delivery occurred when the vendor delivered the software product to the customer. The customer has licensed the software, and the vendor has delivered a fully functional version of the software. The customer's obligation to pay for the software and the terms of payment, including the timing of payment, are not contingent on subsequent delivery of the key. The vendor intends to enforce and does not have a history of failing to enforce its right to collect payment under the terms of the original arrangement and has a standard business practice of utilizing keys to enhance collectibility.

Illustration 4-33: Vendor uses keys to enhance collectibility as a standard business practice

Facts

A software vendor licenses and delivers a fully functional version of its software to a customer with a temporary key. Payment terms are standard. The vendor has a customary practice of using temporary keys to enhance collectibility and issues a permanent key on receipt of the final payment. PCS commences on the date of shipment. The vendor intends to enforce, and does not have a history of failing to enforce, its right to collect payment under the terms of the original arrangement.

Analysis

Delivery occurred when the vendor delivered the software product to the customer. The customer has licensed the software, and the vendor has delivered a fully functional version of the software. The customer's obligation to pay for the software and the terms of payment, including the timing of payment, are not contingent on the subsequent delivery of the permanent key. The vendor will enforce, and does not have a history of failing to enforce, its right to collect payment under the terms of the original arrangement. The vendor has a standard business practice of utilizing keys to enhance collectibility.

Illustration 4-34: Vendor does not use keys as a standard business practice

Facts

A software vendor licenses its software product. Payment terms are standard. The vendor does not have a customary practice of using temporary keys to enhance collectibility. The vendor is uncertain about collectibility for this specific customer and issues a temporary key with the fully functional version of its software. The vendor will issue a permanent key on receipt of the final payment. PCS commences on the date of shipment. The vendor intends to enforce, and does not have a history of failing to enforce, its right to collect payment under the terms of the original arrangement.

Analysis

In this example, because the vendor does not have a standard business practice of utilizing keys to enhance collectibility, the selective use of a temporary key to enhance its ability to collect payments indicates that the basic revenue recognition criterion of collectibility being probable has not been satisfied on delivery of the software. Accordingly, revenue should not be recognized until payments are received.

Illustration 4-35: Keys provided as individual products are purchased

Facts

A calendar year-end software vendor has previously licensed Product A to a customer and delivered the software on one disc, which included a copy of Products B and C in addition to Product A. Each product requires an authorization code for the delivered software to be accessed and to function properly. In conjunction with delivering the disc, the vendor provided the customer with the authorization code to Product A but not to Products B and C.

On December 31, the customer licenses Products B and C from the vendor. The vendor delivers authorization codes for Products B and C on January 2.

Analysis

Delivery should not be deemed to have occurred until the vendor delivers the authorization codes for Products B and C on January 2. Although the customer has previously received Products B and C in connection with the delivery of Product A, these products are not functional until receipt of the applicable authorization codes.

The following paragraphs provide further illustrations of these concepts.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Example 4: Authorization Codes — Optional Functions

985-605-55-145

This Example illustrates the guidance in paragraphs 985-605-25-27 through 25-28.

985-605-55-146

A vendor includes 10 optional functions on a compact disc read-only memory (CD-ROM) on which its software product is licensed. Access to those optional functions is not available without a permanent key. Users can order the optional functions and receive permanent keys to enable the full use of those functions.

985-605-55-147

The vendor would recognize revenue for each individual optional function when the user purchases it by placing an order, evidence of such order exists, and the key is delivered to the user.

985-605-55-148

Although the user has received a fully functional version (except for the keys) of the optional functions on the CD-ROM, the user has not agreed to license them. Because no evidence of an arrangement exists (as discussed in paragraphs 985-605-25-15 through 25-17), revenue for the optional functions may not be recognized when the CD-ROM is delivered.

Example 5: Authorization Codes — Access to Additional CPU

985-605-55-149

This Example illustrates the guidance in paragraphs 985-605-25-27 through 25-29.

985-605-55-150

A software vendor's products run on two different levels of central processing units (CPUs) of the same manufacturer — Model X and Model Y (both of which are on the same platform). The vendor enters into a license arrangement with a user whereby the user licenses the vendor's products to run on Model X but allows the user to move to Model Y at no additional charge. The vendor delivers the product in the form of a disc pack along with a CPU **authorization code**. At the time the user chooses to move to Model Y, the user does not receive a new disc pack; rather the vendor gives the user a new CPU authorization code.

985-605-55-151

The vendor would recognize revenue on the delivery of the disc pack. Delivery of the authorization code to move to another CPU is not considered to be an additional software deliverable.

Keys associated with demonstration software

Question 4-37 **A software vendor ships a fully functional version of a product and a 60-day temporary key to a customer for demonstration purposes. If the customer chooses to license the software, the vendor will provide a permanent key. Can revenue be recognized on the delivery of the software and temporary key?**

Revenue only may be recognized when all of the basic revenue recognition criteria of ASC 985-605 have been met. In this case, persuasive evidence of an arrangement does not exist unless and until the customer accepts the software and enters into a license agreement. However, if the customer enters into a license agreement, the vendor may recognize revenue before the permanent key is delivered if all of the following criteria are achieved:

- The demonstration version of the software delivered by the vendor is fully functional
- The customer's obligation to pay for the software and the terms of payment, including the timing of payment, are not contingent on subsequent delivery of the permanent key
- The vendor intends to enforce, and does not have a history of failing to enforce, its right to collect payment under the terms of the original arrangement
- The vendor has a standard business practice of utilizing keys to enhance collectability

4.9 The vendor's fee is fixed or determinable and collectibility is probable

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-30

The other prerequisite in paragraph 985-605-25-3 for revenue recognition is that both of the following conditions be met:

a. The vendor's fee is fixed or determinable.

b. Collectibility is probable.

985-605-25-31

A software licensing fee is not fixed or determinable if the amount is based on the number of units distributed or copied, or the expected number of users of the product. Revenue recognition for variable-pricing arrangements is discussed in paragraphs 985-605-25-52 through 25-57. Additionally, if an arrangement includes rights of return or rights to refunds without return of the software, Subtopic 605-15 requires that conditions that must be met in order for the vendor to recognize revenue include that the amount of future returns or refunds can be reasonably estimated.

The fixed or determinable criterion refers to whether the total consideration in an arrangement is either known or estimable with reasonable certainty. Fixed or determinable does not evaluate the ability of the customer to pay the fees contained in the arrangement (this is addressed by the collectibility criterion discussed below), but rather if the fees will be reduced by a future action of the vendor (e.g., by granting a future concession) or the exercise of rights of returns or refund granted, either explicitly or implicitly, to the buyer. If a vendor cannot conclude at the outset of an arrangement that the fee is fixed or determinable, then the revenue generally is recognized either as payments from the customer become due or as rights of return or refund lapse, if all of the other basic revenue recognition criteria of ASC 985-605 have been met.

Additionally, revenue may not be recognized if the economic benefits from the transaction are not expected to accrue to the entity. Accordingly, it is not appropriate to recognize revenue when collectibility of the arrangement consideration is not probable. AcSEC intended that the term "probable" as used in ASC 985-605 be the same as in ASC 450, *Contingencies*, which defines the term as "likely to occur."

Assessing whether collectibility is probable

Question 4-38 What factors should be considered when determining whether collectibility of amounts due from customers pursuant to the terms of an arrangement is probable?

In assessing whether collectibility is probable, the following should be considered:

- If temporary keys or authorization codes are used in the arrangement, whether the vendor has a standard business practice of utilizing these features to enforce collectibility (see Question 4-36).
- Whether there are any known indicators that an otherwise creditworthy customer may not remit payments due pursuant to the contractual terms of the arrangement.
- Whether the vendor can demonstrate that the customer is creditworthy. Creditworthy is defined as the financial ability (i.e., wherewithal) to pay in accordance with the contractual payment terms.

A vendor should have a documented credit policy, based on objective and verifiable criteria, to ensure consistency in evaluating whether a customer is creditworthy. As this evaluation may require judgment, a vendor should document the basis for its conclusions with contemporaneous, relevant information. The documentation may include an approved credit application, recent financial information, credit reports, historical payment information and other relevant information. This credit evaluation should not include the impact of any contingent or assumed financing arrangements or potential insurance proceeds.

If a vendor's history includes a significant level of bad debt expense, this indicates the vendor should evaluate whether its existing criteria are adequate in evaluating if collectibility is probable, or if it should revise the existing credit screening policy and/or processes.

A vendor must evaluate whether a customer is creditworthy at the outset of each transaction, based on all the relevant facts and circumstances at that time, regardless of any previous experiences with the customer. For example, a vendor may have entered into previous transactions with a customer, believing the customer to be creditworthy, and collected all amounts due from the customer in accordance with its payment terms. If a customer enters into an additional arrangement, the vendor should re-evaluate if the customer is creditworthy at the outset of the subsequent arrangement. Based on the facts and circumstances at that time, the vendor may conclude the customer is no longer creditworthy.

Additionally, if a vendor has entered into a previous arrangement with a customer and concluded that collectibility was probable at the outset of that arrangement, but the customer has not remitted payment relating to that arrangement as of the date that a subsequent arrangement is entered into, consideration should be given as to whether collectibility of amounts due pursuant to the subsequent agreement should be deemed probable. Assuming there is no customer satisfaction issue, the failure to pay in accordance with the original agreement's payment terms may indicate the customer is no longer creditworthy.

If collectibility is not probable at the outset of the arrangement, revenue should be recognized when the cash is received (assuming all other basic criteria have been met).

The following examples illustrate these concepts:

Illustration 4-36: Initial assessment of creditworthiness

Facts

On 15 December 20X0, a software vendor enters into a license agreement for $500,000. Payment terms are $200,000 due net 30 days and $300,000 due net 60 days. The vendor's standard payment terms are net 60 days. The vendor has sufficient contemporaneous, relevant information and documentation to demonstrate that the customer is creditworthy, in accordance with the vendor's credit policy.

Analysis

The collectibility criterion has been satisfied because the vendor can demonstrate that the customer is creditworthy in accordance with its credit policy based on contemporaneous relevant information. If all of the other basic revenue recognition criteria of ASC 985-605 have been met, the vendor may recognize revenue of $500,000 when the software is delivered.

Illustration 4-37: Customer does not pay in accordance with payment terms in prior transaction

Facts

On 15 May 20X1, the software vendor and customer from Illustration 4-36 above, enter into a second arrangement whereby the customer licenses additional software for $400,000 with payment terms of $200,000 due net 30 days and $200,000 due net 60 days.

The customer did not pay the fees for the initial license agreement in accordance with the contractual terms. As of 15 May 20X1, $300,000 of the initial transaction consideration, originally scheduled for payment 14 February 20X1, is still outstanding. There are no customer satisfaction issues, and there was no information available at the outset of the original transaction to indicate the customer was not creditworthy.

Contemporaneous, relevant information as of the date of the subsequent agreement indicates that the customer's financial condition has deteriorated, and it is not creditworthy in accordance with the vendor's credit policy.

Analysis

Because collectibility is not deemed to be probable for the subsequent arrangement, revenue should be recognized as cash is received (if all of the other basic revenue recognition criteria of ASC 985-605 have been met). Additionally, the vendor should consider the need to record an allowance for bad debts relating to amounts due pursuant to the original agreement.

Illustration 4-38: Use of temporary keys to ensure collection

Facts

On 15 December 20X0, a software vendor enters into a perpetual software license arrangement with a customer for total arrangement consideration of $500,000, with payment terms net 30 days. The vendor delivers a fully functional version of the licensed software and a temporary key, which is automatically disabled if a customer does not pay in accordance with the terms of the arrangement. The vendor does not have a standard business practice of utilizing temporary keys to ensure collectibility. The vendor does not have sufficient contemporaneous, relevant documentation to demonstrate the customer's creditworthiness in accordance with its credit policy.

Analysis

The vendor does not have a standard business practice of using a temporary key to enforce collections but has done so in this arrangement. Additionally, it did not conclude that the customer was creditworthy, based on its credit policy. Accordingly, revenue should be recognized as cash is received (if all of the other basic revenue recognition criteria of ASC 985-605 have been met).

If collectibility is deemed probable at the outset of an arrangement and revenue is recognized, but events later indicate that it is not probable that an accounts receivable recorded in connection with the recognition of revenue will be collected due to subsequent collectibility related matters (e.g., due to a deterioration in the financial condition of the customer), bad debt expense should be recorded (the previously recognized revenue should not be reversed — see Question 4-40).

Satisfying the collectibility criterion by insuring accounts receivable

Question 4-39 **If a vendor is unable to conclude that amounts due from a customer pursuant to a software licensing arrangement are probable of collection, is the collectibility criterion satisfied if the vendor insures the amounts receivable from the customer through a credit default swap or other means?**

In a credit default swap or similar arrangement, a vendor enters into an arrangement with a counterparty that agrees to insure the risk that a customer will not pay amounts due pursuant to a software licensing arrangement in exchange for regular periodic payments (essentially an insurance premium). If the customer defaults, the counterparty will purchase the uncollectible receivable from the vendor.

We believe that such arrangements do not satisfy the collectibility criterion for revenue recognition pursuant to ASC 985-605. Rather, we believe that the collectibility criterion is meant to assess whether it is probable that fees due pursuant to an arrangement with a customer will be collected from that particular customer and not from an insurer or other third party. Accordingly, if collectibility from the customer cannot be assessed as probable, no revenue should be recorded relating to the software licensing arrangement until cash is received from the customer.

A vendor that enters into a credit default swap or similar arrangement generally should account for the swap as a derivative instrument pursuant to the provisions of ASC 815, *Derivatives and Hedging*. Any amounts collected from the counterparty if and when a customer defaults should be presented as other operating income and not revenue. If the swap or other similar arrangement meets the definition of a derivative, any change in fair value should be presented as other operating income/expense and not revenue. Any amounts paid to the counterparty would directly increase the carrying value (e.g., fair value) of the derivative, while any amounts collected from the counterparty if and when a customer defaults would decrease the carrying value (e.g., fair value) of the derivative. Over time, the fair value of the derivative will change as initial market expectations about the collectibility of the underlying receivable change, resulting in derivative gains or losses that should be recorded in other operating income as collectibility expectations deteriorate or improve, respectively, from those that existed at inception of the swap arrangement.

Accounting for uncollectible accounts receivable

Question 4-40 **How should software vendors account for uncollectible account receivables?**

A vendor's ability to demonstrate the customer is creditworthy at the outset of the arrangement does not suggest it will never experience a bad debt. Events may occur after the vendor's initial assessment that may require the vendor to conclude outstanding amounts originally assessed as probable of collection are in fact uncollectible.

Although the specific facts and circumstances that lead to a conclusion that an uncollected accounts receivable balance should be accounted for as a bad debt will vary, accounts receivable generally are not paid in full by customers based on one of the following reasons:

- The customer cannot pay (i.e., the customer is no longer creditworthy)
- The customer never could pay (i.e., the initial creditworthy assessment was incorrect)
- The customer does not want to pay (i.e., the customer is experiencing product satisfaction issues)
- The customer is not required to pay (i.e., customer is exercising rights of return or cancellation provisions)

Bad debt expense or error in the initial assessment of collectibility

A bad debt represents an amount due from a customer that was originally deemed creditworthy but is subsequently unable to pay the remaining amounts due under the arrangement. Bad debt expense, when recognized, typically should be recorded as a general and administrative expense.

To determine if an uncollectible accounts receivable can be appropriately accounted for as a bad debt expense, a vendor should consider the following:

- Would the customer pay if it had the ability to pay?
- At the outset of the arrangement, did sufficient contemporaneous, relevant information and documentation exist to support a conclusion that the customer was creditworthy in accordance with the vendor's credit policy?
- Did an event or events that affected the customer's ability to pay occur subsequent to the initial assessment? In other words, did new facts or circumstances arise after the initial assessment to indicate that the customer is unable to pay?

If the answer to all three questions above is yes, the uncollected accounts receivable should be accounted for as a bad debt. However, if there is no new information or if the new information was known or should have been known at the outset of arrangement, then it is likely an error was made in the initial assessment. Material errors included in previously issued financial statements should be reported as prior-period adjustments by restating the prior period financial statements in accordance with the guidance provided by ASC 250, Accounting Changes and Error Corrections. These situations should be evaluated on the specific applicable facts and circumstances and may require the use of professional judgment.

Customer satisfaction issues

A vendor may conclude a customer has the financial ability to pay; however, the customer may choose to withhold payment due to dissatisfaction with the products or services delivered by the vendor. In these circumstances, the vendor may choose to mitigate the customer satisfaction issue by providing the customer with an accommodation, such as agreeing to a reduction in the fee or accepting a return not contractually required. These accommodations are concessions (see Question 4-47), and the associated reduction in accounts receivable should be reflected as a reduction in revenue.

It is not appropriate to accrue an amount for unspecified potential future concessions or customer satisfaction issues at the outset of a software licensing arrangement. Such accounting is fundamentally inconsistent with the assertion that the fee is fixed or determinable and the arrangement is not subject to change (i.e., the vendor will not grant a concession).

Customer is executing a contractual right of return

A customer may choose not to pay fees due under an arrangement in accordance with a contractual right of return or cancellation provision. In this case, the contractual right of return is an element of the arrangement that should have been accounted for appropriately by the vendor pursuant to the right of return guidance (see Chapter VI) at the outset of the arrangement. If the vendor did not appropriately account for the contractual right of return at the outset of the arrangement based on information available to it at that time, then it is likely an error was made in the initial accounting for the transaction. Material errors included in previously issued financial statements should be reported as prior-period adjustments by restating the prior period financial statements in accordance with the guidance provided by ASC 250.

However, if based on its historical experience with returns or cancellations, the vendor estimated that no or an immaterial amount of returns would occur at the outset of an arrangement and a customer later exercises a right of return or cancellation, this may require a change in estimate to be accounted for prospectively. These situations should be evaluated on the specific applicable facts and circumstances and may require the use of professional judgment.

The following examples illustrate these concepts:

Illustration 4-39: Uncollectible accounts receivable

Facts

A vendor enters into a software license arrangement with a customer. The customer is deemed to be creditworthy at the outset of arrangement based on contemporaneous, relevant information in accordance with the vendor's credit policy. The vendor concludes at the outset of the arrangement that the other basic revenue recognition criteria of ASC 985-605 have been met and recognizes revenue relating to the arrangement. Subsequent to the initial assessment, the customer files for bankruptcy protection under Chapter 11, and the vendor determines the uncollected license fee is uncollectible. The events giving rise to the customer filing for bankruptcy protection arose after the origination of the arrangement and the reporting of the financial results of the period in which the arrangement was executed.

Analysis

The events which gave rise to the customer filing for bankruptcy arose after the outset of the arrangement. As a result, the write-off of the account receivable should be recorded as a bad debt expense in the period the fees were deemed uncollectible.

Illustration 4-40: Customer satisfaction issue

Facts

Assume the same facts as in Illustration 4-39 above, except that instead of the customer declaring bankruptcy, the vendor agrees to issue a credit memo to the customer due to dissatisfaction with the licensed software product.

Analysis

The customer was creditworthy at the outset of arrangement and still is creditworthy; therefore, accounting for the credit memo as bad debt expense is not appropriate. The vendor reduced the fees under the arrangement to mitigate a customer satisfaction issue. This is a concession and should be accounted for as a reduction of revenue. Additionally, the vendor must consider the implication of this concession on its future assertions that fees are fixed or determinable at the outset of a software licensing arrangement (see Question 4-47).

Illustration 4-41: Standard short-term money-back guarantee

Facts

Assume the same facts as in Illustration 4-40 above, except that instead of the customer declaring bankruptcy, the license agreement includes a 30-day money back guarantee based on the software product performing to standard specifications. The vendor typically provides this guarantee in all arrangements and has established the appropriate history to estimate the potential returns pursuant to the right of return guidance (see Chapter VI). The vendor recognizes revenue on delivery of the licensed software, after determining all of the other basic revenue recognition criteria of ASC 985-605 have been met. The customer chooses to return the software within the 30 day period.

Analysis

The return of the software should be accounted for as a reduction in the sales return allowance recorded by the vendor pursuant to the right of return guidance. It would not be appropriate to recognize the return as bad debt expense.

Assessing whether fees are fixed or determinable

Question 4-41 **What factors should be considered when evaluating whether a fee is fixed or determinable?**

The fixed or determinable criterion refers to whether the consideration in an arrangement is either known or estimable with reasonable certainty. When making this determination, the following factors should be considered:

- *Whether the arrangement contains extended payment terms.* As further discussed in the Questions on extended payment terms in Chapter IV, a basic consideration in determining if a fee for a software arrangement is fixed or determinable relates to the risk that technological obsolescence and similar factors will cause a vendor to grant the customer a refund or other concession. Accordingly, software arrangements with extended payment terms may not meet the fixed or determinable fee criterion.

- *Whether it is likely that the vendor will grant a concession to the customer.* An objective of the fixed or determinable criterion is to ensure that the elements of the transaction are known and that the arrangement is not subject to change — that is, that the vendor will not grant a concession. Even in arrangements without extended payment terms, if a vendor has a history of granting concessions that are not required under the original terms of the arrangement, the vendor should challenge the appropriateness of recognizing revenue until the conditions that have historically caused it to grant the concessions have been resolved.

- *Whether the amount of the fee is based on the number of copies of the software sold or based on the number of users of the software* (see Question 4-31 for discussion of multiple-license arrangements). For example, assume a vendor enters a licensing arrangement to license 100 copies of a software product for total arrangement consideration of $100,000, payable at a rate of $1,000 per delivered copy. Pursuant to the customer's request, the vendor delivers the first ten copies concurrent with signing the contract that evidences the arrangement. Because the fee is based on the number of copies of the software product delivered, only $10,000 (ten copies delivered for $1,000 per copy) is fixed or determinable when the ten copies are delivered. Additional amounts become fixed or determinable as the vendor delivers the additional copies.

- *Whether the arrangement includes a right of return or right to a refund without returning the software.* The rights of returns guidance in ASC 985-605-25-60 and 25-61 requires that the amounts of future returns or refunds be reasonably estimable before the vendor may recognize any revenue under the arrangement (see Chapter VI). If the returns or refunds are not reasonably estimable, as described in the right of return guidance, then the arrangement fee is not considered to be fixed or determinable.

Whether a fee is fixed or determinable is assessed once, at the outset of the arrangement, and does not change for the duration of the arrangement. If a vendor cannot conclude at the outset of an arrangement that the fee is fixed or determinable, then the revenue generally should be recognized either as payments from the customer become due, as cash is received (from the customer and without vendor participation in a financing arrangement — see Question 4-53), or as rights of return or refund lapse (if all of the other basic revenue recognition criteria of ASC 985-605 have been met).

Accounts receivable and deferred revenue

Question 4-42 **How should a software vendor account for amounts billed to customers for services that have not yet been performed or for arrangement fees that are not fixed or determinable or collectible?**

In general, only amounts ultimately expected to be recognized as revenue should be classified as deferred revenue (e.g., cash payments received from customers prior to services being rendered). Accordingly, it is not appropriate to record a receivable and an offsetting amount of deferred revenue when fees associated with a software licensing arrangement are not 1) fixed or determinable or 2) collectible.

In some situations, a vendor may bill a customer prior to performing services for that customer or when the arrangement fee is not fixed or determinable. For example, a vendor may deliver a product to a customer under an arrangement that includes a right to return the product within a specified time period. If the vendor is unable to estimate future returns at the date of delivery, it cannot recognize revenue until either it develops the ability to make such an estimate or the return right expires (see Chapter VI). However, the vendor may have the right to bill the customer on delivery pursuant to the terms of the arrangement. A question arises in such situations as to whether accounts receivable and related deferred revenue or monetary liabilities should be recognized by the vendor.

We believe that it generally is not appropriate to record deferred revenue and offsetting accounts receivable in situations similar to the example discussed above. As the basic criteria for revenue recognition have not been satisfied and no amounts have been collected from the customer, neither party has completed its obligations pursuant to the arrangement. Accordingly, for accounting purposes, the arrangement should be accounted for in a manner similar to any executory contract under which neither party has performed. In such cases, neither a receivable nor a payable should be recorded in the vendor's financial statements until cash is received or the basic criteria for revenue recognition have been satisfied.

Contingent usage-based fees

Question 4-43 **Software vendors may enter into arrangements whereby fees are determined based on applying a constant multiplier to the frequency that the licensee uses the software. If the usage-based fees are not paid timely, the licensee loses the right to use the software and the vendor has no continuing obligations, such as to provide PCS. How should such fees be accounted for?**

It is important to understand the structure of these arrangements as the revenue recognition may vary significantly based on the specific facts and circumstances. The following excerpt from the implementation guidance included in ASC 985-605 provides relevant guidance in accounting for such fees when the software functionality is used by the licensee in processing an activity on which the usage-based fee is measured.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Arrangements that Include Usage-Based Fees

985-605-55-5

Software vendors may enter into arrangements for licensing rights and postcontract customer support that include contingent usage-based fees. Usage-based fees are determined based on applying a constant multiplier to the frequency that the licensee uses the software. For example, a vendor may license customer call center software whereby a fee of $.01 is charged for each call handled. That fee structure is different from fees that are determined based on the number of individuals or workstations that use or employ the software (that is, user-based fees). If usage-based fees are not paid timely, the licensee's perpetual license to use the software is vacated and the vendor has no continuing obligation to provide postcontract customer support.

985-605-55-6

Usage-based fees are not specifically addressed in this Subtopic. However, paragraph 985-605-25-7, which provides guidance as to what constitutes vendor-specific objective evidence of fair value of the elements of a software arrangement, states, in part, that when a vendor's pricing is based on multiple factors such as the number of products and the number of users, the amount allocated to the same element when sold separately must consider all the factors of the vendor's pricing structure. Accordingly, usage-based fees should be considered in determining whether there is sufficient vendor-specific objective evidence of fair value of all the elements of an arrangement.

985-605-55-7

The following examples focus on circumstances in which software is used by the licensee only in the activity that underlies the measurement of the usage-based fee; that is, the software provides the licensee with no internal-use functionality for which a usage-based fee would not be charged. The examples illustrate how a software vendor would recognize revenue for the perpetual license, postcontract customer support, and contingent usage-based fee elements.

Separate Fees for License, Usage, and Renewal of Postcontract Customer Support

985-605-55-8

An arrangement may provide for a nonrefundable initial fee for the perpetual license and contingent usage-based fees determined monthly or quarterly and due shortly thereafter. Postcontract customer support is provided at no additional charge for the first year and the licensee may purchase renewal postcontract customer support annually thereafter for a fixed amount that is deemed substantive (the renewal rate).

985-605-55-9

The existence of a substantive renewal rate for postcontract customer support allows for the determination of the portion of the initial fee that should be allocated to the perpetual license through the application of the residual method described in paragraphs 985-605-25-10 through 25-11. That amount should be recognized as revenue when the criteria in paragraph 985-605-25-3 are satisfied. The amount allocated to postcontract customer support would be recognized pursuant to the requirements of paragraph 985-605-25-67 through 25-69. The usage-based fee should be recognized at the time a reliable estimate can be made of the actual usage that has occurred (estimates may be used, for example, if there is a lag in the reporting of actual usage), provided collectibility is probable.

Postcontract Customer Support Included in Usage-Based Fee

985-605-55-10

An arrangement may provide for a nonrefundable initial fee for the perpetual license and contingent usage-based fees determined monthly or quarterly and due shortly thereafter. Postcontract customer support is provided at no additional stated charge (or the pricing of postcontract customer support is stated as being included in the contingent usage-based fee).

985-605-55-11

Because there is no substantive renewal rate for postcontract customer support, there is no vendor-specific objective evidence of fair value of the postcontract customer support that is to be provided, which precludes application of the residual method to determine the portion of the initial fee allocable to the perpetual license. Further, there is not sufficient objective evidence to demonstrate that some portion of the initial fee does not represent payment for future postcontract customer support. Accordingly, pursuant to paragraphs 985-605-25-9 through 25-11 and 985-605-25-70, the initial fee should be recognized ratably over the period that the vendor expects to provide postcontract customer support because there is no contractual term for the postcontract customer support. The usage-based fee would be recognized at the time a reliable estimate can be made of the actual usage that has occurred, provided collectibility is probable.

All Fees Usage-Based

985-605-55-12

An arrangement may provide for a perpetual license solely in exchange for contingent usage-based fees determined monthly or quarterly and due shortly thereafter. Postcontract customer support is provided at no additional stated charge.

985-605-55-13

The usage-based fee represents payment for both the perpetual license right and postcontract customer support. However, that fee becomes fixed or determinable only at the time actual usage occurs. Therefore, revenue should be recognized at the time a reliable estimate can be made of the actual usage that has occurred, provided collectibility is probable.

For arrangements where all fees are usage-based and VSOE of fair value does not exist for the undelivered elements such as PCS, software vendors should recognize revenue in accordance with Question 3-16. However, software vendors may also analogize to implementation guidance included in ASC 985-605-55-12 through 55-13 and recognize revenue at the time actual usage occurs and a reliable estimate can be made.

4.10 Factors that affect the determination of whether a fee is fixed or determinable and collectible

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-32

The following guidance addresses various considerations related to whether a fee is fixed or determinable and collectible, specifically:

a. Extended payment terms (see paragraphs 985-605-25-33 through 25-35)

b. Reseller arrangements (see paragraph 985-605-25-36)

c. Customer cancellation privileges (see paragraph 985-605-25-37)

d. Fiscal funding clauses (see paragraphs 985-605-25-38 through 25-40)

985-605-25-33

A number of arrangements that call for fixed or determinable payments, including minimum royalties or license fees from resellers, specify a payment period that is short in relation to the period during which the customer is expected to use or market the related products. Other arrangements have payment terms that extend over a substantial portion of the period during which the customer is expected to use or market the related products. Because a product's continuing value may be reduced due to the subsequent introduction of enhanced products by the vendor or its competitors, the possibility that the vendor still may provide a refund or concession to a creditworthy customer to liquidate outstanding amounts due under the original terms of the arrangement increases as payment terms become longer.

985-605-25-34

For the reason cited in the preceding paragraph, any extended payment terms in a software licensing arrangement may indicate that the fee is not fixed or determinable. Further, if payment of a significant portion of the software licensing fee is not due until after expiration of the license or more than 12 months after delivery, the licensing fee shall be presumed not to be fixed or determinable. However, this presumption may be overcome by evidence that the vendor has a standard business practice of using long-term or installment contracts and a history of successfully collecting under the original payment terms without making concessions. In such a situation, a vendor shall consider such fees fixed or determinable and shall recognize revenue upon delivery of the software, provided all other conditions for revenue recognition in this Subtopic have been satisfied.

985-605-25-35

If it cannot be concluded that a fee is fixed or determinable at the outset of an arrangement, revenue shall be recognized as payments from customers become due (assuming all other conditions for revenue recognition in this Subtopic have been satisfied).

Because of the relatively short life cycle of many software products, the susceptibility of software to technological obsolescence and other external factors, the guidance in ASC 985-605 indicates that fees in arrangements involving extended payment terms may not be fixed or determinable. This is the case regardless of the creditworthiness of the customer. Because a software product's continuing value may be reduced due to the subsequent introduction of enhanced products (either by the vendor or another software vendor), the possibility that the vendor will grant concessions to a customer to liquidate amounts due under the original terms of an arrangement or modify the licensing of a subsequent version of the licensed software increases as payment terms become longer. If a vendor cannot conclude at the outset of an arrangement that the fee is fixed or determinable, then the entire fee must be recognized as payments from the customer become due.

Identifying extended payment terms

Question 4-44 **What factors should be considered when evaluating whether an arrangement contains extended payment terms?**

Arrangements that provide payments terms that extend beyond a vendor's normal, or standard, payment terms should be deemed to include extended payment terms. As discussed in greater detail in Question 4-45, the inclusion of extended payment terms in any arrangement may indicate that the fees associated with that arrangement are not fixed or determinable. Extended payment terms may indicate the customer is relying on a future event as trigger for the payment, such as a new software release, installation, acceptance and financing.

ASC 985-605 does not define what is considered to be a "normal" payment term because the determination is vendor specific. We believe that a vendor's normal payment terms represent the terms generally extended to the majority of its customers. Further, we believe a software vendor's normal payment terms generally will not exceed three-to-six months. If a vendor concludes its normal payment terms do exceed three-to-six months, there should be a substantive business purpose for using such payment terms (other than a customer accommodation such as budgetary constraints).

A vendor's standard payment terms may vary based on the type of business or class of customer. For example, payment terms generally provided to end users may differ from those typically provided to resellers, or normal payment terms for enterprise-wide applications may be multiple monthly installments whereas normal payment terms for shrink wrap applications may be one installment due in 30 days. As a practical matter, however, we believe that most vendors will only have a few classes of customers.

Additionally, standard payment terms may differ based on business practices in various geographic locations where a vendor has operations. For example, a vendor's normal payment terms for international customers may be 90 days whereas normal payment terms for domestic customers may be 30 days.

We believe that the documentation of a software vendor's revenue recognition policies should include a definition of its standard payment terms. These terms should be determined by reference to the vendor's specific business practices and not by comparison to competitors' practices or other industry information. While such information may be helpful in understanding a vendor's business environment, we do not believe it is relevant in assessing what constitutes a specific vendor's normal payment terms.

ASC 985-605-25-34 contains a presumption that a fee is not fixed or determinable if a significant portion of the payment is not due until after expiration of the license or more than 12 months following delivery of the licensed software. For purposes of applying this paragraph, we believe that 10% or more of an arrangement fee should be presumed to constitute a significant portion of the fee (as determined by amounts relating to a software license, bundled PCS, contractual services and other elements included in an arrangement). However, the provisions of ASC 985-605-25-34 should not be read to imply that payment terms less than one year or less than the license period are, by definition, fixed or determinable. As stated above, any payment terms that are in excess of the vendor's customary business practices should be evaluated as extended payment terms.

Arrangement fees due pursuant to payment terms extending beyond one year are presumed not to be fixed or determinable unless the vendor has established a history of successfully collecting under the original payment terms without making concessions.

The following example illustrates these concepts:

Illustration 4-42: Extended payment terms

Facts

A calendar year-end software vendor enters into an agreement with a customer to perpetually license Product A for $1 million on 31 December 20X1. The license arrangement includes first year PCS with optional PCS renewals for years 2 and 3 priced at VSOE of fair value. Payment terms are as follow:

$250,000 due 31 January 20X2

$250,000 due 30 April 20X2

$250,000 due 31 July 20X2

$250,000 due 31 October 20X2

The vendor's standard payment terms are net 45 days.

Analysis

The arrangement includes extended payment terms. The vendor's standard payment terms are net 45 days, but, in this case, the vendor has agreed to allow the customer to pay $750,000 of the $1 million of arrangement consideration after 45 days.

It would not be appropriate for the vendor to recognize revenue for the arrangement before the payments become due unless it has a history of offering extending payment terms and successfully collecting under the original payment terms without making concessions. Accordingly, if all of the other basic revenue recognition criteria of ASC 985-605 have been met, the vendor would recognize revenue as the payments become due. In this example, the vendor would recognize $250,000 of license revenue in each of the four calendar quarters of 20X2.

Overcoming the presumption that extended payments are not fixed or determinable

Question 4-45 **Can a vendor overcome the presumption that fees due pursuant to arrangements containing extended payment terms are not fixed or determinable?**

As discussed in Question 4-44, if payments are due more than one year from the delivery of the licensed software or after expiration of the software license, there is a rebuttable presumption that the fees are not fixed or determinable. However, even if an arrangement specifies that payments are due less than twelve months from delivery of the software, if the payment terms are longer than the vendor's customary terms, this may indicate that the arrangement's fee is not fixed or determinable.

In evaluating whether extended payment terms indicate that an arrangement's fees are not fixed or determinable, the vendor's history of using such terms should be considered. The fees associated with an arrangement that contains extended payment terms still may be deemed fixed or determinable (even if such payments are beyond one year) if the vendor can demonstrate that it has a history of successfully collecting under the original payment terms without making concessions (Question 4-47 discusses what constitutes a concession). The history should consist of a substantive number of completed historical transactions with similar types of customers, products, economics and length of payment terms as the current arrangement. The economics of payment terms should be evaluated carefully for both the length of the payment term as well as the underlying payment stream within the term of the arrangement. For example, we do not believe a history of three-year quarterly payment terms would establish a relevant history for a three-year annual payment term or that a history of three annual payments would establish a relevant history for one payment due at the end of three years.

To support an assertion that fees due pursuant to arrangements containing extended payment terms are fixed or determinable, a vendor should prepare an analysis that includes a substantive number of completed historical transactions with similar types of customers, products, economics and length of payment terms to the current arrangement. This analysis should compare the timing of the actual payments received to the contractual payment terms of the arrangements and determine if a concession was granted during the period of payments. This analysis, once prepared, should be regularly updated and reevaluated to ensure that the vendor can continue to support that it has a history of collecting without providing concessions. For example, if a vendor granted a concession in anything other than a de minimus level of recent transactions, it may determine it has established a history of granting concessions that will affect future considerations of whether fees in arrangements containing extended payment terms are fixed or determinable (see Question 4-49).

When evaluating whether a vendor's history supports a conclusion that fees due pursuant to arrangements containing extended payment terms are fixed or determinable, care must be taken to ensure that the vendor's history is relevant to the transaction under evaluation. Historical experiences with extended payment terms may not be relevant to the introduction of a new product, to an extension of payment terms beyond a previous customary range or to a different type of license. For example, it may not be appropriate for a vendor to use its history of offering extended payment terms in arrangements for perpetual licenses of Product A when evaluating an arrangement relating to a time-based license of Product A or for a perpetual license of Product B. In evaluating a vendor's history, the historical arrangements should be comparable to the current arrangement's terms and circumstances to conclude that the history is relevant.

As noted above, for vendors to demonstrate a history of successfully collecting under extended payment terms without making concessions, a substantive number of completed comparable historical transactions are required. Determining whether a vendor has a sufficient amount of completed transactions with comparable payment terms may require the exercise of professional judgment. We believe that the level of evidence required is sufficiently high that many vendors may be unable to conclude that sufficient relevant experience exists.

Additionally, even if a vendor has a history of collecting payments due under extended payment terms without making concessions, ASC 985-605-25-13 and 25-14 require that the software vendor must not intend to provide refunds or concessions that are beyond the provisions of the arrangement. If, for whatever reason, a vendor anticipates it is likely a future concession will be provided to a customer, a conclusion that fees associated with the arrangement are fixed or determinable would not be appropriate.

The following excerpt from the implementation guidance included in ASC 985-605 provides guidance relating to the factors that should be considered when determining if a vendor can overcome the presumption that fees associated with an arrangement containing extended payment terms are not fixed or determinable.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Overcoming the Presumption of Concessions in Arrangements with Extended Terms

985-605-55-22

Paragraph 985-605-25-34 indicates that, if a significant portion of the software licensing fee is not due until after expiration of the license or more than 12 months after delivery, the licensing fee shall be presumed not to be fixed or determinable. That presumption may be overcome by evidence that the vendor has a standard business practice of using long-term or installment contracts and a history of successfully collecting under the original payment terms without making concessions.

985-605-55-23

To have a history of successfully collecting under the original payment terms without making concessions, a vendor would have to have collected all payments as due under comparable arrangements without providing concessions. For example, one year of payments under three-year payment arrangements would not provide sufficient history because all of the payments under the contracts would not yet have been paid as due.

985-605-55-24

In addition to a history of collecting payments as due without making concessions, paragraphs 985-605-25-13 through 25-14 require that the software vendor not intend to provide refunds or concessions that are beyond the provisions of the arrangement.

985-605-55-25

In evaluating a vendor's history, the historical arrangements should be comparable to the current arrangement relative to terms and circumstances to conclude that the history is relevant. Examples of factors that should be assessed in this evaluation include the following:

a. Similarity of customers, for example:

    1. Type or class of customer. New arrangements with substantially the same types and class of customer indicate that the history is relevant. Significant differences call into question the relevance of the history.

b. Similarity of products included, for example:

    1. Types of products. Similarity in the types of products included under the new license arrangement (for example, financial systems, production planning, and human resources) indicate that the history is relevant.

    2. Stage of product life cycle. Product maturity and overall stage within its product life cycle should be considered when assessing the relevance of history. The inclusion of new products in a license arrangement would not automatically preclude the vendor from concluding that the software products are comparable. For example, if substantially all of the products under one license arrangement are mature products, the inclusion of a small number of newly developed products in a subsequent arrangement may not change the overall risk of concession and economic substance of the subsequent transaction.

    3. Elements included in the arrangement. No significant differences in the nature of the elements included in the arrangements indicate that the history is relevant. Significant rights to services or discounts on future products included in some arrangements, but not others, may indicate that there is a significant difference between the arrangements. For example, a

history developed for arrangements that included bundled postcontract customer support and rights to additional software products would not be comparable to an arrangement that does not include these rights.

c. Similarity of license economics, for example:

1. Length of payment terms. For the history to be considered relevant, the overall payment terms should be similar. Although a nominal increase in the length of payment terms may be acceptable, a significant increase in the length of the payment terms may indicate that the terms are not comparable.

2. Economics of license arrangement. The overall economics and term of the license arrangement should be reviewed to ensure that the vendor can conclude that the history developed under a previous arrangement is relevant, particularly if the primary products licensed are near the end of their lives and the customer would not be entitled to the updated version under a postcontract customer support arrangement.

The following examples illustrate these concepts:

Illustration 4-43: Sufficient relevant vendor history

Facts

A software vendor enters into a license agreement with a customer for a perpetual license of Product A bundled with one year of PCS for $1,000,000. The vendor has VSOE of fair value for the PCS. The $1,000,000 is due in monthly installments over three years. The vendor has a history of successfully collecting under the original payment terms without making concessions for this type of three-year agreement. The vendor's history includes a substantive number of similar completed transactions.

Analysis

In this example, the vendor has sufficient relevant history of successfully collecting under the original payment terms without making concessions to overcome the presumption that the fee is not fixed or determinable.

Illustration 4-44: Insufficient relevant vendor history

Facts

Assume the same facts as in Illustration 4-43 above, except that the $1,000,000 is due in monthly installments over five years. The vendor has a history of successfully using three-year payment terms but has not previously provided five-year payment terms to a customer.

Analysis

In this example, the vendor does not have sufficient relevant history to overcome the presumption that the fee is not fixed or determinable. The vendor has a history of successfully collecting arrangements with three-year monthly payment terms but not five–year monthly payment terms.

The economics of the payment terms are not similar between a three-year and five-year arrangement. In order to overcome the presumption that the fees included in such an arrangement are not fixed or determinable, the vendor would need to successfully complete a substantive number of transactions to establish history for five-year monthly payments.

Illustration 4-45: Type of license

Facts

Assume the same facts as in Illustration 4-44 above, except that the vendor enters into a three-year license for Product A instead of a perpetual license. The vendor does not have a history of providing extended payment terms in time-based license arrangements.

Analysis

Because the vendor does not have a history of offering extended payment terms in time-based license arrangements, it does not have sufficient relevant history to overcome the presumption that the fee is not fixed or determinable. The payment history for perpetual license arrangements is not an acceptable surrogate for payment history for time-based license arrangements as the underlying economics of perpetual and time-based license agreements are different.

Impact of subsequent cash receipts on the determination of whether fees are fixed or determinable

Question 4-46 **If a software vendor enters into an arrangement including extended payment terms and cannot conclude at the origination of the agreement that the fees are fixed or determinable, but collects the fees due under the arrangement prior to the issuance of the financial statements, does the subsequent cash receipt provide sufficient evidence to conclude the licensing fee is fixed or determinable, allowing the vendor to recognize revenue in the unissued financial statements?**

No. The following excerpt from the implementation guidance included in ASC 985-605 discusses this situation in greater detail.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Subsequent Cash Receipt when Vendor Does Not Have a Practice of Providing Extended Terms

985-605-55-26

Paragraph 985-605-25-34 states that the presumption that an extended payment term license fee due more than 12 months after delivery of the software is not fixed or determinable may be overcome by evidence that the software vendor has a standard business practice of using long-term or installment contracts and has a history of successfully collecting under the original payment terms without making concessions.

985-605-55-27

For example, on December 1, a calendar-year-end software vendor enters into a licensing arrangement with payments due in installments over two years, beginning in May of the following year. After December 31 but before the vendor issues its year-end financial statements (or before the financial statements are available to be issued, as discussed in Section 855-10-25), the customer pays the full amount due. As of December 1, the software vendor has met all other conditions of revenue recognition except that it does not have a standard business practice of using long-term or installment contracts.

985-605-55-28

Paragraph 985-605-25-35 requires that the software vendor determine whether the fee is fixed or determinable at the outset of the arrangement, which in this situation is December 1. The subsequent cash receipt does not provide sufficient evidence to render the licensing fee as fixed or determinable and does not allow the software vendor to recognize revenue in the December 31 financial statements.

985-605-55-29

The only circumstances sufficient to overcome the presumption that the license fee is not fixed or determinable are that the software vendor has both of the following:

a. A standard business practice of using long-term or installment contracts

b. A history of successfully collecting under the original payment terms without making concessions.

985-605-55-30

Because the software vendor met all other conditions of revenue recognition, it would recognize revenue in the period it receives payment in full directly from the customer (see paragraph 985-605-55-15).

See Question 4-59 for discussion of the effect of prepayments on software revenue recognition.

What is a concession?

Question 4-47 **What kinds of changes to an arrangement with a customer should be considered a concession by the vendor?**

Broadly defined, a concession can be any action undertaken on behalf of a specific customer by a vendor that is not required pursuant to the terms of the original contractual arrangement between the parties. While it is impossible to create a comprehensive list of the nature or types of all concessions, there are general rules to apply when evaluating specific facts and circumstances. Potential concessions should be evaluated by assessing whether, if the terms of the potential concession had been known at the outset of the arrangement, the vendor's action would have:

- Affected the amount of revenue originally recognized for the arrangement
- Affected the timing of the original revenue recognition for the arrangement
- Increased the deliverables or extended the customer's rights beyond those in the original transaction

If any of the above is applicable to a vendor's action, the action is a concession.

Concessions or changes to the terms and conditions of an original agreement may be difficult to identify as they are not always documented as amendments to the original arrangement. Additionally, the decision to grant a concession to a customer typically occurs outside of the accounting department. A company's policies and procedures should ensure concessions are granted only after receiving the appropriate approval. Additionally, a vendor should have the appropriate controls and procedures in place to identify concessions, if any should occur, and report them to the appropriate accounting and finance personnel, who can assess the implications of such concessions on the company's revenue recognition practices.

The following paragraphs provide guidance relating to the identification of concessions.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Concessions by a Software Vendor to Customers

985-605-55-18

Paragraph 985-605-25-33 states that because a product's continuing value may be reduced due to the subsequent introduction of enhanced products by the vendor or its competitors, the possibility that the vendor still may provide a refund or concession to a creditworthy customer to liquidate outstanding amounts due under the original terms of the arrangement increases as payment terms become longer. Concessions by a software vendor may take many forms and include, but are not limited to, any of the following kinds of changes to the terms of an arrangement:

a. Changes that would have affected the original amount of revenue recognized

b. Changes that reduce the arrangement fee or extend the terms of payment

c. Changes that increase the deliverables or extend the customer's rights beyond those in the original transaction.

985-605-55-19

Examples of concessions by a software vendor that reduce an arrangement fee or extend the terms of payment include the following:

a. Extending payment due dates in the arrangement (except when the extension is due to credit problems of the customer)

b. Decreasing total payments due under the arrangement (except when the decrease is due to credit problems of the customer)

c. Paying financing fees on a customer's financing arrangement that was not contemplated in the original arrangement

d. Accepting returns that were not required to be accepted under the terms of the original arrangement.

985-605-55-20

Examples of concessions by a software vendor that increase the deliverables include the following:

a. Providing discounted or free postcontract customer support that was not included in the original arrangement

b. Providing various types of other discounted or free services (beyond those provided as part of the vendor's normal product offerings or warranty provisions), upgrades, or products that were not included in the original arrangement

c. Allowing the customer access to products not licensed under the original arrangement without an appropriate increase in the arrangement fee

d. For term licenses, extending the time for a reseller to sell the software or an end user to use the software

e. For limited licenses, extending the geographic area in which a reseller is allowed to sell the software, or the number of locations in which an end user can use the software.

985-605-55-21

Although the nature of a concession may vary by type of arrangement, many of the concessions described in the preceding two paragraphs could be granted for any type of license arrangement regardless of its form (that is, term arrangement, perpetual arrangement, site license arrangement, enterprise license arrangement, and so forth). Examples of changes to the terms of an arrangement that are not concessions include the following:

a. Changes that increase the deliverables with a corresponding appropriate increase in the arrangement fee

b. Changes that eliminate the software vendor's delivery obligation without a refund of cash.

The following examples illustrate these concepts:

Illustration 4-46: Extension of payment terms

Facts

On 31 December 20X1, a calendar year-end software vendor enters into an arrangement with a creditworthy customer to perpetually license 1,000 seats of Product X for $1 million plus PCS priced at 15% of the software license fee, or $150,000 per year. The PCS is priced at VSOE of fair value. The vendor's standard payment terms for similar customers are two equal payments, one due at contract origination and the second due on the first anniversary of contract origination. The vendor has established a history of successfully collecting in full under these payment terms without making concessions. In July 20X2, the customer requests, and the vendor grants, a one-year extension on the second and last payment. No evidence exists to indicate that the extension was granted due to credit problems of the customer.

Analysis

The vendor only has a history of successfully collecting two annual payments without making concessions (see Question 4-45). The revised payment terms are over a three-year period. If the revised payment terms were known at the outset of the arrangement, the vendor would have concluded the fee was not fixed or determinable. Accordingly, allowing the customer to extend the due date for the second payment by one year represents a concession.

Assuming the vendor recognized revenue relating to the software license when the software was delivered at the outset of the arrangement and recognized the fees relating to the initial PCS period ratably over the first year of the license, no accounting is required at the date of the concession as it did not create a new undelivered element in the arrangement and the collectibility of the amounts remains probable. However, this concession must be included as an exception in the vendor's analysis to evaluate if it has a history of successfully collecting under the original payment terms without granting concessions.

This conclusion might be different if evidence existed that indicated that the extension of the payment due date was in response to credit problems of the customer. If the extension were granted to a customer originally deemed creditworthy but that later experienced financial difficulties in an attempt by the vendor to maximize the amount that might ultimately be obtained from the customer, the extension should not be deemed a concession. However, a bad debt provision would be required if collectibility was no longer probable.

Illustration 4-47: Reduction in fees

Facts

Assume the same facts as Illustration 4-46 above, except that in December 20X2, the customer pays half of the final payment and indicates to the vendor that it will not pay the remaining license fees due to dissatisfaction with the licensed product. The vendor agrees to the reduction in fees as an accommodation to the customer. No evidence exists to indicate that the reduction was granted due to credit problems of the customer.

Analysis

The vendor has accepted a reduction in fees due pursuant to an arrangement with a creditworthy customer. In this example, the concession resulted in a reduction in the amounts expected to be received under the original arrangement. Accordingly, the reduction in payments represents a concession.

Assuming the vendor recognized revenue relating to the software license when the software was delivered at the outset of the arrangement and recognized the fees relating to the initial PCS period ratably over the first year of the license, this concession should be accounted for as a reduction in revenue in the period the concession is granted.

In this example, if the vendor did not agree to the reduction in payments as a customer accommodation, but ultimately did not collect from the customer, it may assert that the reduction is not a concession because it did not agree to the reduction in the contractual fees. To support such an assertion, however, we believe a vendor must demonstrate attempts to enforce the contractual payment terms with evidence including, but not limited to, formal correspondence demanding payment, notices of default, the use of collection agencies and termination of the customer's rights to PCS.

Illustration 4-48: Additional new product(s) or services are provided without the appropriate additional consideration

Facts

Assume the same facts as Illustration 4-46 above, except that the vendor also regularly licenses Product Y for $2,000 per seat on a standalone basis to other customers. On 31 March 20X2, the vendor delivers 10 licenses of Product Y to the customer free of charge. The original arrangement with the customer did not provide a right of return or exchange for the licensed software (Product X).

Analysis

The vendor provided the 10 licenses of Product Y without an appropriate corresponding increase in the arrangement fee. In substance, it appears that the vendor is providing a credit for a price reduction in the purchase of Product X and applying it to the purchase of Product Y. The arrangement did not provide for a right of return or exchange. This is a concession because had the vendor been obligated to deliver Product Y at the outset of the arrangement, that would have reduced the amount of the revenue that could have been recognized for Product X.

Assuming the vendor recognized revenue relating to the license of Product X when the software was delivered at the outset of the arrangement and recognized the fees relating to the initial PCS period ratably over the first year of the license, no accounting is required at the date of the concession as the concession did not create a new undelivered element in the arrangement (as product Y was delivered at the time the concession was granted). However, this concession must be included as an exception in the vendor's analysis to evaluate if it has a history of successfully collecting under the original payment terms without granting concessions.

Illustration 4-49: PCS provided without appropriate payment from the customer

Facts

Assume the same facts as Illustration 4-46 above, except that on 31 December 20X2, the customer does not renew PCS. However, the vendor continues to provide PCS services. In July 20X3, the customer renews the PCS arrangement for $150,000 for the period from 1 July 20X3 to 30 June 20X4. The customer does not pay fees for the PCS services provided by the vendor during the period from 1 January to 30 June 20X3.

Analysis

The vendor provided the customer with six months of free PCS services, which was not included in the original contractual terms and conditions of the arrangement. Had it been known at the outset of the arrangement that the initial PCS period bundled with the license of the software was 18 months instead of one year, amounts otherwise attributed to the software license would have been allocated to PCS and recognized over the initial 18 month PCS period. Accordingly, the provision of six months of PCS services that was not in accordance with the original contractual terms of the arrangement is a concession.

This concession altered the timing of the revenue recognized under the arrangement but did not create a new undelivered element, as the free service period ended on the date the subsequent PCS arrangement was entered into. Assuming that it was not known that the PCS services would be provided during the six month period ending 30 June 20X3 prior to commencement of that period, no accounting is required as of the date the concession is identified. However, this concession must be included as an exception in the vendor's analysis to evaluate if it has a history of successfully collecting under the original payment terms without granting concessions.

Illustration 4-50: Customer allowed to return licensed software

Facts

Assume the same facts as Illustration 4-46 above, except that on 30 June 20X2, the vendor accepts a return of 100 seats of Product X and refunds $100,000 to the customer. The original arrangement with the customer did not provide a right of return or exchange for the licensed software (Product X).

Analysis

The vendor extended the rights provided to the customer under the original agreement by allowing the return. If this right of return was known at the outset of the arrangement, the vendor would have been required to evaluate the right and determine the appropriate accounting pursuant to the right of return guidance (see Chapter VI). Accounting for the right of return could have altered the pattern of revenue recognition for the arrangement. Accordingly, allowing the customer to return the 100 licenses of Product X is a concession.

Assuming the vendor recognized revenue relating to the license of Product X when the software was delivered at the outset of the arrangement, and recognized the fees relating to the initial PCS period ratably over the first year of the license, the refund should be accounted for as a reduction of revenue in the period the concession was granted. This action must be evaluated to determine if the original accounting for the arrangement was in error. Material errors included in previously issued financial statements should be reported as prior-period adjustments by restating the prior period financial statements in accordance with the guidance provided by ASC 250, Accounting Changes and Error Corrections. Additionally, this concession must be included as an exception in the vendor's analysis to evaluate if it has a history of successfully collecting under the original payment terms without granting concessions.

Illustration 4-51: Customer allowed to exchange licensed software

Facts

Assume the same facts as Illustration 4-46 above, except that on 30 June 20X2, the vendor allows the customer to exchange 100 seats of Product X for 50 seats of Product Y. There are more than minimal differences in price, features and functionality between Products X and Y.

The original arrangement with the customer did not provide a right of return or exchange for the licensed software (Product X). At the date the arrangement was executed, the vendor did not have a history of granting concessions and no concession was anticipated in connection with this arrangement.

Analysis

The vendor extended the rights under the original agreement by providing the customer a right of return not included in the original agreement. Because Products X and Y have more than minimal differences in price, features and functionality, had the right to exchange the licensed Product X for Product Y been included in the terms of the original agreement, that right would have been accounted for as a right of return pursuant to the right of return guidance (see Chapter VI). Accounting for the right of return could have altered the pattern of revenue recognition for the arrangement. Accordingly, allowing the customer to exchange 100 seats of Product X for 50 seats of Product Y is a concession.

Assuming the vendor recognized revenue relating to the license of Product X when the software was delivered at the outset of the arrangement and recognized the fees relating to the initial PCS period ratably over the first year of the license, no accounting is required at the date of the concession, as it did not create a new undelivered element in the arrangement (Product X was returned and Product Y was delivered on the date of the concession). This action must be evaluated to determine if the original accounting for the arrangement was in error. Material errors included in previously issued financial statements should be reported as prior-period adjustments by restating the prior period financial statements in accordance with the guidance provided by ASC 250. Additionally, this concession must be included as an exception in the vendor's analysis to evaluate if it has a history of successfully collecting under the original payment terms without granting concessions.

These types of transactions may be referred to as "quid pro quo" transactions in which the customer's decision to purchase additional product is predicated on the vendor providing the customer with a right that was not included in the original arrangement, such as a credit from the original transaction in the form of a right of return. While such a transaction may make good business sense and may result in incremental revenue to the vendor, it is still a concession. The vendor must consider the implications of granting such concessions when determining the appropriate accounting for future transactions including extended payment terms.

Vendor actions that are not concessions

Question 4-48 **Question 4-47 explains that any action undertaken on behalf of a customer by a vendor that is not required pursuant to the terms of the original contractual arrangement between the parties may be a concession. What types of actions would not constitute a concession?**

An amendment to an agreement is not a concession if it 1) increases the products or services to be delivered by the vendor to the customer with a corresponding appropriate increase in the arrangement fee, 2) reduces or eliminates a vendor's obligation to deliver a contracted-for product or service without a refund of cash or a reduction in the amounts due from the customer or 3) reduces or eliminates a vendor's obligation to deliver a contracted-for product or service for a reduction in fees that is commensurate with the reduction in the vendor's obligations. Additionally, the provision of nominal amounts of products or services to a customer in connection with marketing and promotional activities generally is not considered a concession.

The following examples illustrate these concepts:

Illustration 4-52: Additional product for a corresponding increase in fees

Facts

On 31 December 20X1, a calendar year-end software vendor enters into an arrangement with a creditworthy customer to perpetually license 1,000 seats of Product X for $1,000,000 plus PCS priced at 15% of the software license fee, or $150,000 per year. Product X is sold at a discount of 50% from list price. The PCS is priced at VSOE of fair value. The vendor also sells perpetual software licenses of Product Y. The vendor's standard payment terms are as follows: 60% due net 30 days, 40% due net 90 days. On 31 March 20X2, the vendor licenses and delivers 1,000 seats of Product Y to the same customer for $2,000,000 representing a 50% discount from list price, a discount that is customary for similarly situated customers purchasing Product Y separately.

Analysis

This is not a concession as the vendor licensed the 1,000 seats of Product Y for an appropriate amount of additional consideration.

Illustration 4-53: Promotional activities

Facts

Assume the same facts as Illustration 4-52 above, except that on 30 June 20X2, the vendor offers $5,000 of "free" consulting services to all customers who have licensed more than $1,000,000 of software in an attempt to broaden customer awareness of the range of services that it offers.

Analysis

This is not a concession as the amount of "free" services is nominal relative to the initial transaction, and the offer is made to an entire class of customers as a new promotion. Concessions are typically additional rights provided to a specific customer.

Evaluating whether a vendor has established a history of concessions

Question 4-49 **What factors should be evaluated to determine if a vendor has established a history of granting concessions in arrangements containing extended payment terms?**

Vendors that utilize arrangements containing extended payment terms may, from time to time, provide a concession to a customer prior to the collection of all fees due under the terms of the original agreement. Determining when and how many concessions can be provided to customers by a vendor before it establishes a history of granting concessions that would preclude it from being able to subsequently conclude that any fees due pursuant to arrangements containing extended payment terms are fixed or determinable at the outset of the arrangement will be dependent on the facts and circumstances and will require the use of professional judgment.

When assessing a vendor's history of providing concessions, the following factors should be considered:

- *What caused the vendor to provide the concession (i.e., what are the vendor's motivations in providing the concession)?* For example, was a concession granted due to an isolated case of customer dissatisfaction with the vendor's products or services, or is the concession indicative that the continuing value of the vendor's products or services to the customer has been reduced due to the subsequent introduction of enhanced products by the vendor or its competitors?

If the motivations that led to the vendor agreeing to provide the concession are likely to occur again, this would be indicative of a pattern of concessions that would preclude a vendor from being able to conclude that any fees due pursuant to arrangements containing extended payment terms are fixed or determinable at the outset of the arrangement.

- *What is the number and nature of concessions historically granted? Is a concession an isolated incident or indicative of a developing pattern*? A few concessions granted relatively far apart in time or a few concessions in comparison to the volume of successfully conducted extended payment term arrangements, and that have been granted for differing reasons, may not be indicative of a pattern of concessions that would preclude a vendor from being able to conclude that any fees due pursuant to arrangements containing extended payment terms are fixed or determinable at the outset of the arrangement.
- *What was the amount of the concession as a percentage of the total arrangement consideration*? Concessions for which the value is insignificant in comparison to the overall arrangement consideration received by the vendor are generally not indicative of a pattern of concessions that would preclude a vendor from being able to conclude that any fees due pursuant to arrangements containing extended payment terms are fixed or determinable at the outset of the arrangement. For purposes of evaluating this criterion, we believe that any concession whose value is equal to or greater than 10% of the arrangement consideration should be considered significant.

Although each situation must be evaluated based on the applicable facts and circumstances, we generally believe that anything other than a de minimus amount of concessions in both dollar value or frequency, when compared to the volume of successfully conducted extended payment term arrangements, constitutes a history of concessions that would preclude a vendor from being able to conclude that any fees due pursuant to arrangements containing extended payment terms are fixed or determinable at the outset of the arrangement. Additionally, an increased frequency of recent concessions may call this matter into question even if past experience was far superior.

The following examples illustrate these concepts:

Illustration 4-54: Vendor agrees to provide insignificant additional services

Facts

A software vendor enters into a perpetual license agreement with a customer to license a software product and to provide installation and training services associated with the licensed product. The agreement requires the vendor to provide 1,000 hours of installation and training services. Total arrangement consideration of $2,000,000 is due as follows: $1,000,000 due 30 days from contract origination, and four equal payments of $250,000 due every three months thereafter. The vendor's standard payment terms are net 90 days.

Near the end of the training phase, the customer realizes the training of its entire staff will require two days of training (16 hours) in excess of the contracted-for 1,000 hours. The customer requests the vendor to provide the services for no additional charge. The vendor agrees to do so. The vendor has agreed to provide like amounts of services in similar situations in the past.

Analysis

Given the nominal amount of the additional services that the vendor has agreed to provide to this customer, and has agreed to provide to customers in similar situations in the past, this does not establish a history of concessions that would preclude the vendor from being able to conclude that fees due pursuant to arrangements containing extended payment terms are fixed or determinable at the outset of the arrangement.

Illustration 4-55: Vendor agrees to provide additional services that are more than insignificant
Facts Assume the same facts as Illustration 4-54 above, except that near the end of the training phase, the customer requests the vendor provide an additional 100 hours of training services for no additional charge. The vendor agrees to do so. **Analysis** This is a concession as the "free" additional hours are more than nominal. The vendor should receive the appropriate amount of additional consideration for the additional services provided. By not charging the customer for these additional services, the vendor has provided a more than nominal discount on the services provided to the customer. If the vendor has agreed to provide a like amount of services to customers in similar situations in the past, this would establish a history of concessions precluding it from being able to conclude that fees due pursuant to arrangements containing extended payment terms are fixed or determinable at the outset of the arrangement.

When a vendor asserts at the outset of an arrangement that the fees are fixed or determinable, it is representing that the terms and conditions of the arrangement are complete and not subject to change, and that all of the elements of the arrangement have been identified. A vendor that establishes a history of granting concessions loses the ability to assert that current arrangements are not subject to change. Accordingly, if it is concluded that a vendor has a history of granting concessions in arrangements containing extended payment terms, the vendor generally will be prohibited from recognizing revenues relating to an arrangement containing extended payment terms prior to the fees becoming due.

In such cases, it is not appropriate to recognize revenue and a related allowance for estimated potential future concessions at the outset of an arrangement. There is generally no reliable, objective and verifiable way for a vendor to estimate the frequency or value of potential concessions as historical experience may not be indicative of the pattern and magnitude of concessions the vendor may grant in the future. Additionally, to recognize revenue, the basic criterion that fees are fixed or determinable must be satisfied. It is not appropriate to reserve for potential concessions at the same time an assertion is made that the fees are fixed or determinable and are not likely to be reduced due to future concessions.

Numerous restatements have resulted from cases where management inappropriately asserted that arrangement fees were fixed or determinable at the outset of the arrangement. However, with hindsight, these vendors discovered the history utilized to make such an assertion was not reliable, relevant or sufficient. This incorrect assertion resulted in an error in the original accounting treatment. Therefore, a vendor should have the appropriate controls in place to identify concessions and the ability to monitor and evaluate the implications of granting the concessions, if any.

Extended payment terms relating to multiple years of PCS bundled with a software license

Question 4-50 **A vendor sells a perpetual software license bundled with multiple years of PCS. VSOE of fair value exists for PCS. The payment terms of the arrangement specify that amounts equal to the VSOE of fair value of one year of PCS are due at the beginning of years two and three. The remainder of the fees, relating to the software license and the first year of PCS, must be paid in accordance with the vendor's standard payment terms. May the payments relating to the software license and the first year of PCS be considered fixed or determinable at the outset of the arrangement?**

In such situations, we believe that the fees relating to the software license and the initial PCS period may be considered fixed or determinable at the outset of the arrangement because such fees are due and payable within the vendor's standard payment terms.

Although payments are to be received in periods that are beyond the vendor's standard payment terms, the amounts due are equal to the VSOE of fair value of PCS and coincide with the commencement of years two and three of the bundled PCS periods. If the customer only purchased the license and one-year PCS, the fees would be fixed or determinable.

See Question 4-61 for a discussion of the ordering of revenue recognition in a multiple-element arrangement when the fees are not fixed or determinable.

Effect of vendor financing arrangements with third parties on the determination of whether an arrangement's fee is fixed or determinable

Question 4-51 **What effect do financing arrangements with third parties have on the assessment of whether fees included in an arrangement are fixed or determinable?**

Financing arrangements are common in the software industry due to the high cost of acquiring and implementing software packages. A vendor may use financing arrangements to manage its cash flows or its days' sales outstanding (DSO). Alternatively, a vendor may work with third parties to assist customers in obtaining financing for purchases of software or services (see Question 4-53).

Prior to the adoption of the guidance in ASC 985-605, vendors often would liquidate outstanding amounts due pursuant to arrangements containing extended payment terms through factoring or similar arrangements with third parties so that they might recognize revenues for the arrangement prior to collection of amounts due from the customers. However, pursuant to ASC 985-605, such transactions do not "cure" an assessment that fees associated with an arrangement containing extended payment terms are not fixed or determinable because the financing arrangements do not change the nature or structure of the transaction between the vendor and customer.

The assessment of whether a fee is fixed or determinable is performed once, at the outset of the arrangement between the vendor and the customer. If a fee cannot be assessed as fixed or determinable at that time, revenue only can be recognized at the earlier of when the payment becomes due or when the cash is received from the customer without vendor participation in a financing arrangement.

The following excerpt from the implementation guidance within ASC 985-605 provides clarification relating to the effects of transferring amounts due pursuant to arrangements containing extended payment terms to third parties.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Transfer by Vendor of Extended Payment Rights to Independent Third Party Without Recourse

985-605-55-31

Paragraph 985-605-25-34 states that any extended payment terms in a software licensing arrangement may indicate that the fee is not fixed or determinable. The licensing fee is presumed not to be fixed or determinable if payment of a significant portion of the fee is not due until after expiration of the license or more than 12 months after delivery.

985-605-55-32

The presumption that the licensing fee is not fixed or determinable is not overcome if, at the outset of the arrangement or subsequently, the vendor receives cash on the transfer of the extended payment term arrangement. That is true even if the extended payment term arrangement is irrevocably transferred or otherwise converted to cash without recourse to the vendor. The difference in this situation, as compared to the situation in paragraph 985-605-55-15, which addresses prepayments received directly from customers, is that the transfer of the extended payment term arrangement does not change the nature or structure of the transaction between the vendor and customer. Therefore, the presumption in paragraph 985-605-25-34 has not been overcome.

See Question 4-59 for discussion of the effect of prepayments on software revenue recognition.

The following example illustrates these concepts:

Illustration 4-56: Vendor's financing of an arrangement that includes extended payment terms

Facts

A software vendor enters into a $5 million perpetual license arrangement with a customer. The payment terms are as follows: $1.25 million due at contract signing followed by 24 equal monthly payments. Concurrent with the execution of the software licensing arrangement with the customer, the vendor factors the receivable without recourse with an independent third party. The vendor receives $4.5 million ($5 million less factoring charges) on the execution of the financing arrangement. The customer remains obligated to make payments under the original terms of the software licensing arrangement.

The vendor's standard payment terms are net 90 days. The vendor does not have a history of successfully collecting under the original payment terms without making concessions for a substantive number of completed historical arrangements with similar types of customers, products, economics and length-of-payment terms as the current arrangement.

Analysis

At the outset of the arrangement, the fee cannot be considered fixed or determinable due to its extended payment terms. The financing arrangement does not change this assessment. Although the vendor was paid in full, the payment was not made by the customer. Therefore, revenue should be recognized at the earlier of the date payments become due and payable or the date payments are made by the customer.

If a vendor concludes that amounts due pursuant to an arrangement containing extended payment terms are not fixed or determinable at the outset of the arrangement, any transfer of such receivables to a third party should not be accounted for as a transfer of a financial instrument pursuant to ASC 860, *Transfers and Servicing*, because prior to revenue recognition that results in a recognized accounts receivable, no financial asset exists that can be transferred pursuant to such guidance. Rather, the transfer should be accounted pursuant to the provisions of the guidance on sales of future revenues in ASC 470, *Debt*. Conversely, if a vendor is able to conclude that fees due pursuant to an arrangement containing extended payment terms are fixed or determinable and recognizes revenue at the outset of the arrangement (see Question 4-45), a subsequent transfer of any receivable associated with the amount of revenue recognized should be accounted for in accordance with ASC 860.

The guidance in ASC 470 on sales of future revenues specifies that any of the following factors creates a rebuttable presumption that the proceeds from any such transaction should be classified as debt by a vendor:

- The transaction does not purport to be a sale (i.e., the form of the transaction is debt)
- The enterprise has significant continuing involvement in the generation of cash flows due to the investor
- The transaction is cancelable by either the enterprise or the investor through payment of a lump-sum or other transfer of the enterprise's assets

- The investor's rate of return is explicitly or implicitly limited by the terms of the transaction,
- Variations in the enterprise's revenue or income underlying the transaction have only a trifling effect on the investor's rate of return
- The investor has any recourse to the enterprise relating to the payments due to the investor

In the majority of arrangements involving the sale or licensing of software, we believe that the vendor will have significant continuing involvement in the generation of cash flows due to the investor because it will provide PCS, and potentially other services, to the customer. Accordingly, we expect that in most transactions to which the provisions of ASC 985-605-55-31 and 55-32 are applicable, the payments received by the vendor from the third party will be recorded as debt, rather than as deferred revenue, based on the provisions of ASC 470.

If the proceeds of a vendor's sale of amounts due pursuant to an arrangement containing extended payment terms that are not deemed fixed or determinable at the outset of the arrangement are recorded as debt, the timing of revenue recognition for the arrangement with the customer generally would not be affected. That is, revenue would be recognized as payments from the customer become due, if all of the other basic revenue recognition criteria of ASC 985-605 have been met.

Customer financing of arrangements without extended payment terms without vendor participation

Question 4-52 **If a customer obtains financing from a third party for the purchase of software or services without involvement of the vendor, and the arrangement between the vendor and the customer does not contain extended payment terms, does the financing transaction have any effect on the vendor's accounting for the transaction?**

If a customer obtains financing without participation of the software vendor, there generally is no effect on the vendor's accounting for the transaction. However, if the vendor provides the customer with extended payment terms, consideration must still be given to determining that the vendor has a history of successfully collecting under the original payment terms without making concessions for a substantive number of completed historical arrangements with similar types of customers, products, economics and length-of-payment terms as the current arrangement.

The following excerpt from the implementation guidance in ASC 985-605 provides further guidance relating to the effect of customer financing transactions of arrangements without extended payment terms in which the vendor has no participation.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Effect of Customer Financing of Extended Payments

985-605-55-33

For illustrative purposes, the following implementation guidance on customer financing of extended payments assumes that the software arrangement is a single product or single element arrangement. However, the guidance also applies to multiple element arrangements. The guidance is organized as follows:

a. Customer financing with no vendor participation

b. Vendor participation in customer financing

c. Indicators of incremental risk when vendor participates in customer financing

d. Overcoming the presumption of incremental risk when vendor participates in customer financing

e. Vendor actions that may not indicate incremental risk

f. Effect of interest rate buydown in connection with customer financing

g. Additional considerations when a reseller obtains financing.

Customer Financing with No Vendor Participation

985-605-55-34

Paragraph 985-605-55-15 addresses a situation in which a customer obtains financing, without the software vendor's participation, and prepays amounts due the software vendor under previously negotiated extended payment terms. That guidance indicates that a software vendor should recognize revenue in advance of scheduled payments if amounts related to extended payment terms are received directly from customers without the software vendor's participation in its customers' financing arrangements, provided all other requirements of revenue recognition in this Subtopic are met. Paragraphs 985-605-55-31 through 55-32 indicate that a software vendor should not recognize revenue in advance of scheduled payments if amounts related to extended payment terms are received as a result of the software vendor's transfer of a customer's extended payment term obligation to a third party, without recourse to the software vendor.

985-605-55-35

The guidance referred to in the preceding paragraph relates to arrangements with extended payment terms. However, a software vendor may enter into an arrangement with an end user customer that contains customary (that is, not extended) payment terms and the end user customer may obtain, without the software vendor's participation, financing from a party unrelated to the software vendor. In such an arrangement, the software vendor would recognize revenue upon delivery of the software product, provided all other requirements of revenue recognition in this Subtopic are met.

See Question 4-59 and Question 4-60 for a discussion of the effect of prepayments on software revenue recognition.

Customer financing with vendor participation

Question 4-53 **When would a vendor's participation in a customer's financing transaction with a third party preclude a determination that an arrangement's fee is fixed or determinable?**

Software vendors may have arrangements with third parties to assist customers in obtaining financing for purchases of software or services. The nature and extent of a vendor's participation in a customer's financing transaction can have a significant effect on revenue recognition.

The key to determining when a vendor's participation in a customer's financing transaction with a third party affects the vendor's ability to determine that the arrangement's fees are fixed or determinable is in assessing whether the vendor's participation results in incremental risk that the vendor will provide a refund or concession to either the customer or the financing party. If such incremental risk exists, there is a rebuttable presumption that the fees associated with the arrangement are not fixed or determinable.

The following implementation guidance within ASC 985-605 provides a number of conditions or vendor actions that should be deemed to result in incremental risk that the vendor will provide a refund or concession.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Indicators of Incremental Risk when Vendor Participates in Customer Financing

985-605-55-38

As indicated in the preceding two paragraphs, vendor participation in the customer's financing is important to how revenue is recognized in a software arrangement that contains extended payment terms. However, a vendor may also participate in customer financing in arrangements with an end-user customer that contain customary (that is, not extended) payment terms for which the arrangement fee ordinarily would be considered fixed or determinable. For example, simultaneously with entering into a software arrangement, or before the scheduled payment due date(s), the software vendor participates in the end user customer's financing with a party unrelated to the software vendor.

985-605-55-39

A software arrangement fee is not fixed or determinable (see paragraph 985-605-25-3) if a software vendor meets either of the following conditions:

a. The vendor lacks the intent or ability to enforce the original payment terms of the software arrangement if the financing is not successfully completed.

b. In past software arrangements, the vendor altered the terms of original software arrangements or entered into another arrangement with customers, to provide extended payment terms consistent with the terms of the financing.

985-605-55-40

If a software vendor's participation in an end user customer's financing results in incremental risk that the software vendor will provide a refund or concession to either the end user customer or the financing party, there is a presumption that the arrangement fee is not fixed or determinable. Any one of the following conditions or software vendor actions would result in incremental risk and a presumption that the fee is not fixed or determinable:

a. The vendor is required to indemnify the financing party above and beyond the standard indemnification provisions that are explicitly included in the software arrangement between the software vendor and the end user customer.

b. The vendor is required to make representations to the financing party related to customer acceptance of the software that are above and beyond the written acceptance documentation, if any, that the software vendor has already received from the end user customer.

c. The vendor is obligated to take action against the customer on behalf of the financing party (such as to terminate the license agreement or any related services) if the end user customer defaults under the financing, and the action results in more than insignificant direct incremental costs. This would not apply if, as part of the original arrangement, the customer explicitly authorizes the vendor upon request by the financing party to take those specific actions against the customer and does not provide for concessions from the vendor as a result of such action.

d. The ability of the vendor to enter into another software arrangement with the customer for the same or similar product is prohibited or limited if the end user customer defaults under the financing, unless, as part of the original arrangement, the customer explicitly authorizes the vendor upon request by the financing party to take those specific actions against the customer.

e. The vendor is required to guarantee, certify, or otherwise attest in any manner to the financing party that the customer meets the financing party's qualification criteria.

f. The vendor has previously provided concessions to financing parties or to customers to facilitate or induce payment to financing parties.

g. Provisions exist that lead to the vendor's guarantee of the customer's indebtedness to the financing party.

985-605-55-41

If the presumption is not overcome, the software vendor would recognize revenue as payments from the customer become due and payable to the financing party, provided all other requirements of revenue recognition in this Subtopic are met.

See Question 4-59 for discussion of the effect of prepayments on software revenue recognition guidance. See Question 4-60 for discussion of effect of prepayments on software revenue recognition guidance when the vendor participates in customer financing.

If any of the above conditions are present, a presumption exists that an arrangement's fee is not fixed or determinable. However, this presumption can be rebutted if the vendor has a standard business practice of entering into similar arrangements with financing parties that have substantially similar provisions, has a history of not providing refunds or concessions to the customer or the financing party pursuant to those arrangements and the financier does not have recourse to the vendor.

The following excerpt from the implementation guidance in ASC 985-605 provides guidance as to assessing whether the presumption that a fee is not fixed or determinable when vendor participates in customer financing can be overcome.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Overcoming the Presumption of Incremental Risk when Vendor Participates in Customer Financing

985-605-55-42

Paragraphs 985-605-55-38 through 55-40 provide indicators of incremental risk that result in a presumption that a fee is not fixed or determinable in an arrangement in which a software vendor participates in an end user customer's financing with a party unrelated to the software vendor. However, the presumption may be overcome in certain circumstances. The software vendor should use the guidance in paragraphs 985-605-25-34 and 985-605-55-22 through 55-25.

985-605-55-43

To overcome the presumption, there should be evidence that the software vendor has a standard business practice of entering into similar arrangements with financing parties that have substantially similar provisions, and has a history of not providing refunds or concessions to the customer or the financing party.

985-605-55-44

Additionally, with respect to the incremental risk indicator in paragraphs 985-605-55-38 through 55-40, the software vendor would consider whether it has relevant history with arrangements in which it granted extended payment terms to its customers. A history of the software vendor's having granted concessions to either its customers in similar arrangements in which it provided extended payment terms or unrelated financing parties in similar arrangements in which the software vendor participated would prevent the software vendor from overcoming the presumption that the fee is not fixed or determinable.

985-605-55-45

In circumstances in which there is sufficient evidence to overcome the presumption that the fee is not fixed or determinable, the software vendor would still evaluate the nature of the incremental risk to determine if there are other accounting ramifications, such as the accounting for the software vendor's continuing involvement that results from a guarantee of the customer's indebtedness (recourse).

In contrast to the conditions specified in ASC 985-605-55-38 through 55-41, which create a presumption that fees are not fixed or determinable, other actions of a vendor do not create such a presumption. The following excerpt from the implementation guidance in ASC 985-605 discusses these actions.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Vendor Actions that May Not Indicate Incremental Risk

985-605-55-46

In connection with a software vendor's participation in an end user customer's financing of a software arrangement, the following are examples of vendor actions that generally would not cause the vendor to assume incremental risk that the vendor will provide a refund or concession to either the end user customer or the financing party:

a. The vendor introduces the customer and financing party and facilitates their discussions.

b. The vendor assists the customer in prequalifying for financing, so long as the software vendor does not guarantee, certify, or otherwise attest in any manner to the financing party that the customer meets the financing party's qualification criteria.

c. The vendor represents to the financing party that the software vendor has free and clear title to the licensed software or the right to sublicense if the vendor makes the same written representations in the software arrangement with the end user customer.

d. The vendor warrants to the financing party that the software functions according to the software vendor's published specifications if the vendor makes the same written warranty in the software arrangement with the end user customer.

e. The vendor takes action, which was explicitly authorized by the customer in the original arrangement, to terminate the license agreement or any related services, or to not enter into another arrangement for the same or similar product.

f. The vendor makes customary recourse provisions to its customer related to warranties for defective software.

Determining whether the fixed or determinable criterion has been satisfied when third-party financing is involved may require the exercise of professional judgment.

The following examples illustrate these concepts:

Illustration 4-57: Servicing receivables on behalf of a financier

Facts

A vendor maintains a relationship with a third-party financier to facilitate financing for its customers. The vendor's role in the financing transaction generally is limited to referring its customers that request financing terms to the financier and facilitating their discussions.

The vendor also has agreed to service receivables on behalf of the financing party. The vendor's responsibilities under this agreement are limited to billing the customers and applying monthly payments to the customers' accounts on behalf of the financier.

The vendor does not guarantee customers' receivables to the financier, and the financier has no recourse to the vendor in the event of customer defaults.

Analysis

The fact that a vendor agrees to service receivables on behalf of the financing party is an indication that the vendor may have assumed an incremental risk of concession in connection with the customers' financing transactions. To preserve the continuing relationship with the financier and the ability to refer customers in connection with future sales, the vendor may provide concessions to customers. Determining whether this risk is significant will be based on specific facts and circumstances and may require the use of professional judgment.

Servicing a receivable may be strictly an administrative function without any accounting consequence, particularly if the vendor has a history of not providing concessions to customers, or the financier, in connection with similar completed financing transactions. However, if the vendor has previously provided any concessions in connection with financing transactions that it has agreed to service on behalf of the financier, or lacks any relevant history associated with servicing the financier's receivables, this would be indicative that there is significant incremental risk of a concession.

Illustration 4-58: Remarketing rights

Facts

A vendor's agreement with a financing party includes the right of first refusal in the event of default whereby the vendor has the right to repurchase the software at a stipulated price from the financing party. The vendor asserts that this provision was included in the agreement to prevent its software from being resold at a minimal price at auction or in a fire sale.

Analysis

Software licensing arrangements generally do not allow an end user to relicense the vendor's software. Therefore, any repurchase is simply a concession to the financing party. Fees due pursuant to arrangements containing such provisions should not be considered fixed or determinable at the outset of the arrangement.

Interest rate buydowns

Question 4-54 **A vendor may assist a customer in obtaining financing with a financing party by arranging to buydown the interest rate the financier would otherwise charge the customer. The buydown may occur in connection with the original arrangement between the software vendor and customer, or it may occur at a later point in time. Further, a buydown may occur with or without the customer's knowledge. How do such buydowns affect the vendor's revenue recognition for the arrangement with the customer?**

The timing of an interest rate buydown affects whether the buydown should be evaluated as a reduction of revenue or a concession. However, whether the customer is aware of the buydown does not.

A buydown that is evidenced contemporaneously and occurs simultaneously with the original arrangement between the vendor and customer is an integral part of the arrangement (whether the customer is aware of it or not) and should be accounted for as a reduction of the total arrangement fee to be recognized as revenue in accordance with ASC 985-605.

This accounting also is consistent with the accounting for consideration provided by a vendor to a customer in connection with a current revenue transaction pursuant to ASC 605-50, *Revenue Recognition — Customer Payments and Incentives*. Pursuant to such guidance, cash consideration (including equity instruments and credits that a customer can apply against trade amounts owed to the vendor) given by a vendor to a customer is presumed to be a reduction of the selling price of the vendor's products or services and should be characterized as a reduction of revenue when recognized in the income statement.

Conversely, a buydown that is not evidenced contemporaneously or does not occur simultaneously with the original arrangement with the customer is not part of the original arrangement. Rather, it is considered a concession because it represents a reduction in the arrangement fee not contemplated in the original arrangement (see Question 4-47). Such concessions must be included as an exception in a vendor's analysis to evaluate if it has a history of successfully collecting under an arrangement's original payment terms without granting concessions.

The following excerpt from the implementation guidance in ASC 985-605 provides relevant guidance relating to such transactions.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Effect of Interest Rate Buydown in Connection with Customer Financing

985-605-55-47

A software vendor may assist a customer in obtaining financing with an entity unrelated to the software vendor that has a more attractive interest rate than that typically offered by the financing entity. For example, a software vendor may buydown the interest rate a financing entity would otherwise charge to the software vendor's customer. That interest rate buydown may occur simultaneously with the original software arrangement, or it may occur later. Further, that interest rate buydown may occur with or without the customer's awareness.

985-605-55-48

Revenue recognition is affected by the timing of the interest rate buydown. However, whether the customer is aware of the buydown does not affect revenue recognition.

985-605-55-49

An interest rate buydown that is evidenced contemporaneously and occurs simultaneously with the original arrangement between the software vendor and customer is considered an integral part of the arrangement because of its timing. Because the interest rate buydown is an integral part of the original arrangement, customer awareness is not relevant. The amount of the interest rate buydown would be treated as a reduction of the total arrangement fee to be recognized in accordance with this Subtopic, and not as a financing or other expense.

985-605-55-50

A software vendor's buydown of an interest rate that is not evidenced contemporaneously or occurs other than simultaneously with the original arrangement is not considered an integral part of the original arrangement. Rather, it constitutes a concession because it represents a reduction in the arrangement fee not contemplated in the original arrangement (see paragraphs 985-605-55-18 through 55-21). Because the interest rate buydown is a concession, it is irrelevant whether the customer is or is not aware of it.

Accounting for vendor's guarantees of customer financing arrangements

Question 4-55 **How should a vendor account for a guarantee provided in connection with a financing arrangement with a third party?**

If evaluation of the factors discussed in the related implementation guidance in ASC 985-605-55-42 through 55-45 (see Question 4-53) indicates that a vendor has assumed incremental risk of a concession because it has guaranteed a customer's indebtedness, a question arises as to whether such a guarantee is within the scope of ASC 460, *Guarantees*. Pursuant to ASC 460, such a guarantee is not within its scope if the guarantee causes the vendor to conclude that the fee is not fixed or determinable such that revenue will be recognized as payments from the customer become due and payable to the financing party. Accordingly, the guarantee is not accounted for separately pursuant to ASC 460 in such cases.

We believe that it will be rare for a software vendor to conclude that fees due pursuant to an arrangement in which it has guaranteed amounts due from a customer to a third-party financier are fixed or determinable at the outset of the arrangement. However, if the presumption that such an arrangement's fee is not fixed or determinable is overcome, a liability must be recognized for the guarantee based on the guidance in ASC 460. In such cases, the guarantee represents an element of the arrangement that must be evaluated for separation from the other elements of the arrangement for revenue recognition purposes. ASC 460-10-30-2 states that "if a guarantee is issued as part of a transaction with multiple elements with an unrelated party (such as in conjunction with selling an asset or entering into an operating lease), the liability recognized at the inception of the guarantee should be an estimate of the guarantee's fair value." Accordingly, such a guarantee must be separated from the rest of the arrangement and recorded at its estimated fair value. Because ASC 460 requires the use of the estimated fair value of the guarantee, VSOE of fair value of the guarantee is not required.

When a guarantee is accounted for in such a manner, the allocation methodology appears similar to a reverse residual method. The use of this allocation methodology is generally prohibited when allocating arrangement consideration pursuant to ASC 985-605. However, we believe that its use in these situations is appropriate based on an analogy to the multiple-element arrangement guidance in ASC 605-25-15-3A.

