TIS Section 5100

Revenue Recognition

.01 Equipment Sales Net of Trade-Ins

Inquiry—A Client who deals in heavy equipment records all sales at net of trade-ins. Is this an acceptable accounting practice?

Reply—Support for the accounting treatment for trade-ins which this client follows could not be found. Sales should be credited with the nominal or stated contract price, and the difference between (a) the trade-in allowance and (b) the amount determined by pricing the trade-in at net realizable value minus normal profit margin should be treated as a sales allowance or discount. The traded-in equipment should be set up in inventory at an amount which, when reconditioning costs are added, will allow a margin approximating a normal profit when the sale is made.

.02 Rights to Broadcast Time Received for Services

Inquiry—An advertising agency creates and sells jingles and station identifications to radio and television stations. The agency receives broadcast time credit as part payment. This broadcast time is then resold by the agency to its clients. Should this broadcast time be recognized by the advertising agency:

1. when the agency bills the radio or television station, or
2. when it is subsequently sold to advertisers?

Reply—The broadcast time credit should be recognized as income when the services are billed to the station. It may be necessary to estimate the value of the credits. A corresponding asset account should be charged. This asset would be relieved as the broadcast time is sold by the advertising agency. [Amended]

.04 Discounts on Prepaid Funeral Arrangement Plans

Inquiry—An incorporated mortuary sells pre-need funeral plans in addition to rendering current mortuary services. These pre-need funeral plans are sold at a discount in order to be attractive to the public. All monies received from the sale of these plans are placed in a trust fund which has been set up at a local bank. The bank is the trustee of the trust and makes investments as it sees fit. The pre-need funeral plan agreements stipulate that all income earned by the trust belong to the mortuary, and withdrawals of such income from the trust may be made by the mortuary periodically. In return for the feature of the agreements calling for the mortuary's entitlement to the trust fund income, purchasers of the pre-need plans are permitted to buy the plans at a substantial discount. The agreements also provide for fully-covered funeral benefits in certain cases, although the plans may not be fully paid at time of death. Another advantage to the purchasers is that the costs of their funerals will not be influenced by increases in the cost of living index.

Certain expenses are met by the mortuary in the selling of its pre-need funeral plans; these are recorded monthly in a separate expense account in its general ledger. Trust fund income earned is also recorded monthly in the mortuary's general ledger, in a separate income account. As pre-need plans are utilized by persons who had purchased them earlier, the special discounts mentioned in the preceding paragraph are recorded in a separate expense account in the mortuary's general ledger. It should be emphasized here that such discounts are not reflected as an expense in the mortuary's operations until such time the plans are actually used, whereas the expenses of the sales of the plans and the income earned by the trust affect operations currently, with no dependency whatsoever on the deaths of the purchasers or holders of the plans.

In order to achieve a better matching of expenses with revenues accruing from the sales of plans, could the trust fund income or the excess of trust fund income over the expenses of selling the plans be deferred until the plans are utilized? Or could the special discounts be charged to income at some date prior to the utilization of the plans?

Reply—It would be more acceptable to currently accrue or recognize selling expenses, fees and commissions, and trust fund income rather than use the "completed contract" or deferral accounting approach. If it is a fact that costs of furnishing services commonly exceed the trust funds expended at time of utilizing a plan, current provision should be made on an estimated basis for the potential or possible losses (more accurately, estimated excess of future servicing costs over monies to be released from trust to defray same) on plans not utilized as yet at the balance sheet date.

The special discounts are more in the nature of sales adjustments rather than costs or expenses.

.07 One-Cent Sales

Inquiry—A client in the fast food business has a "one-cent sale" once a week. For example, the sale might be two cheeseburgers for the price of one (60¢) plus one cent. The company would record the transaction as follows:

Cash (.60 + .01)	$.61	
Advertisement Expense	.59	
Sales (.60 x 2)		$1.20

The company makes this entry so that their "food costs" are not distorted, but should an adjustment be made at the end of the year for financial reporting purposes eliminating this advertising expense against sales?

Reply—The practice of crediting sales and charging advertising expense for the difference between the normal sales price and the "bargain day" sales price of merchandise is not acceptable for financial reporting. Realization of the full sales price cannot properly be imputed under such conditions. To do so would seem to imply that the same quantities would have been sold if the price had not been reduced.

It might however be appropriate to adjust the cost of sales and charge advertising for the cost of the one-cent hamburger. Such cost of sales should include only out-of-pocket expenses.

.08 Life Membership Fees in a Club

Inquiry—A company is engaged in a service club enterprise. What is the proper accounting for life membership fees?

Reply—The life membership fees should be allocated over the time the individual may be expected to require the services of the club.

.10 Members of Country Club Assessed for Debt Retirement

Inquiry—A country club has voted to impose a special yearly assessment on its membership for ten years. The proceeds are to be used to retire a first mortgage on the property of the club.

The assessment is being imposed on all members including voting certificate holders and nonvoting associate members.

Is the proper accounting treatment of this transaction a contribution to capital, or are dues to be reflected in the annual income statement?

Reply—When billing the assessments each year, the receivables from the members can be shown as an asset with a credit to income for the special assessment. Such amounts might then be appropriated to a special membership equity, perhaps entitled "appropriation for retirement of debt." The financial statements should disclose that the directors had voted a special assessment for ten years and the amount of assessment per year. The first or the last year for the assessment, or both, should also be disclosed.

.11 Excise Tax on Club Dues

Inquiry—The members of certain private clubs must pay a federal excise tax in addition to their annual dues. Should the clubs record, as revenues, the dues net of the excise tax, or should revenues include both dues and taxes?

Reply—A club, in collecting excise taxes on dues, is acting as no more than an agent or conduit for the federal government. The amounts paid to the club by members to be turned over as excise taxes should not be construed as dues, and to show them as such on the income statement is erroneous.

.14 Recognition of Fees Earned on Construction Mortgage Placements

Inquiry—A client is in the business of bringing lenders and borrowers together for a fee. When a construction mortgage has been arranged and agreed to, it would appear that the client has earned its fee. However, because of the terms of the fee arrangement, there is some doubt as to when the income should be recognized.

The following is a summary of the types of transactions involved:

1. Negotiable Note

The company receives a negotiable note in payment of its fees. Generally the note is unsecured and non-interest-bearing and is payable over the same period as the construction draws on the related mortgage are to be made.

2. Nonnegotiable Note

The terms of the nonnegotiable note are comparable to the negotiable note.

3. Commitment Letter, Not Contingent on Future Events

The company receives a letter from the borrower indicating that the lender and the borrower have agreed on the terms of the mortgage. In addition, the letter states that the borrower agrees to pay the company a fixed fee by a specified date for services rendered in arranging the loan.

4. Commitment Letter, Contingent on Future Draws

The company receives commitment letters from the borrower as described in No. 3 above. However, the commitment letters state that a certain amount of the fee will not be paid unless or until certain construction draws are received from the lender.

When should revenue be recognized as earned by the client?

Reply—Revenue recognition is discussed in FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, paragraphs 83 and 84.

Applying the guidelines of Concepts No. 5, paragraphs 83 and 84, to the specific situations, revenue would be recognized as follows:

1. Negotiable Note

Income would be recognized when the services have been performed and billed which may be prior to receipt of the negotiable note.

2. Nonnegotiable Note

The terms of the nonnegotiable note are comparable to the negotiable note, and revenue would be recognized in a similar manner.

3. Commitment Letter, Not Contingent on Future Events

Such a letter would be evidence that the services have been rendered and are now "billable"; therefore, the fee has been earned and income should be recognized.

4. Commitment Letter, Contingent on Future Draws

From the description, it appears that the agreement between the client, borrower, and lender in this case is such that the parties do not consider all the services rendered until actual borrowings take place even though the client need not physically do anything else. In such a situation, a portion of the fees should be deferred until the stipulated draw provisions have been met.

.16 Rental Revenue Based on Percentage of Sales

Inquiry—A supermarket built an addition to its store to house a liquor store. The rent to the liquor store is to be a percent of its sales. On its income statement, would it be proper for the supermarket to include the liquor store sales as though they were their own sales? The rent would then appear as a gross margin.

Reply—No. In accordance with FASB Statement No. 13, paragraph 1 (AC L10.101), this transaction meets the definition of a lease, which is ". . . the right to use property, plant, or equipment (land or depreciable assets or both) usually for a stated period of time."

The revenue received from the liquor store represents rental income to the supermarket and it would be inappropriate for the supermarket to include as its sales the sales of the liquor store. However, it would be appropriate for the supermarket to include the rental income as part of its gross revenues. [Amended June 1995.]

