The revised revenue recognition proposal – software and cloud services

What you need to know

• The FASB and IASB issued a second exposure draft of their joint revenue model that is closer to current US GAAP than their 2010 proposal.

• The proposed model would supersede industry-specific revenue guidance for software in the Accounting Standards Codification.

• The proposal would significantly change how entities evaluate revenue recognition for software and cloud services contracts.

• The proposed requirement that entities estimate variable consideration and include it in the transaction price would result in changes in practice for many software and cloud services entities.

• Questions would likely arise over how to apply the proposed requirements about the pattern of transfer (and revenue recognition) to certain deliverables in software and cloud services arrangements.

Overview

The revised revenue recognition proposal issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) would result in significant changes in practice for software and cloud services companies.

In this publication, we focus on the following areas that we expect to be of interest to software and cloud services companies as they consider the potential effects of the proposal:

• Identifying separate performance obligations in software and cloud services arrangements
The effects of the proposed requirements for estimating variable consideration, including extended payment terms and reseller and distributor arrangements

Allocation of the transaction price to separate performance obligations, including the use of a residual technique

Considerations for determining when control transfers for various goods and services, including licenses, maintenance services, integrated solutions, royalties, services billed based on usage and authorization codes

Other matters including contract costs and collectibility

This publication supplements our general Technical Line, *Double exposure: the revised revenue recognition proposal* (SCORE No. BB2231), which describes the Boards’ November 2011 Exposure Draft (ED) in detail, and should be read in connection with it.

We encourage software and cloud services companies to read this supplement carefully, consider the potential effects on their revenue recognition practices and express any concerns to the FASB. This publication does not represent our final or formal views because the proposal could change as the Boards deliberate further.

**Identify the separate performance obligations**

**Distinct performance obligations**

Performance obligations in the proposed standard are akin to deliverables under current US GAAP. Generally, transactions involving the licensing or selling of software involve the delivery of multiple elements. These elements, which may represent performance obligations, may include software products, specified upgrades and enhancements, software maintenance (including bug fixes, customer support and the right to receive unspecified upgrades/enhancements on a when-and-if basis), cloud services and professional services.

The ED provides a two-step process to identify the distinct performance obligations within a contract. Under the first step, an entity focuses on the individual good or service. An individual good or service would be distinct when either of the following criteria is met:

- The entity regularly sells the good or service separately.
- The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (including resources previously delivered under the same contract).

The determination of whether a good or service is distinct may require a vendor to exercise judgment, but generally this first step would be similar to current practice under today’s multiple-element arrangements guidance.

Under the second step of the process, notwithstanding the results of the first step, the goods and services would be evaluated in the context of the overall arrangement. Specifically, regardless of the results from the evaluation under the first step, an entity would have to evaluate the relationships between goods and services within the arrangement to determine whether they should be combined. This assessment
would be based on how the goods and services are delivered to the customer (i.e., the level of customization and integration with other performance obligations). Under the second step of the model, goods and services would be combined into a single performance obligation if both of these criteria are met:

- The goods and services are highly interrelated and transferring them to the customer requires the entity to also provide a significant service of integrating the goods and services into the combined item(s) for which the customer has contracted.
- The bundle of goods and services is significantly modified or customized to fulfill the contract.

While these criteria appear similar, they are meant to address different circumstances. Both criteria must be met to treat the otherwise distinct bundled goods and services as a single performance obligation.

As discussed further below, the proposed model for assessing the separate performance obligations within an arrangement represents a change from current practice and may change how a company accounts for the promised goods and services within an arrangement.

**Performance obligations in a software arrangement**

Many software arrangements contain similar deliverables, including the software license, services currently defined as post-contract customer support (PCS) and other services (since PCS is defined in ASC 985-605, which would be superseded, we refer to such services as “maintenance services” throughout this publication). These arrangements are considered multiple-element arrangements.

Under the current software revenue recognition guidance, an entity may account for these elements separately only if the entity has established vendor-specific objective evidence (VSOE) of fair value for at least the undelivered elements. As a result, entities frequently have to combine these multiple elements into a single unit for accounting purposes and recognize revenue only when delivery of the last element commences (e.g., over the PCS period if the only undelivered element is PCS).

In one of the most significant changes for software entities, the proposed model changes these separation requirements, focusing on whether the elements are distinct, as discussed above. As a result, many entities likely would reach different conclusions about which goods and services can be accounted for separately.

Another significant potential change relates to the treatment of maintenance services. Current US GAAP defines PCS as the right to receive services or unspecified upgrades and enhancements (or both) after the license period begins. Generally, the services include telephone support and correction of errors (bug fixes or debugging) as well as unspecified upgrades or enhancements. In practice, these separate items are, with few exceptions, treated as a single deliverable.

Under the proposed model, software entities would likely re-evaluate whether the individual services included in traditional maintenance services arrangements are actually multiple distinct performance obligations. For example, an entity may determine that bug fixes and telephone support are provided principally, if not solely, to ensure that the software is functioning as promised and therefore, those
services are part of the warranty coverage for the software and are not a revenue element. However, these services may contain elements of both an assurance warranty (non-revenue element) and service-type warranty (revenue element). Due to the nature of those services, software entities may find it difficult to reasonably account for them separately. In these circumstances, the ED would require the warranty services to be accounted for entirely as a service-type warranty in which a portion of the arrangement consideration is deferred and recognized over the service period rather than as a cost accrual. The end result in these cases would likely be consistent with current accounting practice.

Conversely, the entity would likely conclude that if-and-when available upgrades and enhancements to the software are a promised good in the arrangement and would have to evaluate whether they represent a separate performance obligation.