A guarantee liability recorded pursuant to the provisions of ASC 460 should be reduced by a credit to earnings as the vendor is released from risk under the guarantee. Depending on the nature of the guarantee, the noncontingent liability (i.e., the stand-ready obligation) would be reduced either a) on expiration or settlement of the guarantee, b) over the term of the guarantee using a systematic and rational method or c) if the guarantee is a derivative within the scope of ASC 815, *Derivatives and Hedging*, as the fair value of the guarantee changes. Recognition and measurement of the contingent liability related to the vendor's contingent loss pursuant to the guarantee provided to the financier is subject to the provisions of ASC 450, *Contingencies*, unless the guarantee is accounted for as a derivative.

Extended payment term considerations for arrangements involving software and nonsoftware elements

Question 4-56 **Do extended payment terms included in a multiple-element arrangement affect the determination of how revenue should be recognized for elements that are not subject to the scope of ASC 985-605?**

If an arrangement involves software and nonsoftware elements, the vendor is required to determine whether it can separate the elements that are within the scope of ASC 985-605 from the elements that are not within its scope (see Chapter I). Nonsoftware elements included in such an arrangement are typically composed of hardware and essential software (see Question 1-5), or elements that are accounted for in accordance with the lease guidance in ASC 840, *Leases,* but also could include other services. If an arrangement containing both software and nonsoftware elements includes extended payment terms, the analysis of those payment terms differs for the elements within the scope of ASC 985-605 versus the elements that are not.

For the elements within the scope of ASC 985-605, consideration must be given as to whether the inclusion of extended payment terms in an arrangement precludes the vendor from assessing the arrangement fees as fixed or determinable at the outset of the arrangement. If it is concluded that the fees attributable to the elements in the scope of ASC 985-605 are not fixed or determinable, those fees should be recognized as payments from the customer become due, assuming that all other conditions for revenue recognition in ASC 985-605 have been satisfied (see Question 4-58).

Similar accounting should be afforded to any elements that are separated pursuant to the provisions of the multiple-element arrangements guidance in ASC 605-25, from elements subject to the scope of ASC 985-605 and which, after separation, are accounted for in accordance with the provisions of SAB Topic 13.

In contrast, however, for elements accounted for in accordance with the lease guidance in ASC 840, a vendor should consider whether the collectibility of payments subject to extended payment terms is reasonably predictable. If the vendor concludes that fees attributable to elements accounted for in accordance with ASC 840 are not reasonably predictable, those elements must be accounted for as operating leases pursuant to the lease guidance. The elements cannot be accounted for as sales-type leases based on the provisions of ASC 840-10-25-42 through 25-44. Additionally, the vendor should consider whether some portion of the payments attributable to the hardware are, in substance, contingent rentals that should be excluded from minimum lease payments pursuant to ASC 840 (see Question 2-1).

Discounting amounts due pursuant to extended payment terms that are fixed or determinable

Question 4-57 **If a vendor is able to conclude that fees due pursuant to an arrangement containing extended payment terms are fixed or determinable at the outset of an arrangement and recognizes revenue (if all of the other basic revenue recognition criteria of ASC 985-605 have been met), should the amount of revenue recognized, and any associated receivable, be based on the net present value of the future payments?**

Yes. ASC 835-30-15-3, *Interest — Imputation of Interest*, indicates that receivables with payment terms exceeding one year, or that are not due based on customary trade terms, generally should be recorded at their net present value. For purposes of applying the provisions of ASC 835-30 to arrangements containing extending payment terms, we believe the reference to customary trade terms is analogous to terms that are not in accordance with the vendor's standard payment terms. Accordingly, we believe when a vendor is able to conclude that fees due pursuant to an arrangement containing extended payment terms are fixed or determinable at the outset of the arrangement, any amounts of revenue recognized, and associated receivables recorded, should be based on the net present value of the future payments (even if the fees are due in less than one year).

We understand the SEC staff shares this view. In SAB Topic 13, the SEC staff states that it believes the concept of recording a receivable at its net present value applies to all non-standard payment-terms arrangements — not just arrangements with payments in excess of twelve months (SAB Topic 13.A.3.a, Question 1, Footnote 20).

Recognition of revenue when fees are not fixed or determinable

Question 4-58 **How should a vendor recognize revenue for an arrangement when it cannot conclude that the arrangement's fees are fixed or determinable?**

If all of the other basic revenue recognition criteria of ASC 985-605 have been met, revenue is recognized as payments become due if a fee is not fixed or determinable.

The following excerpt from the implementation guidance in ASC 985-605 provides relevant guidance.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Illustration of Extended Payment Terms

985-605-55-16

A software vendor (with a fiscal year ending September 30) may enter into a licensing arrangement and simultaneously deliver its product to a customer on September 29. Payment terms are $600,000 due 30 days from September 29, and $400,000 due 13 months from September 29. The licensing fee is not fixed or determinable because a significant portion of the fee is due more than one year after delivery of the software and the vendor cannot overcome the presumption in paragraph 985-605-25-34.

985-605-55-17

Paragraph 985-605-25-35 requires that the vendor recognize revenue as payments from customers become due (assuming all other conditions for revenue recognition in this Subtopic are met). In this situation, $600,000 would be recognized as revenue on October 29 when the payment becomes due and the remaining $400,000 would be recognized 12 months later on October 29 of the following fiscal year.

Effect of prepayments on revenue recognition

Question 4-59 **If the fee associated with an arrangement containing extended payment terms is not fixed or determinable at the outset of arrangement, revenue should be recognized as payments become due. However, if payments are received directly from customers in advance of the scheduled payments for such arrangements, may a vendor recognize revenue relating to the amounts received?**

If a fee is not fixed or determinable at the outset of an arrangement, the fee can be recognized as revenue on the earlier of when the payment becomes due or when the cash is received directly from the customer (if all of the other basic revenue recognition criteria of ASC 985-605 have been met). However, prepayments may not be recognized if not received directly from a customer or if the vendor has participated in a customer financing transaction (Question 4-60 discusses the effects of a vendor's participation in a customer's financing transaction).

This concept is addressed in the implementation guidance of ASC 985-605, see the applicable excerpt below.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Extended Payment Terms

985-605-55-14

The following provides implementation guidance related to extended payment terms and their effect on the determination of whether a fee is fixed or determinable and collectible (see paragraphs 985-605-25-33 through 25-37)

a. Effect of prepayments

b. Illustration of extended payment terms

c. Concessions by a software vendor to customers

d. Overcoming the presumption of concessions in arrangements with extended terms

e. Subsequent cash receipt when vendor does not have a practice of providing extended terms

f. Transfer by vendor of extended payment rights to independent third party without recourse

g. Effect of customer financing of extended payments.

Effect of Prepayments

985-605-55-15

Paragraph 985-605-25-35 states that, if a fee on a software arrangement with extended payment terms is not fixed or determinable at the outset of an arrangement, revenue shall be recognized as payments become due. A vendor may receive payments related to an arrangement with extended payment terms directly from customers in advance of scheduled payments without the software vendor's participation in its customers' financing arrangements. The software vendor should recognize such payments as revenue when received, in advance of scheduled payments, provided all other requirements of revenue recognition in this Subtopic are met.

Effect of prepayments when a vendor participates in customer financing

Question 4-60 **How should a vendor recognize revenue for fees associated with an arrangement containing extended payment terms not determined to be fixed or determinable at the outset of arrangement if it receives payments in advance of the scheduled due dates after participating in a customer's financing transaction with a third party?**

If a vendor's participation in a customer's financing transaction results in it assuming incremental risk that a refund or concession will be granted to the end user or the financing party, the fee is presumed not to be fixed or determinable. If the vendor cannot overcome that presumption, the vendor should recognize revenue as payments from the customer become due and payable to the financing party (if all of the other basic revenue recognition criteria of ASC 985-605 have been met). Any amounts received by the vendor (from either the customer or the financier) prior to revenue recognition should be recorded as deferred revenue.

The following paragraphs provide relevant guidance relating to such transactions.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Effect of Prepayments on Software Revenue Recognition when the Vendor Participates in Customer Financing

985-605-55-36

Paragraph 985-605-55-15 addresses a situation in which amounts related to extended payment terms are received directly from customers without the software vendor's participation in its customers' financing arrangements. However, a vendor may participate in the customer's financing. For example, a software vendor may enter into an arrangement with an end-user customer that contains extended payment terms and receive payments in advance of the scheduled due dates after the vendor participated in the customer's financing with a party unrelated to the software vendor.

985-605-55-37

If the software vendor's participation in the customer's financing results in incremental risk that the software vendor will provide a refund or concession to either the end user customer or the financing party, the presumption is that the fee is not fixed or determinable. If the software vendor cannot overcome that presumption, the vendor would recognize revenue as payments from the customer become due and payable to the financing party, provided all other requirements of revenue recognition in this Subtopic are met. The software vendor would account for any proceeds received from the customer or the financing party prior to revenue recognition as a liability for deferred revenue. Indicators of incremental risk are discussed in paragraphs 985-605-55-38 through 55-40. Paragraphs 985-605-55-42 through 55-45 address the evidence the vendor would consider to overcome the presumption.

See Question 4-59 for discussion of effect of prepayments on revenue recognition. See Question 4-53 for discussion of indicators of incremental risk and their effect on the evaluation of whether a fee is fixed or overcoming the presumption that a fee is not fixed or determinable when vendor participates in customer financing.

Revenue recognition for multiple-element arrangements when the fee is not fixed or determinable

Question 4-61 **When a fee is not fixed or determinable, revenue is recognized as payments become due. In a multiple-element arrangement for which the vendor determines it can account for the elements separately, in what order are the elements recognized as revenue?**

There is no formal guidance that outlines the appropriate order of revenue recognition for elements included in a multiple-element arrangement when fees associated with the arrangement are not fixed or determinable. However, we are aware of three different methods used in practice:

1. Amounts are first allocated to the undelivered elements included in the arrangement as payments become due or are received.
2. If the undelivered element is PCS, or other services, an amount equal to the estimated value of the services to be rendered prior to the next payment becoming due should be allocated to the undelivered services. The residual of the payment is allocated to the delivered elements of the arrangement. This method is based on an assumption that the vendor has the ability to discontinue PCS services in the event of default by the customer.

3. Payments are proportionately allocated to each of the elements included in the arrangement.

The various alternatives are illustrated in the following example:

Illustration 4-59: Revenue recognition for multiple-element arrangements when the fee is not fixed or determinable

Facts

A calendar year-end software vendor sells a perpetual software license bundled with one year of PCS for $2,530 on 1 January 20X1. The vendor has established VSOE of fair value of PCS at 15% of the initial software license fee ($330 in this example, or $2,200 x 15%).

Payment terms are $1,000 due 31 March 20X1, $750 due 30 June 20X1 and $780 due 31 December 20X1. These terms are extended payment terms as compared to the vendor's standard payment terms. The vendor is unable to conclude that the fees are fixed or determinable at the outset of the arrangement.

All of the other basic revenue recognition criteria of ASC 985-605 have been met.

Analysis

The following table summarizes how revenue would be recognized based on the three methods described above for the first year of the arrangement, and the related deferred revenue that should be recorded on the balance sheet at the end of each quarter:

Revenue recognition

	Three months ended				
	3/31/X1	**6/30/X1**	**9/30/X1**	**12/31/X1**	**Year ended 12/31/X1**
Method 1	$ 752.50	$ 832.50	$ 82.50	$ 862.50	$ 2,530.00
Method 2	917.50	667.50	82.50	862.50	2,530.00
Method 3	935.00	717.50	48.75	828.75	2,530.00

Deferred revenue

	3/31/X1	**6/30/X1**	**9/30/X1**	**12/31/X1**
Method 1	$ 247.50	$ 165.00	$ 82.50	$ –
Method 2	82.50	165.00	82.50	–
Method 3	65.00	97.50	48.75	–

These amounts are computed as follows:

Method 1

Pursuant to this method, amounts are first allocated to the undelivered PCS as payments become due or are received. When the first payment of $1,000 becomes due on 31 March 20X1, nine months of PCS remains to be delivered to the customer. Accordingly, 75% of the PCS is deferred (nine months of the twelve-month PCS period), or $247.50 (75% multiplied by the VSOE of fair value of PCS of $330). The remaining amount of the payment, or $752.50, is recognized as revenue.

In the three months ended 30 June 20X1, three months of PCS revenue deferred from the first payment is recognized as revenue ($82.50, or $330 multiplied by 25%). Additionally, the payment due June 30 ($750) is recognized, for a total of $832.50.

In the three months ended 30 September 20X1, three months of PCS revenues deferred from the first payment is recognized as revenue ($82.50, or $330 multiplied by 25%).

In the three months ended 31 December 20X1, the last three months of PCS revenue deferred from the first payment are recognized as revenue ($82.50, or $330 multiplied by 25%). The payment of $780 due December 31 is also recognized, for a total of $862.50.

Method 2

Pursuant to this method, as the undelivered element is PCS, an amount equal to the estimated value of the PCS services to be rendered prior to the next payment becoming due is allocated to the undelivered services. The residual of the payment is allocated to the software license.

When the first payment of $1,000 becomes due on 31 March 20X1, three months of PCS remains to be delivered to the customer prior to the next payment on 30 June 20X1. Accordingly, 25% (three months of the twelve-month PCS period) of the VSOE of fair value of the PCS is deferred, or $82.50 (25% multiplied by the VSOE of fair value of PCS of $330). The remaining amount of the payment, or $917.50, is recognized as revenue.

In the three months ended 30 June 20X1, the three months of PCS revenue deferred from the first payment is recognized as revenue ($82.50, or $330 multiplied by 25%). At June 30, six months of PCS remains to be delivered prior to the next payment becoming due. Accordingly, of the $750 payment due June 30, $165 ($330 multiplied by 50%, or one-half year) is deferred, and the remaining amount of the payment ($585) is recognized, for a total amount recognized during the three-month period of $667.50.

In the three months ended 30 September 20X1, three months of PCS revenue deferred from the second payment is recognized as revenue ($82.50, or $165 multiplied by 50%).

In the three months ended 31 December 20X1, the last three months of PCS revenue deferred from the second payment is recognized as revenue ($82.50, or $165 multiplied by 50%), and the payment of $780 due December 31 also is recognized, for a total of $862.50.

Method 3

Pursuant to this method, payments that become due should be allocated proportionately to each of the elements in the arrangement based on the relative values of the elements. In this example, the vendor would allocate the fees as follows:

License fee	$ 2,200	87%
PCS	330	13%
Total	$ 2,530	

The vendor should defer $130 of the initial payment ($1,000 multiplied by 13%) for PCS and amortize it into revenue over the three-month period until the next payment becomes due. The remaining amount of the payment ($870) would be allocated to the software license. Accordingly, revenue of $935 is recognized during the three months ended 31 March 20X1 (the software license of $870 plus $65 for three months of PCS provided to the customer).

When the second payment becomes due on June 30, the vendor would allocate $97.50 ($750 multiplied by 13%) to be amortized into revenue over the remaining six-month PCS period. The remaining amount of the payment ($652.50) should be allocated to the software license. Accordingly, revenue of $717.50 is recognized during the three months ended 30 June 20X1 (the amount of the second payment allocated to the software license of $652.50 plus $65 for three months of PCS provided to the customer).

In the three months ended 30 September 20X1, three months of PCS revenue deferred from the second payment is recognized as revenue ($48.75, or $97.50 multiplied by 50%).

In the three months ended 31 December 20X1, the last three months of PCS revenue deferred from the second payment is recognized as revenue ($48.75, or $97.50 multiplied by 50%), and the payment of $780 due December 31 is also recognized, for a total of $828.75.

Of the three methods described above, we believe that the first is preferable but that the other two are also acceptable. We believe the method a vendor elects to use is an accounting policy election. The policy selected should be applied consistently to all comparable transactions and disclosed in the accounting policy note to the financial statements if material.

4.11 Reseller arrangements

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-36

For reseller arrangements, if any of the following factors or conditions exist, they also shall be considered in evaluating whether the fixed or determinable fee and collectibility criteria for revenue recognition are met:

a. Business practices, the reseller's operating history, competitive pressures, informal communications, or other factors indicate that payment is substantially contingent on the reseller's success in distributing individual units of the product. Contractual arrangements under which the reseller is obligated to pay only as and if sales are made to users shall be accounted for as consignments.

b. Resellers are new, undercapitalized, or in financial difficulty and may not demonstrate an ability to honor a commitment to make fixed or determinable payments until they collect cash from their customers.

c. Uncertainties about the potential number of copies to be sold by the reseller may indicate that the amount of future returns cannot be reasonably estimated on delivery. Examples of such factors include the newness of the product or marketing channel, competitive products, or dependence on the market potential of another product offered (or anticipated to be offered) by the reseller.

d. Distribution arrangements with resellers require the vendor to rebate or credit a portion of the original fee if the vendor subsequently reduces its price for a product and the reseller still has rights with respect to that product (sometimes referred to as price protection). If a vendor is unable to reasonably estimate future price changes in light of competitive conditions, or if significant uncertainties exist about the vendor's ability to maintain its price, the arrangement fee is not fixed or determinable. In such circumstances, revenue from the arrangement shall be deferred until the vendor is able to reasonably estimate the effects of future price changes and the other conditions in this Subtopic have been satisfied.

ASC 985-605-20 provides the following definitions of a user and a reseller:

> **User:** Party that ultimately uses the software in an application.
>
> **Reseller:** Entity licensed by a software vendor to market the vendor's software to users or other resellers. Licensing agreements with resellers typically include arrangements to sublicense, reproduce or distribute software. Resellers may be distributors of software, hardware or turnkey systems, or they may be other entities that include software with the products or services they sell.
>
> Resellers also may be referred to as distributors, indirect partners, system integrators or companies that integrate or embed a vendor's software into their own hardware and software products, such as value-added resellers (VARs) or original equipment manufacturers (OEMs). Although a transaction with a VAR or an OEM is somewhat different than with other resellers because the vendor's product is being resold as part of another product or service, many of the same accounting issues arise because the substance of such transactions may be more similar to that with a direct reseller than that with a user.
>
> The distinction between whether a customer is a user or a reseller is important because ASC 985-605 generally is more restrictive in permitting revenue recognition for arrangements with resellers at the outset of the arrangement than it is for arrangements with users. While all of the revenue recognition criteria of ASC 985-605 must be evaluated when a vendor enters into a transaction to sell its software products to other than an end user, additional consideration must be given to whether the fees due pursuant to an arrangement with a reseller are fixed or determinable and collectible.

Evaluating whether fees associated with reseller arrangements are fixed or determinable and collectible

Question 4-62 **What considerations are applicable to evaluating whether fees in an arrangement with a reseller are fixed or determinable and collectible?**

We believe that concluding that fees due pursuant to an arrangement with a reseller are fixed or determinable generally is difficult. A reseller may be a significant source of recurring software sales for a vendor. Additionally, a reseller may represent a vendor's only distribution channel for a specific product or geographic region. Accordingly, a vendor may be willing to provide resellers with greater rights than those it would provide to end users to maintain a mutually beneficial relationship and maximize future sales opportunities through the reseller. Additionally, a vendor may provide concessions it is not otherwise contractually obligated to provide if a reseller is unable to sell licensed products to end users or when the vendor announces a software upgrade and the reseller previously did not have product return rights.

Because of these factors, there is a greater inherent risk that the fees are not fixed or determinable in an arrangement with a reseller because a vendor may not be able to: 1) reasonably estimate the effects of rights of return or other rights given to a reseller or 2) conclude that it will not grant a future concession. Accordingly, a vendor may be precluded from recognizing revenue relating to a reseller agreement until the reseller sells the licensed products to end users, or the vendor receives cash from the reseller, as further discussed below.

Arrangements with resellers have been the subject of a number of restatements by public registrants and certain SEC enforcement actions. In many such situations, the vendor recognized revenue at the outset of the arrangement and then subsequently provided concessions to the reseller. These concessions provided evidence that, in hindsight, the risk of the product sale had not truly been transferred to the reseller when revenue relating to the sale was initially recognized. Many of these situations were due to a failure to appropriately consider many of the factors described below.

ASC 985-605-25-36 explicitly identifies factors a vendor must consider when determining whether an arrangement fee with a reseller is fixed or determinable. We believe certain additional factors also should be considered when assessing whether fees due pursuant to such arrangements are fixed or determinable and collectible at the outset of the arrangement. We believe that these factors should be evaluated regardless of whether the arrangement with a reseller includes extended payment terms or not. Further, we believe these factors should be considered to determine whether the potential exists that the vendor may provide a future concession if the reseller is not successful in selling software obtained from the vendor to end customers even if the arrangement fee has been received from a reseller at the outset of an arrangement.

The additional factors that should be considered include the following:

- *Whether the arrangement contains extended payment terms*. It is presumed that a fee is not fixed or determinable if an arrangement's payment terms extend beyond the vendor's normal payment terms (see Question 4-44).

- *Whether the payment terms coincide with the reseller's sales to end users.* Such arrangements may be in substance a consignment because the obligation of the reseller to pay the amounts due pursuant to the arrangement is contingent on the reseller successfully selling the licensed software products to the end customer. Revenue should not be recognized for such arrangements until the product is sold to the end customer because the reseller has not assumed risk of loss for the product. Additionally, the rights of return guidance in ASC 605-10 precludes the recognition of revenue on sale to a reseller if the reseller is not obligated to pay or lacks the financial ability to pay apart from financing provided by the seller (such as linking payment terms to sales by the reseller). In such situations, revenue for the arrangement should be recognized on the receipt of evidence of sale to end customers by the reseller (the "sell-through" method) rather than on delivery to the reseller (the "sell-in" method) — assuming that the vendor does not have a history of granting refunds or concessions to a reseller after the product has been sold through to the end user.

  Additionally, a software vendor that provides financing to a reseller has a variable interest in the reseller. In such cases, the vendor should apply the provisions of ASC 810-10 regarding consolidation of variable interest entities to determine if the reseller is a variable interest entity. If the reseller is a variable interest entity, the vendor also must determine whether it should consolidate the reseller. The Ernst & Young publications, Financial Reporting Developments, *Consolidation and the Variable Interest Model — Determination of a controlling financial interest (prior to the adoption of ASU 2015-02)* (Revised September 2014, SCORE No. BB1905) and *Consolidation — Determination of a controlling financial interest and accounting for changes in ownership interests (after the adoption of ASU 2015-02)* (September 2017, SCORE No. 02856-161US), may be helpful in making these evaluations.

- *Whether collection of the fees associated with a reseller arrangement can be assessed as probable.* A vendor must evaluate whether a reseller has both the intent *and* the ability to pay fees as they become due regardless of whether it is successful in selling the licensed product to users or collecting payment from those users. This issue may be particularly applicable to resellers that are new, poorly capitalized or experiencing financial difficulty.

  If a reseller has a pattern of not paying as amounts became due on previous agreements or seeking payment terms from the vendor longer than those it provides to end users, this may be indicative that the reseller does not have the intent or ability to pay. In such situations, or if a reseller is in financial difficulty or sufficient reliable information is not available to assess its financial condition, collectibility should not be deemed probable. Under such circumstances, revenue should not be recognized prior to the receipt of cash (even if the reseller has sold the licensed product to end users).

- *Whether uncertainties about the potential number of copies of licensed software that will be sold by the reseller indicate that the amount of future returns cannot be reasonably estimated pursuant to the provisions of the rights of return guidance in ASC 605-10* (see Question 6-3). Examples of factors that may raise such uncertainties include the newness of the product or marketing channel, competitive products or dependence on the market potential of another product offered (or anticipated to be offered) by the reseller.
- *Whether an arrangement with a reseller includes rights of return, exchange or stock balancing rights*. If such rights exist, the amounts of future returns or refunds resulting from these rights must be reasonably estimable, or the rights must lapse before the vendor may recognize any revenue under the arrangement in accordance with the provisions of the rights of return guidance in ASC 605-10. However, in software arrangements with a reseller, the factors discussed in this Question, or other factors, may indicate it is possible the vendor will grant a reseller a concession and allow returns after the contractual return period has expired (or that were not allowed pursuant to the original terms of the arrangement). The likelihood of future concessions may preclude a vendor from recognizing revenue on the expiration of contractual return provisions.

  If a vendor concludes at the outset of an arrangement with a reseller that it cannot make a reliable estimate of future returns, we believe that revenue generally should be recognized using the sell-through method for the duration of the arrangement.
- *Whether a reseller arrangement requires a vendor to rebate or credit a portion of an arrangement's fee if the vendor subsequently reduces its price for a product and the reseller still has rights with respect to that product (sometimes referred to as price protection rights)*. If such rights are provided to a reseller (either explicitly in the contractual arrangement or if the vendor has a history of providing price protection regardless of whether contractually required), and the vendor is unable to reasonably estimate future price changes, or if significant uncertainties exist about the vendor's ability to maintain its price, the arrangement fee is not fixed or determinable (see Question 6-14). In such cases, all revenue from the arrangement should be deferred until the earlier of the vendor's development of an ability to reasonably estimate the effects of future price changes, or the product is sold by the reseller to the end user (the sell-through method).

  Because most vendors operate in competitive environments that may adversely affect their ability to maintain the prices of products due to factors outside their control, it may be difficult for a vendor to reasonably estimate amounts that it may have to remit to resellers in the future pursuant to price protection clauses. We understand the SEC staff shares this view.

  In certain cases, vendors may agree to provide an amount of price protection to a reseller that is expressly limited ("capped") by the terms of the contractual arrangement. In such situations, if the vendor 1) cannot make a reasonable estimate of the amounts that may be refunded to a reseller pursuant to the price protection clause, 2) does not have a history of granting concessions or refunds in excess of the maximum amount in similar completed arrangements and 3) does not intend to grant a concession relating to the current arrangement, we believe that the vendor may deem the arrangement fees, net of the maximum amount that may be provided to the reseller pursuant the price protection clause, fixed or determinable.
- *Whether a vendor has induced a reseller to buy more product than can be promptly resold.* Vendors may be able to convince resellers to accept additional product near period ends, often with more favorable payment or return conditions, in order to meet quarterly and annual operating targets (sometimes referred to as channel-stuffing). If a vendor has induced a reseller to buy substantially more product than can be promptly resold, or be resold prior to becoming technologically obsolete, by offering deep discounts or providing rights to return unsold product that is in excess of the normal sales return privileges offered, this calls into question whether the consideration related to the transaction is fixed or determinable.

Discounts offered to a customer as a result of channel-stuffing should be recognized as an adjustment of the selling prices of the vendor's products and should reduce the amount of revenue, once recognized, presented in the vendor's income statement. Expanded rights of returns offered to customers in connection with channel-stuffing should be considered carefully to determine if they prevent the vendor from recognizing revenue at the time of the sales transaction. Pursuant to the rights of return guidance in ASC 605-10, revenue from sales transactions shall be recognized at the time of sale if the amount of future returns can be reasonably estimated, among other criteria (see Chapter VI). The ability to make reasonable estimates of returns is affected by, among other things, the presence or absence of relevant historical return experience and the seller's marketing policies and relationships with its customers.

A company's ability to make reasonable estimates of sales returns may be impaired if sales activity is not consistent with its historical sales patterns, or if expanded rights of returns have been granted as a result of channel-stuffing. Significant increases in, or excess levels of, inventory in a distribution channel due to channel-stuffing may affect or preclude the ability to make reasonable estimates of future product returns. Revenue should be recognized using the sell-through method in such situations.

- *Whether the arrangement includes either explicit or implicit commitments by the vendor to assist the reseller in selling the product to end users*. For example, if a vendor participates in joint sales calls with the reseller, makes joint presentations at trade shows, directs customers to the reseller or otherwise assists in completing sales to end users, revenue should not be recognized prior to the vendor's completion of its obligations to the reseller — generally on sale to the end user (the sell-through method).
- *Whether a transaction is complex, involving both a reseller and an end user*. In such instances, the vendor's obligation to each party in the contract must be clearly understood. Consultation with legal counsel may be necessary to understand the respective obligations of the vendor and the reseller to the end user. Further, a heightened risk of future concessions may exist in such an arrangement if the end user finds the reseller's performance under the contract unsatisfactory (even though the vendor may not be legally obligated to provide such concessions). Understanding the contractual terms and conditions between the reseller and end user is critical to determining the appropriate accounting for the transaction.
- *The reseller's bargaining strength*. Vendors also should consider their bargaining strength relative to that of a reseller in determining whether an arrangement's fee is fixed or determinable. A reseller that 1) represents a significant portion of a vendor's software sales, 2) represents a new or emerging channel or 3) has a significant role in a new product offering may have the ability to demand concessions from the vendor. If a vendor cannot assess at the outset of an arrangement that it is unlikely that it will grant concessions, revenue relating to the arrangement should be recognized using the sell-through method.
- *Other characteristics*. Such characteristics include the vendor's past business practices, the reseller's operating history, competitive pressures, the environment of the geographic location of the reseller and side arrangements and informal communications also may indicate that payment is substantially contingent on a reseller's success in selling units of the product to the end customer. Revenue generally should be recognized using the sell-through method in such situations.

Because of the factors discussed above, it may be difficult for a software vendor to conclude that fees associated with a reseller agreement are fixed or determinable at the outset of the arrangement, thus precluding use of the sell-in method of revenue recognition. This difficulty is increased when an arrangement includes extended payment terms.

The evaluation of arrangements with resellers often requires a careful analysis of the facts and circumstances of the transaction, including an understanding of the rights and obligations of the parties and the vendor's customary business practices in such arrangements. Professional judgment may be required when assessing whether the substance of a transaction is a consignment, an arrangement for which fees cannot be assessed as fixed or determinable or an arrangement for which revenue recognition is not appropriate for other reasons.

Even if a software vendor is able to utilize the sell-in method of revenue recognition for sales to resellers, the use of that method should be reviewed periodically in light of changes in the vendor's business or products. Such changes may include:

- A vendor providing concessions to resellers that it had not previously (e.g., accepting returns or extending payment terms not required under the terms of original arrangement). Question 4-47 discusses vendor actions that may constitute concessions.
- A vendor introduces new products, or enters into lines of business or relationships with distributors for which it has no comparable history to make a reasonable estimate of future returns associated with return rights provided to a reseller.

The following examples illustrate these concepts:

Illustration 4-60: Arrangement with a thinly-capitalized reseller

Facts

A software vendor enters into an arrangement to deliver various software products to a reseller for arrangement consideration of $500,000. The reseller has a history of not remitting payments when due pursuant to the terms of previous arrangements with the vendor. Based on a review of the reseller's most recent financial statements, the vendor notes that the reseller has a history of operating losses, a working capital deficit and is thinly capitalized.

Analysis

Based on the financial condition of the reseller and the vendor's past history, collectibility cannot be assessed as probable at the outset of the arrangement. Accordingly, revenue should not be recognized by the vendor prior to receipt of cash from the reseller.

Illustration 4-61: Price protection provided to a reseller

Facts

A calendar year-end software vendor enters into an agreement with a reseller to distribute its software products. The agreement provides that if the vendor reduces the price of any product, the reseller will receive a refund equal to the difference between the original purchase price and the new purchase price of the product for any units in the reseller's inventory at the time of the price reduction. The vendor's products compete directly with those of other vendors and, from time to time, the vendor has reduced its prices to match price reductions of competitors.

The vendor delivers 2,000 seats of Product A to the reseller on 31 December 20X3 in exchange for fees of $4 million, due 30 days from delivery. Payment is received by the vendor when due.

Analysis

Because the vendor has a history of reducing prices to respond to the actions of its competitors, and actions of its competitors are outside of its control, the vendor is unable to reasonably estimate amounts that it may have to remit to the reseller in the future pursuant to the price protection clause. Accordingly, revenue should not be recognized relating to the amounts received from the reseller before the reseller sells on to end users (i.e., the vendor should use the sell-through method of revenue recognition for the arrangement).

Considerations relating to the "sell-through" method of revenue recognition for arrangements with resellers

Question 4-63 **What type of evidence should a vendor receive from a reseller before recognizing revenue based on sales by the reseller to end users (the sell-through method)?**

Determining the nature and sufficiency of evidence of sales to end users required to recognize revenue when using the sell-through method is a matter of professional judgment that depends on the relevant facts and circumstances. Frequently, the nature of evidence obtained may differ based on the type of the products involved, the class of resellers and end users, the domicile of the reseller or other factors.

If a vendor determines that the nature of evidence it will utilize for purposes of determining when revenue recognition is appropriate will vary for different resellers, it should have a written policy regarding the nature of evidence that is acceptable by type of business, class of resellers and end users, etc. The differences should be clearly identifiable, objectively determinable, verifiable and consistently applied.

Evidence of a reseller's sale to an end user may include:

- Written communication from the reseller indicating the following information:
  - The quantity of products sold
  - The name of the end user
  - The period during which the product was sold
- Copy of an agreement between a reseller and an end user (potentially redacted to protect confidential pricing information)
- First year PCS agreement with the end user
- Purchase order issued by the end user to a reseller
- Evidence of delivery of product by a reseller to an end user or of delivery made directly by the vendor to the end user
- Evidence of receipt of cash by a reseller from an end user

The nature and timing of the vendor's receipt of evidence from a reseller documenting sales to end users may have a significant effect on a vendor's financial statements. Therefore, we recommend that vendors include a right to obtain specific evidence of sales to end users in distribution agreements with resellers. It is not appropriate to recognize revenue using the sell-in method due to the lack of availability of evidence from a reseller. In such circumstances, a vendor's alternatives would include recognizing revenue on the receipt of cash from the reseller.

Vendor involvement in resellers' financing transactions

Question 4-64 **If a reseller has financed the purchase of a vendor's software products or services with a third party, what considerations are applicable to evaluating whether fees associated with the arrangement are fixed or determinable if the vendor has participated in the financing transaction?**

When a vendor participates in a reseller's financing transaction, the risk of concessions is significantly higher. Such financing may be indicative that the reseller does not have the financial ability to pay fees due pursuant to the arrangement absent success at reselling the software licensed from the vendor.

ASC 985-605 has implementation guidance that provides factors that must be considered when determining if fees due pursuant to an arrangement with an end user containing extended payment terms are fixed or determinable if the customer obtains financing from a third party. The guidance includes the following:

- *Customer Financing With No Vendor Participation* (ASC 985-605-55-34 and 55-35) — see Question 4-52.
- *Indicators of Incremental Risk when Vendor Participates in Customer Financing* (ASC 985-605-55-38 through 55-41) — see Question 4-53.
- *Overcoming the Presumption of Incremental Risk when Vendor Participates in Customer Financing* (ASC 985-605-55-42 through 55-45) — see Question 4-53.
- Vendor *Actions that May not Indicate Incremental Risk* (ASC 985-605-55-46) — see Question 4-53.
- *Effect of Interest Rate Buydown in Connection with Customer Financing* (ASC 985-605-55-47 through 55-50) — see Question 4-54.
- *Effect of Prepayments on Software Revenue Recognition When the Vendor Participates in Customer Financing* (ASC 985-605-55-36 and 55-37) — see Question 4-60.

The considerations discussed in the above paragraphs are applicable when evaluating whether fees due pursuant to arrangements with resellers that have financed the payments are fixed or determinable. The factors discussed in Question 4-62 also should be considered when assessing arrangements with resellers.

We believe that the combination of these factors indicates that the risks of concessions inherent in a reseller arrangement are further increased as a result of a vendor's participation in a reseller's financing arrangement. Therefore, the appropriate revenue recognition method in such situations generally is the recognition of revenue on the sell-through method.

The following excerpt from the implementation guidance in ASC 985-605 provides guidance relating to the evaluation of financed reseller arrangements.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Additional Considerations when a Reseller Obtains Financing

985-605-55-51

Paragraphs 985-605-55-34 through 55-51 are phrased in the context of end user customers and do not address the complexities that exist for resellers. However, the underlying concepts in those paragraphs are applicable to customers that are resellers, as well as all of the additional factors in paragraph 985-605-25-36 to consider in evaluating whether an arrangement fee with a reseller is fixed or determinable. Further, the existence of financing by a reseller customer may increase the risk of any of the following:

a. Payment of the arrangement fee is substantially contingent on the distributor's success at reselling the product.

b. The reseller may not have the ability to honor a commitment to pay, which could increase the risk of software vendor concessions regardless of the source of the financing.

c. Returns or price protection cannot be reasonably estimated because of the potential for increased concession risk.

4.12 Customer cancellation privileges

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-37

Fees from licenses cancelable by customers are neither fixed nor determinable until the cancellation privileges lapse. Fees from licenses with cancellation privileges expiring ratably over the license period are considered to become determinable ratably over the license period as the cancellation privileges lapse. In applying the provisions of this paragraph, obligations related to warranties for defective software, including warranties that are routine, short-term, and relatively minor, shall be accounted for in conformity with Topic 450. Additionally, short-term rights of return, such as 30-day money-back guarantees, shall not be considered cancellation privileges; the related returns shall be accounted for in conformity with that Topic.

If a vendor provides a customer with the unilateral right to cancel an arrangement or to cancel it if certain conditions are not met, the vendor must defer revenue recognition until the cancellation provisions are no longer effective because the fee is neither fixed nor determinable. Fees due pursuant to arrangements that provide customer cancellation provisions that expire ratably over the license period become determinable as the cancellation provisions lapse.

Vendors also may provide short-term rights of return whereby customers can return products that operate according to the vendor's published specifications, but which do not meet the needs of the customer. Short-term rights of return are accounted for as returns pursuant to the provisions of the rights of return guidance (see Chapter VI for a discussion of the accounting for rights to return software).

Additionally, vendors may provide a warranty that their products will operate in accordance with published specifications. Terms of an arrangement that allow a customer to return a licensed product or cancel an arrangement due to defective software products that obligate a vendor to repair defective software through the issuance of bug fixes (see Question 4-67) or are warranties that are routine, short-term and relatively minor should be accounted for in accordance with ASC 450, *Contingencies*. Pursuant to ASC 450, vendors should accrue the estimated costs of satisfying the warranty obligations when the revenue from the arrangement is recognized. However, if there are significant uncertainties about possible warranty claims and the range of possible loss pursuant to the warranty obligation is wide, consideration should be given as to whether no revenue should be recorded prior to the development of sufficient experience or until the warranty period expires.

A contractual termination provision triggered by a breach of contract by either party is not considered to be a cancellation privilege for purposes of applying ASC 985-605.

Short-term rights of return

Question 4-65 **How do short-term rights of return provided by a vendor to customers affect software revenue recognition?**

ASC 985-605-25-37 specifies that short-term rights of return, such as 30-day or less money-back guarantees, should be accounted for in accordance with the rights of return guidance in ASC 605-10. If a vendor can make a reasonable estimate of future returns pursuant to the rights of return guidance when customer arrangements include such rights, revenue may be recognized on delivery of software (net of a reserve for estimated returns), if all of the other basic revenue recognition criteria of ASC 985-605 have been met. If a reasonable estimate of future returns cannot be made at the time software is delivered, revenue should not be recognized until the vendor develops an ability to make a reasonable estimate of returns or the return rights lapse, whichever occurs first.

Chapter VI discusses in greater detail the accounting for rights to return software.

Short-term rights of return versus trial periods

Question 4-66 **If a vendor delivers software to a customer for a trial period during which a customer may use the software for demonstration or evaluation purposes, should the customer's right to reject the software if it does not meet its needs be accounted for in a manner similar to a short-term right of return as discussed in Question 4-65?**

No. When software is provided to a customer during a trial period for demonstration or evaluation purposes, the arrangement is in substance a consignment. In such arrangements, the seller delivers a product to a customer, and the customer agrees to receive the product, solely to give the customer the ability to evaluate the delivered product prior to acceptance. When software has been provided to a customer for such purposes, revenue should not be recognized until the earlier of customer acceptance or the acceptance provisions lapsing (see Question 4-27). The right of a customer to reject software that does not meet its needs during a trial period should not be accounted for as a short-term right of return.

Corrections of errors in computer software (bug fixes)

Question 4-67 **If a customer elects not to purchase PCS, but the vendor provides bug fixes free of charge pursuant to warranty obligations, should the vendor account for the bug fixes as a warranty obligation in accordance with ASC 450, *Contingencies,* or PCS?**

ASC 985-605-20 defines postcontract customer support (PCS) as typically including "services, such as telephone support and correction of errors (bug fixing or debugging), and unspecified product upgrades or enhancements developed by the vendor during the period in which the postcontract customer support is provided."

If a customer does not elect to purchase PCS from a vendor, the vendor generally will still provide bug fixes free of charge to ensure that the licensed software operates in accordance with its published specifications. As clarified in the following excerpt from the implementation guidance in ASC 985-605, the provision of bug fixes in such cases should be accounted for as a warranty obligation pursuant to ASC 450.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Bug Fixes Provided to Customers that Choose not to Obtain Postcontract Customer Support

985-605-55-76

In some software arrangements, customers may elect whether to obtain postcontract customer support from the vendor as an element of the software arrangement. To satisfy its warranty obligations, the software vendor provides bug fixes (free of charge) that are necessary to maintain compliance with published specifications to those customers that do not obtain postcontract customer support from the software vendor.

985-605-55-77

Paragraph 985-605-25-37 states that obligations related to warranties for defective software, including warranties that are routine, short-term, and relatively minor, shall be accounted for in conformity with Topic 450. However, postcontract customer support may include services such as the correction of errors (for example, bug fixing).

985-605-55-78

If a software vendor provides bug fixes (under warranty obligations) without charge that are necessary to maintain compliance with published specifications, the vendor would account for the estimated costs to provide bug fixes (that are necessary to maintain compliance with published specifications) in accordance with Topic 450.

However, if bug fixes are provided in connection with other services to a customer, such as telephone support, such services should be accounted for as PCS, even if the contractual arrangement with the customer does not specify that PCS is to be provided by the vendor (see Chapter VII for a discussion of the accounting for PCS arrangements).

4.13 Fiscal funding clauses

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-38

Fiscal funding clauses sometimes are found in software license arrangements in which the licensees are governmental units. Such clauses generally provide that the license is cancelable if the legislature or funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligations under the licensing arrangement.

985-605-25-39

Consistent with paragraph 840-10-25-3, a software licensing arrangement with a governmental unit containing a fiscal funding clause shall be evaluated to determine whether the uncertainty of a possible license arrangement cancellation is a remote contingency. The evaluation of whether the level of uncertainty of possible cancellation is remote shall be consistent with Topic 450, which defines remote as relating to conditions in which the chance of the future event or events occurring is slight.

985-605-25-40

If the likelihood is assessed as remote, the software licensing arrangement shall be considered noncancelable. Such an assessment shall include the factors discussed in paragraphs 958-605-25-33 through 25-34. If the likelihood is assessed as other than remote, the license shall be considered cancelable, thus precluding revenue recognition. A fiscal funding clause with a customer other than a governmental unit that is required to include such a clause creates a contingency that precludes revenue recognition until the requirements of the clause and all other provisions of this Subtopic have been satisfied.

It is common for a license with a governmental unit to contain a fiscal funding clause that provides that the license is cancelable if the funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligation under the license. If a software contract contains a fiscal funding clause, revenue should be recognized in a manner consistent with ASC 840-10-25-3 regarding fiscal funding clauses in lease agreements. This guidance requires making an assessment of the likelihood that the fiscal funding clause will be exercised and result in cancellation of the contract. In making this assessment, consideration should include the governmental unit's past practices and its financial condition.

If the probability of contract cancellation is assessed as remote, the license should be considered non-cancelable. In such cases, revenue may be recognized prior to the funding being appropriated if all of the other basic revenue recognition criteria of ASC 985-605 have been met.

If the probability of contract cancellation is assessed as other than remote, the license should be considered cancelable and revenue should not be recognized until, and only to the extent that, funding is appropriated.

However, a fiscal funding clause included in an arrangement with a customer that is not a governmental unit creates a contingency that precludes revenue recognition until the requirements of the clause and all other provisions of ASC 985-605 have been satisfied.

Definition of a governmental unit

Question 4-68 **ASC 985-605-25-38 through 25-40 provide that a fiscal funding clause included in a software license arrangement with a governmental unit can be assessed to determine if the likelihood that the arrangement will be cancelled is remote. If remote, the arrangement can be considered non-cancelable. However, such accounting is not permitted for an arrangement with a customer other than a governmental unit. How does a vendor determine if a customer is a governmental unit?**

We believe that the guidance from the AICPA Audit and Accounting Guide, *Audits of State and Local Governments (March 1, 2014 Edition),* which defines a governmental entity as having one or more of the following characteristics, should be considered when evaluating whether a software arrangement containing a fiscal funding clause is with a governmental unit:

- Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization's governing body by officials of one or more state or local governments
- The potential for unilateral dissolution by a government with the net assets reverting to a government
- The power to enact and enforce a tax levy

Furthermore, entities are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, that presumption may be rebutted for entities possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics if that determination is supported by compelling, relevant evidence.

5 Multiple-element arrangements

5.1 Chapter summary

Technological advances can have profound effects on a software vendor's business. Customers demand not only a first-class product when making an initial purchasing decision, but given the prohibitive costs to purchase, install and maintain certain software applications, they also demand protection against software obsolescence and the risk that licensed software products will not continue to meet their needs. Vendors offer this protection in the form of the following:

- *Upgrade Rights*. ASC 985-605-20 defines an upgrade as "an improvement to an existing product that is intended to extend the life or improve significantly the marketability of the original product through added functionality, enhanced performance, or both." For example, a newer version of a currently marketed software product is an upgrade. Upgrade rights may be evidenced by a specific agreement, commitment or a vendor's established business practices and may be specified or unspecified.
- *Rights to Additional Software Products*. As part of a software licensing arrangement, a vendor may commit to deliver additional software products in the future, including products not yet in general release. The products to be provided may be specified or unspecified.
- *Return Rights*. A vendor may allow a customer to return a licensed software product for a refund of the purchase price, a credit applied to amounts owed or to be owed for other products, or in exchange for other dissimilar products. ASC 985-605 stipulates that such rights should be accounted for pursuant to the provisions of the rights of return guidance.
- *Exchange Rights*. Exchange rights that allow end users to return a licensed product and receive a similar product with no more than minimal differences in price, features and functionality are accounted for as like-kind exchanges that do not affect revenue recognition. Rights that allow an exchange of a licensed software product for a dissimilar software product or for similar software products with more than minimal differences in price, functionality or features are considered return rights as discussed above.
- *Platform-Transfer Rights.* Platform-transfer rights are defined by ASC 985-605-20 as rights "granted by a vendor to transfer software from one hardware platform or operating system to one or more other hardware platforms or operating systems." Platform-transfer rights may be contractual or exist only as a matter of practice and may or may not require actual physical return of delivered software.

The inclusion of rights, or elements, such as the ones above (or others that are not mentioned above) in a software licensing arrangement complicates revenue recognition for the arrangement because a determination must be made as to whether the elements can be accounted for separately and, if so, how the arrangement consideration should be allocated to the various elements or, if the elements cannot be accounted for separately, how revenue should be recognized for the combined unit of accounting.

5.2 Identifying elements in multiple-element arrangements

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-41

As discussed in paragraph 985-605-25-5, multiple-element arrangements to which contract accounting does not apply may include customer rights to any combination of additional software deliverables, services, or postcontract customer support. If contract accounting does not apply, individual elements in such arrangements shall be accounted for in accordance with paragraphs 985-605-25-3 through 25-14.

985-605-25-42

The following guidance addresses various considerations related to multiple-element arrangements, specifically:

a. Additional software deliverables and rights to exchange or return software (see paragraphs 985-605-25-43 through 25-65), including:
   1. Upgrades or enhancements (see paragraphs 985-605-25-44 through 25-46)
   2. Additional software products (see paragraphs 985-605-25-47 through 25-59)
   3. Rights to exchange or return software (see paragraphs 985-605-25-60 through 25-65)

b. Postcontract customer support (see paragraphs 985-605-25-66 through 25-75)
   1. Postdelivery telephone support at no additional charge (see paragraph 985-605-25-74)
   2. Postcontract customer support granted to resellers (see paragraph 985-605-25-75)

c. Services (see paragraphs 985-605-25-76 through 25-87), including:
   1. Funded software-development arrangements (see paragraphs 985-605-25-86 through 25-87)

985-605-25-43

As part of a multiple-element arrangement, a vendor may agree to deliver software currently and to deliver additional software in the future. The additional deliverables may include upgrades, enhancements, or additional software products. Additionally, a vendor may provide the customer with the right to exchange or return software, including the right to transfer software from one hardware platform or operating system to one or more other platforms or operating systems (a platform-transfer right).

Identifying elements included in an arrangement

Question 5-1 **What factors should be considered when determining if multiple elements are included in a single arrangement?**

ASC 985-605 specifically discusses a number of provisions that when included in an arrangement should be accounted for as an element. These include:

- Upgrades/enhancements to the licensed software
- Additional software products
- Rights to exchange or return software (see Chapter VI)
- Postcontract customer support (PCS) (see Chapter VII)
- Services other than PCS, such as training, installation or consulting (see Chapter VIII)

However, arrangements also may include elements other than those specified above. In general, we believe that an item should be presumed to be an element included in an arrangement if any of the following apply:

1. It is explicitly referred to as an obligation of the vendor in a contractual agreement
2. It requires a distinct action by the vendor
3. The vendor's failure to complete an action would result in a significant contractual penalty
4. The inclusion or exclusion of the item in the arrangement would cause the arrangement consideration to vary by more than an insignificant amount

The relative facts and circumstances should be considered when determining if an item is an element of an arrangement.

In certain cases, arrangements may include provisions whereby a customer can elect to purchase additional products or services from the vendor in the future at agreed-on prices. If such an option is substantive (i.e., truly an option by its nature), then the vendor is not obligated under the option to deliver goods and services unless and until such time as the customer elects to exercise the option. Determining whether an option to acquire additional products or services is substantive requires an assessment as to whether the vendor is truly at risk as to whether the customer will choose to exercise the option. If a software licensing arrangement includes an option to acquire services essential to the functionality of the licensed software that are only available from the vendor (i.e., there is a lack of other qualified service providers that can be engaged to perform the services), we do not believe the option should be considered substantive. If an option is not substantive, we believe the products or services to be delivered by the vendor on exercise of the option should be accounted for as an element of the current arrangement.

Even if an option is substantive, an assessment should be made as to whether the specified additional products or services have been priced at a significant and incremental discount. If the prices contain a significant and incremental discount, the discount should be accounted for separately. If a vendor cannot assess whether an option's pricing includes a significant and incremental discount (because, for example, the customer has received an option to acquire software products not yet available or that are never sold separately by the vendor), consideration should be given to whether the inability to make such an assessment indicates that the optional goods or services should be accounted for as an element of the current transaction.

If an option is substantive and not priced at a significant and incremental discount, the determination of the elements included in the arrangement should include only the noncontingent elements. Sales arising from the customer's exercise of the option to purchase additional products or services should be accounted for as the events occur.

Software licensing arrangements also may include elements not subject to the scope of ASC 985-605. Certain Questions in Chapter I discuss the accounting for arrangements that include elements subject to the scope of ASC 985-605 and elements that are not.

Evaluating separate contracts as a single arrangement

Question 5-2 **If separate contracts are entered into at or near the same time or negotiated as a package with the same customer or a group of related parties, should they be evaluated as a single agreement?**

Determining when multiple contracts represent a single arrangement requires the use of judgment, and both the form and the substance of an arrangement must be considered in the evaluation. Often vendors have continuing and multi-faceted relationships with their customers (including resellers), and this business relationship will lead to numerous signed or oral arrangements between the two parties. The existence of concurrent agreements suggests that these multiple agreements may represent a single arrangement and, as such, the timing and measurement of revenue recognition may be affected by the various elements and payment terms of the overall arrangement.

The following excerpt from the implementation guidance within ASC 985-605 provides relevant guidance that should be considered when assessing if multiple agreements or contracts between a vendor and a customer or a group of related parties should be considered separate arrangements or one multiple-element arrangement.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Multiple-Element Arrangements

985-605-55-3

The following provides implementation guidance related to arrangements with multiple elements (see paragraphs 985-605-25-5 through 25-7):

a. Effect of multiple contracts or agreements

b. Arrangements that include usage-based fees

  1. Separate fees for license, usage, and renewal of postcontract customer support

  2. Postcontract customer support included in usage-based fee

  3. All fees usage-based.

Effect of Multiple Contracts or Agreements

985-605-55-4

Software vendors may execute more than one contract or agreement with a single customer. However, a group of contracts or agreements may be so closely related that they are, in effect, parts of a single arrangement and should be viewed as one multiple-element arrangement when determining the appropriate amount of revenue to be recognized in accordance with this Subtopic. The form of an arrangement is not necessarily the only indicator of the substance of an arrangement. The existence of any of the following factors (which are not all-inclusive) may indicate that a group of contracts should be accounted for as a single multiple-element arrangement:

a. The contracts or agreements are negotiated or executed within a short timeframe of each other.

b. The different elements are closely interrelated or interdependent in terms of design, technology, or function.

c. The fee for one or more contracts or agreements is subject to refund, forfeiture, or other concession if another contract is not completed satisfactorily.

d. One or more elements in one contract or agreement are essential to the functionality of an element in another contract or agreement.

e. Payment terms under one contract or agreement coincide with performance criteria of another contract or agreement.

f. The negotiations are conducted jointly with two or more parties (for example, from different divisions of the same entity) to do what in essence is a single project.

In addition to the factors outlined above, we believe that the following factors also should be considered as a single arrangement:

- If the separate contracts require delivery of the same product(s) or service(s)
- If the separate contracts relate to the delivery of the same product(s) or service(s) to multiple customer locations
- If the contracts were negotiated in contemplation of one another, regardless of the time frame over which the contracts are signed (a strong indicator)
- If it was likely that a follow-on contract to provide services relating to a previously licensed software product would be executed. In such cases, we believe that the original contract and the subsequent contracts generally should be considered one arrangement. Factors that may indicate that such a contract is likely include:
  - The vendor performs such services for a majority of the customers that license its software products
  - Pricing of the service contract is agreed to at the date the software product was licensed

On the other hand, if the contracts were awarded by the customer pursuant to separate bona-fide competitive bid processes, we believe this is a strong indicator that the contracts should be accounted for as standalone arrangements.

While we do not believe that any single factor above is necessarily determinative, a presence of any one, or a combination, of these factors (other than competitive bid processes) may indicate that contracts entered into at or near the same time should be evaluated as a single arrangement with multiple deliverables. Conversely, the absence of all of the above factors (other than proximity of negotiation/execution) may overcome the presumption that separate contracts entered into at or near the same time are a single arrangement. All facts and circumstances applicable to an arrangement should be considered when making this determination.

A vendor should establish controls to identify on a timely basis multiple contracts initiated with the same customer or group of related parties to ensure that these arrangements are identified to accounting personnel with the appropriate knowledge to determine the effect on the accounting for the arrangements.

The following examples illustrate these concepts:

Illustration 5-1: Contracts negotiated together

Facts

A software vendor enters into an arrangement to license Product A and provide one year of PCS to a customer for $500,000. Additionally, the vendor enters into a separate contract to provide services relating to the customization of the software. The contracts were negotiated at the same time by the same personnel. The customization efforts are essential to the functionality of the licensed software, and the fee for the software license and related PCS is subject to refund if the customization services are not completed to the customer's satisfaction within six months of the origination of the agreement.

Analysis

In this illustration, the software license and the customization arrangements should be treated as one multiple-element arrangement. The fact that 1) the contracts were negotiated concurrently, 2) the contracts are with the same customer, 3) the customization services are essential to the functionality of the licensed software and 4) the fees due pursuant to the software license arrangement are subject to refund if the customization services are not completed to the customer's satisfaction are all indicators that these contracts should be accounted for as a single arrangement.

Illustration 5-2: Contracts awarded pursuant to separate competitive bid process

Facts

A software vendor enters into two arrangements to license Product A, a storage management software product, and Product B, an application development product, and to provide one year of PCS on each product, with the same customer within the same month. The contracts were negotiated and executed by the same vendor and customer personnel. The customer's purchasing decisions were made pursuant to a competitive bid process. The software products function independently of each other, and the payment terms of the respective arrangements are not linked.

Analysis

Because the contracts were awarded by the customer pursuant to separate bona-fide competitive bid processes, the software products function independently, and the payment terms are not linked, the two contracts should be treated as two separate arrangements.

Illustration 5-3: Master purchase agreement

Facts

A software vendor has a master arrangement with a customer that is purchasing licenses and PCS for Product A for several departments within the customer's organization. Two separate purchase orders are signed within one month for Product A licenses and PCS. The vendor fulfills the delivery obligations under one of the purchase orders but delivery under the second purchase order is incomplete. The delivery under the second purchase order does not in any way affect the functionality of the products delivered under the first purchase order.

Analysis

In this illustration, the two purchase orders should be treated as a multiple license arrangement. Revenue can be recognized on the first purchase order (if all of the other basic revenue recognition criteria of ASC 985-605 have been met) prior to delivery of the software covered by the second purchase order.

Illustration 5-4: Funded development arrangement

Facts

A software vendor enters into an arrangement to license Product A and provide PCS to a customer that is a hardware manufacturer. The arrangement specifies that Product A is to be used by the customer for internal use purposes only. Concurrently, the vendor enters into a funded development arrangement with the customer whereby the vendor commits to use its best efforts to develop its next version of Product A to be compatible with the next generation of the hardware manufacturer's product. In return for its development efforts, the vendor will be reimbursed for the direct development costs it incurs (headcount and overhead). The two arrangements are negotiated separately and the license to Product A was the subject of a competitive bid process. The software vendor reasonably expects to benefit in the marketplace from establishing/maintaining the compatibility of its products with the customer's product. Fees due pursuant to the Product A licensing arrangement are not refundable if the development efforts are not successful.

Analysis

In this illustration, the software license and the funded development agreement should be accounted for separately. The fact that 1) the fees under the license to Product A are not subject to refund if the development efforts are not successful and 2) the customer used a competitive bid process prior to purchasing the licensed software indicate that these are separate agreements. These factors outweigh the facts that 1) the contracts were negotiated and executed concurrently, 2) the contracts are with the same customer and 3) the funded development effort relates to establishing or maintaining compatibility of the licensed software with a hardware platform (on a best-efforts basis).

When-and-if-available deliverables

Question 5-3 **Should products or services included in a software licensing arrangement that will be provided to the customer on a when-and-if-available basis be accounted for as an element included in a multiple-element arrangement?**

ASC 985-605-25-5 states, in part, that software arrangements may provide for multiple deliverables, some of which may be described as being deliverable only on a when-and-if-available basis. It further states that "when-and-if-available deliverables shall be considered in determining whether an arrangement includes multiple elements. Accordingly, the requirements of this Subtopic with respect to arrangements that consist of multiple elements should be applied to all additional products and services specified in the arrangement, including those described as being deliverable only on a when-and-if-available basis."

When deliberating the software revenue recognition guidance, AcSEC concluded that when-and-if-available deliverables specified in an arrangement should be accounted for as an element included in a multiple-element arrangement because such deliverables were bargained for by the customer for inclusion in the arrangement. Accordingly, if as part of a software licensing arrangement a vendor commits to deliver, on a when-and-if-available basis, additional software product(s), whether specified (see Questions 5-21 through 5-26) or unspecified (see Questions 5-27 through 5-30), or specified or unspecified upgrades or enhancements to the licensed and delivered products, such commitments should be considered an element of the arrangement.

Commitments to provide unspecified upgrades and enhancements on a when-and-if-available basis to customers that are PCS subscribers are not accounted for as a separate element. Rather, the commitment to provide when-and-if-available unspecified upgrades or enhancements is accounted for as a part of the PCS element of the arrangement. However, if a vendor has committed to provide a specified upgrade or enhancement to a licensed and delivered product on a when-and-if-available basis, that commitment must be accounted for as a separate element of the arrangement (as a specified upgrade right), regardless of whether the customer is required to be a current PCS subscriber in order to receive the specified upgrade on its release by the vendor.

Evaluating future discounts

Question 5-4 **If an arrangement provides a customer with the right to a discount on a future purchase from the vendor, should the right to the future discount be accounted for separately? If so, how is arrangement consideration allocated when a more-than-insignificant discount is included in an arrangement?**

Contractual arrangement terms that give customers the right to future purchases of additional products or services from a vendor for an amount below fair value, in addition to the current products and services being purchased, generally should be accounted for separately when included in an arrangement. A discount that is not more than insignificant generally requires no accounting recognition.

A discount on the purchase of future products or services provided to a customer in connection with a current arrangement is considered to be more than insignificant if it meets certain criteria, see Question 1-4 for a discussion of those criteria.

The following are examples of when discounts may be considered significant and incremental:

Illustration 5-5: Discount consistent with discount inherent in current transaction

Facts

An enterprise software vendor offers ten different modules that may be licensed individually or in any combination. All of the modules are available for immediate delivery. The vendor enters into an arrangement with a customer to license six modules for a fee that represents a 35% discount from the vendor's aggregate list prices for those six modules. The arrangement provides that the customer may license the remaining four modules at a 35% discount from list price if, at its option, it licenses the other modules within one year.

Analysis

Because the 35% discount from list price on any modules licensed within one year is consistent with the discount from list price included in the current arrangement, the vendor has not granted a discount that is incremental to the discount inherent in the pricing of the other elements included in the arrangement. Accordingly, the discount is not more than insignificant and should not be accounted for separately.

Illustration 5-6: Discount is not incremental to discounts typically provided to other customers

Facts

A vendor enters an arrangement to license Product X for 20% off list price. The arrangement also provides the customer with a right to a 50% discount off list price for any future licenses of Product Y. The vendor separately licenses Product Y to other customers on a standalone basis for approximately 50% off list price.

Analysis

Although the 50% discount from list price on any future licenses of Product Y is significant in the context of the transaction with the customer and is incremental to the discount inherent in the pricing of the other elements included in the arrangement, it is not incremental to the discount typically provided to customers purchasing Product Y on a standalone basis. Accordingly, the discount is not more than insignificant and should not be accounted for separately.

Illustration 5-7: More-than-insignificant discount offered

Facts

A vendor enters an arrangement with a customer to license software Product A for $50,000, a discount of 20% from the vendor's list price. The vendor also grants the customer a 50% discount on any future licenses from the $100,000 list price of Product B. The vendor normally licenses Product B in standalone transactions at a discount not in excess of 20% off that product's list price.

Analysis

The future discount is significant in the context of the overall arrangement with the customer, is incremental to the discount inherent in the pricing of the other elements included in the arrangement and is incremental to the discount typically provided to customers purchasing Product B on a standalone basis. The discount is more than insignificant and should be accounted for separately.

Evaluating future discounts on options to purchase additional copies of products

Question 5-5 **A vendor might offer a small or insignificant discount on additional copies of the licensed product or other products that exist at the time of the offer but are not part of the arrangement. ASC 985-605-15-3 states that "[i]f the discount or other concessions in an arrangement are more than insignificant, a presumption is created that an additional element or elements (as defined in paragraph 985-605-25-5) are being offered in the arrangement." What is a "more-than-insignificant" discount in relation to options to purchase additional copies of the licensed product?**

If an arrangement contains an option that allows the customer to purchase additional copies of products licensed by and delivered to the customer, the option is not considered a more-than-insignificant discount. In such cases, the implementation guidance in ASC 985-605-55-86 and 55-87, excerpted below, provides that revenue should be recognized as the rights to additional copies are purchased, based on the price-per-copy as stated in the arrangement. Additional copies of delivered software are not considered an undelivered element because the duplication of software is considered incidental to an arrangement, and the delivery criterion is met on the delivery of the first copy or product master.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Applicability of Discount Accounting to Option to Buy Additional Copies of Software

985-605-55-86

Paragraph 985-605-15-3(d) states that if a discount or other concessions in an arrangement are more than insignificant, a presumption is created that an additional element or elements (as defined in paragraph 985-605-25-5) are being offered in the arrangement.

985-605-55-87

However, the provisions of paragraph 985-605-15-3(d) should not be applied to an option within a software arrangement that allows the customer to purchase additional copies of products licensed by and delivered to the customer under the same arrangement. In that case, revenue should be recognized as the rights to additional copies are purchased, based on the price per copy as stated in the arrangement. Additional copies of delivered software are not considered an undelivered element. In accordance with paragraphs 985-605-25-22 through 25-24, duplication of software is considered incidental to an arrangement, and the delivery criterion is met upon the delivery of the first copy or product master.

The following example further illustrates these concepts:

Illustration 5-8: Future discounts on options to purchase additional copies of products

Facts

A vendor enters into an arrangement to license and deliver 1,000 copies of both Product A and B at a 30% discount from the vendor's list prices for these products. The arrangement also guarantees a price to the customer for future purchases of the same products, up to an additional 5,000 copies of each product, at a 70% discount from list price. This 70% discount is incremental to discounts typically provided to other customers.

Analysis

Pursuant to ASC 985-605-55-87, because the provisions of ASC 985-605-15-3(d) should not be applied to an option that allows the customer to purchase additional copies of the products licensed and delivered under the same arrangement, this option is not an element and requires no accounting.

However, if the option to purchase additional copies was not in substance a conditional arrangement, but in fact represented a commitment to purchase more copies (e.g., under an extended payment term arrangement whereby deliveries coincided with the subsequent payments), then a relative (proportionate) allocation of the effective discount rate over the entire arrangement would be required, consistent with the guidance on accounting for significant incremental discount in ASC 985-605-55-82 through 55-85 (see discussion below).

Allocating arrangement consideration to a significant discount

Question 5-6 **If an arrangement contains a more-than-insignificant discount, how should that discount be accounted for?**

If an arrangement contains a more-than-insignificant discount, a portion of the arrangement consideration should be deferred and recognized as revenue as follows:

1. If the discount can be applied to one of a number of specified products or services with known VSOE of fair value that may be purchased from the vendor in the future, then the product or service with the lowest estimated VSOE of fair value should be used in determining the amount of arrangement consideration allocable to the discount. The amount applicable to the discount should be deferred and recognized as revenue as the future products or services are delivered to the customer (if all of the other basic revenue recognition criteria of ASC 985-605 have been met) or when the customer's right to the discount lapses. If multiple future purchases will receive the discount, the deferred revenue associated with the discount should be recognized proportionately as the future products or services are delivered, such that a consistent discount rate is applied to those purchases.

The following example illustrates these concepts:

Illustration 5-9: Allocation of a significant discount to a number of specified products or services with known VSOE of fair value

Facts

A vendor enters into an arrangement to license Products A and B to a customer for a total of $200. Additionally, the vendor agrees to provide a discount of $30 if the customer licenses either product C, D or E within a year of the inception of the arrangement. The VSOE of fair value of both product A and B is $100. The VSOE of fair value of products C, D and E range from $100 for product C to $400 for product E. The future discount is more than insignificant.

Analysis

The vendor should allocate the discount proportionately based on the relative VSOE of fair value of products A, B and C (because product C is the lowest possible fair value of the future purchase on which the discount may be used). The overall discount rate is 10% ($30 discount divided by the total VSOE of fair value of products A, B and C of $300). The amount of arrangement consideration allocable to the sale of products A and B is $180 (the arrangement consideration of $200 reduced by the overall discount of 10%). The remaining $20 (arrangement consideration of $200, minus the amount allocable to products A and B of $180) should be recorded as deferred revenue and recognized on the earlier of the customer's purchase of either product C, D or E or the expiration of the discount period.

2. When the future products or services to which the discount will be applied either 1) are not specified or 2) do not have VSOE of fair value, the accounting is dependent on whether the maximum amount of the discount can be quantified:

- If the maximum amount of the discount can be quantified, a portion of the arrangement consideration should be allocated to the current and future purchases based on an assumption that the customer will purchase the minimum amount of future products or services necessary to obtain the maximum discount available. Deferred revenue associated with the discount should be recognized proportionately as the future products or services are delivered, such that a consistent discount rate is applied to those purchases.

The following example illustrates these concepts:

Illustration 5-10: Allocation of a significant discount when the discount does not specify the future product to which it relates and the maximum discount can be quantified

Facts

A vendor licenses products A and B along with a right to a future discount of 50% off list price, to a maximum of $200, on future purchase(s) of its other products, C through Z, for a two-year period. Total arrangement consideration is $100. VSOE of fair value of products A and B are $60 and $40, respectively, and VSOE of fair value of Products C through Z range from $200 to $800. The 50% discount is a more-than-insignificant discount.

Analysis

The vendor should account for the discount based on an assumption that the customer will purchase the least amount of products and services that allows it to receive the maximum discount to which it is entitled. Accordingly, the vendor should allocate the $200 discount to Products A and B and the assumed purchases of additional product(s). The overall discount is 40% [$200/$500, or the maximum future discount divided by the sum of the fair values of products A and B ($100) plus the minimum amount of purchases required to obtain the maximum discount ($400)]. The vendor should defer $40 (40% discount rate multiplied by the $100 of arrangement consideration) of the arrangement consideration and allocate $60 to products A and B. If the customer uses the discount by purchasing additional products with VSOE of fair value totaling $400, the vendor would recognize $240 in revenue (if all of the other basic revenue recognition criteria of ASC 985-605 have been met) on delivery of those products ($200 in cash received plus the $40 of deferred revenue). If the discount expires unused, the $40 in deferred revenue would be recognized at that time.

- If the maximum amount of the discount is not quantifiable (e.g., if the amount of future purchases to which the discount can be applied is not limited or the fair values of the items subject to the discount are not known), revenue allocated to each element included in the arrangement should be reduced by the discount rate.

The following example illustrates these concepts:

Illustration 5-11: Allocation of a significant discount when the discount does not specify the future product to which it relates and the maximum discount is not quantifiable

Facts

A vendor sells products A and B along with a right to a future discount of 50% off list price, with no maximum dollar value of the discount, on all future purchases of its other products, C through Z. Total arrangement consideration for products A and B is $100. VSOE of fair value of products A and B are $60 and $40, respectively, and VSOE of fair value of products C through Z range from $200 to $800. The 50% discount is a more-than-insignificant discount.

Analysis

The vendor should apply the 50% discount to products A and B and all future products purchased using the discount. Accordingly, $50 of arrangement consideration would be allocated to products A and B. The remaining $50 of arrangement consideration should be deferred. If the customer purchases additional products using the discount, the vendor would recognize revenue equal to the cash received on the delivery of those products. The previously deferred $50 should be recognized ratably over the discount period or, if no period is specified in the arrangement, over the estimated period during which additional purchases will be made by the customer.

The following excerpt from the implementation guidance within ASC 985-605 provides further guidance on how to account for arrangements that include a more-than-insignificant discount.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Accounting for Significant and Incremental Discounts

985-605-55-82

Consistent with paragraph 985-605-25-8, if a software arrangement includes a right to a significant incremental discount on a customer's future purchase of a product or services, a proportionate amount of that significant incremental discount shall be applied to each element covered by the arrangement based on each element's fair value without regard to the significant incremental discount. See Example 10 (paragraph 985-605-55-185 for illustrations of this guidance)

985-605-55-83

If the maximum amount of the incremental discount on the future purchases is quantifiable, that quantifiable amount should be allocated to the elements of the arrangement and the future purchases assuming that the customer will purchase the minimum amount necessary to utilize the maximum discount, if either of the following conditions exists:

a. The future products or services to which the discount is to be applied is not specified in the arrangement (for example, a customer is allowed a discount on any future purchases).

b. The fair value of the future purchases cannot be determined under paragraphs 985-605-25-6 through 25-7.

See Example 10, Cases B1 and B2 (see paragraphs 985-605-55-191 through 55-194) for illustrations of this guidance.

985-605-55-84

The maximum amount of the significant incremental discount on future purchases may not be quantifiable. For example, the future purchases that can be purchased under the significant incremental discount arrangement are not limited by quantity of products or services. Revenue otherwise allocated to each element covered by the arrangement without regard to the significant incremental discount shall be reduced by the rate of the significant incremental discount. See Example 10, Case C (paragraph 985-605-55-197) for an illustration of this guidance.

985-605-55-85

The portion of the fee deferred as a result of the significant incremental discount shall be recognized as revenue proportionately as the future purchases are delivered, assuming all other revenue recognition criteria are met, such that a consistent discount rate is applied to all purchases under the arrangement. If the future purchases are not limited by quantity of products or services, the portion of the fee that is deferred as a result of the presence of a significant incremental discount shall be recognized as revenue as a subscription in accordance with paragraphs 985-605-25-58 through 25-59.

Following are the examples in ASC 985-605-55 referenced above which address the treatment of discounts.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Example 10: Accounting for Significant Incremental Discounts

985-605-55-185

The following Cases illustrate the guidance in paragraphs 985-605-15-3 through 15-4 and 985-605-55-82 through 55-85.

a. Application of discount to each element covered by the arrangement (Case A)

b. Future products or services unknown, but maximum future discounts quantifiable (Case B)

c. No maximum future discount (Case C)

d. Discount significant but not incremental (Case D).

985-605-55-186

In each Case, vendor-specific objective evidence of fair value equals list price.

Case A: Application of Discount to Each Element Covered by the Arrangement

985-605-55-187

A software vendor sells Product A for $40 with a right to a discount (the coupon) of $30 on another of its software products, Product B. Vendor-specific objective evidence of fair value is $40 for Product A and $60 for Product B. The $30 discount on Product B is a significant incremental discount that normally would not be given in comparable transactions.

985-605-55-188

The vendor would allocate the $30 discount across Product A and Product B. The overall discount is 30% ($30/$100). Therefore, upon the delivery of Product A, the vendor would recognize $28 of revenue and defer $12. If the customer uses the discount and purchases Product B, the vendor would recognize $42 in revenue upon delivery of Product B ($30 in cash received plus the $12 previously deferred). If the discount expires unused, the $12 in deferred revenue then would be recognized.

Case B: Future Products or Services Unknown, but Maximum Future Discounts Quantifiable

985-605-55-189

The following Cases illustrate the guidance in paragraph 985-605-55-83:

a. Dollar discount on any one additional product purchased (Case B1)

b. Half-price discount on any future purchases with cumulative maximum (Case B2)

c. Discount on future purchases significant and incremental to discount on original purchase (Case B3)

985-605-55-190

In each Case, the maximum future discounts can be quantified, although the future products or services that the customer will purchase and apply the discounts are not known.

Case B1: Dollar Discount on Any One Additional Product Purchased

985-605-55-191

A software vendor sells Product A for $40 with a right to a discount (the coupon) of $20 on any one of its other software products, Products B through Z. Vendor-specific objective evidence of fair value for Product A is $40 and for Products B through Z ranges from $30 to $100. The $20 discount is a significant incremental discount that normally would not be given in comparable transactions.

985-605-55-192

The vendor would allocate the $20 discount across Product A and the assumed purchase of whichever of Product B through Z has the lowest fair value ($30). The overall discount is 28.57% ($20/$70). Therefore, upon delivery of Product A, the vendor would recognize $28.57 in revenue, and defer $11.43. If the customer uses the discount and purchases the additional Product with a fair value of $30, the vendor would recognize $21.43 in revenue upon its delivery (the $11.43 previously deferred and the additional cash license fee due of $10). If the discount expires unused, the $11.43 in deferred revenue then would be recognized.

Case B2: Half-Price Discount on Any Future Purchases with Cumulative Maximum

985-605-55-193

A software vendor sells Product A for $40 with a right to a discount (the coupon) of 50% off list price on any future purchases of its other software products, Products B through Z, with a maximum cumulative discount of $100. Vendor-specific objective evidence of fair value for Product A is $40 and for Products B through Z ranges from $20 to $100. The 50% discount is a significant incremental discount that normally would not be given in comparable transactions.

985-605-55-194

The vendor would assume that the maximum discount will be used. Therefore, the vendor would allocate the $100 discount across Product A and the assumed additional products to be purchased. The overall discount is 41.67% ($100/$240). Therefore, upon the delivery of Product A, the vendor would recognize $23.33 of revenue and defer $16.67. If the customer uses the discount by purchasing additional products with fair value totaling $200, the vendor would recognize $116.67 in revenue upon delivery of those products ($100 in cash received plus the $16.67 previously deferred). If the discount expires unused, the $16.67 in deferred revenue then would be recognized.

Case B3: Discount Future Purchases Significant and Incremental to Discount on Original Purchase

985-605-55-195

A software vendor sells Product A for $60, which represents a 40% discount off its list price (vendor-specific objective evidence) of $100. In the same transaction, it also provides the right to a discount of 60% off of the list price (vendor-specific objective evidence) on any future purchases of units of software Product B for the next 6 months with a maximum discount of $200. The discount of 60% on future purchases of units of Product B is a discount normally not given in comparable transactions.

985-605-55-196

Because the discount offered on future purchases of Product B normally is not given in comparable transactions and is both significant and incremental in relation to the 40% discount, it would be accounted for as part of the original sale consistent with Case B2. The vendor would assume that the maximum discount will be used. Therefore, the vendor would allocate the $240 discount ($40 on Product A and $200 maximum on future purchases) across Product A and the assumed additional products to be purchased. The overall discount is 55.38% ($240/$433.33; $433.33 is the sum of the $100 list price of Product A and the $333.33 accumulated list price of Product B that results in a maximum discount of $200). Therefore, upon the delivery of Product A, the vendor would recognize

$44.62 of revenue and defer $15.38. If the customer uses the discount by purchasing additional products with fair value totaling $333.33, the vendor would recognize $148.71 in revenue upon delivery of those products ($133.33 in cash received plus the $15.38 previously deferred). If the discount expires unused, the $15.38 in deferred revenue then would be recognized.

Case C: No Maximum Future Discount

985-605-55-197

A software vendor sells Product A for $40 with a right to a discount (the coupon) of 50% off list price on any future purchases of its other software products, Products B through Z, with no maximum cumulative discount. Vendor-specific objective evidence of fair value for Product A is $40. Vendor-specific objective evidence of fair value (which equals list price) of Products B through Z ranges from $20 to $100. The 50% discount is a significant incremental discount that normally would not be given in comparable transactions.

985-605-55-198

The vendor would apply the 50% discount to Product A and all future products purchased using the discount. Therefore, upon the delivery of Product A, the vendor would recognize $20 of revenue and defer $20. If the customer purchases additional products using the discount, the vendor would recognize revenue equal to the cash received upon the delivery of those products. The previously deferred $20 should be accounted for as a subscription in accordance with paragraphs 985-605-25-58 through 25-59 and recognized pro rata over the discount period or, if no period is specified in the arrangement, over the estimated period during which additional purchases will be made.

Case D: Discount Significant but Not Incremental

985-605-55-199

A software vendor sells Product A for $30 with the right to a discount of 70% off list price (vendor-specific objective evidence) on any future purchases of its other software products, Products B through P, for the next 6 months with no maximum cumulative discount. Product A is also given at a 70% discount and the vendor-specific objective evidence of fair value of Product A is $100.

985-605-55-200

Because the discount offered on future purchases over the next 6 months is equal to the discount offered on the current purchase (70%), there is no accounting necessary in the original sale for the discount offered on future purchases.

The term "discount" as used in ASC 985-605 is the difference between the arrangement fee and VSOE of fair value for all elements in the arrangement. A question arises as to how to compute the amount of a discount when the software vendor is applying the residual method because VSOE of fair value does not exist for all of the elements included in an arrangement but does exist for all of the undelivered elements. The vast majority of software vendors do not have VSOE of fair value for products, whether currently available or to be sold in the future, because the software generally is not sold separately. In this situation, the software vendor should compute the discount provided in the initial arrangement by comparing the published list price of the delivered elements in the arrangement to the residual value attributable to those delivered elements. If the discount on future purchases is significant and incremental to the discount provided on the delivered elements in the initial arrangement, the software vendor should account for the discount on future purchases separately using the guidance discussed above. This concept is illustrated in the excerpt from the implementation guidance within ASC 985-605-55 below.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Effect of Discounts on the Residual Method

985-605-55-88

The following provides implementation guidance as to the effect of discounts on the application of the residual method of recognizing software revenue (see paragraphs 985-605-25-10 through 25-11)

985-605-55-89

Paragraph 985-605-15-3(d) defines a more-than-insignificant discount with respect to future purchases, and Example 10 (see paragraph 985-605-55-185) provides examples of accounting for significant incremental discounts that are within the scope of this Subtopic. The term discount, as used in this Subtopic, is the difference between the arrangement fee and vendor-specific objective evidence of fair value when vendor-specific objective evidence of fair value exists for all elements in the arrangement. However, a question arises as to how to compute the amount of a discount if the software vendor is applying the residual method as described in paragraphs 985-605-25-9 through 25-11, because vendor-specific objective evidence of fair value does not exist for all of the elements in the arrangement.

985-605-55-90

For example, a software vendor enters into an arrangement with a customer that licenses currently available software products and services (referred to as the initial arrangement) and offers a discount off of its published list price on future purchases of products not previously licensed by the customer. The software vendor does not have vendor-specific objective evidence of fair value of its software products. However, the software vendor is able to apply the residual method pursuant to paragraphs 985-605-25-9 through 25-11, when the only undelivered elements are services.

985-605-55-91

In this situation, the software vendor would compute the discount provided in the initial arrangement by comparing the published list price of the delivered elements in the initial arrangement to the residual value attributable to those delivered elements. If the discount on future purchases of future products is significant and incremental to the discount provided on the delivered elements in the initial arrangement, the software vendor should apply the significant and incremental discount on future purchases to the initial arrangement using the guidance in paragraphs 985-605-55-82 through 55-85.

985-605-55-92

See Example 11 (paragraphs 985-605-55-201) for an illustration of this guidance.

Example 11: Effect of Discounts on Future Products on the Residual Method

985-605-55-201

On December 31, 20X1, a software vendor licenses Product A (with a published list price of $100) on a perpetual basis, bundled with postcontract customer support for the first year, to a customer for $80. The customer may elect to renew postcontract customer support following the initial year at a stipulated rate of $15, which requires the software vendor to apply the residual method pursuant to paragraphs 985-605-25-10 through 25-11. In conjunction with the licensing of Product A, the software vendor offers the customer a 55% discount off of its published list price on the purchase of all new products released by the vendor during the three years subsequent to December 31, 20X1, with no maximum cumulative discount. Based on the guidance in paragraph 985-605-55-91, the vendor would perform the following calculation to assist in determining whether the discount offered on future purchases of future products is significant and incremental (as discussed in paragraph 985-605-15-3(d)).

	Published list price	Residual value	Discount from published list price
Product A	$ 100	$ 65	35.00%
Future products	Unknown	Unknown	55.00%
Additional discount from published list price			20.00%

985-605-55-202

Assuming that the software vendor concludes that the additional discount (that is, 20% in this Example) on future purchases is significant and incremental, the vendor would allocate such discount to Product A and defer revenue related to the postcontract customer support in the initial arrangement as follows.

(a)	(b)	(a)*(b)=(c)	(d)	(c)+(d)=(e)	(f)	(f)-(e)
Published list price	**Additional list price discount**	**Revenue deferral for additional discount**	**Revenue deferral for postcontract consumer support**	**Total revenue deferral**	**Arrangement fee**	**Upfront revenue product A**
$ 100	20%	$ 20	$ 15	$ 35	$ 80	$ 45

985-605-55-203

Consistent with Example 10, Case C (see paragraph 985-605-55-197), on delivery of Product A the vendor would recognize $45 of revenue and defer $35, provided all other requirements of revenue recognition in this Subtopic are met. The $15 revenue related to postcontract customer support deferred pursuant to the residual method would be recognized over the initial year of the license in accordance with paragraphs 985-605-25-67 through 25-69. The $20 deferred revenue related to the discount would be accounted for as a subscription in accordance with paragraphs 985-605-25-58 through 25-59 and recognized pro rata over the 3-year discount period. If the customer purchases additional products using the discount, the vendor would recognize revenue equal to the fee attributable to those additional products, provided all other requirements of revenue recognition in this Subtopic are met.

Indemnification provisions

Question 5-7 **If a software vendor indemnifies a licensee in a software licensing arrangement against liability and damages from patent infringement and similar claims against the vendor's software, how should the indemnification be accounted for by the vendor?**

ASC 460, *Guarantees*, specifies accounting and disclosure requirements for certain guarantees and clarifies that indemnification clauses provided by software vendors to licensees are within the scope of ASC 460.

ASC 460 further concludes that because a third-party infringement claim covered by such an indemnification could impair the licensee's ability to use the licensed software (e.g., if an injunction is issued or the claim is ultimately proven), the underlying indemnification in this arrangement is related to the performance of the licensed software — that is, the licensed software cannot function as intended until the vendor cures the alleged infringement defect. Accordingly, the indemnification clause is similar to a product warranty that qualifies for a scope exception from the initial recognition and measurement provisions of ASC 460 as set forth below.

Excerpt from Accounting Standards Codification

Guarantees — Overall

Implementation Guidance and Illustrations

460-10-55-31

As an element of its standard commercial terms, a software vendor-licensor includes an indemnification clause in a software licensing agreement that indemnifies the licensee against liability and damages (including legal defense costs) arising from any claims of patent, copyright, trademark, or trade secret infringement by the software vendor's software. That indemnification arrangement constitutes a guarantee that is not subject to the recognition requirements or the initial measurement requirements of the General Subsections of Sections 460-10-25 or 460-10-30, respectively.

460-10-55-32

That arrangement exhibits the characteristic in paragraph 460-10-15-4(c): the indemnification obligates the seller-licensor (guarantor) to make a payment to the buyer-licensee (guaranteed party) based on changes in an underlying related to the software license (an asset of the guaranteed party). In this situation, the underlying is the occurrence of an infringement claim against the licensee that results in any liabilities or damages related to the licensed software (the asset) of the licensee (the indemnified party).

460-10-55-33

Nonetheless, because a possibility exists, regardless of how remote, that an infringement claim covered by the indemnification could impair the licensee's ability to use the licensed software (for example, if an injunction is issued or the claim is ultimately proven), the underlying is also related to the performance (regarding function, not price) of that licensed software — that is, the licensed software cannot function as intended until the seller-licensor cures the alleged infringement defect. Thus, the arrangement qualifies for the scope exception in paragraph 460-10-25-1(b).

460-10-55-34

However, it would be subject to the disclosure requirements of the General Subsection of Section 460-10-50, as well as the disclosure requirements specified in the Product Warranties Subsection of that Section.

Although not subject to the initial recognition and measurement provisions of ASC 460, such indemnification clauses are subject to the disclosure requirements of that Topic. A vendor is required to disclose the following information related to such indemnification clauses:

- The nature of the guarantee provided by the indemnification clause, including the approximate term of the guarantee, how the guarantee arose and the events or circumstances that would require the vendor to perform under the guarantee.
- The current carrying amount of the liability, if any, for the vendor's obligations under the guarantee (including the amount, if any, recognized as a loss contingency pursuant to ASC 450, *Contingencies*), regardless of whether the guarantee is freestanding or embedded in another contract.

- The nature of 1) any recourse provisions that would enable the vendor to recover any of the amounts paid under the guarantee from third parties and 2) any assets held either as collateral or by third parties that, on the occurrence of any triggering event or condition under the guarantee, the vendor can obtain and liquidate to recover all or a portion of any amounts paid pursuant to the guarantee. The vendor would need to indicate, if estimable, the approximate extent to which the proceeds from liquidation of such assets would be expected to cover the maximum potential amount of future payments that it might be required to make pursuant to the guarantee.
- The vendor's accounting policy and methodology used in determining its liability for product warranties (including any liability, such as deferred revenue, associated with extended warranties).
- A tabular reconciliation of the changes in the vendor's aggregate product warranty liability for the reporting period, including the beginning balance of the aggregate product warranty liability, the aggregate reductions in that liability for payments made (in cash or in kind) under the warranty, the aggregate changes in the liability for accruals related to product warranties issued during the reporting period, the aggregate changes in the liability for accruals related to pre-existing warranties (including changes in estimates), and the ending balance of the aggregate product warranty liability.

Is an option to extend a time-based license indefinitely an element of an arrangement?

Question 5-8 **If a software vendor enters into a time-based license arrangement that includes an option for the licensee to extend the license indefinitely (i.e., to convert the license from a time-based license to a perpetual license), is the conversion option an element that should be accounted for at the outset of the arrangement?**

The option to convert a time-based license arrangement to a perpetual license arrangement is not an element in the arrangement as there is no additional delivery requirement, and the receipt of the additional fees are contingent on the decision by the customer to exercise the option. Revenue for the fees received relating to the exercise of the option may be recognized when the option is executed, if all of the other basic revenue recognition criteria of ASC 985-605 have been met.