.20 Payment for Termination of License Agreement

Inquiry—A research and development company holds numerous patents. The company derives its income from the sale of products which utilize its patents as well as from the licensing of the patents, for which it receives royalties, and also from the sale of patent rights, for which it receives a single payment for the term of the license.

A licensee desired to terminate its license, since it was no longer using the technology contained in the company's patent, and paid to the company a lump sum termination payment. This payment approximated the amount the company would have earned during the remaining years of the license agreement. How should the termination payment be reflected in the company's financial statements?

Reply—The transaction is similar to sale of a license for the remaining life of a patent and should be accounted for in the same manner. If this is the sole license for a patent, any remaining unamortized cost of such patent should be written off at this time. If the license represents only a portion of the use of the patent, an appropriate portion of the remaining unamortized cost should be written off. The proceeds should be included in this year's current operations, and there should be disclosure that a major source of income from licensing agreements is being terminated.

.25 Finished Parts Held by Manufacturer for Customers

Inquiry—Corporation A, a subcontractor, manufacturers precision parts to customers' specifications. Parts produced by Corporation A are inspected by a customer's quality control representative and then held in a secured area in Corporation A's plant. Corporation A is entitled to full contract payment on parts inspected and held in the secured area. Historically, there has been a short time span between completion date and scheduled shipment date, but recently production efficiency has improved to the extent that contracts are completed significantly in advance of scheduled shipment dates. Based on the recent experience of Corporation A, what is the proper date for revenue recognition?

Reply—FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, paragraph 83, states in part:

"Revenues are not recognized until earned. An entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues . . . ."

Revenue should be recognized at the time of inspection and delivery to the secured areas, since the realization criteria have been met. Corporation A should disclose the method followed for income recognition as part of its disclosure of accounting policies.

.28 Revenue From Private Label Sales

Inquiry—Corporation A produces certain products that are sold under Corporation B's label. Corporation B reimburses Corporation A for all direct costs of raw material, ingredients, and packaging plus 10¢ per pound processing fee. Corporation A prepares an invoice for each shipment which itemizes the various direct costs plus 10¢ per pound processing fee. Should Corporation A record the total invoice amount as a sale or should it record the processing fee as revenue and the reimbursed direct costs as a reduction of expenses?

Reply—Corporation A should probably record the total invoice amount as a sale. Accounting for contracts of this type would be treated similar to cost-plus-fixed-fee contracts discussed in ARB No. 43, Chapter 11A, Cost-Plus-Fixed-Fee Contracts. [Amended]

.31 Accounting for Zero Coupon Bonds

Inquiry—A client purchased a 20-year zero coupon treasury bond for $189, with a maturity value of $1,000, at an 8 1/2% yield to maturity.

(1) What authoritative pronouncement would provide guidance for this transaction?

(2) How is the interest income computed for financial reporting purposes?

Reply—(1) APB Opinion No. 21, Interest on Receivables and Payables, would apply. APB Opinion No. 21, paragraph 2, states that, "The principles discussed in this Opinion are applicable to receivables and payables which represent contractual rights to receive money or contractual obligations to pay money on fixed or determinable dates, whether or not there is any stated provision for interest . . . Examples are secured and unsecured notes, debentures, bonds . . ."

(2) APB Opinion No. 21, paragraph 15, states that, "the difference between the present value and the face amount should be amortized to reflect the interest income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period." This is the "interest" method described in APB Opinion No. 12, Omnibus Opinion, paragraphs 16 and 17. However, other methods of amortization may be used if the results obtained are not materially different from those which would result from the "interest" method.

The following is an example of the application of the interest method. To calculate the semi-annual amount, multiply the purchase price by 4 1/4% (half of 8 1/2%) to arrive at the adjusted cost basis for the first six-month period. Then repeat this calculation for the next six-month period using the adjusted cost basis. The total amount of income (accrual) in the first year will be $16.40. Each year the cost basis is increased by the amount of income (accrual) reported in the previous year, as indicated in the following example:

Semi-Annual Period	Your Purchase Price or Adjusted Cost Basis	1/2 Purchase YTM	Accrual During Period	Adjusted Coast Basis at End of Period
1	$189.00	4.25%	$8.03	$197.03
2	197.03	4.25%	8.37	205.40
3	205.40	4.25%	8.73	214.13
4	214.13	4.25%	9.10	223.23

The interest income would be reported annually for financial reporting purposes. If the bond is held to maturity, there will be no gain or loss. If sold prior to maturity any gain or loss is determined by the difference between the adjusted cost basis and the selling price.

.33 Operating Lease With Rental Payments Rebated Against Purchase Price

Inquiry—A lessor corporation leases construction equipment for periods of six to eighteen months under short-term cancellable leases. The leases provide that during the first six months, 100 percent of the rentals paid may be applied toward the purchase price of the equipment if the lessee decides to purchase the equipment; during the next three months the percentage drops to 80 percent, and after nine months 60 percent may be applied toward the purchase price. The leases do not qualify as capital leases. How should the lessor account for the leases and the respective rebates?

Reply—The authoritative literature does not address this matter. The lessor should record rental income until the lessee decides to purchase the equipment. The lessor should then record the sale of the equipment net of the applicable rebate. The amount recorded as rental income should not be reclassified as sales proceeds.

.35 Involuntary Conversion—Recognition of Gain

Inquiry—A tornado virtually destroys a company's building on June 12, 19X0. The company has insurance and expects to be reimbursed for costs incurred to refurbish the building. The company's fiscal year-end is June 30, 19X0. On August 15, 19X0, prior to the issuance of the financial statements, the company receives a check in excess of the carrying amount of the building. Should the company recognize the gain on the involuntary conversion in the June 30, 19X0 financial statements?

Reply—No. Since the company was reimbursed for an amount in excess of the carrying amount of the building there was no loss to record on June 30, 19X0. The gain, which was received on August 15, 19X0, was a gain contingency on June 30, 19X0. Per FASB Statement No. 5, Accounting for Contingencies, paragraph 17, contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization.

.36 Sales of Investment to Minority Stockholder

Inquiry—A corporation enters into an agreement to sell an investment accounted for on the equity method to a minority stockholder in return for his shares in the corporation. The fair value of the investment exceeds its book value. Would the corporation recognize a gain on this transaction or would the excess be credited to equity?

Reply—APB Opinion No. 29, Accounting for Nonmonetary Transactions, paragraph 18, states that a transfer of a nonmonetary asset to a stockholder or to another entity in a nonreciprocal transfer should be recorded at the fair value of the asset transferred, and that a gain or loss should be recognized on the disposition of the asset. APB Opinion No.

29, paragraph 18 also indicates that the fair value of an entity's own stock reacquired may be a more clearly evident measure of the fair value of the asset distributed in a nonreciprocal transfer if the transaction involves acquiring stock for the treasury or retirement.

The corporation should recognize as a gain, in the year in which the transaction occurs, the excess of the fair value of the investment transferred over its carrying amount.

.37 Sales Price Based on Future Revenue

Inquiry—A company sold one of its direct-mail catalog offices for cash plus a percentage of revenue to be earned over the next five years. The sales agreement limits the percentage of revenue to a stipulated maximum. Management believes the maximum will be earned within the five-year period. When should revenue from this transaction be recorded?

Reply—According to FASB Statement No. 5, Accounting for Contingencies, paragraph 17, revenues from "Contingencies that might result in gains usually are not (recognized) prior to (their) realization."

Unless it is assured that adequate revenue will be earned to cause payment of the contingent portion of the sales price, the contingent portion of the sales price should only be accrued as earned. The accuracy and reasonableness of management's projections must be ascertained. If realization is assured, which would be relatively infrequent, revenue should be recorded as of the date of the sale using the present value of the projected cash receipts in accordance with APB Opinion No. 21, Interest on Receivables and Payables.

.38 Subsequent Event Related to Vendor-Specific Objective Evidence for Software Revenue Recognition

Inquiry —Vendor-specific objective evidence (VSOE) of fair value may be established by management after the balance sheet date but before the issuance of the financial statements, either by separate sales or by establishment of a price by a pricing committee. May an entity use such evidence to recognize revenue at the balance sheet date in accordance with SOP 97-2, *Software Revenue Recognition* (ACC 10,700)?

Reply—No. Establishment of VSOE after the balance sheet date is a Type II subsequent event, as discussed in SAS No. 1, section 560, *Subsequent Events* (AU 560). As a result, revenue should be deferred at the balance sheet date in accordance with paragraph 12 of SOP 97-2 (ACC 10,700.12), as amended by SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions (ACC 10,770). However, if subsequent to 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 VSOE (in accordance with paragraph 10 of SOP 97-2 [ACC 10,700.10]) to recognize revenue at the balance sheet date.

