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Software Revenue Recognition

A Roadmap to Applying AICPA Statement of Position 97-2

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Contents

Preface

Issued in October 1997, AICPA Statement of Position (SOP) 97-2, *Software Revenue Recognition*, provides detailed guidance on accounting for revenue associated with software and software-related arrangements. At the time of its issuance, SOP 97-2 primarily applied to companies that sold software. Increasingly, however, companies in other industries (e.g., manufacturing, retail, service) have become subject to the provisions of SOP 97-2 because more and more of the products these companies sell rely on software to function.

Such accounting is complex, which has led to the issuance of additional guidance, such as subsequent SOPs, Technical Practice Aids, EITF Issues, and SEC guidance. Even with this additional guidance, many of the increasing number of companies affected by SOP 97-2 still find it difficult to navigate the complexity of the SOP's provisions.

This Roadmap is a response to those concerns; it not only addresses many revenue recognition issues raised in SOP 97-2 and related accounting literature but also includes interpretive guidance and examples after each corresponding paragraph of SOP 97-2. We hope this Roadmap helps financial statement preparers apply, and financial statement users understand, the more complex provisions of SOP 97-2.

Questions and Answers

Introduction

SOP 97-2
1. Statement of Position (SOP) 91-1, *Software Revenue Recognition*, was issued in 1991 to provide guidance on applying generally accepted accounting principles to software transactions and to narrow the range of revenue recognition practices that were in use before its issuance. Since the issuance of SOP 91-1, practice issues have been identified that the AICPA's Accounting Standards Executive Committee (AcSEC) believes are not addressed adequately in SOP 91-1. In addition, AcSEC believes some of the guidance in SOP 91-1 should be reconsidered. This SOP supersedes SOP 91-1.

1-1: Background of SOP 97-2

SOP 97-2[1] was issued on October 27, 1997, by the AcSEC[2] of the AICPA. On March 31, 1998, the AcSEC issued SOP 98-4, which discusses deferral of the effective date of a provision of SOP 97-2. In December 1998, the AcSEC issued its most recent SOP on software revenue recognition, SOP 98-9, which addresses the modification of SOP 97-2 with respect to certain transactions. Furthermore, the AICPA staff issued TPAs that provided additional guidance on accounting and reporting issues associated with SOP 97-2 (see Q&As 1-2 and 1-3).

1-2: AICPA Technical Practice Aids — Background and Level of Authority

Question

What are the TPAs, and what level of authority do they have?

Answer

The TPAs are technical questions and answers. Certain TPAs (see Q&A 1-3) address specific implementation issues for SOP 97-2, identified by the Software Revenue Task Force of the AICPA Accounting Standards Division (Task Force). Although TPAs are in the lowest level of the GAAP hierarchy (i.e., "other accounting literature"), as set out in SAS 69, the TPAs mentioned above contain the best available guidance on transactions that are within the scope of SOP 97-2. All software TPAs were reviewed by the SEC staff and the AcSEC Planning Subcommittee before issuance.

1-3: AICPA Technical Practice Aids — Transition Requirements

Question

What are the transition requirements for newly released TPAs?

[1] Throughout this publication, short forms of the standards are used. For the full citations, please see Appendix D.

[2] For the full forms of acronyms, please see Appendix C.

Answer

TPAs should be applied prospectively for transactions entered into after the TPA release date (i.e., the date the TPA is posted on the AICPA's Web site). The SEC staff has informally agreed not to object to prospective application of a TPA but has indicated that it will not accept such application when it believes the current accounting is egregious.

The first three sets of TPAs were distributed without a release date, the last two sets with a release date. In the May 24, 2002, release, the AICPA listed the following release dates for all relevant TPAs:[3]

January 8, 1999 — TIS Sections 5100.38–.44

November 5, 1999 — TIS Sections 5100.45–.49

May 8, 2000 — TIS Sections 5100.50–.59

December 29, 2000 — TIS Sections 5100.60–.69

May 24, 2002 — TIS Sections 5100.70–.74

February 7, 2003 — TIS Sections 5100.75–.76

Scope

SOP 97-2

2. This SOP provides guidance on when revenue should be recognized and in what amounts for **licensing**, selling, leasing, or otherwise marketing computer software.[1] It should be applied to those activities by all entities that earn such revenue. It does not apply, however, to revenue earned on products or services containing software that is incidental[2] to the products or services as a whole.

Footnote 1 — Terms defined in the glossary are set in **boldface** type the first time they appear in this SOP.

Footnote 2 — Indicators of whether software is incidental to a product as a whole include (but are not limited to) (*a*) whether the software is a significant focus of the marketing effort or is sold separately, (*b*) whether the vendor is providing postcontract customer support, and (c) whether the vendor incurs significant costs that are within the scope of FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*. An example of the applicability of this SOP to revenue earned on products containing software is included in appendix A ["Examples of the Application of Certain Provisions of This Statement of Position"].

2-1: Entities That Have Arrangements Within the Scope of SOP 97-2

Question

What types of entities may have arrangements that are within the scope of SOP 97-2?

[3] For the full text of these TPAs, please see Appendix A.

Answer

In addition to entities in the software industry, entities that should consider whether they earn revenue from licensing, selling, leasing, or otherwise marketing software include those in the networking, telecommunications equipment, computer hardware, electronic, and semiconductor industries. As a result, even companies that do not consider themselves software companies (e.g., manufacturers, retailers, and service providers), should consider the application of SOP 97-2. This list may lengthen as products and services become "smarter" through technology. The application of SOP 97-2 in these industries will sometimes have no effect on the measurement of revenue or on the timing of revenue recognition. In certain circumstances, however, the effect can be dramatic.

EITF Issue 03-5 contains guidance on making the scope determination. The Task Force consensus states:

> In an arrangement that includes software that is more than incidental to the products or services as a whole, software and software-related elements are included within the scope of SOP 97-2. Software-related elements include software products and services . . . as well as any non-software deliverable(s) for which a software deliverable is essential to its functionality. For example, in an arrangement that includes software, computer hardware that will contain the software, and additional unrelated equipment, if the software is essential to the functionality of the hardware, the hardware would be considered software-related and, therefore, included within the scope of SOP 97-2. However, because the software is not essential to the functionality of the unrelated equipment, the equipment would not be considered software-related and would, therefore, be excluded from the scope of SOP 97-2. [Footnote omitted]

2-1.1: Examples of Company Disclosures Applying SOP 97-2 to Recognize Revenue

Question

What are some examples of recent company disclosures that apply SOP 97-2 to recognize revenue?

Answer

The following table lists examples of company disclosures that apply SOP 97-2 when recognizing revenue:

Company	Industry	Company's Description of Business	Excerpts From Description of Company's Revenue Recognition Policy
Palm, Inc.	Personal computers	"Palm, Inc. is a leading provider of mobile computing solutions. Our leadership is the result of creating devices that make it easy for end users to manage and communicate with others in their lives, to access and share their most important information and to avail themselves of the power of computing wherever they are. We design our devices to appeal to consumer, professional, business, education and government users around the world. We currently offer Treo™ smartphones as well as handheld computers, add-ons and accessories. We distribute these products through a network of wireless carriers and retail and business distributors worldwide."	"Revenue is recognized when earned in accordance with applicable accounting standards, including SOP 97-2, as amended. Revenue from software arrangements with end users is recognized upon delivery of the software, provided that collection is probable and no significant obligations remain. Deferred revenue is recorded for PCS and any other future deliverables, and is recognized over the support period or as the elements of the agreement are delivered. VSOE of the fair value of the elements contained in software arrangements is based on the price determined by management having the relevant authority when the element is not yet sold separately, but is expected to be sold in the marketplace within six months of the initial determination of the price by management."
Network Appliance, Inc.	Computer storage devices	"Network Appliance is a supplier of enterprise storage and data management software and hardware products and services. Our solutions help global enterprises meet major information technology challenges such as managing storage growth, assuring secure and timely information access, protecting data and controlling costs by providing innovative solutions that simplify the complexity associated with managing corporate data. Network Appliance solutions are the data management and storage foundation for many of the world's leading corporations and government agencies."	"The company recognizes revenue in accordance with SOP 97-2. Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the fee is fixed or determinable, collectibility is probable. Revenues from software upgrade and maintenance arrangements, premium hardware maintenance services and storage review services are recognized ratably over the contractual term. For arrangements with multiple elements, we recognize revenue using the residual method. For our undelivered software-related elements, we apply the provisions of SOP 97-2 and determine fair value of these undelivered elements based on VSOE. If VSOE cannot be obtained to establish fair value of the undelivered elements, paragraph 12 of SOP 97-2 would require that revenue from the entire arrangement be initially deferred and recognized ratably over the period these elements are delivered."