**How we see it**

Eliminating the concept of VSOE of fair value as a separation criterion would be a significant change for software entities. Although the accounting guidance of ASC 985-605 has been in existence for a number of years, entities have struggled with establishing VSOE of fair value. This is often reflected in comment letters and other communications from regulators. Although the two-step process in the proposed guidance may require judgment, it would make the assessment of separating performance obligations less prescriptive and potentially less time intensive.

**Performance obligations for arrangements with significant production, modification and customization**

Entities may enter into arrangements with customers that involve significant production, modification or customization of the licensed software. Under the current guidance in ASC 985-605, if an arrangement to deliver software or a software system requires significant production, modification or customization of the licensed software, the software entity should account for the arrangement in accordance with ASC 605-35. Commonly known as contract accounting, ASC 605-35 requires software transactions within its scope to be accounted for as a single deliverable recognized under the percentage-of-completion or completed contract methods.

As a result of the proposed model, namely the second step for the determination of distinct performance obligations as discussed above, we anticipate entities would likely reach similar conclusions when determining the unit of account for these types of arrangements. That is, an entity would likely conclude that the software license and professional services are highly interrelated and that significant integration and customization or modification is required.

These concepts are illustrated below.
**Illustration 1 – Identifying separate performance obligations – no significant customization**

A software entity provides a customer with a perpetual software license and maintenance services that include telephone support, bug fixes and unspecified upgrades/enhancements on a when-and-if-available basis for a term of three years, with the option to renew the maintenance services thereafter. The license does not require significant installation services or customization. The prices for standalone sales of maintenance services vary significantly, and therefore VSOE of fair value does not exist.

Under current practice, the entity would not have the ability to separately account for the delivered software license, which would therefore be bundled with the maintenance services and recognized over the service period. As VSOE of fair value would no longer be a separation criterion under the proposed guidance, the entity instead would be required to determine whether the performance obligations are distinct.

**Step 1 – Consideration of individual goods and services**

**Software license** – The entity does not have a history of sales of its software license without maintenance services. However, the entity has determined the customer can use the software with readily available resources. The entity concludes the software can be utilized without the support of the promised maintenance services, and can be run on its existing IT system as significant installation services are not required. In this example, the software license would meet the criteria of being distinct under the first step of the process.

**Telephone support and bug fixes** – The software entity has determined that telephone support and bug fixes are warranty services. The proposed guidance would require the entity to determine which type of warranty the telephone support and bug fixes represent (assurance warranty, service-type warranty or both) to determine the appropriate accounting.

**Unspecified upgrades/enhancements** – While the entity has an extensive history of selling a bundle of maintenance services that includes these unspecified upgrades/enhancements, it does not have a history of selling unspecified upgrades/enhancements on a standalone basis. However, the customer can use the unspecified upgrades/enhancements with readily available resources, which, in this case, would be the software license that was previously delivered. In this example, the unspecified upgrade/enhancement would meet the criteria for being distinct under the first step of the process.

**Step 2 – Consideration of how goods and services have been bundled**

Notwithstanding the results from the first step, the entity must evaluate how the goods and services of the arrangement are delivered to the customer to determine whether any, or all, performance obligations should be combined. In this fact pattern, the entity concludes that significant integration is not required for the software license and the maintenance services and, as such, the goods and services do not represent a single performance obligation.
Illustration 2 – Identifying separate performance obligations – significant production, modification and customization

An entity contracts with a customer to provide a customized customer relationship management (CRM) software solution that will include a suite of software products as well as the professional services necessary to tailor the software to meet the customer’s needs. These services include software design, software build/configuration and installation. Under the proposed model, the entity has to determine which of these promised goods and services are separate performance obligations. Because the entity has bundled these goods and services in a way that leads the entity to conclude they are highly interrelated, the entity focuses its analysis on the second step of the proposed model.

Step 2 – Consideration of how goods and services have been bundled

Under this step of the proposed model, the software entity must evaluate how the goods and services of the arrangement are delivered to the customer to determine whether any, or all, of the promised goods and services should be combined. When evaluating the interrelation of the goods and services, the entity notes the following:

- The design services and build/configuration services are highly interrelated with the software product. In the contract, the software entity has promised the customer that it will deliver a completed software installation, which can only be made possible through the design and build/configure services. In addition, the software has been significantly customized to meet the customer’s needs.

- The customized software license requires significant integration into the customer’s IT system. In the contract, the software entity has promised that it will provide these significant installation services. The process of installing the software will also require significant customization of the licensed software.

Based on its analysis, the software entity determines that all of the promised goods and services represent a single performance obligation and that it need not evaluate the criteria in the first step of the model.

Performance obligations in a cloud services arrangement

Deliverables in a cloud services arrangement may include the cloud services (such as software-as-a-service), hardware or other products or services. These services may include a license to the software of which the customer may have the right to take possession. Cloud services entities also frequently offer professional services such as implementation, data migration, business process mapping, training and project management services in addition to the cloud service itself. These professional services may be required for a customer to begin using the cloud services in the manner described in the contract.

ASC 985-605 currently provides a framework to determine whether cloud services arrangements are subject to the scope of the software revenue recognition guidance. Based on this framework, cloud services arrangements generally fall within the scope of the multiple-element arrangement guidance in ASC 605-25 and the general revenue recognition guidance of SAB Topic 13. ASC 605-25 provides guidance on how to identify separate units of accounting in a
multiple-element arrangement. To treat deliverables as separate units of accounting, the delivered item or items must have standalone value upon delivery. A delivered item has standalone value if any vendor sells that item separately or if the customer could resell that item on a standalone basis. Cloud services entities frequently have to exercise significant judgment to determine whether the professional services they provide to a customer represent a separate deliverable.