.39 Software Revenue Recognition for Multiple-Element Arrangements

Inquiry—Software vendors may execute more than one contract or agreement with a single customer. Should separate contracts or agreements be viewed as one multiple-element arrangement when determining the appropriate amount of revenue to be recognized in accordance with SOP 97-2, *Software Revenue Recognition* (ACC 10,700)?

Reply—A group of contracts or agreements may be so closely related that they are, in effect, parts of a single arrangement. 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 arrangement:

- The contracts or agreements are negotiated or executed within a short time frame of each other.
- The different elements are closely interrelated or interdependent in terms of design, technology, or function.
- The fee for one or more contracts or agreements is subject to refund or forfeiture or other concession if another contract is not completed satisfactorily.
- One or more elements in one contract or agreement are essential to the functionality of an element in another contract.
- Payment terms under one contract or agreement coincide with performance criteria of another contract or agreement.
- The negotiations are conducted jointly with two or more parties (for example, from different divisions of the same company) to do what in essence is a single project.

.40 Software Revenue Recognition Related to Year 2000 Compliant Software

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* (ACC 10,700)?

Reply—Yes. The criteria of SOP 97-2 (ACC 10,700) 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 (ACC 10,700.13–.14). 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 [ACC 10,700]). 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 (AC R75), 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.

.41 Effect of Prepayments on Software Revenue Recognition

Inquiry—Paragraph 29 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.29), 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 should be recognized as payments become due. Should a vendor recognize revenue for amounts (related to an arrangement with extended payment terms) received directly from customers (without the software vendor's participation in its customers' financing arrangements) in advance of scheduled payments?

Reply—Yes, provided all other requirements of revenue recognition in SOP 97-2 (ACC 10,700) are met.

.42 Extended Payment Terms and Software Revenue Recognition

Inquiry—A software vendor with a fiscal year ending September 30 enters into a licensing arrangement and simultaneously delivers its product to a customer on September 29. Payment terms are as follows: $600,000 due thirty days from September 29; $400,000 due thirteen 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 28 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.28). How much revenue should the vendor recognize during the current fiscal year ending September 30?

Reply—None. Paragraph 29 of SOP 97-2 (ACC 10,700.29) requires that the vendor recognize revenue as payments from customers become due (assuming all other conditions for revenue recognition in the SOP are met). In this situation, $600,000 should be recognized as revenue on October 29 when the payment becomes due and the remaining $400,000 should be recognized twelve months later on October 29 of the following fiscal year.

.43 Corrections of Errors in Computer Software (Bug Fixes)

Inquiry—A software vendor licenses software products to customers. Customers may elect to obtain postcontract customer support (PCS) from the software vendor as an element of the software arrangement, or customers may choose not to obtain PCS. In order 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 PCS from the software vendor.

Paragraph 31 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.31), states, "… obligations related to warranties for defective software, including warranties that are routine, short-term, and relatively minor, should be accounted for in conformity with FASB Statement No. 5." However, the SOP's glossary (ACC 10,700.149) indicates that PCS may include services such as the correction of errors (for example, bug fixing). If a software vendor provides bug fixes (under warranty obligations) free of charge that are necessary to maintain compliance with published specifications, should the software vendor account for the estimated costs to correct the bugs in accordance with FASB Statement No. 5, Accounting for Contingencies (AC C59), or should the vendor consider the practice of providing bug fixes free of charge part of PCS (which may result in the deferral of revenue)?

Reply—In this situation, the software vendor should account for the estimated costs to provide bug fixes (that are necessary to maintain compliance with published specifications) in accordance with FASB Statement No. 5 (AC C59).

.44 Postcontract Customer Support During the Deployment Phase of Computer Software

Inquiry—A software vendor enters into an arrangement with a customer to deliver its software product and to provide postcontract customer support (PCS). The product will be deployed in stages. The stipulated term of the PCS period begins six months after delivery of the product, though the vendor has a history of regularly making available to all customers the services or unspecified upgrades/enhancements normally associated with PCS as soon as its products are delivered. (That is, the customer receives any upgrades/enhancements released by the vendor during the six-month period after product delivery.) The PCS 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 PCS 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 (VSOE) of fair value of the PCS when the product is less than fully deployed because the only PCS sold separately is the renewal of PCS (that is, the predetermined renewal rate). Is PCS considered to commence at the date of product delivery or six months after delivery? Should the vendor consider the PCS predetermined renewal rate to be VSOE of fair value for PCS?

Reply—In this situation, the PCS arrangement commences upon product delivery because the customer receives any upgrades/ 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 PCS is sold separately, and therefore, it should be used to establish VSOE of fair value of the PCS. In this situation, the vendor should initially defer the portion of the arrangement fee related to the three and one-half years of PCS provided under the arrangement based on the predetermined renewal rate.

.45 Effect of Change in License Mix on Software Revenue Recognition

Inquiry—Software arrangements may allow a user to change or alternate its use of multiple products/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 utilize 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 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 the software vendor recognize revenue for these kinds of arrangements?

Reply—If the other criteria in SOP 97-2, *Software Revenue Recognition* (ACC 10,700), for revenue recognition are met, revenue should be recognized upon 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.

.46 Nonmonetary Exchanges of Software (Part I)

Inquiry—Is an exchange by a software vendor of 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 stand-alone additional product the culmination of the earnings process? That is, should that exchange be recorded at fair value or at carryover basis?

Reply—Paragraph 21a of APB Opinion No. 29, Accounting for Nonmonetary Transactions, states that 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 does not culminate an earning process. Therefore, if the technology/products received by the software vendor in the exchange were to be sold, licensed, or leased in the same line of business as the software vendor's technology/products delivered in the exchange, the software vendor should record the exchange at carryover basis. However, if the technology/products received by the software vendor in the exchange were to be sold, licensed, or leased in a different line of business from the software vendor's technology/products delivered in the exchange, the exchange is the culmination of the earnings process and the exchange should be recorded at fair value provided that:

1. the fair value of the technology/products exchanged or received can be determined within reasonable limits (that is, vendor-specific objective evidence of fair value of the

software given up, or the value of the technology/products received, as if the software vendor had received or paid cash), and

2. the technology/products received in the exchange are expected, at the time of the exchange, to be deployed and utilized by the software vendor and the value ascribed to the transaction reasonably reflects such expected use.

If neither the fair value of the technology/products exchanged nor the fair value of the technology/products received can be reasonably determined, the exchange should be recorded at carryover basis. Paragraph 26 of APB Opinion No. 29 states 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 enterprise may be the only available measure of the transaction.”

.47 Nonmonetary Exchanges of Software (Part II)

Inquiry—Is an exchange by a software vendor of a license of its software to a customer in exchange for a license to the customer’s technology that the software vendor intends to utilize for internal use the culmination of the earnings process? That is, should that exchange be recorded at fair value or at carryover basis?

Reply—Providing that the fair value of either of the nonmonetary assets involved in the transaction can be determined within reasonable limits, the software vendor should record the exchange at fair value because the exchange is subject to the guidance in paragraph 18 of APB Opinion No. 29, Accounting for Nonmonetary Transactions. Further, EITF Issue No. 86-29, Nonmonetary Transactions: Magnitude of Boot and the Exception to the Use of Fair Value, which provides guidance on interpreting APB Opinion No. 29, states that a product or property held for sale and exchanged for a productive asset does not fall within the modifications to the basic principle of paragraph 18 of APB 29 (even if they were in same line of business) and should be recorded at fair value.

Thus, that exchange is the culmination of the earnings process and that exchange should be recorded at fair value provided that:

1. the fair value of the technology/products exchanged or received can be determined within reasonable limits (that is, vendor-specific objective evidence of fair value of the software given up, or the value of the technology/products received, as if the software vendor had received or paid cash), and

2. the technology/products received in the exchange are expected, at the time of the exchange, to be deployed and utilized by the software vendor and the value ascribed to the transaction reasonably reflects such expected use.

If neither the fair value of the technology/products exchanged nor the fair value of the technology/products received can be reasonably determined, the exchange should be recorded at carryover basis. Paragraph 26 of APB Opinion No. 29 states 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 enterprise may be the only available measure of the transaction.”

The following matrix summarizes the answers in TIS section 5100.46 and .47:

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 (i.e., inventory) fn 1	Technology to be held for sale in the ordinary course of business (i.e., inventory) fn 2	1. Yes 2. No	1. Record at historical cost 2. Record at fair value fn 3
Software product held for sale in the ordinary course of business (i.e., inventory)	Internal-use software fn 4	N/A	Record at fair value fn 3

The following example illustrates the answers in TIS section 5100.46 and .47:

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

Software vendor XYZ agrees to exchange product A with Company PQR for licenses to product B. Software vendor XYZ intends to relicense product B (as a stand-alone product or embedded in product A) to its customers. Company PQR intends to use product A for internal use.