Company	Industry	Company's Description of Business	Excerpts From Description of Company's Revenue Recognition Policy
Hewlett-Packard and subsidiaries	Diversified computer systems	"HP is a leading global provider of products, technologies, software, solutions and services to individual consumers, small and medium sized businesses ("SMBs"), large enterprises, including the public and education sectors. Our offerings span personal computing and other access devices, imaging and printing-related products and services, enterprise information technology infrastructure, including enterprise storage and server technology, enterprise system and network management software, and multi-vendor customer services, including technology support and maintenance, consulting and integration and managed services."	"HP recognizes revenue when persuasive evidence of a sales arrangement exists, delivery occurs or services are rendered, the sales price or fee is fixed or determinable and collectibility is reasonably assured. When a sales arrangement contains multiple elements, such as hardware and software products, licenses and/or services, HP allocates revenue to each element based on its relative fair value, or for software, based on VSOE of fair value. In the absence of fair value for a delivered element, HP first allocates revenue to the fair value of the undelivered elements and the residual revenue to the delivered elements. Where the fair value for an undelivered element cannot be determined, HP defers revenue for the delivered elements until the undelivered elements are delivered. HP limits the amount of revenue recognition for delivered elements to the amount that is not contingent on the future delivery of products or services or subject to customer-specified return or refund privileges. HP uses the residual method to allocate revenue to software licenses at the inception of the license term when VSOE for all undelivered elements, such as Post Contract Support, exists and all other revenue recognition criteria have been satisfied."

Company	Industry	Company's Description of Business	Excerpts From Description of Company's Revenue Recognition Policy
International Business Machines Corporation	Information technology	"IBM is a globally integrated innovation company, serving the needs of enterprises and institutions worldwide. The company seeks to be a partner in its clients' success by enabling their own capacity to innovate, so that they may differentiate themselves for competitive advantage in a globalized economy. IBM views enterprise innovation not only in terms of products and services, but across all dimensions of a business: its business processes, business model, management systems, culture and role in society. To help clients achieve growth, effectiveness, efficiency and the realization of greater value through innovation, IBM draws upon the world's leading systems, software and services capabilities."	"Revenue from perpetual license software is recognized at the inception of the license term while term license software is recognized on a subscription basis over the period that the client is entitled to use the license. Revenue from maintenance, unspecified upgrades on a when-and-if-available basis and technical support is recognized over the period such items are delivered. A software multiple-element arrangement is separated into more than one unit of accounting if all of the following criteria are met: • The functionality of the delivered element(s) is not dependent on the undelivered element(s); • There is VSOE of fair value of the undelivered element(s). VSOE of fair value is based on the price charged when the deliverable is sold separately by the company on a regular basis and not as part of the multiple-element arrangement; and • Delivery of the delivered element(s) represents the culmination of the earnings process for that element(s). If the criteria are not met, the arrangement is accounted for as one unit of accounting which would result in revenue being recognized on a straight-line basis or being deferred until the earlier of when such criteria are met or when the last undelivered element is delivered."

Company	Industry	Company's Description of Business	Excerpts From Description of Company's Revenue Recognition Policy
Oracle Corporation	Application software	"Oracle develops, manufactures, markets, distributes and services database and middleware as well as applications software that helps organizations manage and grow their businesses. Database and middleware software is used for developing and deploying applications on the internet and on corporate intranets. Applications software can be used to automate business processes and to provide business intelligence. We also offer software license updates and product support and other services including consulting, advanced product services, and education."	"While the basis for software license revenue recognition is substantially governed by the provisions of SOP 97-2, we exercise judgment and use estimates in connection with the determination of the amount of software and services revenues to be recognized in each accounting period. For software license arrangements that do not require significant modification or customization of the underlying software, we recognize new software license revenue when: (1) we enter into a legally binding arrangement with a customer for the license of software; (2) we deliver the products; (3) customer payment is deemed fixed or determinable and free of contingencies or significant uncertainties; and (4) collection is probable. If an arrangement does not qualify for separate accounting of the software license and consulting transactions, then license revenue is generally recognized with consulting services based on contract accounting. For arrangements with multiple elements, we defer revenue for any undelivered elements, and recognize revenue when the product is delivered or over the period in which the service is performed. If we cannot objectively determine the fair value of any undelivered element included in bundled arrangements, we defer revenue until all elements are delivered and services have been performed, or until fair value can objectively be determined for any remaining undelivered elements."
Rambus, Inc.	Semiconductors and related devices	"Rambus, Inc., invents and licenses chip interface technologies that are foundational to nearly all digital electronics products. Our chip interface technologies are designed to improve the time-to-market, performance, and cost-effectiveness of our customers' semiconductor and system products for computing, communications and consumer electronics applications."	"Rambus' revenue recognition policy is based on SOP 97-2 as amended by SOP 98-4 and SOP 98-9. Rambus recognizes revenue when persuasive evidence of an arrangement exists, Rambus has delivered the product or performed the service, the fee is fixed or determinable and collection is reasonably assured. If any of these criteria are not met, Rambus defers revenue until such time as all criteria are met."

2-2: Up-Front Services in "Hosting" Arrangements

Hosting arrangements may require the performance of additional services. Such services may include implementation, systems integration, and customization services that are performed up front (i.e., before the beginning of the hosting period). These services may be significant and may occur over an extended period (e.g., two weeks to six months or longer). EITF Issue 00-3 requires that hosting arrangements be accounted for as service transactions if (1) the customer does not have the right to take possession of the software at any time during the arrangement without significant penalty and (2) it is not feasible for the customer either to run the software on its own or to contract with another vendor to host the software. Therefore, the software element is outside the scope of SOP 97-2.

Question

How should revenue and costs related to up-front services in "hosting" arrangements accounted for as service transactions be recognized?

Answer

SAB Topic 13.A.3(f) (see Appendix B) provides guidance on accounting for services, including up-front services, and requires an evaluation of whether the up-front services constitute a separate earnings process. In a hosting arrangement, such services do not constitute a separate earnings process if:

- The up-front services are a necessary and inseparable part of obtaining the hosting services.
- The up-front services have little or no value to the customer in the absence of the hosting arrangement.
- The customer cannot buy the up-front services or the hosting services separately from a third party without significant diminution in the value of the other element.

In these circumstances, the entire arrangement should be accounted for as a single element and any amounts attributable to the up-front services should be deferred until the hosting period begins. Revenue should be recognized (1) over the initial contractual hosting period or (2) over the expected customer relationship period if the customer is expected to benefit from the fees attributable to the up-front services upon renewal of the hosting contract (see footnote 39 in Question 1 of SAB Topic 13.A.3(f)).

Regarding the costs of performing up-front services, Question 3 of SAB Topic 13.A.3(f) indicates that "set-up" costs associated with ongoing customer acquisitions (e.g., precontract-type activities) are not considered "start-up" costs under SOP 98-5. Accordingly, costs incurred during the performance of up-front services that are deemed to be incremental and direct set-up costs may be either (1) expensed as incurred or (2) deferred and charged to expense proportionally over the same period that deferred revenue is recognized as revenue. Questions 4–5 of SAB Topic 13.A.3(f) provide additional guidance on accounting for and identifying such costs.