Under the proposed guidance, entities may find it challenging to identify performance obligations in a cloud services arrangement. For example, an entity may enter into an arrangement that stipulates it will provide a customer with the right to use software (i.e., a license) along with hosting services. Specific guidance currently exists that stipulates whether or not the license is a deliverable within the arrangement, depending on certain criteria specified. However, since this guidance would be eliminated by the proposed guidance, entities would have to consider whether the license is really a promised good or service in the arrangement. For example, if the entity’s historical business practice indicates that it typically provides hosting services without delivering the software, the software license may not be a substantive element of the arrangement (i.e., there is not a valid expectation on the part of the customer that the entity will deliver the software). However, if the entity has historically sold the software license without the hosting services, the software license may be a substantive element of the arrangement. Judgment will be required to make this determination.

In cloud services transactions, customers commonly pay an up-front fee at the inception of the arrangement. The customer frequently can renew the contract without paying this fee again. In most arrangements, the up-front fee does not relate to the actual transfer of a good or service. Instead, the fee relates to the initiation, activation or set-up of a good to be used or a service to be rendered in the future. Under the proposal, entities would need to carefully analyze whether the fee indicates there are other performance obligations in the contract that should be identified. For example, such fees may provide a customer with a renewal option for future services at a discounted rate. Under the proposal, the renewal option would be a separate performance obligation if it represents a material right to the customer.

Under current practice for cloud services arrangements, when there is no corresponding up-front transfer of goods or services, the up-front fees are generally recognized over the longer of the contractual term or the estimated customer relationship. By requiring allocation of the up-front fees to the renewal options, the proposal may represent a change in practice, as illustrated below.

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**Illustration 3 – Non-refundable up-front fees**

A cloud services entity enters into an agreement with a customer. The arrangement includes a license to the cloud services entity’s software and a noncancelable one-year subscription to access the licensed application (the cloud services deliverable of the arrangement). The contracted amount for the software license is an up-front, non-refundable fee of $1,000,000, and the fee for the cloud services is $500,000 for one year. The customer has the right to renew the cloud services each year for $500,000. The cloud services entity routinely sells renewals of a one-year cloud services subscription for $500,000 per year.
Illustration 3 – Non-refundable up-front fees (continued)

In this example, assume the cloud services entity determines the software license and cloud services are a single performance obligation. Additionally, there are no other promised goods and services within the arrangement (i.e., the up-front fee is not associated with the transfer of any other good or service to the customer). However, the entity determines that the right to renew the cloud services each year for $500,000 is a material right to the customer, as that renewal rate is significantly below the rate the customer paid for the first year of service ($1.5 million total). Based on its historical experience, the entity determines its average customer relationship is three years. As a result, the entity determines that the contract provides the customer the right to a discounted annual contract renewal that the customer is likely to exercise twice.

Because the renewal options are separate performance obligations, the cloud services entity would allocate the $1,500,000 transaction price to the renewal options and cloud services. The amount allocated to the renewal options would be recognized as each of the two renewal periods is either exercised or forfeited. (Note that the amount allocated to the renewal options will likely differ from the stated up-front fee as a portion will be allocated to the services performed in the first year and the remainder allocated to the renewal options. Accounting for customer options of additional goods is discussed in Sections 3.7 and 5.1.1 of the general Technical Line.)

Alternatively, the proposed model also provides that the cloud services entity could value the renewal option by “looking through” to the optional services. In that fact pattern, the cloud services entity would determine the total transaction price as the sum of the up-front fee of $1 million plus three years of cloud service fees ($1.5 million), or $2.5 million. The cloud services entity would then allocate that amount to all of the services expected to be delivered, or three years of cloud services. This approach would generally be consistent with current practice.

Rights to specified future products/upgrades or enhancements

Software entities may provide customers the right to specified future products, upgrades or enhancements as part of a software arrangement. This right may be explicit in a customer arrangement, or may result from the vendor providing the customer with a product roadmap or other information that is specific both in terms of the future functionality and time frame in which the functionality is expected to be delivered.

Under the ED, those rights would be identified as a promised good or service and evaluated to determine whether they are a separate performance obligation. However, as discussed above, that evaluation would be based on whether the promised upgrades or enhancements are distinct rather than whether VSOE of fair value exists for those upgrades.

As a result, the current practice of accounting for arrangements that include these types of promised goods and services would likely change significantly. Under current practice, revenue for the entire arrangement is typically deferred because entities are generally unable to establish VSOE of fair value for the specified upgrades or enhancements. Under the ED, we expect that software entities would no longer be required to defer all of the revenue from these types of arrangements because the initial software license and the specific upgrade likely would meet the criteria to be accounted for as separate performance obligations.
How we see it
The proposal could change the way software entities view specified upgrades. Entities have long avoided offering or marketing specified upgrades to customers because they could not establish VSOE of fair value and would therefore have to defer revenue associated with the delivered software license. If software entities begin offering these types of upgrades, finance personnel could face new challenges. New processes and controls may need to be developed to track specified upgrades being offered to customers and potential customers.

Determine the transaction price
The ED defines the transaction price as “the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, sales taxes).” This means revenue would include estimates of variable consideration, the effects of the time value of money, noncash consideration and consideration paid or payable to a customer. We discuss below the more significant aspects of determining the transaction price and how software and cloud services entities would be affected.

Variable consideration
Entities frequently enter into arrangements in which a portion of the transaction price could vary (due to contract clauses such as discounts, rebates, refunds, credits, incentives, bonuses/penalties, contingencies or potential future concessions). Under the proposal, variable consideration would be measured based on one of two approaches – the “expected value” or “the most likely amount.”

Under the expected value approach, the entity would estimate the transaction price by identifying the possible outcomes of a contract and probabilities of those outcomes. The individual possible outcomes would be multiplied by their probability and added to calculate a probability-weighted amount. The most likely amount approach would be used to predict the single most likely amount in a range of possible consideration amounts the entity would be entitled to receive.