Accounting by software vendor XYZ . The exchange of product A for product B by software vendor XYZ would not result in the culmination of the earnings process for software vendor XYZ because software vendor XYZ exchanged property held for sale (product A) for property to be sold in the same line of business (product B) to facilitate future sales to other customers. The exchange should be recorded at carryover basis (that is, no revenue should be recognized until product B was sublicensed to other customers in a subsequent transaction).

Accounting by Company PQR . The exchange of product B for product A by Company PQR would result in the culmination of the earnings process for Company PQR because Company PQR exchanged property held for sale (product B) for a productive asset (product A, which will be used by Company PQR as an amortizable asset). The exchange should be recorded by Company PQR at fair value (that is, revenue should be recognized on the exchange). Such accounting treatment is based on the fact that the fair value of the technology exchanged or received can be reasonably determined and that a business purpose exists for the transaction.

.48 Application of Contract Accounting in Software Arrangements (Part I)

Inquiry—In paragraph 7 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.07), what is the meaning of the phrase "using the relevant guidance herein?"

Reply—The phrase "using the relevant guidance herein" refers to paragraphs 74-91 of SOP 97-2 (ACC 10,700.74-.91), which provide guidance on applying contract accounting to certain arrangements involving software.

.49 Application of Contract Accounting in Software Arrangements (Part II)

Inquiry—Footnote 4 to paragraph 7 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.07), states: "If a software arrangement includes services that meet the criteria discussed in paragraph 65 (ACC 10,700.65) of this SOP, those services should be accounted for separately." The type of services addressed by paragraph 65 (ACC 10,700.63) are described in paragraph 63 and specifically exclude post contract customer support (PCS)-related services. For a software arrangement that is subject to contract accounting and that includes PCS-related services (other than those meeting the cost accrual criteria in paragraph 59 of SOP 97-2 (ACC 10,700.59)), how should the software vendor account for such PCS-related services?

Reply—If the software vendor has vendor-specific objective evidence of the fair value of such PCS-related services that has been determined pursuant to paragraph 57 of SOP 97-2 (ACC 10,700.57), those PCS-related services should be accounted for separately from the balance of the arrangement that is being accounted for in conformity with Accounting Research Bulletin (ARB) No. 45, *Long-Term Construction-Type Contracts* and the relevant guidance in paragraphs 74-91 of SOP 97-2 (ACC 10,700.74-.91), and in SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts (ACC 10,330).

.50 Definition of More-Than-Insignificant Discount and Software Revenue Recognition

Inquiry—As discussed in paragraph 3 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.03), in connection with the licensing of an existing product, a vendor might offer a small or insignificant discount 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. Paragraph 3 indicates that those discounts are not within the scope of SOP 97-2 (ACC 10,700). However, footnote 3 to paragraph 3 (ACC 10,700.03) states that "[i]f the discount or other concessions in an arrangement are more than insignificant, a presumption is created that an additional element(s) (as defined in paragraph 9) is being offered in the arrangement." What is a "more-than-insignificant" discount, as discussed in footnote 3 to paragraph 3 of SOP 97-2 (ACC 10,700.03)?

Reply—For purposes of SOP 97-2 (ACC 10,700), a more-than-insignificant discount with respect to future purchases that is provided in a software arrangement is a discount that is: (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, and (3) significant. Insignificant discounts and 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) are not unique to software transactions and are not included in the scope of SOP 97-2 (ACC 10,700). Judgment is required when assessing whether an incremental discount is significant.

The provisions of footnote 3 to paragraph 3 of SOP 97-2 (ACC 10,700.03), 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. Paragraph 21 of SOP 97-2 (ACC 10,700.21), says that 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.

.51 Accounting for Significant Incremental Discounts in Software Revenue Recognition

Inquiry—How should a software vendor account for significant incremental discounts that are within the scope of SOP 97-2, *Software Revenue Recognition* (ACC 10,700)?

Reply—If a software arrangement includes a right to a significant incremental discount on a customer's future purchase of a product(s) or service(s), a proportionate amount of that significant incremental discount should be applied to each element covered by the arrangement based on each element's fair value (VSOE) without regard to the significant incremental discount. (See Examples 1 through 6 below.)

If (a) the future product(s) or service(s) 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), or (b) the fair value of the future purchases cannot be determined under paragraph 10 of SOP 97-2 (ACC 10,700.10), but 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. (See Examples 2 and 3 below.)

If the maximum amount of the significant incremental discount on future purchases is not quantifiable (for example, the future purchases that can be purchased under the significant incremental discount arrangement are not limited by quantity of product(s) or service(s)), revenue otherwise allocated to each element covered by the arrangement without regard to the significant incremental discount should be reduced by the rate of the significant incremental discount. (See Example 5 below.)

The portion of the fee that is deferred as a result of the significant incremental discount should 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 product(s) or service(s), the portion of the fee that is deferred as a result of the presence of a significant incremental discount should be recognized as revenue as a subscription in accordance with paragraphs 48 and 49 of SOP 97-2 (ACC 10,700.48–.49).

Examples (For purposes of the examples, VSOE of fair value equals list price)

Example 1: A software vendor sells Product A for $40 along with a right to a discount (the "coupon") of $30 on another of its software products, Product B. VSOE of fair value for Product A is $40 and VSOE of fair value for Product B is $60. The $30 discount on Product B is a significant incremental discount that would not normally be given in comparable transactions.

The vendor should 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 would be recognized at that time.

Example 2: A software vendor sells Product A for $40 along with a right to a discount (the "coupon") of $20 on any one of its other software products, Products B through Z. VSOE of fair value for Product A is $40 and VSOE of fair value for Products B through Z ranges from $30 to $100. The $20 discount is a significant incremental discount that would not normally be given in comparable transactions.

The vendor should 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 would be recognized at that time.

Example 3: A software vendor sells Product A for $40 along 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. VSOE of fair value for Product A is $40 and VSOE of fair value for Products B through Z ranges from $20 to $100. The 50% discount is a significant incremental discount that would not normally be given in comparable transactions.

The vendor should assume that the maximum discount will be utilized. 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 would be recognized at that time.

Example 4: A software vendor sells Product A for $60, which represents a 40% discount off its list price (VSOE) of $100. In the same transaction, it also provides the right to a discount of 60% off of the list price (VSOE) 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 not normally given in comparable transactions.

Because the discount offered on future purchases of Product B is not normally given in comparable transactions and is both significant and incremental in relation to the 40% discount, it must be accounted for as part of the original sale consistent with Example 3 above. The vendor should assume that the maximum discount will be utilized. 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 would be recognized at that time.

Example 5: A software vendor sells Product A for $40 along 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. VSOE of fair value for Product A is $40 and VSOE 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 would not normally be given in comparable transactions.

The vendor should 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 48 and 49 of SOP 97-2 (ACC 10,700.48–.49), 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.

Example 6: A software vendor sells Product A for $30 along with the right to a discount for 70% off list price (VSOE) 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 VSOE of fair value of Product A is $100.

As 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.

.52 Fair Value of PCS in a Perpetual License and Software Revenue Recognition

Inquiry—The fee for a perpetual software license includes post-contract customer support (PCS) services for a term of two years. However, only one-year PCS renewal rates are offered to those holding the perpetual license rights. Do rates for the PCS renewal terms provide vendor-specific objective evidence (VSOE) of the fair value of the PCS element included (bundled) in the software arrangement pursuant to the provisions in paragraphs 10 and 57 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.10 and .57)?

Reply—Yes, if the PCS renewal rate and term are substantive. The dollar amount of the one-year PCS renewal rate multiplied by two (which reflects the PCS term included in the arrangement) constitutes VSOE of the fair value of PCS pursuant to the provisions in paragraphs 10 and 57 of SOP 97-2 (ACC 10,700.10 and .57).

.53 Fair Value of PCS in a Short-Term Time-Based License and Software Revenue Recognition

Inquiry—A multiple-element software arrangement subject to the accounting requirements of SOP 97-2, *Software Revenue Recognition* (ACC 10,700), provides a 12-month time-based software license that includes (bundles) 6 months of post-contract customer support (PCS) services for a total fee of $100,000, and specifies a 6-month renewal fee for PCS services of $5,000. Are there arrangements that include time-based software licenses and PCS services wherein the duration of the time-based software license is so short that a renewal rate or fee for the PCS services does not represent vendor-specific objective evidence (VSOE) of the fair value of the bundled PCS?