2-3: Example of a "Hosting" Arrangement

Entity Q, a software vendor, offers its office productivity package in an online format whereby a user accesses a Web site and stores files on a secure server. The applications will always be maintained at the most up-to-date version available, and customers have rights to telephone support. Customers are permitted to enter into this arrangement with either the vendor or one of the registered partners who will provide the same services. The customer will pay a fee of $200 for a one-year "right to use" license for software. Renewal fees are $200 for each subsequent year renewed. The customer does not have the ability to take physical delivery of the software.

Question

Is this arrangement within the scope of SOP 97-2?

Answer

No. The license cannot be unbundled from the hosting service because the customer is not permitted to take delivery and may only use the hosting service of Entity Q or its partners. Therefore, in accordance with EITF Issue 00-3, the arrangement is not within the scope of SOP 97-2. Entity Q should recognize the $200 over the one-year term of the arrangement once the customer has access to the software.

2-4: Examples of Arrangements in Which Software Is More Than Incidental to the Hardware

Example 1

Vendor Z (Z) designs, develops, manufactures, and installs broadband infrastructure components (hardware and related software) for wireless telecommunications. Vendor Z's products contain embedded software. Within the next year, Z plans to market software upgrades separately. These upgrades will enhance previously delivered software rather than render it obsolete. In addition, Z provides PCS for its products and has made numerous statements about the uniqueness of its software and the advantage it has over the competition. Vendor Z has also disclosed that it incurs significant costs for software R&D.

Example 2

Company A (A), a public company, designs, manufactures, and sells high-performance network data storage devices for data-intensive network environments (file servers). Company A includes operating and protocol software in the file servers that it ships to customers; A also sells its protocol software, but not its operating software, separately. Both types of software are essential to the functionality of the file servers. In addition, A offers customers PCS and the software is a significant focus of its marketing efforts.

Question

Are the sales of products in these examples within the scope of SOP 97-2?

Answer

Yes, the products in both examples would be within the scope of 97-2.

In Example 1, the software is not incidental to Z's products since it plays an integral role in the company's marketing efforts, which focus on using noncustomized software upgrades to proof Z's products from technical obsolescence. In addition, the company provides PCS and incurs significant costs that are within the scope of Statement 86. Therefore, SOP 97-2 would apply.

In Example 2, the software is more than incidental to the arrangement since A offers its customers PCS and the software is a significant focus of its marketing efforts. Therefore, SOP 97-2 would apply.

2-5: License Versus Sale of Software

The scope of SOP 97-2 encompasses revenue recognition for both licenses and sales of software.

Question

Under SOP 97-2, is accounting for software licenses different from accounting for sales of software?

Answer

No. The basic principles are the same. Although software arrangements generally are structured as licenses rather than sales to protect vendors from unauthorized duplication of their software, the rights transferred in software licensing arrangements are virtually the same as the rights transferred in sales. This legal distinction is generally not a reason to account for a license and an outright sale differently.

2-6: Comparison of SOP 97-2 and SAB Topic 13 (Part I)

Question

What topics of SAB Topic 13 may apply to software arrangements?

Answer

SAB Topic 13 includes additional discussion of the following topics:

- **Definition of an Arrangement** — Persuasive evidence of an arrangement is one of the four SOP 97-2 criteria that must be met for revenue recognition. Both SOP 97-2 and SAB Topic 13 discuss the need to evaluate the company's previous business practices as part of an arrangement. However, footnote 3 in SAB Topic 13.A.1 further clarifies the definition of "arrangement." In addition, Question 1 of SAB Topic 13.A.2 discusses "side" agreements and the need to evaluate their impact on revenue recognition, and Question 2 of SAB Topic 13.A.2 covers the sale of goods on a consignment basis.

- **FOB Shipping Terms** — SAB Topic 13 discusses the impact of FOB shipping terms on revenue recognition. Although not addressed in SOP 97-2, the AICPA Task Force deliberated this issue and released TIS Section 5100.69, which refers vendors to the guidance in Question 3 of SAB Topic 13.A.3(a).

- **Customer Acceptance** — SOP 97-2 contains minimal guidance on the relationship between customer acceptance and revenue recognition. It does emphasize, however, that revenue should not be recognized until the customer acceptance criteria are met. Questions 1 and 3 of SAB Topic 13.A.3(b) provide detailed guidance on how the customer acceptance criteria affect revenue recognition. Question 1 of SAB Topic 13.A.3(b) also discusses the four general forms that most customer acceptance criteria take. TIS Section 5100.67 refers vendors to SAB Topic 13's guidance on customer acceptance.

- **Beginning of License Term** — SOP 97-2 does not provide guidance on the appropriate date for the beginning of a license term (i.e., the delivery date or license inception date). However, SAB Topic 13.A.3(d) and TIS Section 5100.70 clarify that revenue should not be recognized in a license before the inception of the license term.

- **Accounting for Various Cost Elements, Including Commissions and Other Deferred Costs** — SOP 97-2 discusses the requirements for revenue recognition but does not explicitly discuss accounting for the associated costs. SAB Topic 13 provides guidance on cost recognition in several sections. The response to Question 1 (including footnote 57) of SAB Topic 13.A.4(a) provides guidance on the deferral of costs when revenue is also deferred. Questions 4–5 of SAB Topic 13.A.3(f) provide further guidance on cost deferral (See also Q&A 2-2).

- **Consideration of the Relationship Period** — Question 1 (including footnote 39) of SAB Topic 13.A.3(f) provides guidance on the period over which deferred up-front fees should be recognized in income. SAB Topic 13 indicates that revenue generally should be recognized over the contractual period or the expected customer life, whichever is longer and more representative of the substance of the arrangement. Paragraphs 48–49 of SOP 97-2 discuss the period over which revenue should be recognized for subscriptions and require ratable recognition over the term of the arrangement beginning with delivery of the first product or, if there is no stated term, over the estimated economic life of the products covered by the arrangement beginning with delivery of the first product. Paragraphs 57–58 of SOP 97-2 discuss contractual PCS and require recognition over the contractual term of the PCS arrangement or, for implicit PCS, over the period during which PCS is expected (see also Q&A 59-1).

2-7: [Omitted]

2-8: Comparison of SOP 97-2 and SAB Topic 13 (Part II)

Question

What are some differences between SAB Topic 13 and SOP 97-2?

Answer

Bill and Hold — SAB Topic 13.A.3(a) provides guidance on bill-and-hold transactions, while SOP 97-2 does not. The AcSEC had considered a proposal to include bill-and-hold provisions in SOP 91-1. AcSEC members rejected that proposal because, given the nature of software, it was unlikely that there would be a valid business reason for delaying delivery. That is, it would be unlikely that a customer would (1) be unable to take delivery of the software and (2) request that the software be "put aside" for later delivery. (See also Q&A 22-2.)

Extended Payment Terms — In software arrangements, the inclusion of extended payment terms requires analysis of whether the arrangement fee is fixed or determinable. In addition, payment terms that extend beyond 12 months after delivery are subject to a presumption that the fee is not fixed or determinable. Various TPAs (TIS Sections 5100.41–.42 and 5100.57–.66) discuss revenue recognition for arrangements with extended payment terms. Nonsoftware arrangements with such terms are subject to APB Opinion 21 (as are software arrangements with extended payment terms for which the fee is fixed or determinable). The text of SAB Topic 13 does not specifically address extended payment terms. However, footnote 5 of SAB Topic 13.A.1 indicates that the SEC staff considers the guidance in paragraphs 26 and 30–33 of SOP 97-2 to apply to sales transactions for which no other authoritative guidance exists. Footnote 5 also indicates that entities should consider paragraphs 27–29 of SOP 97-2 in transactions involving a high risk of technological obsolescence.