This concept was clarified in the following excerpt of the implementation guidance within ASC 985-605.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Effect of Option to Extend a Time-Based License Indefinitely

985-605-55-115

The following illustrates the guidance in paragraphs 985-605-25-6 through 25-7.

985-605-55-116

A software vendor may sell a product with postcontract customer support under a three-year term license with postcontract customer support renewable after one year. Vendor-specific objective evidence of fair value exists for postcontract customer support. The arrangement specifies that at any time during its term the customer can extend the license for the product indefinitely for an additional fee. Effectively, the arrangement contains an option to convert the three-year term license into a perpetual license for the product.

985-605-55-117

The option itself is not an element as contemplated in paragraphs 985-605-25-6 through 25-7 because there is no new deliverable. The exercise of the option merely affords the customer a longer time period to use the same product that it already has as part of the original arrangement. The additional fee to exercise the option is essentially the same as the fee for an extension or renewal of a license, as discussed in paragraphs 985-605-55-105 through 55-109.

985-605-55-118

If the perpetual license for the product necessitated another delivery of software media because the term license software media contained a self-destruct or similar mechanism to allow the vendor to control the usage of its intellectual property, that would not create an element or deliverable to be accounted for in the original arrangement. However, such media would need to be delivered before the option exercise fee could be recognized as revenue.

Question 4-23 discusses the guidance related to the effect of commencement of extension or renewal of license term.

Requirements to escrow a software program's source code

Question 5-9 **Many software licensing arrangements require the vendor to deliver the licensed software's source code into a third party escrow account, usually subsequent to the delivery of the software to the customer. Should such a requirement be accounted for as an element included in a multiple-element arrangement?**

Software licensed by a vendor typically is provided to the customer in the form of object code, which is a sequence of instructions that can be read and executed by a computer. Software vendors typically retain a program's source code, or the programming statements that are created by a programmer in a programming language that can be read by people but not computers.

Source code must be converted to object code or machine language by a compiler or an assembler program before a computer can read and execute the program. The object code file contains code that is difficult for a human to read or modify, whereas source code is easy to read and can be manipulated. For the purpose of developing upgrades and enhancements to the program, or for programming bug fixes, the source code must be used.

Software licensing arrangements regularly contain provisions that require the vendor to deliver the licensed software's source code into an escrow account as a protective measure such that if the software vendor ceases operations the customer would have access to the source code of the licensed software. Because such provisions are protective rights conditioned on a future event (i.e., the software vendor's cessation of operations), we do not believe a standard contractual provision (i.e., a provision that is commonly included in a vendor's software licensing arrangements) requiring the vendor to place the licensed software's source code into escrow should be accounted for as an element included in a multiple-element arrangement.

However, if the provision imposes unique obligations on the vendor, the facts and circumstances should be evaluated carefully to determine if the requirement should be accounted for as an element.

If a software vendor is contractually required to deliver source code to a customer as part of an arrangement, that delivery obligation should be accounted for as an element of the arrangement.

Consideration provided by a software vendor to a customer

Question 5-10 **How should a vendor account for cash or other sales incentives paid to a customer in connection with a software licensing arrangement?**

Vendor offers of sales incentives such as discounts, coupons or rebates in connection with a current revenue transaction, or offers for cash rebates or refunds in exchange for completing a specified number of purchases or remaining a customer for a specified time period, should be accounted for pursuant to ASC 605-50, *Revenue Recognition — Customer Payments and Incentives*.

Pursuant to ASC 605-50, cash consideration (including equity instruments and credits that a customer can apply against trade amounts owed to the vendor) given by a vendor to a customer is presumed to be a reduction of the selling price of the vendor's products or services and should be characterized as a reduction of revenue when recognized in the income statement. However, this presumption can be overcome and the consideration characterized as a cost incurred if 1) the vendor receives an identifiable benefit (goods or services) in exchange for the consideration and 2) the fair value of the benefit received can be reasonably estimated.

If consideration provided by a vendor consists of a "free" product or service (e.g., a gift certificate or a free airline ticket that will be honored by another, unrelated entity) or anything other than the vendor's cash or equity instruments, the cost of the consideration should be characterized as an expense, generally cost of sales, when recognized in the income statement.

The cost of sales incentives offered voluntarily and without charge to customers that can be used or that become exercisable as a result of a single exchange transaction, and that do not result in a loss on the sale of a product or service, should be recognized by a vendor at the later of the following:

a. The date at which the related revenue is recognized by the vendor

b. The date at which the sales incentive is offered (which would be the case when the sales incentive offer is made after the vendor has recognized revenue)

Certain sales incentives entitle a customer to receive a refund or rebate of a specified amount of a prior purchase of a product or service by submitting a form or claim (e.g., a software vendor may offer mail-in rebates relating to software purchased and downloaded from its website). A vendor should recognize a liability (or deferred revenue) for such sales incentives at the later of a) or b) above, based on the estimated amount of refunds or rebates that will be claimed by customers. However, if the amount of future rebates or refunds cannot be reasonably and reliably estimated, a liability should be recognized for the maximum potential amount of the refund or rebate (i.e., no reduction for breakage should be made).

If a vendor offers a customer a rebate or refund of a specified amount of cash consideration that is redeemable only if the customer completes a specified, cumulative level of revenue transactions or remains a customer for a specified time period, it should recognize the rebate or refund obligation as a reduction of revenue. The reduction of revenue is recognized based on a systematic and rational allocation of the cost of honoring the rebates or refunds earned and claimed to each of the underlying revenue transactions that result in progress by the customer toward earning the rebate or refund. Measurement of the total rebate or refund obligation should be based on the estimated number of customers that ultimately will earn and claim rebates or refunds under the offer (i.e., breakage should be considered if it can be reasonably estimated). However, if the amount of future rebates or refunds cannot be reasonably estimated, a liability should be recognized for the maximum potential amount of the refund or rebate (i.e., no reduction for breakage should be made).

The ability to make a reasonable estimate of the amount of future rebates or refunds for sales incentives entitling customers to a reduction in or refund of the price of a prior purchase, or that can be earned based on cumulative purchases or by remaining a customer for a specified time period, depends on many factors and circumstances. However, the following factors may impair a vendor's ability to make a reasonable estimate:

- Relatively long periods in which a particular rebate or refund may be claimed
- The absence of historical experience with similar types of sales incentive programs with similar products or the inability to apply such experience because of changing circumstances
- The absence of a large volume of relatively homogeneous transactions

The following examples illustrate these concepts:

Illustration 5-12: Volume rebates

Facts

A vendor sells off-the-shelf software to resellers for $100 per license. If a reseller purchases more than 1,000 licenses in a year, the price is reduced to $90 per license and the vendor provides the reseller a rebate of $10 per license for the first 1,000 licenses.

Analysis

Since the vendor is offering the resellers a rebate of a specified amount of cash consideration that is redeemable only if a specified, cumulative level of revenue transactions is completed, the vendor should recognize the rebate obligation as a reduction of revenue as the revenue transactions that contribute to the realization of the rebate take place pursuant to ASC 605-50. Measurement of the total rebate obligation should be based on the estimated number of resellers that ultimately will earn and claim rebates under the offer. However, if the amount of future rebates cannot be reasonably estimated, a liability should be recognized for the maximum potential amount of the rebate.

Illustration 5-13: Cost reimbursements

Facts

A software vendor holds periodic user conferences. To entice significant customers to attend these conferences, the vendor reimburses their travel and lodging costs.

Analysis

Such payments are subject to the scope of ASC 605-50. Because the vendor does not receive an identifiable benefit associated with the reimbursements, they should be characterized as a reduction of revenue when recognized in the income statement.

Membership in a customer advisory council or similar group

Question 5-11 **As a part of a license arrangement, a software vendor may provide a customer with the right to join its Customer Advisory Council (Council). This right is not given to all customers. The Council may be comprised of the vendor's larger customers from a variety of industries. Membership in the Council permits the customer to receive briefings on product strategy and development and is a mechanism by which the customer can deliver feedback on the vendor's strategy or provide guidance to the vendor on features and product innovation that they would most like to see. The members of the Council also may receive beta products for evaluation and review in advance of such products being made available to other customers. Is a contractual right to be a member in a Customer Advisory Council, or similar group, an element of an arrangement that must be accounted for?**

The right to be a member of such a group in and of itself generally is not an element included in a multiple-element arrangement. The provision of beta products to the Council members for their evaluation also generally would not require accounting treatment provided that these products were 1) not a stated or specified obligation of the vendor in the license arrangement and 2) clearly provided on an "as-is" basis with no requirement on the vendor's part to support or update them.

However, a vendor should closely review the activities of the Council and presentations made by the vendor to the Council, particularly to identify if upgrade rights are effectively being committed to the Council members. Similarly, the provision of beta products that include functionality beyond the currently licensed product may increase the risks that a specified upgrade right has been created with these customers (see Questions 5-13 and 5-16). This risk should be considered when evaluating future license sales to Council members.

Accounting for sunset clauses

Question 5-12 **How should a software vendor account for a contractual provision requiring it to provide a customer with a replacement software product if it discontinues supporting a licensed product?**

Software purchasers have become increasingly concerned that vendors may discontinue supporting ("sunset") a licensed software product and "transfer" or "migrate" the features and functionality of the currently licensed product to a new product. The new product may or may not have more features and functionality than the discontinued product, or may be a suite of products of which the discontinued product comprises only a portion. The product generally is renamed and is not provided to current PCS subscribers of the discontinued product. Should a customer wish to continue receiving support that includes upgrades and enhancements from the software vendor, it must purchase the new product, even if it is not interested in acquiring any additional features and functionality that are part of the new product, and pay incremental license fees.

We understand that many customers have come to consider such practices a "ploy" by software vendors to generate additional license fees for products that are substantially the same as the currently licensed products. Accordingly, customers have begun to request provisions in software licenses to protect them from such practices and to help ensure that a vendor will continue to support and provide updates to licensed programs. These provisions are referred to as Sunset Clauses.

Sunset Clauses also are frequently demanded by customers during or following a merger of companies that sell competing products. Concerned that the acquirer will sunset one of the merged company's similar products, customers of both the acquirer's products and the target's products may negotiate to include a Sunset Clause in license agreements to protect themselves from purchasing licenses of products that the company subsequently may sunset.

Depending on the applicable facts and circumstances, we believe such clauses should be accounted for in a manner analogous to one of the following:

- A product exchange right
- A right to receive unspecified future products (i.e., a "subscription")
- An upgrade right for a specified upgrade/enhancement or a right to a specified additional software product

Examples of sunset clauses

The following are examples of Sunset Clauses that we have seen in practice; however, these examples are not all-inclusive:

> In the event the Vendor deletes functions from the Software and transfers or offers those functions in other or new products, the portion of those other or new products that contain the function in question, or the entire product, if the functions cannot be separated out, shall be provided to Customer at no additional charge, provided that Customer has in place a current Maintenance Services Agreement for such Software.
>
> If Vendor ceases to offer Support services at any time during which Licensee has elected to receive or renew Support for any Product licensed pursuant to this agreement ("Sunset Product"), Vendor shall provide to Customer and support, at no additional charge, any product announced or licensed by Vendor to any other customer ("Replacement Product") that 1) is or is marketed as a replacement for or successor to such Sunset Product, 2) has substantially similar price to such Sunset Product and 3) provides substantially similar functionality and features as the Sunset Product.

Any clauses such as the above must be evaluated, based on the considerations discussed in the remainder of this Question, to determine what effect, if any, they have on the accounting for the software licensing arrangement.

Accounting for a sunset clause as PCS

Regardless of the customer's motivation for including a Sunset Clause in an arrangement, our experience is that such clauses generally are structured to apply only to those customers that have PCS arrangements in force at the time the currently licensed software product is discontinued. Accordingly, some believe such clauses should be accounted for as PCS.

PCS is defined in ASC 985-605-20 as the right to receive services such as bug fixes and phone support or unspecified product upgrades or enhancements, or both, after the software license period begins. This paragraph also defines upgrades or enhancements as an "improvement to an existing product that is intended to extend the life or improve significantly the marketability of the original product through added functionality, enhanced performance, or both." Unspecified upgrades or enhancements are PCS only if they are offered on a when-and-if-available basis. ASC 985-605-20 also specifically provides that PCS does not include either 1) upgrade rights, defined as rights to receive one or more specific upgrade or enhancements that will be sold separately or 2) rights to additional software products (See Question 7-1).

Based on these definitions, we believe it generally will be inappropriate to account for Sunset Clauses as PCS. As discussed previously, we understand that the intent of Sunset Clauses is to provide customers that have licensed a certain software product with the right to receive an equivalent, but different, software product, if such a product is marketed, when and if the vendor decides to cease supporting the licensed product. We believe that customers requesting such a clause are not seeking a commitment from the vendor that it will provide future features or functionality to the currently licensed product, but rather assurance that the licensed software will remain available and will be supported and supplemented by upgrades and enhancements (on a when-and-if-available basis), or be replaced by an equivalent product, so long as the software vendor is continuing to sell the licensed product in its broader sense. Accordingly, we believe that such clauses generally are neither a right to receive services from the vendor, nor a right to receive upgrades or enhancements to the currently licensed product.

Product exchange rights

Rights to exchange currently licensed software for products with no more than minimal differences in price, features or functionality should be accounted for as like-kind exchanges. Such rights generally have no effect on revenue recognition for the currently licensed product.

We believe that Sunset Clauses may be accounted for in a manner analogous to an exchange right when the clause specifies the replacement product to be provided if the currently licensed product sunset is 1) limited to a product that has no more than minimal differences in price, functionality or features from the licensed product at the time that the licensed product is sunset (i.e., we believe that the comparison should be between the licensed product and the replacement product at the date the licensed product is sunset and not between the replacement product and the originally licensed product, which may have been substantially enhanced if the sunsetting occurs several years later) and 2) the vendor has no plans to sunset the licensed product when it enters into the arrangement.

In our view, such clauses do not provide additional rights to the customer, or impose additional obligations on the vendor, but rather are a negotiated protective right that preserves the rights otherwise conferred to the customer by the terms of the arrangement if and when the vendor chooses to discontinue supporting the licensed product. Such clauses require no action on the part of the vendor; in fact, they are in many respects designed to prevent an action. Unless and until the vendor makes a decision to sunset the currently licensed product, such a clause imposes no obligation to deliver an additional software product to the customer, nor does it currently allow the customer to exchange the licensed product for another product. However, when and if a vendor decides to cease supporting the currently licensed product, such a clause requires it to provide the customer an equivalent software product (i.e., one that does not differ significantly in terms of price, features and functionality) in exchange for the currently licensed product, if such a product is then marketed.

Accordingly, we believe accounting for such a clause in a manner analogous to an exchange right best reflects its nature as a negotiated protective right that preserves rights provided by the license arrangement but does not provide rights to additional features and functionality.

For such clauses, however, an additional factor to consider is whether the customer is required to return, or loses the right to continue to use, the currently licensed product when and if it is sunset and a replacement product provided. ASC 985-605 provides that if 1) an additional product is provided to a customer, 2) the currently licensed software is not returned to the vendor and 3) the customer has the right to continue to use the currently licensed software, then the customer's right to receive the additional software should not be accounted for as an exchange right, but rather as a right to additional software products (see Chapter VI). We believe that most Sunset Clauses do not address whether the customer is required to return the sunset product to the vendor or whether it can continue to use such a product. Accordingly, this provision of ASC 985-605 may appear to preclude accounting for Sunset Clauses in a manner analogous to an exchange right.

However, we believe that AcSEC intended this provision to apply to situations in which the customer has the option to choose between licensed products that are supported by the software vendor — that is, software products that have continuing value in the marketplace. In the case of a product that has been sunset, the lack of ongoing support, including provision of upgrades and enhancements, significantly degrades the value of the software to the customer and others in the marketplace. In fact, we believe that this degradation in value is one of the primary reasons that customers insist on including Sunset Clauses in software licenses.

Accordingly, we believe that a customer's right to keep software that has been sunset when replaced by an equivalent product pursuant to a Sunset Clause should be viewed as a non-substantive right to which the above provisions of ASC 985-605-25-60 and 25-61 do not apply and, therefore, does not preclude accounting for the right as an exchange right. However, to avoid any ambiguity, we also recommend that vendors agreeing to the inclusion of Sunset Clauses in software licensing arrangements should, if possible, specify that the customer must return or surrender the right to use the currently licensed product if it is sunset and replaced by an equivalent product.

We also have considered whether a sunset right that cannot be accounted for as an exchange right instead should be accounted for in a manner analogous to a right of return. ASC 985-605-25-61 states that "exchanges by users of software products for dissimilar software products or for similar software products with more than minimal differences in price, functionality, or features are considered returns," and that such return rights should be accounted for in conformity with the rights of return guidance in ASC 605-10. However, similar to the discussion in the immediately preceding paragraph, we believe that AcSEC intended this provision to apply when a customer has the option to return a currently licensed and supported product to the vendor in exchange for a license to another supported, but dissimilar, product. Accordingly, we believe that Sunset Clauses generally should not be accounted for as a right of return.

In addition to clauses structured as discussed above, there may be other instances in which it is appropriate to account for a Sunset Clause as an exchange. For example, a Sunset Clause may contemplate that a replacement product may have more than minimal differences in functionality or features from the sunset product (e.g., if the sunset product is replaced by a product suite). In such cases, the clause may contractually limit the customer's ability to use the replacement product to only the equivalent features and functionality of the sunset product and preclude access to the new product features or functionality. Determining if such clauses may be accounted for in a manner analogous to an exchange right will require a careful analysis of the applicable facts and circumstances of the arrangement, including whether it is technologically feasible to restrict customer access to certain features and functionality of the replacement product and, of course, the exercise of significant professional judgment.

If a Sunset Clause cannot be accounted for in a manner analogous to an exchange right, we believe it generally should be evaluated to determine if it should be accounted for in a manner analogous to either 1) a right to an unspecified additional software product (subscription accounting) or 2) a right to one of the following specified future deliverables:

- An upgrade right for a specified upgrade/enhancement
- A specified additional software product

Each of these is discussed in greater detail below.

Subscription accounting

ASC 985-605 distinguishes PCS from the right to unspecified future products as follows: "a vendor may agree to deliver software currently and to deliver unspecified additional software products in the future… For example, the vendor may agree to deliver all new products to be introduced in a family of products over the next two years. These arrangements are similar to arrangements that include postcontract customer support in that future deliverables are unspecified. Nevertheless, they are distinguished from arrangements that include postcontract customer support because the future deliverables are products, not unspecified upgrades or enhancements."

We believe that when a Sunset Clause provides a customer the right to any unspecified product that "replaces" the currently licensed version, including any unspecified new features and functionality included in that product, and that right cannot be accounted for in a manner analogous to an exchange right (based on the considerations discussed above), it may be accounted for in a manner analogous to a right to receive unspecified future products (see Question 5-29). This accounting should be applied even if the vendor has no intention of sunsetting the currently licensed product at the outset of the arrangement.

Rights to unspecified future products should be accounted for as a subscription, and "all software product-related revenue from the arrangement should be recognized ratably over the term of the arrangement beginning with delivery of the first product" provided that all other revenue recognition criteria are met. When determining the period over which revenue should be recognized for arrangements containing such clauses, a vendor should consider whether future PCS renewals (which include the right to receive unspecified future products if and when the currently licensed product is sunset) are priced at a significant and incremental discount (see Question 7-17). If future PCS renewals are *not* priced at a significant and incremental discount, the revenue from the arrangement should be recognized ratably over the initial PCS period, assuming the Sunset Clause is operative only as long as the customer has an in-force PCS arrangement and the initial PCS period is substantive (i.e., one year or longer — see Question 7-21). However, if 1) the term of the right conveyed by the Sunset Clause is not specified, 2) the initial PCS period is not substantive or 3) future PCS renewals have been priced at a significant and incremental discount or the vendor cannot determine if future PCS renewals have been so priced, the revenue should be recognized ratably over the estimated economic life of the licensed software product.

It is important to note that this accounting is only appropriate when the replacement product, including its features and functionality, is unspecified as of the date the agreement for the currently licensed product is executed. If these items are specified, we believe the Sunset Clause generally should be accounted for in a manner analogous to either a right to a specified future upgrade/enhancement or a specified additional software product, as discussed below.

All relevant facts and circumstances, and not just the contractual language, must be considered when determining if a Sunset Clause is in fact analogous to a right to a specified future upgrade/enhancement or a specified additional software product. A replacement product, or its features and functionality, may be considered specified even if the product, and its features and functionality, are not explicitly set forth in the licensing arrangement. For example, if a software vendor 1) anticipates that it will sunset a product, 2) has agreed to the inclusion of a Sunset Clause in an arrangement with a customer to license that product and 3) has orally conveyed the replacement product, including its features and functionality, to be provided once the licensed software is sunset, it would be inappropriate to conclude that the replacement product is unspecified.

Rights to a specified future deliverable

We believe that when a Sunset Clause specifies a replacement product, the features or functionality that will be included in it (either contractually or through other communications to the customer), the right should be accounted for in a manner analogous to either 1) a right to a specified future upgrade/enhancement or 2) a specified additional software product.

In either case, the right should be accounted for as an element of the arrangement with the customer. Timing of revenue recognition would depend on whether or not VSOE of fair value for the upgrade right (see Question 5-18) or the specified additional software product (see Question 5-23) exists.

If a software vendor could demonstrate that other customers will be charged incremental license fees, assessed at a price that is both substantive and consistently charged across a class of customers, for any additional features and functionality when these features or functionality are made available in the replacement product, then VSOE of fair value potentially could be established for the upgrade right or the specified additional software product. In such cases, we believe that no amounts would be required to be deferred for the right to a specified future upgrade/enhancement or a specified additional software product because fair value for the replacement software product would be received by the vendor when the currently licensed product is sunset.

However, we believe that it will be rare that a software vendor will be able to demonstrate that it will receive VSOE of fair value for upgrade rights for a specified future upgrade/enhancement or a specified additional software product to be provided when a currently licensed product is sunset. In the absence of such evidence, all revenue relating to the initial arrangement (including bundled PCS, professional services and other elements in the arrangement) must be deferred until the earlier of one of the following events:

- The vendor establishes VSOE of the fair value of 1) the upgrade right for a specified upgrade/enhancement or the specified additional software product and 2) all other undelivered elements included in the arrangement
- The vendor delivers all elements included in the arrangement
- The currently licensed product is sunset, the replacement product is delivered, and VSOE of fair value exists for any remaining undelivered elements included in the arrangement (e.g., if the vendor has established VSOE of fair value for PCS and that is the only remaining undelivered element)

5.3 Upgrades or enhancements

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-44

As part of a multiple-element arrangement, a vendor may agree to deliver software currently and provide the customer with an upgrade right for a specified upgrade or enhancement. The upgrade right may be evidenced by a specific agreement, commitment, or the vendor's established practice. (Rights to receive unspecified upgrades or enhancements on a when-and-if-available basis are postcontract customer support.) The upgrade right shall be accounted for as a separate element in accordance with paragraphs 985-605-25-3 through 25-14. Guidance on the application of those paragraphs to multiple-element software arrangements that include upgrade rights is in paragraphs 985-605-25-45 through 25-46.

985-605-25-45

If a multiple-element arrangement includes an upgrade right, the fee shall be allocated between the elements based on vendor-specific objective evidence of fair value. The fee allocated to the upgrade right is the price for the upgrade or enhancement that would be charged to existing users of the software product being updated. If the upgrade right is included in a multiple-element arrangement on which a discount has been offered (see paragraph 985-605-25-8), no portion of the discount shall be allocated to the upgrade right. If sufficient vendor-specific evidence exists to reasonably estimate the percentage of customers that are not expected to exercise the upgrade right, the fee allocated to the upgrade right shall be reduced to reflect that percentage. This estimated percentage shall be reviewed periodically. The effect of any change in that percentage shall be accounted for as a change in accounting estimate.

985-605-25-46

The amount of the fee allocated to the upgrade right shall be recognized as revenue when the conditions in paragraphs 985-605-25-3 through 25-14 are met. If sufficient vendor-specific objective evidence does not exist for the allocation of the fee to the upgrade right, revenue from the arrangement shall be deferred until the earlier of either:

a. The point at which such sufficient vendor-specific objective evidence does exist.

b. The point at which all elements of the arrangement have been delivered.

ASC 985-605-20 defines an upgrade/enhancement as "an improvement to an existing product that is intended to extend the life or improve significantly the marketability of the original product through added functionality, enhanced performance, or both. The terms upgrade and enhancement are used interchangeably to describe improvements to software products; however, in different segments of the software industry, those terms may connote different levels of packaging or improvements."

When a software arrangement provides the customer with an upgrade right for a specified upgrade or enhancement of the licensed software in addition to the licensed software products, that right (a "specified upgrade right") must be accounted for as a separate element of the arrangement. However, rights to receive unspecified upgrades on a when-and-if-available basis should be accounted for as PCS (see Chapter VII).

When a specified upgrade right is included in a software licensing arrangement, a portion of the total licensing fee should be allocated to that element based on VSOE of fair value, if such evidence exists (however, our experience is that it would be rare for a software vendor to establish VSOE of fair value for a specified upgrade right because the right usually pertains to a product that is always sold with PCS and never in a separate standalone sale). If the arrangement includes a discount, no portion of the discount should be allocated to the specified upgrade right.

If a software vendor does not have VSOE of fair value for a specified upgrade right, revenue should not be recognized for the arrangement until the earlier of one of the following events occurs:

- The vendor establishes VSOE of 1) the fair value of the specified upgrade right and 2) the fair value of all other undelivered elements included in the arrangement
- The vendor delivers all elements included in the arrangement
- The upgrade/enhancement that is the subject of the upgrade right is delivered and VSOE of fair value exists for the remaining undelivered elements included in the arrangement (e.g., if the vendor has VSOE of fair value for PCS and that is the only remaining undelivered element once the upgrade/enhancement that is the subject of the upgrade right has been delivered)
- The vendor communicates to the customer in the same manner that the specified upgrade right was initially communicated that the specified upgrade will never be delivered (and will not be included in a subsequent release)

Determining if an arrangement includes a specified upgrade right

Question 5-13 **What factors should be considered when assessing whether an arrangement includes a specified upgrade right?**

An upgrade right is defined in ASC 985-605-20 as "the right to receive one or more specific upgrades or enhancements." In deliberating the software revenue recognition guidance, AcSEC acknowledged that they believed that when arrangements include upgrade rights, it may be difficult to determine which version of the software induced the customer to enter into the arrangement.

When a customer has sufficient detail regarding the future state of a product (e.g., future releases) at the time a contract is executed, it is difficult to know whether that information influenced the customer's current buying decision. For example, a customer may desire specific features or functionality not available in the vendor's currently available product that the vendor communicates (contractually or otherwise) will be included in a future version. If a customer understands the future features or functionality that a vendor plans to incorporate into its products and the anticipated release date of the enhanced product, or if the vendor contractually commits to provide enhancements to the licensed product that are desired by a customer, the customer may agree to buy the product today relying on the fact it will receive the enhanced version of the product at a later date. In such cases, the arrangement may include an upgrade right for a specified upgrade/enhancement (a "specified upgrade right") that should be accounted for as an element of the transaction.

ASC 985-605 distinguishes between a specified upgrade right and postcontract customer support (PCS) arrangements offered by software vendors that typically provide customers the rights to receive unspecified upgrades in the future on a when-and-if-available basis. A right to receive an unspecified upgrade/enhancement on a when-and-if-available basis is accounted for as a component of PCS, while specified upgrade rights and rights to receive specified additional software products are both accounted for as separate elements of the arrangement — even if a customer would otherwise be entitled to the specified upgrade/enhancement or the additional products as a part of PCS or if the agreement stipulates that the specified upgrade will only be provided on a when-and-if-available basis.

An upgrade may be specified explicitly by stating the upgrade name or version number in the agreement. For example, a vendor may license version 3.0 of a product and commit to provide version 3.1. In addition, discussion in an arrangement of specific features and functionality to be included in future versions of the currently licensed software generally would represent a specified upgrade right, even if the customer will receive the upgrades as a purchaser of PCS.

When a vendor contractually commits to provide a specified upgrade to a customer, a non-rebuttable presumption exists that the customer has bargained for the specified upgrade right. In these situations, the arrangement should be deemed a multiple-element arrangement that includes a specified upgrade right that must be accounted for as an element of the arrangement. In such cases, arrangement consideration should be allocated to the specified upgrade right and recognized as revenue as discussed in Questions 5-18 and 5-20, respectively.

Determining that a specified upgrade right has been provided to a customer is relatively straightforward when a vendor explicitly commits to provide an upgraded version of the licensed product as a contractual term of an arrangement with a customer. However, information regarding a specified upgrade right may be communicated through means other than contractual provisions. These other communications (e.g., roadmaps, websites and trade shows) may also cause a customer to make a current purchasing decision while relying on the fact it will receive the upgraded or enhanced version of the product at a later date. In such cases, the arrangement may include a specified upgrade right that should be accounted for as an element of the arrangement. Examples of such communications include the following:

- Vendors may commit to provide specified upgrades though communications made outside of a written agreement with a customer. Examples of such commitments include written statements by representatives of the vendor authorized to enter into arrangements with customers and written responses to a customer's request for proposal that are accepted by the customer. As a practical matter, commitments also include announcements or other statements committing, agreeing or otherwise promising to deliver or make available a specified upgrade.

- If a vendor contractually agrees to deliver unspecified upgrades on a when-and-if-available basis pursuant to a PCS arrangement, an express conditional right exists (i.e., the right to receive the upgrade is conditioned on "when and if" the upgrades are made available by the vendor). A vendor may make specific communications to a customer about future upgrades outside of a contractual arrangement by means of product roadmaps (see Question 5-16), announcements, press releases, web sites, marketing collateral or other means. Notwithstanding the inclusion of "entire arrangement" clauses in an agreement as discussed below, such communications may be considered by the customer to be part of an arrangement with a vendor, practically eliminating the conditional aspect of the express contractual right (i.e., removing the "if" in "when-and-if available") resulting in a specified upgrade right.

- A vendor's established business practices may create an implied upgrade right even if no such contractual right has been provided to a customer. For example, a vendor may have a practice of voluntarily providing upgrades to customers despite the lack of a contractual obligation to do so to keep customers satisfied, to gain market share or for other reasons.

  Voluntarily providing upgrades indicates an arrangement includes implied PCS (see Question 7-2). However, when a vendor has established such a practice and has also made specific communications about future upgrades to customers, this may create an implied specified upgrade right that should be accounted for as a separate element of the arrangement.

Determining when a specified upgrade right has been provided to a customer if a contract does not explicitly include such a right may require the exercise of professional judgment. However, the key consideration is whether the vendor has provided a level of information to its customers regarding the features, functionality and release date of future product enhancements in sufficient detail such that it is likely the vendor has created an expectation by the customer that it will receive a specific upgrade/enhancement without significant additional cost. Key factors to consider in making this judgment include:

- *What level of detail regarding the features, functionality and the anticipated release date of future product enhancements has been provided to the customer*? Generally, the greater the level of detail and specificity contained in communications to the customer, and the closer the anticipated release date of the enhancements to the origination of the arrangement with the customer, the more likely it is that the customer has formed an expectation regarding the release of the future product enhancement(s) that has affected the current purchasing decision.

The following examples illustrate communications that may or may not be of such specificity that a specified upgrade is created.

Illustration 5-14: Communications that may or may not indicate that the arrangement includes a specified upgrade right

	Example communication	Analysis
1.	We anticipate that a new version of the Omega product will be released over the next 18-24 months. The features included in such release will consider feedback from user groups and our customers.	This communication should not be accounted for as a specified upgrade right because of the lack of specific detail regarding the enhancements that will be included in the next version of the product.
2.	We anticipate that a new version of the Omega product will be released within the next 12 months. The composition of such release will consider feedback from user groups and our customers. However, at a minimum, this release will be designed to ensure compatibility with Shutters XL Media Center Edition. *(Presume that the currently shipped product does not function with Shutters XL.)*	In contrast to Example 1., this communication may be a specified upgrade right because of the level of detail regarding the minimum enhancements that will be included in the next version of the product and the specificity and relative proximity of the projected release date to the date of the arrangement with the customer.
3.	We anticipate that a merged product, containing the best features of the two combining companies' competing products (Alpha and Omega), as determined by feedback solicited from user groups and our customers, will be released within the next four years. We anticipate that the successor product will evolve over time and incorporate the latest in web-based architecture. Additionally, we will evaluate which of the unique capabilities of Alpha can be incorporated into Omega in the shorter-term.	This communication should not be accounted for as a specified upgrade right because of the lack of specificity and timing as to the incorporation into Omega of any of Alpha's features.
4.	We anticipate that within 18 months the combined company will release an enhanced version of Omega, which will increase Omega's performance in sales management tracking through the incorporation of Alpha's remote and wireless access capabilities into the Omega product.	In contrast to Example 3., this communication may be a specified upgrade right because of the level of detail regarding the specific features of Alpha to be incorporated into Omega within a specified time frame in relatively close proximity to the date of the arrangement with the customer (the version that will be released within 18 months).

General information about product developments or the timing thereof, trends in product development and corporate outlook typically are not of such specificity that a specified upgrade right should be deemed to exist. Further, information provided about an upgrade/enhancement by third parties (e.g., industry or trade groups, uncompensated product reviewers) generally does not create a specified upgrade right, unless the third party is acting as the vendor's agent because the communications are not directly between the vendor and the customer.

- *Has the vendor used caveat language regarding its plans to deliver an upgrade/ enhancement that can be judged to have created a reasonable amount of uncertainty in the mind of a customer about whether it will actually receive such an upgrade/ enhancement*? Many software companies include caveat language in their written arrangements with customers wherein, by signing the written arrangement, the customer acknowledges that 1) it has not relied on any information outside the written arrangement or 2) its rights to publicly announced upgrades or other marketed upgrades are expressly limited. Additionally, many vendors include language in marketing collateral, websites, etc. indicating that the determination of when enhancements to its current products will be made available, if ever, remains at the vendor's sole discretion and that the information contained in such communications does not constitute a commitment to deliver an upgrade/enhancement.

Examples of caveat language and other arrangement terms that might be used by a software vendor include:

- "This information is intended to outline our general product direction and it should not be relied on in making a purchasing decision."
- "This material is for information purposes only, and may not be incorporated into any contract."
- "This information is not a commitment, promise or legal obligation to deliver any material, code, or functionality."
- "The development, release, and timing of any features or functionality described for our products remains at our sole discretion."
- "Entire arrangement" clauses that limit customers to those deliverables specified in the written arrangements (i.e., by signing, the customer agrees that they were not entitled to anything other than the products contained within the specific arrangement)
- Language in the written arrangement such as "the customer has not relied on the availability of any future version of the purchased product or any future product in executing the license agreement."

Such caveat language may serve to create a reasonable amount of uncertainty in the customer's mind as to whether or not they will ever receive a specific upgrade/enhancement. However, a vendor's use of robust caveat language may still be insufficient to interject a reasonable amount of uncertainty into communications that otherwise are likely to have created an expectation by the customer that it will receive a specific upgrade/enhancement (i.e., a communication likely was to have affected the customer's current buying decision) if the communication contains detailed descriptions of the functionality to be included in future enhancements and the targeted release dates are within a relatively short time horizon.

Caveat language works best in situations where information is provided to customers in the form of a general communication, such as a press release or web page, and the caveat language is included in both the general communication document(s) and in written arrangements with customers. As an example, if a vendor announces on its website that the next version of its product will be available in 12-18 months, but provides little detail regarding the features and functionality to be included in the next version and includes caveat language both on the website and in the written arrangement with the customer, this caveat language generally will create sufficient uncertainty such that it is not a likely expectation of a customer to receive a specific upgrade/enhancement.

Regardless of the existence of what might otherwise be appropriate caveat language, any communication with the customer by the vendor, or its representatives, that contradicts or otherwise indicates the caveat language should not limit the customer's expectations, should be deemed to make the caveat language ineffective for evaluation purposes. For example, if a product roadmap is customized to a specific customer's needs and shared with that customer (either at management's discretion or to meet a contractually specified requirement), the presence of caveat language generally would not be a sufficient basis to conclude that a likely expectation by the customer that it will receive a specific upgrade/enhancement has been mitigated.

- *Is the communication of a general nature made available to all customers or to an entire class of customers, or is it specific to one or a few customers*? Although the form of communication in and of itself will not be conclusive in determining whether a specified upgrade right exists, it is important to understand the form of communication to assist in evaluating the factors discussed above in their proper context. Generally, it is less likely that information broadly communicated to all customers, or an entire class of customers, will create an expectation by any individual customer that it will receive a specific upgrade/enhancement although customer-wide communications may be designed to create such an expectation (e.g., roadmaps following mergers of companies providing competing products). Conversely, it is relatively more likely that a communications made specifically to one or a few customers would create such an expectation.

- *Does a vendor have a practice of separately charging a substantive amount (and relevant history to corroborate an assertion that it will continue to do so) for upgrades/ enhancements communicated to customers*? Such a history may indicate that enhanced products, once released, will be subject to a subsequent arrangement with the customer and, therefore, are not an element of the current arrangement that must be accounted for as a specified upgrade right.

The following examples illustrate these concepts:

Illustration 5-15: Contractual arrangement includes a specified upgrade right

Facts

A vendor licenses version 6.0 of a software product. The vendor currently is developing an upgrade of its product to version 7.0, which will be available for general release in two months. The vendor includes in the contractual arrangement a right for the customer to obtain version 7.0 on its release.

Analysis

Because the contract specifies that the customer will receive Version 7.0 of the licensed software on its release, the agreement includes a specified upgrade right that must be accounted for as an element of the arrangement.

Illustration 5-16: PCS combined with specific communications outside of the contract regarding upgrades to be provided without the use of caveat language

Facts

A vendor currently markets version 6.0 of a software product. The vendor currently is developing an upgrade to version 6.0 of its software product. The upgrade, version 7.0, will be available for general release in two months. The vendor publicly announces the release date, version number and new features and functionality that will be included in version 7.0.

After the announcement, the vendor enters a software arrangement to license Version 6.0 bundled with one year of PCS that entitles the customer to unspecified upgrades on a when-and-if-available basis. The written agreement with the customer does not include specific rights to version 7.0. However, the PCS arrangement grants the customer the right to receive all future upgrades, when-and-if-available, without limitation.

Analysis

Because the vendor has communicated a high level of detail and specificity regarding the release of the version 7.0 upgrade, which is expected to be released within a short time frame, and has not included any caveat language relating to the release of the upgrade, the conditional aspect of the right to receive upgrades on a when-and-if-available basis has been removed. Accordingly, it is difficult to determine which version was licensed. The agreement should be deemed to include a specified upgrade right that should be accounted for as an element of the arrangement.

Illustration 5-17:	PCS combined with specific communications regarding upgrades to be provided with the use of caveat language

Facts

Assume the same facts as in Example 2 above, except that the announcements relating to the anticipated release of version 7.0 of the software product include caveat language stating that the determination of when version 7.0 will be made available, if ever, remains at the sole discretion of the vendor. Additionally, the upgrade will be available for general release in ten to twelve months instead of two months. Additionally, the written agreements with the customer include "entire arrangement" clauses that limit customers to those deliverables specified in the agreement (i.e., by signing, the customer concurs that they were not entitled to anything other than that contained within the specific agreement.)

Analysis

In this illustration, the vendor has used caveat language that can be judged to have created a reasonable amount of uncertainty in the customer's mind as to whether or not they will ever receive the upgrade to version 7.0. Accordingly, no specified upgrade right exists that must be accounted for as a separate element of the arrangement.

Illustration 5-18:	Vendor history combined with specific communications creates a specified upgrade right

Facts

A vendor licenses version 6.0 of its software product to a customer. The contract does not include any provisions for the customer to receive subsequent upgrades or other support (i.e., the contract does not specify that PCS is an element of the arrangement).

The vendor has a history of providing upgrades free of additional charge to customers that have purchased a product within three months of the release of an upgrade even though the arrangements with the customers do not require it to do so.

The vendor currently is developing an upgrade to Version 7.0 of the licensed product. Information regarding the upgrade has been specified on the vendor's web site and in marketing materials delivered to prospective customers. This information describes the new features and functionality, the anticipated release date and the hardware and operating system requirements. Version 7.0 will be available for general release in two months.

Analysis

Because 1) the vendor has a history of regularly providing its customers with free product upgrades if the previous version of the product has been licensed within three months of the release, even if not contractually obligated to do so and 2) the upgrade is specified in marketing materials made available to the customer, an implied specified upgrade right exists that must be accounted for as an element of the arrangement.

Illustration 5-19: Communications made in written response to a request for proposal

Facts

In a written response to a request for proposal (RFP), a vendor represents to a prospective customer that Product A will have specific functionality included in a future upgrade within six months. The customer decides to license the currently marketed version of software Product A from the vendor. The licensing agreement does not commit the vendor to deliver the upgrades specified in the RFP; instead, the agreement states that the vendor will deliver all upgrades to Product A on a when-and-if-available basis under PCS.

Analysis

Because the vendor has committed to provide an upgrade to the currently licensed product in the response to the RFP, it is likely that the customer has formed an expectation that has affected its decision to license the current version of the software product. Accordingly, the arrangement should be deemed to include a specified upgrade right that should be accounted for as an element of the arrangement.

In order for vendors to protect themselves from unintentionally granting specified upgrade rights, we recommend companies carefully and regularly review their marketing materials, web sites, press releases, talking points used by sales personnel and other media available to customers. Additionally, vendors should be particularly cautious of creating commitments in written correspondence with customers (e.g., responses to RFPs). Further, vendors that license software with PCS or other agreements that grant customers rights to future upgrades, even on a when-and-if-available basis, should consider expressly limiting (in the contractual arrangement and in the marketing collateral) the customer's rights to publicly announced upgrades or other marketed upgrades . The specific facts and circumstances must be evaluated in each case, and we recommend companies consult with their accounting and legal advisors when determining whether a specified upgrade right exists.

Specified upgrade rights versus rights to information updates

Question 5-14 **What is the difference between a specified upgrade right and rights to updates that keep the software product updated with current information (referred to herein as "information updates")?**

ASC 985-605-20 defines an upgrade as "an improvement to an existing product that is intended to extend the life or improve significantly the marketability of the original product through added functionality, enhanced performance, or both." This definition focuses on improvements to a software product achieved through added functionality or enhanced performance.

As part of a software licensing arrangement, a vendor may commit to update a software product with more current information ("information updates") to maintain current functionality and performance. For example, a vendor of retail point-of-sale software may provide periodic information updates for changes in sales tax laws by taxing jurisdictions. A commitment to provide unspecified information updates on a when-and-if-available basis to maintain the existing functionality of a licensed software program (either due to contractual obligations or as a matter of practice) should be accounted for as PCS rather than a specified upgrade right. However, if a particular information update is specified at the outset of an arrangement (either an initial software license or a PCS renewal), it should be accounted for as a specified upgrade right (see Question 7-5).

If a single release contains both information updates and specified upgrade rights and the specified upgrade right cannot be separated from the information update, we believe the release should be accounted for as a specified upgrade right.

The following examples illustrate these concepts:

Illustration 5-20: Informational updates provided to maintain functionality of licensed software

Facts

A software vendor enters into an arrangement to license payroll processing software to a customer. As part of the arrangement, the vendor agrees to provide periodic updates to keep the product current for changes in payroll tax laws during the term of the software license.

Analysis

Such updates change the features and functionality of the licensed software as changes in law occur. Accordingly, the vendor's obligations to provide the informational updates should be accounted for as a part of PCS.

Illustration 5-21: Specified upgrade to add functionality to licensed software

Facts

Assume the same facts as Illustration 5-20 above, except that the vendor also agrees to provide to the customer an enhancement within three months that will allow the software to calculate and deduct withholdings for court-ordered payroll garnishments. The software, as originally licensed by the customer, does not include such functionality.

Analysis

Because the vendor has agreed to deliver an upgrade that will enhance the features and functionality of the software, and the additional features and functionality and general release time frame of the upgrade are known to the customer, the commitment should be accounted for as a specified upgrade right.

Specified upgrade rights versus a right to receive unspecified upgrades

Question 5-15 **How do specified upgrade rights differ from rights to receive unspecified upgrades?**

ASC 985-605 distinguishes between a specified upgrade right and PCS arrangements offered by software vendors that typically provide customers the rights to receive unspecified upgrades in the future when and if such upgrades are released by the vendor. An upgrade right for unspecified upgrade/enhancements provided on a when-and-if-available basis is accounted for as PCS (see Chapter VII), while specified upgrade rights are accounted for as a separate element of the arrangement, even if a customer would otherwise be entitled to the specified upgrade/enhancement as a part of PCS.

Considerations relating to product roadmaps

Question 5-16 **A vendor may provide customers a product roadmap that outlines plans regarding future enhancements to its products or the strategic direction of its product development efforts. Can the provision of such information to customers result in an arrangement being deemed to contain a specified upgrade right?**

Yes, the provision of product roadmaps to a customer can result in an arrangement being deemed to include a specified upgrade right.

Roadmaps may take such forms as product development plans, press releases, information on a website, marketing collateral or executive presentations. Roadmaps may be used by a vendor in its marketing activities for the following reasons, among others:

- To influence the selection of the vendor's software over a competitor's
- To keep its customer base informed of the planned evolution of its currently available products
- Subsequent to an acquisition, to provide the combined customer base information regarding the combined enterprise's planned product migration path

As discussed in Question 5-13, when a customer has sufficient detail regarding the future state of a product (e.g., future features and functionality) at the time a contract is executed, it is difficult to know if that information influenced the customer's current buying decision. For example, a customer may desire specific features or functionality that are not available in the vendor's currently marketed product, but the roadmap suggests will be included in a future version. If the roadmap describes the future features or functionality and the anticipated release date of the enhanced product, the customer may agree to buy the product today, based on the expectation it will receive the enhanced version of the product at a later date. Because it is difficult to understand all the factors that influence a customer's buying decision when specific details regarding the future features and functionality and release date of a product have been communicated, that communication (the roadmap) could have affected the customer's current buying decision and created a specified upgrade right that should be accounted for as an element of the arrangement.

If a roadmap describes the features, functionality and release date of future product enhancements in sufficient detail for the customer to know what will be made available and the general timeframe in which it will be delivered, a specified upgrade right generally has been created. However, significant judgment is required when determining if a roadmap describes the features, functionality and release date of future product enhancements in sufficient detail such the information included in the roadmap likely was to have affected the customer's current buying decision. When evaluating whether a roadmap has created such an expectation, the factors discussed in Question 5-13 should be considered.

Specified upgrade rights versus additional specified software products

Question 5-17 **How should a vendor determine if it has provided a customer with a specified upgrade right or a right to additional specified software products as an element of an arrangement? Is the distinction important?**

ASC 985-605 does not provide guidance on how to distinguish between a vendor's commitment to deliver an additional software product from commitments that amount to a specified upgrade right. However, the distinction is important because if an arrangement includes a discount, when allocating the arrangement consideration to the elements included in a multiple-element arrangement (assuming the elements can be accounted for separately), no portion of the discount may be allocated to a specified upgrade right, while a proportionate amount of the discount may be allocated to an additional software product.

A key consideration relates to whether the undelivered software product is an enhanced version of the delivered product. If so, the right should be accounted for as a specified upgrade right. If not, the right should be accounted for as the right to receive a specified additional software product. ASC 985-605 does not define software products; however, it does provide guidelines to differentiate among products. ASC 985-605-25-64 states that "products are considered to be the same product if there are no more than minimal differences among them in price, features, and functions, and if they are marketed as the same product, even though there may be differences arising from environmental variables such as operating systems, databases, user interfaces, and platform scales. Indicators of "marketed as the same product" include the same product name (although version numbers may differ) and a focus on the same features and functions."

In some cases, it may be readily apparent whether a vendor has provided a customer a specified upgrade right or a right to receive additional specified software products. In other cases, the exercise of professional judgment may be required. Although any determination must be based on the applicable facts and circumstances, the following factors should be considered:

- *The name of the undelivered product*. If the product has a different name than the delivered software product, this may indicate that a right to an additional specified software product exists.
- *How the undelivered product is marketed*. If the additional product is marketed as a software product distinct from the currently delivered product, this may indicate that a right to an additional specified software product exists.
- *The nature and significance of differences in the features and functionality of the undelivered product from the delivered product*. If the undelivered product has significant differences in the features and functionality, or if the undelivered product functions outside the domain of the currently licensed products, this may indicate that a right to an additional specified software product exists.
- *Whether the customer receives the right to use the undelivered product as a replacement for the currently licensed and delivered product as opposed to being able to use it in addition to such product*. If the undelivered product is intended to be used to substantially replace the licensed product, this is a strong indicator of a specified upgrade right.
- *Whether the undelivered product requires a significant development effort*. If so, this may indicate that a right to an additional specified software product exists.
- *Whether the pricing of the undelivered product, including discounts provided to existing customers, is consistent with the delivered product*. If the additional product is priced at an amount that is significantly higher than the price of the currently delivered product, or if users of the currently delivered product are offered no discount, or only an insignificant discount, in connection with new licenses of the additional product, this may indicate that a right to an additional specified software product exists.

The following examples illustrate these concepts:

Illustration 5-22: Arrangement includes a right to a specified additional software product

Facts

A software vendor offers a popular spreadsheet software program, Spreadsheet. The vendor also offers a word processing program, Processor. The programs are marketed as distinct products and have different features and functionality. The programs are regularly sold separately by the vendor (i.e., the vendor regularly licenses Spreadsheet without also licensing Processor in the arrangement and vice versa).

The vendor enters into an arrangement with a customer to license the current version of Spreadsheet, version 4.0. The customer is a current licensee of Processor, version 3.0. The vendor currently is developing an upgrade of Processor to version 4.0, which it anticipates will be available for general release in two months. The arrangement specifies that the customer is to be provided version 4.0 of Processor once released.

Analysis

In this illustration, the right to receive version 4.0 of Processor is a right to a specified additional software product that should be accounted for in accordance with ASC 985-605-25-47 through 25-50. Spreadsheet and Processor have separate names, different features and functionality and are sold and marketed separately. These factors indicate the programs are different products.

Illustration 5-23: Arrangement includes a specified upgrade right

Facts

Assume the same facts as in Illustration 5-22 above, except that the vendor markets the two programs, in conjunction with certain other programs (e.g., calendar and e-mail programs), as a suite of programs, termed Productivity, to businesses as a packaged solution. The programs included in Productivity, while separately named, are not marketed as distinct products and, although they have different features and functionality, are not separately licensed by the vendor.

The vendor enters into an arrangement with a customer to license the Productivity suite of programs, which includes version 4.0 of Spreadsheet and version 3.0 of Processor. The vendor currently is developing an upgrade of Processor to version 4.0, which it anticipates will be available for general release in two months. The arrangement specifies that the customer is to be provided version 4.0 of Processor once released.

Analysis

In this example, the right to receive the specific enhanced version of Processor is a specified upgrade right that should be accounted for in accordance with ASC 985-605-25-44 through 25-46. Although Spreadsheet and Processor have separate names and different features and functionality, the programs are not marketed separately. Rather, they are marketed as a component of a solution composed of a number of programs. This indicates that the solution is the software product, and not the component programs of the solution.

Allocating arrangement consideration to specified upgrade rights

Question 5-18 **When an arrangement includes a specified upgrade right, and the elements of the arrangement can be accounted for separately, how should amounts be allocated to the specified upgrade right?**

ASC 985-605 requires a unique allocation of an arrangement's consideration to a specified upgrade right that does not apply to any other elements. In multiple-element arrangements, if the total VSOE of the fair value of each of the elements in the arrangement exceeds the amount to be received under the arrangement (i.e., a discount exists) no portion of the discount may be allocated to the specified upgrade right. In deliberating the software revenue recognition guidance, AcSEC indicated that when arrangements include specified upgrade rights, it is difficult to determine which version of the software the customer purchased. Therefore, to prevent the allocation of too much revenue to the delivered product, AcSEC concluded that no discount in an arrangement should be allocated to a specified upgrade right.

The following example illustrates these concepts:

Illustration 5-24: Allocating arrangement consideration to specified upgrade rights

Facts

A software vendor licenses version 3.0 of Product A to a customer for $200,000. The arrangement includes a right allowing the customer to receive version 4.0 at no additional charge. VSOE of fair value of version 3.0 of the product is $175,000 and VSOE of fair value of the specified upgrade right to version 4.0 is $50,000. There are no other elements in the arrangement.

Analysis

An inherent discount of $25,000 ($175,000+$50,000-$200,000) exists in the arrangement, but none should be allocated to the specified upgrade right. Rather, all of the discount should be allocated to the software product. Accordingly, $150,000 ($200,000-$50,000) of arrangement consideration is allocated to the delivered software product (version 3.0) and $50,000 is allocated to the specified upgrade right.

The above example illustrates the accounting for a specified upgrade right when VSOE of fair value exists. However, our experience is that it would be rare for a software vendor to establish VSOE of fair value for a specified upgrade right because the right usually pertains to a product that is always sold with PCS or a software license and never in a separate standalone sale.

Estimating breakage when allocating arrangement consideration to specified upgrade rights

Question 5-19 **If a vendor anticipates that not all customers provided with a specified upgrade right will exercise the right to receive the enhanced product (i.e., breakage will occur), may it consider the anticipated breakage when determining the amount of arrangement consideration that should be allocated to a specified upgrade right (assuming that the specified upgrade right can be accounted for separately from the other elements of the arrangement)?**

A number of factors may cause a customer not to exercise a specified upgrade right, including the following:

- The cost in time and money of implementing the upgrade may be prohibitive when compared to the benefits.
- The new features of the upgrade may not be important to a customer.
- The customer may not want to learn new commands for perceived marginal improvements.
- The customer may be concerned by the perceived higher potential for bugs/disruptions in a major upgrade and may defer/avoid upgrade until such time as this matter is clear.
- The upgrade may require more hardware capability than the customer presently possesses.

If a specified upgrade right included in an arrangement can be accounted for separately, ASC 985-605-25-45 states that if "sufficient vendor-specific evidence exists to reasonably estimate the percentage of customers that are not expected to exercise the upgrade right, the fee allocated to the upgrade right should be reduced to reflect that percentage." Accordingly, if vendor-specific evidence of the percentage of customers not expected to exercise a specified upgrade right exists, the amount allocated to the specified upgrade right should be reduced by the estimated breakage percentage.

When assessing whether evidence to estimate breakage exists, the following should be considered:

- *Does sufficient company-specific information exist on which to base the breakage assumptions?* It would be problematic if a vendor does not have information systems that have the ability to capture and analyze the data necessary to develop objective, reliable company-specific history to support a breakage estimate or lacks sufficient objectively-determinable, reliable company-specific information for other reasons. It would be inappropriate to estimate and recognize breakage based on reference to industry averages or peer companies' experience.
- *Are breakage assumptions based on a large population of relatively homogenous transactions?* If such a population does not exist, a vendor will lack the level of experience with the rates at which customers will fail to exercise a specified upgrade right needed to reasonably estimate the breakage rate.
- *Is a vendor's historical experience with rates at which customers exercise specified upgrade rights predictive of future redemption rates?* Changes in marketing policies, customer needs, competitor actions or other factors may affect customers' exercise patterns and may mean that historical evidence is not an appropriate basis on which to estimate future breakage rates.
- *Can reliable estimates of breakage be made on a timely basis?* Recurring, significant differences between actual breakage rates and estimated rates may be indicative of an inability to make such estimates (even if the difference is not material to a vendor's consolidated financial statements).

Absent sufficient evidence that an estimable portion of customers will not exercise a specified upgrade right, the vendor must assume all customers will exercise the upgrade rights (i.e., no assumption that breakage will occur should be made when allocating arrangement consideration to the specified upgrade right).

The following example illustrates these concepts:

Illustration 5-25: Estimating breakage when allocating arrangement consideration to specified upgrade rights

Facts

A software vendor licenses version 3.0 of Product A to a customer for $200,000. The arrangement includes a right allowing the customer to receive version 4.0 at no additional charge. VSOE of fair value of Version 3.0 of the product is $175,000 and VSOE of fair value of the specified upgrade right to Version 4.0 is $50,000. There are no other elements in the arrangement.

An inherent discount of $25,000 ($175,000+$50,000-$200,000) exists in the arrangement, but none of the discount is allocated to the specified upgrade right. Rather, the entire discount is allocated to the software product. Accordingly, $50,000 of arrangement consideration is allocable to the specified upgrade right (see Question 5-18), prior to any consideration of breakage. Vendor-specific evidence exists that 20% of customers will not exercise the upgrade right to version 4.0.

Analysis

Arrangement consideration of $40,000 should be allocated to the specified upgrade right ($50,000 multiplied by the 80% of customers that are expected, based on the vendor-specific evidence, to exercise the upgrade right).

The percentage of customers expected not to exercise specified upgrade rights should be reviewed periodically, and the effect on any deferred revenue due to any change in the estimated breakage percentage should be accounted for as a change in accounting estimate as prescribed by ASC 250, *Accounting Changes and Error Corrections*.

Although paragraph ASC 985-605-25-45 provides for the consideration of breakage when a specified upgrade right may be accounted for separately from the other elements included in a multiple-element arrangement, our experience is that it would be unusual for a software vendor to be able to establish VSOE of fair value for a specified upgrade right included in a software licensing arrangement because the right usually pertains to a product that is always sold with PCS and never in a separate standalone sale. Accordingly, in most situations, the upgrade right within the scope of ASC 985-605 cannot be accounted for separately from the delivered software product. In such cases, revenue should be recognized as discussed in Question 5-20.

Revenue recognition for an arrangement containing a specified upgrade right

Question 5-20 **If an arrangement includes a specified upgrade right that is within the scope of ASC 985-605, when should revenue relating to the arrangement be recognized if the specified upgrade right cannot be accounted for separately? When should revenue be recognized for arrangement consideration allocated to a specified upgrade right that can be accounted for separately?**

When an arrangement includes a specified upgrade right that cannot be accounted for separately, revenue relating to the arrangement should not be recognized until the earlier of one of the following events:

- The vendor establishes VSOE of 1) the fair value of the specified upgrade right and 2) the fair value of all other undelivered elements included in the arrangement (subject to the exceptions stated in ASC 985-605-25-9 and 25-10).
- The vendor delivers all elements included in the arrangement.
- The upgrade/enhancement that is the subject of the specified upgrade right is delivered, and VSOE of fair value exists for the remaining undelivered software elements included in the arrangement (e.g., if the vendor has VSOE of fair value for PCS and that is the only remaining undelivered element once the specified upgrade has been delivered).
- The vendor communicates to the customer that the upgrade/enhancement that is the subject of the specified upgrade right will never be delivered (and will not be included in a subsequent release). The vendor communication to the customer of the cessation of an upgrade right generally should be in a format similar to the one that created the specified upgrade right. For example, if a press release created the upgrade right, then a press release announcing the cessation of plans to develop/deliver the new features and functionality generally would be required.

When an arrangement includes a specified upgrade right that can be accounted for separately, arrangement consideration allocated to the specified upgrade right should not be recognized as revenue until the upgrade/enhancement is delivered or the vendor communicates to the customer that the upgrade/enhancement that is the subject of the specified upgrade right will never be delivered (and will not be included in a subsequent release). As discussed above, in such cases the vendor communication to the customer generally should be in a format similar to the one that created the specified upgrade right. However, our experience is that it would be unusual for a software vendor to be able to establish VSOE of fair value for a specified upgrade right included in a software licensing arrangement that is within the scope of ASC 985-605 because the right usually pertains to a product that is always sold with PCS and never in a separate standalone sale. In such situations, the specified upgrade right cannot be accounted for separately from the other elements of the arrangement.

5.4 Additional software products

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-47

As part of a multiple-element arrangement, a vendor may agree to deliver software currently and deliver specified additional software products in the future. The rights to these additional products may be included either in the terms of a postcontract customer support arrangement or in a separate agreement. Even if the rights to the additional software products are included in a postcontract customer support arrangement, the revenue allocable to the additional software products shall be accounted for separately from the postcontract customer support arrangement as an element of a multiple-element arrangement.

985-605-25-48

Multiple-element arrangements that include rights to undelivered additional software products that are not subscriptions (see paragraphs 985-605-25-58 through 25-59) shall be accounted for in accordance with paragraphs 985-605-25-3 through 25-14. Guidance on the application of those paragraphs to such arrangements is provided in paragraphs 985-605-25-49 through 25-57.

985-605-25-49

The fee from the arrangement shall be allocated among the products based on vendor-specific objective evidence of fair value. The allocation shall be based on the relative sales prices of the products, determined pursuant to paragraphs 985-605-25-6 through 25-8. If vendor-specific objective evidence of fair value does not exist, paragraph 985-605-25-9 requires that all revenue from the arrangement be deferred until the earlier of either:

a. The point at which such sufficient vendor-specific objective evidence does exist.

b. The point at which all elements of the arrangement have been delivered.

985-605-25-50

The fee allocated to the additional software products shall not be reduced by the percentage of any customers that are not expected to exercise the right to receive additional software products.

985-605-25-51

If the arrangement is based on a price per product (not a price per copy), the portion of the fee allocated to a product shall be recognized as revenue when the product is delivered, assuming all other provisions of paragraph 985-605-25-3 through 25-14 are met.

In a software arrangement, a vendor may agree to deliver software products currently and also agree to deliver additional software products in the future. The rights to the additional software products may be included in the same licensing agreement, a PCS agreement or another agreement that comprises the arrangement between a vendor and a customer. Regardless of the agreement that includes such rights, a customer's right to receive additional software products represents a separate element included in a multiple-element arrangement.

ASC 985-605 distinguishes between the right to receive specified additional software products and the right to receive unspecified additional software products. A right to receive specified additional software products is accounted for as a separate element included in a multiple-element arrangement as discussed above, while a right to receive unspecified additional software products is accounted for as a subscription (see Questions 5-28 and 5-29).

Additional software products versus specified upgrade rights

Question 5-21 **How should a vendor determine if it has provided a customer with a specified upgrade right or a right to additional software products as an element of an arrangement?**

Question 5-17 discusses considerations relating to whether a right to additional software products or a specified upgrade right has been provided to a customer by a software vendor.

Specified versus unspecified additional software products

Question 5-22 **What is the difference between a specified and an unspecified additional software product? Does the accounting for an arrangement that includes a right to specified additional software products differ from an arrangement that includes a right to unspecified additional software products?**

The accounting for the right to receive specified additional software products differs significantly from the right to receive unspecified additional software products. A right to receive specified additional software products is accounted for as a separate element included in a multiple-element arrangement. If a right to additional software products is included in an arrangement, the arrangement must be evaluated to determine if the right (and any other undelivered elements included in the arrangement) can be accounted for separately based on the guidance contained in ASC 985-605-25-3 through 25-14. If such a right can be accounted for separately, the arrangement consideration is allocated to the right based on VSOE of fair value (see Question 5-23). Revenue is recognized for the right once the additional software product is delivered (see Question 5-24) if all of the other basic revenue recognition criteria of ASC 985-605 have been met.

Conversely, if an arrangement includes a right to receive unspecified additional software products, the entire arrangement is accounted for as a subscription and revenue is recognized ratably over the term of the arrangement or the economic life of the products covered by the arrangement. No allocation of arrangement consideration is made among the various elements included in the arrangement (i.e., the vendor may not separately account for the license or other elements of the arrangement).

In some cases, determining that a right to specified additional software products is included in an arrangement may be relatively straightforward. If a vendor contractually agrees to deliver in the future an explicitly referenced software product (e.g., stating the product name or version number in the agreement), or a product with specific features and functionality that differs from product(s) delivered to date, the agreement contains a right to a specified additional software product — even if the product will only be provided on a when-and-if-available basis.

However, communications made outside of a written agreement with a customer also may indicate that a vendor has provided a customer with a right to specified additional software products as an element of an arrangement. Examples of such communications include written statements by representatives of the vendor authorized to enter into arrangements with customers and written responses to a customer's request for proposal that describe the anticipated features and functionality of future software products that the vendor will provide to the customer as part of the arrangement.

Conversely, a right to unspecified additional software products typically commits a vendor to provide a customer with any new products that it introduces within a specified time period, without regard to the specific features and functionality of the new products. For example, as part of an agreement with a customer a vendor may agree to deliver all new products to be introduced in a family of products over the next two years. In such a case, the arrangement should be deemed to include a right to unspecified additional software products.

The following examples illustrate these concepts:

Illustration 5-26: Arrangement includes a right to a specified additional software product

Facts

A vendor of financial accounting software enters into an arrangement with a customer to license its general ledger, accounts receivable and accounts payable products. These products are delivered to the customer at the outset of the arrangement. In addition to the currently delivered products, the vendor commits to deliver payroll processing software in development at the time the agreement is executed when and if available. Although not contractually specified, the vendor has communicated the anticipated features and functionality of the payroll processing software product.

Analysis

Because the vendor has specified the product, including the features and functionality of the payroll software that will be provided to the customer when and if available, the arrangement includes a right to a specified additional software product that must be accounted for as an element of the arrangement.

Illustration 5-27: Arrangement includes a right to an unspecified additional software product

Facts

A vendor of financial accounting software enters into an arrangement with a customer to license its general ledger, accounts receivable and accounts payable products. These products are delivered to the customer at the outset of the arrangement. In addition to the currently delivered products, the vendor commits to deliver any financial reporting software products that it releases during the next three years. The vendor has not communicated specific details regarding the features and functionality of any such future products.

Analysis

Because the vendor has committed to deliver any financial reporting products released within a specified time period, and no specificity regarding the features and functionality of such products has been discussed, the arrangement contains a right to unspecified additional software products and should be accounted for as a subscription.

Allocating arrangement consideration to a right to specified additional software products

Question 5-23 **When an arrangement includes a right to a specified additional software product, and the elements of the arrangement can be accounted for separately, how should arrangement consideration be allocated to, and revenue recognized for, the right to the specified additional software product?**

If a vendor agrees to deliver specified additional software products (even if on a when-and-if-available basis), the arrangement must be evaluated to determine if the vendor can separately account for the multiple elements of the arrangement. To do so, VSOE of the fair value of either 1) all of the software elements included in the arrangement or 2) the additional software products and other undelivered elements included in the arrangement must exist such that the fee from the arrangement can be allocated to the various elements.

If VSOE of fair value exists for all elements included in the arrangement, the arrangement consideration should be allocated using the relative-fair-value method such that each element of the arrangement is allocated a proportionate amount of consideration and discount from the arrangement. If VSOE of fair value exists only for the undelivered elements of the arrangement, an amount of arrangement consideration equal to VSOE of fair value of the right to the specified additional software product should be allocated to the right. However, our experience is that it would be rare for a software vendor to establish VSOE of fair value for a software product because products are almost always sold with PCS and never in a separate standalone sale.

If a right to specified additional software products can be accounted for as a separate unit of accounting, revenue should be recognized for the amount of arrangement consideration allocated to the right once the additional software products are delivered to the customer.

If VSOE of fair value for at least of all of the undelivered elements included in the arrangement does not exist, then ASC 985-605 requires that all revenue from the arrangement be deferred until the earlier of the point at which 1) VSOE of fair value of any remaining undelivered elements does exist or 2) all elements of the arrangement have been delivered.

The following examples illustrate these concepts:

Illustration 5-28: VSOE of fair value of all elements exists

Facts

A software vendor enters into an arrangement with a customer to license the current version of one of its products, Product A, version 4.0. The customer is a current licensee of Product B, version 3.0. The vendor currently is developing an upgrade of Product B to version 4.0. The arrangement specifies that the customer is to be provided version 4.0 of Product B once released. Fees due pursuant to the arrangement total $200,000.

Product A is delivered to the customer at the outset of the arrangement. Product B, version 4.0, is delivered three months later.

The vendor has determined that VSOE of fair value of Product A is $150,000 and of version 4.0 of Product B is $100,000.

Analysis

The right to receive the enhanced version of Product B is a right to a specified additional software product that should be accounted for as an element of the arrangement. The arrangement consideration should be allocated to Product A and the right to receive the enhanced version of Product B based on their relative fair values, as follows:

Product	VSOE of fair value	%	Allocated arrangement consideration	%
A	$ 150,000	60%	$ 120,000	60%
B	100,000	40%	80,000	40%
Total	$ 250,000		$ 200,000	

The $120,000 of arrangement consideration allocated to Product A may be recognized as revenue on delivery of the product at the outset of the arrangement, and the $80,000 allocated to Product B may be recognized on its delivery three months later, if all of the other basic revenue recognition criteria of ASC 985-605 have been met. Note that in our experience it is very unusual for a software vendor to have established VSOE of fair value for an undelivered software product, generally due to the lack of a standalone sale.

Illustration 5-29: VSOE does not exist for all elements of the arrangement

Facts:

A software vendor enters into an arrangement with a customer to license the current version of one of its products, Product A, version 4.0. The customer is a current licensee of Product B, version 3.0. The vendor currently is developing an upgrade of Product B to version 4.0. The arrangement specifies that the customer is to be provided version 4.0 of Product B once released.

In addition to the software products, the arrangement includes one year of PCS relating to both Product A and Product B.

Product A is delivered to the customer at the outset of the arrangement. Product B, version 4.0, is delivered three months later.

Fees due pursuant to the arrangement total $280,000. The vendor does not have VSOE of the fair value of either Products A or B. VSOE of fair value of PCS for Products A and Product B is $50,000 and $30,000, respectively.

Analysis

The right to receive the specific enhanced version of Product B is a right to a specified additional software product that should be accounted for as an element of the arrangement. Because the vendor lacks VSOE of fair value for the software products, revenue recognition for the arrangement should be deferred until the earlier of the point at which 1) sufficient VSOE of fair value of any remaining undelivered elements does exist or 2) all elements of the arrangement have been delivered (see Questions 3-15 through 3-20).

When the vendor delivers Product B, VSOE of fair value exists for the remaining elements of the arrangement (i.e., PCS for both products). Revenue may be recognized using the residual method to allocate the arrangement consideration (see Questions 3-12 through 3-14). In this example, 9 months of the PCS period bundled with the software sale remains to be provided to the customer. Accordingly, $60,000 ($80,000 ÷ 12 months x 9 months) should be deferred. The remaining amount of arrangement consideration ($220,000, of which $20,000 would be PCS and $200,000 license revenue) may be recognized as revenue on the delivery of Product B, if all of the other basic revenue recognition criteria of ASC 985-605 have been met.

Estimating breakage when allocating arrangement consideration to specified additional software products

Question 5-24 **If a vendor anticipates that not all customers granted a right to receive additional software products will exercise such rights (i.e., that breakage will occur), may it consider the anticipated breakage when determining the amount of arrangement consideration that should be allocated to a right to specified additional software products (assuming that the right can be accounted for separately from the other elements of the arrangement)?**

No. Unlike the manner in which arrangement consideration is allocated to specified upgrade rights that can be accounted for separately (see Question 5-19), the amount of an arrangement's fee allocated to specified additional software products cannot be reduced by the estimated percentage of customers expected not to exercise the right to receive the additional software products. Unlike specified upgrade rights, AcSEC believes it is likely that all customers will elect to receive additional software products, and the fee allocated to the additional software products should not be reduced by an amount of estimated breakage.

5.5 Price-per-copy arrangements

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-52

Some fixed fee license or reseller arrangements provide customers with the right to reproduce or obtain copies at a specified price per copy (rather than per product) of two or more software products up to the total amount of the fixed fee. A number of the products covered by the arrangement may not be deliverable or specified at the inception of the arrangement. Although the price per copy is fixed at the inception of the arrangement, an allocation of the arrangement fee to the individual products generally cannot be made, because the total revenue allocable to each software product is unknown and depends on the choices to be made by the customer and, sometimes, future development activity while the arrangement is in effect. Nevertheless, as discussed in paragraph 985-605-25-56, in certain situations, revenue can be allocated to the products that are undeliverable or not specified at the inception of the arrangement.

985-605-25-53

In arrangements in which no allocation can be made, until the first copy or product master of each product covered by the arrangement has been delivered to the customer assuming the provisions of paragraphs 985-605-25-3 through 25-14 are met, revenue shall be recognized as copies of delivered products either:

a. Are reproduced by the customer.

b. Are furnished to the customer if the vendor is duplicating the software.

985-605-25-54

Once the vendor has delivered the product master or the first copy of all products covered by the arrangement, any licensing fees not previously recognized shall be recognized. (At that point, only duplication of the software is required to satisfy the vendor's delivery requirement. As discussed in paragraphs 985-605-25-22 through 25-24, duplication of the software is incidental to the arrangement, and delivery is deemed to have occurred upon delivery of the product master or first copy.) When the arrangement terminates, the vendor shall recognize any licensing fees not previously recognized.

985-605-25-55

The revenue from the kind of arrangements discussed in the preceding two paragraphs shall not be recognized fully until either of the following conditions is met:

a. Delivery is complete for all products covered by the arrangement.

b. The aggregate revenue attributable to all copies of the software products delivered is equal to the fixed fee, provided that the vendor is not obligated to deliver additional software products under the arrangement.

985-605-25-56

Nevertheless, certain arrangements that include products that are not deliverable at the inception impose a maximum number of copies of the undeliverable product(s) to which the customer is entitled. In such arrangements, a portion of the arrangement fee shall be allocated to the undeliverable product(s). This allocation shall be made assuming that the customer will elect to receive the maximum number of copies of the undeliverable product(s).

985-605-25-57

The revenue allocated to the delivered products shall be recognized when the product master or first copy is delivered. If, during the term of the arrangement, the customer reproduces or receives enough copies of these delivered products so that revenue allocable to the delivered products exceeds the revenue previously recognized, such additional revenue shall be recognized as the copies are reproduced or delivered. The revenue allocated to the undeliverable product(s) shall be reduced by a corresponding amount.

A vendor may enter into fixed fee arrangements whereby customers may reproduce or obtain copies of two or more software products at a specified price per copy (rather than per product) up to the total amount of the agreed-on fee. Although the price per copy is known at inception, an allocation of the arrangement fee to the individual products included in the arrangement generally cannot be made because the amounts ultimately allocable to each software product is dependent on choices to be made by the customer and, sometimes, future development activity while the arrangement is in effect.

If all products included in an arrangement are not delivered, a portion of the fee would be allocated to the undelivered products. If the arrangement specifies the maximum number of copies of the undelivered products that may be received by the customer, arrangement consideration can be allocated to the undelivered elements assuming the customer will elect to receive the maximum number of copies of the undelivered products.

Revenue recognition for price-per-copy arrangements

Question 5-25 **If an arrangement specifies that fees due to a vendor are based on the number of copies of a licensed software product delivered to or made by a customer, how should revenue relating to the arrangement be recognized?**

Fees due pursuant to a multiple-element arrangement may be based on a price per copy such that the aggregate licensing fee to be received by a vendor is a function of the number of copies of the licensed product delivered to or made by the customer. In such cases, arrangement consideration is not allocated among the software products based on VSOE of fair value of the licensed software products. Because fees are based on the number of copies of the software product delivered in this type of arrangement, only the fees associated with the delivered copies are fixed or determinable (see ASC 985-605-25-30 and 25-31 and related Questions 4-38 through 4-43). Additionally, pursuant to ASC 985-605-25-13 and 25-14, it is inappropriate to allocate arrangement consideration to delivered items when realization of those amounts is contingent on the delivery of additional items. Accordingly, revenue should be recognized as the copies are delivered to, or made by the customer, if all of the other basic revenue recognition criteria of ASC 985-605 have been met.

The following example illustrates these concepts:

Illustration 5-30: Revenue recognition for price-per-copy arrangement

Facts

A calendar year-end software vendor enters into an arrangement with a customer to license Products A, B and C on 1 January 20X1. The agreement specifies that the customer will pay a per-copy fee for each individual product based on the following terms:

Product A	$ 1,000
Product B	500
Product C	5,000

The total fee will vary based on the number of each product the customer selects.

A copy of each licensed software product is delivered to the customer at the inception of the arrangement. The customer makes the following copies of each of the products during the vendor's quarterly reporting periods as follows:

	Three months ended	
Product	31 March 20X1	30 June 20X1
A	20	30
B	40	20
C	10	20

Analysis

The vendor should recognize revenue relating to the arrangement of $90,000 during the quarter ended 31 March 20X1, computed as follows:

Product	Amounts copied	Price per copy	Revenue
A	20	1,000	$ 20,000
B	40	500	20,000
C	10	5,000	50,000
Total			$ 90,000

Revenue relating to the arrangement of $140,000 should be recognized during the quarter ended 30 June 20X1, computed as follows:

Product	Amounts copied	Price per copy	Revenue
A	30	1,000	$ 30,000
B	20	500	10,000
C	20	5,000	100,000
Total			$ 140,000

Fixed aggregate license fee in a price-per-copy arrangement

Question 5-26 **Certain software license arrangements provide customers with the right to reproduce or obtain copies at a specified price per copy of two or more software products up to the total amount of a fixed fee. How should such arrangements be accounted for?**

Software vendors may enter into arrangements to license multiple software products to a customer in which the aggregate amount of fees due pursuant to the arrangement are fixed, but the amount attributable to any of the various products included in the arrangement are variable based on the number of copies actually made by or delivered to the customer. For example, a vendor may enter into a site license that gives the customer a right to make multiple copies of three software products, Products A, B and C, at a price per copy of $1,000, $500 and $5,000, respectively, up to a fixed fee of $50,000. The customer may choose to receive a single product (e.g., 50 copies of Product A) or any combination of products (e.g., 50 copies of Product B and five copies of Product C) until the aggregate amount of the copies equals the arrangement's fixed fee.

These arrangements may be limited to products currently deliverable or may obligate the vendor to deliver additional software products that are currently undeliverable (i.e., software products that are under development or are not identified at the inception of the arrangement). At the inception of such arrangements, the amount of arrangement consideration allocable on a per-copy basis is known, but the amount to allocate to each software product in total is unknown because the customer ultimately will choose how many copies of each software products will be delivered or copied.

Under these circumstances, if all of the licensed software products have not been delivered to the customer at the inception of the arrangement, revenue should be recognized based on the specified price per copy as copies either are made by or delivered to the customer if all of the other basic revenue recognition criteria of ASC 985-605 have been met. However, once a vendor has delivered the first copy or product master of all products licensed by a customer pursuant to such an arrangement, the balance of the arrangement consideration can be recognized as revenue if all of the other basic revenue recognition criteria of ASC 985-605 have been met. The aggregate amount of arrangement consideration due to a vendor pursuant to such an arrangement (i.e., the fixed fee) should not be fully recognized until either 1) delivery is complete for all products covered by the arrangement or 2) the aggregate revenue attributable to all copies of the software products delivered or copied is equal to the fixed fee (provided the vendor is not obligated to deliver additional software products under the arrangement). If the aggregate amount of arrangement consideration due has not been recognized as revenue prior to the expiration of the agreement, any remaining unrecognized fees would be recognized on expiration.

Certain of these fixed fee arrangements impose a maximum number on the amount of copies of an undelivered software product that the customer may receive when the product is delivered. For example, a customer may pay a fixed fee of $50,000 in exchange for multiple copies of Products A ($1,000 each) and B ($500 each), for which product masters have been delivered, and up to five copies of Product C ($5,000 each), which has not been delivered. The customer may choose to receive a single product (e.g., 50 copies of Product A) or a combination of products including up to five copies of Product C (e.g., 50 copies of Product B and five copies of Product C) until the fixed fee amount has been reached.

In these situations, ASC 985-605 requires that the vendor assume the customer will accept the maximum number of the undelivered product(s) and allocate that portion of the fee to the undelivered product(s). The amount of arrangement consideration allocated to the delivered products should be recognized as revenue when the product master or first copy is delivered if all of the other basic revenue recognition criteria of ASC 985-605 have been met. However, if the customer receives enough copies of the delivered software products so that the amount of arrangement consideration allocable to the delivered products exceeds the revenue previously recognized, additional revenue should be recognized as the additional copies are delivered, and the amount of arrangement consideration allocated to the undelivered products should be reduced by a corresponding amount.

The following examples excerpted from the implementation guidance in ASC 985-605 illustrate the accounting for these types of arrangements.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Example 3: Additional Software Products — Price per Copy

985-605-55-134

The following Cases illustrate the guidance in paragraphs 985-605-25-43 through 25-65:

a. One product not available at arrangement date (Case A)

b. No limit on number of copies of undelivered product (Case B).

985-605-55-135

Cases A and B share the following assumptions.

985-605-55-136

A vendor enters into an arrangement under which a customer has the right to make copies of Product A at $100 per copy, copies of Product B at $200 per copy, or copies of Product C at $50 per copy until such time as the customer has made copies aggregating $100,000 based on the per-copy prices. The customer is obligated to pay the $100,000 whether or not the customer makes all the copies to which it is entitled under the arrangement. In all other respects, the $100,000 is considered to meet the criteria of a fixed fee, as described in this Subtopic.

985-605-55-137

Master copies of Products A and B are available currently and have been delivered. Product C is not available yet; therefore, no master copy has been delivered. The contract is clear that no portion of the fee allocable to copies made of Products A and B is refundable if Product C is not delivered, nor is there any further obligation to deliver Product C if copies of Products A and B aggregating $100,000 have been made. The per-copy prices included in the arrangement for Products A and B are the per-copy prices included in the vendor's price list, and the vendor has already approved the per-copy price list for Product C to be $50 per copy. Product C is not essential to the functionality of Products A or B.

Case A: Maximum Number of Copies of Undelivered Product

985-605-55-138

Assume that the maximum number of copies of Product C that can be made is 500.

985-605-55-139

The vendor would allocate $25,000 of the arrangement fee to Product C. The remaining $75,000 of revenue would be recognized when the master copies of Products A and B are delivered to the customer. The $25,000 allocated to Product C would be recognized when the master copy of Product C is delivered to the customer. If the customer duplicates enough copies of Products A and B so that the revenue allocable to those products exceeds $75,000, the additional revenue would be recognized as the additional copies are made.

985-605-55-140

As discussed in paragraph 985-605-25-52, in an arrangement in which a number of products are not deliverable or specified at the inception of the arrangement, an allocation of the arrangement fee generally cannot be made, because the total revenue allocable to each software product is unknown and depends on choices to be made by the customer and, sometimes, future development activity. As discussed in paragraph 985-605-25-56, however, if such an arrangement specifies a maximum number of copies of the undeliverable or unspecified product or products, a portion of the arrangement fee shall be allocated to the undeliverable product or products. This allocation shall be made assuming the customer elects to receive the maximum number of copies of the undeliverable product or products.

985-605-55-141

Because the arrangement states a maximum number of copies of Product C that can be made, a basis for allocating the fair value to each product of the arrangement exists. The amount allocated to the undelivered product is the maximum amount that can be allocable to that product, based on the maximum number of copies of Product C that can be made (500) and the fee per copy ($50). Accordingly, $25,000 would be allocated to Product C and deferred until delivery of the product master. Because all other conditions for revenue recognition in this Subtopic have been met, revenue related to Products A and B may be recognized upon delivery of the masters of those products as discussed in paragraphs 985-605-25-53 through 25-54.

Case B: No Limit on Number of Copies of Undelivered Product

985-605-55-142

Assume that the arrangement does not state a maximum number of copies of Product C that can be made.

985-605-55-143

Revenue would be recognized as copies of Products A ($100 of revenue per copy) and B ($200 of revenue per copy) are made, until the master of Product C is delivered to the customer. Any remaining revenue would be recognized upon delivery of the master of Product C.

985-605-55-144

As discussed in paragraph 985-605-25-52, although the fee per copy is fixed at the inception of the arrangement and the cost of duplication is incidental, the total fee allocated to the undelivered software (Product C) is unknown and will depend on the choices made by the customers as to how many copies of each product will be used.

5.6 Unspecified additional software products

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-58

As part of a multiple-element arrangement with a user, a vendor may agree to deliver software currently and to deliver unspecified additional software products in the future (including unspecified platform transfer rights that do not qualify for exchange accounting as described in paragraphs 985-605-25-60 through 25-65). For example, the vendor may agree to deliver all new products to be introduced in a family of products over the next two years. These arrangements are similar to arrangements that include postcontract customer support in that future deliverables are unspecified. Nevertheless, they are distinguished from arrangements that include postcontract customer support because the future deliverables are products, not unspecified upgrades or enhancements.

985-605-25-59

The software elements of the kinds of arrangements discussed in paragraph 985-605-25-58 shall be accounted for as subscriptions. No allocation of revenue shall be made among any of the software products, and all software product-related revenue from the arrangement shall be recognized ratably over the term of the arrangement beginning with delivery of the first product. If the term of the arrangement is not stated, the revenue shall be recognized ratably over the estimated economic life of the products covered by the arrangement, beginning with delivery of the first product. An intent on the part of the vendor not to develop new products during the term of the arrangement does not relieve the vendor of the requirement to recognize revenue ratably over the term of the arrangement, beginning with the delivery of the first product.

Vendors may agree to deliver unspecified additional software products in the future as part of a multiple-element software arrangement. For example, a vendor may agree to deliver all new products to be introduced in a group of products or a product family over the next three years. Although such elements of an arrangement are similar to PCS in that the additional software products are unspecified, they differ from PCS in that the future deliverables are software products, and not unspecified upgrades or enhancements to the delivered products.

In such situations, there is no basis on which to allocate the arrangement fee to the unspecified products to be delivered because VSOE of fair value for unspecified products does not and cannot exist. All revenue from the arrangement obligating a vendor to provide unspecified additional software products should be recognized ratably (on a straight-line basis) over the term of the arrangement beginning with the delivery of the first product. This pattern of revenue recognition is commonly known as "subscription accounting." If the term of the arrangement is not stated, revenue should be recognized ratably over the estimated economic life of the products covered by the arrangement, beginning with delivery of the first licensed product. This accounting should be applied even if the vendor does not intend to develop any additional software products during the term of the arrangement.

Unspecified additional software products versus specified additional software products

Question 5-27 **What is the difference between a specified and an unspecified additional software product? Does the accounting for an arrangement that includes a right to specified additional software products differ from an arrangement that includes a right to unspecified additional software products?**

Question 5-22 addresses these questions.

Arrangements with resellers including rights to unspecified additional software products

Question 5-28 **A software vendor may enter into an arrangement with a reseller and commit to provide future unspecified additional software products as part of the arrangement. Should such arrangements be accounted for as a subscription in accordance with ASC 985-605-25-58 and 25-59?**

ASC 985-605 does not specifically address whether subscription accounting should be applied to arrangements with resellers. If an arrangement with a reseller includes a right to receive unspecified additional software products, we believe that the provisions of ASC 985-605-25-58 and 25-59 must be considered when determining the appropriate accounting for the arrangement. In such arrangements, revenue is recognized ratably over the economic term of the arrangement (see Question 5-29). However, as with any arrangement with a reseller, a vendor must conclude whether the arrangement should be accounted for using the sell-through method (see Question 4-62). If so, no revenue should be recognized prior to the reseller selling the licensed products to end users — including revenue that might otherwise be recognized on a subscription basis. Determining the appropriate accounting for arrangements with resellers, including arrangements including rights to unspecified additional software products, is dependent on the applicable facts and circumstances and may require the use of professional judgment.

Revenue recognition for arrangements including rights to unspecified additional software products

Question 5-29 **How should revenue be recognized for an arrangement that includes a right for a customer to receive unspecified additional software products?**

When a vendor agrees to deliver unspecified additional software products in the future as part of a multiple-element software arrangement, there is no basis on which to allocate the arrangement fee to the unspecified products to be delivered because VSOE of fair value for unspecified products does not and cannot exist.

Accordingly, all revenue from such arrangements should be recognized ratably over the term of the arrangement beginning with the delivery of the first licensed product (commonly known as "subscription accounting"). If the term of the arrangement is not stated, revenue should be recognized ratably over the estimated economic life of the products covered by the arrangement, beginning with delivery of the first product. We believe changes in the estimated economic life of the products covered by the arrangement should be accounted for prospectively as a change in estimate in accordance with ASC 250, *Accounting Changes and Error Corrections*. Refer to Question 3-20 for guidance when classifying such revenue in the income statement.

Paragraph ASC 985-605-25-59 specifies that this accounting is applicable even if a vendor does not intend to develop any additional software products during the term of the arrangement.