The method used would be the one that best predicts the amount of consideration to which the entity will be entitled.

How we see it
This aspect of the proposal would result in a significant change in practice for software and cloud services entities. Current US GAAP has very restrictive criteria for the treatment of revenue that is not certain. For example, under current guidance, fees must be fixed or determinable to be recognized as revenue. Therefore, fees subject to refund, credits or concessions are generally deferred until the point at which the fee is fixed or determinable. Additionally, current guidance frequently restricts an entity’s ability to recognize revenue for arrangements that include extended payment terms.

Under the proposal, an entity would be required to estimate the amount of consideration it is entitled to receive and include these estimates in the total transaction price that is allocated to the separate performance obligations. Estimates would have to be updated at each reporting period. Restrictions on the recognition of any variable amounts would be based on different, less restrictive criteria than included in current literature (See page 16).
**Extended payment terms**

A software entity’s payment terms may vary based on the type of business or class of customer. Arrangements that provide payment terms that extend beyond an entity’s normal, or standard, payment terms are deemed to include extended payment terms, which under current US GAAP may indicate that fees associated with that arrangement are not fixed or determinable. To recognize revenue from arrangements with extended payment terms, a software entity is currently required to demonstrate it has a history of successfully collecting under the original payment terms without making concessions to the customer. Because many entities are not able to demonstrate this, revenue is deferred until the earlier of when payments become due or cash is collected from the customer.

Under the proposal, software entities would be required to determine the amount of consideration to which they expect to be entitled at the outset of the arrangement and recognize revenue when control is transferred. Software entities would likely be able to recognize revenue on arrangements with extended payment terms on an accelerated basis under the proposed approach compared with today’s accounting model.

<table>
<thead>
<tr>
<th>Illustration 4 – Accelerated revenue recognition compared with current practice</th>
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<tbody>
<tr>
<td>A software entity enters into an arrangement with a customer for a perpetual license of Product A for $1 million. Payment terms are as follows:</td>
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<tr>
<td>$250,000 due in 45 days</td>
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<tr>
<td>$250,000 due in 90 days</td>
</tr>
<tr>
<td>$250,000 due in 135 days</td>
</tr>
<tr>
<td>$250,000 due in 180 days</td>
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<tr>
<td>The software entity’s standard payment terms for such arrangements are net 45 days.</td>
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</table>

**Analysis**

The arrangement includes extended payment terms. Under current practice, the software entity would be required to defer revenue unless it has a history of extending payment terms and successfully collecting under those payment terms without making concessions. In this example, if the software entity is unable to demonstrate such a history, it would recognize no revenue upon the delivery of the software license beyond the $250,000 due within the entity’s normal payment terms. Each of the remaining $250,000 installment payments would be recognized as license revenue at each due date or when cash is received from the customer, whichever is earlier.

Under the proposal, assuming control of the software license is transferred to the customer upon delivery, as long as the entity anticipated it would be entitled to receive the entire transaction amount (i.e., it did not anticipate providing concessions or rebates to the customer) and the effect of the time value of money is not significant (see page 11), the fixed arrangement fee of $1 million would be recognized upon delivery. As discussed further below on page 20, estimated uncollectible amounts would be presented adjacent to revenue in the statement of operations.
**Reseller and distributor arrangements**

Resellers and distributors may be a significant source of recurring sales for software entities, and often will be provided with greater rights than end customers. For example, an entity may provide price protection rights to a reseller or distributor. In such situations, the sales price may not be finalized until the product is sold to the end customer. Under current US GAAP, a common practice for these arrangements is to use the "sell-through" model whereby sales to the reseller or distributor are not recognized until the product is sold through the channel to the end customer. The basis for this practice is that the sales price is not considered fixed or determinable until that point.

Under the proposal, variable consideration would have to be estimated and included in the transaction price. Contrary to current guidance, the proposed model has a presumption that the expected transaction price can be estimated at contract inception (constraining the amount of revenue recognized for variable consideration is discussed later in this publication). Therefore, the use of the sell-through model for arrangements with resellers and distributors may no longer be appropriate in situations in which the previous basis for the approach was uncertainty about the final sales price charged to the reseller or distributor. Instead, entities would be expected to estimate the final selling price and recognize the revenue when control of the promised software is transferred to the reseller or distributor (likely upon the transfer of the software license and not when the software license is sold through the channel).

**Emerging market considerations**

Due to business practices in certain geographical regions (e.g., emerging markets), many software entities have concluded that revenue from transactions in those regions should be recognized on a cash basis under current US GAAP. This conclusion is made for various reasons, including the high risk of side agreements, concerns about collectibility of amounts owed and concessions in those markets. Software entities generally determine that the arrangement fees are not fixed or determinable due to these risks.

The proposed requirement that entities estimate and include as revenue any variable consideration to which they will be entitled could result in a significant change in practice for software companies that currently recognize revenue from customers in emerging markets on a cash basis. An entity doing business in such a market may determine that the likelihood of a transaction price being adjusted is high (e.g., because concessions are granted). But under the proposal, it would have to include its estimate of variable consideration in the transaction price rather than default to recognizing no revenue until the contingency has been resolved.