2-9: Nonmonetary Transactions

Question

Does SOP 97-2 address arrangements involving nonmonetary transactions?

Answer

No. However, the TPAs address the application of Opinion 29, as amended by Statement 153, to the exchange of software licenses between entities. TIS Sections 5100.46–.47 address two types of transactions: (1) the exchange of software that is licensed to a customer for software to be licensed to a customer (or included as a component of software to be licensed) and (2) the exchange of software that is licensed to a customer for software for internal use.

2-10: Examples of SEC Comments on SOP 97-2

Question

What are some of the comments registrants have received from the SEC staff regarding the application of SOP 97-2 and the related disclosures?

Answer

The following are examples of the types of comments and questions registrants have received from the SEC staff regarding the registrant's revenue recognition (or lack thereof) and policy disclosure under SOP 97-2:

General

- How did you decide that SOP 97-2 or SOP 81-1 was (not) applicable?
- How do you meet each of the requirements in paragraph 8 of SOP 97-2?
- Why do you believe recognizing revenue ratably over the period is appropriate?
- Are you providing software on a hosted basis?
- How do you account for specified upgrade rights?
- It appears that software is important to your products.
- Discuss in detail your consideration of SOP 97-2.
- Tell us why you believe your software is incidental to the product.

Multiple Elements

- How do you account for multiple-element arrangements?
- How do you recognize revenue for licenses when incentives (options, warrants, or discounts) are involved?
- How do you determine VSOE of fair value — renewal rates, separate sales, or the residual method?
- How do you have VSOE to establish the fair value of support and maintenance? Is the renewal rate for support and maintenance stated in the license agreement? Do you have separate sales of support and maintenance (i.e., actual renewals)? If so, is the renewal amount you received consistent with the renewal rate stated in the original agreement?
- How are you classifying revenues on bundled arrangements (e.g., license vs. service revenue)?
- Do you provide any services that are essential to the functionality of your software?
- Explain how you account for revenues derived from custom engineering and integration services offered in connection with the design of special hardware and software.
- Disclose whether you account for elements in your multiple-element arrangements by using the separate-element or the residual method of accounting.

Collectibility and Payment Terms

- How do you determine collectibility when conducting business with start-up customers that have no history?
- How are you able to estimate returns on your reseller arrangements so that you do not have to perform sell-through recognition of revenue?
- How do your customer acceptance provisions affect your ability to recognize revenue?
- What kinds of vendor financing arrangements are available to customers, and how have you evaluated those in terms of your revenue recognition policies?
- SOP 97-2 states that any extended payment terms, even those that do not extend beyond 12 months, may indicate that a fee is not fixed or determinable. This is the case regardless of the creditworthiness of the customer. Tell us what normal payment terms are by type of business and class of customer. Clarify the nature of the extended payment terms and why your revenue recognition policy complies with SOP 97-2.

Disclosure

- Disclose how you define VSOE of fair value.
- Disclose the nature of your arrangements with strategic partners.
- Disclose whether you account for elements in your multiple-element arrangements by using the separate-element or the residual method of accounting.
- Disclose how you account for specified upgrade rights, or state that you do not provide specified upgrade rights. See paragraph 38 of SOP 97-2.

2-11: Software Upgrade for Hardware

Company F (F) produces hardware that is being upgraded to a new version. Because the company still has numerous units of the current version of the hardware, it has created a software program to upgrade the current version of the hardware to the new version and will include this software at no additional cost with all sales of the current version until these units are completely sold. Users will not encounter major differences between the two versions of the hardware. The company will not be providing additional support for the upgrade and has not incurred significant costs to create it.

Question

Should F record the revenue from the sale of the software in accordance with SOP 97-2?

Answer

No. As noted in footnote 2 in paragraph 2 of SOP 97-2, indicators of software that is incidental to other products include a lack of significant focus of the marketing effort, software that is not sold separately, lack of PCS, and no significant costs incurred within the scope of Statement 86. Therefore, this software upgrade is deemed incidental to the hardware sold by F and would not be accounted for under SOP 97-2.

2-12: Determination of Whether Significant Costs Are Incurred in a Hosting Arrangement

EITF Issue 00-3 states that "a software element covered by SOP 97-2 is only present in a hosting arrangement if the customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty and it is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software." Footnote 1 of Issue 00-3 further defines "significant penalty" as containing "two distinct concepts: (a) the ability to take delivery of the software without incurring significant cost and (b) the ability to use the software separately without a significant diminution in utility or value."

Question

How should vendors determine whether a hosting arrangement allows the customer to take delivery of the software without incurring significant costs?

Answer

The accounting literature does not contain specific guidance on how to determine the components to be included in measuring the amount of the penalty or the benchmark against which a vendor should measure the amount of the penalty when determining whether that penalty is significant; this determination depends on the facts and circumstances of the arrangement. As indicated by many examples from other GAAP standards, amounts above 10 percent would be considered significant under Issue 00-3. In the example below, the penalty is greater than 10 percent as measured against two benchmarks — the license fee and the arrangement fee (see Q&A 2-13 for the detailed calculation). Establishing a method of determining the components to measure the penalty and the benchmark is an accounting policy decision that a vendor should apply consistently.

Example

Company X (X) enters into hosting arrangements with end customers. Assume that X enters into a contract with the following characteristics:

- Three-year hosting contract.
- Cancellation notice of 180 days.
- Up-front payment of $500,000.
- Monthly hosting payments of $25,000.

The contract also gives the customer a perpetual license to the software, with one year of bundled PCS. A renewal rate is established for PCS at $100,000 per year, and would be paid regardless of whether the customer takes possession of the software (i.e., the PCS payments are incremental to the monthly hosting charges). The customer can take possession of the software at any time. To do so, however, the customer would have to cancel the hosting contract. VSOE of fair value for the software with one year of PCS is $500,000, as established by contracts entered into separately and apart from hosting contracts.

2-13: Calculation of a Significant Penalty

Question

Is a significant penalty included in the above contract?

Answer

Yes. Although the customer has the right to take possession of the software at any time, the customer must first provide six months' notice to cancel the hosting contract. Accordingly, the penalty would be equal to the six months of hosting fees, or $150,000 (i.e., $25,000 × 6). Arguably, significance can be measured by using either the software fee itself (i.e., $150,000 ÷ $500,000 = 30%) or the total noncancelable arrangement fee (i.e., $150,000 ÷ [$500,000 + $150,000] = 23%). In either scenario, the penalty is well above 10 percent. Therefore, under Issue 00-3, this hosting arrangement would not contain a software element covered by SOP 97-2 and would be accounted for as a service contract.

2-14: Hosting Penalties When a Customer Takes Possession of the Software Without Incurring Significant Cost

Assume that the contract in Q&A 2-13 is restructured so that the customer can take delivery of the software at any time without first canceling the hosting contract. The customer would have the right to an additional copy of the software and could run the software independently on the customer's own systems and servers either as part of a parallel structure or for a specific subsidiary. The customer is given this right for no or nominal consideration.

Question

Even though the customer does not have to pay a significant penalty to take possession of the software, is the second requirement of footnote 1 of Issue 00-3 (i.e., the customer can use the software separately without a significant diminution in utility or value) met?

Answer

A vendor must first determine whether the customer's right to take delivery of the software without incurring significant cost is substantive. Some questions to consider include:

- Does the customer have multiple sites and locations? If so, can the customer run the software independently of the hosting arrangement without incurring penalties? That is, if minimum transaction volumes are required under the hosting contract, are they low enough to allow for multiple sites?
- Are the costs of running parallel or multiple copies of the software inconsequential or perfunctory?

If the vendor concludes that the customer would be unable to use the software without a significant diminution in utility or value, the arrangement would be accounted for as a service contract under Issue 00-3.