The following examples illustrate these concepts:

Illustration 5-31: Term for which vendor committed to deliver unspecified additional software products specified

Facts

A vendor of financial accounting software enters into an arrangement with a customer to perpetually license its general ledger, accounts receivable and accounts payable products. These products are delivered to the customer at the outset of the arrangement. In addition to the delivered products, the vendor commits to deliver any financial reporting software products that it releases during the next three years.

Analysis

The vendor should recognize the arrangement fee ratably over the three-year term of the commitment to deliver the unspecified additional software products, beginning with delivery of the first licensed product.

Illustration 5-32:	**Term for which vendor committed to deliver unspecified additional software products not specified**

Facts

Assume the same facts as Illustration 5-31 above, except that the vendor agrees to deliver any financial reporting software products that it releases in perpetuity. The vendor expects (and has vendor-specific evidence supporting such expectation) that it will continue to develop and release products in that product family for no more than the next seven years.

Analysis

Because the additional software products to be delivered are not specified at the outset of the arrangement, the vendor should recognize the arrangement fee ratably over the expected seven-year economic life of the product family, beginning with delivery of the first licensed product.

Illustration 5-33:	**Vendor does not intend to develop future products**

Facts

Assume the same facts as Illustration 5-31 above, except that the vendor does not currently market any financial reporting software products and has no intentions to develop and release such products.

Analysis

Even though the vendor has no intention of developing and releasing any financial reporting software products, because it has committed to provide unspecified additional software products, it should recognize the arrangement fee ratably over the three year term of its commitment to deliver such unspecified products, beginning with delivery of the first licensed product.

Arrangements including rights to unspecified additional software products and extended payment terms

Question 5-30 **If a vendor enters into an arrangement that includes both a right to receive unspecified additional software products and extended payment terms and it cannot conclude at the outset of the arrangement that amounts due from the customer are fixed or determinable, how should revenue from the arrangement be recognized?**

Because of the relatively short life cycle of many software products, the susceptibility of software to technological obsolescence and other external factors, fees in arrangements involving extended payment terms may not be fixed or determinable. ASC 985-605-25-35 provides that if a vendor cannot conclude the arrangement fee is fixed or determinable at the outset of an arrangement containing extended payment terms, revenue should be recognized for the arrangement as payments become due (if all of the other basic revenue recognition criteria of ASC 985-605 have been met).

Pursuant to ASC 985-605-25-59, revenue is recognized ratably over the term of the arrangement beginning with the delivery of the first product for arrangements including rights to unspecified additional software products. If a vendor enters into an arrangement that includes both a right to receive unspecified additional software products and extended payment terms and cannot conclude that amounts due from the customer are fixed or determinable at the outset of the arrangement, a question arises as to how the provisions of ASC 985-605-25-35 and 25-59 interact. That is, should revenue from the arrangement be 1) recognized ratably over the term of the arrangement commencing with delivery of the first software product notwithstanding the fact that the arrangement involves extended payment terms or 2) should revenue be recognized as payments become due?

We believe that before any revenue is recognized for a software licensing arrangement, all of the basic revenue recognition criteria of ASC 985-605 must be met. Accordingly, if a vendor cannot conclude that fees due pursuant to an arrangement including both a right to unspecified additional software products and extended payment terms are fixed or determinable at the outset of the arrangement, no revenue should be recognized for that arrangement prior to payments becoming due. Once payments become due, revenue may be recognized, but the amount recognized should be limited to the lesser of a) the amount of fees that are due and payable or b) the ratable portion of the entire fee that would otherwise be recognized on a subscription basis pursuant to ASC 985-605-25-59.

The following example illustrates these concepts:

Illustration 5-34: Arrangement includes right to unspecified additional software products and extended payment terms

Facts

A calendar year-end vendor of financial accounting software enters into an arrangement with a customer on 31 July 20X1 to license its general ledger, accounts receivable and accounts payable products. These products are delivered to the customer at the outset of the arrangement. In addition to the currently delivered products, the vendor commits to deliver any financial reporting software products that it releases during the next three years.

Total fees of $1,800,000 are due pursuant to the arrangement, based on the following payment terms:

$500,000 due 31 January 20X2

$500,000 due 30 April 20X2

$500,000 due 31 July 20X2

$300,000 due 31 October 20X2

The vendor's standard payment terms are net 45 days. The vendor concludes that the fees are not fixed or determinable at the outset of the arrangement.

Analysis

The arrangement includes a right to unspecified additional software products. Pursuant to ASC 985-605-25-59, $50,000 of revenue per month should be recognized ratably over the three-year subscription period ($1,800,000 ÷ 36 months). However, the arrangement also includes extended payment terms for which the vendor cannot overcome the presumption that the fees are not fixed or determinable at the outset of the arrangement. Accordingly, no revenue relating to the arrangement should be recognized prior to the first payment becoming due on 31 January 20X2. At that point, the vendor may recognize revenue of $300,000 ($50,000 per month x 6 months elapsed in the arrangement), and begin recognizing $50,000 per month ratably over the remainder of the subscription period (because after the first payment becomes due, the amounts that will be recognized on a subscription basis pursuant to ASC 985-605-25-59 will be less than the amounts that have become due and payable).

6 Rights to exchange or return software

6.1 Chapter summary

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-60

As part of an arrangement, a software vendor may provide the customer with the right to return software or to exchange software for products with no more than minimal differences in price, functionality, or features. The accounting for returns is significantly different from the accounting for exchanges. Although it is sometimes difficult to determine whether a transaction is a return or exchange of software, the fact that the software is not returned physically does not preclude accounting for the transaction as either an exchange or as a return. If the software is not returned physically and the customer contractually is entitled to continue to use the previously delivered software, the arrangement shall be accounted for in the manner prescribed in paragraphs 985-605-25-47 through 25-59. If the software is not returned physically and the customer contractually is not entitled to continue to use the previously delivered software, the transaction shall be accounted for either as a return or as an exchange, as discussed in paragraphs 985-605-25-61 through 25-65.

985-605-25-61

If the rights discussed in the preceding paragraph are offered to users (but not resellers), the exchanges are analogous to exchanges by ultimate customers of one item for another of the same kind, quality, and price that are not considered returns described in paragraph 605-15-25-1(f). Conversely, exchanges by users of software products for dissimilar software products or for similar software products with more than minimal differences in price, functionality, or features are considered returns, and revenue related to arrangements that provide users with the rights to make such exchanges shall be accounted for in conformity with Subtopic 605-15. If the other product or products are not available at the time the initial product is delivered, there shall be persuasive evidence that demonstrates there will be no more than minimal differences in price, features, or functionality among the products for the right to qualify as a right to exchange. Additionally, if the vendor expects to incur a significant amount of development costs related to the other product, the other product shall be considered to have more than a minimal difference in functionality.

If an arrangement provides an end user with the right to return licensed software, that right must be evaluated to determine if it should be accounted for as either:

- *A like-kind exchange*. If a delivered software product can be returned in exchange for a similar product with no more than minimal differences in price, features or functionality, the right should be accounted for as a like-kind exchange, which does not affect the determination of how revenue should be recognized for the delivered product.
  - However, this accounting is only applicable to exchange rights granted to end users. Exchange rights granted to resellers should be accounted for as a right of return (see Question 6-12).

- *A right of return.* If a licensed software product may be returned for a refund of the purchase price, for a credit applied to amounts owed or to be owed for other products or in exchange for other products with more than minimal differences in price, features or functionality, the right should be accounted for as a right of return pursuant to the guidance in ASC 605-15.

  Revenue generally may be recognized at the time of sale when the buyer has the right to return a product or receive a refund of consideration paid to the vendor if a reasonable estimate of future returns or refunds can be made pursuant to the provisions of the right of return guidance in ASC 605-15 (if all of the other basic revenue recognition criteria of ASC 985-605 have been met). Unlike the accounting for discounts, which allows deferral of the maximum discount available to the customer, if a reasonable estimate of future returns or cancellations cannot be made, it is inappropriate to conservatively estimate the maximum level of possible returns. Instead, revenue should be recognized as the return or refund provisions lapse or when the criteria in ASC 605-15 have been met, whichever occurs first.

  Rights of return may not be part of a formal agreement but rather established by a vendor's past practices. If, as a matter of practice, a vendor regularly provides customers with rights of return, but that right is not explicitly provided by contract, revenue should not be recognized unless the criteria established by ASC 605-15 are met.

- *A right to additional software products.* If a customer has been granted a right of return and 1) the previously delivered software will not be returned physically and 2) the customer is contractually entitled to continue to use the previously delivered software, the arrangement should be accounted for as a multiple-element arrangement that includes a right to additional software products.

Evaluating whether products can be exchanged for products with no more than minimal differences

Question 6-1 **What factors should be considered in evaluating whether a delivered licensed software product can be exchanged for a product with no more than minimal differences in price, features or functionality?**

ASC 985-605 provides that if a delivered software product can be returned by an end user in exchange for a similar product with no more than minimal differences in price, features or functionality, the right should be accounted for as a right to a like-kind exchange, which does not affect the determination of how revenue should be recognized for the delivered product. However, it does not provide guidance relating to how to determine whether more than minimal differences exist between products.

Accordingly, determining whether a replacement product has no more than minimal differences in price, features or functionality may require the use of professional judgment and will depend on the relevant facts and circumstances. However, we believe that the following factors should be considered in making this determination:

- *Whether in transactions with other parties, the replacement product is sold at amounts that are more than minimally different from the currently licensed product*. We believe that a minimal difference in price generally is a very small difference, on a relative basis (e.g., less than 5%). If software products are not sold separately from PCS, we believe residual amounts allocated to software products when accounting for the licensing arrangements may be compared for purposes of evaluating this factor. Additionally, if it can be demonstrated that a customer was offered the opportunity to purchase either product for a similar price, this supports that there are no more than minimal differences in price.

- *Whether the replacement product is marketed as having significantly enhanced or different features and functionality relative to the delivered product.*

- *Whether the replacement product operates outside the performance domain of the delivered product.*
- *Whether the delivered product has the same name as the product for which it may be exchanged (although version numbers may differ).*

The following example illustrates these concepts:

Illustration 6-1 Right to a like-kind exchange

Facts

A software vendor sells two personal productivity software products, AppointmentBook and Scheduler. The two products utilize a different graphical user interface but sell for a similar price and have similar features and functionality. The vendor enters into an arrangement with a customer to license AppointmentBook for a fee of $20,000. Pursuant to the arrangement, the customer may exchange, at its option, AppointmentBook for Scheduler at any time during the first year of the arrangement. If exchanged, the customer must cease using AppointmentBook.

Analysis

Because the software products marketed by the vendor do not have more than minimal differences in price, features and functionality, the right of the customer to exchange AppointmentBook for Scheduler is an exchange right. If all of the other basic revenue recognition criteria of ASC 985-605 have been met, the vendor may recognize revenue of $20,000 on the delivery of AppointmentBook to the customer. If the customer ultimately exercises the right to exchange AppointmentBook for Scheduler, no accounting recognition would be given to the exchange.

In our experience it is rare for a transaction to qualify for exchange accounting. Very few software vendors produce products containing such a large overlap of features and functionality that the difference between the two could be reasonably viewed as minimal.

Question 6-4 provides additional guidance to regarding a return or exchange right that relates to a product undelivered and unavailable at the time of the initial sale.

Implicit versus explicit rights of return

Question 6-2 **If a software licensing arrangement does not specify contractually that a customer has been provided a right to return the licensed products, should such a right be deemed to exist if the vendor has an established practice of allowing such returns regardless of the lack of contractual rights?**

Yes. A vendor's established business practices may indicate that it provides its customers with an implicit right of return when licensing software. Such rights must be accounted for when included in software licensing arrangements.

An explicit right of return is one that is clearly stated in a contractual arrangement. Conversely, an implicit right of return is not stated in a contractual arrangement but is established when a vendor has a history of accepting returns as a common business practice. Regardless of the type of return right (i.e., implicit or explicit), when such a right is provided to a customer in connection with a software licensing arrangement, revenue should not be recognized before the vendor can make a reasonable estimate of the amount of future returns pursuant to the provisions of the right of return guidance in ASC 605-15, or the return right lapses. Criteria that should be evaluated when determining if a vendor has the ability to make a reasonable estimate of future returns are discussed in Question 6-3.

The following example illustrates these concepts:

Illustration 6-2: Vendor's established practice of allowing returns

Facts

A software vendor includes an explicit provision in its software licensing arrangements that customers do not have the right to return licensed software once delivered. However, in an effort to maintain customer relationships, the vendor frequently accepts customer returns. The vendor typically will issue credits or refunds to the customer for the value of the returned product or allow the customer to exchange the licensed software for dissimilar products that it also markets.

Analysis

Despite the fact the vendor's contracts contain a clause that states customers do not have a right to return licensed software once delivered, the vendor has an established practice of accepting such returns. Accordingly, software licensing arrangements entered into by the vendor include an implicit right of return that must be accounted for, regardless of the contractual provision prohibiting returns.

Evaluating whether a return right exists in a software licensing arrangement is often difficult, especially when contracts do not contain specific provisions relating to the vendor's obligation to accept returns. Because of the relatively low costs of duplicating and delivering software, licensed and delivered software may not be physically returned to the vendor even if a return is granted. If delivered software is returned in exchange for a different software product, a vendor simply may deliver the replacement software product (or allow the customer to download the replacement product). Such actions by a vendor may not be readily identifiable as a return. We believe that a vendor should establish controls that allow such actions to be identified to accounting personnel as they occur.

Determining when a vendor has established a common business practice of accepting returns of delivered software regardless of the lack of contractual provisions that require it to do so may require the use of professional judgment. When assessing a vendor's history in regards to this issue, the following factors should be considered:

- *What caused the vendor to accept the return (i.e., what are the vendor's motivations in allowing the customer to return the delivered product)*? For example, was the return allowed due to an isolated case of customer dissatisfaction with the vendor's products, or is the vendor's action indicative that it will accept such returns due to competitive pressures, to maintain customer relationships on a broad basis or for other reasons?

  If the motivations that led to the vendor agreeing to accept the return are likely to occur again, this could indicate the vendor's software licensing arrangements include an implicit right of return.

- *What is the number and nature of returns historically accepted? Is a return an isolated incident or indicative of a pattern?* A few returns, permitted relatively far apart in time, and that have been granted for differing reasons, may not be indicative of a pattern that the vendor's software licensing arrangements include an implicit right of return. Such returns should be evaluated relative to the vendor's overall volume of transactions.

Although each situation must be evaluated based on the applicable facts and circumstances, we generally believe that if a vendor agrees to accept anything other than a de minimus amount of returns when it is not otherwise obligated to do so, it has an established business practice indicating that its software licensing arrangements contain an implicit right of return.

Factors to consider when determining if a reasonable estimate of returns can be made

Question 6-3 **What factors should be considered to determine if a vendor has the ability to make a reasonable estimate of future returns of licensed software products?**

The guidance for right of return in ASC 605-15 specifies criteria for revenue recognition by a vendor when a customer has the right, explicitly or implicitly, to return the product. Pursuant to that guidance, revenue from such sales transactions shall be recognized at the time of sale only if all of the following conditions are met:

- *The seller's price to the buyer is substantially fixed or determinable at the date of sale.* See Chapter III for a discussion of considerations relating to whether fees for a software licensing arrangement are fixed or determinable.
- *The buyer has paid the seller, or the buyer is obligated to pay the seller and that obligation is not contingent on resale of the product.* As discussed in Question 4-62, this factor is particularly important for transactions with resellers in which a vendor, either by contract or by practice, allows a reseller to delay payment for licensed products until sales to end users occur.
- *The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product.* Because of the intangible nature of software products and the relatively low costs of duplication and distribution of licensed products, this generally is not a significant factor when evaluating rights of return included in software licensing arrangements.
- *The buyer acquiring the product for resale has economic substance apart from that provided by the seller.* As discussed in Question 4-62, this factor is particularly important for transactions with resellers. If a reseller does not have the wherewithal to pay for licensed software products absent resale to end users, or if the arrangement, either explicitly or implicitly, links payment obligations to sales to end users, this may be indicative that the reseller does not have economic substance apart from that provided by the vendor.
- *The seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer.* This factor also is particularly important for transactions with resellers.
- *The amount of future returns can be reasonably estimated.* The guidance in ASC 605-15 provides a number of factors that may indicate a vendor's ability to make a reasonable estimate of future returns or refunds is impaired. The presence of one or more of these factors does not necessarily indicate that a vendor cannot make a reasonable estimate of future returns, depending on the significance of other factors and all relevant facts and circumstances. Likewise, the absence of any of the following factors may not be a sufficient basis to conclude that a reasonable estimate of future returns can be made if other factors exist that may preclude such an estimate. As acknowledged by the right of return guidance, the ability to make a reasonable estimate of the amount of future returns depends on many factors and circumstances that will vary from one case to the next. The factors specified ASC 605-15 are as follows:
  - The susceptibility of the product to significant external factors, such as technological obsolescence or changes in demand. Because of the inherent risk of technological obsolescence and the uniqueness of most software products, this factor may be a relatively larger barrier to the ability to make a reasonable estimate of future returns for software products than for many other types of products.
  - Relatively long periods in which a particular product may be returned. Similar to the immediately preceding factor, if a software vendor offers a relatively long period during which a product may be returned, the risk of technological obsolescence of the licensed product may increase,

thereby increasing the risk that a vendor will not be able to reasonably estimate future returns. We generally would be skeptical that a software vendor that offers a right of return exceeding one year can make a reliable estimate of future returns.

- The absence of historical experience with similar types of sales of similar products, or the inability to apply such experience because of changing circumstances (e.g., changes in the vendor's marketing policies or relationships with its customers).

  Start-up companies and companies selling new or significantly modified products are frequently unable to develop the requisite historical data on which to base estimates of returns. Although determining when a vendor has developed a sufficient amount of history that can be used to make a reasonable estimate of future returns is dependent on the relevant facts and circumstances and may require the use of professional judgment, we believe the following should be considered:

  - The amount of history that a vendor has with a particular product. We believe it would be rare that a vendor can make a reasonable estimate of future returns for a product that has been marketed for less than one year. However, if a product is a next generation version of a well-established software product, or is similar in nature to another existing product and marketed to the same class of customers, a vendor may be able to make a reasonable estimate of sales returns for a product newly released into the marketplace.
  - Whether there is inadequate verifiable evidence of historical experience with a product.
  - Whether there are inadequate internal controls that ensure the reliability and timeliness of the reporting of the appropriate historical information on which to base an estimate.
  - The absence of a large volume of relatively homogeneous transactions.

In SAB Topic 13, the SEC staff provides the following additional factors that may affect or preclude a vendor's ability to make reasonable estimates of product returns under the right of return guidance (SAB Topic 13.A.4.b, Question 1):

- *Significant increases in or excess levels of inventory in a distribution channel (sometimes referred to as "channel-stuffing").* Channel-stuffing is a practice that vendors sometimes use to boost sales by inducing distributors or resellers to buy substantially more merchandise than can be promptly resold or resold before it becomes technologically obsolete. To induce the resellers to make such purchases, a vendor may offer rights to return unsold products that are in excess of the normal sales return privileges offered by the vendor.

  Expanded rights of returns offered to customers in connection with channel-stuffing should be considered carefully to determine if they prevent the vendor from recognizing revenue at the time of the sales transaction. As discussed above, when an arrangement includes a right of return, revenue from sales transactions shall be recognized at the time of sale only if the amount of future returns can be reasonably estimated, among other criteria. The ability to make such estimates is affected by the presence or absence of relevant historical return experience and the vendor's marketing policies and relationships with its customers, among other factors. Significant increases in, or excess levels of, inventory in a distribution channel due to channel-stuffing may affect or preclude a vendor's ability to make reasonable estimates of future product returns, particularly if sales activity is not consistent with historical sales patterns, or if expanded rights of returns have been granted. Revenue should not be recognized on transfer of licensed software products to a reseller (the "sell-in" method) when excess inventory levels exist in the channel.

- *Lack of "visibility" into or the inability to determine or observe the levels of inventory in a distribution channel and the current level of a reseller's sales to end users*. If a vendor does not have reliable information relating to the sales of its products within a distribution channel, it may not have the ability to make a reasonable estimate of future returns. Revenue should not be recognized on transfer of licensed software products to a reseller (the "sell-in" method) in such situations.
- *The significance of a particular reseller to a vendor's (or a reporting segment of the vendor) business, sales and marketing*. As discussed in Question 4-62, a reseller may be a significant source of recurring software sales for a vendor. Additionally, a reseller may represent a vendor's only distribution channel for a specific product or geographic region. Accordingly, a vendor may be willing to accept returns from, or grant concessions to, such a distributor that it might not otherwise be obligated to accept in order to maintain a mutually beneficial relationship and maximize future sales opportunities.

  Accordingly, a vendor may not 1) be able to reasonably estimate the effects of rights of return or other rights given to a reseller or 2) be able to conclude that it will not grant a future concession (see Question 4-47) in the form of allowing returns that it is not otherwise obligated to accept. Accordingly, a vendor may be precluded from recognizing revenue relating to a reseller agreement until the reseller sells the licensed products to end users, or it receives cash from the reseller.
- *The newness of a product.* As discussed above, start-up companies and companies selling new or significantly modified products are frequently unable to develop the requisite historical data on which to base estimates of returns.
- *The introduction of competitors' products with superior technology or greater expected market acceptance.* As discussed above, the inherent risk of technological obsolescence associated with software products should be considered in determining whether a vendor has the ability to make a reasonable estimate of future returns.
- *Other factors that affect market demand and changing trends in that demand for the vendor's products.*

We believe that the insights on the application of the right of return guidance discussed in SAB Topic 13 also should be considered when evaluating an estimate of returns. SAB Topic 13 states that the following items would indicate an inability to make reliable estimates (SAB Topic 13.A.4.a, Question 1):

- *Recurring, significant differences between actual experience and estimated return rates*. Differences in actual and estimated return rates may indicate an inability to make a reliable estimate even if the effect of the difference on the amount of estimated refunds is not material to the consolidated financial statements (e.g., an actual return rate of 40% versus an estimated rate of 25%).
- *Recurring variances between the actual and estimated amount of refunds that are material to either revenue or net income in quarterly or annual financial statements.*
- *The risk that material adjustments (both individually and in the aggregate) to previously recognized revenue will be required is more than remote.* The staff presumes that reliable estimates cannot be made if a customer's return privileges exceed one year. For purposes of evaluating this criterion, the term "remote" is used with the same definition as used in ASC 450, *Contingencies*.

If a vendor is unable to make a reasonable estimate of future returns, revenue should be recognized on the earlier of the expiration of customers' rights of return or when a reasonable estimate of future returns can be made. As stated previously, if a reasonable estimate of future returns or refunds cannot be made, it is inappropriate to conservatively estimate the maximum level of possible returns and recognize revenue based on that estimate, or to simply defer recognition of the gross margin on the transaction.

When a reasonable estimate of future returns can be made, sales revenue and cost of sales should be reported in the income statement and should be reduced to reflect estimated returns.

Changes in estimates of future returns should be accounted for in the period identified pursuant to the provisions of ASC 250, *Accounting Changes and Error Corrections*. Companies should ensure that they have appropriate internal controls to identify changes in estimates on a timely basis.

It is possible that, because of changes in facts and circumstances or due to the terms of transactions, a vendor's ability to reasonably estimate future sales returns pursuant to the right of return guidance may fluctuate. As circumstances change, companies institute new business practices, or arrangements include new or expanded rights of return, companies should reevaluate whether or not they have lost, or potentially developed, the ability to reasonably estimate future returns.

Right of return for product not available at time of delivery of initial product

Question 6-4 **If an arrangement provides a customer with the right to return a licensed software product in exchange for a replacement product (either specified or unspecified) that is not available at the time the licensed product is delivered, what accounting should be applied to that right?**

If a vendor agrees to provide a customer with the right to return a delivered licensed software product in exchange for another product, and the replacement product is not available at the date that the licensed software product is delivered, the right should be accounted for as a right of return pursuant to the rights of return guidance unless, as stated in ASC 985-605-25-61 , there is "persuasive evidence that demonstrates there will be no more than minimal differences in price, features, or functionality among the products." If such persuasive evidence exists, the right may be accounted for as an exchange right (see Question 6-1).

Factors to consider in determining whether a vendor can establish such persuasive evidence at the date licensed software products are delivered include:

- *Whether the replacement product is specified in the arrangement with the customer.* If the product is not specified, we believe that it would be rare for a software vendor to develop persuasive evidence that any replacement product will not have more than minimal differences in price, features or functionality — precisely because the replacement product is not specified and available.

  If the replacement product is specified, the following factors should be considered:

  - Whether a detail program design, as defined by ASC 985-20, *Software — Costs of Software to be Sold, Leased, or Marketed*, exists that describes the planned features and functionality of the replacement product. If so, it should be reviewed to assess whether it indicates that the replacement product will have more than minimal differences in features and functionality from the delivered product. Additionally, the estimated development costs of completing the program design should be assessed. ASC 985-605-25-61 states that "if the vendor expects to incur a significant amount of development costs related to the other product, the other product shall be considered to have more than a minimal difference in functionality."

    Vendors that establish technological feasibility using a working model approach pursuant to ASC 985-20 may not have a detail program design of the replacement product. However, such vendors typically do have a development plan and budget. These may be reviewed instead of a detail program design.

- Whether a price for the replacement product has been established by the vendor's pricing committee or other management having relevant authority and whether that price is minimally different from the price of the delivered licensed software. In making this assessment, consideration should be given as to whether it is probable that the price established by management will not change once the replacement product is introduced into the marketplace. It is often very difficult to assess the likelihood that a price established by management will not change, particularly when a vendor operates in a highly competitive market, past experience has demonstrated that the vendor does not sell the software product for a consistent price among customers or on a standalone basis, the product does not have proven acceptance in the marketplace, the product has (or is anticipated to have) a long sales cycle, or the vendor does not have a history of successfully selling new products into the marketplace at prices set by management. In addition, if VSOE of fair value does not exist for the current product, it would be rare for VSOE of fair value to exist for the replacement product.

- Whether the marketing focus for the replacement product is anticipated to focus on the product's new features and functionality. If so, this may indicate there will be more than minimal differences in features and functionality between the delivered product and the replacement product.

- Whether customers appear to be delaying current purchases in anticipation of the release of the replacement product. If so, this may indicate that the replacement product will have more than minimal differences in features and functionality from the delivered product.

- The projected timeline for release of the replacement product. Extended release dates may indicate that substantial programming time is required to incorporate more than minimal differences in features and functionality from the delivered product into the replacement product or that a significant amount of development costs will be incurred prior to release of the replacement product.

- *The length of time the right to return a delivered product for a replacement product may be exercised by a customer.* As discussed above, ASC 985-605-25-61 states "if the vendor expects to incur a significant amount of development costs related to the other product, the other product shall be considered to have more than a minimal difference in functionality." We understand from discussions with the SEC staff that when evaluating this provision, they believe a vendor must have persuasive evidence that a significant amount of development costs will not be incurred relating to any potential replacement product in order to conclude it is appropriate to account for a right to return a licensed software product for another product as an exchange right. It may be difficult for a vendor to develop such evidence if a right of return remains in force for a period of time exceeding the time frame it estimates will be required to complete its current product development plans.

  Additionally, if the length of time the right to return a delivered product for a replacement product may be exercised by a customer exceeds a vendor's current product development plans, it will be rare that a vendor will have persuasive evidence that replacement products will have no more than minimal differences in features and functionality because it does not know what products may be released and what features and functionality those products may have.

The following examples illustrate these concepts:

Illustration 6-3: Persuasive evidence exists of no more than minimal differences in price, features and functionality

Facts

A software vendor sells a personal productivity software product, AppointmentBook. The vendor is also developing a similar product, Scheduler. Based on the vendor's detail program design, Scheduler will utilize a different graphical user interface, but otherwise have similar features and functionality. The program design indicates that development efforts relating to Scheduler will be completed within six months of the execution of the arrangement with the customer and that the associated costs will not be significant. Marketing efforts will differentiate Scheduler from AppointmentBook based on the different interfaces. Management having the relevant authority has established a price for Scheduler that is consistent with the price for AppointmentBook, and it is probable that the price will not change once Scheduler is released (see Question 3-4 for discussion of factors to consider when evaluating prices established by management).

The vendor enters into an arrangement with a customer to perpetually license AppointmentBook for a nonrefundable fee of $20,000. Pursuant to the arrangement, the customer may exchange, at its option, AppointmentBook for Scheduler for a period of three months following Scheduler's release. If exchanged, the customer must cease use of AppointmentBook.

Analysis

In this illustration, the vendor is able to establish persuasive evidence that the replacement product does not have more than minimal differences in price, features and functionality from the delivered product. Accordingly, the right of the customer to exchange AppointmentBook for Scheduler is an exchange right. If all of the other basic revenue recognition criteria of ASC 985-605 have been met, the vendor may recognize revenue of $20,000 on the delivery of AppointmentBook to the customer. If the customer ultimately exercises the right to exchange AppointmentBook for Scheduler, no accounting recognition would be given to the exchange.

Illustration 6-4: Persuasive evidence of no more than minimal differences in price, features and functionality does not exist

Facts

Assume the same facts as in Illustration 6-3 above, except the arrangement provides that the customer may exchange AppointmentBook for Scheduler once released, or for any enhanced versions of Scheduler or any other personal productivity products released by the vendor during the next five years. The vendor estimates that the completion of all of its current product development plans will require two to three years.

Analysis

In this example, the vendor is unable to establish persuasive evidence that the replacement product will not have more than minimal differences in price, features and functionality from the delivered product because, among other factors, the period during which the customer's exchange right may be exercised exceeds the anticipated timeframe required to complete its current product development plans. Accordingly, the exchange right should be accounted for as a right of return.

If a vendor cannot account for a right to return a delivered licensed software product for a replacement product not yet available as an exchange right, we believe it would be rare that it would have the requisite information necessary to support a reasonable estimate of future returns. Since the products are not yet available, evidence likely will not exist to reasonably estimate what percentage of customers will return the delivered products in exchange for the future products to be released by the vendor. In such cases, revenue must be deferred and recognized as customers' rights of return expire or when a reasonable estimate of future returns can be made. If a reasonable estimate of future returns or refunds cannot be made, it is inappropriate to conservatively estimate the maximum level of possible returns and recognize revenue based on that estimate or to simply defer recognition of the gross margin on the transaction.

Rights to exchange delivered software for unspecified software products

Question 6-5 **A software vendor may enter into an arrangement that provides a customer with the right to exchange delivered software products for unspecified replacement software products. How should a vendor account for such rights?**

When a vendor allows a customer to exchange delivered software for unspecified software products, such a right generally should be accounted for as a right of return pursuant to the rights of return guidance. Exchange accounting generally will not be appropriate because if the replacement product is not specified, it would be rare that a software vendor can develop the persuasive evidence that any replacement product will not have more than minimal differences in price, features or functionality required by ASC 985-605-25-61 precisely because the replacement product is not specified (see Question 6-4).

However, a software vendor may enter into an arrangement that provides the customer the right to exchange delivered software products for other products offered by the vendor, including the right to exchange the delivered software for other products currently marketed by the vendor and any products released by the vendor during the term of the arrangement, up to a specified dollar amount. In such arrangements, the customer typically is allowed to:

- Use certain other, if not all, software products marketed by the vendor at inception of the agreement instead of the delivered product(s)
- Use any unspecified future software product(s) the vendor releases during the term of the arrangement instead of the delivered product(s)
- Use any combination of currently available or unspecified additional software products, up to an amount permitted by the contractual arrangement with the customer
- Modify the mix of product(s) being used as many times as desired

For example, a customer initially may license only certain of the products within a vendor's portfolio of products. Pursuant to the terms of the license, the customer may stop using all or a portion of the originally delivered products and exchange them for other products marketed by the vendor, including products released by the vendor in the future. However, the aggregate value of all products delivered and in use by the customer at any point in time cannot exceed a contractually specified amount. All of the products available may or may not be delivered to the customer at the inception of the arrangement.

Although similar to an arrangement containing re-mix rights as discussed in ASC 985-605-55-99 and 55-100, such arrangements differ in that the customer has the right to exchange currently delivered products for unspecified additional software products released by the vendor during the term of the arrangement.

ASC 985-605-25-61 indicates that a right to exchange software for software with no more than minimal differences in price, functionality and features should be accounted for as an exchange right. ASC 985-605-25-61 further states that if a product made available for exchange "is not available at the time the initial product is delivered, there should be persuasive evidence that demonstrates there will be no more than minimal differences in price, features, or functionality among the products in order for the right to qualify as a right to exchange. Additionally, if the vendor expects to incur a significant amount of development costs related to the other product, the other product shall be considered to have more than a minimal difference in functionality." Because it may take an extended period of time and substantial R&D efforts to bring a product to market, we believe that a vendor generally will not be able to develop persuasive evidence that unspecified future products included in such arrangements could have only minimal differences in functionality from the currently delivered products and thus qualify for exchange accounting.

As discussed above, if an exchange right does not qualify for exchange accounting, the right generally should be accounted for as a right of return pursuant to the rights of return guidance. However, we believe that arrangements such as the ones described above may be accounted for as an in-substance subscription in accordance with the provisions of ASC 985-605-25-9 through 25-11 and ASC 985-605-25-59 if the exchange right can be exercised multiple times, and:

- If a perpetual license arrangement, the period during which the exchange right may be exercised is potentially unlimited (e.g., the exchange right can be exercised as long as the customer is a PCS subscriber) or is consistent with the estimated economic life of the licensed software products
- If a time-based license arrangement, the exchange right may be exercised over the entire term of the arrangement (or as long as the customer is a PCS subscriber if a multi-year time-based license arrangement)

If these criteria are met, we believe that the arrangement is an in-substance subscription to the vendor's portfolio of software products as described in ASC 985-605-25-9 through 25-11. Accordingly, we believe such arrangements should be accounted for as a subscription in accordance with ASC 985-605-25-59, with the arrangement's fee recognized ratably over the term of the arrangement beginning with the delivery of the first licensed software product to the customer (see Question 5-29).

The following examples illustrate these concepts:

Illustration 6-5: Exchange rights exercisable for unspecified additional software products over the entire term of a time-based license arrangement

Facts

A calendar year-end software vendor enters into a three-year time-based license agreement that provides a customer with the right to use up to $5,000 (list price) of any combination of the vendor's then currently available software Products A, B and C, and any additional software products that the vendor releases during the three-year term of the agreement. The combination of products can be remixed at any time.

The per-user list prices of the currently available Products A, B and C are $250, $100 and $90, respectively. The per unit list price of future software products will be established by the pricing committee, which consists of management with the relevant authority, as such products are developed and released.

There are no rights to return the licensed software. The license arrangement includes first year PCS with optional PCS for years 2 and 3, priced at VSOE of fair value. The license fee is payable net 30 days.

The customer's ability to exercise the exchange right is unlimited and may be used for the entirety of the arrangement, as long as it remains a PCS subscriber.

Analysis

Because the agreement includes a right to remix for unspecified future software products that can be exercised multiple times over the entirety of the term of the arrangement (as long as the customer is a PCS subscriber), the arrangement should be accounted for as an in-substance subscription in accordance with ASC 985-605-25-9 through 25-11. Revenue for the arrangement should be recognized ratably over the subscription period in accordance with ASC 985-605-25-59 beginning with the delivery of Products A, B and C (if all of the other basic revenue recognition criteria of ASC 985-605 have been met).

Illustration 6-6: Right to exchange delivered software for unspecified products for a limited period of time

Facts

A calendar year-end software vendor enters into an arrangement with a customer to license Product A on a perpetual basis. The customer may return Product A at any time within two years following execution of the arrangement and receive any product introduced by the vendor in the Product A family over that period. The customer may exercise this return right an unlimited number of times during the two years following execution of the arrangement. However, the customer loses the right to use any licensed software product when it is returned to the vendor.

The estimated economic life of the Product A is five years.

Analysis

Because the exchange right is limited to a period of time that is substantially less than the five-year estimated economic life of the licensed software product (i.e., the two years following execution of the arrangement), the vendor should account for the exchange right as a right of return pursuant to the provisions of the rights of return guidance (see Question 6-3).

Illustration 6-7: Unlimited rights to exchange delivered software for unspecified products

Facts

A calendar year-end software vendor enters into an arrangement with a customer to license Product A on a perpetual basis. The customer may return Product A in exchange for any product in the Product A family marketed by the vendor at the origination of the arrangement or subsequently released by the vendor. This right may be exercised an unlimited number of times by the customer as long as it is a current PCS subscriber. However, the customer loses the right to use any licensed software product on its return to the vendor.

The estimated economic life of Product A is ten years.

Analysis

Because the exchange right may be exercised an unlimited number of times and during a potentially unlimited term (i.e., as long as the customer is a PCS subscriber), the vendor should account for the arrangement as an in-substance subscription in accordance with ASC 985-605-25-9 through 25-11. Revenue for the arrangement should be recognized ratably over the subscription period (the estimated economic life of the software in this situation because no arrangement term is specified) in accordance with ASC 985-605-25-59 beginning with the delivery of Product A (if all of the other basic revenue recognition criteria of ASC 985-605 have been met).

Rights of return included in multiple-element arrangements when VSOE of fair value exists

Question 6-6 **If a multiple-element software licensing arrangement includes a right to return delivered licensed software products and VSOE of fair value exists such that the vendor may account for the elements of the arrangement separately, how should the vendor account for the customer's right of return?**

A vendor may enter into a multiple-element arrangement that includes software products and PCS or other services. If VSOE of fair value exists for all of the elements in the arrangement, or at least for the undelivered elements, the arrangement consideration should be allocated to the various elements based on such evidence.

In such arrangements, the customer may have a right to return delivered software products or other elements of the arrangement that must be accounted for pursuant to the provisions of the rights of return guidance. Rights of return do not affect the determination of the amount of arrangement consideration that can be allocated to an element accounted for separately. However, such rights do affect when the amount of allocated arrangement consideration may be recognized as revenue (see Question 6-3). When an element is subject to a right of return, revenue should not be recognized until an estimate of future returns can be made pursuant to the provisions of the rights of return guidance or the right of return expires.

The following examples illustrate these concepts:

Illustration 6-8: VSOE of fair value exists for undelivered elements

Facts

A calendar year-end software vendor enters into an arrangement with a customer to perpetually license Product A and to provide one year of PCS for $120,000. The arrangement provides the customer with the right to return the licensed product for any reason within 90 days following execution of the agreement. VSOE of fair value of Product A does not exist. However, based on PCS renewals, VSOE of fair value of PCS is $30,000 (see Chapter VII). Using the residual method, arrangement consideration is allocated to the software and PCS as follows:

Arrangement consideration	$ 120,000
Less: VSOE of fair value of PCS	(30,000)
Arrangement consideration allocable to Product A	$ 90,000

Based on company-specific historical information, the vendor can reasonably estimate that 10% of customers will exercise the right to return delivered software.

Analysis

If all of the other basic revenue recognition criteria of ASC 985-605 have been met, the vendor should recognize revenue of $81,000 ($90,000 less a 10% estimated allowance for returns) on the delivery of Product A to the customer. Additionally, depending on the terms of the arrangement, the vendor may need to consider whether an allowance for returns is necessary for the PCS element of the arrangement in accordance with the rights of return guidance.

Illustration 6-9: VSOE of fair value exists for all elements included in the arrangement

Facts

Assume the same facts as Illustration 6-8 above, except that based on sales of Product A without PCS, the vendor has determined that VSOE of the fair value for the product is $120,000 (note that in practice it is rare that a software vendor can establish VSOE of fair value of software products). Arrangement consideration is allocated to the software and PCS using their relative fair values as follows:

	Fair value	% of relative fair value	Allocated discount	Allocated arrangement consideration
Product A	$ 120,000	80%	$ (24,000)	$ 96,000
PCS	30,000	20%	(6,000)	24,000
Total	$ 150,000		$ (30,000)	$ 120,000

Based on company-specific historical information, the vendor can reasonably and reliably estimate that 10% of customers will exercise the right to return delivered software.

Analysis

If all of the other basic revenue recognition criteria of ASC 985-605 have been met, the vendor should recognize revenue of $86,400 ($96,000 less a 10% estimated allowance for returns) on the delivery of Product A to the customer.

If a vendor is able to make a reasonable estimate of future returns and an arrangement specifies the amount of cash that will be refunded to a customer that exercises a right of return, the amount reserved for estimated returns should be based on the amount of cash that will be refunded or forfeited as a result of the return.

Illustration 6-10: Arrangement subject to a refund

Facts

Assume the same facts as Illustration 6-8 above, except the arrangement with the customer specifies that if the delivered software product is returned, the customer will be entitled to receive a refund of $100,000.

Analysis

If all of the other basic revenue recognition criteria of ASC 985-605 have been met, the vendor should recognize revenue of $80,000 (the arrangement consideration allocable to Product A of $90,000 less an estimated allowance for returns based on the contractually specified refund amount of $100,000 multiplied by 10%) on the delivery of Product A to the customer.

Rights of return included in multiple-element arrangements when VSOE of fair value does not exist

Question 6-7 **If a multiple-element software licensing arrangement includes a right to return delivered licensed software products and VSOE of fair value does not exist such that the vendor is unable to account for the elements of the arrangement separately, how should the vendor account for the customer's right of return?**

A vendor may enter into a multiple-element arrangement that includes software products and PCS or other services. If VSOE of fair value does not exist for all of the elements included in the arrangement, or at least for the undelivered elements, no revenue for the arrangement should be recognized until such evidence exists, or until all elements of the arrangement for which VSOE of fair value does not exist have been delivered. If a vendor enters into a multiple-element arrangement that includes a right to return a delivered software product, or other delivered elements of the arrangement, and if VSOE of fair value does not exist for the delivered product, a question arises as to when revenue from the arrangement should be recognized.

Pursuant to the provisions of the rights of return guidance, a vendor must be able to reasonably estimate the amount of returns prior to recognizing revenue for the arrangement. However, if the amount of arrangement consideration relating to a delivered element subject to a right of return is not known, a vendor cannot make an estimate of the monetary value of the return right. When VSOE of fair value does not exist such that a delivered element subject to a return right cannot be accounted for separately, we believe a vendor will have little or no ability to make a reasonable estimate of the monetary amount of future returns of the delivered element. Accordingly, a vendor generally will be unable to recognize any revenue for the arrangement, including any revenue that otherwise may be recognized ratably over an initial PCS period, until it either develops VSOE of fair value of all of the elements included in the arrangement or of the undelivered elements (thereby allowing it to allocate arrangement consideration to the delivered elements and thus compute a monetary value for the estimated amount of future returns) or the right of return expires.

The following examples illustrate these concepts:

Illustration 6-11: Right to return delivered software product for a limited period of time

Facts

A calendar year-end software vendor enters into an arrangement with a customer to perpetually license software Product A and provide one year of PCS for $100,000. The vendor does not have VSOE of fair value of either the delivered software product or the PCS and must account for the arrangement as one unit of accounting.

The arrangement provides the customer with the right to return the licensed product for any reason within 90 days following execution of the agreement. Based on company-specific historical information, the vendor can reasonably estimate that 10% of customers will exercise the right to return delivered software.

Analysis

No revenue should be recognized by the vendor until the customer's right of return expires, or VSOE of fair value of the undelivered PCS is established, whichever occurs first. Assuming the right of return expires first, the vendor may begin to recognize revenue ratably over the remaining PCS period 90 days after execution of the agreement with the customer.

Illustration 6-12: Right to exchange delivered software product for another product

Facts

A calendar year-end software vendor enters into an arrangement with a customer to perpetually license software Products A and B and provide one year of PCS for both products for $100,000. Both products are delivered to the customer at inception of the arrangement. Pursuant to the terms of the arrangement, the customer may exchange Product A for Product C within 90 days following execution of the agreement. Because Product C has more than minimal differences in price, features and functionality from Product A, the vendor must account for the exchange right as a right of return (see Question 6-1).

VSOE of fair value does not exist for the delivered software products, but does exist for PCS. Based on company-specific historical information, the vendor can reasonably estimate that 10% of customers will exercise the right to exchange Product A for Product C.

Analysis

Although the vendor can apply the residual method to allocate arrangement consideration between the undelivered PCS and the aggregate delivered software products (Products A and B), it does not have the ability to allocate arrangement consideration between Products A and B individually. Accordingly, no revenue should be recognized by the vendor for the arrangement until the earlier of the date 1) the customer exercises the right to exchange Product A for Product C, 2) the customer's exchange right expires or 3) the vendor establishes VSOE of fair value of the delivered software products.

Delivery of substitute product with no more than minimal differences

Question 6-8 **A software vendor may enter into an agreement with a customer to license a product (Product B) that is not currently available. The vendor delivers a substitute product (Product A) and provides the customer with the right to exchange Product A for Product B once available. Product A has no more than minimal differences in price, functionality or features from Product B. Is delivery achieved on the delivery of Product A?**

Question 4-21 addresses this question.

6.2 Platform-transfer rights

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-62

As part of a multiple-element arrangement, a vendor may grant a user a platform- transfer right. Depending on the circumstances, the exercise of a platform-transfer right may represent an exchange, a return, or additional software products for accounting purposes. If the customer contractually is entitled to continue to use the software that was delivered originally (in addition to the software that is to be delivered for the new platform), the platform transfer right shall be accounted for in the manner prescribed in paragraphs 985-605-25-47 through 25-59.

985-605-25-63

The guidance in the following paragraph applies if all of the following conditions are met:

a. As part of a multiple-element arrangement, a vendor offers a user (not a reseller) a platform-transfer right.

b. The provisions of paragraphs 985-605-25-3 through 25-14 are met.

c. The platform-transfer right meets both of the following conditions:

   1. It is for the same product (see paragraph 985-605-25-64).

   2. It does not increase the number of copies or concurrent users of the software product available under the license arrangement.

985-605-25-63A

If all of the conditions in the preceding paragraph are met, the entity shall do both of the following:

a. Recognize the revenue from the software license upon the initial delivery of the software.

b. Treat the exercise of the platform-transfer right as an exchange.

985-605-25-64

Products are considered to be the same product if there are no more than minimal differences among them in price, features, and functions, and if they are marketed as the same product, even though there may be differences arising from environmental variables such as operating systems, databases, user interfaces, and platform scales. Indicators that products are marketed as the same product include the same product name (although version numbers may differ) and a focus on the same features and functions.

ASC 985-605-20 defines platform-transfer rights as rights "granted by a vendor to transfer software from one hardware platform or operating system to one or more other hardware platforms or operating systems." Platform-transfer rights may be specified contractually or may be provided by a vendor as a matter of practice and may or may not require actual physical return of the delivered software.

Similar to arrangements that provide an end user with the right to return delivered licensed software, arrangements that include platform-transfer rights must be evaluated to determine if the right should be accounted for as either:

- *A like-kind exchange.* Platform-transfer rights provided to end users should be accounted for as an exchange right if the right 1) is for the same product and 2) does not increase the number of copies or concurrent users of the software product available under the license arrangement.

  However, this accounting is only applicable to exchange rights granted to end users. Platform-transfer rights granted to resellers should be accounted for as a right of return.

- *A right of return.* If a platform-transfer right is not for the same product, as defined by ASC 985-605-25-64, but does not increase the number of copies or concurrent users of the software product available under the license arrangement, the right should be accounted for as a right of return.

  Revenue generally may be recognized at the time of sale when the customer has the right to return a product if a vendor can make a reasonable estimate of future returns pursuant to the provisions of the rights of return guidance, if all of the basic revenue recognition criteria of ASC 985-605 have been met. If a reasonable estimate of future returns or cancellations cannot be made, it is inappropriate to estimate the maximum level of possible returns. Instead, revenue should be recognized as the return or refund provisions lapse or when the criteria in the rights of return guidance have been met, whichever occurs first (see Question 6-3).

- *A right to additional software products.* An arrangement that allows a customer to continue to use previously delivered software and to receive the same product for use on a differing platform, or increases the number of copies or concurrent users of the software product available under the license arrangement, should be accounted for as a multiple-element arrangement that includes rights to additional software products.

Platform-transfer rights for currently available specified products

Question 6-9 **If a software licensing arrangement provides a customer with the right to exchange a delivered product for a currently available specified product that can be used on another platform, what factors should be considered in determining whether the platform-transfer right may be accounted for as an exchange right?**

ASC 985-605-25-63 and 25-63A provide that platform-transfer rights provided to end users (but not resellers) should be accounted for as an exchange right if the right 1) is for the same product and 2) does not increase the number of copies or concurrent users of the software product available under the license arrangement. ASC 985-605-25-64 provides that a software product is the same product if "there are no more than minimal differences among them in price, features, and functions, and if they are marketed as the same product, even though there may be differences arising from environmental variables such as operating systems, databases, user interfaces, and platform scales. Indicators of "marketed as the same product" include (a) the same product name (although version numbers may differ) and (b) a focus on the same features and functions."

When determining if there are no more than minimal differences in price, features and functions between a delivered product and a specified replacement product, the factors discussed in Question 6-1 should be considered.

The following examples illustrate these concepts:

Illustration 6-13: Delivered product may be exchanged for same product without increasing number of licensed copies

Facts

A software vendor enters into an arrangement to license software Product A for use in an OneX-based environment to a customer on a perpetual basis. The vendor also offers versions of Product A that operate in a Shutters NX or LineX environment. There are minimal differences in price, features and functionality between the versions of Product A designed to operate in the differing environments. The differing versions of Product A are marketed in a similar manner, with a focus on the same features and functionality.

The arrangement contains a provision that allows the customer to exchange the OneX-based Product A delivered at inception of the arrangement for the same product for use in the Shutters NX or LineX environments. However, if the customer exercises this right, it loses the right to use the OneX-based Product A.

Analysis

The vendor should account for the customer's right to transfer platforms as an exchange right because the customer may exchange the delivered product for the same product, as defined by ASC 985-605-25-64, for use on a different platform, and it must cease use of the delivered OneX-based product if it exercises its exchange right.

Illustration 6-14: Delivered product may be exchanged for same product and number of licensed copies increases

Facts

Assume the same facts as in Illustration 6-13 above, except that if the customer exercises its platform-transfer right, it may continue to use the delivered OneX-based Product A.

Analysis

The vendor should account for the customer's right to transfer platforms as a multiple-element arrangement including a right to receive additional software products because the customer may continue to use the delivered OneX-based product if it exercises the exchange right.

Illustration 6-15: Delivered product may be exchanged for dissimilar product

Facts

Assume the same facts as in Illustration 6-13 above, except that the LineX-based version of Product A sells for a significantly different price than the OneX-based version.

Analysis

Because the product delivered to the customer may be exchanged for a product that has more than minimal differences in price, the platform-transfer right cannot be accounted for as an exchange. Instead, the vendor should account for the customer's right to transfer platforms as a right of return pursuant to the rights of return guidance.

Platform-transfer rights for specified products not currently available

Question 6-10 **If a software licensing arrangement provides a customer with the right to exchange a delivered product for a specified product that can be used on another platform, but which is not currently available, what factors should be considered in determining whether the platform-transfer right may be accounted for as an exchange right?**

If an arrangement provides that a customer may exchange a delivered software product for a specified product that can be used on another specified platform, but which is not currently available, the provisions of ASC 985-605-25-63 and 25-64 must be considered as discussed in Question 6-9. Additionally, we believe that the provisions of ASC 985-605-25-61, which states the following, should also be considered.

> "If the other product or products are not available at the time the initial product is delivered, there shall be persuasive evidence that demonstrates there will be no more than minimal differences in price, features, or functionality among the products in order for the right to qualify as a right to exchange. Additionally, if the vendor expects to incur a significant amount of development costs related to the other product, the other product shall be considered to have more than a minimal difference in functionality."

Factors to consider in determining whether a vendor can establish such persuasive evidence at the date it delivers a licensed software product subject to a right to exchange for a similar product, not yet available, designed for use on a different platform include:

- *Whether a detail program design exists.* A detailed program design, as defined by ASC 985-20, may describe the planned features and functionality of the versions of the product designed for use on differing platforms. If so, it should be reviewed to assess whether it indicates that the replacement product will have more than minimal differences in features and functionality from the delivered product. Additionally, the estimated development costs of completing the program design should be assessed.

  Vendors that establish technological feasibility using a working model approach pursuant to ASC 985-20 may not have a detail program design of the replacement product. However, such vendors typically do have a development plan and budget. These may be reviewed instead of a detail program design.

- *Whether a price for the replacement product has been established.* If a price for the replacement product has been set by the vendor's pricing committee or other management having relevant authority and whether that price is minimally different from the price of the delivered licensed software. In making this assessment, consideration should be given as to whether it is probable that the price established by management will not change once the replacement product is introduced into the marketplace. It is often very difficult to assess the likelihood that a price established by management will not change, particularly when a vendor operates in a highly competitive market, the product does not have proven acceptance in the marketplace, the product has (or is anticipated to have) a long sales cycle, or the vendor does not have a history of successfully selling new products into the marketplace at prices set by management.

- *Whether the marketing focus for the replacement product is anticipated to focus on that product's new features and functionality*. If so, this may indicate there will be more than minimal differences in features and functionality between the delivered product and the replacement product.

- *Whether customers appear to be delaying current purchases in anticipation of the release of the replacement product*. If so, this may indicate that the replacement product will have more than minimal differences in features and functionality from the delivered product.

- *The projected timeline for release of the replacement product.* Extended release dates may indicate that substantial programming time is required to incorporate more than minimal differences in features and functionality from the delivered product into the replacement product or that a significant amount of development costs will be incurred prior to release of the replacement product.

- *The length of time that the right to exchange a delivered product may be exercised by a customer.* We understand from discussions with the SEC staff that when evaluating the provisions of ASC 985-605-25-61, they believe that a vendor must have persuasive evidence that a significant amount of development costs will not be incurred relating to any potential replacement product in order to conclude that is appropriate to account for a right to return a licensed software product for another product as an exchange right. It may be difficult for a vendor to develop such evidence if a platform-transfer right remains in force for a period of time exceeding the time frame that it estimates will be required to complete its current product development plans.

  Additionally, if the length of time that a platform-transfer right may be exercised by a customer exceeds a vendor's current product development plans, it will be rare that a vendor will have persuasive evidence that replacement products will have no more than minimal differences in features and functionality because it does not know what products may be released and what features and functionality those products may have.

The following examples illustrate these concepts:

Illustration 6-16: Persuasive evidence exists that there will be no more than minimal differences between the delivered product and replacement products

Facts

A software vendor enters into an arrangement to license software Product A, for use in an OneX-based environment, to a customer on a perpetual basis. Although the vendor does not currently offer versions of Product A that operate in any other environments, the arrangement contains a provision that allows the customer to exchange the OneX-based Product A delivered at inception of the arrangement for the same product for use in the Shutters NX or LineX environments, if such products are released within one year following execution of the agreement. However, if the customer exercises this right, it loses the right to use the delivered OneX-based Product A.

The vendor is developing versions of Product A for use in the Shutters NX and LineX environments. Based on the vendor's detail program designs, there will be no more than minimal differences in features and functionality between the versions of Product A designed to operate in the differing environments. The vendor anticipates that the differing platform versions of Product A will be released within three months, and the costs of the associated development efforts will not be significant. The differing versions of Product A are to be marketed in a similar manner with a focus on the same features and functionality. The vendor's pricing committee has established prices for the versions of Product A designed for use on the differing platforms that are consistent with the price of the OneX-based version.

Analysis

In this illustration, the vendor has persuasive evidence that the products designed for use on the differing platforms, once released, will have no more than minimal differences in price, features and functionality. Additionally, the customer must stop using the delivered OneX-based product if it exercises its platform-transfer right. Accordingly, the vendor may account for the platform-transfer right as an exchange right.

Illustration 6-17: Persuasive evidence that there will be no more than minimal differences between the delivered product and replacement products does not exist

Facts

Assume the same facts as in Illustration 6-16 above, except the customer may exchange the OneX-based version of Product A the vendor has delivered for any Shutters NX or LineX based versions of Product A the vendor releases during the next five years. The vendor anticipates that completion of its current product development plans, including further enhancements of the Shutters NX and LineX-based versions of Product A, once released, will require approximately two years.

Analysis

In this illustration, the vendor is unable to establish persuasive evidence that versions of Product A designed for use in a Shutters NX or LineX environment will not have more than minimal differences in price, features and functionality from the delivered product because the period during which the customer's exchange right may be exercised exceeds the anticipated timeframe required to complete its current product development plans. Accordingly, the exchange right should be accounted for as a right of return pursuant to the rights of return guidance.

Platform-transfer rights for unspecified products

Question 6-11 **If a software licensing arrangement provides a customer with the right to exchange a delivered product for a product designed for use on an unspecified platform, what factors should be considered in determining whether the platform-transfer right may be accounted for as an exchange right?**

When a vendor allows a customer to exchange delivered software for unspecified software products, such a right generally should be accounted for as a right of return pursuant to the rights of return guidance. Exchange accounting generally will not be appropriate because if the replacement product is not specified, it would be rare that a software vendor can develop the persuasive evidence that any replacement product will not have more than minimal differences in price, features or functionality required by ASC 985-605-25-61 — precisely because the replacement product is not specified.

The following examples illustrate these concepts:

Illustration 6-18: Platform-transfer right for unspecified platforms

Facts

A software vendor enters into an arrangement to license Product A for use in an OneX-based environment to a customer on a perpetual basis. The vendor does not currently market this product for use in any other environments.

The arrangement contains a provision that allows the customer to exchange the OneX-based Product A delivered at inception of the arrangement for any versions of Product A that the vendor releases for use on any other platforms over the next five years. However, if the customer exercises this right, it loses the right to use the OneX-based Product A.

At the date the agreement is executed, the vendor has no plans to develop versions of Product A for use on any other platforms. The vendor anticipates that completion of its current product development plans will require approximately three years.

Analysis

In this example, the vendor is unable to establish persuasive evidence that any replacement product will not have more than minimal differences in price, features and functionality from the delivered OneX-based product. The vendor has no means of assessing whether any versions of Product A released for use on other platforms will have more than minimal differences in price, features and functionality. Accordingly, the exchange right should be accounted for as a right of return pursuant to the rights of return guidance.

Illustration 6-19: Software vendor's licenses are platform independent; the right to receive an exchange for currently available or future unspecified platforms is provided as long as the customer maintains PCS

Facts

A software vendor's established business practice is to license its products in a platform-independent manner. The vendor's products have no more than minimal differences in features, functionality and prices between products that are designed to work in the differing environments, as evidenced by the vendor's marketing materials and pricing practices.

The software vendor enters into an arrangement to license Product A and does not state the platform. The license agreement's only reference to platforms is to list the currently available platforms for all of the licensed products. The arrangement also obligates the vendor to provide PCS on Product A for a period of one year. PCS is renewable annually. This PCS arrangement does not specify the platform utilized by the customer. The software vendor has established VSOE of fair value for PCS.

The license agreement contains a provision that allows the customer to exchange any of its licensed products for use on one platform for licenses for the same product for use on a different platform (such exchange right applies both to currently available platforms and to future unspecified available platforms), as long as the customer has a current PCS arrangement in force and does not exceed the total number of licenses purchased.

The vendor's historical annual development costs related to porting its products onto other platforms have been less than 5% of its total development costs for the year and the vendor's forecasted expenditure for the next year is consistent with these historical percentages.

Analysis

In this example, the platform exchange right for unspecified future platforms is limited to one year (the year that the customer has an in-force PCS arrangement). The vendor has persuasive evidence that the products designed for use on differing platforms, once released, will have no more than minimal differences in features, functionality and prices. This evidence is based on the vendor's business practices and the insignificance of the vendor's forecasted development costs related to porting its products on other platforms for the next twelve months (the time period of the platform exchange right for unspecified future platforms). Accordingly, the vendor may account for the platform-transfer right as an exchange right.

6.3 Exchange rights provided to resellers

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-65

As part of their standard sales terms or as a matter of practice, vendors may grant resellers the rights to exchange unsold software for other software, including software that runs on a different hardware platform or operating system. Because the reseller is not the ultimate customer (see paragraph 985-605-25-61), such exchanges, including those referred to as stock balancing arrangements, shall be accounted for as returns. Arrangements that grant rights to make such exchanges shall be accounted for in conformity with Subtopic 605-15, even if the vendors require the resellers to purchase additional software to exercise the exchange rights.

As part of a formal arrangement or as a business practice, software vendors may grant resellers some or all of the following rights:

- The right to exchange unsold licensed software for other software, including versions of the unsold licensed software for use on a different platform
- The right to return unsold licensed software for a refund or credits towards future purchases of the vendor's products

- Rights to a rebate or a credit equal to a portion of the original fee if the vendor subsequently reduces its price for a product and the reseller still has rights with respect to that product (commonly referred to as price protection)
- Rights to return unsold licensed software for other products of equal or lesser value pursuant to contractual limits on volume of rotations (commonly referred to as stock balancing arrangements)

All of these rights should be accounted for as rights of return pursuant to the rights of return guidance, regardless of whether these rights relate to the right to exchange unsold licensed software for software products having no more than minimal differences in price, functionality and features.

Reseller arrangements including the right to exchange or return unsold licensed software products

Question 6-12 **How should a software vendor account for exchange or return rights provided to resellers?**

A software vendor may allow, either as part of a formal arrangement (e.g., a stock balancing arrangement), or as a matter of practice, a reseller to return unsold licensed software products in exchange for other products that it markets, including versions of the unsold licensed software for use on a different platform or later versions of the same product or for a refund or credits against future purchases. Any such rights provided by a vendor to a reseller should be accounted for as a right of return pursuant to the rights of return guidance, even if the reseller's ability to return unsold licensed software is limited to the exchange of such products for other products having no more than minimal differences in price, features and functionality.

AcSEC believed that all rights to exchange or return software provided to a reseller should be accounted for pursuant to the rights of return guidance. ASC 605-15-15-2 specifies that "exchanges by ultimate customers of one item for another of the same kind, quality, and price (e.g., one color or size for another) are not considered returns." AcSEC concluded that rights allowing end users to exchange software products for other products having no more than minimal differences in price, functionality and features are equivalent to rights of ultimate customers to exchange "one item for another of the same kind, quality, and price" that ASC 605-15 stipulates should not be accounted for as returns. However, because ASC 605-15-15-2 limits the application of exchange accounting to exchanges by "ultimate customers," AcSEC concluded that an exchange right provided to resellers, which are not a software vendor's ultimate customers, should be accounted for as a right of return.

The following examples illustrate these concepts:

Illustration 6-20: Right to exchange licensed products for similar products

Facts

A software vendor enters into an arrangement to license 1,000 copies of Product A to a reseller for $1,000,000. The licensed software is delivered at inception of the arrangement. The arrangement includes a provision that allows the reseller to exchange any copies of Product A not sold to an end user within six months of execution of the arrangement for an equivalent number of copies of Product B. Product B has no more than minimal differences in price, features or functionality from Product A.

Analysis

The vendor should account for the exchange right provided to the reseller as a right of return pursuant to the provisions of the rights of return guidance because the reseller is not the ultimate customer for the licensed software.

Illustration 6-21: Right to return unsold software for credits towards additional purchases
Facts Assume the same facts as Illustration 6-20 above, except that the reseller has the right to exchange any unsold copies of Product A for a credit of $1,000 per returned copy towards the purchase of any of the other products marketed by the vendor, limited to one-half of the purchase price of the other products (e.g., if the reseller purchases an additional $1,000 of products, it can receive a credit of $500 towards that purchase if one copy of Product A is returned). **Analysis** The vendor should account for the reseller's right to return unsold copies of the licensed software as a right of return pursuant to the rights of return guidance. The fact that the reseller must purchase additional software to take advantage of the return right does not affect the accounting.

Factors to consider when determining if a vendor has the ability to make a reasonable estimate of future returns pursuant to the rights of return guidance are discussed in Question 6-3, including considerations applicable to arrangements with resellers.

Platform-transfer rights provided to resellers

Question 6-13 **How should a software vendor account for platform-transfer rights provided to resellers either as part of a formal arrangement or as a matter of practice?**

As discussed in Questions 6-9 through 6-11, platform-transfer rights provided by a software vendor to end users may be accounted for as like-kind exchanges if certain conditions are met. However, if a platform-transfer right is granted to a reseller, the right should be accounted for as a right of return pursuant to the rights of return guidance, even if the right could be accounted for as an exchange right if provided to an end user. AcSEC believes exchange rights provided to resellers should be accounted for as a right of return because resellers are not a software vendor's ultimate customers.

The following example illustrates these concepts:

Illustration 6-22: Platform-transfer right accounted for as a like-kind exchange
Facts A software vendor enters into an arrangement with a reseller to license 1,000 copies of Product A for use in a OneX-based environment. The licensed software is delivered at inception of the arrangement. The vendor also offers versions of Product A that operate in a Shutters NX or LineX environment. There are no more than minimal differences in price, features and functionality between the versions of Product A designed to operate in the differing environments. The differing versions of Product A are marketed in a similar manner with a focus on the same features and functionality. The arrangement contains a provision that allows the reseller to exchange any number of copies of the OneX-based Product A delivered at inception of the arrangement for the same number of copies of Product A for use in the Shutters NX or LineX environments. **Analysis** Although such a right would be accounted for as a like-kind exchange if provided to an end user (see Question 6-9), the vendor should account for the reseller's right to transfer platforms as a right of return pursuant to the rights of return guidance because the reseller is not the vendor's ultimate customer.

Factors to consider when determining if a vendor has the ability to make a reasonable estimate of future returns pursuant to the rights of return guidance are discussed in Question 6-3, including considerations applicable to arrangements with resellers.

Price protection provided to resellers

Question 6-14 **Arrangements between a software vendor and a reseller may include, either as a matter of formal agreement or due to a vendor's business practices, price-protection clauses whereby the vendor will refund or provide a credit equal to a portion of the original fee towards future purchases if the vendor subsequently reduces its price for a previously delivered licensed software product and the reseller still has rights with respect to that product. How do such price-protection clauses affect a vendor's accounting for an arrangement with a reseller?**

Price-protection clauses may require a vendor to refund a portion of an arrangement's fees to a reseller. Accordingly, such clauses should be accounted for as a right of refund pursuant to the rights of return guidance. However, we believe it often will be difficult for a software vendor to make a reasonable estimate pursuant to the rights of return guidance of future refunds to resellers based on price-protection clauses due to some or all of the following factors:

- An inability to forecast if price decreases will be necessary due to competitors' introductions of products that have superior functionality and features into the marketplace.
- An inability to reasonably estimate future price changes due to competitive conditions, or significant uncertainties about the vendor's ability to maintain its price (e.g., if a competitor initiates a price reduction for competing products, the vendor would be compelled to reduce its prices as well).
- The inability to forecast whether price decreases will occur in the future for a product newly introduced to the marketplace.
- If the total amount that a vendor must pay to a reseller pursuant to a price-protection clause is a function of the quantity of licensed software held by the reseller when a price decrease is initiated by the vendor multiplied by the per unit decrease in price, the inability to reasonably estimate the quantity of product that a reseller will have on hand at a future point in time.
- The lack of significant experience with a particular reseller selling similar products in a similar geographical area.
- Whether the amount of price protection provided to a reseller is capped (i.e., the agreement specifies a maximum amount that the vendor will provide to a reseller as a result of future price reductions). If the amount of price protection is capped, a vendor may able to estimate the amount of future refunds pursuant to the rights of return guidance. In such cases, however, the vendor's history (or lack thereof) of not providing price protection refunds in excess of the contractually stipulated amount must be considered.

If a vendor is unable to make a reasonable estimate of amounts that may be paid in the future pursuant to price-protection clauses due to the factors above (or others circumstances), revenue from the arrangement should be deferred until the vendor is able to reasonably estimate the effects of future price changes and the other basic criteria for revenue recognition have been satisfied or until the product is delivered to the end user (the sell-through method).

The following example illustrates these concepts:

Illustration 6-23: Price-protection clause accounted for as a right of return

Facts

A software vendor enters into an arrangement with a reseller to license 1,000 copies of Product A for $1,000,000. The price per copy is based on the vendor's list price, less a 20% discount. Pursuant to the terms of the licensing agreement, the vendor must refund an amount to the reseller if it reduces the list price of the software, computed as 80% of the reduction in price multiplied by the number of unsold copies at the date of the price reduction.

The vendor has a limited history of selling Product A. The market in which Product A competes is fragmented and price sensitive.

Analysis

The price-protection clause provided by the vendor to the reseller should be accounted for as a right of return pursuant to the rights of return guidance. Because the vendor has a limited history of selling Product A and participates in a fragmented market in which customers are price sensitive, there are factors that indicate that the vendor is unable to reasonably estimate future price changes due to competitive conditions. Accordingly, revenue for the arrangement should be recognized as the software is licensed to end users.

Factors to consider when determining if a vendor has the ability to make a reasonable estimate of future returns pursuant to the rights of return guidance are discussed in Question 6-3, including considerations applicable to arrangements with resellers.

7 Postcontract customer support

7.1 Chapter summary

Postcontract Customer Support (PCS) is defined in ASC 985-605-20 as follows:

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Glossary

985-605-20

Postcontract Customer Support

The right to receive services (other than those separately accounted for as described in paragraph 985-605-25-79) or unspecified product upgrades or enhancements, or both, offered to users or resellers, after the software license period begins, or after another time as provided for by the postcontract customer support arrangement. Unspecified upgrades or enhancements are postcontract customer support only if they are offered on a when-and-if-available basis. Postcontract customer support does not include any of the following:

a. Installation or other services directly related to the initial license of the software

b. Upgrade rights

c. Rights to additional software products.

Postcontract customer support may be included in the license fee or offered separately. Postcontract customer support generally is referred to in the software industry as maintenance. However, the term maintenance is not used in referring to postcontract customer support for the following reasons:

a. It has taken on a broader meaning in the industry than the one described in Subtopic 985-20.

b. It may be confused with hardware maintenance as it is used elsewhere in Codification.

c. Its meaning varies from entity to entity.

The right to receive services and unspecified upgrades or enhancements provided under postcontract customer support generally is described by the postcontract customer support arrangement. Typical arrangements include services, such as telephone support and correction of errors (bug fixing or debugging), and unspecified product upgrades or enhancements developed by the vendor during the period in which the postcontract customer support is provided. Postcontract customer support arrangements include patterns of providing services or unspecified upgrades or enhancements to users or resellers, although the arrangements may not be evidenced by a written contract signed by the vendor and the customer.

Many software licensing arrangements expressly state that a software vendor will provide PCS (express PCS) as part of the arrangement. However, the fact PCS is included in a software licensing arrangement also may be implied if a vendor has historically provided, or if it expects to provide, PCS to a customer or class of customers even if not contractually obligated to do so (see Questions 7-1 through 7-7). If PCS (whether express or implied) is included in a software licensing arrangement, it generally should be accounted for as an element of the arrangement unless certain conditions are met (see Questions 7-31 and 7-32).

If a multiple-element software licensing arrangement includes express or implied PCS, the total fee from the arrangement must be allocated among the elements based on VSOE of fair value, if such evidence exists. Arrangement consideration allocated to PCS generally should be recognized as revenue ratably (i.e., straight-line) over the contractual term of the PCS arrangement or, if the PCS is implied, the period during which PCS will be provided. PCS is recognized ratably because it is assumed that PCS is provided ratably. However, in certain limited situations, it may be appropriate to recognize revenue for fees allocated to PCS in proportion to the amounts expected to be charged to expense for the PCS services rendered (see Questions 7-8 through 7-30).

If VSOE of fair value does not exist such that PCS included in a multiple-element arrangement cannot be accounted for separately and the only undelivered element is PCS, the entire arrangement fee should be recognized ratably over the contractual term of the PCS arrangement for an explicit PCS arrangement or over the period during which PCS is expected to be provided for an implied PCS arrangement.

7.2 Services that qualify as PCS

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-66

Software arrangements may include the right to postcontract customer support. Postcontract customer support includes the right to receive postcontract customer support services or unspecified upgrades or enhancements, or both, offered to users or resellers. A vendor may develop historical patterns of regularly providing all customers or certain kinds of customers with the services or unspecified upgrades or enhancements normally associated with postcontract customer support, or may anticipate doing so, even though there is no written contractual obligation or the stipulated postcontract customer support term commences at some date after delivery. In those situations, an implied postcontract customer support arrangement exists that commences upon product delivery. For purposes of applying the guidance in this Subtopic, postcontract customer support includes a vendor's expected performance based on such patterns, even if performance is entirely at the vendor's discretion and not pursuant to a formal agreement.

Services typically comprising PCS

Question 7-1 **What types of services do software vendors typically provide to their customers as PCS?**

Elements typically contained in a PCS arrangement include:

- Unspecified enhancements (updates or upgrades) to the licensed products when and if made available by the vendor
- Bug fixes
- Technical support (via phone, web or fax) including such features as access to online support tools, knowledge bases and technical experts
- Compatibility with third party products/versions
- Unspecified tax, legal and regulatory updates
- Critical problem alerts, including security alerts and patches
- Remote diagnosis of problems

PCS does not include services such as installation, training, and customization services that may be accounted for separately pursuant to ASC 985-605 (see Chapter VIII)

An update generally is composed of a minor enhancement, bug fixes and other small changes that do not result in significant changes to the features and functionality of the licensed software (although they may improve functionality and sometimes add new functionality). Changes to the program after installing an update are often invisible to a user. Minor updates generally are signified by minor changes to the version number, such as an update from version 4.0 to version 4.1 or 4.01 (i.e., "right-of-the-dot changes").

In contrast, an upgrade generally consists of major enhancements, including significant new features and functionality, to licensed software. Upgrades generally are signified by a change in the first digit of the version number of the software, such as from version 4.0 to version 5.0 (i.e., "left-of-the-dot changes").

In practice, many companies do not distinguish between "updates" and "upgrades," and many use the words interchangeably. ASC 985-605 itself does not separately define updates but defines upgrades as an "improvement to an existing product that is intended to extend the life or improve significantly the marketability of the original product through added functionality, enhanced performance, or both. The terms upgrade and enhancement are used interchangeably to describe improvements to software products; however, in different segments of the software industry, those terms may connote different levels of packaging or improvements."

Some believe that if only updates are provided to users of licensed software and upgrades must be paid for, then PCS does not exist in a vendor's software licensing arrangements. However, we believe it would be rare to conclude a vendor is not providing PCS in such situations. We believe a conclusion that PCS has not been provided in such situations should be limited to those situations in which the conditions specified in ASC 985-605-25-71 through 25-73 are satisfied (see Questions 7-31 and 7-32).

Bug fixing may not be considered PCS when offered as a single element pursuant to a warranty provision of a software licensing arrangement if the bug fixes are required for the software to function pursuant to the software's published specifications (see Question 4-67). Additionally, postdelivery telephone support provided to users by a vendor at no additional charge may be recognized together with an initial software licensing fee in certain limited situations.

Implied PCS

Question 7-2 **If PCS is not explicitly described in a software licensing arrangement or a separate fee is not contractually specified as relating to PCS, can the arrangement still include PCS (implied PCS) that should be accounted for as an element of the arrangement? What conditions would indicate that implied PCS has been included in a software licensing arrangement?**

A software vendor may not be contractually obligated to provide PCS to customers but if the vendor historically has provided, or expects to provide PCS, ASC 985-605 presumes that a PCS arrangement exists. This is referred to as implied PCS. Implied PCS should be accounted for as an element included in a multiple-element arrangement even if performance is entirely at the discretion of the vendor.

An arrangement in which a vendor allows a reseller to provide unspecified upgrades/enhancements to its customers when and if released by the vendor also is an implied PCS arrangement between the vendor and reseller (even when the contract is silent regarding such services and no fee is separately stated as PCS). An implied PCS arrangement exists even if the vendor does not provide any services or telephone support directly to the reseller's customers.

The following examples illustrate these concepts:

Illustration 7-1: Upgrades and enhancements provided free of charge to existing licensees on a broad basis

Facts

A software vendor enters into an arrangement to license Product A to a customer. Although the arrangement does not explicitly state that PCS is to be provided to the customer, the vendor has a history of releasing upgrades and enhancements to Product A and making these available for download from its website by any licensees of Product A free of charge.

Analysis

Although the vendor is not contractually obligated to provide PCS to the customer, its history of providing upgrades and enhancements to the licensed software free of charge indicates that an implied PCS element is included in the software licensing arrangement. Accordingly, the arrangement should be accounted for as a multiple-element arrangement.

Illustration 7-2: Upgrades and enhancements provided free of charge to specific customer

Facts

A software vendor enters into an arrangement to license Product A to Customer B. The customer has purchased a significant amount of software from the vendor in the past, and the vendor anticipates that it will continue to do so. Because of the significance of the sales to Customer B, the vendor historically has provided upgrades and enhancements to software licensed by Customer B even though it was not contractually obligated to do so. However, the vendor historically has not provided upgrades and enhancements to software licensed by other customers unless contractually obligated to do so.

Analysis

Because the vendor has a historical practice of providing upgrades and enhancements to software licensed by Customer B regardless of whether it has contractually agreed to do so, implied PCS exists in any arrangement pursuant to which software is licensed to Customer B.

Although the vendor does not have a history of providing PCS to customers other than Customer B unless contractually obligated to do so, sales by the vendor to any other customers should be evaluated carefully to determine if implied PCS also exists in those arrangements based on its history with Customer B. In particular, sales to customers that have had, or are expected to have, volumes similar to Customer B should be evaluated carefully to determine if implied PCS is or will be provided to the customer.

Contractual PCS term commences after delivery

Question 7-3 **Does an implied PCS arrangement exist when the contractual PCS term commences after licensed software has been delivered?**

The period from the date licensed software is delivered through the date the contractual term of the PCS commences often is referred to as a warranty or free maintenance period. However, our experience is that the services provided before the contractual PCS term commences generally are more than what is provided as part of a standard warranty and often are the same as the services that will be provided once the contractual PCS term commences. Furthermore, the customer almost always receives upgrades/enhancements released during the period from delivery of the software to the commencement of the contractual PCS term. The upgrades/enhancements released before the contractual PCS term commences may be provided to the customer as released or after the contractual PCS term commences (as a cumulative release or in the next upgrade/enhancement released by the vendor).

Accordingly, when the contractual term of a PCS arrangement does not commence on delivery of licensed software but rather at a later date (e.g., after the software is installed), we believe that implied PCS exists for the period of time from delivery of the software until the contractual PCS term commences. We believe it would be rare for a software vendor to be able to support an assertion that implied PCS does not exist in such an arrangement unless the criteria in ASC 985-605-25-71 and 25-72 are met.

The following examples illustrate these concepts:

Illustration 7-3: Free PCS period included in software licensing arrangement

Facts

A software vendor licenses software Product A to a customer bundled with a one-year PCS term for $10,000. The VSOE of fair value of software Product A is $9,000. Based on renewals of PCS (see Question 7-11), the VSOE of fair value of one year of PCS is $1,500. The contractual PCS term commences when a six-month free maintenance period expires. The user is entitled to all unspecified upgrades/enhancements, including those released during the free maintenance period.

Analysis

Because the user is entitled to unspecified upgrades/enhancements released prior to the commencement of the contractual PCS term, an implied PCS arrangement exists for the first six months following delivery of the licensed software. Accordingly, the arrangement should be deemed to include an 18 month PCS period instead of the contractually specified one-year period commencing six months from delivery of the licensed software. VSOE of the fair value of the 18 month PCS period should be based on the amount charged by the vendor for one year of PCS on renewal (see Question 7-10), or $2,250 ($1,500 x 1.5 years). Using the relative-fair-value method, the vendor should allocate revenue as follows:

	VSOE of fair value	**% of relative fair value**	**Allocated discount**	**Allocated arrangement consideration**
Product A	$ 9,000	80%	$ (1,000)	$ 8,000
PCS (18 months)	2,250	20%	(250)	2,000
Total	$ 11,250		$ (1,250)	$ 10,000

The vendor may recognize the $8,000 of arrangement consideration allocated to Product A on delivery, if all of the other basic revenue recognition criteria of ASC 985-605 have been met. The revenue allocated to PCS should be recognized over the combined contractual and implied 18 month term beginning on delivery of the licensed software product.

Illustration 7-4: Implied PCS provided during installation

Facts

On 1 July 20X6, a software vendor enters into an arrangement with a customer to perpetually license version 1.0 of Product A, bundled with installation services and one year of PCS (which includes telephone support, bug fixes and the rights to upgrades/enhancements when and if available). The installation services are not essential to the functionality of the software and may be accounted for separately (see Chapter VIII).

VSOE of fair value exists for the installation services and for one year of PCS, based on amounts charged by the vendor for one year of PCS on renewal (see Question 7-11). The installation services will be completed three months from the execution of the software license (1 October 20X6).

The contract states that during the installation period the software is under warranty. The customer will receive only bug fixes and telephone support during the warranty period. During the warranty period, version 2.0 of Product A is released but is not delivered to the customer. After the warranty period, the vendor releases version 3.0 of Product A, which the customer installs on 1 November 20X6 (after completion of the installation services and the commencement of the contractual PCS term).

Analysis

In this illustration, the warranty period is implied PCS. Although the contract states that during the warranty period the customer is not entitled to upgrades/enhancements, all of the cumulative upgrades/enhancements and bug fixes to the version that was initially delivered were received when version 3.0 was released and installed. Accordingly, VSOE of fair value of the PCS for an additional three months should be deferred and recognized as PCS over the three-month implied PCS period (i.e., an amount equal to 15 months of PCS should be deferred on execution of the software license arrangement and recognized ratably over 15 months — see Question 7-10).

Indeterminable implied PCS period

Question 7-4 **When implied PCS is included in a software licensing arrangement, but the implied PCS period is not determinable (e.g., because the length of an installation period cannot be determined), can a vendor separately account for PCS? If not, over what period should revenue be recognized for the arrangement?**

When implied PCS exists in a software licensing arrangement, but the implied PCS period is not determinable, there is no basis to allocate arrangement consideration to the PCS — even if VSOE of fair value exists for PCS (see Question 7-11) — because the length of the PCS period cannot be established such that the fees attributable to PCS can be computed (see Question 7-10). Accordingly, we believe the entire arrangement fee should be deferred until the PCS period (the combined contractual and, if applicable, implied PCS periods) can be determined. If PCS is then the only undelivered element, revenue for the entire software licensing arrangement should be recognized as discussed below:

- If VSOE of fair value of PCS does not exist, the entire arrangement fee should be recognized ratably over the known PCS period, if all of the basic revenue recognition criteria of ASC 985-605 have been met (the "Full Deferral" approach — see Question 3-16). Alternatively an amount of revenue equal to the total arrangement consideration less the pro-rata portion applicable to the remaining PCS period can be recognized. The pro-rata portion applicable to the remaining PCS period is then recognized over the PCS period (the "Cumulative Catch-Up" approach — see Question 3-16).

- If VSOE of fair value of PCS has been established, the difference between VSOE of fair value for the remaining PCS period and the total arrangement consideration should be recognized as revenue if all of the basic revenue recognition criteria of ASC 985-605 have been met (i.e., the residual method should be applied to determine the amount of arrangement consideration that should be deferred once the PCS period is known). Amounts deferred should be recognized ratably over the PCS period.

Use of the "Combined Services" approach (see Question 3-16) would be inappropriate in such situations because the longer of the two service periods cannot be determined at the outset of the arrangement (because the PCS period is indeterminate).

The following example illustrates these concepts:

Illustration 7-5: Length of PCS period is indeterminable at contract inception

Facts

On 1 April 20X6, a software vendor enters into an arrangement with a customer to perpetually license version 1.0 of Product A, bundled with installation services, and one year of PCS (which includes telephone support, bug fixes and the rights to upgrades/enhancements when and if available). The installation services are not essential to the functionality of the software and may be accounted for separately based on the provisions of ASC 985-605 (see Chapter VIII).

The contract states that during the installation period the software is under warranty. The customer will receive only bug fixes and telephone support during the warranty period. However, the customer will receive all cumulative upgrades/enhancements released by the vendor during the warranty period once the installation services are completed and the contractual PCS term commences.

VSOE of fair value exists for the installation services and for one year of PCS, based on the amount charged by the vendor for one year of PCS on renewal. Based on previous experience, the vendor estimates that completion of the installation services will take three months. However, the implied PCS period is uncertain because the customer has stipulated that the installation services must be performed after software licensed from another vendor has been installed by customer personnel, and it is uncertain when this will be completed.

Installation services commence 1 July 20X6 and are completed 30 September 20X6.

Analysis

Because the length of the implied PCS period is indeterminable at inception of the arrangement, VSOE of fair value of the combined initial PCS period (i.e., the implied and contractual PCS terms) cannot be determined at the outset of the arrangement. Accordingly, the software license, the installation services and the PCS cannot be accounted for separately. No revenue should be recognized until the earlier of the date at which the PCS period is determinable or the commencement of the installation services on 1 July 20X6.

Because the vendor is able to make a reasonable estimate of the time required to complete the installation services based on its past history and it has established VSOE of the installation services and PCS, it should apply the residual method of allocating arrangement consideration on 1 July 20X6. Amounts equal to VSOE of fair value of the installation services and 15 months of PCS should be deferred and recognized as these services are performed. Any remaining arrangement consideration may be recognized as software license fees, if all of the other basic revenue recognition criteria of ASC 985-605 have been met.

Updates to maintain compliance with laws

Question 7-5 **Does a PCS arrangement exist when a vendor agrees to provide, or has a history of providing, updates that are required for licensed software to remain compliant with current laws or regulations free of charge?**

If a vendor commits, either explicitly or implicitly, to provide upgrades and enhancements to licensed software such that a licensed software product will be modified to comply with any changes in law or regulation when and if such changes occur, the commitment is PCS because the vendor has granted the customer rights to receive upgrades or enhancements to the licensed software on a when-and-if-available basis. Upgrades or enhancements that maintain compliance with changes in law or regulation meet the definition of an upgrade/enhancement pursuant to the definition contained in ASC 985-605-20 as they extend the life of the licensed software and significantly increase its marketability because if the software is not updated, it would become obsolete whenever a significant change occurs.

The following example illustrates these concepts:

Illustration 7-6: Implied PCS when a vendor has a history of providing updates to remain compliant with laws

Facts

A software vendor licenses payroll processing software. Its software licensing agreements typically do not contain explicit provisions requiring the vendor to update the licensed software for changes in payroll tax laws. However, the vendor historically has provided updates to its customers whenever there is a change in law.

Analysis

Because the vendor has a history of providing updates to customers that have previously licensed its software when a change in law occurs, an implied PCS arrangement exists in its software licensing arrangements.

If a vendor commits to provide a modification to a licensed software product for a change in law or regulation that is known at the time the contract (including both initial software licenses and PCS renewals) is negotiated or signed, such a commitment should be considered a specified upgrade right (see Questions 5-13 through 5-20). We believe that this accounting is analogous to the conclusions reached by the Software Revenue Recognition Task Force in AICPA Technical Practice Aid 5100.40, *Software Revenue Recognition Related to Year 2000 Compliant Software*, which discusses an instance where a commitment to deliver an enhancement to licensed software for a known event exists at the date a software licensing arrangement is executed. Although this guidance is non-authoritative as it was not included in the Codification, we believe it provides relevant information.

Technical Practice Aid 5100.40

Inquiry — Is a commitment to deliver in the future a Year 2000 compliant version of a software product to an existing customer or to a customer that is acquiring a non-Year 2000 compliant version considered an upgrade right or specified upgrade in accordance with SOP 97-2, *Software Revenue Recognition*?

Reply — Yes. The criteria of SOP 97-2 related to specified upgrades apply whether or not the commitment is contained under a warranty provision. Given the ramifications of non-Year 2000 compliant software, special attention should be given to paragraphs 13 and 14 of SOP 97-2. Further, the Securities and Exchange Commission released an Interpretation in August 1998 titled, *Statement of the* Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies, *Investment Advisors, Investment Companies, and Municipal Securities Issuers*. Part of that Interpretation states, "Year 2000 issues may affect the timing of revenue recognition in accordance with (SOP 97-2). For example, if a vendor licenses a product that is not Year 2000 compliant and commits to deliver a Year 2000 compliant version in the future, the revenue from the transaction should be allocated to the various elements — the software and the upgrade. Entities should also consider FASB Statement No. 48, *Revenue Recognition When the Right of Return Exists*, relating to any product return issues such as for products containing hardware and software, including whether the necessary conditions have been met to recognize revenue in the period of sale, whether that revenue should be deferred, or whether an allowance for sales return should be provided." In such situations, a vendor generally would be required to defer all revenue until it delivers the upgraded (compliant) version.