Reply—Yes, and the fact pattern in this question is an example of such a situation. For time-based software licenses with a duration of one year or less, the fair value of the bundled PCS services is not reliably measured by reference to a PCS renewal rate. The short time frame during which any unspecified upgrade provided under the PCS agreement can be used by the licensee creates a circumstance whereby one cannot objectively demonstrate the VSOE of fair value of the licensee's right to unspecified upgrades.

Though a PCS service element may not be of significant value when it is provided in a short duration time-based license, SOP 97-2 (ACC 10,700), does not provide for an exception from its provision that VSOE of fair value is required for each element of a multiple-element arrangement. Consequently, when there is no VSOE of the fair value of PCS 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 paragraph 12 (or paragraph 59, if applicable) of SOP 97-2 (ACC 10,700.12 or .59, if applicable). TIS section 5100.54 addresses circumstances where a PCS renewal rate in connection with a multi-year time-based license may not constitute VSOE of the fair value of PCS.

.54 Fair Value of PCS in a Multi-Year Time-Based License and Software Revenue Recognition

Inquiry—Arrangements for multi-year time-based software licenses may include: 1) initial (bundled) post-contract customer support (PCS) services for only a portion of the software license's term (for example, a five-year time-based software license that includes initial PCS services for one year) and 2) a renewal rate for PCS for an additional year(s) within the time-based license period. Does that renewal rate constitute vendor-specific objective evidence (VSOE) of the fair value of the PCS under paragraphs 10 and 57 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.10 and .57)?

Reply—Yes, if the PCS renewal rate and term are substantive. Circumstances that indicate that the PCS renewal rate or term is **not** substantive include:

- The period of initial (bundled) PCS services is relatively long compared to the term of the software license (for example, four years of initial PCS services in connection with a five-year time-based software license, with a specified PCS renewal rate for the remaining year).
- The aggregate PCS renewal term is less than the initial (bundled) PCS period (for example, a 5-year time-based software license with three year bundled PCS and two annual PCS renewals).
- A PCS 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] PCS for one year for a total arrangement fee of $1,000,000 and that stipulates a PCS renewal rate for the second year of $25,000 when the vendor’s normal pricing practices suggest higher renewal rates).

.55 Fair Value of PCS With a Consistent Renewal Percentage (But Varying Renewal Dollar Amounts) and Software Revenue Recognition

Inquiry—A software vendor charges Customer A $100,000 for a software license with a post-contract customer support (PCS) renewal rate of 15% of the license fee while charging Customer B $150,000 for the same software license with a PCS renewal rate of 15% of the license fee. Does the existence of varying dollar amounts of PCS renewal fees for the same software product (resulting from using a renewal rate that is a consistent percentage of the stipulated software license fee for the same software product) indicate an absence of vendor-specific objective evidence (VSOE) of the fair value of PCS or the possible presence of discounts on PCS that should be accounted for under paragraph 11 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.11)?

Reply—No. Assuming that the PCS renewal rate expressed as a consistent percentage of the stipulated license fee for customers is substantive, that PCS renewal rate would be the VSOE of the fair value of PCS.

.56 Concessions and Software Revenue Recognition

Inquiry—Paragraph 27 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.27), 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 credit-worthy customer to liquidate outstanding amounts due under the original terms of the arrangement increases as payment terms become longer." What kinds of changes to an arrangement would be considered concessions?

Reply—Concessions by a software vendor may take many forms and include, but are not limited to, any one of the following kinds of changes to the terms of an arrangement:

- Changes that would have affected the original amount of revenue recognized;
- Changes that reduce the arrangement fee or extend the terms of payment;
- Changes that increase the deliverables or extend the customer's rights beyond those in the original transaction.

Examples of concessions by a software vendor that reduce an arrangement fee or extend the terms of payment include, but are not limited to, the following:

- Extending payment due dates in the arrangement (except when the extension is due to credit problems of the customer).
- Decreasing total payments due under the arrangement (except when the decrease is due to credit problems of the customer).
- Paying financing fees on a customer's financing arrangement that was not contemplated in the original arrangement.
- Accepting returns that were not required to be accepted under the terms of the original arrangement.

Examples of concessions by a software vendor that increase the deliverables include, but are not limited to, the following:

- Providing discounted or free post-contract customer support that was not included in the original arrangement.
- 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.
- Allowing the customer to have access to products not licensed under the original arrangement without an appropriate increase in the arrangement fee.
- For term licenses, extending the time frame for a reseller to sell the software or an end user to use the software.
- 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.

Although the nature of a concession may vary by type of arrangement, many of the above concessions 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, etc.).

Examples of changes to the terms of an arrangement that are not concessions include, but are not limited to, the following:

- Changes that increase the deliverables with a corresponding appropriate increase in the arrangement fee.
- Changes that eliminate the software vendor's delivery obligation without a refund of cash.

.57 Overcoming Presumption of Concessions in Extended Payment Term Arrangements and Software Revenue Recognition

Inquiry—Paragraph 28 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.28), indicates that, if a significant portion of the software licensing fee is not due until after expiration of the license or more than twelve months after delivery, the licensing fee should 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. What types of evidence are useful in determining whether the vendor has a history of successfully collecting under the original payment terms without making concessions?

Reply—To have a "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.

In addition to a history of collecting payments as due without making concessions, paragraph 14 of SOP 97-2 (ACC 10,700.14) requires that the software vendor must intend not to provide refunds or concessions that are beyond the provisions of the arrangement.

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, but are not limited to, the following:

Similarity of Customers

- **Type or Class of Customer:** New arrangements with substantially the same types and class of customer is an indicator that the history is relevant. Significant differences call into question the relevance of the history.

Similarity of Products Included

- **Types of Products** : Similarity in the types of products included under the new license arrangement (for example, financial systems, production planning, and human resources).
- **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 should 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.
- **Elements Included in the Arrangement:** There are no significant differences in the nature of the elements included in the arrangements. The inclusion of significant rights to services or discounts on future products in some arrangements, but not others, could indicate that there is a significant difference between the arrangements. For example, a history developed for arrangements that included bundled post-contract customer support (PCS) and rights to additional software products would not be comparable to an arrangement that does not include these rights.

Similarity of License Economics

- **Length of Payment Terms:** In order 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.

- **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 PCS arrangement.

.58 Effect of Prepayments on Software Revenue Recognition (Part II)

Inquiry—Paragraph 28 of SOP 97-2 (ACC 10,700.28) says that any extended payment terms in a software licensing arrangement may indicate that the fee is not fixed or determinable. In addition, 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 twelve months after delivery. Is the presumption overcome if the software vendor transfers the rights to receive amounts due on an extended payment term arrangement to an independent third party without recourse to the vendor?

Reply—No. 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 answer does not change 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 TIS section 5100.41 (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 28 of SOP 97-2 (ACC 10,700.28) has not been overcome.

.59 Subsequent Cash Receipt in an Extended Payment Term Arrangement for Software Revenue Recognition

Inquiry—Paragraph 28 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.28), says that the presumption that an extended payment term license fee due more than twelve 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. A calendar year end software vendor enters into a two-year installment payment licensing arrangement with a customer on December 1 and the first payment is due in May of the following year. Subsequent to its December 31 year end but before it issues the financial statements, the software vendor receives from the customer payment of 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. Does the subsequent cash receipt provide sufficient evidence to render the licensing fee as fixed or determinable, and thus allow the software vendor to recognize revenue in the December 31 financial statements?

Reply—No. Paragraph 29 of SOP 97-2 (ACC 10,700.29) requires that the software vendor make the determination of whether the fee is fixed or determinable at the outset of the arrangement, which in this situation is December 1. The only circumstances sufficient to overcome the presumption that the license fee is not fixed or determinable are that the software vendor has (1) a standard business practice of using long-term or installment contracts and (2) has a history of successfully collecting under the original payment terms without making concessions. Since the software vendor has met all other conditions of revenue recognition, it should recognize revenue in the period it receives payment in full directly from the customer (see TIS section 5100.41, Effect of Prepayments on Software Revenue Recognition).

.60 Customer Financing With No Software Vendor Participation and Software Revenue Recognition

(For illustrative purposes, the following inquiry and reply assumes that the software arrangement is a single product/single element arrangement; however, the inquiry and reply also applies to multiple element arrangements.)

Inquiry—TIS section 5100.41 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 TPA 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, providing all other requirements of revenue recognition in SOP 97-2, *Software Revenue Recognition* (ACC 10,700), are met. TIS section 5100.58 indicates 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. Given the two aforementioned TPAs, how should a software vendor recognize revenue if it enters into an arrangement with an end user customer that contains customary (that is, non-extended) payment terms and the end user customer obtains, without the software vendor’s participation, financing from a party unrelated to the software vendor?