2-15: Reassessment of Revenue Recognition Accounting Policies

Question

What are the SEC staff's views on when revenue recognition accounting policies should be reassessed?

Answer

The SEC staff has indicated that revenue recognition accounting policies should be reassessed whenever there are changes in circumstances or contractual provisions for revenue arrangements. This was communicated by G. Anthony Lopez, associate chief accountant in the Office of the Chief Accountant, in a speech at the 2004 AICPA National Conference on Current SEC and PCAOB Developments. He reminded participants how changes in revenue arrangements and an entity's circumstances can affect revenue recognition accounting policies. The following is an excerpt from his speech:

> [C]hanges in circumstances or contractual provisions must be constantly considered in determining whether revenue recognition policies are still appropriate. While this is true for all areas of accounting, the nature and complexity of revenue arrangements when combined with the complexity of an accounting model that has very different guidance for different earnings processes, means that revenue recognition is an area where policies may need to be updated more often than other areas. We have noted that registrants sometimes make an initial assessment of the appropriate revenue recognition policy and do not update that policy as their business changes. For example, if a registrant initially sells products, but its business arrangements evolve to include intellectual property or service deliverables, then SOP 97-2, SAB Topic 13, or other literature may require that such arrangements be accounted for as subscription or service arrangements, which would, of course, have an entirely different revenue recognition pattern. The situation is especially troubling for financial statement users if companies that have basically the same revenue arrangements wind up using vastly different revenue recognition policies simply because their business models took different paths to get to the same place.
>
> Companies in technology industries, where the environment is often rapidly changing, must be particularly alert to these kinds of situations. A specific example of this that commonly arises is the evolution of software embedded in products or used to provide services and how that evolution may change a registrant's previous conclusion that the software is incidental to those products or services. As you may know, if software is deemed more-than-incidental to a product or a service, it must be accounted for as software under SOP 97-2. . . .
>
> My comments . . . are intended to encourage registrants and auditors to be proactive by developing procedures to periodically re-assess their revenue recognition policies in light of changes in facts and circumstances. When such re-assessments are done, it is important for registrants to document the considerations and conclusions they made about the changing nature of the product or service offerings and related impacts on the accounting. That documentation may be useful to registrants in deciding what information to include in their revenue recognition policy footnote. [Footnote omitted]

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3. In connection with the licensing of an existing product, a vendor might offer a small discount (for example, a coupon or other form of offer for five percent off) on additional licenses of the licensed product or other products that exist at the time of the offer but are not part of the arrangement. Such marketing and promotional activities are not unique to software and are not included in the scope of this SOP.[3]

Footnote 3 — As discussed in paragraph .09, arrangements may include multiple elements. If 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 .09) is being offered in the arrangement.

3-1: Significant Incremental Discounts

Question

How should significant incremental discounts be accounted for under SOP 97-2?

Answer

TIS Section 5100.51 provides guidance, including examples, on how a vendor should account for significant incremental discounts within the scope of SOP 97-2. The examples in TIS Section 5100.51 assume that VSOE of fair value equals list price. Note, however, that fair value (i.e., the price at which the element is sold separately) is usually not list price. Thus, a 10 percent discount off list price on purchases of additional products would not fall under footnote 3 of SOP 97-2 if this discount is typical.

3-2: Example of a Discount Offered on the Future Purchase of Additional Copies of a Software Product in an Arrangement

Company A (A) enters into an arrangement to provide 1,000 copies of Software Product X (X) to Customer B (B) for a fixed fee of $20,000. This is the usual price that A charges for 1,000 copies of X. Under the arrangement, B can purchase copies of Software Product Z (Z) for $25 per copy. Company A normally sells copies of Z for $30 per copy. Customer B is expected to purchase 1,000 copies of Z.

Question

In accounting for this arrangement, should A allocate a portion of the $5 discount on the 1,000 copies of Z expected to be purchased by B to the 1,000 copies of X?

Answer

Yes. The offer to provide copies of Z at a discount would be considered more than insignificant and, therefore, an element in the arrangement. The discount element would be determined as follows:

The VSOE of fair value would be $20,000 for X and $30 per copy for 1,000 copies, or $30,000, for Z. VSOE for the total arrangement would be $50,000. The total paid by B is $45,000, so the discount is 10 percent.

Therefore, A could recognize $18,000 ($20,000 fixed fee less the 10 percent discount) upon delivery of the first copy of X, as long as all other criteria for revenue recognition are met. Revenue would also be recognized on Z ($27,000 for 1,000 copies) upon delivery of the first copy of this software product, provided that all other criteria for revenue recognition are met.

3-3: Discounts on Future Upgrades and Enhancements

Company X (X) licenses software products bundled with one year of PCS. PCS may be renewed annually and includes telephone support and bug fixes but no right to future upgrades or enhancements. The company has VSOE of fair value of PCS. Company X is changing its PCS arrangements. The company will now offer its customers that purchase PCS a 50 percent discount on unspecified future enhancements and upgrades to the software product during the PCS term. Customers that do not purchase PCS will not be entitled to this discount.

Question

Does the discount create a presumption that any additional elements are being offered in the arrangement, as discussed in footnote 3 of SOP 97-2?

Answer

No, if X offers this discount to all customers that purchase PCS, the discount does not create a presumption that any additional elements are being offered in the arrangement. Rather, the discount on the unspecified upgrades and enhancements is a feature of the PCS arrangement. This is no different from free, unspecified upgrades or enhancements that are, by definition, part of PCS.

3-4: Early Renewal of Term Arrangement Without VSOE of Fair Value of PCS

Company V (V) entered into a two-year license arrangement with a customer on January 1, 20X4. The total license and PCS fees are $240,000, which were paid at the beginning of the license period and are nonrefundable. Company V does not sell PCS separately and, therefore, does not have VSOE of fair value for PCS. Thus, V recognizes the total arrangement fee ratably over the license term ($10,000 per month). On November 1, 20X5, when $20,000 deferred revenue remains, V and the customer enter into a two-year renewal arrangement for 80 percent of the original license fee, or $192,000. The period covered by the renewal is November 1, 20X5, through October 31, 20X7. That is, the final two months of the original arrangement are encompassed by the new arrangement, and the $20,000 prepayment remaining on the old arrangement is applied to the new arrangement. Therefore, the customer is required to pay only $172,000 ($192,000 – $20,000) to renew the arrangement through October 31, 20X7.

Question

If all other criteria for revenue recognition have been met, how should V account for the early renewal of its license arrangement?

Answer

Company V should recognize the entire arrangement fee, plus the remaining deferred revenue under the original license arrangement, ratably over the new license term (i.e., V should recognize $8,000 per month ([$20,000 + $172,000] ÷ 24 months) through October 31, 20X7). The substance of the new arrangement is that V offered the customer an incentive of a discounted renewal rate for a 24-month period that includes two months covered by the prior arrangement. Therefore, V granted its customer a 20 percent discount on the $10,000 monthly fee for the last two months of the initial arrangement (i.e., $2,000 per month, or a total amount of $4,000) in addition to a reduction in the fee for the remaining 22 months.

EITF Issue 01-9 addresses the accounting for sales incentives. Issue 1 of Issue 01-9 addresses the income statement characterization of incentives granted to customers. It requires that cash consideration (including a sales incentive) given by a vendor to a customer be characterized as a reduction of revenue unless (1) the vendor receives, or will receive, an identifiable benefit (goods or services) in exchange for the consideration and (2) the vendor can estimate reasonably the fair value of the benefit identified under condition (1). Since V did not receive any separate benefit from its customer for granting the sales incentive, V should recognize the sales incentive as a reduction of revenue.

Issue 4 of EITF Issue 01-9 requires that "a sales incentive offered voluntarily by a vendor and without charge to customers that can be used or that becomes exercisable by a customer as a result of a single exchange transaction, and that will not result in a loss on the sale of a product or service," should be recognized at the later of:

"a. The date at which the related revenue is recognized by the vendor.

b. The date at which the sales incentive is offered."