Updates to maintain compliance with a third party's application or operating system

Question 7-6 **Does a PCS arrangement exist when a vendor agrees to provide, has a history of providing or intends to provide updates that are essential for licensed software to remain compliant with a third party's applications or operating system?**

If a vendor either explicitly or implicitly commits to provide upgrades/enhancements such that licensed software will remain compatible with an third party's application or operating system, this commitment is considered to be PCS for the same reasons as described in the response to Question 7-5.

Recognition of accounts receivable for PCS renewal billings

Question 7-7 **A software vendor may bill its customers for renewals of PCS relating to existing software licenses prior to the PCS period commencing. Should the vendor recognize accounts receivable and related deferred revenue when customers are billed?**

We believe it is generally not appropriate to record deferred revenue and an offsetting accounts receivable in such situations. Deferred revenue should not be recorded unless amounts have been received from a customer in advance of services being rendered. Additionally, a valid receivable does not exist at the date of billing because a customer could elect not to renew PCS (i.e., the customer is not obligated to pay prior to the company beginning to provide services). Accordingly, for accounting purposes, the arrangement should be treated in a manner similar to any executory contract under which neither party has performed. In such cases, neither accounts receivable nor deferred revenue should be recorded in the vendor's financial statements. We understand the SEC staff shares this view.

7.3 VSOE of fair value of PCS

Pursuant to ASC 985-605-25-6 and 25-7, VSOE of fair value is limited to the price charged when an element is sold separately or, for an element not yet being sold separately, the price established by management having the relevant authority. ASC 985-605-25-67 through 25-69, which specifically addresses VSOE of fair value of PCS, states that VSOE of fair value should be determined in conformity with ASC 985-605-25-6 and 25-7 and "the fair value of the postcontract customer support should be determined by reference to the price the customer will be required to pay when it is sold separately (i.e., the renewal rate)." That guidance initially appears to be more flexible than ASC 985-605-25-6 and

25-7 but one must remember it says in conformity with ASC 985-605-25-6 and 25-7. Accordingly, we believe that VSOE of fair value of PCS cannot exist if software licensing arrangements do not include an option to renew or if actual renewals of PCS do not exist.

If a multiple-element software arrangement includes express or implied PCS for which VSOE of fair value exists, the total fee from the arrangement must be allocated using either the relative-fair-value or the residual method.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-67

If a multiple-element software arrangement includes explicit or implicit rights to postcontract customer support, the total fees from the arrangement shall be allocated among the elements based on vendor-specific objective evidence of fair value, in conformity with paragraphs 985-605-25-6 through 25-7. The fair value of the postcontract customer support shall be determined by reference to the price the customer will be required to pay when it is sold separately (that is, the renewal rate). The portion of the fee allocated to postcontract customer support shall be recognized as revenue ratably over the term of the postcontract customer support arrangement, because the postcontract customer support services are assumed to be provided ratably.

985-605-25-68

However, revenue shall be recognized over the period of the postcontract customer support arrangement in proportion to the amounts expected to be charged to expense for the postcontract customer support services rendered during the period if both of the following conditions exist:

a. Sufficient vendor-specific historical evidence exists demonstrating that costs to provide postcontract customer support are incurred on other than a straight-line basis. In making this determination, the vendor shall take into consideration allocated portions of cost accounted for as research and development costs and the amortization of costs related to the upgrade or enhancement capitalized in conformity with Subtopic 985-20. Such costs shall be considered as part of the costs to provide postcontract customer support.

b. The vendor believes that it is probable that the costs incurred in performing under the current arrangement will follow a similar pattern.

985-605-25-69

Because the timing, frequency, and significance of unspecified upgrades or enhancements can vary considerably, the point at which unspecified upgrades or enhancements are expected to be delivered shall not be used to support income recognition on other than a straight-line basis.

985-605-25-70

If sufficient vendor-specific objective evidence does not exist to allocate the fee to the separate elements and the only undelivered element is postcontract customer support, the entire arrangement fee shall be recognized ratably over either of the following:

a. The contractual postcontract customer support period for those arrangements with explicit rights to postcontract customer support

b. The period during which postcontract customer support is expected to be provided for those arrangements with implicit rights to postcontract customer support.

PCS revenue recognition pattern

Question 7-8 **Should PCS revenue always be recognized ratably over the period that PCS services are provided by a vendor? Are other methods of recognizing PCS revenue permissible?**

The portion of a software licensing arrangement's fee allocated to PCS generally should be recognized as revenue ratably (i.e., straight-line) over the contractual term of the PCS arrangement or, if the PCS is implied, the period during which PCS is expected to be provided. PCS typically is recognized ratably because PCS services typically are provided ratably.

However, in the limited situations when both of the following criteria specified by ASC 985-605-25-68 are met, it may be appropriate for PCS to be recognized as revenue in proportion to the amounts expected to be charged to expense as the PCS services are rendered:

- Sufficient vendor-specific historical evidence exists demonstrating that costs to provide PCS are incurred on other than a straight-line basis. This includes the pattern in which costs capitalized in conformity with ASC 985-20, *Software — Costs of Software to Be Sold, Leased, or Marketed,* are amortized.
- The vendor believes that it is probable that the costs incurred in performing under the current arrangement will follow a similar pattern.

Whether PCS should be recognized in such a manner will depend on the facts and circumstances, but our experience is that it would be rare for a vendor to recognize PCS in any manner other than ratably.

PCS based on a percentage of the software license fees

Question 7-9 **Must PCS be priced in terms of dollars for VSOE of fair value to exist? May VSOE of fair value be deemed to exist if PCS is priced as a consistent percentage of the software license fee, but dollar amounts vary?**

VSOE of fair value of PCS may be priced as a percentage of the software license fee as long as the term of the PCS period and the percentage of the software license fee are substantive. The following excerpt from the implementation guidance of ASC 985-605 addresses this topic.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Fair Value of Postcontract Customer Support with a Consistent Renewal Percentage (but Varying Renewal Dollar Amounts)

985-605-55-68

A software vendor may charge a customer $100,000 for a software license while charging another customer $150,000 for the same software license. Under each arrangement, the postcontract customer support renewal rate is 15% of the license fee.

985-605-55-69

Assuming that the postcontract customer support renewal rate expressed as a consistent percentage of the stipulated license fee for customers is substantive, that renewal rate would be the vendor-specific objective evidence of the fair value of postcontract customer support. In this situation, the existence of varying dollar amounts of postcontract customer support renewal fees for the same software product does not indicate an absence of vendor-specific objective evidence of the fair value of postcontract customer support or the possible presence of discounts on postcontract customer support that should be accounted for under paragraph 985-605-25-8.

If VSOE of fair value is expressed as a percentage of the software license fee, the PCS renewal percentage generally is applied to either the net license fee or the list price of the software license (but not both). Each method is acceptable. Although applying the PCS renewal percentage to the net license fee appears to be more prevalent in practice, the method used should be consistent with how a vendor actually prices PCS renewals.

If VSOE of fair value, as determined by PCS renewals (see Question 7-11), is expressed as a percentage of the license fee, the percentage must be substantive in order for VSOE of fair value of PCS to exist. Determining whether a PCS renewal rate is substantive requires professional judgment. We generally would be skeptical that a PCS renewal rate less than 10% of a net software license fee is substantive (however, this should not be interpreted to imply that any rate greater than 10% is, by definition, substantive). However, in certain cases, if an analysis of a vendor's pricing practices indicates that PCS customarily is priced below this level, a vendor may be able to demonstrate why such rates are substantive via reference to the particular facts and circumstances of its business and products.

The following example illustrates these concepts:

Illustration 7-7: VSOE of fair value as a percentage of the software license fee

Facts

A software vendor routinely licenses a software product bundled with one year of PCS. The vendor typically licenses its software at discounts ranging between 30-70% off its list price of $100,000. An analysis of its PCS renewal activities indicates that a substantial majority of renewals of PCS are priced at 15% of the net license fee, regardless of the discount provided to the customer on the software license as compared to the list price.

Analysis

Because a substantial majority of the vendor's PCS renewals are priced at 15% of the net license fee, the vendor has established VSOE of fair value of PCS.

In order for a PCS renewal rate to be substantive, we believe the renewal term must be substantive. Based on the implementation guidance on fair value of PCS in short-term licenses (ASC 985-605-55-59 through 55-61) and on fair value of PCS in multi-year time-based licenses (ASC 985-605-55-62 and 55-63),[6] we believe that to be considered substantive, a renewal term must be equal to or greater than one year and equal to or greater than the PCS term bundled with the initial license.

More than one year of PCS bundled with a perpetual software license

Question 7-10 **If a vendor determines VSOE of fair value of PCS based on renewals for a one-year PCS period, how should it account for software licensing arrangements that bundle more than one year of PCS with a perpetual software license?**

This question has been addressed in the implementation guidance of ASC 985-605, see the applicable excerpt below.

[6] This implementation guidance has been included in this publication in Questions 7-19 and 7-20.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Fair Value of Postcontract Customer Support in a Perpetual License

985-605-55-57

Perpetual software licenses may include postcontract customer support. For example, assume that the fee for a perpetual software license includes postcontract customer support services for a term of two years. However, only one-year postcontract customer support renewal rates are offered to those holding the perpetual license rights.

985-605-55-58

If the postcontract customer support renewal rate and term are substantive, they provide vendor-specific objective evidence of the fair value of the postcontract customer support element included (bundled) in the software arrangement pursuant to paragraphs 985-605-25-6 through 25-7 and 985-605-25-67 through 25-69. The dollar amount of the one-year renewal rate multiplied by two (which reflects the postcontract customer support term included in the arrangement) constitutes vendor-specific objective evidence of the fair value of postcontract customer support pursuant to the provisions in those paragraphs.

Pursuant to the above guidance, if VSOE of fair value exists for one-year PCS renewals, the VSOE of fair value of such renewals multiplied by two should be used to determine the amount of arrangement consideration allocable to PCS when two years of PCS are bundled with the sale of a software license. We believe that this concept also can be applied when the bundled PCS period is shorter or longer than two years (e.g., if an eighteen month or three year initial PCS period is bundled with the sale of a perpetual software license).

Approaches to establishing VSOE of fair value of PCS

Question 7-11 **Does more than one approach to establishing VSOE of fair value of PCS exist?**

We believe that two approaches to establish VSOE of fair value of PCS exist — the Bell-Shaped Curve and the Substantive Renewal Rate. We believe that both of these approaches are consistent with the concept of VSOE of fair value embodied in ASC 985-605 — that VSOE of fair value is represented by offering similar prices to similar customers when an element of an arrangement is sold separately.

VSOE of fair value is defined in both ASC 985-605-25-6 and 25-67. ASC 985-605-25-6 states, in part, "the fee shall be allocated to the various elements based on vendor-specific objective evidence of fair value, **regardless of any separate prices stated within the contract for each element**" (emphasis added), and ASC 985-605- 25-67 states, in part, "if a multiple-element software arrangement includes explicit or implicit rights to postcontract customer support, the total fees from the arrangement shall be allocated among the elements based on vendor-specific objective evidence of fair value, in conformity with paragraphs 985-605-25-6 and 25-7. The fair value of the postcontract customer support shall be determined by reference to the price the customer will be required to pay when it is sold separately (that is, the renewal rate)."

We believe these paragraphs may be reasonably interpreted to permit limited variability in the price charged for PCS renewals. However, the basic concept of ASC 985-605-25-6 must be considered carefully when determining whether the amount of variability in pricing is of such an extent that one cannot conclude that VSOE of fair value of PCS exists. We do not believe that ASC 985-605-25-67 may be read literally to suggest that a PCS renewal rate stated in an individual contract is presumptive VSOE of fair value for the PCS sold with that contract. Accordingly, we believe that under both the Substantive Renewal Rate and Bell-Shaped Curve approaches, a vendor must support its assertion that VSOE of fair value exists by demonstrating similar prices are offered to similar customers.

Regardless of the approach used, evaluating whether a vendor has demonstrated that VSOE of fair value for PCS exists requires a careful analysis of the facts and circumstances and the use of professional judgment. Judgment must be used to evaluate the level of variability in the renewal rate, the appropriateness of the stratification, if any, by customer size, geography, product or other basis (see Question 7-13), and the reasons for prices outside of the vendor's range of VSOE of fair value (outliers). Judgment also will be required to assess the effect of other qualitative factors. Examples of such qualitative factors include:

- *Trends in pricing consistency over time.* For example, it may be relatively easier for a vendor whose pricing consistency has been improving over time to support an assertion that VSOE of fair value exists than one whose pricing consistency has been decreasing over time.
- *Age of the underlying software license to which the PCS renewal relates.* We believe a VSOE of fair value analysis should consider all PCS renewals for a customer class regardless of the date the underlying software license was executed. However, a vendor should consider whether the analysis indicates a higher level of pricing consistency for more recently executed licenses. In such cases, it may be relatively easier to support an assertion that VSOE of fair value exists.

The two approaches, and our interpretation of how each should be applied, are discussed in greater detail below.

The bell-shaped curve approach

The Bell-Shaped Curve Approach evaluates whether VSOE of fair value exists by analyzing a vendor's entire population of PCS renewals. PCS renewal rates specified in software licensing arrangements are not considered in determining whether VSOE of fair value exists for any particular arrangement.

Under the Bell-Shaped Curve Approach, VSOE of fair value of PCS exists when a substantial majority of a company's actual PCS renewals are within a narrow range of pricing. For example, if a software vendor can demonstrate that 80% of its PCS renewal transactions fall within a range of plus or minus 15% from the midpoint of the range (relative percent, not percentage points, e.g., if 20% of the net software license fee is the midpoint, the range would be 17%-23%, not 5%-35%), the vendor would have a reasonable basis to support that VSOE of fair value of PCS exists. In such a case, we believe that the range represents VSOE of fair value, not a single point within the range.

VSOE of fair value of PCS may exist with a smaller number of transactions falling within the range of pricing consistency, if combined with a smaller amount of variance from the midpoint of those transactions falling within the range. However, we believe that such instances would be limited.

When using the Bell-Shaped Curve Approach, software licensing arrangements that include PCS that is priced below the range need to be adjusted — that is, a portion of the license fee should be deferred and recognized over the PCS period. When a range is used to establish VSOE of fair value of PCS, we believe it is most appropriate to use the low end of the range as VSOE for the purpose of adjusting such outliers. Alternatively, use of the midpoint of the range would be acceptable. The estimation method selected should be consistently applied.

Conversely, PCS included in software licensing arrangements in which the PCS renewal rate has been priced above the range of VSOE of fair value generally should not be adjusted, but rather the contractually stated PCS amount should be deferred and recognized over the PCS period. This matter is addressed in ASC 985-605-25-13, which states that the amount of an arrangement's fee allocated to delivered elements does not meet the criterion of collectibility if it is subject to forfeiture, refund or other concession if undelivered elements are not delivered. Attributing a portion of an arrangement's stated PCS fee to the software license would result in such a situation, as PCS generally is subject to cancellation during its term with a refund of the unused period.

The following example illustrates these concepts:

Illustration 7-8: Adjusting the amount allocated to PCS when priced outside of VSOE range under the Bell-Shaped Curve Approach

Facts

Software Vendor A has established VSOE of fair value of PCS using the Bell-Shaped Curve Approach as a range of 16% to 20% of the initial software license fee, based on an analysis of actual PCS renewals. It has also adopted a policy of using the low end of the range as VSOE of fair value of PCS when determining the amount of consideration that should be allocated to PCS when it is bundled with an initial software license at either no stated charge or at an amount less than VSOE of fair value.

Vendor A enters into the following arrangements:

Arrangement	Total arrangement consideration	Contractually specified PCS renewal rate
A	$ 5,000	18%
B	5,000	30%
C	5,000	10%
D	5,000	Not specified

Analysis

Assuming Vendor A allocates arrangement consideration using the residual method, the amount of arrangement consideration that should be allocated to PCS is as follows:

Arrangement	Total arrangement consideration	Amount allocated to license	Amount allocated to PCS
A	$ 5,000	$ 4,100	$ 900
B	5,000	3,500	1,500
C	5,000	4,200	800
D	5,000	4,200	800

Vendor A allocates $900 ($5,000 multiplied by 18%) to PCS for arrangement A because the contractually specified PCS renewal rate is within its range of VSOE of fair value. It allocates $1,500 ($5,000 multiplied by 30%) to PCS for arrangement B because the contractually specified PCS renewal rate is in excess of the VSOE range. However, for arrangement C, the contractually specified PCS renewal rate of 10% (or $500) is not within its range of VSOE of fair value of PCS. Accordingly, $800 (equal to 16% of the arrangement fee, or the low point of the VSOE range) is allocated to PCS. Arrangement D, for which a PCS renewal rate is not specified, is accounted for in a manner similar to arrangement C.

If all of the other basic revenue recognition criteria of ASC 985-605 have been met, Vendor A can recognize the amounts allocated to the software licenses as revenue on delivery of the licensed software to the customer. The amounts allocated to PCS should be recognized ratably over the PCS period.

The substantive renewal rate approach

When using the Substantive Renewal Rate Approach, if a specific customer contract has a substantive renewal rate stated in the contract and the vendor expects that this rate will be consistently applied (within an acceptable range) during the term of the license, the vendor may use that rate as VSOE of fair value of PCS when accounting for the contract.

Some have interpreted this approach to mean that if a renewal rate is specified in a contract with a customer, the rate can be presumed to be VSOE of fair value for that arrangement. However, even if a rate is specified in a contract, we believe when using this approach vendors must demonstrate a stated renewal rate is substantive and consistent with the prices it customarily charges (within a reasonably narrow range) when PCS is renewed.

Determining whether a renewal rate stated in a contract is substantive requires professional judgment. We generally would be skeptical that a PCS renewal rate less than 10% of an initial software license fee is substantive (see Question 7-9).

To support and document its customary pricing practices, a vendor could perform an analysis demonstrating the range of prices that encompasses a significant majority of actual PCS renewals is narrow (similar to the analysis that is required under the Bell-Shaped Curve approach, as discussed above). If this analysis indicates that the range of prices, or the dispersion of prices in the range, is significantly wider than the ranges that would be considered to represent VSOE of fair value using the Bell-Shaped Curve Approach, consideration should be given as to whether the vendor's PCS renewal pricing practices are sufficiently narrow to conclude that a customary pricing practice exists. If a vendor cannot determine its customary pricing practices because of a wide range of actual PCS renewal prices, VSOE of fair value of PCS does not exist. In such cases, revenue from the sale of software bundled with PCS generally should be recognized ratably over the initial PCS period.

The Substantive Renewal Rate Approach is based on the notion that a renewal rate specified in a contractual arrangement represents VSOE of fair value if that rate is substantive (as determined based on the considerations above). Conversely, rates that are not substantive are not deemed to represent fair value. Because this approach relies on contractually specified rates to determine the appropriate accounting for an arrangement, if a contractually stated PCS renewal rate is not substantive (i.e., the rate is below the vendor's customary pricing practices as described above), or if no rate is specified in the contract, evidence of VSOE of fair value does not exist for PCS for that contract. In such cases, when PCS is the last undelivered element the entire arrangement fee must be recognized ratably over the PCS period.

Similar to the Bell-Shaped Curve Approach, however, transactions for which the contractually stated PCS renewal rate has been priced above the vendor's customary pricing practices generally should not be adjusted, but rather the contractually stated PCS amount should be deferred and recognized over the PCS period.

The following example illustrates these concepts:

Illustration 7-9: Adjusting the amount allocated to PCS when priced outside of VSOE range under the Substantive Renewal Rate Approach

Facts

Software Vendor B uses the Substantive Renewal Rate Approach to establish VSOE of fair value of PCS. Vendor B enters into the following arrangements:

Arrangement	Total arrangement consideration	Contractually specified PCS renewal rate
A	$ 5,000	18%
B	5,000	30%
C	5,000	10%
D	5,000	Not specified

Vendor B has determined that it customarily prices PCS, based on an analysis of actual PCS renewals, from 15% to 22%.

Analysis:

Assuming Vendor B allocates arrangement consideration using the residual method, the amount of arrangement consideration that should be allocated to PCS is as follows:

Arrangement	Total arrangement consideration	Amount allocated to license	Amount allocated to PCS
A	$ 5,000	$ 4,100	$ 900
B	5,000	3,500	1,500
C	5,000	N/A	N/A
D	5,000	N/A	N/A

Vendor B allocates $900 (18% of the arrangement consideration of $5,000) to PCS for arrangement A because that amount is substantive and consistent with Vendor B's customary pricing practices. An amount equal to 30% of the arrangement consideration, or $1,500, is allocated to PCS for arrangement B because that amount is substantive and in excess of Vendor B's customary pricing practices. If all of the other basic revenue recognition criteria of ASC 985-605 have been met, Vendor B can recognize the amounts allocated to the software licenses for arrangements A and B as revenue on delivery of the licensed software to the customer. The amounts allocated to PCS should be recognized ratably over the PCS period.

However, the PCS renewal rate specified in arrangement C is not substantive because the specified PCS renewal rate is below Vendor B's customary pricing practices. Because the rate is not substantive, Vendor B lacks VSOE of fair value of PCS for arrangement C, and it cannot separate the software license from the PCS. Accordingly, it must account for both the software license and PCS as one unit of accounting. Revenue should be recognized for the entire arrangement fee ratably over the PCS period. The accounting for arrangement D is similar, due to the lack of a specified PCS renewal rate.

Because the Substantive Renewal Rate Approach is predicated on the notion that the customer will renew PCS at the contractually stated price, we believe the price of the initial PCS renewal should not vary by more than an insignificant amount from the rate stated in the contract. Vendors should periodically analyze their historical initial PCS renewals to validate that this is the case. Subsequent renewals generally should not be renegotiated or changed to an amount that results in PCS pricing outside of the vendor's customary pricing practices.

Frequency of performance of a VSOE of fair value analysis

Question 7-12 **How often should a vendor perform an analysis of PCS renewal pricing to support an assertion that VSOE of fair value of PCS exists?**

Although the facts and circumstances at each company will differ, we believe companies should perform an analysis of PCS renewals to determine whether VSOE of fair value exists at least annually. This test may be performed on a "lag" basis (e.g., a trailing twelve months of renewal data through the previous quarter).

The analysis should be performed more often by any company that has or expects to have more than minimal variability in its PCS renewal rates, such as those operating in highly competitive pricing environments, those whose products are subject to rapid technological obsolescence or are near the end of their technological lifecycle, or those who have a practice of varying or renegotiating PCS renewal rates.

We believe such analyses should be designed to encompass the PCS renewal activity for the entire installed base of customers, or class of customer (see Question 7-13). If a sampling approach is used, it is important to document and demonstrate how the sample is representative of PCS renewals of the entire installed base or customer class. We believe that using a sample would generally be most appropriate for those vendors who 1) have a policy that significantly limits variability in PCS pricing and 2) have historically had minimal variability.

Should a VSOE of fair value analysis be based on one population?

Question 7-13 **When performing an analysis of PCS renewal activity to determine if VSOE of fair value of PCS exists, should the analysis be based on one company-wide population?**

Not necessarily. Companies may charge for PCS at different price points based on different factors such as level of support offering, level of cumulative purchases, customer size, complexity, geographical area or product line (collectively referred to as "customer class"). For example, a company may reduce the price of PCS renewals from 20% of cumulative net software license fees to 18% for all customers that license at least $2,000,000 of software.

Such companies may have more than one VSOE of fair value for PCS and should stratify their analyses by customer class accordingly. When VSOE of fair value analyses are stratified, we believe that the customer classes should be determined based on objective criteria. Additionally, any customer class established should have a population of transactions that provides a sufficient basis to conclude whether VSOE of fair value does or does not exist.

While a stratification methodology may be appropriate in certain circumstances, it rarely would be acceptable to use this methodology to exclude any data from the analysis, even if the data is deemed to be an outlier. In fact, it is particularly important to identify outliers because the purpose of the test is to identify the number of outliers outside of the acceptable range in order to determine whether an acceptable level of pricing consistency exists to establish VSOE of fair value of PCS.

Dollar-value weighting a VSOE of fair value analysis

Question 7-14 **Can a vendor use dollar-value weighting to determine whether PCS renewals are priced consistently enough to establish VSOE of fair value (see Question 7-11)?**

We believe dollar-value weighting should not be used to perform an analysis of PCS renewal activity to determine whether VSOE of fair value of PCS exists. We believe the determination of whether such analyses establish that VSOE of fair value exists should be based on the number of transactions that fall within a range — absent any impact of the dollar values associated with an individual renewal. Dollar-value weighting may appear to be advantageous in limiting the extent of the analysis, or in determining the percentage of transactions falling within an acceptable range, but its use could mask information that would be relevant to an objective analysis.

However, dollar-value weighting generally would be considered when determining if stratifying a population by customer class is appropriate (see Question 7-13).

Effect of PCS price changes on a VSOE of fair value analysis

Question 7-15 **Many software licensing arrangements include provisions that allow a software vendor to increase PCS renewal prices over time (e.g., a provision allowing a vendor to increase the price of PCS renewals by an amount not to exceed a specified percentage per year). How do such provisions affect an analysis of whether VSOE of fair value of PCS exists?**

We believe that to support an assertion that VSOE of fair value of PCS exists, a vendor must be able to demonstrate consistency in the actual pricing of PCS renewals. Although a vendor can price PCS however it sees fit, if too much variability in PCS renewal pricing exists, VSOE of fair value of PCS may not exist.

Small increases in PCS renewal prices generally will not affect the vendor's ability to demonstrate that VSOE of fair value of PCS exists in the short term, and even larger increases may not affect VSOE of fair value in the very short term. Over time, however, the variability in the renewal rate of the vendor's PCS arrangements may become so great that it will no longer be able to support an assertion that VSOE of fair value exists (i.e., a substantial majority of transactions will no longer be within an acceptable range under the Bell-Shaped Curve Approach or the range of customary prices may become too great under the Substantive Renewal Rate Approach).

However, we believe that changes in PCS renewal rates related solely to changes in the Consumer Price Index (CPI) may occur without affecting a vendor's ability to support an assertion that VSOE of fair value exists. ASC 840, *Leases*, provides that rental adjustments based on changes in the CPI generally should be accounted for as contingent rentals and not included in minimum lease payments when determining the classification of a lease as an operating or capital lease (i.e., simply accounted for when they occur and not included in the initial accounting consideration). We believe that adjustments to lease rentals based on changes in the CPI are analogous to adjustments to PCS based on changes in the CPI. Accordingly, by analogy to ASC 840, we believe that a reasonable basis exists to allow a software vendor to increase PCS renewal rates by the change in the CPI without impairing its ability to establish VSOE of fair value of PCS. This analogy allows a vendor to effectively ignore any variability in pricing brought about by changes in PCS renewal rates directly caused by changes in the CPI when determining if a substantial majority of its PCS renewal rates are within a relatively narrow range of pricing.

We believe that for the analogy to ASC 840 to be relevant, the PCS pricing adjustment must be limited to changes in a published and widely recognized CPI index (i.e., a "pure CPI index"). Accordingly, we believe that the analogy should be narrowly applied. It would not be appropriate to apply this analogy to agreements that adjust PCS renewal rates by using a multiple of the CPI, the CPI plus some amount, the lower of or the greater of the CPI or some amount, an amount that is intended to approximate the changes in the CPI or other similar provisions. If a vendor has a practice of increasing its PCS renewal rates by something other than the change in the pure CPI index, the renewal rate transactions (in whole) must be included in the vendor's VSOE of fair value analysis. That is, PCS renewal rates adjusted solely by the change in the pure CPI index would be reflected in the analysis as if no rate change had occurred and all other PCS renewal rates would be reflected in the analysis as-is, without adjustment.

Lapse in and reinstatement of PCS services

Question 7-16 **A customer may decline to renew PCS in a given period but subsequently decide to reinstate such services. When the customer reinstates lapsed PCS, the vendor will often charge an amount related to the periods that PCS was not purchased by the customer. How should revenue be recognized in such circumstances?**

When a customer elects not to renew PCS for a previously licensed software product but later decides to reinstate PCS, the customer generally will receive the cumulative bug fixes and upgrades/enhancements released during the lapsed PCS periods at the time PCS is reinstated. In such cases, a vendor may require the customer to pay an amount relating to the future PCS period and pay an additional amount relating to the lapsed PCS periods. The additional amount may equal the cumulative amount of PCS in arrears, as computed based on amounts previously negotiated with the customer or based on VSOE of fair value for the PCS, or may be some greater or lesser amount.

In such circumstances, we believe the arrangement is a multiple-element arrangement including previously released upgrades/enhancements bundled with a future PCS period. Accordingly, if the vendor has established VSOE of fair value for PCS, that amount (or the contractually stated amount, if higher than VSOE of fair value) should be deferred and recognized as revenue ratably over the PCS period and any residual amount should be recognized as revenue when the cumulative bug fixes and upgrades/enhancements released during the lapsed PCS period are delivered to the customer (if all of the other basic revenue recognition criteria of ASC 985-605 have been met).

In other transactions, however, the customer will only be entitled to bug fixes and upgrades/enhancements, on a when-and-if-available basis, beginning on the date the PCS is reinstated. In such cases, we believe the vendor must defer all amounts received on reinstatement of PCS and recognize these as revenue over the future PCS term, regardless as to whether the amount received equals or is greater than or less than VSOE of fair value of PCS. We believe this accounting is appropriate because such arrangements only contain a single element — PCS to be provided in the future. This accounting should also be applied if no upgrades/enhancements were released during the lapsed PCS period because in such cases there is also only a single element included in the arrangement (the PCS to be provided in the future).

The following examples illustrate these concepts:

Illustration 7-10: Cumulative bug fixes and updates/enhancements provided on reinstatement of PCS

Facts

On 1 July 20X0, a software vendor licenses Product A bundled with one year of PCS, renewable annually, to a customer for $100,000. The customer renews PCS on 1 July 20X1 and 20X2, but does not renew for any subsequent period. On 1 July 20X6, the vendor and customer agree that the vendor will provide PCS for the period 1 July 20X6 to 30 June 20X7, and provide all upgrades and enhancements released during the period 1 July 20X3 to 30 June 20X6 (the period during which the customer did not purchase PCS) for $60,000. The vendor has established VSOE of fair value of PCS as $20,000. The vendor delivers the most current version of Product A, which contains all of the bug fixes and upgrades/enhancements released during the lapsed PCS period, on execution of the arrangement on 1 July 20X6.

Analysis

The vendor should defer an amount equal to VSOE of fair value of PCS, or $20,000, to be recognized as revenue over the period from 1 July 20X6 to 30 June 20X7. The remaining amount of arrangement consideration, $40,000, may be recognized as PCS revenue on 1 July 20X6, if all of the other basic revenue recognition criteria of ASC 985-605 have been met.

Illustration 7-11: Customer is only entitled to future bug fixes and upgrades and enhancements

Facts

Assume the same facts as in Illustration 7-10 above, except that the customer is only entitled to receive bug fixes and upgrades/enhancements to Product A, as released on a when-and-if-available basis, from the date PCS is reinstated.

Analysis

The vendor should defer the entire amount of arrangement consideration, or $60,000, to be recognized as revenue over the period from 1 July 20X6 to 30 June 20X7.

Some software vendors may offer "amnesty" to entice customers with lapsed PCS to reinstate support by offering to waive a portion or all of the "in arrears" PCS and any reinstatement penalties that may be due contractually. Such arrangements should be accounted for as discussed above. The software vendor should, however, evaluate if the amnesty program is a concession from the original arrangement terms with the affected customers (see Question 4-47).

We believe that an amnesty program that is offered on an infrequent basis to all customers generally does not establish a history of concessions (see Question 4-49). Conversely, amnesty offered to a specific customer or series of customers may be indicative of a concession that may be repeated by the vendor in the future. Specifically, we have seen examples where customers have canceled PCS after release of a major upgrade, anticipating that no further major upgrades are likely in the next year, with the expectation the vendor will provide amnesty with release of the next significant upgrade.

Additionally, if a vendor offers a customer amnesty in connection with the execution of a new software license for products previously licensed by the customer, consideration should be given to whether the arrangement is a PCS buydown (see Question 7-18).

PCS renewals offered at a more-than-insignificant discount

Question 7-17 **If a software licensing arrangement allows a customer to renew PCS at a discount from the vendor's VSOE of fair value for PCS, should the discount be accounted for separately?**

A software licensing arrangement may allow a customer to renew PCS at a rate that is discounted from the vendor's VSOE of fair value of PCS, as determined based on actual rates from PCS renewals by other customers (see Question 7-11). In such cases, we believe that the vendor should evaluate whether the discount offered to the customer is more than insignificant. An option to renew PCS in the future at a discount should be considered more than insignificant if it meets all of the following criteria (Question 1-4 discusses these criteria in greater detail):

- The discount is significant in the context of the overall transaction.
- The discount is incremental to the discounts, if any, inherent in the pricing of the other elements included in the arrangement.
- The discount is incremental to the discount typically provided to customers purchasing the same or similar products or services on a standalone basis.

If an option to renew PCS has been priced at a more-than-insignificant discount based on these criteria, the discount should be accounted for as part of the arrangement because the PCS renewal is, in effect, a bargain renewal option. If VSOE of fair value exists for all elements included in the arrangement, fees should be allocated to those elements and the discount based on the aggregate fees to be received from licensing the software and from expected PCS renewals over the estimated economic life of the software (or over the contractually specified period that PCS may be renewed at a discount if less than the economic life of the software).

If the residual method is applied to the arrangement because VSOE of fair value exists for PCS but not for licensed software, the amount of arrangement consideration allocated to a more-than-insignificant discount should result in revenue being recognized equal to VSOE of fair value in all of the PCS renewal periods to which the discount applies.

Amounts allocated to a more-than-insignificant discount should be recognized as revenue ratably over the future discount period (i.e., the period that the PCS will be renewed at a more-than-insignificant discount). If the customer elects not to renew PCS during this period, any unrecognized amounts related to a more-than-insignificant discount should be recognized at that time.

The following examples illustrate these concepts:

Illustration 7-12: VSOE of fair value exists for software product and PCS

Facts

A software vendor enters into an arrangement to perpetually license software Product A bundled with an initial PCS period of one year for $1,000,000. In addition, the arrangement specifies that Customer may renew the PCS for additional one-year periods for $50,000 per year, a discount of $150,000 (75%) from VSOE of fair value of PCS, which the vendor has established as $200,000. VSOE of fair value of Product A is $1,000,000. The discount that the customer will receive on renewal of PCS is 1) is significant in the context of the overall transaction, 2) incremental to the discounts on the Product A and initial PCS period bundle and 3) incremental to the discount typically provided other customers renewing PCS for Product A. The estimated economic life of the software is five years.

Analysis

Because the discount on renewals of PCS is more than insignificant, the discount should be accounted for separately. Because the discount period is not contractually specified, the fees from the arrangement should be allocated to the elements included therein, including the discount, based on the aggregate fees to be received from licensing the software and from expected PCS renewals over the estimated economic life of the software, as follows:

Software Product A bundled with one year of PCS	$ 1,000,000
PCS renewals	
Year 2	50,000
Year 3	50,000
Year 4	50,000
Year 5	50,000
Total arrangement consideration	$ 1,200,000

VSOE of fair value of the software and PCS is as follows:

Software Product A	$ 1,000,000
Initial PCS period bundled with software	200,000
PCS renewals	
Year 2	200,000
Year 3	200,000
Year 4	200,000
Year 5	200,000
Total arrangement consideration	$ 2,000,000

Accordingly, the overall discount included in the arrangement is 40% ($2,000,000 minus $1,200,000, or $800,000, divided by $2,000,000).

The $1,000,000 of arrangement consideration received at the outset of the arrangement should be allocated to the software and the initial period of PCS bundled with the software license as follows:

	VSOE of fair value	Discount rate	Allocated arrangement consideration
Software Product A	$ 1,000,000	40%	$ 600,000
Initial PCS period bundled with software	200,000	40%	120,000
Total	$ 1,200,000		$ 720,000

The $600,000 allocable to Product A may be recognized on delivery of the software, if all of the other basic revenue recognition criteria of ASC 985-605 have been met. The $120,000 allocable to the initial PCS period bundled with the software should be recognized ratably over the period the PCS services will be provided.

The remaining consideration of $280,000 ($1,000,000 arrangement consideration minus $720,000 allocated to Product A and the initial PCS period) should be allocated to the more-than-insignificant discount. This amount should be recognized ratably over the period that the discount will be utilized, as illustrated below.

	PCS renewal fees	Recognition of amount allocated to discount	Revenue recognized
PCS renewals			
Year 2	$ 50,000	$ 70,000	$ 120,000
Year 3	50,000	70,000	120,000
Year 4	50,000	70,000	120,000
Year 5	50,000	70,000	120,000
Total	$ 200,000	$ 280,000	$ 480,000

Illustration 7-13: VSOE of fair value exists for PCS but not the licensed software product

Facts

Assume the same facts as above, except that VSOE of fair value does not exist for the licensed software product.

Analysis

The amount of arrangement consideration allocated to the more-than-insignificant discount should result in revenue being recognized equal to VSOE of fair value in all of the PCS renewal periods to which the discount applies, as follows:

	VSOE of fair value	PCS renewal fees	Amount allocable to discount
PCS renewals			
Year 2	$ 200,000	$ 50,000	$ 150,000
Year 3	200,000	50,000	150,000
Year 4	200,000	50,000	150,000
Year 5	200,000	50,000	150,000
Total	$ 800,000	$ 200,000	$ 600,000

The $1,000,000 of arrangement consideration received at the outset of the arrangement should be allocated to the software, the initial period of PCS bundled with the software license, and the more-than-insignificant discount using the residual method, as follows:

Arrangement consideration	$ 1,000,000
VSOE of fair value of initial PCS period bundled with software	(200,000)
Amount allocable to more-than-insignificant discount (see table above)	(600,000)
Amount allocable to Product A	$ 200,000

The $200,000 allocable to Product A may be recognized on delivery of the software, if all of the other basic revenue recognition criteria of ASC 985-605 have been met. The $200,000 allocable to the initial PCS period bundled with the software should be recognized ratably over the period the PCS services will be provided. The remaining consideration of $600,000 ($1,000,000 arrangement consideration minus the $200,000 allocated to Product A and the initial PCS period, respectively) should be allocated to the more-than-insignificant discount. This amount should be recognized ratably over the period that the discount will be utilized, as illustrated below.

	PCS renewal fees	Recognition of amount allocated to discount	Revenue recognized
PCS renewals			
Year 2	$ 50,000	$ 150,000	$ 200,000
Year 3	50,000	150,000	200,000
Year 4	50,000	150,000	200,000
Year 5	50,000	150,000	200,000
Total	$ 200,000	$ 600,000	$ 800,000

When a more-than-insignificant discount relating to an option to renew PCS at a discounted amount is accounted for as part of an arrangement, we believe that subsequent actual PCS renewals at the discounted price may be excluded from the population of PCS renewals used for determining if VSOE of fair value exists. We believe that the intent of a VSOE of fair value analysis is to determine whether the pricing practices of the vendor result in similar prices being offered to similar customers when PCS is sold separately. PCS renewals that are priced at a more-than-insignificant discount as part of the original software licensing arrangement are, in effect, a bargain purchase option that acts as an economic compulsion for customer renewal of PCS. Accordingly, the renewal of PCS priced at a more-than-insignificant discount is not a separate sale that sheds light on whether the pricing practices of the vendor result in such consistency (i.e., such PCS renewals do not aid in the evaluation of the pricing practices of the vendor, as they are inextricably linked to the original software licensing arrangement).

Note that when a more-than-insignificant discount relating to an option to renew PCS is accounted for as part of an arrangement, we believe that subsequent facts generally cannot be used to modify the accounting for the arrangement. For example, assume a vendor defers revenue related to an option to renew PCS at a more-than-insignificant discount from VSOE of fair value for a five-year period. After two years, VSOE of fair value has declined due to changes in the vendor's PCS pricing practices such that the PCS renewals are no longer priced at a more-than-insignificant discount when compared to the then current VSOE of fair value. Some have suggested that in such cases the remaining amount of deferred revenue relating to the more-than-insignificant discount in the original arrangement may be recognized as revenue in a manner similar to an adjustment of an accounting estimate. However, we believe that the more-than-insignificant discount represented an element of the original arrangement and should therefore be recognized in the manner initially determined appropriate (unless the PCS term was not renewed, in which case all deferred revenue relating to the more-than-insignificant discount could be recognized).

PCS buydowns

Question 7-18 **What is a PCS buydown? What form may a PCS buydown take? What is the appropriate accounting for such arrangements?**

A PCS buydown is a transaction in which a customer negotiates to decrease the rates paid on current and future PCS renewals in exchange for providing current consideration to the vendor. For example, a software vendor may have customers with perpetual or long-term time-based licenses that give them the right to renew PCS at a specified dollar amount or percentage of the software license fee. Subsequent to the origination of a software licensing arrangement with a customer, the vendor's pricing for software licenses and the associated PCS renewal rates for new arrangements decrease. The customer requests a lower PCS renewal rate, but the vendor stipulates that the lower rate is only available with a new license agreement. Accordingly, an arrangement is structured between the software vendor and the customer to "re-license" the originally licensed software for a negotiated price and then future PCS can be purchased at the current (lower) renewal rate as opposed to the old renewal rate stipulated in the original arrangement. (Alternatively, the original software license may be canceled and replaced by a new license relating to the same software — a "cancel-and-replace" transaction.)

Although these arrangements may purport to be software licensing arrangements, any payment associated with an arrangement that 1) does not provide substantive additional rights (e.g., additional software products or additional seats of a currently licensed software product) to a customer in exchange for a payment and 2) results in PCS price that is less than VSOE of fair value as computed using the cumulative license fees paid by the customer is in substance a reduction in the customer's PCS rate. Such payments should be recognized as revenue over the period of the PCS arrangement (i.e., no amount should be recognized up-front as revenue for the sale of a software license).

As discussed in Question 7-16, it is common for PCS buydowns to occur at the time of a reinstatement of PCS or in connection with an amnesty program. If a software vendor and a customer negotiate to reinstate PCS and include a license for additional software in the negotiations it may be very difficult to determine if the license sale is substantive or simply a reduction in the fees that would otherwise have been charged for PCS. In such situations, we would expect the software vendor to provide evidence that the license fee is substantive, based on comparisons to recent software licensing arrangements executed with third parties (that were not negotiated in conjunction with reinstating lapsed PCS), and that the customer requested and has a need for the licenses.

The following examples illustrate these concepts:

Illustration 7-14: Re-licensing of software

Facts

A software vendor enters into an arrangement with Customer A in 20X0 to perpetually license 5,000 seats of Product A for a total fee of $1,500,000. PCS renewals are priced at 20% of the net license fee, or $300,000, which is VSOE of fair value. In 20X2, the licensed product and the associated PCS have fallen in price, such that new customers pay significantly less for the equivalent product and services. The software vendor is unwilling to lower its PCS pricing to Customer A, but instead suggests that the customer upgrade its license rights through the purchase of an unlimited user license to replace the existing arrangement. The vendor and customer execute such a license for $400,000 in license fees and PCS priced at $80,000 per annum. At the date of execution of the second license, the licensed software product has an estimated remaining economic life of five years.

Analysis

In this illustration, although the customer is receiving additional license rights (an unlimited user license in exchange for a limited user license) and is paying a substantially higher amount in the short term ($480,000 in the first year as compared to $300,000 for a PCS renewal under the initial arrangement), this transaction is in substance a PCS buydown because even though the customer receives additional rights, the vendor receives smaller fees over the life of the arrangement. Over the remaining estimated economic life of the software product, the customer will pay a total of $800,000 in combined license and PCS fees as compared to the $1,500,000 that would have been due pursuant to the original arrangement, representing a 47% savings (ignoring the effect of discounting) over that period. Similarly, had the ability to convert a specified user arrangement to an unlimited arrangement been an option within the initial arrangement, PCS on the unlimited arrangement would have presumably been based on a combination of the initial license fee and the option price.

No revenue should be recognized on execution of the arrangement in 20X2. Rather, the arrangement consideration should be recognized ratably over the remaining estimated economic life of the software as PCS revenue. If PCS is not renewed by the customer within the following five years, the remaining deferred revenue at that date should then be recognized as revenue.

Illustration 7-15: Existing software licenses cancelled and replaced by licenses for other products

Facts

On 1 April 20X1, a software vendor licenses 100 seats of budgeting software to a customer. The vendor has established VSOE of fair value of PCS for the budgeting software of $200 per seat and this amount is charged to the customer for PCS renewals. On 13 March 20X3, the customer notifies the vendor it is only using 80 seats of the budgeting software and would like to pay PCS based on the 80 seats in use instead of the 100 seats licensed. Additionally, the customer states that it would like to license 25 seats of consolidation software also marketed by the vendor.

On 28 March 20X3, the vendor and customer enter into an amendment of the original software licensing arrangement whereby the customer perpetually licenses 25 seats of the consolidation software, bundled with an initial one year PCS period, and surrenders the rights to 20 seats of the budgeting software. As part of the arrangement, the vendor agrees that fees for future PCS renewals will be based on 80 seats of budgeting software and 25 seats of consolidation software. Arrangement consideration totals $25,000.

The vendor has established VSOE of fair value of PCS for the consolidation software at 25% of the net software license fee. The agreement stipulates that this amount will be charged for renewals of PCS for the consolidation software. Although the vendor has not established VSOE of fair value for licenses of the consolidation software (either separately or when bundled with an initial PCS period), the fees received in connection with the arrangement are substantive based on comparison to consolidation software licensing arrangements executed by the vendor with third parties.

Analysis

In order to determine the appropriate accounting for this transaction it is important to understand both the substance and the form of the arrangement. That is, can some portion of the arrangement consideration of $25,000 be recognized as software licensing fees on delivery of the consolidation software or is this amount merely a payment for a decrease in the fees to be charged for PCS renewals for the budgeting software.

In this illustration, the customer is receiving substantive additional rights in the form of a license for 25 seats of consolidation software. Further, the license fee for the consolidation software is substantive compared to other bundled sales of the software and PCS, and the PCS renewal rate is at VSOE of fair value. The reduction in the PCS renewal rate for the budgeting software also is substantive because the customer surrendered the right to use 20 seats of the software. Accordingly, at the time of the contract amendment, the vendor should defer the VSOE of fair value of the initial one-year period of PCS for the consolidation software, or $5,000. The residual amount of arrangement consideration of $20,000 ($25,000 minus $5,000) may be recognized on delivery of the software, if all of the other basic revenue recognition of ASC 985-605 have been met.

Illustration 7-16: Existing perpetual licenses cancelled and replaced by a time-based license

Facts

On 1 April 20X1, a software vendor perpetually licenses an unlimited number of seats of payroll software to a customer for $2,000,000. VSOE of fair value of PCS is 20% of the net license fee ($400,000 per annum). The price of the payroll software and the associated PCS subsequently decline such that new customers in 20X3 pay less for the product and PCS. In addition, the customer's own business has stagnated, such that the growth projections that motivated its purchase of an unlimited user license are no longer realistic. The contractual terms of the PCS arrangement do not allow the customer to reduce the number of supported users in exchange for a reduction in PCS.

In September 20X3, the vendor amends the original agreement such that the customer relinquishes its perpetual license in exchange for a five-year time-based license for up to 500 users in exchange for a license fee of $600,000, bundled with one year of PCS. Optionally renewable PCS is priced at 20% of the license fee per annum, or $120,000, which the vendor has established as VSOE of fair value for PCS related to time-based licenses. The fees are substantive in comparison to recent comparable transactions (that were not amendments to existing perpetual arrangements).

Analysis

The customer has not received substantive additional rights in exchange for the payment received by the vendor for the time-based license. In fact, the customer's rights have been reduced significantly from the original arrangement. Over the term of the time-based license, the customer will save $800,000 or 40% (ignoring the effect of discounting) as compared to what it would have spent under the original arrangement.

Accordingly, no revenue should be recognized on execution of the arrangement in 20X3. Rather, the arrangement consideration of $600,000 should be recognized ratably over the term of the time-based license. If PCS is not renewed by the customer during the time-based license, the remaining deferred revenue at that date should be recognized as revenue at that date.

Illustration 7-17: Substantive additional rights received by customer

Facts

In 20X1, a software vendor perpetually licenses 10 seats of Product A to a customer in exchange for license fees of $500,000. The customer renews PCS annually for $100,000 (20% of the net license fees), which is VSOE of fair value for PCS for customers with less than $2,000,000 of cumulative net license fees. The vendor has established VSOE of fair value of PCS for customers with cumulative license fees in excess of $2,000,000 as 16% of net license fees.

On 30 September 20X5, the vendor and the customer enter into an amendment of the existing arrangement that provides the customer a four-year right to deploy Product A on an unlimited basis. After the four-year term, the number of seats deployed converts into a fixed number of perpetual licenses. Arrangement consideration totals $2,400,000, which the contract stipulates relates to software license fees of $2,000,000 and $400,000 for a bundled initial one-year PCS period. Optionally renewable PCS is priced at $400,000 per annum. The $100,000 annual PCS fee originally due is no longer due under the amended agreement.

Analysis

In this illustration, the customer is receiving substantive additional rights in the form of a four-year unlimited deployment period that converts seats deployed by the end of the term into a perpetual license. Since the amendment is an expansion of the scope of the original arrangement, the $2,000,000 license fee should be treated as an incremental license fee to the original $500,000 license fee. The PCS rate of $400,000 per annum should be evaluated in comparison to the cumulative license fees of $2,500,000 to determine if the PCS rate is less than VSOE of fair value. The effective PCS rate subsequent to the amendment is 16% ($400,000/$2,500,000), which is VSOE of fair value for customers with cumulative license fees in excess of $2,000,000.

Accordingly, at the time of the contract amendment the vendor should defer the VSOE of fair value of the initial one-year period of PCS for the consolidation software, or $400,000 (20% of the software license fees). The residual amount of arrangement consideration of $2,000,000 may be recognized on the execution of the amendment, and delivery of the software, if all of the other basic revenue recognition criteria of ASC 985-605 have been met.

Illustration 7-18: Existing licenses cancelled and replaced by an unlimited deployment license

Facts

In 20X5, a software vendor entered into an arrangement with Customer A to perpetually license 100,000 seats of Product A for $2,000,000. PCS renewals are priced at 20% of net license fees, or $400,000, per annum, which is VSOE of fair value. In 20X7, on the second anniversary of the original licensing arrangement, Customer A and the vendor agree to cancel the existing licenses, and enter into an unlimited deployment license for 3 years, after which period the customer will report to the vendor the number of licenses deployed in its organization. The reported amount of deployed licenses then will become the number of perpetual licenses that Customer A is licensed to use prospectively. If Customer A subsequently wishes to deploy additional licenses, these must be separately purchased along with the associated PCS.

The total license fee for this unlimited deployment license is $5,000,000. First year PCS and PCS renewals are priced at 20% of the license fee (i.e., $1,000,000), which is VSOE of fair value. The software vendor requires Customer A to pay an annual PCS fee based on its existing license of 100,000 seats ($400,000) plus PCS on the unlimited deployment license ($1,000,000) for a total PCS fee of $1,400,000 per year. Accordingly, total arrangement consideration received by the vendor in 20X7 for the unlimited licensing arrangement is $6,400,000 for the licenses and the first year of PCS.

Analysis

The difference between this Illustration and Illustration 7-17 above is that the customer is required to pay PCS fees that are based on the cumulative net license fees paid to date (i.e., the customer must continue to pay for PCS relating to the previously purchased licenses). Although the original licenses are "cancelled" and are replaced with licenses deployed under the unlimited deployment arrangement, because the customer is required to continue to pay PCS related to the old licenses, no buydown of PCS has occurred.

Accordingly, at the date the unlimited deployment licensing arrangement is signed, the software vendor may recognize $5,000,000 in license fees (and defer $1,400,000 for PCS to be provided), assuming all other revenue recognition criteria have been met.

Understanding the substance of any PCS buydown transaction is critical because the form of these transactions (i.e., the way the contract or related paperwork reads) generally is substantially different from the substance of the arrangement. This type of transaction may be difficult to detect unless the new arrangement contains a reference to the old arrangement, and the two arrangements are reviewed together to determine if software the customer already is entitled to use is being re-licensed. Accordingly, it is important for vendors to have sufficient controls to determine that these transactions do not occur, or if they do occur, that they are appropriately reported.

Determining VSOE of fair value of PCS in a one year or less multiple-element time-based license arrangement

Question 7-19 **Can VSOE of fair value be determined for PCS included in a time-based license with a term of one-year or less?**

No. ASC 985-605-55-59 through 55-61 describes the accounting for a 12-month multiple-element arrangement that has six months of PCS bundled in the initial fee with a six-month renewal option. Those paragraphs stipulate that for multiple-element time-based software licenses of one year or less, the fair value of the bundled PCS is not reliably determinable by reference to the price charged when PCS is renewed because of the short time frame of the software license.

We believe that the intent of those paragraphs is that VSOE of fair value of PCS cannot be determined for one-year or less time-based multiple-element software licensing arrangements. Accordingly, the license and the PCS cannot be accounted for separately and the entire arrangement fee should be recognized ratably over the license term for these one-year or shorter multiple-element time-based licenses (unless the conditions stipulated by ASC 985-605-25-71 and 25-72 for the recognition of PCS revenues together with the initial licensing fee on delivery of the software are met — see Question 7-31). It would not be appropriate to use the renewal rates of PCS from a vendor's multi-year term or perpetual licensing arrangements, or any other proxy, to establish VSOE of fair value for PCS bundled with a one-year or less term license.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Fair Value of Postcontract Customer Support in a Short-Term License

985-605-55-59

In arrangements that include time-based software licenses and postcontract customer support services, the duration of the time-based software license may be so short that a renewal rate or fee for the postcontract customer support services does not represent vendor-specific objective evidence of the fair value of the bundled postcontract customer support. For example, a software arrangement might provide a 12-month license that includes (bundles) 6 months of postcontract customer support services for a total fee of $100,000 and specifies a 6-month renewal fee for postcontract customer support services of $5,000.

985-605-55-60

For time-based software licenses with a duration of one year or less, the fair value of the bundled postcontract customer support services is not reliably measured by reference to a postcontract customer support renewal rate. The short period during which any unspecified upgrade provided under the postcontract customer support agreement can be used by the licensee prevents objectively demonstrating the vendor-specific objective evidence of fair value of the licensee's right to unspecified upgrades.

985-605-55-61

Although a postcontract customer support service element may not be of significant value when it is provided in a short duration time-based license, this Subtopic does not provide for an exception from its provision that vendor-specific objective evidence of fair value is required for each element of a multiple-element arrangement. Consequently, when there is no vendor-specific objective evidence of the fair value of postcontract customer support services included (bundled) in a multiple-element arrangement, even if the arrangement provides a short duration time-based software license, the total arrangement fee would be recognized under paragraphs 985-605-25-9 through 25-11 (or paragraphs 985-605-25-71 through 25-72, if applicable). Paragraphs 985-605-55-62 through 55-63 address circumstances in which a renewal rate for postcontract customer support in connection with a multiyear time-based license may not constitute vendor-specific objective evidence of the fair value of postcontract customer support.

See Question 7-20 for discussion of the provisions of ASC 985-605-55-62 and 55-63.

VSOE of fair value of PCS for a time-based license

Question 7-20 **Can VSOE of fair value be established for PCS included in a time-based license with a term greater than one year?**

VSOE of fair value of PCS for a time-based license can be established by a vendor when 1) it sells time-based licenses that include optionally renewable PCS, 2) the term of the optionally renewable PCS period is equal to or greater than the term of the initial PCS period bundled with the sale of the software license fee and 3) the term and renewal rate of the PCS are substantive. ASC 985-605-55-62 and 55-63 provides examples of circumstances that, if present in an arrangement, would indicate that the PCS renewal rate or term is not substantive, and thus should not be relied on to establish VSOE of fair value of PCS.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Fair Value of Postcontract Customer Support in a Multiyear Time-Based License

985-605-55-62

Arrangements for multiyear time-based software licenses may include initial (bundled) postcontract customer support services for only a portion of the software license's term (for example, a five-year time-based software license that includes initial postcontract customer support services for one year), and a renewal rate for postcontract customer support for an additional year or years within the time-based license period. If the postcontract customer support renewal rate and term are substantive, that renewal rate constitutes vendor-specific objective evidence of the fair value of the postcontract customer support under paragraphs 985-605-25-6 through 25-7 and 985-605-25-67 through 25-69.

985-605-55-63

Circumstances that indicate that the postcontract customer support renewal rate or term is not substantive include the following:

a. The period of initial (bundled) postcontract customer support services is relatively long compared to the term of the software license (for example, four years of initial postcontract customer support services in connection with a five-year time-based software license, with a specified postcontract customer support renewal rate for the remaining year).

b. The aggregate postcontract customer support renewal term is less than the initial (bundled) postcontract customer support period (for example, a five-year time-based software license with three-year bundled postcontract customer support and two annual postcontract customer support renewals).

c. A postcontract customer support renewal rate that is significantly below the vendor's normal pricing practices in combination with a time-based software license that is for a relatively short period (for example, a two-year time-based software license that includes initial [bundled] postcontract customer support for one year for a total arrangement fee of $1,000,000 and that stipulates a postcontract customer support renewal rate for the second year of $25,000 when the vendor's normal pricing practices suggest higher renewal rates).

This guidance indicates that a PCS renewal term that is less than an initial (bundled) PCS period is not substantive, and ASC 985-605-55-59 through 55-61 (see Question 7-19) indicates that VSOE of fair value of PCS generally cannot be established for time-based software licensing arrangements of one year or less. Accordingly, we believe it is not possible to establish VSOE of fair value of PCS included in any time-based arrangements shorter than two years because such arrangements are the minimum time period that could include an optional renewal period that is at least one year and, therefore, can be deemed substantive. VSOE of fair value may be established for two-year time-based arrangements that bundle an initial PCS period of one year with the software license and include an optional one-year PCS renewal period.

We also believe the concept in ASC 985-605-55-62 and 55-63 relating to the length of an initial PCS period bundled with a software license should be applied to PCS for perpetual licenses. That is, if a perpetual license sale includes an initial PCS period that is relatively long compared to the economic life of the software (and, thus, the optionally renewable PCS periods are relatively short in comparison), the PCS renewal periods may not be substantive, and should not be used to establish VSOE of fair value of PCS.

VSOE of fair value of PCS related to perpetual software licenses generally cannot be used to establish VSOE of fair value of PCS for time-based licenses. PCS services provided to, and renewed by, perpetual license holders differ economically from PCS services provided to holders of time-based licenses because even though the same unspecified product upgrades or enhancements may be provided under each PCS arrangement, the time period during which the customer has the right to use such upgrades or enhancements differs based on the terms of the underlying licenses. When a vendor licenses its software using both perpetual and time-based licenses, evaluating whether VSOE of fair value of PCS has been established generally should be done separately for each type of license.

However, if both of the following circumstances exist, PCS renewal terms in perpetual licenses may provide VSOE of the fair value of PCS services bundled with multi-year time-based software license:

- The term of the software license is substantially the same as the estimated economic life of the software product and related enhancements that occur during that term
- The fees charged for perpetual licenses (including fees from the assumed renewal of PCS for the estimated economic life of the software) and time-based licenses are substantially the same

The following excerpt from the implementation guidance in ASC 985-605 specifically addresses this issue.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Fair Value of Postcontract Customer Support in Perpetual and Multiyear Time-Based Licenses

985-605-55-64

A software vendor may offer licenses for the same product currently as a perpetual license and a multiyear time-based license (for example, two or more years). The pricing of the licenses reflects the duration of the license rights. Renewal rates may provide vendor-specific objective evidence of fair value for postcontract customer support services in the perpetual licenses. However, for multiyear time-based licenses, postcontract customer support services for the entire license term are included (bundled) in the license fee and there is no renewal rate because the time-based license rights are coterminous with the postcontract customer support service period. In this situation, the postcontract customer support renewal terms in the perpetual license do not provide vendor-specific objective evidence of the fair value of the postcontract customer support services element included (bundled) in the multiyear time-based software arrangement pursuant to the provisions of this Subtopic.

985-605-55-65

Paragraphs 985-605-25-6 through 25-7 state that vendor-specific objective evidence of fair value is provided by the price charged when the same element is sold separately. Postcontract customer support services for a perpetual license and for a multiyear time-based license are two different elements. Although the same unspecified product upgrades or enhancements may be provided under each postcontract customer support arrangement, the time period during which the software vendor's customer has the right to use such upgrades or enhancements differs based on the terms of the underlying licenses. Because postcontract customer support services are bundled for the entire term of the multiyear time-based license, those postcontract customer support services are not sold separately.

985-605-55-66

However, in the rare situations in which both of the following circumstances exist, the postcontract customer support renewal terms in a perpetual license provide vendor-specific objective evidence of the fair value of the postcontract customer support services element included (bundled) in the multiyear time-based software arrangement:

a. The term of the multiyear time-based software arrangement is substantially the same as the estimated economic life of the software product and related enhancements that occur during that term.

b. The fees charged for the perpetual (including fees from the assumed renewal of postcontract customer support for the estimated economic life of the software) and multiyear time-based licenses are substantially the same.

985-605-55-67

If the software vendor also offers multiyear time-based licenses for the same product that include bundled postcontract customer support services for a portion of the license period (instead of only including bundled postcontract customer support services for the entire license term), the renewal terms of those transactions may provide vendor-specific objective evidence of the fair value of the postcontract customer support services elements that are bundled for the entire license term. See paragraphs 985-605-55-62 through 55-63 for additional guidance on vendor-specific objective evidence of postcontract customer support renewals.

Our experience has been that it is rare that companies are able to satisfy the above criteria and use PCS renewal rates for perpetual licenses as a basis to establish VSOE of fair value of PCS bundled with time-based licenses.

If a vendor asserts the term of a software license is substantially the same as the estimated economic life of the software product and related enhancements that will occur during the term, it should have relevant history relating to when products have been sunset (i.e., no longer sold or supported) to support its assertion of the estimated life of the software product. Further, we would be skeptical of any assertion that a time-based software license with a term of less than five years is substantially the same as the estimated economic life of a software product and its related enhancements.

The following examples illustrate these concepts (for simplicity, these examples ignore any effect of present value discounting for the time value of money, the effects of which also should be evaluated in applying this guidance):

Illustration 7-19: Software vendor sells both perpetual and time-based software licenses

Facts

A software vendor licenses Product A using two- and three-year time-based licenses with coterminous PCS. The PCS term is always the same as the license term in these arrangements such that PCS is never sold separately. The vendor also licenses Product A on a perpetual basis and has established VSOE of fair value for PCS sold in connection with perpetual licenses based on renewals of PCS by perpetual license holders.

The vendor estimates that the economic life of Product A and related enhancements is seven years. Fees received in connection with perpetual software licensing arrangements exceed those received in connection with time-based licensing arrangements.

Analysis

VSOE of fair value of PCS bundled with the time-based software licenses cannot be established by reference to PCS renewal rates for perpetual licenses because of the economic differences between the services provided to time-based licensees and perpetual licensees. Because PCS for time-based licenses is not sold separately by the vendor, VSOE of fair value for such PCS cannot be established.

Illustration 7-20: Time-based licenses with optionally renewable PCS periods

Facts

A software vendor sells three-year time-based software licenses bundled with a coterminous three-year PCS period (i.e., PCS is bundled for the entire three-year term). The Company also sells three-year time-based licenses for the same product that include an initial PCS period of one year bundled with the license. These latter arrangements include options to renew PCS in years two and three of the license term at an amount equal to 20% of the net software license fees. There are a sizable number of renewal transactions for such licenses, and a substantial majority of these renewals are priced at 20% of the net license fee.

Analysis

The concept of the implementation guidance in ASC 985-605-55-62 and 55-63 is that optional renewals of PCS included in time-based software licenses may provide VSOE of fair value of PCS if the optionally renewable PCS period is greater than or equal to the PCS period bundled with the initial license fee. In this example, the vendor has established that the VSOE of fair value of annual PCS is 20% of the net license fee for its three-year arrangements based on renewals of PCS in years two and three of those arrangements. Accordingly, this rate may be used as the VSOE of fair value for the coterminous PCS bundled with three-year software licenses.

Illustration 7-21: Economic life of software approximates length of time-based license

Facts

A software vendor licenses software with a term of five years with coterminous PCS (i.e., PCS is bundled for the entire five-year term) for $2,000,000. Based on vendor-specific historical practices and product development plans, the vendor demonstrates that the remaining estimated economic life of the software, including enhancements, at the date the time-based license is executed is approximately five years (i.e., after five years, the vendor will sunset or stop providing upgrades on the product).

The vendor also licenses the same software perpetually, bundled with an initial year of PCS, for $1,200,000. VSOE of fair value of PCS is $200,000 per annum based on actual renewals. The vendor asserts that the economics of both the perpetual and the time-based license are the same because the vendor anticipates that a customer licensing the software on a perpetual basis, and annually renewing PCS, also will pay approximately $2,000,000 ($1,200,000 plus four $200,000 annual PCS renewals).

Analysis

In this illustration, the vendor can utilize the PCS renewal rates for perpetual licenses ($200,000 per year) as a basis to establish VSOE of the fair value of the PCS bundled with the five-year software license. Accordingly, on the date the time-based license is executed, the vendor may recognize revenue of $1,000,000 for the software license (if all of the basic revenue recognition criteria of ASC 985-605 have been met), and defer $1,000,000 (5 years of bundled PCS with a fair value of $200,000 per year) to be recognized ratably over the PCS term.

In practice, however, it is often challenging for companies to be able to satisfy the criteria in the implementation guidance at ASC 985-605-55-64 through 55-67 and use PCS renewal rates for perpetual licenses as a basis to establish the VSOE of fair value of PCS bundled with term licenses.

Mandatory PCS arrangements

Question 7-21 **Software vendors may license software using the form of a perpetual license arrangement (i.e., the arrangement refers to the license as a perpetual license), but require the customer to renew or remain current on PCS after the initial bundled PCS period expires or lose the continued right to use the software. How should a software vendor account for such Mandatory PCS arrangements?**

Although such arrangements may purport to be perpetual software licenses, the substance of the arrangement is more akin to a time-based license because the customer will lose the continued right to use the software if PCS is not renewed. In such arrangements, the customer is not only deciding whether to renew PCS each year, but also deciding whether to renew the license. Accordingly, the arrangement is in substance a series of time-based licenses bundled with PCS.

In many Mandatory PCS arrangements, the fee for the initial period is disproportionate to the fee for the renewal periods, even though the deliverables in each period are the same. This is because the fee in the first year is purported to be for both the perpetual license and the initial bundled PCS period, while renewals appear to be just for subsequent PCS periods. For example, the software vendor may charge a renewal fee of 20% of the initial license fee for the renewal of the PCS (which also renews the right to use the associated license).

Since these arrangements are in substance time-based licenses and not perpetual licenses, the fee for both the license and bundled PCS should be recognized ratably. When determining the period over which to recognize the initial fee, some have questioned whether the renewals in the arrangement (e.g., the

20% renewal in the above example) represent a significant and incremental discount that should be accounted for in accordance with the provisions of ASC 985-605-15-3(d) and ASC 985-605-55-86 and 55-87. In general terms, if one were to consider the renewal rate to be at a significant and incremental discount, the initial fee should be recognized over the expected discount period. However, we believe the discounted renewal fees, while significant to the initial bundled license/PCS fee, generally will not be incremental to discounts typically given in comparable transactions (e.g., the 20% renewal pricing is the vendor's standard pricing practice for all customers). Accordingly, the discount in such circumstances should not be accounted for separately (see Question 5-4).

In accounting for the initial fee received in connection with Mandatory PCS arrangements, we believe that either of the following accounting policies is acceptable:

- Recognize the entire fee for the initial software license/PCS bundle ratably over the initial (bundled) PCS period when that period is substantive (i.e., one year or greater). Subsequent renewal fees should be recognized ratably over the contractually stated renewal periods. When the initial bundled PCS period is less than one year, the initial "license fee" (the amount deemed "incremental" — see example below) should be recognized ratably over the estimated economic life of the arrangement as discussed below.
- Defer and amortize over the expected economic life of the arrangement the portion of the initial fee that exceeds the periodic PCS renewal fees. For example, if the fee for a software license bundled with an initial PCS period is $1,000,000, and the subsequent PCS renewals are priced at $200,000 per annum, $800,000 would be deemed to be the "incremental" portion of the initial fee to be recognized over the expected economic life of the arrangement (i.e., the initial and anticipated PCS renewal periods). If the customer elects not to renew PCS in a future period, any remaining deferred revenue would be recognized at that time.

Because this is a policy election, the policy selected by the vendor should be consistently applied and disclosed in the accounting policy note if material to the financial statements. Note, however, that when the initial bundled license/PCS term is less than one year, a vendor would not have a policy election and must use the second option above.

Various PCS levels offered

Question 7-22 **If a vendor offers varying levels of PCS, must VSOE of fair value of the PCS be established separately for each offering?**

Many vendors offer different levels of PCS that relate to different levels of support. For example, many software vendors commonly offer silver, gold and platinum PCS services. The nature of the service levels will vary based upon many factors. These may include support availability (e.g., silver provides support to the customer Monday through Friday from 9 a.m. to 5 p.m., gold provides support Monday through Saturday from 9 a.m. to 6 p.m., and platinum provides support 24 hours per day, 7 days a week) or differing levels of upgrades (e.g., for mature products the most basic level of PCS may entitle a customer only to security patches and phone support).

In such cases, we believe that each offering is a separate product and, as such, VSOE of fair value should be established separately for each product. Additionally, the VSOE of fair value of one product should not be used as a surrogate for VSOE of another. For example, the VSOE of fair value of gold PCS should not be used as a surrogate for VSOE of fair value of the platinum offering.

Deployment-based PCS

Question 7-23 **How is VSOE of fair value of PCS determined when copies of the licensed software are deployed over time and the contract contains a predetermined PCS rate that becomes effective when the license is fully deployed?**

Vendors that license software installed on an enterprise-wide basis often offer deployment-based licenses to customers. A deployment-based license allows customers to pay license or PCS fees that are reduced while the software is being deployed (installed) and increased on full deployment of the licenses. It may be difficult to establish VSOE of fair value of PCS in a deployment-based arrangement because PCS is only sold separately once the software is fully deployed. In a transaction that includes deployment-based PCS (i.e., the PCS rate is based on the number of copies of the software deployed), a bundled initial PCS period should be accounted for using VSOE of fair value of PCS as if fully deployed, if VSOE of fair value exists.

The implementation guidance in ASC 985-605-55-53 through 55-55 provides guidance on determining VSOE of fair value of PCS in a deployment-based contract.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Postcontract Customer Support During Deployment Phase

985-605-55-53

A software vendor enters into an arrangement with a customer to deliver its software product and to provide postcontract customer support. The product will be deployed in stages. The stipulated term of the postcontract customer support period begins six months after delivery of the product. However, the vendor has a history of regularly making available to all customers the services or unspecified upgrades or enhancements normally associated with postcontract customer support as soon as its products are delivered. That is, the customer receives any upgrades or enhancements released by the vendor during the six-month period after product delivery.

985-605-55-54

The postcontract customer support rate inherent in the licensing fee increases over time based on the customer's deployment of the product. After three years, the predetermined renewal rate for postcontract customer support for a fully deployed license is set at a stipulated rate multiplied by the aggregate list price (as established at the inception of the arrangement) of the licensed product, regardless of the status of the deployment efforts. The vendor does not have vendor-specific objective evidence of fair value of the postcontract customer support if the product is less than fully deployed because the only postcontract customer support sold separately is the renewal of postcontract customer support (that is, the predetermined renewal rate).

985-605-55-55

In this situation, the postcontract customer support arrangement commences upon product delivery because the customer receives any upgrades or enhancements released by the vendor during the six-month period after product delivery. In addition, the predetermined renewal rate is the only indicator of fair value because it is the only arrangement under which postcontract customer support is sold separately, and therefore, it should be used to establish vendor-specific objective evidence of fair value of the postcontract customer support. In this situation, the vendor would defer initially the portion of the arrangement fee related to the three and one-half years of postcontract customer support provided under the arrangement based on the predetermined renewal rate.

The following example illustrates these concepts:

Illustration 7-22: VSOE of fair value of PCS in a deployment-based contract

Facts

A software vendor enters into an arrangement to license 900 seats of product P to a customer for $10,000 per seat and to provide PCS related to the licensed product. Under the terms of the contract, the customer will deploy 300 users of P per year for three years. The license fee ($9,000,000) is payable up-front. The arrangement specifies PCS is 15% of the license fee, payable annually based on the number of users to be deployed each year, or $450,000 (300 licenses x $10,000 per license x 15%) in year one, $900,000 (600 licenses x $10,000 per license x 15%) in year two and $1,350,000 (900 licenses x $10,000 per license x 15%) in year three. The customer pays $9,450,000 on contract execution. PCS is renewable in year four at 15% of the total license fee of $9,000,000 or $1,350,000. VSOE of fair value of PCS is 15% based on actual renewals.

Analysis

Although the contractually stipulated PCS fees are reduced during the deployment period, VSOE of fair value of PCS is determinable because the contract contains a pre-determined PCS renewal rate effective when the license is fully deployed and that rate is consistent with VSOE of fair value of PCS. Accordingly, the vendor should defer $450,000 for the initial PCS period bundled with the software license and the difference between the ultimate renewal rate of $1,350,000 and the contractually stated PCS rates during the first and second year deployment periods, or $1,350,000 [($1,350,000 * 3) — ($450,000 + $900,000 + $1,350,000)] from the up-front fee of $9,450,000. The residual amount of $7,650,000 ($9,450,000 — $450,000 — $1,350,000) may be recognized as revenue on delivery of the licensed software, if all of the other basic revenue recognition criteria of ASC 985-605 have been met. The $1,350,000 deferred from the up-front fee should be recognized in revenue as PCS is provided during the deployment periods such that $1,350,000 is recognized for PCS in each deployment period (e.g., $900,000 should be recognized in the initial year, such that when combined with the $450,000 stated rate for the initial deployment period, a total of $1,350,000 of PCS revenue is recognized).

PCS relating to an unlimited number of users during an initial deployment period

Question 7-24 **Software vendors may offer perpetual licenses of a software product that allow a customer to deploy an unlimited number of copies of the licensed software product during an initial deployment period (sometimes referred to as "all-you-can-eat" arrangements), bundled with an initial PCS period that is shorter than the initial deployment period. During the initial deployment period, the customer may renew PCS for a stipulated amount, generally expressed as a percentage of the software license fee. After expiration of the initial deployment period, PCS fees are based on the ultimate number of copies of the software product deployed by the customer. Do PCS renewal rates in effect during the initial deployment period of an arrangement constitute VSOE of fair value of PCS for the initial PCS period bundled with the sale of the software license?**

In such arrangements there are two different pricing methodologies for PCS (i.e., during and after the initial deployment period) and no basis for determining which amount represents VSOE of fair value of the initial PCS period bundled with the sale of the software license. Accordingly, arrangement consideration relating to such arrangements should be recognized over the initial deployment period. This presumes that PCS will be renewed for the optional renewable periods included in the initial deployment period. If PCS is not renewed for these periods, any remaining deferred revenue at the time PCS is no longer being provided should be recognized.

However, if the vendor has sufficient objective evidence to demonstrate the PCS renewal rate that ultimately will be charged to the customer is more likely than not to approximate or be less than the amounts that will be charged during the optional PCS renewal periods included in the initial deployment period, those stipulated renewal rates may be considered VSOE of fair value of PCS for the initial PCS period bundled with the sale of the software license. For purposes of applying this concept, the term more likely than not should be interpreted as a likelihood of more than fifty percent in a manner consistent with ASC 740, *Income Taxes*.

ASC 985-605-55-70 through 55-73 provide relevant guidance for determining the VSOE of fair value of PCS in such arrangements.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Fair Value of Postcontract Customer Support Renewals Based on Users Deployed

985-605-55-70

A software vendor may offer a perpetual license to an end-user customer with postcontract customer support bundled for the initial year. The initial fee is $1,150,000, with $1,000,000 stated as the software license fee and $150,000 stated as the postcontract customer support fee. The end-user customer is entitled to deploy an unlimited number of copies of the software product for a three-year period. During the three-year unlimited deployment period, the end-user customer has the option to renew postcontract customer support annually for Years 2 and 3 for a stipulated fee of 15% of the stated license fee, which is $150,000 per year. After the expiration of the three-year unlimited deployment period, the end-user customer is required to pay additional license and postcontract customer support fees if it deploys additional copies of the software product. The optional postcontract customer support fee for Year 4 and annually thereafter is based on the ultimate number of copies of the software product deployed by the end-user customer at the end of the three-year unlimited deployment period.

985-605-55-71

The annual postcontract customer support renewal rates stipulated for Years 2 and 3 do not constitute vendor-specific objective evidence of fair value for the first year's postcontract customer support in accordance with this Subtopic. In this arrangement there are two different pricing methodologies for postcontract customer support and no basis for determining which pricing methodology produces the appropriate vendor-specific objective evidence of fair value of the postcontract customer support bundled in Year 1 and offered in Years 2 and 3. Accordingly, the vendor would recognize the entire arrangement fee ($1,450,000) ratably over the 3-year deployment period. (The aggregate fee recognized should not exceed the amount that is not subject to forfeiture, refund, or other concession, as required in paragraph 985-605-25-13.) This presumes that postcontract customer support will be renewed in Years 2 and 3; however, if the customer does not renew in Year 2 or 3, the vendor should recognize the remaining deferred revenue at the time postcontract customer support is no longer being provided.

985-605-55-72

If sufficient objective evidence demonstrated that the renewal rate in Year 4 and thereafter is more likely than not (that is, a likelihood of more than 50%, as that term is used in paragraph 740-10-30-5(e)) to approximate or be less than the amount charged in Years 2 and 3, the annual postcontract customer support renewal rates stipulated for Years 2 and 3 would constitute vendor-specific objective evidence of fair value of postcontract customer support.

985-605-55-73

One example of such evidence would be a vendor's past history of deployment with other comparable arrangements that result in postdeployment postcontract customer support fees that approximate postcontract customer support fees charged during the unlimited deployment period. Another example would be a stated cap or maximum on the price to be charged for postcontract customer support in Year 4 and thereafter that would result in a price that approximates or is less than the amount charged in Years 2 and 3. In such a circumstance, the amount allocated to the perpetual license ($1,000,000) would be recognized immediately, provided all other requirements for revenue recognition in this Subtopic are met, and the fair value of postcontract customer support in Year 1 would be recognized ratably over the postcontract customer support period. Likewise, the fees related to postcontract customer support renewals after Year 1 ($150,000 each for Years 2 and 3) would be recognized ratably over the respective postcontract customer support periods.

Software vendors may enter into similar arrangements that provide the customer the right to deploy an unlimited number of perpetual licenses during a specified period. At the end of the unlimited deployment period, the customer must report to the vendor the total number of licenses deployed, which will then be the number of licenses it is licensed to use prospectively.

In certain instances, vendors may state a maximum number of users (or other metric such as number of processors or MIPs) that may be deployed at the end of the unlimited period (a "capped number"). If the customer exceeds the capped number at the end of the deployment period, it will have the choice of 1) paying additional license and PCS fees in order to continue to use all of the licenses deployed or 2) discontinuing the use of a sufficient number of licenses so as to be at or below the capped number.

During the deployment period, the vendor charges PCS fees based on the net license fees charged at inception of the arrangement. Additional PCS fees are charged subsequent to the end of the deployment period if the number of licenses deployed exceeds the capped number, and additional license fees are paid by the customer.

These arrangements differ from the arrangements described above and in Question 7-23 in that one price for PCS is consistently charged throughout, and subsequent to, the deployment period (i.e., there is no reduced charge for PCS during the deployment period). Such arrangements are multiple-element arrangements that should be accounted for pursuant to the provisions of ASC 985-605-25-67 through 25-69. If the vendor has established VSOE of fair value for PCS, it may recognize revenue for the software license using the residual method at inception of the licensing arrangement, if all other revenue recognition criteria have been met. Fees received on expiration of the deployment period for licenses deployed in excess of the capped number should be accounted for similarly.

The following example illustrates these concepts:

Illustration 7-23: PCS is at VSOE rates during and after the unlimited deployment period

Facts

Vendor S sells to Customer A an unlimited deployment license for three years. If the total number of licenses deployed at the end of the three-year period exceeds 10,000, Customer A will pay additional license and PCS fees to continue to use the number of licenses in excess of that amount. PCS for each year within the three-year period is priced at 20% of the upfront net license fees for the initial transaction. PCS for any additional licenses purchased at expiration of the deployment period will also be based on 20% of the subsequent net license fees (i.e., PCS will be priced at 20% of the cumulative net license fees paid in periods subsequent to the expiration of the deployment period). Vendor S has determined that 20% of net license fees paid is VSOE of fair value for its PCS. The software is delivered on the date of the agreement and the stipulated PCS term begins upon that date.

Analysis

Vendor S has established VSOE for PCS and, therefore, should record the initial transaction using the residual method. Presuming that the initial year of PCS is bundled in the initial arrangement, the Company will defer 20% of the arrangement consideration as PCS revenue and recognize the residual amount as license revenue. If the customer has deployed more than 10,000 users by the end of the deployment period, the customer will pay Vendor S additional license and PCS fees if it wishes to continue to use the additional licenses. The amount received for any additional licenses purchased after the deployment period also will be recognized using the residual method (with 20% of the consideration received deferred as PCS revenue).

Arrangements to provide PCS on currently licensed products and any products licensed during the PCS period

Question 7-25 **Software vendors may enter into arrangements to provide PCS on any products licensed by the customer at the date of execution of the PCS arrangement, and any additional products licensed by the customer during the period that PCS services are to be provided. How should such arrangements be accounted for? How do such arrangements affect the accounting for license arrangements executed during the PCS period?**

As with any PCS arrangement, the fees for such arrangements should be recognized ratably over the period the PCS services are to be provided or in proportion to the amounts expected to be charged to expense as the PCS services are rendered.

Because the PCS arrangement specifically relates to any software licenses executed during the PCS period, we believe that any such licenses must be combined with the PCS arrangement and evaluated as a multiple-element arrangement pursuant to the provisions of the implementation guidance on multiple contracts or multiple-element arrangements in ASC 985-605-55-4 (see Question 5-2). How such PCS arrangements affect the accounting for any software licenses executed during the PCS period is dependent on whether the vendor has established VSOE of fair value for the PCS arrangement.

If a vendor regularly sells such contracts separately and is able to establish VSOE of fair value of the arrangements because a substantial majority of the prices of such contracts are within a narrow range, we believe any software license arrangements executed during the PCS period may be accounted for separately using the residual method of arrangement consideration allocation and revenue recognized on delivery of the licensed software to the customer (if all of the other basic revenue recognition criteria of ASC 985-605 have been met).

However, in our experience it would be rare for software vendors to establish VSOE of fair value for such PCS arrangements because they generally are entered into on a limited basis. If VSOE of fair value does not exist, we believe any consideration received on the execution of additional software licenses during the PCS period must be combined with the remaining PCS to be delivered and accounted for as one unit of accounting, with revenue recognized ratably over the remaining PCS period.

The following examples illustrate these concepts:

Illustration 7-24: Vendor has established VSOE of fair value of the PCS arrangement

Facts

On 1 July 20X4, a software vendor enters into an arrangement to provide PCS over a two-year period relating to licenses of Product A that the customer has previously purchased and on any additional copies of Product A the customer licenses during the two-year PCS period. Total fees for the PCS arrangement are $400,000.

The vendor offers such PCS arrangements as a normal service offering to customers that have purchased Product A licenses totaling at least $1 million. Based on a number of separate sales of such PCS arrangements, the vendor has established VSOE of fair value at $400,000.

On 31 March 20X5, the customer and vendor execute a license arrangement for an additional 10 copies of Product A for $200,000, which are delivered to the customer at execution.

Analysis

Because the vendor has established VSOE of fair value for the PCS arrangement and the remaining amount of deferred revenue at 31 March 20X5 represents VSOE of fair value for the remaining PCS services to be provided to the customer, the vendor may recognize the software license fees of $200,000 on 31 March 20X5 (if all of the other basic revenue recognition criteria of ASC 985-605 have been met).

Illustration 7-25: Vendor has not established VSOE of fair value of the PCS arrangement

Facts

Assume the same facts as Illustration 7-24 above, except that the vendor does not offer such arrangements as a regular service offering, but rather has negotiated this arrangement specifically with the customer. Because it has not separately sold such arrangements to other customers, the vendor is unable to establish VSOE of fair value for the PCS arrangement.

Analysis

Because the vendor has not established VSOE of fair value for the PCS arrangement, the software license fees of $200,000 received on 31 March 20X5 should be accounted for in connection with the remaining PCS period and recognized ratably over the period from 31 March 20X5 to 30 June 20X6.

Acquired PCS contracts with committed renewal rates

Question 7-26 **Software vendors may acquire other software companies and incorporate the products of the acquired entity into their product lines and pricing practices. If a software vendor increases the price of PCS provided to licensees of the acquired entity's products, but is unable to increase the price charged to certain customers due to contractual commitments made by the predecessor entity, how do such contracts affect the analysis of whether the vendor can establish VSOE of fair value of PCS?**

In such situations, if the vendor is honoring contractual commitments made by the predecessor entity, and the pricing of the PCS renewals for such customers is not a result of pricing decisions made by management of the acquirer, we believe such PCS renewals may be excluded from the vendor's VSOE of fair value analysis. To include such arrangements in the VSOE of fair value analysis might affect the determination of whether VSOE of fair value exists due to a lack of consistency in the pricing of PCS renewals. We believe that the intent of a VSOE of fair value analysis is to determine whether the pricing practices of the vendor result in similar prices being offered to similar customers when an element of an arrangement is sold separately. PCS renewal prices stipulated by contractual commitments entered into by management of a predecessor entity do not shed light on whether the pricing practices of the vendor result in such consistency (i.e., they do not aid in the evaluation of the pricing practices of the vendor, but are related to the pricing practices of the acquired entity).

However, if the vendor enters into a software licensing arrangement with a customer and is required to provide an initial PCS period in connection with the sale of the software license at a rate that is below VSOE of fair value as a result of contractual arrangements entered into by a predecessor entity, we believe the bundled PCS arrangement must still be accounted for using the vendor's VSOE of fair value of PCS. For example, if a vendor enters into a software licensing arrangement with a customer and must provide PCS at a rate of 10% of the software license fee per annum, and VSOE of fair value of PCS is 15%, the bundled initial PCS period should be accounted for at 15%.

Establishing separate VSOE of fair value for technical support and/or when-and-if-available upgrades

Question 7-27 **A vendor offers PCS services that only include when-and-if-available upgrades/enhancements and provides no technical support (this type of PCS is customarily limited to arrangements with resellers). Similarly, a vendor also may provide technical support exclusive of when-and-if available upgrades? Can VSOE of fair value be established for these offerings?**

VSOE of fair value for these services may be determined if a sufficient population exists to demonstrate consistency of pricing. However, if the service offerings are never sold separately, VSOE of fair value cannot be established. For example, if technical support only is sold to customers that have previously purchased and renewed the right to receive when-and-if-available upgrades/enhancements exclusive of technical support, VSOE of fair value cannot be established for the offering because it is never sold separately. In such cases, VSOE of fair value of an element may not be established by "solving for" a residual amount.

Timing of PCS revenue recognition

Question 7-28 **Certain software vendors recognize PCS revenues (either accounted for as separate unit of accounting or bundled with license fees from perpetual or time-based licenses) on a basis other than a strict "per day" basis. For example, certain vendors use a "mid-month" convention, whereby one full month of revenue is recognized during the month for an arrangement commencing prior to the middle of the month. Conversely, no revenue is recognized during the month for an arrangement commencing subsequent to the middle of the month. Are such conventions an acceptable accounting policy?**

Such conventions are acceptable if it can be demonstrated they result in 1) an amount of revenue materially equivalent to that which would have been recognized using a strict "per day" basis in all financial reporting periods and 2) an immaterial cumulative impact to the vendor's reported balance sheets.