Reply—Because the software arrangement’s payment terms are not extended, as contemplated in paragraph 28 of SOP 97-2 (ACC 10,700.28), and the software vendor does not participate in the end user customer’s financing, the software vendor should recognize revenue upon delivery of the software product, provided all other requirements of revenue recognition in SOP 97-2 (ACC 10,700), are met.

.61 Effect of Prepayments on Software Revenue Recognition When Vendor Participates in Customer Financing

(For illustrative purposes, the following inquiry and reply assumes that the software arrangement is a single product/single element arrangement; however, the inquiry and reply also applies to multiple element arrangements.)

Inquiry—TIS section 5100.41 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. The specific reference to without participation suggests that the answer might be different if the software vendor participates in the customer's financing. How should a software vendor recognize revenue under SOP 97-2, *Software Revenue Recognition* (ACC 10,700), if it enters into an arrangement with an end user customer that contains extended payment terms and the software vendor receives payments in advance of the scheduled due dates after the software vendor participated in the customer's financing with a party unrelated to the software vendor?

Reply—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 (as discussed in TIS section 5100.62), the presumption is that the fee is not fixed or determinable. If the software vendor cannot overcome that presumption, the software vendor should recognize revenue as payments from the customer become due and payable to the financing party, provided all other requirements of revenue recognition in SOP 97-2 (ACC 10,700) are met. The software vendor should account for any proceeds received from the customer or the financing party prior to revenue recognition as a liability for deferred revenue. TIS section 5100.63 addresses when the presumption may be overcome.

.62 Indicators of Incremental Risk and Their Effect on the Evaluation of Whether a Fee is Fixed or Determinable and Software Revenue Recognition

(For illustrative purposes, the following inquiry and reply assumes that the software arrangement is a single product/single element arrangement; however, the inquiry and reply also applies to multiple element arrangements.)

Inquiry—Based on the reply to TIS section 5100.61, and as implied in TIS section 5100.41, considering whether a software vendor participated in the customer's financing is important to how revenue is recognized in a software arrangement that contains extended payment terms. A software vendor enters into an arrangement with an end user customer that contains customary (that is, non-extended) payment terms for which the arrangement fee ordinarily would be considered fixed or determinable. Simultaneously with entering into a software arrangement, or prior to 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. In what circumstances would the software vendor's participation in the end user customer's financing (a) preclude a determination by the software vendor that the software arrangement fee is fixed or determinable pursuant to paragraph 28 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.28), or (b) lead to a presumption (that can be overcome) that the fee is not fixed or determinable in accordance with paragraph 28 (ACC 10,700.28)?

Reply—A software arrangement fee is not fixed or determinable if a software vendor: (a) lacks the intent or ability to enforce the original payment terms of the software arrangement if the financing is not successfully completed, or (b) in past software arrangements, 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. 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 results in incremental risk and a presumption that the fee is not fixed or determinable:

1. Provisions that require the software vendor 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.

2. Provisions that require the software vendor 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.

3. Provisions that obligate the software vendor to take action (such as to terminate the license agreement and/or any related services), which results in more than insignificant direct incremental costs, against the customer on behalf of the financing party in the event that the end user customer defaults under the financing, unless, as part of the original arrangement, the customer explicitly authorizes the software 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.

4. Provisions that prohibit or limit the ability of the software vendor to enter into another software arrangement with the customer for the same or similar product if the end user customer defaults under the financing, unless, as part of the original arrangement, the customer explicitly authorizes the software vendor upon request by the financing party to take those specific actions against the customer.

5. Provisions that require the software vendor to guarantee, certify, or otherwise attest in any manner to the financing party that the customer meets the financing party's qualification criteria.

6. Software vendor has previously provided concessions to financing parties or to customers to facilitate or induce payment to financing parties.

7. Provisions that lead to the software vendor's guarantee of the customer's indebtedness to the financing party.

If the presumption is not overcome, the software vendor should recognize revenue as payments from the customer become due and payable to the financing party, provided all other requirements of revenue recognition in SOP 97-2 (ACC 10,700) are met.

.63 Overcoming the Presumption That a Fee is Not Fixed or Determinable When Vendor Participates in Customer Financing and Software Revenue Recognition

Inquiry—TIS section 5100.62 provides 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. What evidence should the software vendor consider to overcome the presumption that the fee is not fixed or determinable, as discussed in TIS section 5100.62?

Reply—The presumption may be overcome in certain circumstances. The software vendor should use the guidance in paragraph 28 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.28), and TIS section 5100.57.

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.

Additionally, with respect to incremental risk indicator 7 in TIS section 5100.62, in those circumstances in which the software vendor has relevant history with arrangements in which it granted extended payment terms to its customers, the software vendor should consider that history. A history of the software vendor granting concessions to either (a) its customers in similar arrangements in which it provided extended payment terms or (b) 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.

In circumstances where there is sufficient evidence to overcome the presumption that the fee is not fixed or determinable, the software vendor should nevertheless evaluate the nature of the incremental risk to determine if there are other accounting ramifications, for example, accounting for the software vendor's continuing involvement that results from a guarantee of the customer's indebtedness (recourse).

.64 Indicators of Vendor Participation in Customer Financing That Do Not Result in Incremental Risk and Software Revenue Recognition

(For illustrative purposes, the following inquiry and reply assumes that the software arrangement is a single product/single element arrangement; however, the inquiry and reply also applies to multiple element arrangements.)

Inquiry—Related to TIS section 5100.62, are there examples of software vendor actions that generally do not cause the software vendor to assume incremental risk that the software vendor will provide a refund or concession to either the end user customer or the financing party related to the software vendor's participation in an end user customer's financing of a software arrangement?

Reply—Yes. The following examples of software vendor actions generally do not cause a software vendor to assume incremental risk:

1. Software vendor introduces the customer and financing party and facilitates their discussions.

2. Software vendor assists the customer in pre-qualifying for financing as 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.

3. Software 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 software vendor makes the same written representations in the software arrangement with the end user customer.

4. Software vendor warrants to the financing party that the software functions according to the software vendor's published specifications if the software vendor makes the same written warranty in the software arrangement with the end user customer.

5. Software vendor takes action, which was explicitly authorized by the customer in the original arrangement, to terminate the license agreement and/or any related services, or to not enter into another arrangement for the same or similar product.

6. Software vendor makes customary recourse provisions to its customer related to warranties for defective software.

.65 Software Vendor Interest Rate Buy Downs on Customer Financing and Software Revenue Recognition

(For illustrative purposes, the following inquiry and reply assumes that the software arrangement is a single product/single element arrangement; however, the inquiry and reply also applies to multiple element arrangements.)

Inquiry—A customer may desire, and a software vendor may be willing to assist the customer in obtaining financing with a party unrelated to the software vendor that has a more attractive interest rate than typically offered by the financing party. For example, a software vendor arranges to "buy down" the interest rate a financing party would otherwise charge to the software vendor's customer. That interest rate "buy down" may occur simultaneously with the original arrangement between the software vendor and customer, or it may occur at a later point in time. Further, that interest rate "buy down" may occur with or without the customer's awareness. Does either the point in time of the interest rate "buy down", or the awareness by the customer of it, affect revenue recognition under SOP 97-2, *Software Revenue Recognition* (ACC 10,700)?

Reply—The point in time that the interest rate "buy down" occurs affects revenue recognition, however, whether the customer is aware of the "buy down" does not affect revenue recognition.

An interest rate "buy down" which 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 "buy down" is an integral part of the original arrangement, it is irrelevant whether the customer is or is not aware of it. The amount of the interest rate "buy down" should be treated as a reduction of the total arrangement fee to be recognized in accordance with SOP 97-2 (ACC 10,700), and not as a financing or other expense.

A software vendor's "buy down" of an interest rate which 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 TIS section 5100.56). Because the interest rate "buy down" is a concession, it is irrelevant whether the customer is or is not aware of it.

.66 Consideration of Other TPAs on Customer Borrowing When Customer is a Reseller and Software Revenue Recognition

(For illustrative purposes, the following inquiry and reply assumes that the software arrangement is a single product/single element arrangement; however, the inquiry and reply also applies to multiple element arrangements.)

Inquiry—The inquiries in TIS section 5100.60 through .65 specifically refer to a software vendor's arrangements with an end user customer. Are the replies different if the customer is a reseller?