**Time value of money**

For many software and cloud service arrangements, the timing of the payment does not always match the timing of the transfer of goods and services to the customer, particularly for maintenance services or other long-term service arrangements. For example, payment for maintenance services is generally made before the services are provided. Additionally, software arrangements may include extended payment terms even though the transfer of the license occurs upon contract inception.
When a customer pays in arrears, the entity is effectively providing a loan to a customer. Conversely, when the customer pays in advance, the entity has effectively received a loan from the customer. To the extent a transaction includes a financing component that is significant to the contract, an entity must adjust the transaction price to reflect the time value of money. However, the proposed model provides that an entity does not have to consider the time value of money unless the difference between the timing of the customer payment and satisfaction of performance obligations is greater than one year. In determining whether the time value of money is significant, an entity would be required to consider various factors, which would include whether:

- The amount of customer consideration would be substantially different if the customer paid in cash promptly in accordance with typical credit terms in the industry and jurisdiction
- There is a significant difference in timing of the provision of goods and services and the receipt of payment
- The interest rate within the contract (implicit or explicit) is significant

When an entity concludes that a financing component is significant to the contract, the entity would determine the transaction price by discounting the amount of promised consideration.

**How we see it**

The proposed treatment of the time value of money may have a significant effect on long-term performance obligations, especially cloud service arrangements that often include performance obligations expected to be satisfied over multiple years where the payment terms do not match the timing of the services to be provided. While a significant financing component may not exist in these arrangements, the ED would nonetheless require software and cloud entities to perform a formal assessment to determine if a loan is present.

**Allocate the transaction price**

An entity would be required to allocate the total transaction price to the separate performance obligations based on their relative standalone selling prices. The standalone selling price for the separate performance obligations would represent the price at which an entity would sell a good or service on a standalone basis at contract inception. When available, the best evidence of standalone selling price is the observable price of a good or service when sold separately in similar circumstances and to similar customers. However, in many situations standalone selling prices would not be readily observable, and an amount would have to be estimated.

Standalone selling prices would be estimated by considering all reasonably available information, including market conditions, entity-specific factors and information about the customer and customer class. While contractually stated selling prices or list prices may represent relevant information when estimating standalone selling prices, the ED is clear that an entity should not presume them to represent the standalone selling price for a good or service.
However, in a change from the Boards’ initial proposal, the latest proposal would allow an entity to consider using a residual technique to determine the standalone selling price when the standalone selling price of a good or service is highly variable or uncertain. A selling price is considered highly variable when an entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts. Under such an approach, an entity may estimate the standalone selling price by subtracting the sum of the observable selling prices of the other promised goods and services from the total transaction price.

Under current software guidance, a relative selling price allocation is only done when VSOE exists for all of the elements in the arrangements. However, most software entities do not have VSOE for all of their elements. As a result, software entities generally apply the residual method to allocate arrangement consideration to software licenses. The proposed inclusion of the residual technique for estimating standalone selling price may not result in a significant change from current practice for these entities, as they may continue to allocate only a residual amount to the software license. However, entities that currently treat all of the promised goods and services as a single element because of a lack of VSOE for any of the elements would likely identify more separate performance obligations than accounted for under current practice (as discussed above). Entities would have to establish practices and policies for estimating a standalone selling price for the promised goods or services.

**Illustration 5 – Use of a residual technique to estimate selling price**

A software entity has developed a software package that it licenses to corporate customers in bundled packages with three years of professional consultation services (up to 25 hours of professional consultation per month). The transaction price varies significantly as a result of the software entity’s negotiations with each new customer. The pricing of the professional services offered is consistent from customer to customer, regardless of the size or complexity of the customer’s business, and the selling price is always $1,000 per month when the firm sells professional services on a standalone basis. The firm determines that the variability in pricing in bundled arrangements is attributable only to the license.

The software entity enters into an arrangement with a customer for the delivery of the software license and 36 months of professional services for a total transaction price of $100,000. Using a residual technique to estimate the selling price of the license, the software entity would subtract the selling price of the professional services from the total transaction price, resulting in a selling price of $64,000 for the license ($100,000 – (36 months x $1,000)). The entity would then allocate the transaction price to each performance obligation using the relative selling price method, resulting in $64,000 (($64,000 / $100,000) x $100,000) allocated to the license and $36,000 (($36,000 / $100,000) x $100,000) allocated to the professional services.

Using the residual method of allocating the transaction consideration under current US GAAP, the result would be identical. The standalone selling price of the professional services is known ($36,000); therefore, that amount is allocated to the professional services (($36,000 / $100,000) x $100,000). The residual of $64,000 is then allocated to the delivered item (the software license).
Satisfaction of performance obligations

In the final step of the proposed guidance, an entity would recognize revenue when a performance obligation is satisfied by transferring a promised good or service to a customer. A good or service generally is considered to be transferred when the customer obtains control, which the ED defines as when an entity has “the ability to direct the use of and obtain substantially all of the remaining benefits from the asset.” This definition includes the ability to prevent others from directing the use of and obtaining the benefits from an asset.

In many cases, the determination of when control transfers is straightforward. In others, however, it is more complex. As a result, the Boards provided guidance to help entities determine when control transfers over time versus when control transfers at a point in time.

Below we discuss many of the goods and services commonly included in software and cloud services arrangements and considerations for determining when control over those goods or services transfers.

Licensing and rights to use

The proposed guidance for licenses and other rights of use (collectively, licenses) provides that all promises to grant licenses would give rise to a performance obligation that an entity satisfies at a point in time when the customer obtains control of the rights. However, if other performance obligations are included in an arrangement with a license, an entity would be required to evaluate the criteria in step 2 of the proposed model to determine whether the license is a separate performance obligation or whether it should be combined with any, or all, of the other performance obligations.

In addition, many license agreements include variable consideration (e.g., sales-based royalty payments). As discussed further below, while control of the license may have transferred at the inception of the arrangement, the proposed ED limits recognition of certain types of variable consideration.

Services

The proposed model indicates that for many service arrangements, each increment of service may represent a separate performance obligation. However, for services that have a similar pattern of transfer, an entity would be able to account for the services as a single performance obligation as long as the entity can select a single method of measuring progress throughout the contractual period. In these situations, as a practical expedient, entities would not be required to perform the two-step process to determine if these services are separate performance obligations.