Accordingly, V should recognize the sales incentive when the related revenue is recognized. That is, V should reduce revenue recognized over the last two months of the original license term by the sales incentive of $2,000 per month. The remaining deferred revenue ($20,000 – 16,000 = $4,000) and the new license fee of $172,000 should be recognized ratably over the new license period of 22 months (i.e., $8,000 per month [($172,000 + $4,000) ÷ 22 months]).

Early Renewal of Term Arrangement With VSOE of Fair Value of PCS

TIS Sections 5100.70–.74 provide accounting guidance for term licenses when VSOE of fair value exists for PCS.

Relationship to Other Pronouncements

SOP 97-2
4. If a lease of software includes property, plant, or equipment, the revenue attributable to the property, plant, or equipment should be accounted for in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 13, *Accounting for Leases,* and any revenue attributable to the software, including **postcontract customer support (PCS)**, should be accounted for separately in conformity with the guidance set forth in this SOP. However, in conformity with paragraph .02, if the property, plant, or equipment contains software that is incidental to the property, plant, or equipment as a whole, the software should not be accounted for separately.
5. A number of the requirements of this SOP are similar to or overlap those in certain pronouncements of the Accounting Principles Board (APB) or the FASB, such as FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*. This SOP does not alter the requirements of any APB Opinion or FASB pronouncement.

4-1: Leases Involving Hardware and Software

Question

How should revenue be allocated between the hardware and software elements in a lease that includes both hardware and software elements when VSOE of fair value does not exist for any of the software elements and the software is not incidental to the hardware?

Answer

Statement 13 provides guidance on how to allocate consideration in leases involving real estate. This guidance is also applicable to other arrangements involving leased equipment. Paragraph 27 of Statement 13 states:

> If a lease involving real estate also includes equipment, the portion of the minimum lease payments applicable to the equipment element of the lease **shall be estimated by whatever means are appropriate in the circumstances.** The equipment shall be considered separately for purposes of applying the criteria in paragraphs 7 and 8 and shall be accounted for separately according to its classification by both lessees and lessors. [Emphasis added]

In addition, footnote 2 of Issue 00-21 states, in part:

> [F]or purposes of the allocation between deliverables within the scope of higher-level literature and deliverables not within the scope of higher-level literature, an entity's best estimate of fair value is not limited to vendor-specific objective evidence of fair value or third-party evidence of fair value . . . .

Footnote 3 goes on to provide an example involving leased equipment, stating:

> For example, leased assets are required to be accounted for separately under the guidance of Statement 13. Consider an arrangement that includes the lease of equipment under an operating lease, the maintenance of the leased equipment throughout the lease term (executory cost), and the sale of additional equipment unrelated to the leased equipment. The arrangement consideration should be allocated between the Statement 13 deliverables and the non-Statement 13 deliverables on a relative fair value basis using the entity's best estimate of fair value of the Statement 13 and non-Statement 13 deliverables. (Although Statement 13 does not provide guidance regarding the accounting for executory costs, it does provide guidance regarding the allocation of arrangement consideration between the lease and the executory cost elements of an arrangement. Therefore, this example refers to the leased equipment and the related maintenance as Statement 13 deliverables.) The guidance in Statement 13 would then be applied to separate the maintenance from the leased equipment and to allocate the related arrangement consideration to those two deliverables. This Issue would be applied to further separate any non-Statement 13 deliverables and to allocate the related arrangement consideration.

Accordingly, given the absence of specific guidance in SOP 97-2, the guidance in Statement 13 and Issue 00-21 should be applied to software arrangements that include leased equipment. To estimate the minimum lease payments, the vendor should allocate the arrangement consideration between the equipment and software elements on the basis of its best estimate of relative fair value.

Amounts attributable to the software would be accounted for pursuant to SOP 97-2, including the requirement for VSOE of fair value if there are multiple software elements. However, the hardware would be accounted for under Statement 13, including lease classification under paragraphs 7 and 8.

Conclusions

SOP 97-2
6. The following conclusions should be read in conjunction with the *Basis for Conclusions* section, beginning with paragraph .93 of this SOP, and the examples in appendix A, *Examples of the Application of Certain Provisions of This SOP* [paragraph .146].

Basic Principles

SOP 97-2

7. Software arrangements range from those that provide a license for a single software product to those that, in addition to the **delivery** of software or a software system, require significant production, modification, or customization of software. If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the entire arrangement should be accounted for in conformity with Accounting Research Bulletin (ARB) No. 45, *Long-Term Construction-Type Contracts*, using the relevant guidance herein, and in SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* [section 10,330].[4]
8. If the arrangement does not require significant production, modification, or customization of software, revenue should be recognized when all of the following criteria are met.
    - Persuasive evidence of an arrangement exists.
    - Delivery has occurred.
    - The vendor's fee is fixed or determinable.
    - Collectibility is probable.[5]
9. Software arrangements may provide licenses for multiple software deliverables (for example, software products, **upgrades/enhancements**, PCS, or services), which are termed multiple *elements*. A number of the elements may be described in the arrangement as being deliverable only on a **when-and-if-available** basis. When-and-if-available deliverables should be considered in determining whether an arrangement includes multiple elements. Accordingly, the requirements of this SOP with respect to arrangements that consist of multiple elements should be applied to all additional products and services specified in the arrangement, including those described as being deliverable only on a when-and-if-available basis.

Footnote 4 — If a software arrangement includes services that meet the criteria discussed in paragraph .65 of this SOP, those services should be accounted for separately.

Footnote 5 — The term *probable* is used in this SOP with the same definition as used in FASB Statement No. 5, *Accounting for Contingencies*.

9-1: Definition of an Element

Question

What is a software element as defined in SOP 97-2?

Answer

"Software element" is not specifically defined in SOP 97-2. Paragraph 9 of SOP 97-2 lists "software products, upgrades/enhancements, PCS, or services" as examples of software elements but does not offer a more precise definition. EITF Issue 03-5, however, provides clarification, stating that software-related elements include software products and services such as those listed in paragraph 9 of SOP 97-2 (see above), as well as any nonsoftware deliverable(s) for which a software deliverable is essential to its functionality. For example, in an arrangement that includes software, computer hardware that will contain the software, and additional unrelated equipment, if the software is essential to the functionality of the hardware, the hardware would be considered software-related and, therefore, would be within the scope of SOP 97-2. However, if the software is not essential to the functionality of the unrelated equipment, the equipment would not be considered software-related and would be outside the scope of SOP 97-2.

9-2: Accounting for "Free" Software

Some hardware and software vendors offer free software on their Web sites. This free software generally is downloaded from the vendor's Web site for use on the vendor's hardware or in conjunction with other software being sold by the vendor. Examples of free software include datebook planners and organizers, expense tracking programs, and games. Sometimes the vendor develops the software, sometimes the vendor pays others to develop the software, and sometimes the vendor obtains and offers the software without charge.

Question

Does the offer of free software by a vendor constitute an "element" that affects revenue recognition for other products?

Answer

It depends. If an arrangement between a vendor and a customer specifies that free software products will be offered in the future, the value of those products should be considered in accounting for the arrangement under SOP 97-2 even if they will be offered on a when-and-if-available basis. In addition, a vendor's practice of offering its customers free software may cause customers to expect the delivery of other free software in the future. Thus, a customer entering into an arrangement with that vendor may reasonably expect, on the basis of the vendor's past practice, delivery of additional software at no charge. In contrast, a vendor may offer free software on its Web site to both customers and noncustomers. For example, anyone can download Adobe's Acrobat® software for free. In this case, the free software would not be considered in evaluating the accounting for a specific arrangement since the customer would have the right to download the software regardless of its current arrangement with the vendor. The following examples illustrate this point:

Example 1

Vendor V (V) produces hardware consoles that are sold with software included; the software is more than incidental to the product. Vendor V posts a software program on its Web site. The program works on multiple platforms and does not require the user to be a customer of V to access or use the software. Furthermore, the user is not required to purchase hardware from V before downloading the software from V's Web site.