Reply—The inquiries and replies in TIS section 5100.60 through .65 are phrased in the context of end user customers to eliminate the additional discussion that may be necessary to address the complexities that exist for resellers. Paragraph 30 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.30), provides additional factors to consider in evaluating whether an arrangement fee is fixed or determinable if the customer is a reseller. The underlying concepts in the replies should be applied to customers that are resellers; however, all of the additional factors in paragraph 30 of SOP

97-2 (ACC 10,700.30), also should be considered. Further, the existence of financing by a reseller customer may increase the risk that:

1. Payment of the arrangement fee is substantially contingent on the distributor's success at reselling the product.

2. 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.

3. Returns or price protection cannot be reasonably estimated because of the potential for increased concession risk.

.67 Customer Acceptance and Software Revenue recognition

Inquiry—Paragraph 20 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.20), says, "After delivery, if uncertainty exists about customer acceptance of the software, license revenue should not be recognized until acceptance occurs." In a software arrangement that contains a customer acceptance provision, can a software vendor ever recognize revenue (provided all of the other revenue recognition criteria of SOP 97-2 (ACC 10,700) have been met) before formal customer acceptance occurs?

Reply—Yes. Paragraph 20 of SOP 97-2 (ACC 10,700.20) 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, but are not limited to, (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, and (d) historical experience with the specific customer. Public registrants subject to SOP 97-2 (ACC 10,700), should also consider the guidance in SEC Staff Accounting Bulletin No. 101 (SAB 101), Revenue Recognition in Financial Statements, and the Frequently Asked Questions to SAB 101, as it relates to customer acceptance.

.68 Fair Value of PCS in Perpetual and Multi-Year Time-Based Licenses and Software Revenue Recognition

Inquiry—Software licenses for the same product currently are offered by a software vendor as: 1) a perpetual license and 2) a multi-year time-based license (for example, two or more years). The pricing of the licenses reflects the duration of the license rights. Vendor-specific objective evidence (VSOE) of fair value exists for post-contract customer support (PCS) services in the perpetual licenses. For the multi-year time-based licenses, PCS services for the entire license term are included (bundled) in the license fee and there is no renewal rate inasmuch as the time-based license rights are coterminous with the PCS service period. Do the PCS renewal terms in the perpetual license provide VSOE of the fair value of the PCS services element included (bundled) in the multi-year time-based software arrangement pursuant to the provisions of SOP 97-2, *Software Revenue Recognition* (ACC 10,700)?

Reply—No. SOP 97-2 (ACC 10,700) states that VSOE of fair value is provided by the price charged when the same element is sold separately. PCS services for a perpetual license and PCS services for a multi-year time-based license are two different elements. Though the same unspecified product upgrades or enhancements may be provided under each PCS 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 PCS services are bundled for the entire term of the multi-year time-based license, those PCS services are not sold separately.

However, in the rare situations in which both of the following circumstances exist, the PCS renewal terms in a perpetual license provide VSOE of the fair value of the PCS services element included (bundled) in the multi-year time-based software arrangement: (1) the term of the multi-year 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; and (2) the fees charged for the perpetual (including fees from the assumed renewal of PCS for the estimated economic life of the software) and multi-year time-based licenses are substantially the same.

If the software vendor also offers multi-year time-based licenses for the same product that include bundled PCS services for a portion of the license period (instead of only including bundled PCS services for the entire license term), the renewal terms of those transactions may provide VSOE of the fair value of the PCS services elements that are bundled for the entire license term. See TIS section 5100.54 for additional guidance on VSOE of PCS renewals.

.69 Delivery Terms and Software Revenue Recognition

Inquiry—SOP 97-2, *Software Revenue Recognition* (ACC 10,700), says that delivery is one of the basic criteria for revenue recognition. In an arrangement that requires physical delivery of software, are delivery terms that indicate when the customer assumes the risks and rewards of its licensing rights (for example, FOB destination and FOB shipping point terms) relevant in the assessment of whether software has been delivered?

Reply—Yes, including in 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. Public registrants subject to SOP 97-2 (ACC 10,700) should also consider the guidance in SEC Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements, as it relates to when delivery is considered to have occurred.

.70 Effect of Commencement of an Initial License Term and Software Revenue Recognition

Inquiry—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 SOP 97-2, *Software Revenue Recognition* (ACC 10,700), are met. None of the four basic criteria specifically address whether the license term also must commence. For example: On December 20, X0, a software vendor enters into a software arrangement with a first-time customer for the license of Product A and PCS. VSOE of fair value exists for PCS. For reasons that may or may not be known by the software vendor, the customer desires the license to terminate on January 2, X4. The software vendor accepts the customer's terms and structures the arrangement as a three-year term beginning January 3, X1 and ending January 2, X4. On December 20, X0, the software vendor ships the software and collects the fee. Assuming all other criteria for revenue recognition are met, should the software vendor recognize any of the arrangement fee before the license term begins (that is, January 3, X1)?

Reply—No. Revenue should not be recognized prior to the commencement of the initial license term. Deferring recognition of revenue until the initial license term commences is consistent with TIS section 5100.45, which includes a "right to use" concept, and the overall concept of delivery addressed in SOP 97-2 (ACC 10,700).

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

.71 Effect of Commencement of an Extension/Renewal License Term and Software Revenue Recognition

Inquiry—TIS section 5100.70, which addresses the effect of commencement of an initial license term on software revenue recognition, indicates revenue should not be recognized before the license term commences even if all other criteria for revenue recognition have been met. If the license were an extension/renewal of a pre-existing, currently active license for the same product(s), would commencement of the extension/renewal term also be a prerequisite for revenue recognition? For example: Consider the arrangement described in TIS section 5100.70, including that VSOE of fair value exists for PCS. The license term commenced on January 3, X1 and ends on January 2, X4. Now assume that in September X3, the customer decides it wants to be able to continue to use Product A beyond January 2, X4. The software vendor and customer execute an arrangement on September 20, X3 to extend/renew the terms of the existing license through December 31, X5. The extension/renewal arrangement includes only product(s) already included in the existing, currently active arrangement. Assuming all other revenue recognition criteria are met, should the software vendor recognize the portion of the extension/renewal arrangement fee allocated to the license of Product A as revenue on September 20, X3 or January 3, X4?

Reply—The software vendor should recognize the portion of the extension/renewal arrangement fee allocated to the license of Product A as revenue on September 20, X3 if all other revenue recognition criteria are met. In the case of an extension/renewal of a pre-existing, 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/renewal applies.

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

In considering the guidance in paragraphs 28 and 29 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.28–.29), for determining whether the extension/renewal fee is fixed or determinable, the date that the extension/renewal arrangement is executed should be used to determine whether the extension/renewal payment terms are extended.

.72 Effect of Additional Product(s) in an Extension/Renewal of License Term and Software Revenue Recognition

Inquiry—TIS section 5100.71 addresses the effect of commencement of an extension/renewal license term when the extension/renewal arrangement includes only a product(s) already included in the existing, currently active arrangement. If the extension/renewal arrangement includes additional product(s), how should the extension/renewal arrangement fee be allocated to the different products? For example: Consider the arrangement described in TIS section 5100.71, including that VSOE of fair value exists for PCS. The license term of Product A commenced on January 3, X1 and ends on January 2, X4. In September X3, the customer decides it wants to be able to continue to use Product A beyond January 2, X4 and now assume that the customer also wants 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, X3 to extend/renew the terms of the existing, currently active license of Product A through December 31, X5 and also to license Product B. The software vendor has VSOE of fair value for Products A and B, and Product B is expected to be delivered in the first quarter of X4. How should the software vendor allocate and recognize the portions of the extension/renewal arrangement fee allocated to Products A and B?

Reply—The software vendor should allocate the extension/renewal arrangement fee using VSOE of fair value consistent with paragraph 10 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.10). Consistent with TIS section 5100.71, the software vendor should recognize the portion of the extension/renewal arrangement fee allocated to Product A as revenue on September 20, X3 (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/renewal applies. The portion of the extension/renewal arrangement fee allocated to Product B should be recognized when the criteria of paragraph 8 of SOP 97-2 (ACC 10,700.08) are met and the license period for Product B has commenced.

In considering the guidance in paragraphs 28 and 29 of SOP 97-2 (ACC 10,700.28–.29) for determining whether the extension/renewal fee is fixed or determinable, the date that the extension/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, should be used to determine whether the extension/renewal arrangement payment terms are extended.

.73 Software Revenue Recognition for an Arrangement Containing an Option to Extend a Time-Based License Indefinitely

Inquiry—A software vendor sells Product A with PCS under a three-year term license with PCS renewable after year 1. VSOE of fair value exists for PCS. The arrangement specifies that any time during its term the customer can extend the license for Product A indefinitely for an additional fee. Effectively, the arrangement contains an option to convert the three-year term license into a perpetual license for Product A. Does the option to convert represent an element as that term is used in paragraph 10 of SOP 97-2, *Software Revenue Recognition* (ACC 10,700.10)? Would the answer differ if the perpetual license for Product A 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?