For many of the types of services common in software and cloud services arrangements, we believe entities would likely be able to select a single method of measuring progress and, therefore, would treat the services as a single performance obligation.

For the types of services common in software and cloud services arrangements, we believe entities would likely be able to select a single method of measuring progress and, therefore, would treat the services as a single performance obligation.
The proposal indicates that this single method of measuring progress may be either an input or an output method, as long as the method is consistent with the objective of depicting the transfer of goods or services and the entity uses a consistent method for similar contracts with similar performance obligations. We do not believe this would represent a change in practice for most services, although there may be some changes from current practice, as illustrated below.

**Illustration 6 – Transfer of control of software maintenance**

Assume the same facts as in Illustration 1, when the software entity concluded that the bug fixes and telephone support are separate performance obligations from the unspecified upgrades/enhancements. Additionally, assume the software entity determined the bug fixes and telephone support represent a service-type warranty. Further, the service-warranty performance obligation has a different pattern of transfer from the unspecified upgrades/enhancements (thereby preventing the entity from treating both of these services as a single performance obligation). However, the entity determines both are satisfied over time.

Determining the pattern of revenue recognition associated with the service-type warranty may require judgment. For example, based on its history, a software entity may determine that the telephone support and bug fixes are provided continuously over the warranty period (i.e., telephone support and bug fixes represent obligations “to stand ready to perform” during the stated warranty period). A ratable revenue recognition pattern may result under the input method if the entity determines the best depiction of its performance is on the basis of time lapsed during the service period. Alternatively, the entity may conclude that a different pattern of recognition is more appropriate given the historical pattern of when the warranty services are provided.

With respect to the unspecified upgrades/enhancements, the entity would likely have to determine the historical pattern in which the upgrades/enhancements have been provided. For example, if the entity has established a practice of providing only one upgrade each year, say at the end of December, the entity may conclude the appropriate pattern for the unspecified upgrades/enhancements is when the annual upgrade is provided (i.e., an output method would best depict the entity’s performance). Alternatively, if the entity has historically developed and delivered unspecified upgrades/enhancements at multiple points throughout the year with no discernable pattern, it may conclude the most faithful depiction of its performance would be on the basis of time lapsed during the service period under the input method.

**Integrated solutions**

Software entities frequently provide their customers with “integrated solutions” that may include hardware, customized software and professional services. As discussed above, an entity would have to assess whether those promised goods and services represent multiple performance obligations or whether they should be combined into a single performance obligation.

In situations in which the promised goods and services have been combined into a single performance obligation, it is likely the entity would determine that the appropriate revenue recognition attribution period for that combined performance obligation is over time (rather than at a point in time). This would also be consistent with how these arrangements are treated under current US GAAP, under which contract accounting is frequently applied to these types of arrangements.
For example, the significant customization or modification in these arrangements would likely lead the entity to conclude that either the customer is controlling the asset as the asset is being created (e.g., project is being completed within the customer’s IT environment) or the entity is creating an asset that does not have alternative use to the entity (e.g., extensive customization is customer-specific). These are the two primary criteria for determining whether control transfers over time, which are discussed in further detail in Section 6.1 of the general Technical Line.

### Constraining the cumulative amount of revenue recognized

The ED states that if the amount of consideration an entity expects to receive is variable, the cumulative amount of revenue recognized to date cannot exceed the amount that is reasonably assured. That is, an entity would estimate the transaction price of a contract without any constraint on the estimate. However, after the estimated transaction price is allocated to the separate performance obligations, the entity would assess whether it is constrained, or limited, in the amount of allocated consideration it can recognize as revenue upon satisfying the separate performance obligations.

The following criteria would have to be met for an entity to be reasonably assured to be entitled to the amount of consideration allocated to a performance obligation:

- The entity has experience with similar types of performance obligations (or has other evidence such as access to the experience of other entities)
- The entity’s experience (or other evidence) is predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations

Determining whether amounts expected to be received are reasonably assured could require an entity to use significant judgment in assessing past experience with similar contracts. The ED provides indicators of when an entity’s experience may not be predictive of the amount of consideration to which it would be entitled.

### How we see it

Revenue recognition for contingent consideration is significantly limited under current US GAAP. Currently, even if history can demonstrate successful performance, the probability that an entity will successfully complete its remaining performance obligations is not considered. Because the proposal would allow the cumulative recognition of all amounts of revenue up to the total amount in an arrangement that is reasonably assured, we expect this would be a significant change in practice, particularly for multiple-element arrangements that include maintenance and/or cloud services.

### Arrangements that include royalties

Software entities commonly enter into arrangements that require the customer to pay a royalty to the entity as units are distributed (such arrangements may also include a fixed fee). Under these arrangements, software entities generally deliver the software license to the distributor (e.g., an original equipment manufacturer) and grant the distributor the right to distribute the software over a defined period. The ED provides specific guidance to constrain revenue recognition when intellectual property is licensed and the customer promises to pay the entity a variable amount based on the customer’s sale of a product or service (e.g., sales-based royalty). In
these situations, the proposal states that an entity would not be reasonably assured to be entitled to the variable amounts until the uncertainty is resolved (i.e., when the customer’s subsequent sales occur).

**Illustration 7 – Arrangements with fixed and variable fee components**

A software company enters into a contract to license to a retail company an existing software product for the management of online sales and to provide professional services to build the retailer a customized website interface between the software and the retailer’s existing website to provide the retailer some additional features not normally found in the software. However, the retailer can gain full access to the licensed software immediately, without the completion of the professional services. As a result, the entity determines the software license and the professional services are two separate performance obligations.