Evaluation of miscellaneous provisions of PCS arrangements

Question 7-29 **PCS arrangements may include the following provisions:**

1. **Optional PCS renewals must be purchased for all licensed software or the customer must choose not to renew PCS (i.e., PCS renewals must occur on an "all-or-nothing" basis). For example, if a customer has licensed 1,000 seats of a software product, it cannot elect to discontinue PCS for a portion of the licensed seats (e.g., it cannot discontinue PCS on 500 of the 1,000 licensed seats). The customer may formally terminate the licenses to a number of seats and purchase PCS for the remaining seats, but if it wishes to simply cancel PCS and retain licenses on an unsupported basis, all licenses must be unsupported.**
2. **Continued renewal of PCS entitles the customer to purchase additional software products or services from the vendor at a stated price for a stated period (a "price hold").**
3. **Customer's right to deploy an unlimited number of users of licensed software (see Question 7-24) continues as long as the customer renews PCS.**

How should a vendor account for such provisions when included in a PCS arrangement?

Vendors should account for the provisions described above as follows.

1. The requirement to renew PCS on an all-or-nothing basis generally is included in arrangements by a software vendor to lower the risk of "cancel-and-replace" transactions by removing the ability of customers to selectively terminate PCS for software licenses and then subsequently negotiate buydowns on reinstated PCS. As long as PCS renewals are optional, the inclusion of this provision in an arrangement generally does not have accounting consequences. Specifically, we believe that the inclusion of such a provision in a PCS arrangement should not result in PCS being viewed as non-cancelable and coterminous with the related software license.
2. If an arrangement allows customers to acquire additional goods or services at their option, an assessment should be made as to whether the specified additional products or services have been priced at a significant and incremental discount. If the prices contain a significant and incremental discount, the discount should be accounted for separately (see Questions 5-4 and 5-6). Linkage of the right to maintain the price hold to renewal of PCS does not otherwise affect the accounting for the PCS arrangement.
3. If a customer does not lose any rights to licensed software deployed prior to a decision not to renew PCS and PCS renewals are optional, the inclusion of this provision in an arrangement generally does not have accounting consequences. Specifically, we believe that the inclusion of such a provision in a PCS arrangement should not result in PCS being viewed as non-cancelable and coterminous with the related software license.

VSOE of fair value of PCS for new products

Question 7-30 **Can VSOE of fair value of PCS be established for new products introduced by a vendor prior to actual PCS renewals occurring?**

We believe VSOE of fair value of PCS for newly introduced products may be established prior to the occurrence of actual PCS renewals in the following circumstances:

- Management with the relevant authority has established the price for PCS on renewal
- The vendor has entered into a number of software licensing arrangements that contractually specify the PCS renewal rate

As discussed in Question 3-4, we believe it generally will be rare that a vendor will be able to establish VSOE of fair value solely through reference to a price set by management having the relevant authority because it is often very difficult to assess the likelihood that a price established by management will not change once the product or service is sold separately. However, if a vendor has entered into a number of software licensing arrangements that contractually specify a PCS renewal rate consistent with the price set by management having the relevant authority, this may provide sufficient evidence that it is unlikely the price established by management will change once PCS is renewed. Determining when a vendor has entered into a sufficient number of software licensing arrangements that specify a PCS renewal rate to support a conclusion that it is unlikely the rate will change once actual renewals occur requires the use of professional judgment.

If a vendor concludes VSOE of fair value exists for PCS prior to the occurrence of actual renewals based on the criteria above, and actual PCS renewals are subsequently inconsistent with the price established by management and included in the software licensing arrangements (i.e., PCS is not renewed at the contractually specified rate), we believe there is a rebuttable presumption that VSOE of fair value was never established for PCS. In such cases, any arrangements previously accounted for as if VSOE of fair value did exist generally should be evaluated as errors. Material errors included in previously issued financial statements should be reported as prior-period adjustments by restating the prior period financial statements in accordance with the guidance provided by ASC 250, *Accounting Changes and Error Corrections*.

Once PCS renewals occur, the determination of whether VSOE of fair value of PCS exists should be based on an analysis of the PCS renewal activity.

7.4 Upfront recognition of PCS

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-71

Postcontract customer support revenue may be recognized together with the initial licensing fee on delivery of the software if all of the following conditions are met:

a. The postcontract customer support fee is included with the initial licensing fee.

b. The postcontract customer support included with the initial license is for one year or less.

c. The estimated cost of providing postcontract customer support during the arrangement is insignificant.

d. Unspecified upgrades or enhancements offered during postcontract customer support arrangements historically have been and are expected to continue to be minimal and infrequent.

985-605-25-72

If postcontract customer support revenue is recognized upon the delivery of the software, the vendor shall accrue all estimated costs of providing the services, including upgrades or enhancements. Upgrades or enhancements are not developed solely for distribution to postcontract customer support customers; revenues are expected to be earned from providing the enhancements to other customers as well. Therefore, costs shall be allocated between postcontract customer support arrangements and other licenses.

985-605-25-73

A determination that unspecified upgrades or enhancements offered during the postcontract customer support arrangement are expected to be minimal and infrequent shall be evidenced by the patterns of minimal and infrequent unspecified upgrades or enhancements offered in previous postcontract customer support arrangements. A conclusion that unspecified upgrades or enhancements are expected to be minimal and infrequent shall not be reached simply because unspecified upgrades or enhancements have been or are expected to be offered less frequently than on an annual basis. Regardless of the vendor's history of offering unspecified upgrades or enhancements to initial licensees, postcontract customer support shall be accounted for separately from the initial licensing fee if the vendor expects to offer upgrades or enhancements that are greater than minimal or more than infrequent to the users or resellers of the licensed software during the postcontract customer support arrangement.

Recognition of PCS revenues on delivery of licensed software

Question 7-31 **ASC 985-605-25-71 provides certain criteria which, if met, permit PCS revenues to be recognized at the time licensed software is delivered to a customer (if all of the other basic revenue recognition criteria of ASC 985-605 have been met). To what types of software licensing arrangements are these criteria generally applicable?**

Determining whether PCS may be recognized on delivery of licensed software is necessarily dependent on the facts and circumstances. However, when PCS renewals are offered and typically accepted by customers, we believe it would be inappropriate for a vendor to assert that PCS meets the criteria for up-front revenue recognition. We believe software licensing arrangements to which the criteria of ASC 985-605-25-71 apply typically are limited to licenses of pre-packaged or shrink-wrapped software where 1) any telephone support to the customer is provided within a short time frame following purchase of the software license (within one year or less) and 2) significant upgrades/enhancements to the licensed software typically are not provided.

In such cases, the vendor may be able to readily demonstrate that the costs of providing PCS during the arrangement are insignificant. However, in other situations, evaluation of this criterion may not be straightforward. In the latter cases, the evaluation of the total costs of PCS should consider the cost of developing upgrades and enhancements, the cost of developing and releasing bug fixes under warranty provisions and the cost of fulfilling any other support services provided to the customer. Additionally, whether upgrades/enhancements are expected to be minimal and infrequent must be assessed (see Question 7-32).

We believe the determination of whether PCS may be recognized on delivery of licensed software should be made separately for each PCS contract for each product. The assessment of whether the criteria of ASC 985-605-25-71 are met should be applied at the beginning of each initial and renewal license period (for time-based licenses) and once the accounting is determined, it should not be changed during the PCS period.

The following example illustrates these concepts:

Illustration 7-26: Recognition of PCS on delivery of the license software

Facts

A software vendor markets shrink wrap products through retailers and its website. It provides PCS to customers comprised of phone support for questions relating to installation of licensed software and compatibility with various operating systems. All phone support generally is provided within six months of customers' purchases.

The vendor periodically releases updates for minor bug fixes which may be downloaded from its website free of charge. No other upgrades/enhancements are provided to licensed software.

The vendor has a process for monitoring its PCS costs on a product by product basis. PCS costs, when expressed as a percentage of revenue for the related products, have historically been less than 5% of revenue. Costs are expected to approximate this level in the future.

Analysis

The vendor may recognize revenue relating to PCS on delivery of licensed software, if all of the other basic revenue recognition criteria of ASC 985-605 have been met. The estimated cost of providing the PCS should be accrued at the time of sale.

Minimal and infrequent upgrades/enhancements

Question 7-32 **What factors should be considered when determining whether upgrades/enhancements have been and are expected to be minimal and infrequent?**

The determination of whether upgrades/enhancements have been and are expected to continue to be minimal and infrequent should be based on the relevant facts and circumstances. However, we believe this criterion is a very stringent test. Neither a history of nor an expectation of offering unspecified upgrades/enhancements less frequently than on an annual basis is sufficient to support an assertion that unspecified upgrades/enhancements are minimal and infrequent. Rather, we believe that such an assertion must be supported by evidence of a historical pattern of minimal unspecified upgrades/enhancements offered in previous PCS arrangements. Further, we believe this generally should be limited to the infrequent release of upgrades and enhancements to correct minor bugs or errors in previously licensed software. Accordingly, we believe it will be rare that PCS arrangements will meet these criteria.

In assessing whether or not unspecified upgrades/enhancements will be minimal and infrequent, we believe consideration should be given to past and continuing efforts to develop upgrades/enhancements of the product as well as the level of expenditures to develop the unspecified upgrades/enhancements. For example, significant research and development expense on an unspecified upgrade/enhancement would be inconsistent with an assessment that upgrades/enhancements are expected to be minimal and infrequent. Additionally, regardless of a vendor's history of offering unspecified upgrades/enhancements on a minimal and infrequent basis, if it expects to offer unspecified upgrades/enhancements that are greater than minimal or more than infrequent, PCS revenue should not be recognized on delivery of licensed software.

The following example illustrates these concepts:

Illustration 7-27: Upgrades/enhancements are not minimal or infrequent

Facts

A software vendor enters into an arrangement to sell product A bundled with one year of PCS to Customer T for $1,000,000. The vendor has a history of releasing upgrades/ enhancements once a year, and it anticipates that this practice will continue. These upgrades/enhancements have been limited to increasing the speed and memory of the software. VSOE of fair value of PCS exists and approximately 70% of customers renew PCS.

Analysis

In this illustration, the upgrades/enhancements are not considered minimal because the vendor has a history of releasing upgrades/enhancements that increase the functionality of the software. Additionally, upgrades/enhancements are not infrequent because they are released on an annual basis, and the vendor anticipates continuing to release such upgrades/enhancements on such a basis. Accordingly, the vendor should not recognize PCS revenues at the time the licensed software is delivered to customers.

7.5 Postdelivery telephone support at no additional charge

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-74

Postdelivery telephone support provided to users by the vendor at no additional charge shall be accounted for as postcontract customer support, in conformity with this Subtopic, regardless of whether the support is provided explicitly under the licensing arrangement. Although such telephone support may be offered or available for periods exceeding one year, if the vendor has established a history of providing substantially all the telephone support within one year of the licensing or sale of the software, the postcontract customer support may be considered to have a term of one year or less in applying paragraph 985-605-25-71(b). Accordingly, revenue allocable to telephone support may be recognized together with the initial licensing fee on delivery of the software if all the conditions in paragraph 985-605-25-71 are met. This provision applies only to telephone support provided at no additional charge. If revenue allocable to telephone support is recognized together with the licensing fee on delivery, the vendor shall accrue the estimated cost of providing that support.

Free phone support provided to customers

Question 7-33 **If a vendor does not charge separately for PCS, and only provides postdelivery phone support, should the free phone support be considered PCS that should be accounted for as an element included in a multiple-element arrangement?**

Free telephone support provided after the delivery of the software generally should be accounted for as PCS, even if the telephone support is provided pursuant to an implied PCS arrangement. However, if the vendor has established a history of providing substantially all the telephone support within one year of licensing the software, the PCS may be considered to have a term of one year or less (for purposes of determining if PCS revenue may be recognized on delivery of the software) even though the telephone support may be offered or available for more than one year. If the revenue allocated to the telephone support meets all of the other criteria of ASC 985-605-25-71 for up-front revenue recognition, all estimated costs of providing the telephone support should be accrued at the time the revenue is recognized.

We believe vendors wishing to assert that substantially all telephone support is provided within one year or less of execution of software licensing arrangements should implement a monitoring system to measure the amount and timing of support provided to customers relative to the timing of the delivery of licensed software to demonstrate that substantially all the telephone support is provided within one year of delivery of the software.

7.6 Reseller PCS

In arrangements with resellers, distributors, OEMs, etc. (herein collectively referred to as resellers) often it is difficult to determine the extent of PCS provided by software vendors to the resellers. The arrangements with resellers may not specifically address PCS and/or the types of PCS services provided to resellers, and the PCS provided to resellers may differ from the PCS services provided to end users.

Vendors may directly provide PCS to resellers of its products, to end users or to both. Even if PCS is not provided directly to end users, because resellers typically do not engage in the business of enhancing a vendor's product for resale, a vendor may be responsible for providing PCS to resellers to support PCS provided by the resellers to end users.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-75

An arrangement in which a vendor grants a reseller the right to provide unspecified upgrades or enhancements to the reseller's customers is an implied postcontract customer support arrangement between the vendor and the reseller, even if the vendor does not provide direct telephone support to the reseller's customers. If sufficient vendor-specific objective evidence does not exist to allocate the fee to the software and the postcontract customer support, the vendor shall recognize revenue from both the licensing arrangement and the postcontract customer support ratably over the period during which postcontract customer support is expected to be provided.

Accounting for PCS in reseller arrangements that are silent regarding PCS

Question 7-34 **If a software licensing arrangement with a reseller is silent regarding PCS, what factors would indicate that implied PCS exists in the arrangement?**

Arrangements with resellers may not address whether the vendor is obligated to provide PCS to the reseller and/or who will provide PCS to end users of the licensed software. In such cases, vendors often may assert that PCS is provided to the end user by the reseller and that PCS is not provided to the reseller.

However, in our experience, PCS provided to end users by resellers typically is limited to phone support (often referred to as Level 1 support because the reseller responds to the first call placed by end users). Although the reseller generally is sufficiently trained to use and understand the vendor's software and can resolve many inquiries from customers, some are referred back to the vendor because they are beyond the technical expertise of the reseller (often referred to as Level 2 support as it relates to the second point in the PCS service). Additionally, when-and-if-available upgrades/enhancements are developed and released only by the vendor but are provided to end users (either directly by the vendor or indirectly through the reseller). When Level 2 support and when-and-if-available upgrades/enhancements are provided to the end users by the reseller based on PCS provided to the reseller by the vendor, this should be accounted for as implied PCS provided to the reseller by the vendor.

We believe that limited situations may exist where the vendor does not provide PCS to resellers or the PCS provided to resellers is immaterial (e.g., sales of shrink-wrapped software to a retailer). In such cases, if the criteria in ASC 985-605-25-71 through 25-74 are satisfied, PCS revenues may be recognized in connection with software licensing fees.

Establishing VSOE of fair value of PCS in a reseller arrangement

Question 7-35 **Can resellers be considered a separate customer class for purposes of determining whether VSOE of fair value of PCS exists?**

We believe that in cases where the PCS services provided to resellers are different from the PCS services provided to end users it is appropriate to consider resellers a separate customer class (see Question 7-13) when evaluating whether VSOE of fair value of PCS exists (see Question 7-11). We believe this is appropriate because resellers often perform part of the PCS services provided to end users (see Question 7-34).

In connection with licenses of software products to an original equipment manufacturer (OEM) that embeds the software on a hardware device and then sells the device to third parties, we have seen PCS arrangements that do not provide technical support but which entitle the OEM to upgrades on a when-and-if-available basis. These arrangements are frequently structured as an upfront license fee paid to the vendor for the right to an unlimited amount of licenses over a stated term. PCS may be bundled with the software license for the first year of the arrangement, with optional PCS renewal periods for the remainder of the license term. Provided the software vendor has a sufficiently large population of transactions to establish VSOE of fair value for this PCS service pursuant to the provisions of the implementation guidance on PCS in multi-year time-based licenses included at ASC 985-605-55-62 and 55-63 (see Question 7-20), revenue for the license fee may be recorded on delivery, if all of the other basic revenue recognition criteria of ASC 985-605 have been met.

VSOE of fair value of PCS does not exist in a reseller arrangement

Question 7-36 **If a software licensing arrangement executed with a reseller includes PCS (either express or implied), how should revenue be recognized for the arrangement if VSOE of fair value of PCS does not exist?**

When VSOE of fair value of PCS does not exist in a reseller arrangement the fee should be recognized ratably over the PCS period once PCS is the only undelivered element and all of the other basic criteria for revenue recognition have been met.

8 Services

8.1 Chapter summary

Many software arrangements include software as well as services other than PCS such as training, installation, implementation support, software design or development or customization and modification of licensed software (referred to herein as "services"). When arrangements include services beyond PCS, a vendor must determine whether those services are within the scope of the guidance in ASC 985-605. (Note, this discussion presumes the entity has already concluded that the software and software-related elements are within the scope of this guidance.) A service is within the scope of ASC 985-605 if software in the arrangement is essential to the functionality of that service. The guidance covered in this chapter should be considered when accounting for such services.

If the vendor concludes the services are not within the scope of ASC 985-605, the vendor would apply the multiple-element arrangements revenue recognition guidance in ASC 605-25 to identify the separate units of accounting and to allocate the arrangement consideration between the software and non-software elements.

If a software licensing arrangement requires significant production, modification or customization of the software, the entire arrangement should be accounted for using contract accounting as discussed in Chapter 9. However, if a software licensing arrangement includes software-related services such as training, installation or similar services that do not involve significant production, modification or customization of the licensed software, the vendor should determine whether those service elements can be accounted for separately.

In order to separately account for services which do not involve significant production, modification or customization of the licensed software:

- VSOE of fair value of the services must exist
- The services must not be essential to the functionality of any other element of the transaction
- The services must be described in the contract such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services

If these criteria are met, arrangement consideration should be allocated to services in the same manner as it is allocated to other elements of a multiple-element arrangement (i.e., based on VSOE of fair value of the elements). Amounts allocated to services should be recognized as revenue as the services are performed or on a straight-line basis over the service period if no other pattern of performance is discernible.

8.2 Determining if services can be accounted for as a separate element in the arrangement

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-76

Certain arrangements include both software and service elements (other than postcontract customer support-related related services). The services may include training, installation, or consulting. Consulting services often include implementation support, software design or development, or the customization or modification of the licensed software.

985-605-25-77

If an arrangement includes such services, a determination shall be made as to whether the service element can be accounted for separately as the services are performed. Paragraph 985-605-25-78 discusses the criteria that must be considered in making such a determination. If the nature of the services is such that the service element does not qualify for separate accounting as a service, contract accounting shall be applied to both the software and service elements included in the arrangement. Paragraphs 985-605-25-88 through 25-107 address the application of contract accounting to software arrangements.

985-605-25-78

To account separately for the service element of an arrangement that includes both software and services, sufficient vendor-specific objective evidence of fair value shall exist to permit allocation of the revenue to the various elements of the arrangement (as discussed in paragraphs 985-605-25-6 through 25-7 and 985-605-25-9 through 25-11). Additionally, both of the following conditions shall be met:

a. The services are not essential to the functionality of any other element of the transaction.

b. The services are described in the contract such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services.

Revenue recognition for services when VSOE of fair value does not exist

Question 8-1 **If VSOE of fair value of services included in a software licensing arrangement does not exist, is the entire arrangement subject to contract accounting in accordance with ASC 985-605-25-77?**

ASC 985-605-25-78 states that if an arrangement includes software and services, the services should be accounted for separately if 1) sufficient VSOE of fair value exists to permit allocation of the arrangement consideration to the various elements of the arrangement (see Question 8-2), 2) the services are not essential to the functionality of any other element of the transaction (see Question 8-3) and 3) the services are described in the contract such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services (see Question 8-4). ASC 985-605-25-77 states that if these criteria are not met, contract accounting must be applied to both the software and service elements included in the arrangement (see Chapter IX).

Some have interpreted these paragraphs to mean arrangements including services that fail the separability criteria of ASC 985-605-25-78 solely due to a lack of VSOE of fair value (i.e., services that are not essential to the functionality of other elements of the arrangement and are described in a manner such that the total arrangement fees would be expected to vary based on their inclusion or exclusion) should be accounted for using contract accounting. However, we believe that such arrangements should not be accounted for using contract accounting.

We believe paragraphs ASC 985-605-25-88 through 25-107 clearly contemplate situations in which the services are related to significant production, modification or customization of the licensed software. This is supported by ASC 985-605-25-80, which states that "(i)f vendor-specific objective evidence of the fair value does not exist to allocate a portion of the fee to the service element, and the only undelivered element is services that do not involve significant production, modification, or customization of the software (for example, training or installation), the entire arrangement fee shall be recognized as the services are performed" (see Question 8-8 and 8-9).

Additionally, the use of contract accounting would be inconsistent with prior SEC staff comments regarding the inapplicability of ASC 605-35 to service contracts. In 2002 at the 30th Annual AICPA National Conference on Current SEC Developments, the SEC staff noted that long-term service contracts often include multiple deliverables that should be evaluated for separation in accordance with the multiple-elements arrangement guidance in ASC 605-25. The SEC staff discussed the implications of ASC 605-25 when software contracts within the scope of ASC 985-605 involve significant production, modification or customization of the software, as well as "non-construction-related activities." The SEC staff indicated that ASC 605-25-15-3A requires a software vendor to evaluate whether the "construction-related activities" within the scope of ASC 605-35 should be separated from "non-construction activities" that are outside the scope of ASC 605-35.

Accordingly, we believe that if sufficient VSOE of fair value does not exist to permit the allocation of revenue between software and services, and the only undelivered element is services that are not essential to the functionality of other elements of the arrangement and are described in a manner such that the total arrangement fees would be expected to vary based on their inclusion or exclusion, the entire arrangement fee should be recognized as the services are performed, or on a straight-line basis over the service period if no other pattern of performance is discernible.

Determining VSOE of fair value for services

Question 8-2 **How should a software vendor determine whether vendor-specific objective evidence of fair value exists for services?**

ASC 985-605-25-6 provides that VSOE of fair value is limited to the price charged when an element is sold separately or, for an element not yet being sold separately, the price established by management having the relevant authority. ASC 985-605-25-6 also states that "the fee shall be allocated to the various elements based on vendor-specific objective evidence of fair value, regardless of any separate prices stated within the contract for each element."

The two common methods used to establish VSOE of fair value of services included in software licensing arrangements are as follows:

- If a vendor sells the same services on a standalone basis for a fixed fee, the amounts charged in the standalone transactions can be used to determine VSOE of fair value for services included in a multiple-element software licensing arrangement. In order to apply this method, the fixed fee charged for similar separate transactions should be within a reasonably narrow range.

The following example illustrates these concepts:

Illustration 8-1: VSOE of fair value for services based on a fixed fee

Facts

A software vendor enters into an arrangement to provide a customer with a 3-year license of Product X and 100 hours of training for $200,000. The arrangement fee is due on delivery of the software, and the software can be used immediately on delivery. The training is described in the contract as a separate element of the transaction, and the contract indicates that additional training can be purchased at the standard price for training when sold separately. VSOE of fair value for the training is determined to be $25,000 based on standalone sales of 100 hour blocks of training.

The training is not essential to the functionality of the software and is described in the contract such that the total price of the arrangement would be expected to vary as a result of the exclusion of the services.

Analysis

Because VSOE of fair value for the training exists based on the separate sales of the training services at a fixed fee for 100 hours and the training is not essential to the functionality of the licensed software, the services should be accounted for separately from the software. The vendor should allocate arrangement consideration of $25,000 to the undelivered training at inception of the arrangement, which should be recognized as the training services are performed. If all of the other basic revenue recognition criteria of ASC 985-605 have been met, the residual amount of arrangement consideration of $175,000 may be recognized on delivery of the software.

- If a software vendor sells the same services separately on a time-and-materials basis, the rate charged when services are sold separately can be multiplied by the estimated number of hours necessary to complete the services in a multiple-element arrangement to determine VSOE of fair value for the service element. To apply this method, the vendor must have the ability to establish a reasonably dependable estimate of the number of hours required to complete the services.

The following example illustrates these concepts:

Illustration 8-2: VSOE of fair value for services based on a time-and-materials basis

Facts

Assume the same facts as the Illustration 8-1 above, except that the vendor sells training services on a standalone basis at a rate of $200 per hour and has established this amount as VSOE of fair value for training services.

Analysis

Because VSOE of fair value of the training exists based on separate sales of the training services at a rate of $200 per hour, the vendor is able to reliably estimate the number of hours of training to be provided to the customer (based on the contractually stipulated amount) and the services are not essential to the functionality of the licensed software, the services should be accounted for separately from the software. The vendor should allocate arrangement consideration of $20,000 (100 hours multiplied by the hourly rate of $200 per hour) to the undelivered training at inception of the arrangement, which should be recognized as the training services are performed. If all of the other basic revenue recognition criteria of ASC 985-605 have been met, the residual amount of arrangement consideration of $180,000 may be recognized on delivery of the software.

Services essential to the functionality of other elements

Question 8-3 **When should services included in a software licensing arrangement be considered "essential to the functionality" of any other element of the arrangement?**

The following factors are identified in ASC 985-605-25-84 as indicators that services are essential to other elements included in a multiple-element software licensing arrangement and, therefore, should not be accounted for as a separate element of the arrangement:

- *The software is not "off-the-shelf" software.* ASC 985-605-25-83 notes that contract accounting would apply to both the software and service elements of an arrangement that includes core software or off-the-shelf software requiring significant alterations of features and functionality. Question 8-10 discusses differences between off-the-shelf software and core software and the effect of that determination on whether licensed software and the related services should be accounted for using contract accounting.

- *The services include significant alterations to the features and functionality of the off-the-shelf software*. Question 8-11 discusses factors to consider when determining if services involve significant alteration of the features and functionality of the off-the-shelf software.
- *Building complex interfaces is necessary for the vendor's software to be functional in the customer's environment*. Factors to consider when determining whether services involve creating "complex interfaces" are discussed in Question 8-12.
- *The timing of payments for the software is coincident with performance of the services.* When payments for amounts related to the software element of an arrangement become due as services are performed, this is a strong indicator the services are essential to the functionality of the software. Further, when payment terms for amounts relating to licensed software are beyond the normal payment terms for that software when it is sold separately, this is a strong indicator that the services are essential to the functionality of the software.

  Conversely, if a portion of the arrangement fee attributable to the service element of an arrangement (based on VSOE of fair value of the services) is not due until the services are performed, this may be indicative that the services are not essential to the functionality of the software. For example, in an arrangement with total consideration of $100,000, if $95,000 is due on delivery of the software and $5,000 is due on completion of installation, and these payment terms are consistent with the VSOE of fair value of the installation services, this may indicate that installation is not essential to the functionality of the licensed software.
- *Milestones or customer-specific acceptance criteria affect the realizability of the software-license fee.* When all or a portion of the software license fee is either a) paid up-front but refundable if certain service milestones or customer-specific acceptance criteria associated with services included in the arrangement are not achieved or b) payable only on the achievement of service milestones or customer-specified acceptance criteria, this is a strong indicator the services are essential to the functionality of the software.

The following excerpt from the implementation guidance in ASC 985-605 provides examples of the application of these criteria.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Example 8: Multiple-Element Arrangements — Products and Services

985-605-55-169

The following Cases illustrate the guidance in paragraphs 985-605-25-76 through 25-85:

a. Implementation services (Case A)

b. More than minor modifications (Case B)

c. Implementation services not customarily sold separately (Case C)

985-605-55-170

In Cases A, B and C, a vendor has entered into an arrangement to provide a customer with its **off-the-shelf software** product and related implementation services.

Case A: Implementation Services

985-605-55-171

The software and service elements of the contract are stated separately and the vendor has a history of selling these services separately such that the revenue allocation criteria of paragraphs ASC 985-605-25-3 through 25-14 can be satisfied. The software license fees are due under the vendor's normal trade terms, which are net 30 days. The services are expected to be provided over the next 90 days and are of the type performed routinely by the vendor. The features and functionality of the software are not altered to more than a minor degree as a result of these services.

985-605-55-172

In this Case, the vendor would recognize the license revenue allocated to the software element upon its delivery and the revenue allocated to the service element as such services are performed.

985-605-55-173

When license arrangements have multiple elements, revenue shall be allocated to each of the elements and recognized when the related element is delivered and all of the following conditions exist:

a. The undelivered elements are not essential to the functionality of the delivered elements.

b. The revenue allocated to the delivered elements is not subject to forfeiture, refund, or other concession if the undelivered elements are not delivered.

c. Sufficient vendor-specific objective evidence exists to allocate separate prices to each of the elements.

985-605-55-174

The service element in this arrangement is not deemed to be essential to the functionality of the software element because the features and functionality of the software are not altered to more than a minor degree as a result of the services.

Case B: More than Minor Modifications

985-605-55-175

In this Case, the vendor agrees to make more than minor modifications to the functionality of the product to meet needs as defined by the user. The software and service elements of the contract are stated separately and the vendor has a history of selling these services separately such that the revenue allocation criteria of paragraphs 985-605-25-3 through 25-14 can be satisfied. Payment terms are 10% upon installation of the software, with the remainder according to a time line, and the final 25% withheld until acceptance. The desired modifications are not unusual; the vendor has made similar modifications to the product many times and is certain that the planned modifications will meet the user's needs.

985-605-55-176

The vendor would follow the guidance on contract accounting (using either the percentage-of-completion or completed-contract method, depending on the facts and circumstances) included in ASC 985-605-25-88 through 25-107.

The new conditions would preclude service transaction accounting because the functionality of the software product is being altered in more than a minor way, the payment of the fees is coincident with the services being performed, and the software is subject to the user's unique acceptance criteria.

Case C: Implementation Services Not Customarily Sold Separately

985-605-55-177

Assume the same transaction as described in Case A, except that the vendor never sells implementation services separately. The implementation services do not involve significant customization of the software.

985-605-55-178

The vendor would recognize all revenue from the arrangement over the 90 day period during which the services are expected to be performed, commencing with delivery of the software product.

985-605-55-179

The criteria for vendor-specific objective evidence of the fair value require that the element be sold separately or be planned to be sold separately. Because implementation services are neither sold separately nor planned to be sold separately, and upon delivery of the software product such services are the only undelivered elements, paragraph 985-605-25-80 requires that all revenue be recognized over the period during which the implementation services are expected to be provided.

Total price expected to vary as a result of the inclusion or exclusion of services

Question 8-4 **What factors should be considered when determining if services are described in a software licensing arrangement such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services? Is it necessary for the contract to state a separate price for the services for such a conclusion to be reached?**

The strongest indicator that the total price of an arrangement would be expected to vary as a result of the inclusion or exclusion of services is to separately describe the services, and state the price for such services, in the contract. In addition, offers to the customer for the arrangement with or without services for differing total fees indicate the price would be expected to vary.

However, in deliberating the software revenue recognition guidance, the AcSEC indicated their belief that a service element need not be priced separately in order to account for the services separately. If the contract does not separately state a price for the service element, the services must be described in the contract such that the total price of the arrangement would be expected to vary depending on whether the services were included or excluded from the arrangement. In order to meet this requirement, the services should be separately described in the contract such that the services are easily identifiable as a separate element.

A vendor's history of selling these services separately also provides support that the total price would be expected to vary with the exclusion or inclusion of the services from the arrangement.

The following example illustrates these concepts:

Illustration 8-3: Total price expected to vary as a result of the inclusion of the services

Facts

A software vendor enters into an arrangement to provide a customer with a three-year time-based license of Product X, co-terminus PCS and 100 hours of training for $200,000. The arrangement fee is due on delivery of the software. The software can be used immediately on delivery (i.e., the training services are not essential to the functionality of the licensed software). The training is described in the contract as a separate element of the transaction, and the contract indicates that additional training can be purchased at the vendor's standard price for training when those services are sold separately.

Analysis

The service element of this arrangement is not essential to the functionality of the licensed software and is described in the contract such that the total price of the arrangement would be expected to vary as a result of the inclusion or exclusion of the services. In addition, VSOE of fair value for the services exists. Therefore, the services should be accounted for separately from the software.

8.3 Allocating and recognizing revenue for a separate service element

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-79

If an arrangement includes services that meet the criteria of paragraph 985-605-25-78 for separate accounting, revenue shall be allocated among the service and software elements of the contract. This allocation should be based on vendor-specific objective evidence of fair values. (Fair values are not necessarily the same as any separate prices stated for the separate elements of the arrangement.) Revenue allocated to the service element shall be recognized as the services are performed or, if no pattern of performance is discernible, on a straight-line basis over the period during which the services are performed.

985-605-25-80

If vendor-specific objective evidence of the fair value does not exist to allocate a portion of the fee to the service element, and the only undelivered element is services that do not involve significant production, modification, or customization of the software (for example, training or installation), the entire arrangement fee shall be recognized as the services are performed. If no pattern of performance is discernible, the entire arrangement fee shall be recognized on a straight-line basis over the period during which the services are performed.

Allocation of revenue between services and software

Question 8-5 **If services included in a software licensing arrangement meet the criteria for separate accounting pursuant to ASC 985-605-25-78, how should a software vendor allocate arrangement consideration between the services and other elements included in the arrangement? How should revenue be recognized for the various elements?**

If an arrangement includes services that meet the criteria for separate accounting, arrangement consideration should be allocated to services in the same manner it is allocated to other elements of a multiple-element arrangement — based on VSOE of the fair value of the elements. Revenue should be recognized for the elements as is appropriate based on the provisions of ASC 985-605. For services, revenue should be recognized as the services are performed (see Question 8-6).

Revenue recognition for services that are accounted for separately

Question 8-6 **If services included in a software licensing arrangement meet the criteria for separate accounting pursuant to ASC 985-605-25-78, how should the vendor recognize revenue for the services? Should revenue be recognized using the percentage-of-completion method of contract accounting in accordance with ASC 605-35?**

According to ASC 985-605-25-79, arrangement consideration allocated to services that can be accounted for separately from other elements of a software licensing arrangement should be recognized as the services are performed or on a straight-line basis over the service period if no other pattern of performance is discernible. We believe this should be interpreted to mean that services that should be accounted for separately pursuant to the provisions of ASC 985-605-25-78 should be accounted for in a manner similar to the accounting typically applied to service contracts that are outside of the scope of ASC 985-605.

Accounting principles that specifically address the accounting for service contracts are currently limited. The FASB's 1978 Invitation to Comment, *Accounting for Certain Service Transactions* (1978 Invitation to Comment), offered a framework for the accounting for service transactions but was never issued as a final statement. Although reference to the definition of a service transaction and the proposed methods to account for such transactions included in the 1978 Invitation to Comment may be helpful when determining the appropriate revenue recognition for service contracts, the 1978 Invitation to Comment does not provide authoritative guidance.

Accordingly, the revenue recognition criteria in SAB Topic 13 generally are applied when accounting for service transactions that are not specifically addressed by other authoritative literature.

Depending on the service to be provided, performance may occur with the execution of a defined act or acts or occur with the passage of time. Accordingly, revenue from service transactions generally should be recognized using one of the following methods:

- *Specific performance method* — Performance consists of the execution of a single act and revenue is recognized when that act takes place.
- *Proportional performance method* — Performance consists of the execution of more than one act and revenue is recognized based on the proportionate performance of each act in relation to all acts to be performed.
- *Completed performance method* — In certain cases, services may be performed in more than a single act, but the proportion of services performed in the final act is so significant that the customer realizes value from the transaction only when and if the final act is performed. In such cases, performance should be deemed to have occurred, and revenue recognized, when that act takes place.

Software vendors providing services that can be accounted for separately generally recognize revenue using the proportional performance method as the contracted services are provided to the customer or on a straight-line basis over the service period if no pattern of performance is discernible (which is consistent with the provisions of ASC 985-605-25-79).

When services revenues are recognized using the proportional performance method, SAB Topic 13 indicates that revenue should be recognized as services are provided over the term of the contract (i.e., as outputs are provided to the customer) rather than based on the level of costs incurred during the contract (SAB Topic 13.A.3(f), Question 2). In that Question, the SEC staff observed that the level of effort, or cost, incurred by a service provider generally does not correspond to the level of service provided. The SEC staff indicated they generally will object to the application of a revenue recognition method intended to accelerate revenue to better match the expected pattern of contractual costs (i.e., based on an input measure similar to those described in ASC 605-35 — see discussion below).

Application of the proportional performance method to service transactions may result in a revenue recognition pattern that essentially is based on the percentage-of-completion of the total amount of services to be provided. However, it is inappropriate to recognize the costs associated with the services in the same manner. The costs of providing services to a customer generally should be recognized as incurred, even if the costs are not incurred ratably as the services are provided. The "smoothing" of costs in a service transaction is not appropriate. To do so for a service contract accounted for using the proportional performance method of revenue recognition would effectively result in the application of percentage-of-completion accounting, as set forth in ASC 605-35. As discussed below, the application of ASC 605-35 to service contracts is not appropriate if such contracts are not within the scope of ASC 605-35.

ASC 605-35-15-6(j) states that: "Service transactions between a seller and a purchaser in which, for a mutually agreed price, the seller performs, agrees to perform at a later date, or agrees to maintain readiness to perform an act or acts, including permitting others to use entity resources that do not alone produce a tangible commodity or product as the principal intended result (for example, services, not plans, are usually the principal intended result in a transaction between an architect and the customer of an architect)" are not within the scope of that guidance.

The SEC staff generally will object to the application of the provisions of ASC 605-35 to service transactions that are not within its scope. On 30 November 2004, the SEC staff issued a document entitled "Current Accounting and Disclosure Issues in the Division of Corporate Finance." In this document, the SEC staff comments on the misapplication of ASC 605-35 to service contracts and states that the revenue recognition method used for a service contract should reflect the pattern in which the vendor's obligations are fulfilled.

Accordingly, software arrangements that include services that meet the criteria for separate accounting should not be accounted for pursuant to ASC 605-35 because the vendor has already determined that the services are not essential to the functionality of any other element and do not involve significant production, modification or customization of software (and should thus not be accounted for using contract accounting).

The following examples illustrate these concepts:

Illustration 8-4: Proportional performance method used to recognize services revenue

Facts

On 1 April 20X6, a calendar year-end software vendor enters into an arrangement to provide a customer with a three-year time-based license of Product X, co-terminus PCS and 100 hours of training for $200,000. The arrangement fee is due on delivery of the software. The software can be used immediately on delivery (i.e., the training services are not essential to the functionality of the licensed software). The training is described in the contract as a separate element of the transaction, and the contract indicates that additional training can be purchased at the vendor's standard price for training when those services are sold separately. VSOE of fair value for the training is determined to be $30,000 based on the price charged separately for the same training, and VSOE of fair value for the software element and co-terminus PCS is $210,000 (see Question 3-5 for discussion of determination of VSOE for a group of elements).

During the three months ended 30 June 20X6, the vendor provides 80 of the 100 contracted training hours to the customer. The remaining 20 hours are provided during the three months ended 30 September 20X6.

Analysis

The service element of this arrangement is not essential to the functionality of the licensed software and is described in the contract such that the total price of the arrangement would be expected to vary as a result of the inclusion or exclusion of the services. In addition, VSOE of fair value for the services exists. Therefore, the services should be accounted for separately from the software. Using the relative-fair-value method, $25,000 of arrangement consideration should be allocated to the training services.

Service revenue of $20,000 should be recognized by the vendor during the three months ended 30 June 20X6 based on its proportional performance (80 training hours provided to the customer (an output) divided by 100 hours multiplied the $25,000 of arrangement consideration allocable to the training services). The remaining $5,000 of arrangement consideration allocable to the training services should be recognized during the three months ended 30 September 20X6 as the last 20 hours of contracted training are delivered.

Illustration 8-5: Services revenue recognized on a straight-line basis

Facts

On 1 June 20X6, a calendar year-end software vendor enters into an arrangement to provide a customer with a perpetual license of Product X, one year of PCS and installation services for $220,000. The arrangement fee is due on delivery of the software. The installation services are not essential to the functionality of the licensed software. The installation services are described in the contract such that the total price would be expected to vary as a result of their inclusion or exclusion in the arrangement. VSOE of fair value for the installation services is determined to be $50,000 based on amounts charged when similar services are provided to customers on a standalone basis, and VSOE of fair value for PCS is $40,000. The vendor estimates that completion of the installation services will take two months. There is no discernible pattern of outputs as the installation services are performed.

Analysis

The service element of this arrangement is not essential to the functionality of the licensed software and is described in the contract such that the total price of the arrangement would be expected to vary as a result of the inclusion or exclusion of the services. In addition, VSOE of fair value for the services exists. Therefore, the services should be accounted for separately. Using the residual method, arrangement consideration of $50,000 should be allocated to the installation services, $40,000 should be allocated to PCS and the remainder ($130,000) should be allocated to the licensed software.

Because there is no discernible pattern of outputs as the installation services are performed, the $40,000 allocated to the installation services should be recognized on a straight-line basis over the two-month period that the services are rendered. Accordingly, service revenue of $20,000 should be reported by the vendor during each of the three month periods ended 30 June 20X6 and 30 September 20X6, respectively.

Hosting services included in arrangements accounted for pursuant to ASC 985-605

Question 8-7 **If the provisions of ASC 985-605 are applicable to a software licensing arrangement in which a vendor agrees to host the licensed software, can the hosting services be accounted for separately from the licensed software?**

If it is determined that a software licensing arrangement that involves hosting services should be accounted for pursuant to the software revenue recognition guidance based on the criteria in ASC 985-605-05-4 (see Question 1-3), we believe the hosting services generally will meet the criteria established in ASC 985-605-25-78 for separate accounting if the vendor has established VSOE of fair value for the hosting services, and the hosting services are not essential to the functionality of the licensed software. A vendor may establish VSOE of fair value of hosting services based on the price the customer would be required to pay when the hosting service element is sold separately (i.e., the renewal rate), if it can demonstrate that a substantial majority of renewals are priced within a relatively narrow range.

However, if VSOE of fair value of the hosting services does not exist, the entire arrangement fee should be recognized over the period that the hosting services will be provided.

Accounting for arrangements that include services and PCS for which VSOE of fair value does not exist

Question 8-8 **Software vendors may enter into arrangements with customers to license software, provide an initial period of PCS, and provide services that are not essential to the functionality of other elements of the arrangement and that are described in a manner such that the total arrangement fees would be expected to vary based on their inclusion or exclusion. If a vendor that enters into such an arrangement has not established VSOE of fair value for both the PCS element and the services element, how should revenue be recognized for the arrangement?**

Question 3-16 discusses the accounting for such arrangements.

Accounting for subscription arrangements that include services

Question 8-9 **What is the appropriate accounting for software licensing arrangements that include rights to unspecified additional software products (subscription arrangements) and services?**

Vendors may agree to deliver unspecified additional software products in the future as part of software licensing arrangements (a "subscription") that also include services that qualify for separate accounting pursuant to ASC 985-605-25-78. As discussed in ASC 985-605-25-58 and 25-59, in a subscription arrangement there is no basis on which to allocate arrangement consideration between delivered software and unspecified additional software products to be delivered because VSOE of fair value for unspecified products does not and cannot exist. However, it may be possible to allocate arrangement consideration between services and a subscription if a vendor has a history of selling the subscription element separately from the services.

If VSOE of fair value exists for both the service element and the subscription element (i.e., the vendor has established VSOE of fair value of the delivered software and the right to receive unspecified additional software products as a group — see Question 3-5), and the services otherwise may be accounted for separately, the arrangement fee should be allocated between the subscription and the services based on the relative fair value of the elements. Arrangement consideration allocated to the services should be recognized as the services are performed or straight-line over the service period if no pattern of service is discernable (see Question 8-6). Arrangement consideration allocated to the subscription element should be recognized ratably over the term of the arrangement (or the estimated economic life of the products covered by the arrangement if the term is not stated), beginning with the delivery of the first product.

However, if VSOE of fair value does not exist for both the services and the subscription element of the arrangement, the entire arrangement fee should be recognized ratably over the longer of the term of the arrangement (or the estimated economic life of the products covered by the arrangement) or the period over which the services will be provided, beginning with the delivery of the first product.

The following examples illustrate these concepts:

Illustration 8-6: VSOE of fair value of subscription is unknown

Facts

On 30 September 20X6, a calendar year-end software vendor enters into an arrangement to perpetually license Product X, to provide one year of PCS and to provide 100 hours of training for $240,000. In addition, the vendor agrees to deliver all new products in the Product X family during the next three years (collectively with the Product X license and PCS the "subscription"). The training will be performed during the first year of the arrangement and is not essential to the functionality of any other element of the arrangement. The arrangement fee is due on delivery of the licensed software.

The training is described in the contract as a separate element of the transaction, and the contract indicates that additional training can be purchased at the standard price for training sold separately.

VSOE of fair value for the training is determined to be $25,000 based on the price charged for the same training when sold separately. VSOE for Product X, when bundled with PCS and the right to receive unspecified additional software products, does not exist.

Product X is delivered to the customer on 30 September 20X6.

Analysis

The service element of this arrangement is not essential to the functionality of the software and is described in the contract such that the total price of the arrangement would be expected to vary as a result of the exclusion of the services. In addition, VSOE of fair value for the services exists. However, because VSOE of fair value does not exist for the subscription, revenue for the entire arrangement should be recognized ratably over the three years the vendor is committed to deliver new products in the Product X family, beginning with the delivery of Product X on 30 September 20X6.

Illustration 8-7: VSOE of fair value of subscription and services is known

Facts

Assume the same facts as Illustration 8-6 above, except VSOE of the subscription is determined to be $225,000 based on a history of sales of such arrangements exclusive of training services.

Analysis

The subscription and the service element should be accounted for separately based on VSOE of fair value. Using the relative-fair-value method of allocating arrangement consideration, $24,000 should be allocated to the services and $216,000 should be allocated to the subscription. The amount allocated to the services should be recognized as revenue as the services are provided to the customer (see Question 8-6). The amount allocated to the subscription should be recognized ratably over the three years the vendor is committed to deliver new products in the Product X family, beginning with the delivery of Product X on 30 September 20X6.

8.4 Core software versus off-the-shelf software

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-81

An important factor in determining whether the services are essential to the functionality of any other element is whether the software included in the arrangement is considered core or **off-the-shelf software**. **Core software** is software that a vendor uses in creating other software. It is not sold as is because customers cannot use it unless it is customized to meet system objectives or customer specifications. Off-the-shelf software is software that is marketed as a stock item that can be used by customers with little or no customization.

985-605-25-82

Software shall be considered off-the-shelf software if it can be added to an arrangement with insignificant changes in the underlying code and it could be used by the customer for the customer's purposes upon installation. Actual use by the customer and performance of other elements of the arrangement are not required to demonstrate that the customer could use the software off-the-shelf.

985-605-25-83

If significant modifications or additions to the off-the-shelf software are necessary to meet the customer's purpose — for example, changing or making additions to the software, or because the software would not be usable in its off-the-shelf form in the customer's environment — the software shall be considered core software for purposes of that arrangement. If the software that is included in the arrangement is not considered to be off-the-shelf software, or if significant modifications or additions to the off-the-shelf software are necessary to meet the customer's functionality, no element of the arrangement would qualify for accounting as a service, and contract accounting shall be applied to both the software and service elements of the arrangement.

985-605-25-84

Factors indicating that the service element is essential to the functionality of the other elements of the arrangement, and consequently shall not be accounted for separately, include the following:

a. The software is not off-the-shelf software.

b. The services include significant alterations to the features and functionality of the off-the-shelf software.

c. Building complex interfaces is necessary for the vendor's software to be functional in the customer's environment.

d. The timing of payments for the software is coincident with performance of the services.

e. Milestones or customer-specific acceptance criteria affect the realizability of the software-license fee.

985-605-25-85

Judgment is required to determine whether the obligation to provide services in addition to the delivery of software should be accounted for separately as a service element. Services that qualify for accounting as a service element of a software arrangement always are stated separately and have any of the following characteristics:

a. The services are available from other vendors.

b. The services do not carry a significant degree of risk or unique acceptance criteria.

c. The software vendor is an experienced provider of the services.

d. The vendor is providing primarily implementation services, such as implementation planning, loading of software, training of customer personnel, data conversion, building simple interfaces, running test data, and assisting in the development and documentation of procedures.

e. Customer personnel are dedicated to participate in the services being performed.

Core software versus off-the-shelf software

Question 8-10 **What is the difference between off-the-shelf software and core software?**

ASC 985-605-20 defines off-the-shelf and core software as follows:

> *Off-the-shelf software*. Software marketed as a stock item that customers can use with little or no customization.
>
> *Core software*. An inventory of software that vendors use in creating other software. Core software is not delivered as-is because customers cannot use it unless it is customized to meet system objectives or customer specifications.

Off-the-shelf software is marketed as a stock item and requires little or no services before it can be used by customers. Services included in arrangements with off-the-shelf software generally are related to the initial implementation of the software (i.e., installation, training programming simple interfaces), and off-the-shelf software can generally be used by customers on installation. Conversely, core software typically requires significant customization services to meet customers' objectives or specifications. Core software is not delivered as-is because it must be modified before customers can use it for its intended purpose. If software is never sold without services, this may indicate the product is not off-the-shelf software.

If the software included in a software licensing arrangement is core software or if significant alterations to off-the-shelf software are required, service elements included in the arrangement are considered essential to the functionality of the software and contract accounting must be applied to both the software and services elements. Even if significant alterations to licensed off-the-shelf software will not be made, if complex interfaces are required by a customer for the software to be usable in the customer's environment, the interface programming services may be essential to the functionality of the licensed software (see Question 8-12).

The following examples illustrate these concepts:

Illustration 8-8: Sale of off-the-shelf software

Facts

A software vendor enters into a licensing agreement with an airline for a flight crew scheduling product that can be used by the airline immediately on installation with no modifications to the software. The vendor performs the installation. However, the vendor regularly sells the software without any services, as other vendors offer installation services as well.

Analysis

Because the software can be used immediately on installation and the vendor regularly sells the software without services, the software is off-the-shelf software.

Illustration 8-9: Sale of core software

Facts

Assume the same facts as Illustration 8-8, except that the software cannot be used by any of the vendor's customers unless significant alternations are made to the software to meet the customer's specific requirements. The software is not sold without related customization services.

Analysis

Because the software cannot be used immediately on installation and is not sold separately from the related customization services, the software is core software.

Significant alterations to off-the-shelf software

Question 8-11 **ASC 985-605-25-84 states that if services included in a software licensing arrangement involve significant alterations to the features and functionality of off-the-shelf software, this is indicative that the services are more than essential to the functionality of the licensed software. What factors should be considered when determining if alterations to the features and functionality of off-the-shelf software are significant?**

ASC 985-605 does not define "significant alterations" to off-the-shelf software. However, we believe that the following facts and circumstances should be considered in determining if alterations are significant:

- *More-than-insignificant changes are made to the software code.* If more-than-insignificant changes are made to the existing code, or if a significant amount of new code is written, this is an indication that significant alterations are being made to the software.
- *The relative fair value of the services compared to the software.* If the relative fair value of the services is a substantial portion of the entire arrangement fee, this is an indicator the services include significant alterations.
- *Amount of time required to complete alterations.* As the period of time required to complete the alterations increases, the likelihood that they are significant alterations increases.
- *The existence of any contractual cancellation, acceptance or termination provisions for failure to complete the alterations.* Contractual terms that link the performance of the alterations services with acceptance of the software license are a strong indicator the services include significant alterations of the software, particularly if significant risk exists that the vendor will not be able to successfully complete the software alterations to the customer's specifications.

- *Payment terms*. If payment for the licensed software is linked to completion of alterations or the achievement of contractually specified milestones associated with the alterations, this is indicative that the alterations are significant.

Determining when changes to off-the-shelf software represent significant alterations will be dependent on the facts and circumstances and may require the use of professional judgment.

The following examples illustrate these concepts:

Illustration 8-10: Alterations to licensed software are not significant

Facts

A software vendor enters into an agreement with an airline to license a flight crew scheduling software product for $500,000, which is due on execution of the arrangement. The licensed product is off-the-shelf software that generally can be used immediately on installation by an airline with no modifications to the software. Additionally, the vendor agrees to modify the software to reflect the number of flight crew personnel the airline has decided to use on the different types of airplanes that it flies.

The vendor estimates that completion of the customization efforts will require approximately 40 hours of effort by its programming personnel. Based on the sale of such services on a standalone basis, the vendor has established that VSOE of fair value of the contracted services is $200 per hour. Accordingly, the vendor estimates that the fair value of the services relating to alteration of the software is $8,000.

Analysis

Because completion of the services associated with modifying the licensed software is anticipated to be completed within a short period of time, the fair value of the services is small in comparison to the total arrangement consideration, and payment of the arrangement consideration is not linked to successful completion of the services, the vendor's obligation to modify the software does not involve the significant alteration of off-the-shelf software.

Illustration 8-11: Significant alterations to licensed software

Facts

A calendar year-end software vendor markets Product A, an off-the-shelf inventory management software product that utilizes bar codes to identify and track inventory. Product A typically can be used by customers with little or no modification.

The vendor enters into an arrangement to license Product A. The vendor also agrees to modify Product A such that it can utilize radio frequency identification (RFID) tags to identify and track inventory in addition to bar codes.

Total arrangement consideration is $500,000, due as follows: $100,000 on execution of the arrangement, $200,000 due on the delivery of a working model of the modified software to the customer and the remaining $200,000 due on customer certification that the modified software complies with its specifications for use with RFID tags.

The licensed software product is comprised of approximately five million lines of code. The vendor estimates modifying the software to meet the customer's specifications will require the addition of approximately one million lines of code and will take approximately 1,200 hours of effort by its programming personnel. Based on the sale of such services on a standalone basis, the vendor has established VSOE of fair value of the contracted services at $200 per hour. Accordingly, the vendor estimates that the fair value of the services relating to alteration of the software is $240,000.

Analysis

In this example, the fair value of the services relative to the total arrangement consideration, the lines of code that must be modified, the time required to program the modifications, and the fact that payment of a substantial portion of the arrangement consideration is linked to successful completion of the requested modifications all indicate that the services represent a significant alteration to the vendor's off-the-shelf software product. Accordingly, the arrangement should be accounted for using contract accounting.

Complex interfaces

Question 8-12 **ASC 985-605-25-84 states that if services included in a software licensing arrangement involve building complex services that are necessary for the licensed software to function in the customer's environment, this is indicative that the services are essential to the functionality of the licensed software. What factors should be considered when determining if required interfaces are so complex that they should be considered essential to the functionality of the licensed software?**

While ASC 985-605 does not define "complex interfaces," we believe the following should be considered in determining if interfaces are complex:

- *The relative fair value of the services compared to the software.* If the relative fair value of the services related to building the interfaces is a substantial portion of the entire arrangement fee, this is a strong indicator the interfaces are complex and essential to the functionality of the licensed software.
- *The amount of time and effort required to build the interfaces.* As the period of time required to build the interfaces increases, the likelihood that they are complex interfaces increases.
- *The existence of any contractual cancellation, acceptance or termination provisions for failure to complete the interfaces.* Contractual terms that link the completion of the interfaces with acceptance of the software license are a strong indicator interfaces are complex and essential to the functionality of the licensed software, particularly if significant risk exists that the vendor will not be able to successfully build the interfaces.
- *Payment terms.* If payment for the licensed software is linked to completion of the interfaces or the achievement of contractually specified milestones associated with the interfaces, this is a strong indicator that complex interfaces essential to the functionality of the licensed software are being built.
- *Whether other vendors have the necessary expertise to create the interfaces.* If required interfaces can only be created by a vendor that licenses a particular software product (e.g., due to the complex nature of the licensed product), this indicates complex interfaces essential to the functionality of the licensed software are being built.

The absence or presence of any one indicator above is not conclusive as to whether complex interfaces are being built. Determining whether a vendor is building complex interfaces requires the use of professional judgment.

The following example illustrates these concepts:

Illustration 8-12: Complex interfaces are essential to the functionality of the licensed software

Facts

A calendar year-end software vendor licenses Product A, an off-the-shelf inventory management software product that utilizes radio frequency identification (RFID) tags to identify and track inventory.

The vendor enters into an arrangement to license Product A to a customer. The customer has internally developed inventory management software that utilizes bar codes to identify and track inventory. As part of the arrangement, the vendor also agrees to develop an interface between its product and the customer's internally developed software and an interface with the customer's enterprise resource planning (ERP) software.

Total arrangement consideration is $5 million, due as follows: $1 million on execution of the arrangement, $2 million due on completion of the interface with the customer's internally developed inventory management software and the remaining $2 million due on completion of the interface with the ERP software.

Completion of the interfaces is expected to take approximately nine months. There are no other service providers that have the expertise needed to build these interfaces due to the complex nature of the vendor's product.

Analysis

The linkage of the arrangement's payment terms to the completion of the interfaces, the length of time required to build the interfaces and the fact other vendors do not have the requisite expertise to provide the services necessary to create the interfaces all indicate complex interfaces are being built that are essential to the functionality of the licensed software. Accordingly, the arrangement should be accounted for using contract accounting.

Installation services

Question 8-13 **If licensed software cannot be used until it is installed, should installation services be considered essential to the functionality of other elements in an arrangement?**

Installation services must be evaluated in the same manner as any other service in accordance with ASC 985-605-25-76 through 25-85 to determine whether they are essential to the functionality of other elements in an arrangement and whether they can be accounted for as a separate element.

Indicators installation is essential to the functionality of licensed software include:

- The installation involves significant changes to the features or capabilities of the software or building complex interfaces.
- The installation services are unavailable from other vendors.
- Payment of the arrangement consideration coincides with installation.
- Failure to complete the installation would result in the customer receiving a full or partial refund or rejecting the products delivered or services performed to date.

Conversely, indicators installation is not essential to the functionality of the software include:

- Installation does not significantly alter or enhance the licensed software's capabilities.
- Other companies are available to perform the installation.

Characteristics of services that are not essential to the functionality of other elements

Question 8-14 **What are some characteristics of services that are not essential to the functionality of other elements of the transaction?**

ASC 985-605-25-85 provides that services that qualify for accounting as a service element of a software arrangement are always stated separately and have any of the following characteristics:

- *The services are available from other vendors.* Availability of the same services from other vendors is an indication the vendor is not selling a "solution" that only it can provide through extensive customization or modification of the licensed software. If the same services are available from other vendors, it is unlikely the services were critical to the customer's decision to purchase the software.
- While ASC 985-605 does not state other providers must be performing the services in question for a vendor's customers, it will be difficult for a vendor to assert services are *available* from others if this is not the case. For this reason, we would not expect software vendors that perform all of their own services to rely on this characteristic to support separate accounting for services.
- *The services do not carry a significant degree of risk or unique acceptance criteria.* A lack of significant risk of the services being successfully performed and a lack of unique, customer-defined acceptance criteria are indicators the services are routine and perfunctory and are not essential to the functionality of other elements in the arrangement.
- *The software vendor is an experienced provider of the services.* If a software vendor is not experienced at providing contracted-for services, it will be difficult for the vendor to assert the services do not carry a significant degree of risk. An experienced provider of the services will be more likely to complete the services in a manner that meets the customer's expectations, which will decrease the risk that the customer will not accept either the services or the software.
- *The vendor primarily is providing implementation services.* Implementation services such as implementation planning, loading of software, training of customer personnel, data conversion, building simple interfaces, running test data and assisting in the development and documentation of procedures generally are not required for the customer to use the software and are not likely to involve significant alterations to the features and functionality of the software.
- *Customer personnel are dedicated to participate in the services being performed.* The involvement of customer personnel indicates that the customer is sharing at least some of the risk in the project. It also indicates that the skills required to perform the services may not be unique to the software vendor.

8.5 Funded software-development arrangements

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-86

Software-development arrangements that are fully or partially funded by a party other than the vendor that is developing the software typically provide the funding party with some or all of the following benefits:

a. Royalties payable to the funding party based solely on future sales of the product by the software vendor (that is, reverse royalties)

b. Discounts on future purchases by the funding party of products produced under the arrangement

c. A nonexclusive sublicense to the funding party, at no additional charge, for the use of any product developed (a prepaid or paid-up nonexclusive sublicense).

985-605-25-87

A funded software-development arrangement within the scope of Subtopic 730-20 shall be accounted for in conformity with that Subtopic. If the technological feasibility of the computer software product pursuant to the provisions of Subtopic 985-20 has been established before the arrangement has been entered into, Subtopic 730-20 does not apply because the arrangement is not a research and development arrangement. Accounting for costs related to funded software-development arrangements is beyond the scope of this Subtopic. However, if capitalization of the software-development costs commences pursuant to Subtopic 985-20, any income from the funding party under a funded software-development arrangement shall be credited first to the amount of the development costs capitalized. If the income from the funding party exceeds the amount of development costs capitalized, the excess shall be deferred and credited against future amounts that subsequently qualify for capitalization. Any deferred amount remaining after the project is completed (that is, when the software is available for general release to customers and capitalization has ceased) shall be credited to income.

It is not uncommon for software vendors to obtain funds from third parties ("funding parties") to be used in developing software that has not been made available for general release, or in developing additional features and functionality for software products that are in general release. These arrangements may provide the funding party with future benefits such as royalties from any future sales of successfully developed products to third parties, discounts on future purchases of successfully developed products or a nonexclusive sublicense of the products developed at no additional charge.

The accounting for funded software-development arrangements depends on the terms of the arrangement and the stage of development of the software that is subject to the development effort at the time the arrangement is executed. Generally, funded software-development agreements relating to products that have not yet reached technological feasibility, as defined by ASC 985-20, *Software — Costs of Software to Be Sold, Leased, or Marketed*, should be accounted for pursuant to the provisions of ASC 730-20, *Research and Development — Research and Development Arrangements*, while agreements relating to products that have reached technological feasibility should be accounted for pursuant to the provisions of ASC 985-605-25-87.

Funded software-development arrangements versus arrangements to customize software

Question 8-15 **What is the difference between a funded software-development arrangement and an arrangement to perform significant software production, modification or customization of software, as described by ASC 985-605-25-2 and 25-88?**

Funded software-development arrangements are agreements with a funding party relating to a vendor's research and development efforts. In such arrangements, a funding party agrees to pay, either in whole or in part, a vendor's costs of developing new products or additional functionalities or features for existing products or technologies. In a funded software-development arrangement, a vendor generally will retain the intellectual property rights to any developed product or will have the right to acquire the results of the development efforts. These arrangements generally will require the vendor to develop the desired product or enhanced features and functionality on a best-efforts basis and will provide the funding party with future benefits other than the right to license the developed product if and when a product is successfully developed, such as future royalties from any licensing revenues realized by the vendor from sales to third parties.

Conversely, if a vendor has entered into an arrangement to customize core software (as defined by ASC 985-605-25-81) or other currently marketed software to a customer's specifications, that arrangement should be accounted for pursuant to the provisions of ASC 605-35, as a contract to perform significant software production, modification or customization of software. Additionally, if the vendor does not retain the right to or have the right to acquire the results of the development efforts (e.g., the vendor performs customization of the customer's software but does not retain the right to, or have the ability to acquire, the developed software), the arrangement should be accounted for as a contract to perform significant production, modification or customization of software.

The following examples illustrate these concepts:

Illustration 8-13: Agreement to develop a new product to which vendor retains rights

Facts

A software vendor markets software relating to airline operations. The vendor contracts with an airline, Airco, to develop a flight crew scheduling system on a best-efforts basis. The vendor does not currently market such a product. Pursuant to the terms of the arrangement, Airco will fund one-half of all software development costs incurred. If and when a product is successfully developed, Airco will be provided a fully paid-up nonexclusive license to the product. The vendor will retain the intellectual property rights to the developed product, including the right to market the developed product to third parties. However, Airco will be entitled to a 5% royalty relating to any licensing revenues realized by the vendor from sales of a developed product to third parties.

Analysis

The vendor should account for the arrangement as a funded software-development arrangement because it is committed to develop a product that it does not currently market on a best-efforts basis. If and when such a product is developed, the vendor will have the rights to market the product to third parties, in exchange for royalty payments to Airco.

Illustration 8-14: Agreement to modify developed software to a customer's specifications

Facts

Assume that the vendor from Illustration 8-13 above, has successfully developed a flight crew scheduling product, which it markets as a core software product (see Question 8-10) that can be further customized to meet any airline's specific needs. The vendor enters into an arrangement with an airline, Flightco, to license the product and to customize the software to function in Flightco's specific environment for $500,000.

Analysis

Because the vendor has entered into an arrangement to customize a core software product, the arrangement should be accounted for pursuant to the provisions of ASC 605-35 as a contract to perform significant software production, modification or customization of software.

Accounting for a funded software-development arrangement when technological feasibility of the subject software has not been established

Question 8-16 **How should a vendor account for a funded software-development arrangement if technological feasibility of the software subject to the development efforts has not been established?**

If a vendor enters into a funded software-development arrangement with a customer (the "funding party") and technological feasibility of the software that is the subject of the development efforts has not been established in accordance with ASC 985-20, *Software — Costs of Software to Be Sold, Leased, or Marketed*, the arrangement should be accounted for as a research and development (R&D) arrangement pursuant to ASC 730-20, *Research and Development — Research and Development Arrangements*.

The nature of a vendor's obligations under an arrangement determines the appropriate accounting for a funded software-development arrangement accounted for pursuant to ASC 730-20. When evaluating how to account for such an arrangement, a vendor must determine whether it is obligated to repay any funds received from the funding party regardless of the ultimate success of the R&D activities. To the extent that the financial risk associated with the R&D has been transferred to the funding party, the vendor should account for its obligation as a contract to perform R&D for others. To conclude that a liability does not exist, ASC 985-20 requires that the transfer of financial risk to the funding party be "substantive."

The financial risk has been transferred to a funding party if repayment of the funds received by the funding party depends solely on the results of the R&D having future economic benefit. To the extent a vendor is committed to repay any of the amounts provided by the funding party regardless of the outcome of the R&D, all or part of the risk has not been transferred and the arrangement should, at least in part, be accounted for as a financing transaction.

ASC 730-20-25-4 provides the following examples of arrangements in which all or part of the risk related to R&D activities has not been transferred to the funding party:

a. The vendor guarantees, or has a contractual commitment that assures, repayment of the funds provided by the funding party regardless of the outcome of the R&D.

b. The funding party can require the vendor to purchase its interest in the R&D regardless of the outcome.

c. The funding party automatically will receive debt or equity securities of the vendor on termination or completion of the R&D regardless of the outcome.

In these cases, the arrangement is in essence a financing arrangement because the contractual arrangement obligates the vendor to transfer consideration to the funding party regardless of the outcome of the R&D activities.

In some situations the written agreements or contracts may not require the enterprise to repay the funding party, but other conditions may indicate that the vendor still bears the risk of failure of the R&D activities. If conditions suggest that it is probable (as defined in ASC 450, *Contingencies*) that a vendor will repay any of the funds regardless of the outcome of the research and development, there is a presumption that the vendor has an obligation to repay the funding party, and the arrangement should be accounted for as a financing arrangement. That presumption can be overcome only by substantial evidence to the contrary.

ASC 730-20-25-6 provides examples of conditions leading to the presumption that a vendor will repay the funding party:

a. The vendor has indicated that it intends to repay all or a portion of the funds provided regardless of the outcome of the R&D activities.

b. The arrangement includes an express or implied economic penalty to the vendor such that it would more likely pay the funding party than incur the penalty. For example, if the vendor has transferred the right to use core technology to a partnership formed to conduct R&D activities and that technology is significant to its ongoing operations, the absence of a cross-license arrangement or other provisions that permit the vendor to reacquire or use its core technology is evidence of a financing arrangement. This scenario creates a presumption that the vendor would be compelled to purchase the other party's interest in the partnership to effectively reacquire its core technology.

c. A significant related party relationship exists between the vendor and the funding party at the time the arrangement is entered into. SAB Topic 5-O states that a significant related party relationship exists when 10% or more of a funding party is owned by parties related to the enterprise performing the R&D activities. However, the SEC staff also may challenge accounting for the R&D arrangement as a contract for services even though related party ownership is less than 10%. Among other factors, the SEC staff will consider the degree of influence or control exerted by the related parties over the enterprise receiving the funds.

   Specifically, the SEC staff has taken the position that funds received from a related party in a R&D arrangements should be accounted for as a liability to repay the funding party and not as a contract to perform research and development for others, if:

   i. The registrant is required to make royalty payments to the related funding party based on the registrant's revenue as a whole and not just on the revenue stemming from the products developed with funds provided by the related funding party, or

   ii. The registrant has an option, other than a fair value purchase option, to acquire the results of the research and development arrangement.

d. The vendor has essentially completed the R&D activities before entering into the arrangement. In such a case, the funding party may be in essence purchasing a future revenue stream and not funding R&D activities. Such transactions also should be evaluated under ASC 470-10-25-1 and 25-2, *Debt — Overall — Sales of Future Revenues and Various Other Measures of Income*, to determine whether the substance of the funding is debt.

Additionally, consideration must be given to the intentions of the parties to the arrangement at the time the contract was negotiated. For example, despite the form of the contractual arrangement, a vendor may intend to purchase other parties' interests in the arrangement regardless of the success of the project. Indicators that such implicit obligations exist may include a vendor's historical practice of purchasing customer's interests in unsuccessful R&D endeavors or the anticipated after-tax rate of return to the funding party is not representative of the returns normally associated with speculative investments.

SAB Topic 5-O also indicates that evidence a vendor cannot be reasonably expected to repay funds based on its current and projected future financial condition does not overcome the presumption that an obligation exists requiring a R&D arrangement to be accounted for as a financing transaction. ASC 730-20 indicates that a vendor may settle the liability by paying cash, issuing securities or by other means. Thus, while a vendor may not be in a position to pay cash or issue debt (which would eventually be settled in cash), it could issue stock or settle the liability by other means.

A vendor with either an explicit or implicit obligation to repay a funding party pursuant to a R&D funding arrangement should expense R&D costs as incurred. Amounts received from the funding party should be recorded as a liability, regardless of the method of repayment (cash, stock or otherwise).

ASC 730-20-25-7 discusses the accounting for R&D arrangements in which a vendor is committed to repay some, but not all, of a funding parties' investment regardless of the outcome of the R&D. For example, a vendor might be required or expected to reacquire core technology for less than the funding parties' investment or to make certain minimum royalty payments that are less than the funding parties' investment, regardless of the outcome of the R&D. In such cases, only the portion of the funding that is required or expected to be repaid should be accounted for as a financing. In such cases, a vendor should recognize its portion of the R&D expense in the same manner as the liability to the funding party is incurred (e.g., on a pro rata basis).

After completion of the R&D activities in an arrangement accounted for as a financing, the funding from the customer may be "repaid" by the vendor through royalties on future sales of the newly developed products. ASC 730-20 does not specify the accounting for royalty payments when a vendor has accounted for an arrangement as a financing and expects to repay the funding party through a royalty arrangement. We believe there are two acceptable accounting alternatives:

- Treat the accrued liability for repayment as an accrued royalty. Prorate estimated future royalty payments between the accrued liability and royalty expense on the basis of the ratio of the accrued liability to total estimated royalty payments.
- Use an "interest method" to prorate future royalty payments between the accrued liability and interest expense. Using the implicit interest rate, compute the "interest" on the accrued liability and charge this amount to interest expense. The remainder of the royalty payment would reduce the "principal" amount of the accrued liability.

If it is determined that an arrangement to perform R&D services is not a financing arrangement, the vendor should account for the arrangement as a service contract or collaboration. Amounts received from the funding party should be recognized in the income statement as services are performed. Determining whether the recognized amounts should be classified as revenues or as a reduction of R&D expense (contra R&D) in the income statement may require the use of professional judgment but should reflect the nature and economics of the arrangement between the parties.

The following examples illustrate these concepts:

Illustration 8-15: Repayment of funding is required

Facts

A software vendor has been developing a product for administering standardized tests since 20X4. Technological feasibility has not yet been established for the product. On 31 March 20X5, the vendor enters into a funding arrangement with a customer to complete the development and license the new product for $500,000. A fully paid-up nonexclusive license will be provided to the customer when a developed product is available for general release, but the vendor retains all rights to the software (including the right to market the software product to others). In addition, the customer will receive royalties equal to 3% of any future sales of the product to third parties. If future licenses do not generate at least $500,000 in royalties by the end of the contract term, the vendor is required to repay the difference.

Analysis

Because technological feasibility has not been established for the software that is the subject of the contracted development efforts prior to execution of the arrangement, the arrangement should be accounted for in accordance with ASC 730-20. Since repayment of the funds received does not depend solely on the new product having future economic benefit, the arrangement should be accounted for as financing arrangement. The vendor should record a liability equal to the amounts received from the funding party. Development costs should be expensed as incurred until technological feasibility is established.

Illustration 8-16: Repayment of funding is not required

Facts

Assume the same facts as Illustration 8-15 above, except the vendor is not obligated to make any repayments if future licenses do not generate at least $500,000 in royalty payments.

Analysis

Because technological feasibility has not been established for the software that is the subject of the contracted development efforts prior to execution of the arrangement, the arrangement should be accounted for in accordance with ASC 730-20. Since repayment of the funds received depends solely on the new product having future economic benefit, the arrangement should be accounted for as a contract to perform research and development services for others. Amounts received from the funding party should be recognized in the income statement as services are performed.

If technological feasibility of the software subject to the development efforts is established subsequent to the execution of a funded software-development agreement, we believe that the vendor should continue to account for the arrangement pursuant to the provisions of ASC 730-20 and ASC 985-20 and not the software revenue recognition guidance.

Accounting for a funded software-development arrangement when technological feasibility of the subject software has been established

Question 8-17 **How should a vendor account for a funded-software development arrangement if technological feasibility of the software that is the subject of the contracted development efforts has been established?**

If a vendor enters into a funded software-development arrangement for which technological feasibility of the software that is the subject of the development efforts has been established in accordance with ASC 985-20, *Software — Costs of Software to Be Sold, Leased, or Marketed*, the arrangement should be accounted for in accordance with ASC 985-605-25-87. As such, the proceeds received from the funding party should be offset against any costs capitalized for the related software. If the proceeds exceed total capitalized costs, the excess should be deferred and offset against any future amounts that qualify for capitalization. On general release of the software, any remaining deferred amount should be recognized as revenue.

The following example illustrates these concepts:

Illustration 8-17: Accounting for a funded software-development arrangement

Facts

A software vendor has been developing a product for administering standardized tests since 20X4. On 31 March 20X5, the vendor enters into a funding arrangement with a customer to complete the development and license the new product for $500,000. A fully paid-up nonexclusive license will be provided to the customer when a developed product is available for general release, but the vendor retains all rights to the software (including the right to market the software product to others). The customer will receive royalties of 3% of any future sales of the product to third parties, up to a maximum of $500,000. The vendor is not obligated to pay any amounts to the customer if the product is not successfully developed or if there are no or insufficient future sales of the product to allow recovery of the funding party's investment.

Technological feasibility of the product has been established in accordance with ASC 985-20 prior to execution of the arrangement. As of 31 March 20X5, the vendor had capitalized $300,000 in software development costs related to the product.

On 15 May 20X5, the product is made available for general release and is delivered to the customer. The vendor incurs an additional $100,000 in capitalizable costs from 31 March 20X5 through 15 May 20X5.

Analysis

The vendor retains the rights to the developed product and technological feasibility of the software has been established prior to execution of the arrangement, so ASC 985-605-25-87 applies to this arrangement. On 31 March 20X5, the vendor should record a credit of $300,000 to capitalized software costs and defer the remaining $200,000. As the additional $100,000 in costs that meet the requirements for capitalization under ASC 985-20 are incurred, they should be offset against deferred revenue. On completion of development, when the product is available for general release and delivered to the customer, the $100,000 deferred credit remaining after all capitalized costs have been offset should be recognized as revenue.

9 Contract accounting

9.1 Chapter summary

If an arrangement to deliver software or a software system (either alone or together with other products or services) requires significant production, modification or customization of the licensed software, the vendor should account for the arrangement in accordance with ASC 605-35, *Revenue Recognition — Construction-Type and Production-Type Contracts*. Such treatment is referred to in this publication as "contract accounting." Determining whether a software licensing arrangement should be accounted for using contract accounting or the provisions of ASC 985-605 requires the use of professional judgment and is based on the relevant facts and circumstances; however, the two methods are mutually exclusive and are not alternative methods of accounting for the same arrangement.

ASC 605-35 provides guidance on "accounting for the performance of contracts for which specifications are provided by the customer for the construction of facilitates or the production of goods or for the provision of related services." Based on the guidance in ASC 605-35-15-3(f), included within the scope of this guidance are "arrangements to deliver software or a software system, either alone or together with other products or services, requiring significant production, modification, or customization of software."

The two methods of accounting specified by ASC 605-35 for contracts within its scope are the percentage-of-completion and the completed-contract method. The decision about which method should be used is based on the facts and circumstances particular to the arrangement and is not a policy choice. Other accounting methods, such as the recognition of revenue based on progress billings or receipts, are not acceptable.

Although ASC 605-35 does not dictate when to use either method, the percentage-of-completion method generally is viewed as the model that best reflects the economics of construction-type contracts. Contracts that are within the scope of ASC 605-35 generally provide that ownership of the asset under construction transfers to the customer over time as the asset is built. Accordingly, revenue recognition pursuant to the percentage-of-completion method best represents the revenue earned by the contractor as ownership of the asset is transferred.

In most revenue transactions, costs associated with a vendor's performance are recognized as incurred. However, costs associated with contracts accounted for pursuant to ASC 605-35 are accounted for in a different manner. If a contract is accounted for using the percentage-of-completion method, costs are recognized in proportion to the amount of revenue recognized, such that a constant gross margin percentage is recognized during the life of the contract (albeit updated for changes in the estimates of total contract revenues and costs as the vendor progresses toward completion of the contract). If the completed-contract method of accounting is used, costs are accumulated on the balance sheet and recognized when the contact is complete and the associated revenue recognized.

ASC 985-605 provides guidance for the application of contract accounting to software licensing arrangements. This guidance is based on the provisions of ASC 605-35 and focuses on contract segmentation and measurement of progress to completion under the percentage-of-completion method. Consistent with ASC 605-35, use of the percentage-of-completion method of contract accounting is presumed to be preferable. This method should be used unless there is persuasive evidence to overcome that presumption, in which case the completed-contract method of contract accounting should be followed.

Although ASC 605-35 provides that software arrangements involving significant production, modification or customization of the licensed software should be accounted for using contract accounting, the other provisions of ASC 985-605 also must be considered when determining the appropriate accounting for such an arrangement. For example, ASC 605-35-15-3(f) indicates "…transactions that normally are accounted for as product sales should not be accounted for as long-term contracts merely to avoid the delivery requirements normally associated with product sales for revenue recognition. See paragraphs 985-605-25-88 through 25-107 regarding the application of this Subtopic to software contracts." Additionally, the other guidance within ASC 985-605 must also be considered. For example extended payment terms included in a software licensing arrangement may result in a conclusion that the arrangement fees are not fixed or determinable, precluding revenue recognition until payments become due (see Question 9-12). Such payment terms included in an arrangement not subject to ASC 985-605 but accounted for pursuant to ASC 605-35 would not necessarily result in a similar decision regarding when revenue may be recognized.

9.2 Contract accounting

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-88

If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the service element does not meet the criteria for separate accounting set forth in paragraph 985-605-25-78. The entire arrangement shall be accounted for in conformity with the relevant guidance in Subtopic 605-35. Nevertheless, transactions that normally are accounted for as product sales shall not be accounted for as long-term contracts merely to avoid the delivery requirements normally associated with product sales for revenue recognition.

Software arrangements subject to contract accounting

Question 9-1 **When should a vendor account for a software licensing arrangement using contract accounting?**

A software licensing arrangement should be accounted for using contract accounting when the arrangement includes significant production, modification or customization of the licensed software, or other services that are essential to the functionality of any other element of the transaction. Questions 8-1 through 8-14 provide guidance relating to the determination of whether services included in software licensing arrangements meet these criteria.

However, transactions normally accounted for in accordance with the other provisions of ASC 985-605 should not be accounted for using contract accounting simply to avoid its delivery requirements. Therefore, vendors should not apply contract accounting to arrangements that include undelivered software elements, such as products not yet generally available or specified upgrades or enhancements, merely to accelerate revenue recognition. Accordingly, if a vendor has a practice of using short-term arrangements (i.e., 30 to 60 days) for the production, modification or customization of licensed software products, revenue should be recognized on delivery of the completed products, if all of the other basic revenue recognition criteria of ASC 985-605 have been met (i.e., on a completed-contract basis).

Accounting for specified additional software products included in software licensing arrangements accounted for using contract accounting

Question 9-2 **What is the appropriate accounting treatment for an arrangement that includes software and related services that must be accounted for using contract accounting as well as other specified software products that do not have related services requiring the application of contract accounting?**

A software vendor may enter into multiple-element arrangements including services that must be accounted for using contract accounting (e.g., arrangements that require significant production, modification or customization of licensed software). These arrangements also may include other software products and related elements (e.g., PCS) that do not have services related to them that require the application of contract accounting. In such situations, the arrangement should be evaluated to determine if the elements subject to contract accounting can be separated from the elements not subject to contract accounting based on the existence or lack of VSOE of fair value of the elements.

If VSOE of fair value exists such that the elements can be accounted for separately, revenue should be recognized for the elements subject to contract accounting pursuant to the provisions of ASC 985-605-25-89 through 25-107. Revenue should be recognized as is appropriate for the other elements based on the other provisions of ASC 985-605.

If VSOE of fair value does not exist such that the elements cannot be accounted for separately, the guidance in ASC 985-605-25-9 through 25-11 should be applied. Revenue recognition should be deferred until the earlier of the point at which a) VSOE of fair value of the elements does exist or b) all elements of the arrangement have been delivered, unless a service remains undelivered. In the latter case, revenue may be recognized for the arrangement over the service period. If the undelivered services are PCS or services that are not essential to the functionality of any of the licensed software, revenue should be recognized over the remaining service period. However, if the undelivered services are related to significant production, modification or customization of any of the licensed software, or are essential to the functionality of the licensed software or other elements of the arrangement, revenue should be recognized over the remaining service period using contract accounting. In such cases, we believe progress to completion should be calculated based on total revenue and costs of the entire arrangement and not just the portion of the arrangement remaining to be completed.

The following examples illustrate these concepts:

Illustration 9-1: VSOE of fair value exists for multiple products included in an arrangement that includes services subject to contract accounting

Facts

A calendar year-end software vendor enters into an agreement with a customer on 1 February 20X6 to provide Product X, which requires significant customization, and Product Y, which requires no customization, and to provide one year of PCS on both products. Both products are delivered to the customer at inception of the arrangement.

Arrangement consideration totals $500,000. VSOE of fair value for Product X, when bundled with customization services and one year of PCS, is $450,000. VSOE of fair value of Product Y, when bundled with PCS, is $150,000 (see Question 3-5 for discussion of establishing VSOE of fair value for a group of elements). The vendor also has established VSOE of fair value of PCS for both products, based on renewal activity of $25,000 each.

The software customization efforts are completed on 1 July 20X6.

Analysis

The vendor should allocate the arrangement consideration between Product X and its related services and Product Y and its related services based on relative fair value, as follows:

	VSOE of fair value	% of relative fair value	Allocated discount	Allocated arrangement consideration
Product X and related services	$ 450,000	75%	$ (75,000)	$ 375,000
Product Y and related PCS	150,000	25%	(25,000)	125,000
Total	$ 600,000		$(100,000)	$ 500,000

Of the $375,000 allocated to Product X, its related customization services and PCS, $25,000 should be allocated to PCS (see Question 9-3) and recognized over the period PCS is provided. The remaining $350,000 should be accounted for using contract accounting pursuant to the provisions of ASC 985-605-25-89 through 25-107 over the period that the customization efforts are completed (1 February 20X6 to 1 July 20X6).

Of the $125,000 related to Product Y and the related PCS, it should further be allocated to the software and PCS using the residual method as follows:

Amount allocated to Product Y and related PCS	$ 125,000
Less: VSOE of fair value of PCS	(25,000)
Arrangement consideration allocable to Product Y	$ 100,000

If all of the other basic revenue recognition criteria of ASC 985-605 have been met, the $100,000 allocable to Product Y may be recognized on 1 February 20X6, when the software is delivered to the customer. The $25,000 allocated to the PCS should be recognized ratably over the PCS period.

Illustration 9-2: VSOE of fair value does not exist for multiple products included in an arrangement that includes services subject to contract accounting

Facts

Assume the same facts as Illustration 9-1 above, except that VSOE of fair value does not exist for the elements of the arrangement.

Analysis

No revenue should be recognized for the arrangement until the Product X customization efforts are completed on 1 July 20X6. At that point, the entire arrangement fee can be recognized over the remaining PCS period.

Accounting for PCS services included in arrangements accounted for using contract accounting

Question 9-3 **If an arrangement to customize licensed software also obligates a vendor to provide postcontract customer support (PCS) services, should the entire arrangement be accounted for pursuant to the provisions of ASC 605-35?**

A software vendor may enter into arrangements that must be accounted for using contract accounting (i.e., arrangements that require significant production, modification or customization of the software) and that also include PCS. The following excerpt from the implementation guidance of ASC 985-605 provides guidance on the accounting for PCS in an arrangement that otherwise is required to be accounted for using contract accounting.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Postcontract Customer Support in an Arrangement Accounted for Using Contract Accounting

985-605-55-74

Paragraph 985-605-15-3(e) states that if a software arrangement includes services that meet the criteria discussed in paragraph 985-605-25-78, those services shall be accounted for separately. The types of services addressed by that paragraph are described in paragraph 985-605-25-76 and specifically exclude postcontract customer support-related services. A software arrangement may be subject to contract accounting and include postcontract customer support-related services (other than those meeting the cost accrual criteria in paragraphs 985-605-25-71 through 25-72).

985-605-55-75

If the vendor has vendor-specific objective evidence of the fair value of such postcontract customer support-related services determined pursuant to paragraphs 985-605-25-67 through 25-69, those related services shall be accounted for separately from the balance of the arrangement that is being accounted for in conformity with Subtopic 605-35.

Pursuant to these provisions, if VSOE of fair value exists for PCS included in an arrangement that is otherwise accounted for using contract accounting, the PCS services should be accounted for separately from the remainder of the arrangement (i.e., the software and customization services).

However, if VSOE of fair value of PCS does not exist, a question arises as to whether the entire arrangement, including the PCS services, should be accounted for using contract accounting pursuant to the provisions of ASC 605-35. ASC 985-605-25-2 provides that if a software arrangement requires significant production, modification or customization of licensed software, the entire arrangement should be accounted for in conformity with ASC 605-35, using the relevant guidance in ASC 985-605-25-88 through 25-107 on applying contract accounting to certain arrangements involving software.

This paragraph suggests that if VSOE of fair value does not exist for PCS included in an arrangement that is otherwise accounted for using contract accounting, the PCS services also should be accounted for using contract accounting. In such cases, we believe that it would be rare that a software vendor would be able to prepare reliable estimates at completion (EAC) of costs of the contract or estimates of the extent of progress toward completion of the contract because such estimates must contemplate the cost of 1) when-and-if-available upgrades and enhancements as well as 2) phone support and 3) bug fixes that the vendor will provide to the customer pursuant to the terms of the PCS arrangement. ASC 605-35 states that if reliable estimates of the extent of progress toward completion of a contract, contract revenues or contract costs cannot be made, the completed-contract method of contract accounting should be used.

Alternatively, some have suggested that in such cases the entire arrangement, including PCS, should be accounted for using the percentage-of-completion method based on a zero profit margin, as provided by the following paragraphs of ASC 605-35.

Excerpt from Accounting Standards Codification

Revenue Recognition — Construction-Type and Production-Type Contracts

Recognition

605-35-25-67

For circumstances in which there is an assurance that no loss will be incurred on a contract (for example, when the scope of the contract is ill-defined but the contractor is protected by a cost-plus contract or other contractual terms), the percentage-of-completion method based on a zero profit margin, rather than the completed-contract method, is recommended until more precise estimates can be made.

605-35-25-68

The significant difference between the percentage-of-completion method applied on the basis of a zero profit margin and the completed-contract method relates to the effects on the income statement. Under the zero profit margin approach to applying the percentage-of-completion method, equal amounts of revenue and cost, measured on the basis of performance during the period, are presented in the income statement; whereas, under the completed-contract method, performance for a period is not reflected in the income statement, and no amount is presented in the income statement until the contract is completed. The zero profit margin approach to applying the percentage-of-completion method gives users of general purpose financial statements an indication of the volume of an entity's business and of the application of its economic resources.