Reply—The option itself is not an element as contemplated in paragraph 10 of SOP 97-2 (ACC 10,700.10) because there is no new deliverable. The exercise of the option merely affords the customer a longer time period over which to use the same Product A 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/renewal of a license, as discussed in TIS section 5100.71.

Further, the need for another delivery of the software media as a result of a self-destruct or similar mechanism 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.

.74 Effect of Discounts on Future Products on the Residual Method and Software Revenue Recognition

Inquiry—TIS section 5100.50 defines a more-than-insignificant discount with respect to future purchases and TIS section 5100.51 provides examples of accounting for significant incremental discounts that are within the scope of SOP 97-2, *Software Revenue Recognition* (ACC 10,700). The term "discount," as used in SOP 97-2 (ACC 10,700) and the related TPAs, is the difference between the arrangement fee and VSOE of fair value when VSOE of fair value exists 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 in the arrangement but does exist for all of the undelivered elements.

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 VSOE of fair value of its software products. However, the software vendor is able to apply the residual method pursuant to SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions (ACC 10,770), when the only undelivered elements are services.

How should the software vendor determine if the discount on future purchases of future products is significant and incremental (as discussed in TIS section 5100.50) since it does not have VSOE of fair value of its software products?

Reply—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 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 TIS section 5100.51.

Example:

On December 31, 20X1, software vendor licenses Product A (with a published list price of $100) on a perpetual basis, bundled with PCS for the first year, to a customer for $80. The customer may elect to renew PCS following the initial year at a stipulated rate of $15, which requires the software vendor to apply the residual method pursuant to SOP 98-9 (ACC 10,770). 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 software vendor during the three years subsequent to December 31, 20X1, with no maximum cumulative discount. Based on the guidance in the reply above, the software vendor would perform the calculation below to assist in determining whether the discount offered on future purchases of future products is significant and incremental (as discussed in TIS section 5100.50):

	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%

Assuming that the software vendor concludes that the additional discount (that is, 20.00% in this example) on future purchases is significant and incremental, the software vendor should allocate such discount to Product A and defer revenue related to the PCS in the initial arrangement as follows:

(a)	(b)	(a)*(b)= (c)	(d)	(c)+(d)=(e)	(f)	(f)-(e)
Published List Price	Addt'l Discount	Revenue Deferral for Additional Discount	Revenue Deferral for PCS	Total Revenue Deferral	Arrangement Fee	Up-front Revenue Product A
$100	20 %	$20	$15	$35	$80	$45

Consistent with Example 5 in TIS section 5100.51, upon delivery of Product A, the vendor should recognize $45 of revenue and defer $35, provided all other requirements of revenue recognition in SOP 97-2 (ACC 10,700) are met. The revenue related to PCS ($15) deferred pursuant to the residual method should be recognized over the initial year of the license in accordance with paragraph 57 of SOP 97-2 (ACC 10,700.57). The deferred revenue related to the discount ($20) should be accounted for as a subscription in accordance with paragraphs 48 and 49 of SOP 97-2 (ACC 10,700.48–.49) and recognized pro rata over the three-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 SOP 97-2 are met (ACC 10,700).

.75 Fair Value of PCS Renewals Based on Users Deployed and Software Revenue Recognition

Inquiry—A software vendor offers a perpetual license to an end-user customer for a software product with post-contract customer support (PCS) bundled for the initial year. The initial fee is $1,150,000 ($1,000,000 is stated as the software license fee and $150,000 is stated as the PCS fee). The end-user customer is entitled to deploy an unlimited number of copies of the licensed software product for a 3-year period. During the 3-year unlimited deployment period, the end-user customer has the option to renew PCS 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 3-year unlimited deployment period, the end-user customer is required to pay additional license and PCS fees if it deploys additional copies of the software product. The optional PCS 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 3-year unlimited deployment period. Do the annual PCS renewal rates stipulated for years 2 and 3 constitute vendor-specific objective evidence (VSOE) of fair value for the year 1 PCS in accordance with SOP 97-2, *Software Revenue Recognition* (ACC 10,700)?

Reply—No. In this arrangement there are two different pricing methodologies for PCS and no basis for determining which pricing methodology produces the appropriate VSOE of fair value of the PCS bundled in year 1 and offered in years 2 and 3. Accordingly, the vendor should recognize the entire arrangement fee ($1,450,000) ratably over the three-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 14 of SOP 97-2 [ACC 10,700.14]). This presumes that PCS will be renewed in years 2 and 3; however, if the customer does not renew PCS in year two or year three, the vendor should recognize the remaining deferred revenue at the time PCS is no longer being provided.

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 fifty percent, as that term is used in FASB Statement No. 109, Accounting for Income Taxes) to approximate or be less than the amount charged in years 2 and 3, the annual PCS renewal rates stipulated for years 2 and 3 would constitute VSOE of fair value of PCS. One example of such evidence would be a vendor's past history of deployment with other comparable arrangements that result in postdeployment PCS fees that approximate PCS fees charged during the unlimited deployment period. Another example of such evidence would be a stated cap or maximum on the price to be charged for PCS 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 SOP 97-2 (ACC 10,700) are met, and the fair value of PCS in year 1 would be recognized ratably over the PCS period. Likewise, the fees related to PCS renewals after year 1 ($150,000 each for years 2 and 3) would be recognized ratably over the respective PCS periods.

.76 Fair Value in Multiple-Element Arrangements That Include Contingent Usage-Based Fees and Software Revenue Recognition

Inquiry—Software vendors may enter into various multiple-element arrangements that provide for both licensing rights and post-contract customer support (PCS) and 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, customer call center software wherein 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 there is no continuing obligation to provide PCS.

The following scenarios focus on circumstances in which software functionality is used by the software licensee only in processing 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. In each of the three scenarios, how should a software vendor recognize revenue for the perpetual license, PCS, and contingent usage-based fee elements?

Scenario No. 1—Arrangement provides for a non-refundable initial fee for the perpetual license and contingent usage-based fees determined monthly or quarterly and due shortly thereafter. PCS is provided at no additional charge for the first year and the licensee may purchase renewal PCS annually thereafter for a fixed amount that is deemed substantive (the renewal rate).

Scenario No. 2—Arrangement provides for a non-refundable initial fee for the perpetual license and contingent usage-based fees determined monthly or quarterly and due shortly thereafter. PCS is provided at no additional stated charge (or the pricing of PCS is stated as being included in the contingent usage-based fee).

Scenario No. 3—Arrangement provides for a perpetual license solely in exchange for contingent usage-based fees determined monthly or quarterly and due shortly thereafter. PCS is provided at no additional stated charge.

Reply—Usage-based fees are not specifically addressed in SOP 97-2, *Software Revenue Recognition* (ACC 10,700). However, paragraph 10 (ACC 10,700.10), which provides guidance as to what constitutes vendor-specific objective evidence (VSOE) of fair value of the elements of a software arrangement, states, in part: "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 VSOE of fair value of all the elements of an arrangement.

Scenario No. 1—The existence of a substantive renewal rate for PCS 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 SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions (ACC 10,770). That amount should be recognized as revenue when the criteria in paragraph 8 of SOP 97-2 (ACC 10,700.08) are satisfied. The amount allocated to PCS should be recognized pursuant to the requirements of paragraph 57 of SOP 97-2 (ACC 10,700.57). 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.

Scenario No. 2—Because there is no substantive renewal rate for PCS, there is no VSOE of fair value of the PCS 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 PCS. Accordingly, pursuant to paragraphs 12 and 58 of SOP 97-2 (ACC 10,700.12 and .58), the initial fee should be recognized ratably over the period that the vendor expects to provide PCS because there is no contractual term for the PCS. The usage-based fee should be recognized at the time a reliable estimate can be made of the actual usage that has occurred, provided collectibility is probable.

Scenario No. 3—The usage-based fee represents payment for both the perpetual license right and PCS. 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.

Footnotes (TIS Section 5100 — Revenue Recognition):

fn 1 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.

fn 2 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, or
c. a right to further develop the technology received into a product.

fn 3 Assumes that vendor-specific objective evidence of fair value exists and the transaction has a business purpose.

fn 4 A software vendor that receives any of the following would be receiving something other than inventory:
a. a product or technology that only can be used internally (e.g., a financial or management application)
b. a product or technology that only can be used internally to make a product but which does not become part of the product.