In this example, revenue recognition would not be affected, since the software can be accessed and used independently of V's hardware console and is available to anyone who accesses the Web site.

Example 2

Vendor V (V) produces hardware consoles that are sold with software included; the software is more than incidental to the product. Programmer P wishes to place a new software product on V's Web site. Programmer P is offering V the software for free. Therefore, V is not charging users who download the program.

In this example, revenue recognition would not be affected regardless of whether the program can be used on platforms other than V's. Programmer P is merely using V's Web site to distribute the program.

Example 3

Vendor V (V) produces hardware consoles that are sold with software included; the software is more than incidental to the product. Vendor V distributes programs to its current customers; these programs are usable only on V's hardware platform.

In this example, revenue recognition would probably be affected since (1) the software cannot be used independently of V's hardware console and is, therefore, usable only by V's customers, and (2) V has created an expectation in its customers that additional products will be delivered free of charge.

9-3: Indemnifications: Inherent Component of Software License

Question

The standard software license agreement of a software vendor includes a clause that provides for indemnification for liabilities and damages arising from any claims of patent, copyright, trademark, or trade secret infringement by the software vendor's software. Is this indemnification considered an element under SOP 97-2?

Answer

No, this type of indemnification is not an element that can be separated from the software; rather, it is an inherent component of the software license itself and is similar to a standard warranty. (See also Q&A 14-2.)

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

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

The amount allocated to undelivered elements is not subject to later adjustment.[6] However, if it becomes probable that the amount allocated to an undelivered element will result in a loss on that element of the arrangement, the loss should be recognized pursuant to FASB Statement No. 5, *Accounting for Contingencies*. 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.

Footnote 6 — This does not apply to changes in the estimated percentage of customers not expected to exercise an upgrade right. See paragraph .37.

10-1: VSOE of Fair Value for Elements Not Sold Separately

Question

Paragraph 10 of SOP 97-2 limits the evidence that qualifies as VSOE of fair value. Does an element of an arrangement that has already been introduced into the marketplace have to be sold on a stand-alone basis in order to have VSOE of fair value?

Answer

Yes. SOP 97-2's requirement for a separate sale to validate fair value was controversial throughout the SOP's development. This requirement was more restrictive than that of (1) any existing literature that applies to bundled arrangements that do not include software and (2) SOP 91-1 (superseded by SOP 97-2). Under SOP 91-1, if remaining vendor obligations were deemed insignificant, the arrangement fee could be recognized and the costs of the insignificant obligations could be accrued. Under SOP 97-2, insignificant obligations may be considered elements that must be measured separately at fair value.

For software arrangements, the separate-sale requirement has been particularly onerous because, in many such arrangements, some of the elements are never sold separately. The most common arrangement involves software bundled with first-year PCS. Although PCS may be sold separately in subsequent years, the software is never sold separately. Likewise, the PCS would never be sold separately since it is directly associated with the software product. However, paragraph 57 of SOP 97-2 clarifies that PCS "should be determined by reference to the price the customer will be required to pay when it is sold separately (that is, the renewal rate)." Thus, although PCS is never sold separately at the inception of an arrangement, it is sold separately from the license in PCS renewal periods, satisfying the requirements of paragraph 10.

10-2: Elements Sold Separately Infrequently

Question

Would the sale of a software product as a separate element represent VSOE of fair value if the software is sold separately infrequently?

Answer

It depends. The vendor should closely evaluate whether infrequent separate sales of an item constitute sufficient VSOE of the current fair value of the element. The vendor specifically would need to evaluate the timing of the most recent sales in evaluating the relevance of the sale to fair value. For example, if a significant amount of time has elapsed since the last sale, the market may have changed and the sales price in the last sale may not represent the VSOE of fair value of the element.

10-3: Other Considerations in Determining VSOE of Fair Value

Question

Should vendors consider factors other than those described in Q&As 10-1 and 10-2 when determining VSOE of fair value?

Answer

Yes. Vendors should consider the following additional factors when determining whether there is sufficient VSOE of fair value:

- **For Items Sold Separately** — A vendor could use historical pricing information. If prices vary significantly, however, the vendor may be unable to use separate sales prices. To conclude that separate sales prices provide sufficient evidence of VSOE of fair value, a vendor must demonstrate that these prices are highly concentrated around a specific point and within a narrow range. For example, if 90 percent of a vendor's separate sales of PCS during the past 12 months were priced between 15 percent and 17 percent of the net license fee, it may be appropriate to conclude that such separate sales prices constitute evidence of fair value.

On the other hand, if the vendor's separate sales prices reflected the following distribution, it would be inappropriate to conclude that VSOE exists:

Sales Price as a Percentage of Net License Fee	Percentage of Separate Sales
2% to 5%	20%
5% to 10%	30%
10% to 15%	35%
15% to 20%	15%

In evaluating whether separate sales prices are sufficiently concentrated to establish VSOE, a vendor should consider whether the population of separate sales needs to be stratified. Stratification may be required if the vendor has different pricing practices for different types of transactions or products. For example, a vendor may provide larger discounts to large blue-chip customers than it does to its smaller customers. In these situations, the dispersion of separate sales prices of the entire population may be wide, but the dispersion of separate sales prices for transactions with large blue-chip customers may be much less.

Stratification should be based on objective criteria associated with a particular transaction. Factors that may affect pricing, and that a vendor should therefore consider in determining whether the population of separate sales should be stratified, include, but are not limited to:

1. Customer type.
2. Distribution channel.
3. Transaction size or volume (i.e., license fee, number of users).
4. Geographic location.
5. Products sold.
6. The size of the discount granted to a customer would not be a sufficient basis for stratifying the population.
7. If separate sales prices are sufficiently concentrated for a vendor to establish VSOE, a reasonable method of establishing fair value is to use the weighted average of the more recent prices charged for actual transactions when (1) there is some variability in the prices charged and (2) no unusual circumstances or events exist.

- **For Items Not Yet Sold Separately** — When a vendor's management establishes a price for an element not yet sold separately, it should be probable that the element will actually be sold separately for the established price. The price established for an element that the vendor does not have the ability or intent to sell separately would not constitute VSOE of fair value. Factors that may affect whether it is probable that the price will not change include (1) the time between the announcement and the actual sale of the product and (2) whether the vendor has announced the intended price to its customers.

  Assume that Vendor A (A) sells a one-year term license that includes PCS. Vendor A's management has determined that if the company were to sell the PCS separately, the price charged would be 15 percent of the license fee. However, A has never sold PCS separately and does not intend to do so in the future. The 15 percent rate would not constitute VSOE of fair value for the PCS.

- **New Products Versus Existing Products** — The provisions of SOP 97-2 apply both to existing products that have not been sold separately in the past and to products currently under development. In each situation, management with the appropriate level of authority should establish the price, and it should be probable that the price will not change before the actual sale of the product as a separate element. Vendors should also consider selling elements separately to establish VSOE of fair value (e.g., establishing hourly rates for services performed by the vendor).

10-4: List Price Used as VSOE of Fair Value

Question

Can the list price of a product be used as VSOE of fair value (or in the absence of VSOE of fair value) of an element in a multiple-element arrangement?

Answer

The list price of a product can be used only if the list price represents VSOE of fair value. Software vendors often offer customers discounts from the list price; the undiscounted list price may not represent VSOE of fair value. See Q&A 10-3 for further discussion about determining VSOE of fair value. Also, see Q&A 11-1 on allocation of discounts in multiple-element arrangements.