Although this method can be used when a vendor applying contract accounting has reasonable assurance to support that a loss will not be incurred on a contract despite its inability to currently estimate EACs, this method also assumes that the vendor will be able to prepare reliable EACs at some point in the future prior to completion of the contract. As noted above, we believe it will be rare for a vendor to prepare reliable EACs of contract costs when VSOE of fair value of PCS does not exist.

However, we believe when VSOE of fair value of PCS does not exist, the arrangement consideration should be recognized as revenue ratably over the PCS period once the customization services are complete. We believe this accounting is appropriate based on analogy to the provisions of ASC 985-605-25-9, which provides that when "sufficient vendor-specific objective evidence does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement should be deferred until the earlier of the point at which (a) such sufficient vendor-specific objective evidence does exist or (b) all elements of the arrangement have been delivered." However, it provides exceptions to this guidance, including that if the only undelivered element is PCS, the entire fee should be recognized ratably over the PCS period.

This accounting is analogous to the accounting afforded to elements not otherwise subject to the scope of the software revenue recognition guidance, and thus the contract accounting guidance in ASC 605-35, that have been included in a software licensing arrangement that involves the production, modification or customization of software, and that cannot be separated from the software elements of the arrangement pursuant to the provisions of ASC 605-25-15-3A(c). In such cases, the elements subject to the scope of ASC 985-605, and those elements that are not, should be accounted for as one unit of accounting, and revenue should be recognized based on that one unit. Determining the appropriate revenue recognition model to follow in such instances requires the use of professional judgment and is dependent on the relevant facts and circumstances. However, there is a rebuttable presumption that the revenue recognition model applicable to the final element included in the arrangement is the model that should be followed when recognizing revenue for the combined unit of accounting. Pursuant to such a model, revenue should be recognized once the last item has been delivered, or over a performance period if the last element is a service, if all of the other basic revenue recognition criteria of ASC 985-605 have been met. This is analogous to recognizing the arrangement consideration ratably over the PCS period once the customization services are complete.

The following examples illustrate these concepts:

Illustration 9-3: VSOE of fair value exists for PCS included in arrangement to customize licensed software

Facts

On 31 January 20X1, a calendar year-end software vendor enters into an arrangement to license software Product A and to significantly customize the software to meet customer-specified requirements. The vendor also agrees to provide one year of PCS. Customization services are completed on 31 July 20X1.

Total arrangement consideration is $5 million. VSOE of fair value of PCS is $1 million per year.

Analysis

Because the software requires significant customization, the arrangement should be accounted for using contract accounting pursuant to the provisions of ASC 605-35. However, pursuant to the implementation guidance on the application of contract accounting in ASC 985-605-55-75, the PCS should be accounted for separately from the rest of the arrangement at VSOE of fair value. Accordingly, $4 million of arrangement consideration should be allocated to the software and customization services and recognized during the period the customization services are rendered by the vendor (31 January to 31 July 20X1) using contract accounting.

Arrangement consideration of $1 million should be allocated to the PCS services and recognized ratably over the PCS period.

Illustration 9-4: VSOE of fair value does not exist for PCS included in arrangement to customize licensed software

Facts

Assume the same facts as in Illustration 9-3 above, except that VSOE of fair value of PCS does not exist.

Analysis

Because VSOE of fair value of the PCS included in the arrangement does not exist, the PCS cannot be accounted for separately from the software and customization efforts. The vendor should defer recognition of revenue until completion of the software customization efforts on 31 July 20X1. Assuming the vendor does not anticipate a loss on the contract, it also is appropriate to defer the software customization costs. Once the customization services are completed and the PCS period commences, the vendor should recognize the revenue and costs ratably over the remaining PCS period (if all of the other basic revenue recognition criteria of ASC 985-605 have been met).

Specified upgrade rights included in software licensing arrangements accounted for using contract accounting

Question 9-4 **What is the appropriate accounting for an arrangement that includes software and services that must be accounted for using contract accounting and also includes an upgrade right for a specified upgrade/enhancement to the licensed software?**

A software vendor may enter into arrangements to license and deliver software that must be accounted for using contract accounting (e.g., arrangements that require significant installation services that are essential to the functionality of the licensed software) and also include an upgrade right for a specified upgrade/enhancement (a "specified upgrade right") to the licensed software. In this situation, if VSOE of fair value exists for the specified upgrade right (and any services that might be required to customize the licensed software once upgraded), an amount equal to VSOE of fair value of these items should be deferred. In accordance with ASC 985-605-25-45, no portion of any discount included in the arrangement should be allocated to the specified upgrade right and any associated customization services. The residual of the arrangement consideration should be allocated to the other elements of the arrangement and recognized in accordance with ASC 985-605-25-89 through 25-107.

However, in our experience it is rare that a software vendor will be able to establish VSOE of fair value for a specified upgrade right. If a vendor does not have VSOE of fair value for a specified upgrade right to licensed software that is subject to contract accounting, we believe the guidance in ASC 985-605-25-9 through 25-11 is applicable and all revenue and costs should be deferred until sufficient evidence of VSOE of fair value of the specified upgrade right exists or until the upgrade is delivered. If all customization of the licensed software has been completed prior to the delivery of the specified upgrade, revenue for the entire arrangement should be recognized on delivery of the specified upgrade. If customization has not been completed when the specified upgrade is delivered, the vendor should apply the percentage-of-completion method to the arrangement fee over the remaining customization period, assuming the requirements for applying the percentage-of-completion method have been met. In such cases, we believe that the progress to completion should be calculated based on total revenue and costs of the entire arrangement and not just the portion of the arrangement remaining to be completed after the delivery of the upgrade.

The following examples illustrate these concepts:

Illustration 9-5: VSOE of fair value exists for specified upgrade right

Facts

A calendar year-end software vendor enters into an agreement with a customer on 1 February 20X6 to provide software Product X. The product requires significant installation services that are essential to it operating as designed in the customer's environment. Additionally, the vendor agrees to deliver a specified upgrade to Product X. The vendor does not have to perform any services related to installation of the upgrade. The total contract price is $500,000.

The vendor estimates that the installation of Product X will take approximately 1,000 labor hours to complete at an estimated cost of $300,000. As of 31 March 20X6, the vendor had incurred 250 labor hours. Installation is successfully completed 15 June 20X6. The vendor applies the percentage-of-completion method of contract accounting and utilizes labor hours to measures progress toward completion of the installation effort (see Questions 9-19 and 9-20).

The vendor has established VSOE of fair value for the specified upgrade right of $100,000. (Note that in our experience, it is rare that a software vendor will be able to establish VSOE of fair value of a specified upgrade right). The upgrade is delivered to the customer on 1 December 20X6.

Analysis

Because VSOE of fair value of the specified upgrade right exists, the vendor should defer recognition of $100,000 of the arrangement consideration until the upgrade is delivered to the customer.

The remaining $400,000 of arrangement consideration should be recognized over the installation period using the percentage-of-completion method of contract accounting. As of 31 March 20X6, the contract is estimated to be 25% complete (250 hours incurred/1,000 total hours). The vendor should recognize $100,000 in revenue ($400,000 X 25%) and $75,000 in costs ($300,000 X 25%) under Alternative A to the percentage-of-completion method (as explained in ASC 605-35-25-83) during the three months ended 31 March 20X6. During the three months ended 30 June 20X6, the remainder of the $400,000 allocated to the licensed software and installation services, and the remaining contract costs, should be recognized by the vendor.

The $100,000 of arrangement consideration allocated to the specified upgrade right should be recognized on 1 December 20X6, when the upgrade is delivered to the customer.

Illustration 9-6: VSOE of fair value does not exist for specified upgrade right

Facts

Assume the same facts as Illustration 9-5 above, except VSOE of fair value not exist for the specified upgrade right.

Analysis

As VSOE of fair value for the specified upgrade right does not exist, the entire arrangement should be accounted for as one unit of accounting and no revenue should be recognized until the upgrade is delivered.

Contract accounting arrangements including undelivered specified additional products

Question 9-5 **What is the appropriate accounting treatment for an arrangement that includes software and services that must be accounted for using contract accounting and also includes specified additional software products to be delivered in the future?**

A software vendor may enter into arrangements to license and deliver software that must be accounted for using contract accounting (e.g., arrangements that require significant installation services that are essential to the functionality of the licensed software) and agree to deliver specified additional software products in the future. In this situation, if VSOE of fair value exists for the specified additional software products, an amount equal to VSOE of fair value of these items should be deferred. The residual of the arrangement consideration should be allocated to the other elements of the arrangement and recognized in accordance with ASC 985-605-25-89 through 25-107.

If a vendor does not have VSOE of fair value for the specified additional software products, we believe the guidance in ASC 985-605-25-9 through 25-11 is applicable and that all revenue and costs should be deferred until sufficient evidence of VSOE of fair value of the specified additional software products exists or until all the products are delivered. If all customization of the licensed software has been completed prior to the delivery of the specified additional software products, revenue for the entire arrangement should be recognized on delivery of the specified additional product. If customization has not been completed, the vendor should apply the percentage-of-completion method to the arrangement fees over the remaining customization period, assuming the requirements for applying the percentage-of-completion method have been met. In such cases, we believe that the progress to completion should be calculated based on total revenue and costs of the entire arrangement and not just the portion of the arrangement remaining to be completed after the delivery of the specified additional software products.

The following examples illustrate these concepts:

Illustration 9-7: VSOE of fair value of specified additional products exists

Facts

A calendar year-end software vendor enters into an agreement with a customer on 1 February 20X6 to provide software Product X, which requires significant customization, and Product Y, which will be delivered on 30 July 20X6. The total contract price is $500,000.

The vendor estimates that the installation of Product X will take approximately 1,000 labor hours to complete at an estimated cost of $300,000. As of 31 March 20X6, the vendor had incurred 250 labor hours. Installation is successfully completed 15 June 20X6. The vendor applies the percentage-of-completion method of contract accounting and utilizes labor hours to measures progress toward completion of the installation effort.

The vendor has established VSOE of fair value for Product Y of $100,000. Product Y is delivered to the customer on 30 July 20X6.

Analysis

As VSOE of fair value for Product Y exists, $100,000 of the total arrangement consideration of $500,000 should be allocated to Product Y. This amount should be recognized as revenue on delivery of Product Y on 30 July 20X6, if all of the other basic revenue recognition criteria of ASC 985-605 have been met.

The remaining arrangement consideration of $400,000 should be allocated to the Product X software license and related customization services and recognized over the customization period using the percentage-of-completion method. As of 31 March 20X6, the contract is estimated to be 25% complete (250 hours incurred/1,000 total hours). Accordingly, the vendor should recognize $100,000 in revenue ($400,000 X 25%) and $75,000 in costs ($300,000 X 25%) under Alternative A to the percentage-of-completion method (as explained in ASC 605-35-25-83) during the three months ended 31 March 20X6. The remaining revenue and costs associated with the Product X software license and related customization efforts should be recognized during the three months ended 30 June 20X6.

Illustration 9-8: VSOE of fair value of specified additional products does not exist

Facts

Assume the same facts as Illustration 9-7 above, except VSOE of fair value for Product Y does not exist.

Analysis

As VSOE of fair value for Product Y does not exist, the entire arrangement should be accounted for as one unit of accounting and no revenue should be recognized until Product Y is delivered. During the three months ended 31 March and 30 June 20X6, no revenue would be recognized and all costs associated with the software customization effort would be deferred. On delivery of Product Y, the arrangement's entire fees and costs can be recognized.

Rights to unspecified additional software products included in software licensing arrangements accounted for using contract accounting

Question 9-6 **What is the appropriate accounting for a software licensing arrangement that includes services that should be accounted for using contract accounting and also includes an agreement to provide unspecified additional software products in the future?**

Pursuant to ASC 985-605-25-58 and 25-59, arrangements to provide unspecified software products should be accounted for as subscriptions. ASC 985-605-25-59 states that all software product-related revenue from the arrangement should be recognized ratably over the term of the arrangement beginning with delivery of the first product. If the term of the arrangement is not stated, the revenue should be recognized ratably over the estimated economic life of the products covered by the arrangement, beginning with delivery of the first product (see Questions 5-27 through 5-30).

A software vendor may enter into arrangements to license and deliver software that must be accounted for using contract accounting (i.e., arrangements that require significant installation services that are essential to the functionality of the licensed software) and agree to deliver unspecified additional software products in the future. Questions arise as to how the provisions of ASC 985-605-25-58 and 25-59 should be applied if an arrangement also includes services that should be accounted for using contract accounting. In such cases, we believe that no revenue should be recognized for the arrangement until the software customization efforts have been completed. Once customization is complete, revenue should be recorded ratably over the remaining subscription period. Assuming the vendor does not anticipate a loss on the contract, it is appropriate to defer the costs associated with the software customization until such efforts are complete and amortize those costs over the remaining subscription period.

The following example illustrates these concepts:

Illustration 9-9: Rights to unspecified additional software products included in software licensing arrangements accounted for using contract accounting

Facts

A software vendor enters into an agreement with a customer on 1 April 20X6 to provide Product X, which requires significant customization, and to provide any new products that are released in the Product X family over the next 24 months. Total arrangement consideration is $900,000.

The vendor completes the customization efforts on 30 September 20X6, at a total cost of $360,000.

Analysis

Once customization is complete, the vendor should record the $900,000 contract fee and $360,000 in costs ratably over the remaining 18 months of the agreement ($50,000 per month in revenue and $20,000 in costs).

Precontract costs

Question 9-7 **May a software vendor defer costs that are incurred in anticipation of a specific contract that will be accounted for using contract accounting and that will result in no future benefits unless the contract is obtained?**

Pursuant to ASC 605-35, certain types of costs incurred in anticipation of obtaining a contract that will be accounted for pursuant to its provisions may be deferred, if recovery from the future contract is probable. ASC 605-35 provides the following guidance regarding precontract costs.

Excerpt from Accounting Standards Codification

Revenue Recognition — Construction-Type and Production-Type Contracts

Recognition

605-35-25-41

The following accounting is recommended for precontract costs:

a. Costs that are incurred for a specific anticipated contract and that will result in no future benefits unless the contract is obtained shall not be included in contract costs or inventory before the receipt of the contract. However, such costs otherwise may be deferred, subject to evaluation of their probable recoverability, but only if the costs can be directly associated with a specific anticipated contract and if their recoverability from that contract is probable. Precontract costs that are start-up activities shall be expensed as incurred if they are determined to be within the scope of Subtopic 720-15.

b. Costs incurred for assets, such as costs for the purchase of materials, production equipment, or supplies, that are expected to be used in connection with anticipated contracts may be deferred outside the contract cost or inventory classification if their recovery from future contract revenue or from other dispositions of the assets is probable.

c. Costs incurred to acquire or produce goods in excess of the amounts required for an existing contract in anticipation of future orders for the same items may be treated as inventory if their recovery is probable.

d. Learning or start-up costs incurred in connection with existing contracts and in anticipation of follow-on or future contracts for the same goods or services should be charged to existing contracts.

e. Costs appropriately deferred in anticipation of a contract shall be included in contract costs on the receipt of the anticipated contract.

f. Costs related to anticipated contracts that are charged to expenses as incurred because their recovery is not considered probable shall not be reinstated by a credit to income on the subsequent receipt of the contract.

It should be noted that precontract costs within the scope of ASC 720-15, *Other Expenses — Start-Up Costs*, have to be expensed as incurred. Under ASC 720-15, start-up activities are defined broadly as those one-time activities related to opening a new facility, introducing a new product or service, conducting business in a new territory, conducting business with a new class of customer, initiating a new process in an existing facility or commencing some new operation.

As software vendors generally would not begin significant production, modification or customization efforts prior to finalizing a contract with a customer, we believe it will be rare that significant amounts of precontract costs will be incurred in connection with anticipated software licensing arrangements that will be accounted for using contract accounting.

9.3 Applying contract accounting to software arrangements

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-89

In applying contract accounting, the vendor shall use either the percentage-of-completion method or the completed-contract method. The determination of the appropriate method shall be made using the guidance in paragraphs 605-35-25-56 through 25-61 and 605-35-25-90 through 25-93.

985-605-25-90

The following guidance addresses various considerations related to contract accounting, specifically:

a. Segmentation (see paragraphs 985-605-25-91 through 25-92)

b. Measuring progress-to-completion under the percentage-of-completion method (see paragraphs 985-605-25-93 through 25-96)

c. Input measures (see paragraphs 985-605-25-97 through 25-100)

d. Output measures (see paragraphs 985-605-25-101 through 25-107).

Selecting between the percentage-of-completion and completed-contract methods of contract accounting

Question 9-8 **Is one method (either percentage-of-completion or completed-contract) more appropriate when applying contract accounting to software licensing arrangements?**

The basic decision in accounting for contracts is the selection of the accounting methods. This decision requires a careful evaluation of the specific circumstances. Although ASC 605-35 does not dictate when to use the percentage-of-completion method or the completed-contract method, given the nature of arrangements that falls within its scope, the percentage-of-completion method generally is viewed as the model that best reflects the economics of these arrangements. Under this method, a software vendor accounting for arrangements to customize licensed software records revenue and costs as the arrangement progresses. Therefore, the percentage-of-completion method should be used when a vendor has the ability to make reasonably dependable estimates of total contract revenues, total contract costs and the extent of progress toward completion of the contract (see Question 9-9). However, if the contractor enters into an unusual or atypical contract, consideration should be given to which method is most appropriate based on the applicable facts and circumstances. When a company appropriately departs from its normal policy and the contract is significant, disclosure of the departure should be made. (Such a departure would not be a change in accounting, but rather the use of a more appropriate method of accounting for that particular contract.)

ASC 605-35 provides the following guidance regarding the circumstances in which it would be appropriate to use the percentage-of-completion method.

Excerpt from Accounting Standards Codification

Revenue Recognition — Construction-Type and Production-Type Contracts

Recognition

605-35-25-56

The use of the percentage-of-completion method depends on the ability to make reasonably dependable estimates, which, for purposes of this Subtopic, relates to estimates of the extent of progress toward completion, contract revenues, and contract costs.

605-35-25-57

The percentage-of-completion method is considered preferable as an accounting policy in circumstances in which reasonably dependable estimates can be made and in which all the following conditions exist:

a. Contracts executed by the parties normally include provisions that clearly specify the enforceable rights regarding goods or services to be provided and received by the parties, the consideration to be exchanged, and the manner and terms of settlement.

b. The buyer can be expected to satisfy all obligations under the contract.

c. The contractor can be expected to perform all contractual obligations.

605-35-25-58

For entities engaged on a continuing basis in the production and delivery of goods or services under contractual arrangements and for whom contracting represents a significant part of their operations, the presumption is that they have the ability to make estimates that are sufficiently dependable to justify the use of the percentage-of-completion method of accounting. Persuasive evidence to the contrary is necessary to overcome that presumption. The ability to produce reasonably dependable estimates is an essential element of the contracting business. Accordingly, entities with significant contracting operations generally have the ability to produce reasonably dependable estimates and for such entities the percentage-of-completion method of accounting is preferable in most circumstances.

605-35-25-59

Many contractors have informal estimating procedures that may result in poorly documented estimates and marginal quality field reporting and job costing systems. Those conditions may influence the ability of an entity to produce reasonably dependable estimates. However, procedures and systems should not influence the development of accounting principles.

605-35-25-60

The percentage-of-completion method shall be applied to individual contracts or profit centers, as appropriate, based on all of the following considerations:

a. Normally, a contractor will be able to estimate total contract revenue and total contract cost in single amounts. Those amounts should normally be used as the basis for accounting for contracts under the percentage-of-completion method.

b. For some contracts, on which some level of profit is assured, a contractor may only be able to estimate total contract revenue and total contract cost in ranges of amounts. If, based on the information arising in estimating the ranges of amounts and all other pertinent data, the contractor can determine the amounts in the ranges that are most likely to occur, those amounts shall be used in accounting for the contract under the percentage-of-completion method. If the most likely amounts cannot be determined, the lowest probable level of profit in the range shall be used in accounting for the contract until the results can be estimated more precisely.

c. However, in some circumstances, estimating the final outcome may be impractical except to assure that no loss will be incurred. In those circumstances, a contractor shall use a zero estimate of profit; equal amounts of revenue and cost shall be recognized until results can be estimated more precisely. A contractor shall use this basis only if the bases in (a) or (b) are clearly not appropriate.

605-35-25-61

An entity using the percentage-of-completion method as its basic accounting policy shall use the completed-contract method for a single contract or a group of contracts for which reasonably dependable estimates cannot be made or for which inherent hazards make estimates doubtful.

Disclosure

605-35-50-3

An entity that departs from use of the percentage-of-completion method as its basic accounting policy in the circumstances described in paragraph 605-35-25-61 shall disclose such a departure from the basic policy.

ASC 605-35 presumes that companies with significant contracting operations are able to make estimates that are dependable enough to justify using the percentage-of-completion method. In order to overcome that presumption, vendors must have persuasive evidence to the contrary. We believe this presumption may not be appropriate for certain software vendors that do not routinely modify or customize licensed software. Reasonably dependable estimates may be more difficult to develop for software arrangements than "traditional" contracting arrangements contemplated by ASC 605-35. Accordingly, software vendors should consider carefully whether they meet the criteria for applying the percentage-of-completion method and document their conclusions and the basis for those conclusions.

ASC 605-35 discourages vendors from using the percentage-of-completion method of contract accounting when inherent hazards make the vendor's estimates doubtful. "Inherent hazards" relate to contract conditions or external factors that raise questions about contract estimates and the ability of the vendor or customer to perform. Inherent hazards are different from inherent business risks, in that inherent hazards involve conditions and events that would not be considered in the ordinary preparation of contract estimates and would not be expected to recur frequently. These hazards are unrelated to the vendor's typical activities. Examples cited by ASC 605-35 include 1) contracts whose validity is seriously in question, 2) contracts whose completion may be subject to the outcome of pending legislation or litigation and 3) contracts whose resulting properties may be condemned or expropriated. Absent persuasive evidence, we believe it would be rare that these hazards would be applicable to software licensing arrangements.

If a vendor's basic accounting policy when applying contract accounting to a software licensing arrangement is percentage-of-completion, it is still appropriate to use the completed-contract method for a single arrangement or for a group of arrangements if, based on the particular facts and circumstances of an arrangement, 1) the vendor cannot make reasonably dependable estimates of the extent of progress toward completion, total contract revenues or total contract costs or 2) "inherent hazards" make estimates doubtful. However, such a departure from the vendor's basic accounting policy should be disclosed.

Although the percentage-of-completion method of contract accounting is preferred when a vendor can make reasonably dependable estimates of the progress toward completion, total contract revenues and total contract costs, a vendor may use the completed-contract method as its basic accounting policy if its financial position and results of operations would not be materially different from those under the percentage-of-completion method. An example of such a situation is a vendor who enters into relatively short-term contracts during an accounting period. These contracts are completed in such a short amount of time that the results of operations and financial position would not be significantly different under either method. Before concluding that such accounting is appropriate, however, consideration should be given to whether such arrangements are in essence product sales to which contract accounting should not be applied (see Question 9-1).

Application of the percentage-of-completion method of contract accounting

Question 9-9 **Should a vendor be able to estimate total contract revenue and total contract costs as single amounts in order to apply the percentage-of-completion method of contract accounting to a software licensing arrangement?**

ASC 605-35-25-58 to 25-60 concludes that vendors with significant contracting operations generally have the ability to produce reasonably dependable estimates of total contract revenues and costs. In normal circumstances, vendors should be able to estimate total contract revenue and total contract cost in single amounts. In such cases, those amounts should be used when accounting for the arrangement.

However, if reasonably dependable estimates of single amounts of total contract revenues and total contract costs cannot be made, but estimates of ranges of amounts can be made, and some level of profit is assured, the ranges should be used in accounting for the contract. However, the amounts that should be used vary depending on the circumstances. If, based on the information arising in estimating the ranges of amounts and all other pertinent data, the vendor can determine the amounts within the ranges most likely to occur, those amounts should be used. If the vendor cannot determine the most likely amounts, it should use the lowest probable level of profit in the range until it can estimate more precise results.

If a vendor cannot reasonably estimate the final outcome of its performance on a contract except to assure that no loss will be incurred, it may account for the contract using a zero profit margin approach until it can make a more precise estimate. Under the zero profit margin approach to applying the percentage-of-completion method of contract accounting, equal amounts of revenue and costs, as measured based on the costs incurred by a vendor during a reporting period, are presented in the income statement. Development of more precise estimates allowing the recognition of profit using the percentage-of-completion method should be accounted for as a change in accounting estimate.

Question 9-3 addresses how the inclusion of PCS in a multiple-element arrangement that also includes services involving significant production, modification or customization of the licensed software affects the accounting for the arrangement.

Application of the completed-contract method of contract accounting

Question 9-10 **When is it appropriate to apply the completed-contract method of contract accounting to a software licensing arrangement?**

A vendor that does not meet the conditions to use the percentage-of-completion method (e.g., the vendor cannot make reasonably dependable estimates — see Questions 9-8 and 9-9) should use the completed-contract method of contract accounting. Under the completed-contract method, billings and costs are accumulated on the balance sheet while the contract is in progress, but no revenue is recognized until the arrangement is completed or substantially completed. Although the completed-contract method does not rely on estimates, it also does not reflect current performance when the contract extends beyond one accounting period, and it often results in irregular recognition of income.

ASC 605-35-25-67 (see Question 9-3) indicates that if there is an assurance no loss will be incurred on a contract (e.g., when the scope of the contract is not well defined, but the vendor is protected from incurring a loss by contractual terms), the contract should be recorded using the percentage-of-completion method based on a zero profit margin, rather than the completed-contract method. Under the zero profit margin approach to applying the percentage-of-completion method of contract accounting, equal amounts of revenue and costs, as measured based on the costs incurred by a vendor during a reporting period, are presented in the income statement. Development of more precise estimates allowing the recognition of profit using the percentage-of-completion method should be accounted for as a change in accounting estimate.

Question 9-3 addresses how the inclusion of PCS in a multiple-element arrangement that also includes services involving significant production, modification or customization of the licensed software affects the accounting for the arrangement.

Customer acceptance provisions included in software licensing arrangements subject to contract accounting

Question 9-11 **Does a customer acceptance provision included in a software licensing arrangement subject to contract accounting affect a vendor's ability to apply the percentage-of-completion method to the arrangement?**

Software arrangements that are subject to contract accounting may include some form of a customer acceptance provision. Uncertainty relating to customer acceptance may prevent a vendor from making reasonably dependable estimates of the extent of progress toward completion, total contract revenues or total contract costs, all of which are required to apply the percentage-of-completion method of contract accounting (see Questions 9-8 and 9-9). In addition, ASC 605-35-25-57 specifies that both the buyer and vendor must be expected to satisfy their obligations under the contract to apply the percentage-of-completion method of contract accounting.

While the presence of a customer acceptance provision does not automatically indicate that a vendor should account for an arrangement under the completed-contract method, if there is significant uncertainty regarding customer acceptance, the completed-contract method should be applied and no revenue should be recognized until acceptance occurs or is reasonably assured. The implementation guidance in ASC 985-605-55-80 and 55-81 on the effects of customer acceptance on software revenue recognition, and SAB Topic 13, should be considered in assessing the effect of customer acceptance provisions on software arrangements subject to contract accounting (see Question 4-27).

Additional factors to consider in determining whether acceptance is uncertain in contract accounting arrangements include:

- *Historical experience with similar types of arrangements.* If the vendor has a history of meeting acceptance criteria in similar arrangements, this may be an indicator that acceptance is reasonably assured.
- *Payment terms.* If a significant portion of the fee is not due until customer acceptance occurs, or if payments made prior to acceptance are refundable, this may be an indicator that acceptance is uncertain.
- *Customer participation in the project.* If the customer is actively involved in the arrangement, including the development of the project plan, there may be a greater likelihood that acceptance will occur.
- *Nature of the project and the existence of other vendors.* If the project is critical to the customer and there are no other vendors who can perform similar services, there may be a greater likelihood that acceptance will occur.

If a vendor concludes a contract should be accounted for using the completed-contract method due to significant uncertainty regarding customer acceptance, we believe that it would not be appropriate to accumulate costs related to the contract on the balance sheet until acceptance occurs or is reasonably assured.

Inclusion of extended payment terms in software licensing arrangements subject to contract accounting

Question 9-12 **When should revenue be recognized if a software licensing arrangement subject to contract accounting includes extended payment terms?**

Payments due pursuant to software licensing arrangements that are subject to contract accounting may be spread over the term of the project. Payments may become due based on the passage of time or may be linked to the achievement of contract milestones. If a software licensing arrangement includes such payments, and those terms are in excess of the payment terms normally provided to the vendor's other customers, the arrangement should be considered to include extended payment terms (see Question 4-44).

Because of the relatively short life cycle of many software products, the susceptibility of software to technological obsolescence and other external factors, a software product's continuing value may be reduced due to the subsequent introduction of enhanced products (either by the vendor or another software vendor). Accordingly, the possibility a vendor will grant concessions to a customer to liquidate amounts due under the original terms of an arrangement or modify the licensing of a subsequent version of the licensed software increases as payment terms become longer. As a result, fees in software licensing arrangements involving extended payment terms may not be fixed or determinable.

We believe that these same concerns are applicable to fees due pursuant to extended payment terms included in a software licensing arrangement involving services subject to contract accounting. In such cases, it may be difficult for a vendor to make the reasonably dependable estimates of total contract revenue that are required to apply the percentage-of-completion method of contract accounting. If so, we believe that the vendor should account for the contract using the completed-contract method of contract accounting. In addition, if the completed-contract method is used due to uncertainties resulting from the extended payment terms, we believe it would not be appropriate to accumulate costs related to the contract on the balance sheet in excess of payments due when applying the completed-contract method.

Recognition of anticipated losses on software licensing arrangements subject to contract accounting

Question 9-13 **If a software vendor projects that it will incur a loss on completion of a software licensing arrangement that is accounted for using contract accounting, should the anticipated loss be accrued? If so, what costs should be considered when determining whether a loss on a contract is projected and the amount of the loss to be recorded?**

Yes. ASC 605-35 requires recognition of the entire amount of projected losses on contracts accounted for in accordance with its provisions in the period when the loss first becomes evident.

Excerpt from Accounting Standards Codification

Revenue Recognition — Construction-Type and Production-Type Contracts

Recognition

605-35-25-46

When the current estimates of total contract revenue and contract cost indicate a loss, a provision for the entire loss on the contract shall be made. Provisions for losses shall be made in the period in which they become evident under either the percentage-of-completion method or the completed-contract method.

605-35-25-47

If a group of contracts are combined based on the criteria in paragraphs 605-35-25-8 through 25-9, they shall be treated as a unit in determining the necessity for a provision for a loss. If contracts are segmented based on the criteria in paragraphs 605-35-25-12 through 25-14 the individual segments shall be considered separately in determining the need for a provision for a loss.

605-35-25-48

Losses on cost-type contracts, although less frequent, may arise if, for example, a contract provides for guaranteed maximum reimbursable costs or target penalties. In recognizing losses for accounting purposes, the contractor's normal cost accounting methods shall be used in determining the total cost overrun on the contract, and losses shall include provisions for performance penalties.

605-35-25-49

The costs used in arriving at the estimated loss on a contract shall include all costs of the type allocable to contracts under paragraph 605-35-25-37. Other factors that should be considered in arriving at the projected loss on a contract include all of the following:

a. Target penalties and rewards

b. Nonreimbursable costs on cost-plus contracts

c. Change orders

d. Potential price redeterminations.

605-35-25-50

In circumstances in which general and administrative expenses are treated as contract costs under the completed-contract method of accounting, the estimated loss shall include the same types of general and administrative expenses.

Other Presentation

605-35-45-1

The provision for loss arises because estimated cost for the contract exceeds estimated revenue. Consequently, the provision for loss shall be accounted for in the income statement as an additional contract cost rather than as a reduction of contract revenue, which is a function of contract price, not cost. Unless the provision is material in amount or unusual or infrequent in nature, the provision shall be included in contract cost and shall not be shown separately in the income statement. If it is shown separately, it shall be shown as a component of the cost included in the computation of gross profit.

605-35-45-2

Provisions for losses on contracts shall be shown separately as liabilities on the balance sheet, if significant, except in circumstances in which related costs are accumulated on the balance sheet, in which case the provisions may be deducted from the related accumulated costs. In a classified balance sheet, a provision shown as a liability shall be shown as a current liability.

This accounting is applicable regardless of whether a contract is accounted for using the percentage-of-completion or completed-contract method of contract accounting pursuant to ASC 605-35.

9.4 Combining and segmenting contracts

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-91

Software contracts may have discrete elements that meet the criteria for segmenting in paragraphs 605-35-25-10 through 25-14. If a contract is segmented, each segment is treated as a separate profit center. Progress-to-completion for each segment shall be measured in conformity with paragraphs 985-605-25-93 through 25-96.

985-605-25-92

Some vendors of arrangements that include software combined with services or hardware or both do not identify the elements separately and do not sell them separately because of agreements with their suppliers. Other vendors who are not restricted by such agreements nevertheless bid or negotiate software and other products and services together. Arrangements that do not meet the segmentation criteria in paragraph 605-35-25-12 are prohibited from being segmented, unless the vendor has a history of providing the software and other products and services to customers under separate arrangements and the arrangement meets the criteria in paragraph 605-35-25-13.

Combining contracts for purposes of determining if contract accounting should be applied to a software licensing arrangement

Question 9-14 **How should a software vendor determine if multiple contracts entered into with a customer within a relatively short period of time should be combined when one or more of the arrangements involve significant production, modification or customization of the licensed software or services that are essential to other elements of the arrangement, and thus accounted for using contract accounting?**

As discussed in Question 5-2, the criteria used to determine if arrangements are linked are outlined in the implementation guidance in ASC 985-605-55-4 and supplemental guidance issued by the SEC. The guidance in ASC 605-35-25-5 through 25-9, which discusses when contracts should be combined for purposes of applying its provisions, should also be considered.

Excerpt from Accounting Standards Codification

Revenue Recognition — Construction-Type and Production-Type Contracts

Recognition

605-35-25-5

A group of contracts may be so closely related that they are, in effect, parts of a single project with an overall profit margin, and accounting for the contracts individually may not be feasible or appropriate. If there is a close relationship between profitable and unprofitable contracts, such as in the case of contracts that are parts of the same project, the group may be treated as a unit in determining the necessity for a provision for loss (see paragraph 605-35-25-47) and consideration should be given to combining such contracts for profit recognition purposes. The presumption in combining contracts is that revenue and profit are earned, and should be reported, uniformly over the performance of the combined contracts.

605-35-25-6

For example, a group of construction-type contracts may be negotiated as a package with the objective of achieving an overall profit margin, although the profit margins on the individual contracts may vary. In those circumstances, if the individual contracts are performed and reported in different periods and accounted for separately, the reported profit margins in those periods will differ from the profit margin contemplated in the negotiations for reasons other than differences in performance.

605-35-25-7

Contracts may be combined for accounting purposes only if they meet the criteria in paragraphs 605-35-25-8 through 25-9.

605-35-25-8

A group of contracts may be combined for accounting purposes if all the following conditions exist:

a. The contracts are negotiated as a package in the same economic environment with an overall profit margin objective. Contracts not executed at the same time may be considered to have been negotiated as a package in the same economic environment only if the time period between the commitments of the parties to the individual contracts is reasonably short. The longer the period between the commitments of the parties to the contracts, the more likely it is that the economic circumstances affecting the negotiations have changed.

b. The contracts constitute in essence an agreement to do a single project. A project for this purpose consists of construction, or related service activity with different elements, phases, or units of output that are closely interrelated or interdependent in terms of their design, technology, and function or their ultimate purpose or use.

c. The contracts require closely interrelated construction activities with substantial common costs that cannot be separately identified with, or reasonably allocated to, the elements, phases, or units of output.

d. The contracts are performed concurrently or in a continuous sequence under the same project management at the same location or at different locations in the same general vicinity.

e. The contracts constitute in substance an agreement with a single customer. In assessing whether the contracts meet this criterion, the facts and circumstances relating to the other criteria should be considered. In some circumstances different divisions of the same entity would not constitute a single customer if, for example, the negotiations are conducted independently with the different divisions. On the other hand, two or more parties may constitute in substance a single customer if, for example, the negotiations are conducted jointly with the parties to do what in essence is a single project.

Contracts that meet all of these criteria may be combined for profit recognition and for determining the need for a provision for losses in accordance with paragraphs 605-35-25-46 through 25-47. The criteria shall be applied consistently to contracts with similar characteristics in similar circumstances.

605-35-25-9

Production-type contracts that do not meet the criteria in paragraph 605-35-25-8 or segments of such contracts may be combined into groupings such as production lots or releases for the purpose of accumulating and allocating production costs to units produced or delivered on the basis of average unit costs if both of the following circumstances exist:

a. The contracts are with one or more customers for the production of substantially identical units of a basic item produced concurrently or sequentially.

b. Revenue on the contracts is recognized on the units-of-delivery basis of applying the percentage-of-completion method.

If multiple contracts meet the criteria for combining, the provisions of ASC 985-605 and ASC 605-25 should be applied to determine if any of the elements of the arrangement subject to the scope of ASC 985-605 and, by extension, ASC 605-35, should be accounted for separately from any elements of the arrangement that are not subject to their scope (see Questions 2-2 and 2-3). However, it is not appropriate to separate elements that would be individually subject to contract accounting (e.g., segment individual software products that each require significant customization) unless the segmentation criteria discussed in Question 9-15 are met.

Segmenting contracts

Question 9-15 **When should elements of a software licensing arrangement subject to contract accounting be segmented and accounted for as separate units of accounting?**

Pursuant to ASC 605-35-25-10, a contract or a group of combined contracts may include several elements or phases, each of which the vendor negotiated separately and agreed to perform without regard to the performance of the others. If those elements are accounted for as a single profit center, the periodic income reported may differ from that contemplated in the negotiations. In such cases, if specific criteria established by ASC 605-35 are satisfied, the elements of the contractual arrangement should be segmented and accounted for as separate units of accounting (termed profit centers by ASC 605-35). If the project is segmented, arrangement consideration can be assigned to the different elements to achieve different rates of profitability based on the relative value of each element or phase to the estimated total contract revenue.

ASC 605-35 provides the following guidance relating to the segmenting of contracts subject to its scope.

Excerpt from Accounting Standards Codification

Revenue Recognition — Construction-Type and Production-Type Contracts

Recognition

605-35-25-10

A single contract or a group of contracts that otherwise meet the criteria for combining may include several elements or phases, each of which the contractor negotiated separately with the same customer and agreed to perform without regard to the performance of the others. If those activities are accounted for as a single profit center, the reported income may differ from that contemplated in the negotiations for reasons other than differences in performance. If the project is segmented, revenues can be assigned to the different elements or phases to achieve different rates of profitability based on the relative value of each element or phase to the estimated total contract revenue.

605-35-25-11

A project, which may consist of a single contract or a group of contracts, with segments that have different rates of profitability may be segmented if it meets the criteria in paragraphs 605-35-25-12 through 25-14. The criteria for segmenting shall be applied consistently to contracts with similar characteristics and in similar circumstances.

605-35-25-12

A project may be segmented if all of the following steps were taken and are documented and verifiable:

a. The contractor submitted bona fide proposals on the separate components of the project and on the entire project.

b. The customer had the right to accept the proposals on either basis.

c. The aggregate amount of the proposals on the separate components approximated the amount of the proposal on the entire project.

605-35-25-13

A project that does not meet the criteria in the preceding paragraph may be segmented only if it meets all of the following criteria:

a. The terms and scope of the contract or project clearly call for separable phases or elements.

b. The separable phases or elements of the project are often bid or negotiated separately.

c. The market assigns different gross profit rates to the segments because of factors such as different levels of risk or differences in the relationship of the supply and demand for the services provided in different segments.

d. The contractor has a significant history of providing similar services to other customers under separate contracts for each significant segment to which a profit margin higher than the overall profit margin on the project is ascribed. In applying this criterion, values assignable to the segments shall be on the basis of the contractor's normal historical prices and terms of such services to other customers. A contractor shall not segment on the basis of prices charged by other contractors, because it does not follow that those prices could have been obtained by a contractor who has no history in the market.

e. The significant history with customers who have contracted for services separately is one that is relatively stable in terms of pricing policy rather than one unduly weighted by erratic pricing decisions (responding, for example, to extraordinary economic circumstances or to unique customer-contractor relationships).

f The excess of the sum of the prices of the separate elements over the price of the total project is clearly attributable to cost savings incident to combined performance of the contract obligations (for example, cost savings in supervision, overhead, or equipment mobilization). Unless this condition is met, segmenting a contract with a price substantially less than the sum of the prices of the separate phases or elements would be inappropriate even if the other conditions are met. Acceptable price variations shall be allocated to the separate phases or elements in proportion to the prices ascribed to each. In all other situations a substantial difference in price (whether more or less) between the separate elements and the price of the total project is evidence that the contractor has accepted different profit margins. Accordingly, segmenting is not appropriate, and the contracts shall be the profit centers.

g. The similarity of services and prices in the contract segments and services and the prices of such services to other customers contracted separately should be documented and verifiable.

605-35-25-14

A production-type contract that does not meet the criteria in paragraphs 605-35-25-12 through 25-13 may also be segmented and included in groupings such as production lots or releases for the purpose of accumulating and allocating production costs to units produced or delivered on the basis of average unit cost under the conditions specified in paragraph 605-35-25-9.

According to ASC 985-605-25-92, arrangements that do not meet the segmentation criteria in ASC 605-35-25-12 cannot be segmented unless the vendor has a history of providing the software and other products and services under separate arrangements and the arrangement meets the criteria in ASC 605-35-25-13. We believe that software vendors generally will not meet the above criteria (e.g., providing similar services to other customers under separate contracts for each segment). Therefore, we expect that it will be relatively rare that software licensing arrangements subject to contract accounting can be segmented pursuant to the provisions of ASC 605-35-25-13.

If a contract or group of combined contracts qualifies for segmentation, the vendor may account for each segment as a separate profit center. However, segmentation is not required. ASC 605-35 notes that the criteria for segmenting should be applied consistently to contracts with similar characteristics and in similar circumstances.

If a vendor elects to segment elements, it should measure progress to completion on the individual elements of the software arrangement using the method that best approximates the progress to completion on that element. Progress to completion on different segments of the same arrangement may be measured by different measurements.

Accounting for contract options and additions

Question 9-16 **If a customer requests additional deliverables before a vendor completes all obligations pursuant to a software licensing arrangement accounted for using contract accounting, should the additional deliverables be combined with the original contract?**

ASC 605-35 provides the following guidance on contract options and additions:

Excerpt from Accounting Standards Codification

Revenue Recognition — Construction-Type and Production-Type Contracts

Recognition

605-35-25-29

An option or an addition to an existing contract shall be treated as a separate contract in any of the following circumstances:

a. The product or service to be provided differs significantly from the product or service provided under the original contract.

b. The price of the new product or service is negotiated without regard to the original contract and involves different economic judgments.

c. The products or services to be provided under the exercised option or amendment are similar to those under the original contract, but the contract price and anticipated contract cost relationship are significantly different.

If an option or addition to an existing contract does not meet any of these conditions, it may be combined with the original contract if it meets the criteria in paragraphs 605-35-25-8 through 25-9. Exercised options or additions that do not meet the criteria for treatment as separate contracts or for combining with the original contracts shall be treated as change orders on the original contracts.

Application of the criteria contained in ASC 605-35-25-8 and 25-9 are discussed in Question 9-14. If an exercised option or addition does not meet the criteria for separation or combination with the original contract, it should be treated as a change order to the contract (see Question 9-17).

Accounting for change orders and claims

Question 9-17 **How should a software vendor account for change orders or claims associated with a software licensing arrangement accounted for using contract accounting?**

As discussed in ASC 605-35-25-25, change orders are modifications of an original contract to change existing provisions without adding new ones. In some cases, the scope and pricing of change orders may be approved by the vendor and the customer on a timely basis during the vendor's performance period. In other cases, the scope may be approved, but the pricing of the change order may not be finalized until a later date. In still other cases, both the scope and pricing of the change order may not be approved until after completion of the contract. Accounting for change orders differs with the underlying circumstances:

- Approved Change Orders — If both the scope and price of a change order are approved by the customer and the vendor during the vendor's performance period, contract revenues and costs should be adjusted accordingly. If the percentage-of-completion method of contract accounting is being used to account for the contract, the amount of estimated contract revenues and costs should be adjusted for the effect of the change order. This should be accounted for as a change in estimate, resulting in a remeasurement of the percentage complete and the amount of recognized revenues and expenses.
- Partially Approved Change Orders — If the scope of a change order has been agreed to by the customer and the vendor, but the pricing has not, the accounting varies depending on whether the contract is accounted for using the percentage-of-completion or completed-contract method of contract accounting.

  Percentage-of-completion method

  - If it is not probable that costs related to unpriced change orders will be recovered through a change in the basic contract price, such costs should be treated as contract costs in the period incurred (i.e., they should be expensed). This effectively assumes that the change order costs will be recovered by the basic contract price.
  - If it is probable that the additional costs associated with the change order will be recovered through a change in the basic contract price, the costs should either 1) be deferred until the parties have agreed to a change in contract price or 2) treated as contract costs in the period incurred, with a like amount of contract revenue recognized. We believe that a vendor should select one of these two methods and apply it consistently when accounting for unpriced change orders.
  - If it is probable that the contract price will be adjusted by more than the amount of the related costs and if the amount of the excess can be reliably estimated, the original contract price also should be adjusted for that amount if realization of the adjusted contract price is probable. However, because it is difficult to substantiate the amount of unpriced change orders, revenue in excess of costs attributable to unpriced change orders should only be recorded when recovery is assured beyond a reasonable doubt (e.g., when a vendor's historical experience provides such assurance or when a vendor has received a bona fide pricing offer from a customer).

Completed-contract method

- Costs attributable to unpriced change orders should be deferred as contract costs if it is probable such costs will be recovered from contract revenues.

  Recovery of unpriced change orders should be deemed probable if the future event or events necessary for recovery are likely. Vendors should consider the customer's written approval of the scope of the change order, separate documentation for change order costs that are identifiable and reasonable and the vendor's favorable experience in negotiating change orders, especially for the specific type of contract or change order being evaluated.

- Unapproved Change Orders — Change orders that are in dispute or unapproved both in scope and price should be evaluated as claims as discussed below.

Claims

Claims are defined in ASC 605-35-25-30 as "amounts in excess of the agreed contract price (or amounts not included in the original contract price) that a contractor seeks to collect from customers or others for customer-caused delays, errors in specifications and designs, contract terminations, change orders in dispute or unapproved as to both scope and price, or other causes of unanticipated additional costs."

A vendor may adopt an accounting policy to recognize revenue for claims when accounting for software licensing arrangements using contract accounting only when received or awarded. We believe that this accounting is preferable for software licensing arrangements accounted for using contract accounting.

Alternatively, vendors may recognize a claim as additional contract revenue if it is probable that the claim will result in additional revenue *and* the amount can be reliably estimated. All of the following conditions must exist to recognize a claim:

- The contract or other evidence provides a legal basis for the claim, or a legal opinion has been obtained stating that under the circumstances there is a reasonable basis to support the claim.
- The additional costs are caused by unforeseen circumstances and are not related to deficiencies in a vendor's performance.
- In relation to the work performed, the costs associated with the claim are identifiable or otherwise determinable and are reasonable.
- Evidence supporting the claim is objective and verifiable (not based on management's "feel").

If these requirements are met, the vendor may record revenue for the claim, but only to the extent that contract costs have been incurred. Accordingly, even if a reliable estimate of the claim amount is greater than the costs incurred, the "excess" amount of the claim should not be recognized as contract revenue until the claim is settled. Any such amounts, as well as any claims that do not meet the criteria above, represent contingent assets that, pursuant to ASC 450, *Contingencies*, should not be recognized until realized. Costs attributable to claims should be treated as a cost of contract performance as incurred.

Adjustments to total contract revenues

Question 9-18 **How should an adjustment to the fees due pursuant to a software licensing arrangement accounted for using the percentage-of-completion method of contract accounting be recorded?**

Adjustments to total estimated contract revenues (e.g., due to change orders or claims — see Question 9-17) should be reflected in the percentage-of-completion calculation in the period they become known. Reductions of total fees should be reflected as a reduction in revenue and not recorded as a bad debt expense. Bad debt expense only should be recorded if the customer is unable to pay the agreed-on fees. Frequent adjustments to total estimated contract revenues should be considered in determining whether the vendor has the ability to make reasonably dependable estimates of total contract revenues (see Question 9-9) and whether fees are fixed or determinable.

9.5 Applying the percentage-of-completion method to software arrangements

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-93

Paragraph 605-35-25-70 describes the approaches to measuring progress on contracts (or segments thereof) under the percentage-of-completion method. Those approaches are grouped into input and output measures, as follows:

a. Input measures are made in terms of efforts devoted to a contract. They include the methods based on costs and on efforts expended.

b. Output measures are made in terms of results achieved. They include methods based on units produced, units delivered, contract milestones, and value added. For contracts under which separate units of output are produced, progress can be measured on the basis of units of work completed.

985-605-25-94

For software contracts, an example of an input measure is labor hours. An example of an output measure is arrangement milestones, such as the completion of specific program modules.

985-605-25-95

If, as discussed in paragraph 985-605-25-91, a software contract includes a discrete element that meets the segmentation criteria of Subtopic 605-35, the method chosen to measure progress-to-completion on the element shall be the method that best approximates progress-to-completion. Progress-to-completion on separate elements of the same software arrangement may be measured by different methods. The software vendor shall choose measurement methods consistently, however, so that it uses similar methods to measure progress-to-completion on similar elements.

985-605-25-96

Output measures, such as value-added or arrangement milestones, may be used to measure progress-to-completion on software arrangements, but many entities use input measures because they are established more easily. Related guidance is provided in paragraphs 605-35-25-70 through 25-78.

If a vendor determines that the percentage-of-completion method is the appropriate method of contract accounting, it must then determine the appropriate approach to measuring progress under the arrangement.

Selecting a method to measure progress to completion requires the use of professional judgment. However, once an approach is selected, that approach should be consistently used when accounting for similar arrangements.

Measuring progress to completion using input versus output measures

Question 9-19 **What are the differences between input measures and output measures? Is the use of one preferable to the other when applying the percentage-of-completion method of contract accounting?**

When using the percentage-of-completion method of contract accounting, vendors may measure the extent of progress toward completion of the contract using either input or output measures. Inputs measure progress toward completion indirectly, based on an established or assumed relationship between a unit of input and productivity (see Questions 9-21 and 9-22). For example, labor hours may be used to estimate the progress of a software customization project. Outputs measure results achieved. Methods based on units of work performed, units delivered, contract milestones and value added are output measures (see Questions 9-23 and 9-24).

Output measures generally are better measures of progress towards completion of a contract. As such, we believe the use of output measures is preferable, if such measures are available.

Both input and output measures have drawbacks in some circumstances, and companies should consider carefully which are most appropriate for use based on the particular facts and circumstances. Inputs measure progress toward completion indirectly by using an established or assumed relationship between units of input and productivity. If those relationships do not materialize (e.g., because of inefficiencies or other factors), the use of input measures may not be appropriate. Conversely, outputs directly measure contract revenue in terms of results achieved based on units produced or delivered, value added or contract milestones. These generally provide a better approximation of progress to completion than input measures but are often difficult to reliably measure or verify. While it may be relatively simple to determine which tasks have been completed on a contract, it may be difficult to translate the completion of those tasks into a measure of progress toward completion on the overall contract. Because of this difficulty, our experience is that input measures are more commonly used to measure progress toward completion of a contract than are output measures.

A vendor must use judgment in determining whether it will use inputs or outputs for measuring progress toward completion for a particular type of contract. However, once a method is selected, it should be consistently applied to all contracts with similar characteristics. Different measurement methods may be appropriate for different types of contracts if the disparate methods provide the best measurement of progress based on the particular characteristics of the varying types of contracts.

The following example illustrates the differences that can result from using inputs versus outputs to measure progress to completion:

Illustration 9-10: Recognizing revenue from input versus output measures

Facts

On 1 October 20X6, a calendar year-end software vendor enters into an agreement to license a software program and significantly customize the licensed software to meet the customer's requirements for consideration of $1,000,000. The licensed software is composed of five modules. The vendor has determined that the completion of the customization efforts related to each module contributes equally to progress on the overall arrangement. The vendor expects to incur 1,000 labor hours and $500,000 in costs to complete the arrangement. At 31 December 20X6, two modules have been completed and installed, and the vendor has incurred 550 labor hours and $300,000 of costs.

The vendor computes earned revenues and costs of earned revenues pursuant to the percentage-of-completion method of contract accounting using Alternative A as described by ASC 605-35-25-83 (see Question 9-20).

Analysis

The amount of revenue, costs and gross profit recognized by the vendor during the period ended 31 December 20X6 would depend on the measure used to estimate progress toward completion of the overall arrangement, as illustrated below:

Labor hours (input measure)

Labor hours incurred to date		550
Total estimated labor hours		1,000
Estimated percentage complete		55%
Revenue recognized ($1,000,000 * 55%)	$	550,000
Costs of revenues recognized ($500,000 * 55%)		275,000
Gross profit recognized	$	275,000

Costs (input measure)

Costs incurred to date	$	300,000
Total estimated costs		500,000
Estimated percentage complete		60%
Revenue recognized ($1,000,000 * 60%)	$	600,000
Costs of revenues recognized ($500,000 * 60%)		300,000
Gross profit recognized	$	300,000

Modules completed (output measure)

Modules completed		2
Total modules		5
Estimated percentage complete		40%
Revenue recognized ($1,000,000 * 40%)	$	400,000
Costs of revenues recognized ($500,000 * 40%)		200,000
Gross profit recognized	$	200,000

Significant judgment is required to determine the method that will most accurately reflect the progress toward completion. In general, having more points of reference (e.g., 1,000 hours versus five modules) is preferable. However, other factors specific to the arrangement also should be considered. For example, in this situation, if inefficiencies in labor hours are anticipated at the beginning of the contract, outputs may be a more appropriate indicator of the progress of the project.

Computation of income earned for a period under the percentage-of-completion method

Question 9-20 **If the percentage-of-completion method of contract accounting is used to account for a software licensing arrangement, how should revenue, costs of revenue and gross profit be calculated each period?**

Two different approaches to determining earned revenue, costs of earned revenue and gross profit are provided by ASC 605-35. Either of the alternative approaches may be used, but they must be applied on a consistent basis.

Excerpt from Accounting Standards Codification

Revenue Recognition — Construction-Type and Production-Type Contracts

Recognition

605-35-25-82

Total estimated gross profit on a contract, the difference between total estimated contract revenue and total estimated contract cost, must be determined before the amount earned on the contract for a period can be determined. The portion of total revenue earned or the total amount of gross profit earned to date is determined by the measurement of the extent of progress toward completion using one of the methods discussed in paragraphs 605-35-25-70 through 25-81. The computation of income earned for a period involves a determination of the portion of total estimated contract revenue that has been earned to date (earned revenue) and the portion of total estimated contract cost related to that revenue (cost of earned revenue). Two different approaches for determining earned revenue and costs of earned revenue are provided in the following paragraph and paragraph 605-35-25-84. Either of the alternative approaches may be used on a consistent basis.

Alternative A

605-35-25-83

Earned revenue, cost of earned revenue, and gross profit are determined as follows:

a. Earned revenue to date shall be computed by multiplying total estimated contract revenue by the percentage of completion (as determined by one of the acceptable methods of measuring the extent of progress toward completion). The excess of the amount over the earned revenue reported in prior periods is the earned revenue that shall be recognized in the income statement for the current period.

b. Cost of earned revenue for the period shall be computed in a similar manner. Cost of earned revenue to date shall be computed by multiplying total estimated contract cost by the percentage of completion on the contract. The excess of that amount over the cost of earned revenue reported in prior periods is the cost of earned revenue that shall be recognized in the income statement for the current period. The difference between total cost incurred to date and cost of earned revenue to date shall be reported on the balance sheet.

c. Gross profit on a contract for a period is the excess of earned revenue over the cost of earned revenue.

Alternative B

605-35-25-84

Earned revenue, cost of earned revenue, and gross profit are determined as follows:

a. Earned revenue is the amount of gross profit earned on a contract for a period plus the costs incurred on the contract during the period.

b. Cost of earned revenue is the cost incurred during the period, excluding the cost of materials not unique to a contract that have not been used for the contract and costs incurred for subcontracted work that is still to be performed.

c. Gross profit earned on a contract shall be computed by multiplying the total estimated gross profit on the contract by the percentage of completion (as determined by one of the acceptable methods of measuring extent of progress toward completion). The excess of that amount over the amount of gross profit reported in prior periods is the earned gross profit that shall be recognized in the income statement for the current period.

The following example illustrates the application of the two approaches:

Illustration 9-11: Earned revenue, cost of earned revenue and gross profit under Alternative A and Alternative B

Facts

On 1 April 20X6, a software company enters into a contract to provide software and customization services to develop functionality specific to the customer's operating environment. The company uses labor hours (an input method) to measure progress toward completion. Financial data related to the contract is as follows:

Estimated contract revenues	$1,000,000
Estimated contract costs	600,000
Estimated gross profit	$ 400,000
Estimated gross profit percentage	40%

Additional information	**Total**	**Period**
Three months ended 30 June 20X6		
Contract costs incurred to date	$ 200,000	$ 200,000
Measure of progress (based on labor hours)	25%	25%
Three months ended 30 September 20X6		
Contract costs incurred to date	$ 425,000	$ 225,000
Measure of progress (based on labor hours)	75%	50%
Three months ended 31 December 20X6		
Contract costs incurred to date	$ 600,000	$ 175,000
Measure of progress (based on labor hours)	100%	25%

Analysis

The amounts of earned revenue, cost of earned revenue and gross profit under each approach for the nine-month period are as follows:

	Alternative A (1)	Alternative B (2)
Three months ended 30 June 20X6		
Earned revenue	$ 250,000	$ 300,000
Cost of earned revenue	150,000	200,000
Gross profit	$ 100,000	$ 100,000
Gross profit percentage	40%	33%
Three months ended 30 September 20X6		
Earned revenue	$ 500,000	$ 425,000
Cost of earned revenue	300,000	225,000
Gross profit	$ 200,000	$ 200,000
Gross profit percentage	40%	47%
Three months ended 31 December 20X6		
Earned revenue	$ 250,000	$ 275,000
Cost of earned revenue	150,000	175,000
Gross profit	$ 100,000	$ 100,000
Gross profit percentage	40%	36%

(1) The following illustrates the calculation of the appropriate amounts for the three months ended 30 September 20X6 under Alternative A:

Earned revenue	
Total estimated contract price	$ 1,000,000
Measure of progress	x 75%
Cumulative revenue earned	750,000
Less amount recognized in three months ended 30 June 20X6	250,000
Amount recognized in three months ended 30 September 20X6	$ 500,000
Cost of earned revenue	
Total estimated costs	$ 600,000
Measure of progress	x 75%
Cumulative cost of earned revenue	450,000
Less amount recognized in three months ended 30 June 20X6	150,000
Amount recognized in three months ended 30 September 20X6	$ 300,000
Gross profit	
Earned revenue per above	$ 750,000
Cost of earned revenue per above	450,000
Cumulative gross profit	300,000
Less amount recognized in three months ended 30 June 20X6	100,000
Amount recognized in three months ended 30 September 20X6	$ 200,000

(2) The following illustrates the calculation of the appropriate amounts for the three months ended 30 September 20X6 under Alternative B:

Gross profit	
Total estimated gross profit	$ 400,000
Measure of progress	x 75%
Cumulative gross profit	300,000
Less amount recognized in three months ended 30 June 20X6	100,000
Amount recognized in three months ended 30 September 20X6	$ 200,000
Cost of earned revenue	
Total cumulative costs incurred at 30 September 20X6	$ 425,000
Less amount recognized in three months ended 30 June 20X6	200,000
Amount recognized in three months ended 30 September 20X6	$ 225,000
Earned revenue	
Cumulative cost incurred at 30 September 20X6	$ 425,000
Add cumulative gross profit at 30 September 20X6	300,000
Cumulative earned revenue at 30 September 20X6	725,000
Less amount recognized in three months ended 30 June 20X6	300,000
Amount recognized in three months ended 30 September 20X6	$ 425,000

This example is relatively simple because there are no changes in estimates during the term of the contract. It does illustrate, however, that in such a situation, the gross profit percentage would be consistent for all periods under the first approach. The amount of gross profit is the same each period under either approach. The only differences are the allocation of earned revenue and cost of earned revenue over the life of the contract.

9.6 Input measures

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-97

Input measures of progress-to-completion on arrangements are made in terms of efforts devoted to the arrangement and, for software arrangements, include methods based on costs, such as cost-to-cost measures, and on efforts expended, such as labor hours or labor dollars. Progress-to-completion is measured indirectly, based on an established or assumed relationship between units of input and productivity. A major advantage of input measures is that inputs expended are easily verifiable. A major disadvantage is that their relationship to progress-to-completion may not hold if inefficiencies exist or if the incurrence of the input at a particular point does not indicate progress-to-completion.

985-605-25-98

Costs incurred shall be included in measuring progress-to-completion only to the extent that they relate to contract performance. Items not specifically produced for the arrangement, such as hardware purchased from third parties or off-the-shelf software, shall not be included in the measurement of progress-to-completion.

985-605-25-99

Labor hours often are chosen as the basis for measuring progress-to-completion, because they closely approximate the output of labor-intensive processes and often are established more easily than output measures. Core software requires labor-intensive customization. Therefore, labor hours provide a good measure of progress-to-completion on elements of software arrangements that involve the customization of core software.

985-605-25-100

If the measurement of progress-to-completion is based primarily on costs, the contribution to that progress of hardware and software that were produced specifically for the arrangement may be measurable and recognizable before delivery to the user's site. For example, efforts to install, configure, and customize the software may occur at the vendor's site. The costs of such activities are measurable and recognizable at the time the activities are performed.

Common input measures

Question 9-21 **What type of input measures are commonly used to measure progress toward the completion of an arrangement accounted for using contract accounting?**

The following common input measures are used to determine progress on a contract:

- *Cost-to-cost* — Pursuant to this method, progress (the percentage complete) is determined by dividing costs incurred to date by the total amount of costs expected to be incurred.

  This method assumes there is a direct correlation between the amount of costs incurred and completion of the vendor's obligations. If it is apparent that this is not the case, the cost-to-cost method should not be used. For example, if the early stages of a contract require the use of specialized labor or the incurrence of unusually high levels of costs that will not be required for the remainder of the contract, it may not be appropriate to measure progress based on the amount of costs incurred.

  As further discussed in Question 9-22, costs of items not specifically produced for an arrangement should not be included in the measurement of progress to completion when using inputs to measure percentage-of-completion.

  Determining the costs that should be included in the measurement is key to the use of this method. Generally, costs directly related to the contract, including amounts paid to subcontractors, and indirect costs specifically allocable or identifiable to the contract should be included in the calculation.

  When determining the amount of contract costs that have been incurred, amounts paid in advance of the performance of work generally should not be included.

- *Efforts-expended* — Efforts-expended methods determine progress based on the ratio of a unit of measure (such as labor hours, machine hours or material quantities) expended to date compared to the total amount of the unit expected to be expended through the contract's completion.

Under the labor-hours method, for example, the extent of progress toward completion is measured by the ratio of hours performed to date to the estimated total labor hours. Estimated labor hours should include 1) the estimated labor hours of the vendor and 2) the estimated labor hours of any subcontractors engaged to perform work for the project. If the efforts of the subcontractors cannot be reasonably estimated, an efforts-expended method should not be used. For example, if a vendor cannot obtain reliable estimates of subcontractors' labor hours, it should not use the labor-hours method.

Although an efforts-expended measurement may be more closely linked to productivity than a cost-to-cost method, inefficiencies and other factors may weaken the relationship between the unit of measurement and progress toward completion of the contract.

Measuring progress to completion using costs incurred

Question 9-22 **If progress to completion is measured using costs incurred to date as compared to total estimated costs (the cost-to-cost method — see Question 9-21), which costs should be included in the calculation?**

Only costs directly related to the vendor's performance on the contract may be included in the computation of progress to completion. The costs of items not specifically produced for an arrangement, such as off-the-shelf software, should not be included in the measurement of progress to completion. However, such costs should be accumulated in the same manner as other contract costs and accounted for pursuant to the provisions of ASC 605-35. Additionally, such costs must be included when determining whether a projected loss on the arrangement should be accrued pursuant to ASC 605-35-25-46 through 25-50 (see Question 9-13).

Software development costs incurred prior to the origination of the arrangement being accounted for using contract accounting (e.g., costs previously incurred to develop core software that will be customized) may not be included in the measurement of progress toward completion, regardless of whether any such previous development costs were capitalized under ASC 985-20.

Additionally, any precontract costs capitalized by a vendor in anticipation of a specific contract (see Question 9-7) should not be included in the measurement of progress toward completion of a contract.

The following example illustrates these concepts:

Illustration 9-12: Costs directly related to the vendor's performance is included in the measure of progress towards completion

Facts

A software vendor markets a core software product that contains five million lines of code. The vendor enters into a software licensing arrangement that will require modification of an estimated one million lines of code of the core software product. The vendor proposes to use lines of code as an input measure for purposes of applying the percentage-of-completion method of contract accounting to the arrangement and recognize 80% (four million lines of unmodified code divided by five million total lines of code) of the arrangement fee on delivery of the core software to the customer.

Analysis

ASC 985-605-25-98 is clear that measurements of progress toward completion should only be based on contract performance. In this situation, the unmodified code was not specifically produced for this arrangement, so it would not be appropriate to include it in a measurement of progress to completion. The vendor should base its estimates of progress toward completion on the one million lines of code to be modified, not the total five million lines of code.

9.7 Output measures

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Recognition

985-605-25-101

Progress on arrangements that call for the production of identifiable units of output can be measured in terms of the value added or milestones reached. Although progress-to-completion based on output measures is measured directly from results achieved, thus providing a better approximation of progress than is provided by input measures, output measures may be unreliable because of the difficulties associated with establishing them.

985-605-25-102

For the value added to be verifiable, the vendor must identify elements or subcomponents of those elements. If output measures are neither known nor reasonably estimable, they shall not be used to measure progress-to-completion.

985-605-25-103

If value added by off-the-shelf software is to be included in the measurement of progress-to-completion, such software cannot require more than minor modifications and must be usable by the customer for the customer's purpose in the customer's environment. If more than minor modifications or additions to the off-the-shelf software are necessary to meet the functionality required under the arrangement terms, either by changing or making additions to the software, or because the software would not be usable by the customer in its off-the-shelf form for the customer's purpose in the customer's environment, it shall be accounted for as core software.

985-605-25-104

Value added by the customization of core software shall be included in the measurement of progress-to-completion of the customization and installation at the user's site. However, if the installation and customization processes are divided into separate output modules, the value of core software associated with the customization of a module shall be included in the measurement of progress-to-completion when that module is completed.

985-605-25-105

Contract milestones may be based on contractual project plans. Contractual provisions generally require the performance of specific tasks with the approval or acceptance by the customer. Project plans generally schedule inspections in which the project's status is reviewed and approved by management. The completion of tasks that trigger such inspections are natural milestones because they are subject to relatively independent review as an intrinsic part of the project management process.

985-605-25-106

Considerations other than progress-to-completion affect the amounts that become billable at particular times under many arrangements. Accordingly, although the achievement of contract milestones may cause arrangement revenues to become billable under the arrangement, the amounts billable shall be used to measure progress-to-completion only if such amounts indeed indicate such progress.

985-605-25-107

The milestones selected to measure progress-to-completion shall be part of the management review process. The percentage-of-completion designated for each milestone shall be determined considering the experience of the vendor on similar projects.

Establishing output measures

Question 9-23 **What are some of the difficulties associated with establishing output measures in software licensing arrangements accounted for using contract accounting?**

As noted in ASC 985-605-24-102, a vendor must be able to identify elements or subcomponents of elements in an arrangement that add value to the customer to use output measures. This may be particularly difficult for software arrangements, as the arrangement may involve the customization of one software program or the sale of hardware that includes customized software. These types of arrangements may not provide enough points of reference to measure progress toward completion of the contract using output measures.

Using milestones as an output measure to determine progress toward completion

Question 9-24 **If milestones are used as an output measure, can the payment terms associated with achievement of those milestones be used to recognize revenue?**

A software vendor may enter into arrangements to license and deliver software that must be accounted for using contract accounting (e.g., arrangements that require significant installation services that are essential to the functionality of the licensed software) and which link payment from the customer to the achievement of certain specific tasks (milestones). Although the achievement of contractually specified milestones may result in a portion of the arrangement consideration becoming due and payable, the amounts due should not be used to measure progress toward completion of the contract unless such amounts are in fact representative of progress, as discussed in ASC 985-605-25-106 (even if the milestone payments are nonrefundable if subsequent milestones are not achieved).

If milestones are used as an output measure for purposes of determining progress toward completion of a contract, management should determine the percentage of completion allocated to each milestone based on its experience with similar projects. These amounts may or may not equal the percentage of total consideration due on achievement of each milestone. For example, a contract may be structured to include a relatively large payment on the achievement of a milestone early in the vendor's efforts towards completion of the contract. If management does not have experience with similar projects and is not able to estimate the percentage that should be allocated to each milestone in such cases, it may be more appropriate to use an input measure to determine progress toward completion.

10 Disclosures

10.1 Chapter summary

ASC 985-605 does not include any specific disclosure requirements. However, if an arrangement has elements subject to both ASC 985-605 and ASC 605-25, the elements within the scope of ASC 605-25 will be subject to the required disclosures included in the multiple-elements arrangements guidance. Additionally, ASC 235-10, *Notes to Financial Statements — Overall*, requires a description of all significant accounting policies, such as revenue recognition policies. According to paragraph ASC 235-10-50-3, the disclosure should encompass important judgments as to the appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods. In particular, disclosures should encompass those accounting principles and methods that involve any of the following:

- A selection from existing acceptable alternatives
- Principles and methods peculiar to the industry in which the reporting entity operates
- Unusual or innovative applications of generally accepted accounting principles

Disclosure of revenue recognition policies is an area closely scrutinized by the SEC staff in review of registrants' filings. Companies should ensure all such disclosures are clear and complete.

SAB Topic 13 provides the SEC staff's belief that registrants always should disclose their policy on revenue recognition because revenue recognition generally involves some level of judgment (SAB Topic 13.B., Question 1). This disclosure should include a description of when revenue is recognized (e.g., on delivery, completion of services or ratably over the contract period). If a company has different policies for different types of revenue transactions, the policy for each material type of revenue arrangement should be disclosed. If sales transactions have multiple elements, such as a product and service, the revenue recognition disclosure should clearly state the accounting policy followed for each element, as well as how multiple elements are determined and valued.

In addition, the December 2005 Current Accounting and Disclosure Issues from the Division of Corporation Finance sets forth the SEC staff's belief that each registrant should disclose a description of its major revenue generating products and services and the arrangements used to deliver them to its customers. This disclosure should include a discussion of the essential terms of major contracts, or groups of similar contracts, including a discussion of payment terms and any unusual provisions or conditions.

Disclosures should also include:

- Whether contracts with a single counterparty are combined or bifurcated.
- Whether multiple elements included in an arrangement can be accounted for separately, and how such determination is made.
- When multiple elements are separated, whether the arrangement consideration is allocated among the units of accounting using the relative-fair-value or residual method. Additionally, companies should disclose how VSOE of fair value was established (or that VSOE has not been established for one or more elements).

- For elements in an arrangement that cannot be separated, companies should disclose the revenue recognition policy for the combined unit of accounting.
- The existence of any side agreements and the effect of such agreements on revenue recognition.

For public registrants, the categories of revenue — product license fees, PCS revenues and services revenues — that exceed 10% of total revenue should be reported as separate line items on the face of the statement of operations, with the related costs and expenses applicable to those items disclosed as separate line items in the same manner, pursuant to Regulation S-X, Rule 5-03(b) 1 and 2. When categories of revenue are presented, we believe the amounts presented should be the same as the revenue allocated using VSOE of fair value, without regard to the amounts stated in the licensing arrangements. Determination of the costs and expenses related to each revenue line item, particularly PCS, may be difficult, and we believe reasonable allocations may be used. If allocations are made for purposes of presentation of costs of revenue, disclosure of the allocation method should be considered.

10.2 Management's Discussion and Analysis

SAB Topic 13 requires that Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) include a discussion of liquidity, capital resources, results of operations and other information necessary to provide an understanding of a registrant's financial condition, changes in financial condition and results of operations. Although not all-inclusive, public registrants applying the provisions of ASC 985-605 should consider the following in connection with the preparation of MD&A:

- Whether the company has begun to grant extended payment terms that will result in a longer collection period for accounts receivable and slower cash inflows from operations.
- Whether the company is experiencing changing trends in a sales channel or with a separate class of customer that could be expected to have a significant effect on future sales or returns.
- Whether significant growth in revenue has been achieved through promotional programs that are not expected to recur.
- Whether the company experiences irregular intervals in selling new software licenses if this has a significant impact on revenue trends.
- The effect of new products or competitors' products, along with a discussion of the effect of product revenues, estimated future revenues and amortization of capitalized software costs.
- Whether there is a dependency on a disproportionately high amount of contract executions and shipment levels at quarter and year ends, if there is significant risk that such levels will not be consistently maintained.
- Whether gross margin variances should be categorized by type of revenue (e.g., software, services, PCS and hardware) or whether variances have been caused by a change in the mix of product or services revenues.
- Which significant judgments involved in critical accounting estimates that affect revenue recognition should be discussed as a critical accounting policy. Examples of such judgments include whether VSOE of fair value of elements included in a multiple-element arrangement exists and estimates used to measure percentage-of-completion when arrangements are subject to contract accounting.
- The term of financing arrangements with customers.

A Transitional considerations in adopting the revised guidance in ASU 2009-14

A.1 Chapter summary

Arrangements containing both hardware and software frequently are accounted for based on the guidance within ASC 985-605. ASC 985-605 requires its provisions to generally be applied to the sale of any products or services containing or utilizing software when the software is considered more than incidental to the product or service. Because of evolving technology, the functionality of an increasing array of products has been improved or expanded with embedded software. As software has become a more significant component of tangible products, many entities have determined that the software component of their tangible product is more than incidental, such that the accounting for the entire arrangement is subject to ASC 985-605.

If the arrangement falls within the scope of ASC 985-605, there are two methods entities can use to allocate the arrangement consideration to the units of accounting of a multiple-element revenue transaction — the relative-fair-value method or the residual method. The relative-fair-value method is used if vendor-specific objective evidence (VSOE) of fair value exists for all of the elements in the arrangement. Conversely, the residual method is used in situations in which the vendor has VSOE of fair value only for the undelivered elements and therefore allocates the residual amount of consideration to the delivered elements (causing any discount in the arrangement to be allocated to the delivered elements). The residual method is used most commonly in practice, as it is difficult for vendors to establish VSOE of fair value for software licenses (i.e., the delivered element). When vendors are unable to demonstrate VSOE of fair value for the undelivered elements, the arrangement is considered one unit of accounting, and revenue generally is deferred for all delivered elements until the last element is delivered. Many preparers and users expressed concerns that this accounting result was not reflective of the economics of the underlying transaction, as entities were not able to recognize revenue for the delivered items (e.g., the product with embedded software) at the time of delivery.

This issue was compounded by the recent revisions to the measurement principles in the multiple-element arrangements revenue recognition guidance in ASC 605-25, *Revenue Recognition — Multiple-Element Arrangements* (amendments codified in ASU 2009-13). While the prior multiple-element arrangements guidance was relatively consistent with ASC 985-605 with respect to the guidance for when and how to separate deliverables sold as part of multiple-element arrangements into different units of accounting, the revisions to ASC 605-25 removed the requirement for objective evidence of fair value to exist in order to separately account for the delivered items in a multiple-element arrangement and eliminated the residual method as an acceptable allocation methodology. As a result, multiple-element arrangements subject to the revised guidance in ASC 605-25 likely will have different accounting results than those subject to the software revenue recognition guidance. This divergence in the level of evidence required for separation of multiple deliverables under the revised ASC 605-25 led the Emerging Issues Task Force (EITF) to undertake a project to modify the scope of ASC 985-605 to reduce the number of tangible products subject to its scope. As a result of ASU 2009-14, many tangible products previously falling within the scope of ASC 985-605 will now be accounted for under the revised multiple-element arrangements revenue guidance in ASC 605-25.

ASU 2009-14 changes revenue recognition for tangible products containing software elements and nonsoftware elements as follows:

- The tangible element of the product is *always* outside the scope of ASC 985-605, without regard to the accounting for the software element.
- When the software elements and nonsoftware elements function together to deliver the product's essential functionality, the hardware and essential software are both considered "nonsoftware elements" and are outside of the scope of ASC 985-605. This means that both the hardware and the qualifying related software elements are excluded from the scope of the software revenue guidance and are accounted for under the general revenue recognition guidance, most likely under the revised multiple-element arrangements revenue guidance.
- Undelivered elements in the arrangement related to the nonsoftware elements also are excluded from the software revenue recognition guidance.

ASC 985-605-65-1 provides transition guidance for entities adopting the provisions of ASU 2009-14. ASU 2009-14 provides flexibility in the timing and manner in which an entity may elect to adopt the provisions in the ASU. The revised guidance must be adopted by all entities no later than fiscal years beginning on or after 15 June 2010 (1 January 2011 for calendar-year entities). Entities may elect to adopt the revised guidance through either of the following methods:

- *Prospective application* to all revenue arrangements entered into or materially modified after the date of adoption
- *Retrospective application* to all revenue arrangements for all periods presented

ASU 2009-14 also allows for early adoption. If an entity elects to prospectively adopt the provisions of ASU 2009-14 in a period that is not the first reporting period in their fiscal year, the guidance in ASU 2009-14 must be applied as of the beginning of the entity's fiscal year. Therefore, the new guidance must be applied to all revenue arrangements entered into or materially modified since the beginning of the fiscal year. For example, if a calendar-year entity elects to adopt the revised guidance in the fourth quarter of 2009, the entity must apply the provisions of ASU 2009-14 to all transactions initiated or materially modified on or after 1 January 2009.

Irrespective of the timing and manner in which an entity elects to adopt the provisions of ASU 2009-14, the entity also must adopt the requirements of ASU 2009-13 (containing the revisions to the multiple-elements arrangement guidance) at the same time and in the same manner.

A.2 Transition and effective date

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Transition and Open Effective Date Information

985-605-65-1

The following represents the transition and effective date information related to Accounting Standards Update No. 2009-14, Software (Topic 985): Certain Revenue Arrangements That Include Software Elements:

a. The pending content that links to this paragraph shall be applied on a prospective basis for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, unless the vendor elects to adopt the pending content on a retrospective basis in accordance with paragraph 985-605-65-1(d).

b. Earlier application is permitted.

   1. If a vendor elects earlier application and the period of adoption is not the first reporting period in the vendor's fiscal year, the pending content that links to this paragraph shall be applied through retrospective application from the beginning of the vendor's fiscal year.

   2. If earlier application is elected in a period other than the first reporting period in the vendor's fiscal year, the vendor shall disclose at a minimum the following information for all previously reported interim periods in the year of adoption: revenue, income before income taxes, net income, earnings per share, and the effect of the change for the appropriate captions presented.

c. If a vendor elects to apply the pending content that links to this paragraph on a prospective basis, the vendor shall provide the disclosures included in paragraph 605-25-65-1(c) through (d).

d. A vendor may elect, but is not required, to adopt the pending content that links to this paragraph through retrospective application applying the guidance in paragraphs 250-10-45-5 through 45-10. If a vendor elects retrospective application, the disclosures in paragraphs 250-10-50-1 through 50-3 shall be provided.

e. A vendor must adopt the pending content that links to this paragraph in the same period and use the same transition method that it uses to adopt the pending content that links to paragraph 605-25-65-1.

Considerations for retrospective adoption

Question A-1 **What factors need to be assessed if an entity elects to adopt the provisions of ASU 2009-14 through retrospective application?**

Given the flexibility provided in determining when and how to adopt the provisions in ASU 2009-14, an entity will have to consider carefully the approach that is most appropriate for its particular facts and circumstances. Specifically, full retrospective application is not permitted if the entity cannot adhere to the practicability requirements of ASC 250, *Accounting Changes and Error Corrections*. Because the application of the guidance in ASU 2009-14 requires significant estimates, retrospective application is not permitted if it is impossible to identify objective information that provides evidence to support those estimates that existed at the retrospective application dates and would have been available when those financial statements would have been originally issued.

If an entity concludes it is impracticable to determine the cumulative effect of applying a change in accounting principle to any prior period, the revised guidance should be applied as if the change was made prospectively as of the earliest date practicable, in accordance with the requirements of ASC 250. For example, assume an entity elects to adopt the requirements of ASU 2009-14 for its 2009 fiscal year. The entity determines it has the information needed to apply retroactively the provisions of ASU 2009-14 to fiscal 2008, but not 2007. Therefore, in this situation, the entity would apply the new guidance for revenue arrangements that are entered into or materially modified after the earliest date that it is practicable to determine the effect of applying the new guidance, or the first day of its fiscal 2008 year. In such cases, the reasons as to why the entity determined full retrospective application to be impractical and the method used to retrospectively adopt ASU 2009-14 would need to be disclosed by the entity.

Prior to selecting the adoption method, entities should consider the quality of data that is available to support the estimates needed to apply the revised guidance to historical revenue arrangements that include software that is essential to the functionality of tangible products.

Adoption of ASU 2009-13 and ASU 2009-14

Question A-2 **Can an entity adopt the provisions contained in ASU 2009-14 without also adopting the revisions to the multiple-element arrangements guidance, as codified in ASU 2009-13?**

No. ASU 2009-14 is required to be adopted in the same period and using the same transition method as ASU 2009-13; therefore, entities need to adopt the guidance in both ASUs at the same time and in the same manner.

Evaluation of "materially modified"

Question A-3 **If adopted prospectively, the guidance in ASU 2009-14 is to be applied to all new and materially modified revenue arrangements subsequent to the date of adoption. Does the guidance in ASU 2009-14 provide a definition of or factors to consider in determining whether contracts have been "materially modified"?**

No. During the deliberations for ASU 2009-14, the EITF discussed whether the final guidance should include factors for entities to consider in determining whether a contract was "materially modified." However, the EITF concluded that the determination of "materially modified" should be based on the relevant facts and circumstances and is a matter of professional judgment.

In making the determination of when an arrangement has been materially modified, we believe entities should consider the nature of the modifications as well as the expected effect on the existing arrangement. To the extent a modification results in a substantive change to the overall arrangement, this likely will be considered a material modification. Essentially, we believe a material modification could result from any material change to the arrangement that is the result of bona fide negotiations between the parties that in some way changes the nature or timing of the delivery of elements in the arrangement. We believe such modifications could include, but are not limited to, the following changes that result from negotiations between the parties:

- An increase or decrease in the total arrangement consideration that is more than insignificant
- A significant change in the contracted deliverables (e.g., modifying existing deliverables, adding new deliverables such that prices of deliverables change, removing deliverables)
- A significant change in the period of the arrangement (i.e., an extending or shortening the original contracted term that does not result from the unilateral exercise of an option held by either party). However, extending the term of the arrangement without any changes in pricing may represent an incremental (i.e., new) contract, even if the incremental contract was effected through a change in an existing contract (see further discussion below)
- A significant modification to the delivery schedule for contracted deliverables

To the contrary, non-substantive changes to an arrangement would not constitute a material modification. Such modifications could include changes that do not materially affect the underlying terms and conditions of the arrangement and lack economic substance (e.g., administrative changes such as changes to general customer or vendor information, changes of a delivery address, changes in legal terms and conditions that do not substantively affect the overall arrangement, or changes to consideration or deliverables, or the timing thereof, that are not significant).

Additionally, we believe that modifying a contract to provide for the delivery of additional software products or services at the same rates as in the existing contract generally would constitute a new arrangement, not a material modification. For example, an entity has an existing contract to provide 1,000 software licenses at a rate of $200 per seat. If the customer requests an additional 200 licenses at the same price of $200 per seat, we believe this is in substance a new contract and not a material modification of the existing agreement.

Each modification to an arrangement will need to be evaluated separately to determine the potential effect on the arrangement immediately preceding the modification. We also believe that entities should evaluate whether a series of immaterial modifications rises to the level of a material modification when considered in the aggregate. For example, an entity may have three modifications to an arrangement over a two-month period. The entity may evaluate each modification as immaterial to the overall arrangement; however, in evaluating the effect of the three modifications on the arrangement prior to the amendments, the entity concludes that the modifications in total are material. Therefore, the entity may determine it is appropriate to reevaluate the arrangement using the provisions of ASU 2009-14. In such situations, an entity will need to evaluate not only the magnitude of the modification(s), but also the period over which the assessment is made. Depending on the number and type of modifications, it may be appropriate for an entity to evaluate all modifications made to an arrangement within a particular quarter, while other entities may evaluate changes made during a rolling twelve-month period. In all cases, entities will need to apply judgment in assessing whether a modification to an existing arrangement is material.

Further, based on our discussions with the SEC staff, we believe that the staff expects entities will provide robust disclosures in their Management's Discussion and Analysis in the Form 10-K (and Form 10-Q) about material modifications to existing contracts if the modifications materially affect current period results and overall trends. These disclosures should include the business purposes for the modification as well as the effect of the modification on current period revenues and operating results (i.e., the amount of previously deferred revenue that was recognized upon modification by applying the provisions of ASU 2009-14).

Deferred revenue related to a materially modified arrangement

Question A-4 **After an entity has adopted the guidance in ASU 2009-14, it materially modifies a contract that was previously subject to the scope of ASC 985-605. After the modification, the entity concludes that a portion or all of the modified arrangement is no longer subject to the scope of ASC 985-605 (due to the scoping exceptions provided in ASU 2009-14). If there is deferred revenue recorded related to the arrangement, should the deferred revenue related to that contract be adjusted at the time of the modification, and if so, by how much?**

As a result of applying the existing guidance in ASC 985-605 (prior to the adoption of ASU 2009-13 and ASU 2009-14), an entity may have deferred revenue recorded on its balance sheet related to delivered elements for which revenue was not recognized as the separation criteria within that guidance were not met. However, if that contract is materially modified (see Question A-3 for a discussion on determining when a contract is materially modified) after the date the entity adopts the provisions in the new ASUs, that contract should now be accounted for in accordance with the revised guidance. If, as a result of the modification, an entity concludes that a portion or all the modified arrangement is no longer subject to the scope of ASC 985-605, the entity will apply other revenue recognition guidance (most likely ASC 605-25 and SAB Topic 13) to the excluded portions of the arrangement. If there is deferred revenue recorded related to the portions subject the other revenue recognition guidance, the balance of deferred revenue will need to be evaluated at the date of the modification to determine if an adjustment should be made.

For example, an entity materially modifies an arrangement originally accounted for under ASC 985-605. Because of the material modification, the entity evaluates the elements within the arrangement and determines that the hardware and software within the arrangement function together to provide the essential functionality of the tangible product. Therefore, management determines this transaction is no longer within the scope of ASC 985-605. Instead this transaction is within the multiple-element arrangements guidance in ASC 605-25. The entity will need to follow the steps outlined below to determine the appropriate adjustment, if any, that is necessary at the date of modification. It is important to note, however, that if the delivered element giving rise to the deferred revenue does not meet the separation criteria based on the provisions of ASU 2009-13, then no initial adjustment to the deferred revenue would be appropriate.

For an entity that adopts ASU 2009-13 and ASU 2009-14 prospectively, that guidance requires that its provisions be applied to contracts that are materially modified after the date of adoption. This requirement is applicable even for contracts that are modified after the year of adoption. However, neither ASU 2009-13 nor ASU 2009-14 specifically addresses how deferred revenue should be adjusted upon the material modification of a contract. As a result, we believe there may be more than one acceptable method to calculate the amount of adjustment to deferred revenue, as follows:

- Alternative A — Reallocate the arrangement consideration to all of the identified elements in the arrangement (both delivered and undelivered) based on the information available on the modification date. Allocated consideration would be recognized in revenue for all delivered elements (adjusting deferred revenue as appropriate), and consideration attributable to the undelivered elements would be recognized as those elements are delivered. As discussed further below, we believe this approach is the preferable approach but may be difficult to apply in all situations.
- Alternative B — Determine the estimated selling price (using VSOE, TPE or best estimate, as appropriate) for the remaining undelivered elements as of the date of the material modification. The remaining consideration to be received plus any deferred revenue is compared to the total estimated selling price of the undelivered elements, and any excess deferred revenue would be recognized on the modification date.