The entity delivers the software license shortly after the agreement is finalized (and the retail company has full use of that license immediately). However, the entity will study certain purchasing patterns of the retailer’s customers before completing the customized interface and, as a result, it anticipates it will not complete those services for six to eight months.

In return for providing the license and the professional services, the entity will be entitled to $12,000 in fixed fees plus 0.05% of the revenue generated from the retailer’s website sales for the 15 months after the arrangement is finalized (payable monthly). Based on the historical sales of the retailer, the entity estimates it will receive $55,000 in sales-based royalties (for a total transaction price of $67,000).

The entity does not believe the sales-based (variable) amounts are attributable to a single performance obligation; therefore, the entity would apply the relative selling price method to allocate the estimated transaction price. The entity determines the standalone selling price of the professional services is $45,000 (based on the expected hours it anticipates will be necessary to complete the customization) and the standalone selling price for the license is $15,000 (based on other licensing agreements).

The entity would allocate $50,250 (($45,000 / $60,000) to the professional services and $16,750 (($15,000 / $60,000) to the software license.

Because the arrangement includes variable fees, the entity would be limited to recognizing cumulative revenue only up to the amounts that are reasonably assured. However, the entity concludes that the variable fees (sales-based royalties) are associated with the license of the software. Therefore, the entity would be unable to conclude that any of those variable amounts are reasonably assured due to the specific guidance in paragraph 85 of the proposal that states that sales-based royalties on intellectual property arrangements are not reasonably assured until the sales occur.
Illustration 7 – Arrangements with fixed and variable fee components (continued)

Therefore, at the time the entity transfers the software license to the retailer, although the entity has allocated $16,750 to the license, the entity would be limited to recognizing $12,000. As the sales-based royalties are received, and assuming there are no changes in the estimated variable consideration, the entity would continue to recognize those amounts as revenue until a total of $16,750 is recognized. Once the entity recognizes all amounts allocated to the license, additional royalty payments received would be deferred until the professional services commence. However, because the professional services will be completed before all of the royalty payments are received, the entity would not be able to recognize all of the amounts allocated to those services at the time the services are provided, but would have to wait until the royalty payments are received.

Usage-based fees

Cloud services pricing models continue to evolve as entities attempt to give customers more options and flexibility. For example, cloud services arrangements may be based solely upon usage (i.e., the customer does not pay a fixed monthly fee, but pays only a fee based upon actual usage). Alternatively, cloud service providers may have hybrid pricing models under which the customer pays a monthly or annual subscription fee for a fixed amount of usage during the contractual period, and may pay incremental fees for usage above the fixed amount. If a multiple-element cloud services arrangement includes a usage-based component, the proposal would require the entity to estimate the variable consideration using either the expected value approach or the most likely amount approach, whichever best predicts the consideration to which the entity will be entitled. Estimating variable consideration is required for purposes of determining the total transaction price to be allocated to the identified performance obligations in the arrangement.

Questions may arise under the proposed guidance when measuring satisfaction of performance obligations in arrangements that include usage-based fees. For many cloud services entities, the output method may be the most suitable method of recognizing revenue. The ED is clear that if an entity has a right to invoice a customer in an amount that corresponds directly with the value to the customer for the entity’s performance completed to date, the entity would recognize revenue in the amount to which the entity has the right to invoice. It is likely that entities will often find this method the most appropriate method of depicting the transfer of cloud services with usage-based fees.

How we see it

Determining how and when a software entity satisfies a performance obligation to a customer may be challenging for software entities, particularly for goods and services for which control transfers continuously (e.g., maintenance services). ASC 985-605 generally requires revenue for maintenance services to be recognized ratably over the service period (i.e., straight-line). Under the proposal, no such rule would exist. While the proposal does not include passage of time as a method of measuring progress, the ED indicates that “time lapsed” may be an acceptable basis for measuring an entity’s efforts to satisfy a performance obligation under the input method.
Software entities would be required to determine the measurement method that best depicts their performance. They would no longer be able to automatically assume that revenue for maintenance services is recognized ratably. Significant judgment may be required. Accordingly, this area may represent a change from current practice for certain software entities.

**Electronic delivery of software**

Software entities may deliver their software to customers electronically, typically by placing the software on their websites for download. Generally, software vendors require their customers to have an access code before they can begin downloading the software. Under current US GAAP, if the entity delivers software electronically, the delivery criterion for revenue recognition is met when the customer has the reasonable ability to access the licensed software. This condition generally is met when the entity provides the necessary access code to the customer that allows the customer to begin downloading the licensed software, and the entity’s server is functioning. We believe that software companies generally would conclude that control is transferred when these conditions are met and, therefore, the timing of revenue recognition for electronically delivered software likely would not change under the proposal.

**Authorization codes**

Entities frequently use authorization codes, or keys, to give customers access to multiple copies of licensed software. For example, a software vendor may license its software to a customer for 1,000 users. The vendor may provide the customer with a fully functioning version of its software on day one and, at some future point, provide the customer with the authorization codes to allow the customer to deploy the remaining 999 users. The entity may use the 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. Under current US GAAP, if an entity uses keys or authorization codes and has not yet delivered the remaining keys or codes to the customer necessary for reproduction, delivery may still be deemed to have occurred if certain conditions are met, including the entity having delivered a fully functional version of the software to the customer. This accounting is predicated on the conclusion that, since the customer has a fully functional version of the software, the entity’s remaining obligations (i.e., providing access to the remaining copies) are incidental and, therefore, the entity has substantially performed on that deliverable.

Under the proposed standard, however, the treatment of these types of transactions is unclear and may depend on how delivery is specified in the contract. For example, depending on the terms under which an entity promises to the deliver the authorization codes to a customer, one view could be that each copy of the software represents a separate performance obligation. Therefore, the entity would have to allocate the transaction price to each of the 1,000 user licenses. Under this view, the entity would not satisfy its performance obligation for each deployed user of the software until the customer has been provided the necessary authorization codes for each user. Alternatively, the entity may conclude that the performance obligation has been satisfied once the entity has provided the customer the reasonable ability to obtain the authorization codes, even though the process of providing those codes has not been completed because the customer has not yet
requested them. While we believe the later alternative is a reasonable representation of the entity’s performance, it is not clear whether this view would be acceptable under the ED.

**Illustration 8 – Software license sold with authorization codes**

ECA Co enters into an agreement to sell a perpetual software license to a customer that allows up to 1,000 copies to be used by the customer’s employees. A fully functional version of the software is delivered to the customer upon the execution of the agreement. To prevent unauthorized users from accessing the software, ECA Co will issue authorization codes, or keys, to the customer’s employees as they become registered to use the software. The customer will contact ECA Co to obtain the authorization codes. Payment for the software is due within 30 days of delivery regardless of the numbers of keys requested by the customer or issued by ECA Co.

Under this fact pattern, when referring to the indicators provided by the ED, ECA Co could determine the following:

- The customer is obligated to pay ECA Co regardless of the number of keys issued.
- Upon the execution of the license agreement, the customer has legal title to the software license and is able to control which of its employees will be granted access.
- ECA Co delivers the software to the customer upon the execution of the license agreement, which includes acceptance by the customer.
- ECA Co may still retain certain risks associated with the software license because it is obligated to deliver the remaining keys. Historically, ECA Co’s costs associated with delivering the outstanding keys are immaterial.
- The necessary authorization codes will be provided upon employee registration and they may register for and receive the authorization codes immediately; therefore, ECA Co provided the customer the reasonable ability to obtain the authorization codes.

Based on this assessment of the facts and circumstances of this agreement, ECA Co could recognize revenue upon delivery of the license to the customer.

**Other matters**

**Collectibility**

The ED defines collectibility as the risk that an entity will not be able to collect outstanding balances from the customer. Under the proposal, estimates of uncollectible amounts (both at contract inception and subsequent changes to those estimates) would be presented adjacent to revenue in the statement of operations. An entity should account for the receivable balance in accordance with ASC 310.

The proposed guidance on collectibility represents a potentially significant change to how all entities recognize revenue. The proposal considers collectibility in the measurement and presentation of revenue, while existing standards consider collectibility only in the recognition of revenue. Current US GAAP for revenue...
recognition, including software transactions, states that revenue can be recognized only if collectibility is reasonably assured. If collectibility is not reasonably assured, an entity generally recognizes revenue once cash has been received. As a result, in situations in which an entity determines there is uncertainty regarding an individual customer’s ability to pay, considering collectibility in the measurement and presentation of revenue likely will result in earlier revenue recognition in those transactions.

Illustration 9 – Collectibility

A software entity enters into an arrangement to sell a perpetual software license for Product A to Customer X for $400,000, with payment due in 30 days.

The software entity has a history of prior sales with Customer X. At the time of the sale of Product A, the software entity notes that Customer X has not paid the fees of a prior arrangement in accordance with the contractual terms. Contemporaneous relevant information at the date of the sale of Product A indicates that Customer X’s financial condition has deteriorated and that it is not creditworthy in accordance with the software entity’s credit policy.

Under current US GAAP, the software entity would determine that collectibility is not reasonably assured. Therefore, revenue would not be recognized until cash is received, assuming all of the other basic criteria of SAB Topic 13 have been met. However, because collectibility is not a recognition criterion under the proposal, the software entity would recognize revenue for the sale of Product A upon delivery. The amount that is estimated to be uncollectible at the time of sale is separately reported adjacent to revenue.

Contract costs

The ED also provides guidance for accounting for an entity’s costs incurred in obtaining and fulfilling a contract to provide goods and services to customers. This guidance would apply to both contracts obtained and contracts under negotiation.

Current US GAAP provides little guidance on the capitalization of contract costs, including costs incurred in obtaining a contract. The guidance that does exist is narrow in scope but is widely used by analogy. For example, many companies analogize to the guidance on deferred loan origination costs in ASC 310.

Under the ED, incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) would be recognized as an asset, but only when the costs are expected to be recovered. As a practical expedient, the proposal permits immediate expense recognition for contract acquisition costs related to contracts with a duration of one year or less.

The ED divides contract fulfilment costs into two categories – those that give rise to an asset and those that should be expensed as incurred. The proposal makes clear that when considering the appropriate accounting treatment for contract fulfilment costs, any other applicable literature should be considered first, such as ASC 985 for software. Section 7.3.2 of the general Technical Line discusses costs to fulfill a contract in further detail.
How we see it
While the proposed capitalization of costs may affect the amounts software entities capitalize for obtaining and fulfilling a contract, the proposal would be consistent with current practice for some companies. For example, under current US GAAP, many cloud services entities defer sales commissions related to cloud services transactions, which are recognized as expense over the same period as the underlying revenue.

Next steps
Given the potential consequences, we encourage software and cloud services companies to gain an understanding of the proposed guidance, including how it would apply to their customer contracts, and provide the Boards with feedback on the proposal. The comment period ends on 13 March 2012. The Boards also plan to perform various outreach efforts to gather information and obtain the views of interested parties about the proposed guidance.

Endnotes:

1 ASC 985-605, Software – Revenue recognition
2 ASC 605-35, Revenue Recognition – Construction-Type and Production-Type Contracts
3 ASC 605-25, Revenue Recognition – Multiple-Element Arrangements
4 SEC Staff Accounting Bulletin Topic 13, Revenue Recognition
5 ASC 310, Receivables