Each of these two alternatives is discussed further below.

Some have suggested a possible third alternative would be to not recognize any adjustment of the deferred revenue at the date of the material modification of the contract and instead allocate that deferred revenue plus any remaining consideration to be received to the remaining undelivered elements, based on the relative-selling-price method. However, we do not believe that this is an acceptable method. The deferred revenue relates to delivered elements that did not meet the previous separation criteria within ASC 985-605. Upon adoption of the provisions within ASU 2009-14, it is likely that many of these contracts will no longer be within the scope of ASC 985-605 and will instead fall under the multiple-element arrangements guidance in ASC 605-25. Therefore, it is likely that many of the elements that previously did not meet the separation criteria within ASC 985-605 guidance will meet the separation criteria within the revised ASC 605-25 guidance. In such situations, failing to adjust the deferred revenue to reflect the revenue associated with the delivered elements would not be in conformity with the provisions of ASU 2009-13.

Alternative A — Adjustment of deferred revenue based on reallocation of arrangement consideration to all elements

Under this alternative, an entity would identify all of the elements in the arrangement (based on the terms of the modified contract), determine which elements remain within the scope of ASC 985-605 and which ones do not, and reallocate the total arrangement consideration to these elements on the date of a material modification using the relative-selling-price method within ASC 605-25. To the extent there are contract elements within the scope of ASC 985-605, the entity would then allocate and recognize the revenue associated with those elements using the guidance in ASC 985-605.

While we believe that this approach is most consistent with the underlying principles of the revised guidance, we also acknowledge that it may be very difficult to apply in certain situations. Under this alternative, an entity would have to use the most appropriate information available to determine estimated selling price for each of the elements. One approach to applying this alternative would be to use current information for any undelivered elements as of the date of modification and historical information for the delivered elements (i.e., based on information that was available at the inception of the arrangement). However, entities may not have the historical information necessary to apply this approach, especially for longer-term contracts. In such situations, an entity may determine that using current information for all elements is the most appropriate basis for determining estimated selling price. However, this approach also has its limitations, as current data may not provide relevant information for all delivered elements.

We believe that entities that elect to follow Alternative A should apply this approach in all situations where it is practicable, but in situations where it is not practicable, such entities should use Alternative B for those contracts.

The following example illustrates this concept:

Illustration A-1: Deferred revenue related to a materially modified arrangement under Alternative A

Facts

In early 2007, Entity M entered into a long-term arrangement with Customer S. The arrangement called for Entity M to deliver a tangible product containing software essential to the functionality of that product at the onset of the agreement, and to provide five years of PCS support, for total transaction consideration of $3 million, of which $2 million was received up-front and $200,000 was to be paid annually. However, the marketing materials provided to Customer S provided specific developments plans and timelines for the next generation of the software and, as a result, it was determined that the arrangement also included a specified upgrade right. Because the software was more-than-incidental to the tangible product, Entity M determined that the transaction was to be accounted for using the guidance within ASC 985-605.

Entity M does not have VSOE for any of the elements within the arrangement, including the specified upgrade right. Because Entity M does not have VSOE for the undelivered elements, the guidance within ASC 985-605 requires Entity M to defer all revenue until such elements have been delivered. As of 1 January 2009, Entity M has not yet provided the specified upgrade.

Entity M elects to adopt the provisions of ASC 2009-13 and ASU 2009-14 as of 1 January 2009, using the prospective method. In March 2009, Customer S, citing financial difficulties, indicated they intended to break the contract. In order to maintain an arrangement with Customer S, Entity M offered to reduce the PCS price to $150,000 per year if Customer M would extend the agreed-upon PCS period for an additional three years. Customer S agrees to the revised terms.

Entity M determines that this is a material modification of the contract and that the provisions of ASU 2009-13 and ASU 2009-14 need to be applied to this agreement, as the modification took place after the date of adoption of the new standards. Because of the undelivered specified upgrade, Entity M has not recognized any revenue to date under this transaction. At the date of modification, the deferred revenue balance was $2.4 million.

Analysis

Entity M first analyzes the transaction using the scope of ASC 985-605 as revised by ASU 2009-14. Based on that guidance, Entity M determines that the materially modified arrangement meets the scope exclusion criteria of ASC 985-605. That is, the tangible product and the software function together to provide the essential functionality of the tangible product and therefore should be considered nonsoftware elements. Additionally, the undelivered elements within the arrangement (PCS and specified upgrade) both relate to nonsoftware elements of the arrangement and therefore also should be considered nonsoftware elements. As a result, Entity M determines the entire transaction should be accounted for under the multiple-element arrangements guidance in ASC 605-25 and the revenue recognition guidance in SAB Topic 13.

In determining how to allocate the total arrangement consideration based on the current terms of the arrangement using the relative-selling-price method, Entity M will have to establish a consistent methodology for determining best estimate of selling price. Entity M may elect to base estimated selling price for the remaining undelivered elements (i.e., six years of PCS and the specified upgrade right) on information available as of the date of contract modification and base its best estimate of selling price for the delivered elements (i.e., tangible product containing software and two years of PCS) on information available as of the date of contract inception. Under this approach, Entity M determines that the best estimate of selling price for the tangible product is $2.4 million, and the best estimate of selling price of the delivered PCS is $220,000 per year. Additionally, Entity M determines that the best estimate of selling price for the undelivered PCS and specified upgrade right is $180,000 per year and $300,000, respectively.

Based on these best estimates of selling price, Entity M would allocate the total arrangement consideration of $3.3 million ($2 million received upfront, $400,000 received in years 1 and 2 for PCS, and the remaining $900,000 to be received for the next six years of PCS) as follows:

Deliverable	Estimated selling price in (000's)	Percent of total	Allocated discount	Allocated considerations
Tangible product and software	$ 2,400	57%	$ (524)	$ 1,876
PCS, years 1-2	440	10	(96)	344
PCS, years 3-8	1,080	26	(235)	845
Specified upgrade	300	7	(65)	235
Total	$ 4,220		$ (920)	$ 3,300

Based on the above relative-selling-price allocation, Entity M determined that, as of the contract modification date, revenue to be recognized on the undelivered services equals $1.08 million. As a result, Entity M would reduce the deferred revenue balance by $2.22 million, to $180,000 (such that remaining consideration to be received of $900,000 plus deferred revenue balance of $180,000 equal the revenue allocated ($1.08 million) to the undelivered elements of the arrangement). The excess amount of $2.22 million in deferred revenue would be recognized in revenue as of the date of the contract modification.

However, Entity M may not have the historical information needed to apply the prior approach, especially because of the long-term nature of its contracts. As a result, Entity M may determine that using current information for all elements is the most appropriate basis for determining estimated selling price. However, this approach also has its limitations. For example, if Entity M determines its best estimate of selling price for tangible product using cost plus an acceptable margin, the current cost of tangible product may not be comparable to the cost of those same components two years ago (and that same tangible product may not even be available today).

Alternative B — Adjustment of deferred revenue based on determination of estimated selling price for the undelivered elements

Alternative B focuses only on the undelivered elements in the arrangement at the time of the contract modification (assuming that revenue allocated to the delivered items would have been recognized prior to the modification had the principles of ASU 2009-13 and ASU 2009-14 been applied). Therefore, under this alternative, once an entity has determined which elements are within the scope of ASC 985-605 versus which ones are no longer within that scope, the entity would reallocate the transaction consideration by focusing only on the undelivered elements. While this approach may not align with the principles of the guidance in ASU 2009-13 as well as Alternative A previously discussed, we believe this alternative is a more practical approach that still meets the spirit of the revisions to the multiple-element arrangements guidance in ASU 2009-13.

Under this approach, an entity would evaluate the remaining undelivered elements within the arrangement upon the material modification of a contract. The entity would determine an estimated selling price for each of those elements (using VSOE, TPE or best estimate of selling price, whichever is appropriate). The entity would then ensure this amount is available for future revenue recognition, either through consideration still to be received or through the recognition of deferred revenue. To the extent that there is any excess deferred revenue at the date of contract modification, this amount would be recognized in revenue upon the material modification of the contract.

The following example illustrates this concept:

Illustration A-2: Deferred revenue related to a materially modified arrangement under Alternative B

Facts

This illustration uses the same fact pattern as described in the Example for Alternative A.

Analysis

As described in the analysis in the Example for Alternative A, Entity M determines the transaction is no longer within the scope of ASC 985-605 and should instead be accounted for in accordance with the guidance in ASC 605-25 and SAB Topic 13.

Under Alternative B, Entity M determines that the best estimate of selling price of the remaining six years of PCS and the specified upgrade is $180,000 per year and $300,000, respectively, or $1.38 million. Pursuant to the contract, Entity M will receive an additional $900,000 in consideration from Customer S during the remaining PCS period. Therefore, Entity M determines that the deferred revenue at the date of contract modification should be $480,000. The excess $1.92 million in deferred revenue (i.e., the $2.4 million recorded less the $480,000 determined in the assessment of total arrangement consideration) would be recognized in revenue as of the date of the contract modification.

Given the complexities surrounding the accounting for deferred revenue, we believe that transparent disclosures about the material modifications and their effect on the financial statements should be provided. While not a specific requirement in ASU 2009-13, we believe that in order to comply with the objective of the transitional disclosure requirements, an entity should disclose both its accounting policy for treatment of deferred revenue upon material modification of a contract and the amount of revenue recognized during the period due to contract modifications. In addition, based on our discussions with the SEC staff, we believe the staff will expect robust disclosures within Management's Discussion and Analysis in the Form 10-K (and Form 10-Q) to the extent that the recognition of deferred revenue upon material modification of contracts materially affects current year (and interim period) results and overall trends.

Transitional disclosure requirements

Question A-5 **Are there any transitional disclosure requirements associated with ASU 2009-14?**

ASU 2009-14 does not specifically require an entity to make any transitional disclosure requirements. However, to the extent that an entity's transactions were previously accounted for under the provisions of the software revenue recognition guidance, and, as a result of adopting the provisions of ASU 2009-14, those transactions are now accounted for under the multiple-element arrangements guidance, an entity will have to comply with the transitional disclosure requirements of ASU 2009-13. Those requirements are as follows:

Excerpt from Accounting Standards Codification

Revenue Recognition — Multiple-Element Arrangements

Transition and Open Effective Date Information

605-25-65-1

c. In the year of adoption, a vendor shall disclose information that enables users of the financial statements to understand the effect of the change in accounting principle if the pending content that links to this paragraph is adopted on a prospective basis. To satisfy that objective, a vendor shall disclose at a minimum the following qualitative information by similar types of arrangements:

1. A description of any change in the units of accounting
2. A description of the change in how a vendor allocates the arrangement consideration to various units of accounting
3. A description of the changes in the pattern and timing of revenue recognition
4. Whether the adoption of the pending content that links to this paragraph is expected to have a material effect on financial statements in periods after the initial adoption.

d. If the effect of adopting the pending content that links to this paragraph is material, the qualitative information shall be supplemented with quantitative information in the period of adoption to satisfy the objective of enabling users to understand the effect of the change in accounting principle. Depending on a vendor's facts and circumstances, the following are examples of methods (but not the only potential methods) that may individually or in combination provide quantitative information to satisfy that objective:

1. The amount of revenue that would have been recognized in the year of adoption if the related arrangements entered into or materially modified after the effective date were subject to the measurement requirements of Subtopic 605-25 (before the amendments resulting from Update 2009-13).
2. The amount of revenue that would have been recognized in the year before the year of adoption if the arrangements accounted for under Subtopic 605-25 (before the amendments resulting from Update 2009-13) were subject to the measurement requirements of the pending content that links to this paragraph.
3. For arrangements that precede the adoption of the pending content that links to this paragraph, the amount of revenue recognized in the reporting period and the amount of the deferred revenue as of the end of the period from applying the guidance in Subtopic 605-25 (before the amendments resulting from Update 2009-13). For arrangements that were entered into or materially modified after the effective date of the pending content that links to this paragraph, the amount of revenue recognized in the reporting period and the amount of deferred revenue as of the end of the period from applying the guidance in the pending content that links to this paragraph.

The required transitional disclosures are dependent upon the method an entity elects to adopt the revisions to the multiple-element arrangements guidance, as codified by ASU 2009-13. For entities that have elected to retrospectively apply the provisions of this guidance to all periods presented, the typical disclosures surrounding an accounting change (as provided in ASC 250-10-50) are required. For entities that elect prospective application, the transitional disclosures required by ASU 2009-13 specify an overall objective that the disclosures provide sufficient information to enable users to understand the effect this change in accounting principle has on revenue trends.

If the effect of adopting the provisions of ASU 2009-13 is material, the guidance requires that the entity supplement its qualitative disclosures with quantitative disclosures in order to satisfy the overall disclosure objective. The guidance in ASC 605-25-65-1(d) provides examples of quantitative disclosures that an entity may decide to provide, depending on the entity's individual facts and circumstances. The examples provided in ASU 2009-13 are as follows:

- For arrangements that were entered into or materially modified after the adoption of the provisions of ASU 2009-13, disclose the amount of revenue that would have been recognized in the year of adoption if those arrangements were subject to the historical guidance in ASC 605-25 (previously EITF 00-21). This disclosure allows a user of financial statements to compare current year revenues with prior year revenues, both accounted for under EITF 00-21.
- For arrangements that precede the adoption of the guidance in ASU 2009-13, disclose the amount of revenue that would have been recognized in the year before the year of adoption if those arrangements accounted for under the historical guidance in ASC 605-25 (previously EITF 00-21) were subject to the measurement requirements of the guidance in ASU 2009-13. Under this alternative, the entity would estimate what its prior year revenues would have been if it had applied the new guidance. We believe one approach to providing this information would be to estimate the change in revenues that would have resulted in the prior year if contracts originating or materially modified during that year were accounted for under the new guidance.
- For arrangements that precede the adoption of the guidance in ASU 2009-13, disclose the amount of revenue recognized in the reporting period and the amount of the deferred revenue as of the end of the period from applying the historical guidance in ASC 605-25 (previously EITF 00-21). Additionally, for arrangements that were entered into or materially modified after the adoption of ASU 2009-13, disclose the amount of revenue recognized in the reporting period and the amount of deferred revenue as of the end of the period from applying the guidance in ASU 2009-13. While this method would not allow a user of financial statements to directly compare the revenues from the prior year to the year of adoption, it would provide information about the magnitude of revenue to be recognized under contracts that continue to be accounted for under the new and old guidance.

The quantitative example disclosures above refer to arrangements subject to the guidance in ASC 605-25 (previously EITF 00-21); however, we believe an entity also would provide similar disclosures for arrangements that were previously accounted for under ASC 985-605 but are now subject to the pending content in ASC 605-25 (as amended by ASU 2009-13) due to the revisions in ASU 2009-14. While the EITF has provided examples of disclosures that individually or in combination may provide users of the financial statements with quantitative information to understand the effect of the change in accounting, the examples are not intended to be prescriptive or all-inclusive. Therefore, entities may present quantitative information in a manner different than the examples provided in ASC 605-25-65-1(d) to the extent the underlying objective of the transition guidance is still met.

B Abbreviations used in this publication

Abbreviation	*FASB Accounting Standards Codification*
ASC 235	FASB ASC Topic 235, *Notes to Financial Statements*
ASC 250	FASB ASC Topic 250, *Accounting Changes and Error Corrections*
ASC 350-40	FASB ASC Subtopic 350-40, *Intangibles — Goodwill and Other — Internal-Use Software*
ASC 450	FASB ASC Topic 450, *Contingencies*
ASC 460	FASB ASC Topic 460, *Guarantees*
ASC 470	FASB ASC Topic 470, *Debt*
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ASC 605-15	FASB ASC Subtopic 605-15, *Revenue Recognition — Products*
ASC 605-20	FASB ASC Subtopic 605-20, *Revenue Recognition — Services*
ASC 605-25	FASB ASC Subtopic 605-25, *Revenue Recognition — Multiple-Element Arrangements*
ASC 605-35	FASB ASC Subtopic 605-35, *Revenue Recognition — Construction-Type and Production-Type Contracts*
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ASC 730	FASB ASC Topic 730, *Research and Development*
ASC 740	FASB ASC Topic 740, *Income Taxes*
ASC 810	FASB ASC Topic 810, *Consolidation*
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ASC 840	FASB ASC Topic 840, *Leases*
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ASC 855	FASB ASC Topic 855, *Subsequent Events*
ASC 860	FASB ASC Topic 860, *Transfers and Servicing*
ASC 985-20	FASB ASC Subtopic 985-20, *Software — Costs of Software to Be Sold, Leased, or Marketed*
ASC 985-605	FASB ASC Subtopic 985-605, *Software — Revenue Recognition*
ASC 985-845	FASB ASC Subtopic 985-845, *Software — Nonmonetary Transactions*
ASU 2009-13	Accounting Standards Update No. 2009-13, *Multiple-Deliverable Revenue Arrangements*
ASU 2009-14	Accounting Standards Update No. 2009-14, *Certain Revenue Arrangements that Include Software Elements*

Abbreviation	*Other Authoritative Standards*
SAB Topic 5-O	SEC Staff Accounting Bulletin No. 63, *Application of SFAS No. 68, "Research and Development Arrangements," when funding parties are affiliated with enterprise performing those activities*
SAB Topic 13	SEC Staff Accounting Bulletin No. 104, *Revenue Recognition*

Abbreviation	*Non-Authoritative Standards*
EITF 00-21	EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables"
EITF 09-3	EITF Issue No. 09-3, "Applicability of SOP 97-2 to Certain Arrangements That Include Software Elements"

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D Relationship to other pronouncements

For entities that have not adopted ASU 2009-14

D1 Introduction and scope

D1.1 Chapter summary

Chapters D I and D II are applicable for those entities that have not yet adopted the provisions of the FASB's Accounting Standards Update 2009-14, Certain Revenue Arrangements that Include Software Elements (ASU 2009-14). As discussed in the opening letter of this publication, ASU 2009-14 revises the guidance regarding the types of arrangements that fall within the scope of software revenue recognition guidance. The new guidance provides a scope exception for many transactions that were previously within the scope of ASC 985-605. As a result of the issuance of ASU 2009-14, we have revised the first two chapters of this publication to reflect the changes to the scope of the software revenue recognition guidance.

However, ASU 2009-14 is not effective until fiscal years beginning after June 15, 2010, although early adoption is permitted. As a result, there are a number of entities who have not yet adopted the provisions of that guidance. Those entities should continue to follow the guidance contained in this appendix (D I and D II) rather than Chapter I and II of this publication. (Note: all other Chapters in this publication are applicable regardless of whether or not the entity has adopted the provisions of ASU 2009-14.)

D1.2 Introduction and scope

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Overview and Background

985-605-05-1

This Subtopic provides guidance on when revenue should be recognized and in what amounts for **licensing**, selling, leasing, or otherwise marketing computer software.

985-605-05-2

[Not used]

985-605-05-3

Software arrangements range from those that provide a license for a single software product to those that, in addition to the **delivery** of software or a software system, require significant production, modification, or customization of software.

985-605-05-4

Structurally, the form of a **hosting arrangement** may be split into two elements:

a. The right to use software

b. The hosting service.

The arrangement may or may not include a license right to the software and the customer may or may not have an option to take delivery of the software. The guidance beginning in paragraph 985-605-55-119 addresses the scope application of this Subtopic to a hosting arrangement.

Scope and Scope Exceptions

985-605-15-1

This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic, see Section 985-10-15, with specific qualifications and exceptions noted below.

985-605-15-2

The guidance in this Subtopic applies to all entities.

985-605-15-3

The guidance in this Subtopic applies to the following transactions and activities:

a. Licensing, selling, leasing, or otherwise marketing computer software.

b. Leases of software that include property, plant, or equipment, if the software is more than incidental (see [c]) to the property, plant, or equipment as a whole. Any revenue attributable to the software, including postcontract customer support, shall be accounted for separately in conformity with the guidance in this Subtopic (see Subtopics 840-20 and 840-30 for guidance on revenue attributable to the property, plant, and equipment).

c. Other arrangements for products or services that include software that is more than incidental to the products or services as a whole. Indicators of software that is more-than-incidental to a product as a whole include (but are not limited to):

   1. The software is a significant focus of the marketing effort or is sold separately.

   2. The vendor is providing postcontract customer support.

   3. The vendor incurs significant costs that are within the scope of Subtopic 985-20.

   In such arrangements, the guidance in this Subtopic applies to the software and software-related elements. Software-related elements include software products and services such as those listed in paragraph 985-605-25-5 as well as any nonsoftware deliverable or deliverables for which a software deliverable is essential to their functionality. For example, in an arrangement that includes software, computer hardware that will contain the software, and additional unrelated equipment, if the software is essential to the functionality of the hardware, the hardware would be considered software-related. However, if the software is not essential to the functionality of the additional unrelated equipment, the equipment would not be considered software-related.

d. More-than-insignificant discounts on future purchases that are offered by a vendor in a software arrangement. More-than-insignificant discounts have all of the following characteristics:

   1. Incremental to the range of discounts reflected in the pricing of the other elements of the arrangement

   2. Incremental to the range of discounts typically given in comparable transactions

   3. Significant.

   If the discount or other concessions in an arrangement are more than insignificant, a presumption is created that an additional element or elements (as defined in paragraph 985-605-25-5) are being offered in the arrangement.

   Judgment is required when assessing whether an incremental discount is significant.

e. Arrangements to deliver software or a software system, either alone or together with other products or services, that require significant production, modification, or customization of software (See Subtopic 605-35.) Paragraphs 985-605-25-88 through 25-107 provide guidance on applying contract accounting to certain arrangements involving software. If a software arrangement includes services that meet the criteria discussed in paragraph 985-605-25-78, those services should be accounted for separately.

The guidance beginning in paragraph 985-605-55-119 addresses the scope application of this Subtopic to a hosting arrangement.

985-605-15-4

The guidance in this Subtopic does not apply to the following transactions and activities:

a. Arrangements for products or services containing software that is incidental to the products or services as a whole

b. Leases of software that include property, plant, or equipment, if the software is incidental to the property, plant, or equipment as a whole

c. Marketing and promotional activities not unique to software transactions, such as the following:

  1. Insignificant discounts on future purchases that are offered by a vendor in a software arrangement. For example, a vendor may offer a small discount (a coupon or other form of offer for 5 percent off) on additional licenses of the licensed product or other products that exist at the time of the offer but are not part of the arrangement.

  2. Discounts that are not incremental to discounts typically given in comparable transactions (for example, volume purchase discounts comparable to those generally provided in comparable transactions).

Frequently asked questions

Determining if an arrangement is within the scope of ASC 985-605

Question D1-1 **What factors should be considered in assessing whether an arrangement is within the scope of ASC 985-605??**

ASC 985-605 requires a determination of the applicability of its provisions at an activity level versus an entity level (i.e., whether an entity is a software entity, as described by itself or by others, is not in and of itself determinative as to whether the provisions of ASC 985-605 should be applied).

Accordingly, many entities that consider themselves hardware or equipment vendors may still have "software activities" that should be accounted for pursuant to ASC 985-605. These entities commonly include companies operating in the telecommunications, medical device, computer networking equipment and server industries, among others, but can also include companies that consider themselves to be manufacturers of consumer products. We have seen the SEC staff challenge whether the accounting of companies whose products or services contain a software component should be subject to the provisions of ASC 985-605. This has, on occasion, resulted in registrants restating their financial statements to account for the sales of their products or services pursuant to the provisions of ASC 985-605.

Any entity that markets products or services that include a software component must consider the applicability of ASC 985-605, even if it does not consider itself to be a software company. Further, although a company may conclude, based on an evaluation of the factors discussed in ASC 985-605, that the sales of its products are not currently subject to the provisions of ASC 985-605, this conclusion may change in the future as its products or services, and the related technology, continue to evolve. Accordingly, a continuous assessment of the applicability of the provisions of ASC 985-605 must be made.

ASC 985-605 indicates that its provisions are applicable to the sale of any products or services containing or utilizing software when the software content is more than incidental. However, determining whether software content is more than incidental to the products or services in which the software is contained can be difficult, primarily because this determination requires considerable judgment. ASC 985-605-15-3 provides that the following factors must be considered when making this determination:

- *Is the software a significant focus of the marketing effort or is the software sold separately?*

  Evaluation of this factor seeks to determine if the focus of the company's marketing effort for the product or service is on the software component such that the customer's buying decision is significantly influenced by the software component of the product (e.g., the software component is a factor that differentiates the product from competitor products). The greater the emphasis on the features and functionality of the software in the marketing of the product or service by the vendor, the more likely it is that the software is important to the customer's buying decision. In such cases, the software may be more than incidental.

  For purposes of evaluating this factor, consideration should be given to the content of marketing collateral (e.g., advertisements, product brochures, vendor websites, tear sheets, proposals and sales personnel training and presentations) and whether the product or service is described and differentiated based on the software's features and capabilities or by features and capabilities of the product or service that are primarily driven by the functionality of the software. If the software's features are marketed, the relative significance of that focus to the overall marketing effort for the product or service must be evaluated.

  When software is sold without the associated product or service, this generally is an indicator that the software is more than incidental to the products and services that are being marketed.

  We understand that when evaluating the focus of the marketing effort for a product or service, the SEC staff will read the company's discussion of its business, including the products and services that it offers, contained in any SEC filings. Additionally, our experience with the staff indicates that they often will read the content of a company's website and other publicly available information to evaluate the focus of its marketing efforts.

- *Are updates, upgrades and other support services provided on the software component of the product? That is, does the vendor provide postcontract customer support (PCS)?*

  ASC 985-605 defines PCS, in part, as the right to receive services (other than those accounted for separately), or unspecified product upgrades/enhancements on a when-and-if-available basis, or both. PCS typically includes one or more of the following:

  - Telephone support
  - Bug fixes or debugging
  - Unspecified upgrades/enhancements on a when-and-if-available basis

A vendor that sells software enabled hardware may combine support for both the hardware and the software elements of the delivered product. In such situations, it may be challenging to determine the significance of each component of the PCS provided to the customer.

PCS may be provided by a software vendor even though not evidenced by a written contract. This is referred to as implied PCS (see Question 7-2). Implied PCS also must be considered in evaluating this factor. We believe that if a vendor provides PCS for software marketed in conjunction with, or as a part of, a product or service offered for sale (either as a condition of a written contract or through implied PCS), this is an indicator that the software is more than incidental.

However, the services comprising PCS should be considered before concluding that the software is more than incidental. For example, assume a vendor provides periodic updates on a when-and-if-available basis, but 1) the updates are limited to bug fixes and no new functionality or features are provided to the customer and 2) the bug fixes are not provided on a regular basis. Although the definition of PCS provided by ASC 985-605 encompasses bug fixes, when bug fixes are the only item provided after delivery of the licensed software, and that is the vendor's continuing intent, the vendor is in essence providing services pursuant to a warranty (see Question 4-67).

While the presence of PCS may be an indicator that the software is more than incidental, the absence of PCS should not be presumed to indicate that the software is incidental. As illustrated by the excerpt of the illustrative guidance below, situations may exist where the customer does not need PCS and, despite its absence, the provisions of ASC 985-605 are applicable.

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Example 2: Scope — A Developer of Interactive Training Courses

985-605-55-130

This Example illustrates the guidance in paragraphs 985-605-15-3 through 15-4 regarding the determination of whether the software is incidental to the products or services as a whole.

985-605-55-131

An entity develops interactive training courses for sale or licensing to customers. These courses are delivered on a compact disc, which is loaded onto a customer's computer. The courses are developed such that, based on the responses received to a particular question, different questions are generated and content of the course material that is displayed is determined in a manner that directs the user's learning experience in a more focused way. The course developer's costs for the development of the software content are within the scope of Subtopic 985-20 and are significant. The interactive nature of the courses is mentioned prominently in the marketing efforts.

985-605-55-132

This Subtopic is applicable because the software is not incidental to the product.

985-605-55-133

Although some might say that the product is educational services, the marketing of the product focuses on the software-reliant interactive features. In addition, the course developer incurs significant costs that are within the scope of Subtopic 985-20. The nature of the relationship between the vendor and the customer is not one in which the customer would have a need for postcontract services. Consequently, the absence of postcontract customer support is not presumptive that software is incidental to the product. Accordingly, a conclusion is reached that the software is not incidental to the product as a whole. Therefore, the provisions of this Subtopic apply.

- *Are the costs to develop the software component of the product significant in relation to the costs to develop the product as a whole? That is, does the vendor incur significant costs that are within the scope of ASC 985-20, Software — Costs of Software to Be Sold, Leased, or Marketed?*

  A cursory reading of this indicator might lead one to simply consider whether significant costs have been capitalized pursuant to the provisions of ASC 985-20. However, we believe that the indicator seeks to determine whether significant costs have been incurred, regardless of whether such costs have been capitalized. The scope of ASC 985-20 includes all the costs incurred in the development of the software component of the product (which generally are expensed as research and development) and those that are production costs (which generally are capitalized).

When evaluating the appropriate aggregate pool of costs of developing the product as a whole (i.e., ASC 985-20 costs and the "hardware" or "equipment" development costs), we believe a pure quantification of the ASC 985-20 or software costs is not necessarily determinative regarding the significance of the total development costs. For example, if internally generated development costs are incurred relating to software but a larger amount is incurred to acquire or develop a "box" that houses the software during development of a product, the software development costs incurred may still indicate that the software is more than incidental.

Additionally, when development costs relate to both hardware and software, it is important to analyze the components of the development costs. That is, consideration should be given to the relationship of the software development costs to the hardware development costs. When the software development costs are significant relative to the total development costs of the product this is an indicator that the software is more than incidental. This analysis may be challenging for companies engaged in certain activities. For example, companies may be involved in developing ASIC (Application-Specific Integrated Circuit) chips for a particular application. ASICs are commonly used in such areas as automotive computers to control the functions of the vehicle, in networking equipment and in PDAs. At a very simplistic level, ASIC technology may be viewed as software on a chip (as opposed to the integrated circuits that control functions such as RAM in a PC). Therefore, it may be inherently difficult to distinguish between the software and hardware elements of ASIC development costs.

If a vendor concludes that the software component of its products or services is incidental to those products or services as a whole, that conclusion should be periodically evaluated. This is particularly true for companies in technology-based industries, because of the rapidly changing environment in which many of these companies operate and the evolution of software embedded in their products or used to provide their services.

Because of evolving technology, many products now contain a software component that is critical to their operation and success in the marketplace. We expect that this trend will continue in the future. For example, many products and services that are commonplace today, or are anticipated to come to market in the near future, are reliant on software components that are either currently included in the products and services, or are under development. Because of these factors, companies that have traditionally viewed themselves as hardware, equipment or consumer products manufacturers may determine that they are required to apply the provisions of ASC 985-605 due to changing circumstances.

When assessing whether changes in a company's products or services indicate that included software has become more than incidental, the SEC staff outlined the following factors that should be considered in a speech at the December 2004 AICPA Conference on SEC Current Developments.

- When evaluating whether the software is a significant focus of the marketing effort of the product or service, companies should focus on whether changes to the features and functionality of the product or service being promoted by advertisements directly result from the software.

- In some situations, hardware manufacturers or service providers find the underlying software works so well that it develops a market among their competitors. They then begin to license that software separately for sale so their competitors can use the software in their product and service offerings. That would represent a change in circumstances that may suggest that the embedded software is more than incidental.
- Changes in circumstances also may affect a company's accounting for software costs. Companies should carefully consider the interaction between ASC 985-20 and ASC 350-40, *Intangibles — Goodwill and Other — Internal Use Software,* as it relates to accounting for the costs of software related to product or service offerings. A determination that such costs are most appropriately accounted for pursuant to ASC 985-20 may indicate that the software is more than incidental to the products or services that it is included in or sold with.

The SEC staff also commented that companies who have software underlying products and services that they believe are non-software centric should consider the following indicators of whether the software is more than incidental:

- Do the rights to use the software remain solely with the vendor or are the rights transferred to the customer as part of the product or service offering? If the rights to use the software survive cessation of the service or sale of the product, this is an indicator that the software is more than incidental.
- Does the licensed software require the customer to provide dedicated information technology (IT) support? If the customer must maintain and troubleshoot the underlying software, it may be more than incidental.

This speech also emphasized the following matters:

- The factors identified in the software revenue recognition guidance as those to be considered when determining whether software is more than incidental are not determinative, presumptive or all inclusive. Further, the Staff acknowledged that these factors can be difficult to apply to products or services not traditionally viewed as software related. We believe this point emphasizes that the determination of whether software is more than incidental is a matter that requires professional judgment.
- A change in circumstances resulting in a company concluding that software is not incidental also would require the costs of developing the software be accounted for pursuant to ASC 985-20 rather than as internal use software.
- The provisions of ASC 985-605-15-3 should be evaluated when an arrangement includes software that is more than incidental. ASC 985-605-15-3 requires an evaluation to determine whether the software is essential to the functionality of other items in the arrangement in order to determine whether those other items also should be accounted for pursuant to ASC 985-605, even if they would not otherwise appear to be subject to the scope of ASC 985-605 (see Question D1-2).
- Because a company's determination in this area involves significant judgment and would likely have a material effect on a company's revenue recognition policy, a detailed discussion of these factors and the related conclusions within the Critical Accounting Policies section of MD&A may be appropriate.

The following examples illustrate these concepts. As mentioned above, it is difficult to consider one indicator more persuasive than another, so a careful evaluation of the facts and circumstances is required to determine whether the provisions of ASC 985-605 are applicable to all of a company's activities, certain product lines or individual transactions.

Illustration D1-1: Equipment differentiated based on features and functionality of included software

Facts

Company X manufactures and sells vending machines to hospitals and other health care providers that use the machines to restrict and monitor access to drugs and other supplies. The vending machines include software that provides enhanced security controls over access to the supplies (e.g., employees must have their fingerprints scanned, and that image must match the scanned image in the database on the machine to permit access). The enhanced security features enabled by the software content of the machines are a primary focus of the company's marketing efforts. Company X also offers a maintenance contract on the machine and provides one upgrade to the software every 18–24 months.

Analysis

In this example, the software is more than incidental. The software is a factor that makes the vending machine different from other vending machines, and that difference is a primary focus of the company's marketing efforts for the machine. A customer purchasing this type of machine is likely to do so because of the software-enabled security features.

Illustration D1-2: Consideration of PCS

Facts

A telecommunications company sells equipment with embedded software and provides maintenance services for two years on the equipment. Pursuant to the maintenance agreement the customer is entitled to receive bug fixes on the software and maintenance on the hardware. The hardware maintenance requires an engineer to go to the customer's site to diagnose any problems and to repair the hardware, and provide minor replacement parts. The vendor has periodically provided software updates to the equipment, however these updates did not add any features or functionality, but merely ensured that the equipment remained compatible with third-party telecommunications networks. Changes to the third party networks were communicated to the industry as a whole and vendors of comparable equipment, including the company's competitors, also provided comparable updates to the software embedded in their equipment. The company has not incurred significant software development costs and the features of the software are not a focus of the company's marketing efforts.

Analysis

In this example, the primary consideration is whether the maintenance agreement should be considered PCS, indicating that the software is more than incidental. The bug fixes typically provided by the company pursuant to the maintenance arrangement are analogous to repairs to a product under a warranty arrangement to ensure that the product operates as promised. Although the company has provided software updates to purchasers of the equipment, the updates have been in response to industry-wide changes driven by third parties, were comparable to updates released at approximately the same time by the company's competitors and did not add any additional features or functionality to the equipment. This type of maintenance contract generally would not indicate that PCS is being provided by the vendor. Accordingly, in this example the software is not more than incidental to the equipment as a whole.

Illustration D1-3: Significance of software development costs

Facts

A medical device company develops and manufactures a product that includes a software component. The company does not consider itself to be a software company and does not provide upgrades to the software component of the device. The vendor incurs significant research and development costs in connection with developing its products. Of the total development costs incurred, approximately 65% relates to developing the software and 35% to the hardware. The company accounts for its software development costs using a working model approach pursuant to ASC 985-20. Software development costs capitalized pursuant to ASC 985-20 have been immaterial.

Analysis

In this illustration, the significance of the software development costs incurred by the company in relation to the total costs of developing the product indicates that the software is more than incidental. Note that this determination considers all costs incurred by the company that are in the scope of ASC 985-20, not just the amount capitalized.

This example should not be interpreted to mean that an inverse relationship of software development costs to hardware development costs (i.e., software development costs are less than hardware development costs) necessarily means that software is incidental to a product as a whole.

Illustration D1-4: Focus of marketing efforts not on software

Facts

Company F manufactures automobiles that include software required to operate the vehicle. Company F's marketing focus is on the automobile, not the software. Once the software is installed in the vehicle, the software is not updated with subsequently developed versions. Although Company F incurs costs that are within the scope of ASC 985-20, these costs are insignificant relative to the total production and development costs of the automobile.

Analysis

The software is incidental to the sale of the automobile. Although the software may be critical to the operations of the automobile, the software itself is not the focus of the marketing effort, PCS is not provided on the software and the ASC 985-20 costs incurred by the company are insignificant.

Applicability of ASC 985-605 to software hosting arrangements

Question D1-2 **Are the provisions of the software revenue recognition guidance applicable to arrangements in which a vendor agrees to host licensed software or should such arrangements be accounted for as service contracts?**

Some vendors enter into transactions to provide customers with software functionality without the customer having to install the licensed software on their own hardware. Instead, the vendor's software resides on its own servers, or those of third parties engaged by the vendor, and the customer accesses the software on an as-needed basis via a dedicated link or the Internet. Reasons for transactions of this nature might include the vendor's desired business model or the desire of a customer to avoid a dedicated in-house information systems infrastructure for the support of licensed software.

Such transactions typically are referred to as "hosting," Application Service Provider (ASP) or Software as a Service (SaaS) arrangements. Structurally, the form of these arrangements may be split into two elements: 1) the right to use the licensed software and 2) the hosting service. The arrangements may or may not include an explicit license of the software and the customer may or may not have an option to take delivery of the software.

Although the vendor's software is undoubtedly key to its ability to meet its obligations to its customer in a hosting arrangement, such arrangements may or may not be subject to the scope of the software revenue recognition guidance. To determine whether such arrangements are subject to the scope of the software revenue recognition guidance, the substance of the arrangement must be evaluated to determine whether a service which is based on the software is being delivered to the customer. The illustrative guidance in ASC 985-605 includes factors that must be considered in making such determination, as follows:

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Implementation Guidance and Illustrations

Hosting Arrangement

985-605-55-119

This implementation guidance addresses the scope application of this Subtopic to a hosting arrangement.

985-605-55-120

[Paragraph not used]

985-605-55-121

A software element subject to this Subtopic is only present in a hosting arrangement if both of the following criteria are met:

a. The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.

b. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

Accordingly, a hosting arrangement in which the customer has an option as specified in this paragraph is within the scope of this Subtopic.

985-605-55-122

For purposes of item (a) in the preceding paragraph, the term *significant penalty* contains two distinct concepts:

a. The ability to take delivery of the software without incurring significant cost

b. The ability to use the software separately without a significant diminution in utility or value.

985-605-55-123

Therefore, arrangements that do not give the customer such an option are service contracts and are outside the scope of this Subtopic. Hosting arrangements that are service arrangements may include multiple elements that affect how revenue should be attributed.

985-605-55-124

For those hosting arrangements in which the customer has the option, as described in paragraph 985-605-55-122 to take possession of the software, delivery of the software occurs when the customer has the ability to take immediate possession of the software. If the software element is within the scope of this Subtopic, all of this Subtopic's requirements for recognizing revenue, including vendor-specific objective evidence of fair value and the requirement that the fee allocated to the software element not be subject to forfeiture, refund, or other concession, must be met to recognize revenue upon delivery for the portion of the fee allocated to the software element. The portion of the fee allocated to the hosting element should be recognized as the service is provided. Hosting arrangements that are within the scope of this Subtopic may also include other elements, such as specified or unspecified upgrade rights, in addition to the software product and the hosting service.

985-605-55-125

If the vendor never sells, leases, or licenses the software in an arrangement within the scope of this Subtopic, then the software is utilized in providing services and the development costs of the software should be accounted for in accordance with Subtopic 350-40.

The fact that a hosting arrangement conveys to the customer a license to software hosted by the vendor is not in and of itself a sufficient basis to conclude that the arrangement is subject to the scope of the software revenue recognition guidance. ASC 985-605-55-121 specifies that a hosting arrangement should only be deemed to include a software element that should be accounted for pursuant to the software revenue recognition guidance "if the customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty and it is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software." Each of these factors is discussed in more detail below.

A vendor does not have to deliver licensed software included in a hosting arrangement for a software element to exist in the arrangement. Conversely, a software element is not present in a transaction merely because the vendor delivers a copy of the licensed software to the customer. The key in determining whether a software element exists is whether the customer has a substantive right to take possession of the licensed software and use it for its intended purpose without further utilization of the hosting services offered by the vendor. In other words, for a software element to be deemed to exist in a hosting arrangement the customer must be able to use the software in-house, or engage a third party unrelated to the vendor to host the software on its behalf, and it must be able to do so without incurring a significant penalty.

ASC 985-605-55-122 defines a significant penalty using two distinct criteria: 1) the ability to take delivery of the software without incurring significant cost and 2) the ability to use the software separately without a significant diminution in utility or value. In order to conclude that a significant penalty does not exist, the vendor must be able to demonstrate that the customer can meet both of the conditions above. However, the guidance does not provide specific guidelines on how to apply these two criteria in practice.

We believe that the following factors should be considered in evaluating whether a customer has the ability to take delivery of software included in a hosting arrangement without incurring significant cost:

- *Whether financial penalties or operational barriers act as a significant disincentive to the customer taking possession of the software*. An example of such a barrier is a contractual requirement that significant fees or penalties must be paid to the vendor in connection with taking possession of the software. Another form of penalty may be a requirement to pay or forfeit a significant amount of "unused" hosting fees on cancellation of the hosting contract. Accordingly, a hosting arrangement should be carefully evaluated to determine if the amount of hosting fees that the customer must either 1) pay on cancellation or 2) forfeit if prepaid represents a "significant cost."

Although a bright line does not exist to determine significance, if a penalty represents more than 10% of the overall arrangement fees (generally comprised of the software license fees, the initial bundled PCS period and noncancelable hosting fees), we believe a rebuttable presumption exists that the penalty is significant. Additionally, a penalty of less than 10% may be significant based on the applicable facts and circumstances. The evaluation should be based on whether the amount of the penalty creates a sufficiently large disincentive such that it is not likely that the customer would incur the penalty to take possession of the software. In evaluating whether any fees or penalties are significant, we believe that the amount of the fees or penalties should be evaluated both in the context of the overall arrangement economics as well as the financial condition of the customer.

- *Whether there is an explicit, reasonable mechanism in the contractual arrangement by which the customer can exercise a right to take possession of the software.*
- *Whether other economic barriers or costs exist that act as a significant disincentive to the customer taking possession of the software*. For example, specialized hardware may be required to run the software that is available only from the vendor and the vendor does not separately sell the hardware. In such instances, the customer would not be able to independently host the software.

  Similarly, specialized hardware may be available from other vendors, but the cost of obtaining that hardware may be so high that a significant disincentive exists. Furthermore, if specialized technicians are needed to run the software, the cost to hire the technicians also may be a significant disincentive.
- Whether there is an absence of an adequate number of qualified replacement service providers. A lack of service providers that could host the licensed software due to 1) unique features, functionality, operating system requirements of the software, 2) the need to hire specialized technicians to run the software at a significant cost or 3) other factors may be a significant disincentive.

We believe that the following factors should be considered in evaluating whether a customer has the ability to use software separately without a significant diminution in utility or value:

- *Whether the customer can utilize all of the functionality of the software if the software is not hosted by the vendor*. For example, if the software would not be able to process substantially the same number of transactions in approximately the same time period if not hosted by the vendor, this may indicate that the customer cannot use the software separately from the vendor's hosting services without a significant diminution in utility or value.
- *Whether software upgrades are only available to customers for whom the vendor hosts the software*. If the functionality provided by upgrades to the software is important to customers, and such upgrades would not be made available if the software is not hosted by the vendor, the utility of the software to a customer is likely significantly diminished if the vendor's hosting services are discontinued.

If a software element is not deemed to be included in a hosting arrangement pursuant to the provisions of ASC 985-605-55-121 through 55-125, the entire arrangement should generally be accounted for as a service contract in accordance with the provisions of the multiple-element arrangements guidance in ASC 605-25 and the general revenue recognition guidance in SAB Topic 13. If an arrangement is composed of only the right to use the software and the hosting service, the two elements generally should be accounted for as one unit of accounting pursuant to ASC 605-25 as the right to use the software generally would not have standalone value. As the hosting service is the last element to be delivered, the entire arrangement fee should be recognized as revenue as the hosting service is performed.

A hosting arrangement also may include elements in addition to software and hosting services (e.g., hardware). When a software element is deemed to be included in the arrangement and all of the elements in the arrangement fall within the scope of ASC 985-605, the determination of whether the elements can be accounted for separately should be made pursuant to ASC 985-605 (see Questions3-1 through 3-20). However, when software is not present in a hosting arrangement, or if software is present but not all of the elements included in the arrangement are within the scope of ASC 985-605, the arrangement must be evaluated pursuant to the multiple-element arrangements guidance in ASC 605-25 to determine whether the elements of the arrangement subject to the scope of ASC 985-605 can be accounted for separately from the elements that are not within its scope (see Questions D2-1 through D2-4). Financial Reporting Developments, *Revenue recognition — Multiple element arrangements, Accounting Standards Codification 605-25* (Revised March 2018, SCORE No. BB1843) may be helpful in making this evaluation.

Certain hosting arrangements may require the customer to pay an amount at inception of the arrangement (an "up-front fee"). How such fees should be accounted for is dependent on the nature of the fee and the accounting literature that should be used to account for the elements of the arrangement.

- If all elements of the arrangement, including hosting or any other services, are within the scope of ASC 985-605 based on its scope provisions or the provisions of ASC 985-605-15-3 (see Question D1-2), the separation criteria in ASC 985-605 are applicable and must be evaluated.

  If vendor-specific objective evidence (VSOE) of fair value exists for each element, the arrangement consideration should be allocated to the various elements using the relative fair value method such that each element of the arrangement is allocated a proportionate amount of consideration, and any discount, from the arrangement. If VSOE exists only for the undelivered elements of the arrangement, an amount of arrangement consideration equal to VSOE of fair value should be allocated to the undelivered elements and the remaining amount of arrangement consideration, if any, should be allocated to the delivered elements (see Questions 3-1 through 3-20). If VSOE of fair value does not exist for the undelivered elements, the revenue should be recognized on the earlier of the following (assuming all of the basic criteria for revenue recognition of ASC 985-605 have been met):

  - VSOE is developed for the undelivered elements
  - All elements of the arrangement have been delivered
  - If the last undelivered element of the arrangement is a service, such as a hosting service, that does not involve significant production, modification or customization of the licensed software, the entire fee should be recognized over the period that the services will be performed

- If the elements of the arrangement are not within the scope of ASC 985-605, the arrangement should be accounted for as a service contract in accordance with the provisions of the multiple-element arrangements guidance in ASC 605-25 and SAB Topic 13 as discussed above. We believe that in such cases a vendor generally will be unable to separately account for a delivered software license due to a lack of standalone value (as required by ASC 605-25). In such cases, the delivered elements cannot be accounted for separately from the ongoing hosting services pursuant to the provisions of ASC 605-25 and revenue for the arrangement generally should be recognized as the hosting services (i.e., the last element delivered) are performed.

The following examples illustrate these concepts:

Illustration D1-5: All elements subject to the software revenue recognition guidance, VSOE of fair value of hosting services exists

Facts

Vendor S enters into an arrangement with Customer C to license software Product and provide hosting services for one year for $1,500,000, which is paid at inception of the arrangement. The arrangement also states that the vendor will perform implementation services that will allow the customer to access the hosted software. The software is more than incidental to the services included in the arrangement. The contract states that $1,000,000 is for the software license, $100,000 is for the implementation services and $400,000 is for the first year of hosting services. The hosting services are cancelable with thirty days' notice. If cancelled, the customer receives a pro-rata refund of the $400,000 hosting fee.

The customer has the contractual right to take possession of the software without incurring a significant penalty and it is feasible for the customer to run the software on its existing hardware or engage other vendors to host the software. The costs to take possession of the software, or to transfer the hosting services to a third party, are $25,000. The implementation services are not essential to the functionality of the software and hosting services. VSOE of fair value of the hosting services is $500,000 based on annual renewals of the services (see Question 8-7). VSOE of fair value of the implementation services does not exist.

Analysis

The costs to take possession of the software, or transfer hosting services to a third party, are not significant in relation to the overall arrangement. Because the customer has the right to take possession of the licensed software without significant penalty and it is feasible for the customer to utilize its existing hardware to run the software, or to engage others to host the software, the licensed software is subject to the scope of the software revenue recognition guidance.

Additionally, because the software is more than incidental to the services included in the arrangement, the services also are subject to the scope of the software revenue recognition guidance. Since VSOE of fair value exists only for the hosting services, revenue should be recognized once the hosting services are the only undelivered element (assuming the software license term has commenced and all of the basic revenue recognition criteria of ASC 985-605 have been met). At the time the implementation services are complete, Vendor S should defer $500,000 to be recognized over the period that the hosting services will be delivered. The residual arrangement consideration of $1,000,000 can be recognized as revenue if all of the basic revenue recognition criteria of ASC 985-605 have been met.

Note that in an arrangement involving hosting services, we do not believe application of the "combined services" approach described in Question 3-16 is appropriate. Accordingly, although the implementation services are not essential to the functionality of the software and hosting services, no revenue should be recognized until their completion.

Illustration D1-6: All elements subject to software revenue recognition guidance, VSOE of fair value does not exist for any elements

Facts

Assume the same facts as in Illustration D1-5 above, except that VSOE of fair value does not exist for any of the elements included in the arrangement.

Analysis

For the reasons cited in Illustration D1-5, each of the elements is subject to the scope of the software revenue recognition guidance. However, because VSOE of fair value does not exist for any of the elements, the entire arrangement fee should be recognized ratably over the period the hosting services are performed once the implementation services are completed, if all of the basic revenue recognition criteria of ASC 985-605 have been met.

Illustration D1-7: Elements are not subject to the scope of the software revenue recognition guidance

Facts

Assume the same facts as in Illustration D1-5 above, except that if the customer elects to take possession of the software, it must pay an additional software licensing fee of $250,000. In the context of this arrangement, the requirement that the customer must pay an additional $250,000 to the vendor if it elects to take possession of the software represents a significant penalty that serves as a disincentive to the customer taking such action.

Analysis

Pursuant to the provisions of ASC 985-605-55-121 through 55-125, the licensed software is not subject to the scope of the software revenue recognition guidance because there is a significant disincentive to the customer taking possession of the software. Instead, all elements of the arrangement should be accounted for as a service contract pursuant to the provisions of the multiple-element arrangements guidance in ASC 605-25 and the general revenue recognition guidance in SAB Topic 13.

The structure of the arrangement indicates that the software does not have standalone value to the customer. Accordingly, it cannot be accounted for separately from the implementation and hosting services pursuant to the provisions of ASC 605-25.[7] Accordingly, the entire arrangement fee should be recognized over the period that the hosting services will be provided (once the implementation services are completed).

Determining when delivery has occurred in a hosting arrangement accounted for pursuant to the provisions of ASC 985-605 is discussed in Question 4-34.

[7] Financial Reporting Developments, *Revenue Recognition — Multiple-Element Arrangements, Accounting Standards Codification 605-25* (Revised March 2018, SCORE No. BB1843) discusses factors that should be considered when determining whether a delivered item has standalone value.

Applicability of ASC 985-605 to non-software deliverables included in an arrangement containing more-than-incidental software

Question D1-3 **Are non-software elements included in an arrangement that contains software that is more than incidental to the products or services as a whole within the scope of ASC 985-605??**

In general, an element is considered a software element if the software component of that element is considered more than incidental (see Question D1-1) or if the element is software related (e.g., upgrades and enhancements to software, PCS and software services). Elements other than these generally are considered non-software elements (e.g., hardware or non-software related services such as transaction processing). However, pursuant to ASC 985-605-15-3, certain non-software elements may be considered software elements subject to the scope of the software revenue recognition guidance if the software is considered essential to the functionality of those elements (e.g., hardware sold as part of a packaged solution that is dependent on the software included in the arrangement to perform its intended function).

Excerpt from Accounting Standards Codification

Software — Revenue Recognition

Scope and Scope Exceptions

985-605-15-3

The guidance in this Subtopic applies to the following transactions and activities:

a. [Omitted from this Question]

b. [Omitted from this Question]

c. Other arrangements for products or services that include software that is more than incidental to the products or services as a whole. Indicators of software that is more-than-incidental to a product as a whole include (but are not limited to):

   1. The software is a significant focus of the marketing effort or is sold separately.

   2. The vendor is providing postcontract customer support.

   3. The vendor incurs significant costs that are within the scope of Subtopic 985-20.

   In such arrangements, the guidance in this Subtopic applies to the software and software-related elements. Software-related elements include software products and services such as those listed in paragraph 985-605-25-5 as well as any nonsoftware deliverable or deliverables for which a software deliverable is essential to their functionality. For example, in an arrangement that includes software, computer hardware that will contain the software, and additional unrelated equipment, if the software is essential to the functionality of the hardware, the hardware would be considered software-related. However, if the software is not essential to the functionality of the additional unrelated equipment, the equipment would not be considered software-related.

d. [Omitted from this Question]

e. [Omitted from this Question]

If an arrangement contains both software elements (elements that are in the scope of ASC 985-605 individually) and non-software elements (elements that are not in the scope of ASC 985-605 individually), the provisions of ASC 985-605-15-3 must be applied to the arrangement to determine if the non-software elements should be accounted for pursuant to the software revenue recognition guidance in ASC 985-605 because the software is essential to the functionality of those items (see Question D2-1 for an exception to this guidance when a software licensing arrangement includes a lease of hardware). If some or all of the non-software deliverables are determined to be outside the scope of ASC 985-605, the provisions of the multiple-element arrangements guidance in ASC 605-25 must be applied to determine if the software and non-software elements of the arrangement can be accounted for separately.

When arrangements include both hardware and software, the application of the provisions of ASC 985-605-15-3 to determine whether the software elements are essential to the functionality of the hardware may require the exercise of professional judgment. Some of the factors that should be considered in making such a determination include:

- Does the hardware have substantive functionality without the software. That is, could a customer be reasonably expected to purchase the hardware without also purchasing the software?
- Is the hardware commonly sold without the software that is included in the arrangement? Or are the software and hardware always sold as a package or a solution?
- Is the hardware available from other vendors and compatible with other vendors' software? We believe that application of the provisions of ASC 985-605-15-3 generally should not result in a non-software element being subject to the scope of the software revenue recognition guidance if that element is available from other vendors and is compatible with the other vendors' software.
- If the hardware is delivered prior to delivery or installation of the software, is payment for the hardware contingent on delivery or successful installation of the software deliverable?

If a determination is made that non-software elements included in an arrangement also should be accounted for pursuant to the software revenue recognition guidance, its provisions should be applied to the arrangement to determine if the various elements of the arrangement can be accounted for as separate units of accounting and, if so, how the arrangement consideration should be allocated to the elements (see Questions 3-1 through 3-20).

Evaluating whether future discounts are more than insignificant

Question D1-4 **What factors should be considered to assess whether a future discount is more than insignificant? Should the right to the discount on a future purchase be accounted for separately?**

Pursuant to ASC 985-605-15-3(d), more-than-insignificant discounts on future purchases of software included in a software arrangement are within the scope of the software revenue recognition guidance. Contractual arrangement terms that give customers the right to future purchases of additional products or services from a vendor for an amount below their fair value, including the ability to renew PCS at rates below established VSOE of fair value, in addition to the current products and services being purchased, generally should be accounted for separately. A discount that is not more than insignificant generally requires no accounting recognition.

A discount on the purchase of future products or services provided to a customer in connection with a current arrangement is considered to be more than insignificant if it meets each of the following criteria:

- The future discount is significant in the context of the overall transaction. For example, if an arrangement for which the total consideration is $200,000 includes the right to buy an item that normally sells for $2,000 for $1,000, that discount is not significant in the context of the overall transaction. Determining when a discount is significant to the overall transaction will require the use of professional judgment and will be dependent on the relevant facts and circumstances.

- The future discount is incremental to the discounts, if any, inherent in the pricing of the other elements included in the arrangement. For example, if the customer were granted a discount of 20% on the elements included in the arrangement, a 20% discount on future purchases of additional products or services would generally not be considered incremental.
- The future discount is incremental to the discount typically provided to customers purchasing the same or similar products or services on a standalone basis. If the customer is not provided a discount that is incremental to that which other customers generally receive, no incremental value has been provided to the customer through the future discount.

Refer to Question 5-4 for guidance on the accounting for a future discount that it is deemed more than insignificant as an element in the arrangement.

D2 Relationship to other pronouncements

D2.1 Chapter summary

The software revenue recognition guidance included in ASC 985-605 is not intended to alter the requirements of any other authoritative guidance included in the ASC as it relates to the application of that guidance to software licensing arrangements. For example, ASC 985-605 states if an arrangement includes a lease of property, plant or equipment (e.g., computer hardware or other tangible property such as land or other depreciable assets) and software elements, the former should be accounted for as a lease pursuant to the provisions of ASC 840, *Leases*.

This chapter discusses the interaction of the requirements of ASC 985-605 with the requirements of the lease accounting guidance, general revenue recognition guidance, multiple-element arrangements guidance and nonmonetary transactions guidance.

Frequently asked questions

Interaction of the software revenue recognition guidance with the lease accounting guidance

Question D2-1 **How does software revenue recognition guidance included in ASC 985-605 interact with the lease accounting guidance included in ASC 840? How should arrangement consideration be allocated to the elements of an arrangement subject to ASC 840 and those subject to ASC 985-605?**

ASC 840-10-15 provides guidance on how to determine whether an arrangement contains a lease that is within the scope of the lease guidance, based on the following model:

- The arrangement involves the use of property, plant or equipment (i.e., land and/or depreciable assets),
- The property, plant or equipment in the arrangement is either explicitly or implicitly identified, and
- The arrangement conveys to the purchaser/lessee the "right to use" the specified property, plant or equipment.

ASC 840-10-15 provides that if a multiple-element arrangement contains a lease, then the classification, recognition, measurement and disclosure provisions of the lease guidance must be applied to the lease elements of the arrangement. That is, ASC 840-10-15 requires that any lease in any arrangement be separated and accounted for pursuant to the lease guidance. Non-lease elements of the arrangement (e.g., elements that are in the scope of the software revenue recognition guidance or other authoritative literature) are not within the scope of the lease guidance and should be accounted for in accordance with other applicable literature.

Accordingly, if a lease includes 1) a lease of property, plant or equipment (e.g., computer hardware) and 2) software elements, the lease of the tangible property should be accounted for pursuant to the lease guidance (regardless of whether the software is more than incidental to the hardware) and the software elements, including postcontract customer support (PCS), should be accounted for separately in accordance with the guidance in ASC 985-605. However, if the software is incidental to the property, plant or equipment as a whole (e.g., software embedded in an automobile), the entire arrangement should be accounted for as a lease. Determining whether software is more than incidental to products in which it is contained requires the use of professional judgment. Factors that should be considered in making this determination include (See Question D1-1):

- Is the software a significant focus of the marketing effort or sold separately?
- Does the vendor provide PCS for the software?
- Are software development costs significant in relation to the costs to develop the product as a whole?

Although neither the lease guidance nor the software revenue recognition guidance address how to allocate an arrangement's consideration when it involves a sale or license of software and a lease of hardware or other tangible property, ASC 840-10-15-19 provides that such allocation should be done on a relative-fair-value basis, consistent with the multiple-element arrangements guidance in ASC 605-25-15-3A(b) as follows:

Excerpt from Accounting Standards Codification

Revenue Recognition — Multiple-element Arrangements

Scope and Scope Exceptions

605-25-15-3A (b)

Other Topics address separation but not allocation. If another Topic provides guidance requiring separation of deliverables within the scope of that Topic from deliverables not within the scope of that Topic, but does not specify how to allocate arrangement consideration to each separate unit of accounting, such allocation shall be based on the relative selling price of the deliverables within the scope of that Topic and the deliverables not within the scope of that Topic. For example, leased assets are required to be accounted for separately under the guidance of Subtopics 840-20 and 840-30. See paragraph 605-25-55-3. (For purposes of the allocation between deliverables within the scope of another Topic and deliverables not with the scope of that other Topic, the selling price shall be determined using the guidance as discussed in paragraphs 605-25-30-6A through 30-6B.) Subsequent identification of separate units of accounting and allocation of arrangement consideration to the deliverables not subject to that Topic would be governed by the provisions of this Subtopic.

ASC 840-10 provides that such allocation should be done on a relative fair value basis, consistent with the guidance in ASC 605-25. ASC 605-25 provides that "(i)f higher-level literature provides guidance requiring separation of deliverables within the scope of higher-level literature from deliverables not within the scope of higher-level literature, but does not specify how to allocate arrangement consideration to each separate unit of accounting, such allocation should be performed on a relative fair value basis using the entity's best estimate of the fair value of the deliverable(s) within the scope of higher-level literature and the deliverable(s) not within the scope of higher-level literature" (footnote references omitted).

Accordingly, if an arrangement includes software elements that are within the scope of the software revenue recognition guidance and non-software elements that are subject to the scope of the lease guidance, the arrangement consideration (e.g., the minimum lease payments) should be allocated between the lease elements (i.e., the elements subject to the scope of ASC 840) and the elements subject to the scope of ASC 985-605 (i.e., the software and software-related elements) on a relative fair value basis using the vendor's best estimate of fair values in accordance with the provisions of ASC 605-25. Separating the lease elements from the elements subject to the scope of ASC 985-605 is not elective, even if VSOE of fair value of the elements does not exist. If more than one element of the arrangement is subject to the scope of ASC 985-605, any amounts allocated to the software elements included in the arrangement should be further evaluated to determine if VSOE of fair value exists such that they can be further separated into differing units of accounting pursuant to the provisions of the software revenue recognition guidance.

Arrangements involving leases generally contain payment streams that occur over a period of time. Pursuant to the software revenue recognition guidance, a license fee should be presumed not to be fixed or determinable if a significant portion of the fee is due after the expiration of the license or more than twelve months after delivery. Accordingly, if the payments relating to a software licensing arrangement containing a lease extend beyond twelve months, the portion of the payments allocated to the software elements is presumed not to be fixed or determinable. The presumption that the software portion of the payments is not fixed or determinable may be overcome if the vendor has an established standard business practice of using long-term or installment (including long-term leasing) contracts and a history of successfully collecting under the original payment terms without making concessions. If it is concluded the software portion of the payments is not fixed or determinable, the revenue attributable to the software elements of a leasing arrangement should be recognized as each payment becomes due.

The following example illustrates these concepts:

Illustration D2-1: Interaction of the software revenue recognition guidance with the lease accounting guidance

Facts

A vendor enters into a three-year time-based arrangement with a customer to provide a packaged solution that includes computer hardware, a software license and PCS of the software. The licensed software is more than incidental to the arrangement. The arrangement does not include significant production, modification or customization of the licensed software. Monthly payments of $5,000 ($180,000 in total) are due under the lease term. The vendor has historically offered three-year leases of computer hardware and software, and fully collected amounts due pursuant to the original terms of such arrangements without granting concessions to customers. The lease payments are probable of collection.

The vendor does not sell the hardware and software separately, but based on sales by other vendors of comparable hardware on a standalone basis, it estimates that its fair value is $80,000. Management's best estimate of the fair value of the software and PCS included in the arrangement, were it to be sold on a standalone basis, is $120,000.

Analysis

Payments due pursuant to the arrangement should be allocated as follows:

	Management's best estimate of fair value	Proportion of fair value	Allocation of payments
Hardware	$ 80,000	40%	$ 72,000
Software and PCS	120,000	60%	108,000
Total	$ 200,000	100%	$ 180,000

When revenue should be recognized for the $72,000 allocated to the hardware should be determined pursuant to the provisions of ASC 840. For example, if the lease of the hardware qualifies as a sales-type lease, the vendor may recognize the initial sale, and the related cost of sale, of the computer hardware on delivery and the related interest income over the lease term in accordance with the provisions of ASC 840.

The $108,000 allocated to the software and PCS should be further evaluated pursuant to ASC 985-605 to determine if the software can be accounted for separately from the PCS.

If an arrangement includes a lease of hardware that contains embedded software or "firmware" that is not more than incidental to the hardware, the entire arrangement should be accounted for pursuant to the provisions of ASC 840. As discussed in Question D1-1, the provisions of ASC 985-605 are not applicable to software included in arrangements when the software is incidental to the products or services as a whole.

Applicability of the lease guidance to hardware with embedded software that is more than incidental

Question D2-2 **If an arrangement includes a lease of hardware that contains embedded software or "firmware" that is more than incidental to the hardware, should the hardware be accounted for pursuant to the software revenue recognition guidance included in ASC 985-605 or the lease guidance included in ASC 840?**

If an arrangement includes 1) a lease of hardware (or other tangible property) and 2) software elements, we believe that the lease of the tangible property should be accounted for pursuant to ASC 840, even if embedded software is more than incidental to the tangible property included in the arrangement. Question D2-1 discusses how the arrangement consideration should be allocated between the hardware and the software in such an arrangement.

This requirement was discussed in a speech made by the SEC staff at the December 2003 AICPA Conference on SEC Current Developments. The staff emphasized "leased assets are required to be accounted for separately under the guidance of Statement 13. That would also include hardware or equipment that has been leased as part of a software arrangement. For example, if a registrant leased a customized build-to-suit software system to its customer, the hardware or equipment components and related executory costs are required to be unbundled and accounted for separately under Statement 13."

Interaction of ASC 985-605 with SAB Topic 13

Question D2-3 **How does ASC 985-605 interact with SAB Topic 13?**

SAB Topic 13 states in part "if a transaction is within the scope of specific authoritative literature that provides revenue recognition guidance, that literature should be applied. However, in the absence of authoritative literature addressing a specific arrangement or a specific industry, the staff will consider the existing authoritative accounting standards as well as the broad revenue recognition criteria specified in the FASB's conceptual framework that contain basic guidelines for revenue recognition" (SAB Topic 13.A.1). Accordingly, the provisions of SAB Topic 13 should be used any time an issue is not specifically addressed in ASC 985-605.

Additionally, in some instances SAB Topic 13 and ASC 985-605 address the same issue but SAB Topic 13 provides more extensive guidance relating to the issue. For example, SAB Topic 13 provides a greater amount of guidance relating to the effect of customer acceptance provisions on revenue recognition for an arrangement. In such instances, public registrants should always consider the guidance included in SAB Topic 13 when determining the appropriate accounting for an arrangement. We believe that private companies should as well.

Interaction of the software revenue recognition guidance with the multiple-element arrangements guidance

Question D2-4 **How does the software revenue recognition guidance included in ASC 985-605 interact with the multiple-element arrangements guidance included in ASC 605-25??**

ASC 985-605 provides guidance regarding the timing and amount of revenue recognition for licensing, selling, leasing or otherwise marketing computer software, unless the software is incidental to the products or services as a whole. ASC 985-605 also provides guidance relating to the separation of multiple elements included in a software licensing arrangement and for the allocation of arrangement consideration among units of accounting. Because ASC 985-605 provides guidance on both the separation of deliverables and the allocation of arrangement consideration, the guidance in ASC 985-605 should be applied to elements within its scope instead of the provisions of ASC 605-25.

If an arrangement contains elements both within (i.e., software elements) and not within (i.e., non-software elements) the scope of ASC 985-605, the provisions of ASC 985-605-15-3 must be applied to determine if the non-software elements should be accounted for pursuant to ASC 985-605 because the software is essential to the functionality of those items (see Question D1-1).

If the application of ASC 985-605-15-3 results in a conclusion that all non-software elements of an arrangement are subject to the scope of ASC 985-605, the separation and allocation of arrangement consideration guidance of ASC 985-605 should be followed for those elements (see Questions 3-1 through 3-20). This is required by ASC 605-25-15-3A(a), which provides that "if another Topic provides guidance regarding the determination of separate units of accounting and how to allocate arrangement consideration to those separate units of accounting, the arrangement or the deliverables in the arrangement that is within the scope of that Topic shall be accounted for in accordance with the relevant provisions of that Topic rather than the guidance in this Subtopic."

If the arrangement is determined to include software elements and elements not subject to the scope of ASC 985-605, the separation and allocation of arrangement consideration guidance of ASC 605-25 should be applied to determine if the non-software elements can be separated from the software elements. ASC 605-25-15-3A(c) provides that "if another Topic provides no guidance regarding the separation of the deliverables within the scope of that Topic from those deliverables that are not or the allocation of arrangement consideration to deliverables within the scope of that Topic and to those that are not, then the guidance in this Subtopic shall be followed for purposes of such separation and allocation." In such situations, it is possible that elements within the scope of ASC 985-605 cannot be separated from other elements in the arrangement, based on the application of the separation and allocation guidance of ASC 605-25. If so, both the elements subject to the scope of ASC 985-605 and those elements that are not should be accounted for as one unit of accounting and revenue should be recognized based on that one unit.

Determining the appropriate revenue recognition model to follow in such instances requires the use of professional judgment and is dependent on the relevant facts and circumstances. However, we believe that there is a rebuttable presumption that the revenue recognition model applicable to the last delivered element included in the arrangement is the model that should be followed when recognizing revenue for the combined unit of accounting. Pursuant to such a model, revenue should be recognized once the last element has been delivered, or over a performance period if the last element is a service, assuming the other revenue recognition criteria have been met.

Additionally, we understand that the SEC staff generally will object to any revenue recognition model that results in revenue recognition as products are delivered or services are performed (i.e., any method other than the method applicable to the last element included in the arrangement) if elements cannot be separated into multiple units of accounting pursuant to ASC 605-25 due to a lack of standalone value. The SEC staff believes that recognizing revenue on the delivery of items that have no standalone value is contrary to the principles contained in ASC 605-25.

The presumption that revenue recognition should be based on the final element may be overcome based on the facts and circumstances of the arrangement. For example, it may be inappropriate to recognize revenue based on the final element included in the arrangement when one element included in the arrangement clearly comprises the majority of the value of the overall combined unit of accounting (i.e., it is the predominant deliverable included in the arrangement). In such cases, it may be appropriate to recognize revenue for the combined unit of accounting based on the revenue recognition guidance otherwise applicable to the predominant deliverable.

If the elements included in an arrangement are services that cannot be separated into different units of accounting, the revenue associated with the agreement may be recognized 1) ratably over the period beginning when delivery of the last service commences (if delivery of the services is front-loaded or occurs ratably) or 2) over the period of the entire arrangement using a proportional performance model of revenue recognition.

The proportional performance model can only be utilized when the vendor's pattern of performance under the arrangement can be determined. This model focuses on the pattern in which service is provided to the customer (i.e., based on vendor outputs) and not the manner in which the vendor incurs costs or expends effort. Often it will be difficult to identify a common performance measurement for disparate services included in a multiple-element arrangement. The absence of such a measurement may preclude a vendor's ability to utilize the proportional performance method for revenue recognition.

Financial Reporting Developments, *Revenue recognition — Multiple element arrangements*, *Accounting Standards Codification 605-25* (Revised March 2018, SCORE No. BB1843) discusses in greater detail application of the provisions of ASC 605-25.

The following example illustrates these concepts:

Illustration D2-2: Interaction of the software revenue recognition guidance with the multiple-element arrangements guidance

Facts

A vendor sells a software license, bundled with postcontract customer support (PCS), hardware and installation. The licensed software is essential to the functionality of the hardware. Additionally, the vendor sells the customer a storage cabinet for, among other things, the user manuals for the licensed software.

Analysis

Because the software is essential to the functionality of the hardware included in the arrangement, the hardware is subject to the scope of ASC 985-605 pursuant to the provisions of ASC 985-605-15-3. While the first four elements of the arrangement are subject to ASC 985-605, the storage cabinet is outside its scope because the software is incidental to its use.

The arrangement should be evaluated pursuant to ASC 605-25 to determine if the storage cabinet can be separated from the ASC 985-605 elements (the software license, PCS, hardware and installation) and, if so, what amount of arrangement consideration should be allocated to it. If the cabinet is separable, the arrangement consideration for the software elements would be further allocated (if possible), and then recognized, pursuant to ASC 985-605. Revenue should be recognized for the sale of the cabinet when the basic revenue recognition criteria set forth in SAB Topic 13 have been satisfied.

Interaction of the software revenue recognition guidance with the guidance for nonmonetary transactions

Question D2-5 **How do the provisions of the software revenue recognition guidance included in ASC 985-605 apply to nonmonetary exchanges of software?**

A software vendor may enter into a nonmonetary transaction whereby it provides a license to a product it markets in exchange for a license to a software product or technology of the counterparty. The vendor may sublicense the counterparty's product to other customers as a standalone product, utilize the counterparty's technology as a component of the software products it markets or use it internally.

ASC 845, *Nonmonetary Transactions*, provides relevant guidance relating to the accounting for nonmonetary transactions. Pursuant to that guidance, the accounting for nonmonetary transactions generally should be based on the fair value of the assets or services received or exchanged, whichever is more evident, unless one of the following conditions exists:

- The fair value of neither the asset(s) received nor the asset(s) relinquished is determinable within reasonable limits. For a nonmonetary exchange involving software, we believe VSOE of fair value of either the software received or relinquished must exist to conclude that fair value is determinable within reasonable limits. In practice, it would be rare for a vendor to demonstrate VSOE of fair value of software products (as such products are rarely sold individually and not along with other elements, such as PCS).
- The transaction is an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange.
- The exchange transaction lacks commercial substance. A nonmonetary exchange has commercial substance if an entity's future cash flows are expected to significantly change as a result of the exchange. An entity's future cash flows are expected to significantly change if either of the following criteria is met:
  - The risk, timing and amount of the future cash flows of the asset(s) received differs significantly from the configuration of the future cash flows of the asset(s) transferred.
  - The entity-specific value of the asset(s) received differs from the entity-specific value of the asset(s) transferred, and the difference is significant in relation to the fair values of the assets exchanged.

The application of the provisions of ASC 845 to nonmonetary exchanges of software for software that will be used as a component of the vendor's software or sublicensed or sold to other customers is addressed in ASC 985-845, *Software — Nonmonetary Transactions*.

Exchange transactions to facilitate sales to customers

Excerpt from Accounting Standards Codification

Software — Nonmonetary Transactions

Recognition

985-845-25-1

A software vendor may exchange a license of its software to a customer in exchange for a license to the customer's technology that permits the software vendor to sublicense the customer's technology to other customers as a component of the software vendor's products or as a standalone additional product.

985-845-25-2

Paragraph 845-10-30-3 states that, if certain conditions apply, a nonmonetary exchange shall be measured based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) of the nonmonetary asset relinquished, and not on the fair values of the exchanged assets. One of those conditions is an exchange to facilitate sales to customers, that is, an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange.

985-845-25-3

Therefore, if the technology or products received by the software vendor in the exchange are sold, licensed, or leased in the same line of business as the software vendor's technology or products delivered in the exchange, the software vendor shall measure the exchange based on the recorded (carryover) amount of the software issued in exchange.

985-845-25-4

However, if the technology or products received by the software vendor in the exchange are sold, licensed, or leased in a different line of business from the software vendor's technology or products delivered in the exchange, the exchange shall be measured based on the fair values of the exchanged technology or products, if both of the following conditions exist:

a. The fair value of the technology or products exchanged or received is determinable within reasonable limits (that is, vendor-specific objective evidence of fair value of the software given up, or the value of the technology or products received, as if the software vendor had received or paid cash)

b. The transaction has commercial substance, as described in paragraph 845-10-30-4, including that the technology or products received in the exchange are expected, at the time of the exchange, to be deployed and used by the software vendor and the value ascribed to the transaction reasonably reflects such expected use.

985-845-25-5

If neither the fair value of the technology or products exchanged nor the fair value of the technology or products received is determinable within reasonable limits, the exchange shall be measured based on the recorded (carryover) amount of the technology or products relinquished in exchange. Paragraph 845-10-30-8 indicates that if neither the fair value of a nonmonetary asset transferred nor the fair value of a nonmonetary asset received in exchange is determinable within reasonable limits, the recorded amount of the nonmonetary asset transferred from the entity may be the only available measure of the transaction.

Exchange transactions for software for internal use

Software vendors also may exchange a license to their software for a license to a counterparty's software that will be used for internal purposes. The application of the provisions of ASC 845 to such exchanges is as follows:

Excerpt from Accounting Standards Codification

Software — Nonmonetary Transactions

Recognition

985-845-25-6

A software vendor may also exchange a license of its software to a customer in exchange for a license to the customer's technology that the software vendor intends for internal use.

985-845-25-7

If the fair value of either of the nonmonetary assets involved in the transaction is determinable within reasonable limits, the software vendor shall measure the exchange based on the fair values of the assets exchanged, consistent with the guidance in paragraph 845-10-30-1.

The following table summarizes the guidance on nonmonetary exchanges of software:

Software — Nonmonetary Transactions

Implementation Guidance and Illustrations

985-845-55-1

The following table summarizes the guidance in this Subtopic.

Software Vendor's Technology Exchanged	Software Vendor's Use of Technology Received	Same Line of Business	Accounting Treatment
Software product held for sale in the ordinary course of business (that is, inventory)[a]	Technology to be held for sale in the ordinary course of business (that is, inventory)[b]	1. Yes 2. No	1. Record at historical cost 2. Record at fair value[c]
Software product held for sale in the ordinary course of business (that is, inventory)	Internal-use software[d]	N/A	Record at fair value[c]

(a). Licenses to software products, source code, and object code that the software vendor sells, licenses, or leases in the ordinary course of business would constitute inventory.

(b). A software vendor that receives any of the following would be receiving inventory:

a. A product to resell, sublicense, or sublease

b. A right to embed the technology received into a product

c. A right to further develop the technology received into a product.

(c). Assumes that vendor-specific objective evidence of fair value exists and the transaction has commercial substance.

(d). A software vendor that receives any of the following would be receiving something other than inventory:

a. A product or technology that can be used only internally (for example, a financial or management application)

b. A product or technology that can be used only internally to make a product but which does not become part of the product.

The following example illustrates nonmonetary exchanges of software products:

Software — Nonmonetary Transactions

Implementation Guidance and Illustrations

Example 1: Exchange of Software Products

985-845-55-2

This Example illustrates the guidance in this Subtopic for both the software vendor (see Section 985-845-25) and the other party to the nonmonetary exchange.

985-845-55-3

Software Vendor A licenses Software Product 1 (a suite of financial accounting applications) to customers in the normal course of business. Software Vendor A has vendor-specific objective evidence of fair value of Product 1 resulting from prior cash transactions with its customers. Product 1 includes technology (Product 2) sublicensed by Software Vendor A from Entity B.

985-845-55-4

Software Vendor A agrees to exchange Product 1 with Entity B for licenses to Product 2. Software Vendor A intends to relicense Product 2 (as a separate product or embedded in Product 1) to its customers. Entity B intends to use Product 1 for internal use.

985-845-55-5

Software Vendor A would account for the transaction as follows.

985-845-55-6

Software Vendor A exchanged property held for sale (Product 1) for property to be sold in the same line of business (Product 2) to facilitate future sales to other customers. The exchange would be measured based on the recorded (carryover) amount of Product 1. No revenue would be recognized until Product 2 is sublicensed to other customers in subsequent transactions.

985-845-55-7

Entity B would account for the transaction as follows.

985-845-55-8

Entity B exchanged property held for sale (Product 2) for a productive asset (Product 1, which will be used by Entity B as an amortizable asset). The exchange would be measured based on fair value by Entity B, and revenue would be recognized on the exchange. Such accounting treatment is based on the fact that the fair value of the technology exchanged or received is reasonably determinable and that the exchange has commercial substance.

Based on the provisions of ASC 985-845 above, a vendor should recognize a nonmonetary exchange of software at fair value only if it can support culmination of the earnings process by demonstrating: 1) the software received is to be sold in a different line of business from the software provided in exchange, 2) VSOE of fair value of the product received or exchanged exists and 3) commercial substance. When evaluating commercial substance, an entity should also be able to demonstrate a substantive business purpose for structuring the transaction in such a manner, including a substantive need for the software product received. Pursuant to ASC 845 and ASC 985-845, VSOE of fair value of the software product received should be used if it is more evident than VSOE of fair value of the software product surrendered.

The table in ASC 985-845-55-1 above summarizes these provisions.

ASC 985-845 also states that fair value accounting is not permitted for a nonmonetary exchange that lacks commercial substance. Accordingly, a vendor also must consider whether the nonmonetary exchange has commercial substance as described in ASC 845.

Transactions involving boot

ASC 845 also addresses the accounting for nonmonetary exchanges including an amount of monetary consideration or boot. A nonmonetary transaction that includes boot should be accounted for as a monetary exchange if the boot is equal to 25% or more of the fair value of the exchange. In such cases, the entire arrangement should be accounted for at fair value.

The inclusion of boot in a transaction involving the exchange of software products does not provide evidence of the fair value of the software products exchanged. In many such arrangements, a software vendor will be unable to evaluate the significance of boot included in a nonmonetary transaction because VSOE of fair value for neither the software given up nor the software received will exist. In such cases, the nonmonetary component and monetary component of the arrangement should each be accounted for separately. This accounting also should be applied if the fair value of an exchange is determinable (i.e., VSOE of fair value exists for the software products exchanged) but the amount of boot is less than 25% of the fair value of the exchange. If the nonmonetary component of such an arrangement 1) represents an exchange of software held for sale in the ordinary course of business, 2) lacks commercial substance or 3) does not meet any of the criteria specified in ASC 985-845 above, then the nonmonetary component of the arrangement should be measured at the recorded amount of the software given up. Boot received should be accounted for in accordance with the provisions of ASC 845-10-30-6. Boot paid should be accounted for as a purchase of inventory.

Transactions with the same counterparty

ASC 845-10 provides guidance with respect to purchases and sales of inventory with the same counterparty.

Excerpt from Accounting Standards Codification

Nonmonetary Transactions — Overall

Initial Measurement

845-10-30-15

A nonmonetary **exchange** whereby an entity transfers finished goods inventory in exchange for the receipt of raw materials or work-in-process inventory within the same line of business is not an exchange transaction to facilitate sales to customers for the entity transferring the finished goods, as described in paragraph 845-10-30-3(b), and, therefore, shall be recognized by that entity at fair value if both of the following conditions are met:

a. Fair value is determinable within reasonable limits.

b. The transaction has commercial substance (see paragraph 845-10-30-4).

845-10-30-16

All other nonmonetary exchanges of inventory within the same line of business shall be recognized at the carrying amount of the inventory transferred. That is, a nonmonetary exchange within the same line of business involving either of the following shall not be recognized at fair value:

a. The transfer of raw materials or work-in-process inventory in exchange for the receipt of raw materials, work-in-process, or finished goods inventory

b. The transfer of finished goods inventory for the receipt of finished goods inventory.

Based on the provisions of ASC 845-10, above, we believe that it will be rare that an exchange of a license to a vendor's software product for a license to the counterparty's software product that the vendor will then sublicense or sell to its customers will be accounted for at fair value. We believe that such exchanges generally are an exchange of finished goods for finished goods to be sold in the same line of business.

Further, we believe that an exchange by a vendor of a currently marketed software product for a right to embed the technology received into a product that will be licensed to other customers, or a right to further develop the technology received into such a product, is analogous to the exchange of a finished good for a raw material. Pursuant to the above guidance, such transactions should be accounted for at fair value, assuming that VSOE of fair value exists and the transaction has commercial substance.

Footnote (c) of ASC 985-845-55-1 indicates that a nonmonetary exchange of software must be recorded at carryover basis if the transaction does not have a valid business purpose. The assessment of whether a nonmonetary exchange has a valid business purpose is equivalent to the assessment of commercial substance and should be made pursuant to ASC 845.

Exchanges of software for a nonmonetary asset other than software

The guidance in ASC 985-845 refers and applies specifically to exchanges of software for software. If a software vendor exchanges software for a nonmonetary asset other than software (e.g., a computer monitor), the transaction should be accounted for pursuant to ASC 845.

The following example illustrates these concepts:

Illustration D2-3: Nonmonetary exchange of software for an asset other than software

Facts

A software vendor, Softco, licenses Product A, a suite of financial accounting applications, to customers in the normal course of business. Softco does not have VSOE of fair value for the software. Softco agrees to exchange a stated number of perpetual licenses to Product A and one year of PCS with Autoco, an automobile manufacturer, for 10 automobiles. The automobiles will be utilized by Softco's sales personnel in the performance of their responsibilities. The transaction has commercial substance for each vendor.

Analysis

Softco should account for the exchange at fair value based on the fair value of the automobiles (fair value of the software is not determinable because Softco does not have VSOE of fair value for the software) because as Softco exchanged finished goods held for sale in the ordinary course of business (Product A) for productive assets to be used for internal purposes (the automobiles). The transaction does not meet any of the conditions, as discussed above, for an exception to the general requirement of ASC 845 that nonmonetary exchanges be recorded at fair value.

ASC 985-605-55-4 includes several factors that should be considered when determining whether a group of contracts should be accounted for as a single multiple-element arrangement. We believe those factors should be considered when determining if separate software licensing transactions between the same counterparties should be combined for purposes of accounting for the transactions as a nonmonetary exchange of software pursuant to the provisions of ASC 985-845. ASC 845-10-25-4 also provides factors for determining when two or more purchase and sales transactions with the same counterparty should be combined for purposes of applying ASC 845. We believe that these factors should be considered as well.

ASC 845 provides that if one transaction is legally contingent on the execution of another transaction with the same counterparty, the two transactions are deemed to have been entered into in contemplation of one another and should be considered a single nonmonetary exchange. The issuance of invoices and the exchange of offsetting cash payments is not a factor in determining whether two or more purchase and sales transactions with the same counterparty should be considered a single nonmonetary exchange transaction. However, if one transaction is not legally contingent on the execution of another transaction with the same counterparty, the following factors may indicate that a purchase transaction and a sales transaction were entered into in contemplation of one another and should be considered a single nonmonetary exchange:

- There is a specific legal right of offset of obligations between counterparties involved in inventory purchase and sales transactions. The ability to offset the payable(s) and receivable(s) related to the separately documented purchase and sales transactions indicates that there is a link between them and, therefore, it is an indicator that the separately documented transactions were entered into in contemplation of one another.
- Purchase and sales transactions were entered into at terms that were off-market when the arrangements were agreed to between counterparties. This indicator may be more relevant for transactions with products for which a vendor has established VSOE of fair value than for transactions with products that are subject to greater discretionary pricing.
- There is relative certainty that a reciprocal transaction with the same counterparty will occur.

The following example illustrates these concepts:

Illustration D2-4: Nonmonetary exchange of software for an asset other than software

Facts

On 25 June 20X9, a calendar year-end software vendor, Softco, licenses Product A bundled with one year of PCS to another software vendor, Vendor X, for $1,000,000. Payment is due from Vendor X to Softco on 31 July 20X9.

On 30 June 20X9, Softco agrees to license Product B, bundled with one year of PCS, from Vendor X for $1,150,000, payment due 31 July 20X9. The software licensing agreement stipulates that Softco may offset the amount due from Vendor X against the amount it is required to remit to Vendor X on 31 July 20X9.

Analysis

The fact that the software licensing arrangements were executed within a short time of each other and that the second arrangement allows Softco to offset the amounts it owes against the amounts due from Vendor X indicate that the separate arrangements were entered into in contemplation of one another and should be evaluated as a single nonmonetary exchange. Both Softco and Vendor X should apply the provisions of ASC 985-845 and the related factors discussed above to the arrangements to determine the appropriate accounting.

E List of FAQs

F Summary of important changes

There have been no significant changes since the September 2016 edition.

EY | Assurance | Tax | Transactions | Advisory

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