10-5: Penalties Used as VSOE of Fair Value

Question

If a multiple-element arrangement stipulates a penalty for not delivering a certain element, would the amount of the penalty represent VSOE of fair value?

Answer

Parties to an arrangement can set penalties for nonperformance on the basis of factors including, but not limited to, the fair value of the undelivered element. These other factors could indicate that the amount of the penalty is not VSOE of fair value. See Q&A 10-3 for further discussion about determining VSOE of fair value and Q&A 10-4 for discussion of when list price may represent VSOE of fair value.

10-6: Multiple Elements Accounted for as a Single Element

Question

Paragraph 10 of SOP 97-2 discusses VSOE of fair value in the context of each element in a multiple-element arrangement. If an arrangement includes multiple elements, can a group of elements be considered a single element under SOP 97-2?

Answer

Yes. Although EITF Issue 00-21 excludes software elements included in multiple-element arrangements, its guidance is applicable by analogy. This Issue refers to units of accounting that may consist of more than one deliverable. Two elements that are sold together may be treated as one element for unbundling purposes. For example, an arrangement may include a three-year term license for software and PCS that typically are sold together and services that are sold separately. The software and PCS may be treated as a single element — i.e., the arrangement fee would be allocated on the basis of the VSOE of fair value of the software and PCS as a single element, and services would be treated as a separate element.

Example

A software vendor enters into an arrangement to deliver Software Products A, B, and C to a customer. Product A is sold separately; VSOE of fair value can be established on that basis. Products B and C are always sold together, never separately; therefore, VSOE of fair value does not exist separately for Products B and C. However, since Products B and C are always sold together, VSOE of fair value does exist on a combined basis (i.e., the price charged when the products are sold together). Under these circumstances, Products B and C can be combined and treated as a single element in the arrangement.

10-7: VSOE of Fair Value for Nonsoftware Elements

Question

Do the VSOE rules of SOP 97-2 (as discussed in paragraph 10) apply to nonsoftware elements of an arrangement in which software elements are more than incidental?

Answer

No. EITF Issue 03-5 states that in an arrangement that contains nonsoftware deliverables, only software and software-related elements are within the scope of SOP 97-2. Accordingly, elements not defined as software or software-related elements (as defined in Issue 03-5) should be separated from the software elements in accordance with Issue 00-21.

10-8: Residual Value as Evidence of VSOE of Fair Value

Question

Assume that a company enters into a multiple-element arrangement in which VSOE of fair value exists for the undelivered element (Product B) but not for the delivered element (Product A). The company uses the residual value method to allocate the arrangement fee, as detailed in SOP 98-9 (i.e., the portion allocated to Product A is the total arrangement fee less the fair value of Product B). If the company enters into a subsequent multiple-element arrangement in which VSOE of fair value is required for Product A, can the portion of the arrangement fee allocated to Product A under the residual method in the first arrangement be used as VSOE of fair value in the subsequent arrangement?

Answer

No. The amount allocated to a particular element in an arrangement under the residual method does not represent VSOE of fair value. VSOE of fair value should be determined in accordance with paragraph 10 of SOP 97-2.

SOP 97-2
11. If a discount is offered in a multiple-element arrangement, a proportionate amount of that discount should be applied to each element included in the arrangement based on each element's fair value without regard to the discount. However, as discussed in paragraph .37, no portion of the discount should be allocated to any upgrade rights. Moreover, to the extent that a discount exists, the residual method described in paragraph .12 attributes that discount entirely to the delivered elements. [Paragraph 11 was amended, effective for transactions entered into in fiscal years beginning after March 15, 1999, by paragraph .06(a) of SOP 98-9.]

11-1: Allocation of Discounts in Multiple-Element Arrangements

Paragraph 11 of SOP 97-2 discusses the allocation of discounts in a multiple-element arrangement.

Question

Can a discount be allocated on the basis of relative list prices?

Answer

Not unless the list price is VSOE of fair value (i.e., the price at which the element is sold separately). Note that a discount should be allocated to the elements of an arrangement on the basis of relative VSOE of fair values, which may not be the same as relative list prices.

11-2: Whether Discounts in Multiple-Element Arrangements Should Be Allocated to All Elements

Question

Does a discount offered in a multiple-element arrangement have to be allocated to all elements in the arrangement?

Answer

Yes, with two exceptions:

- Multiple-element arrangements that include a specified upgrade right. Paragraph 37 of SOP 97-2 provides that no discount is allocated to the specified upgrade right.
- Application of the residual method. With the use of the residual method, the entire discount is allocated to the delivered elements.

SOP 97-2

12. If sufficient vendor-specific objective evidence does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement should be deferred until the earlier of the point at which (*a*) such sufficient vendor-specific objective evidence does exist or (*b*) all elements of the arrangement have been delivered. The following exceptions to this guidance are provided.
    - If the only undelivered element is PCS, the entire fee should be recognized ratably (see paragraphs .56 through .62).
    - If the only undelivered element is services that do not involve significant production, modification, or customization of software (for example, training or installation), the entire fee should be recognized over the period during which the services are expected to be performed (see paragraphs .63 through .71).
    - If the arrangement is in substance a subscription, the entire fee should be recognized ratably (see paragraphs .48 and .49).
    - If the fee is based on the number of copies, the arrangement should be accounted for in conformity with paragraphs .43 through .47.
    - There may be instances in which there is vendor-specific objective evidence of the fair values of *all* undelivered elements in an arrangement but vendor-specific objective evidence of fair value does not exist for one or more of the delivered elements in the arrangement. In such instances, the fee should be recognized using the residual method, provided that (*a*) all other applicable revenue recognition criteria in this SOP are met and (*b*) the fair value of all of the undelivered elements is less than the arrangement fee. Under the residual method, the arrangement fee is recognized as follows: (*a*) the total fair value of the undelivered elements, as indicated by vendor-specific objective evidence, is deferred and (*b*) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements. [Paragraph 12 was amended, effective for transactions entered into in fiscal years beginning after March 15, 1999, by paragraph .06(b) of SOP 98-9.]

13. The portion of the fee allocated to an element should be recognized as revenue when the criteria in paragraph .08 of this SOP are met with respect to the element. In applying those criteria, the delivery of an element is considered not to have occurred if there are undelivered elements that are essential to the functionality of the delivered element, because the **customer** would not have the full use of the delivered element.

13-1: Accounting for Arrangements in Which Undelivered Elements Are Essential to the Functionality of the Delivered Elements

Paragraph 13 of SOP 97-2 states, in part, "[T]he delivery of an element is considered not to have occurred if there are undelivered elements that are essential to the functionality of the delivered element . . . ." SAB Topic 13 uses the same concept.

Question

What accounting applies in a multiple-element software arrangement when undelivered elements are essential to the functionality of the delivered elements?

Answer

In general, there are two possible methods of accounting for multiple-element arrangements in which the undelivered elements are essential to the functionality of the delivered elements: (1) no revenue on the arrangement is recognized until the undelivered elements have been delivered or (2) the arrangement is accounted for under SOP 81-1. (For further discussion of the circumstances in which application of SOP 81-1 is, or may be, appropriate, see paragraphs 7, 64, 69, and 74 of SOP 97-2, as well as other related paragraphs included in the SOP's "Basis for Conclusions.")

13-2: Application of the Concept "Essential to the Functionality"

Question

Does the guidance on "essential to the functionality" apply to products as well as services?

Answer

Yes. Although most of the guidance in SOP 97-2 focuses on "essential to the functionality" in the context of services, it is clear from the general guidance and the examples in Appendix A that vendors are also required to consider whether additional undelivered products are essential to the functionality of the delivered elements.

Paragraph 13 of the SOP states, in part, that "the delivery of an element is considered not to have occurred if there are undelivered elements that are essential to the functionality of the delivered elements, because the customer would not have the full use of the delivered element." The same concept is reflected in paragraph 105 of SOP 97-2 in the "Basis for Conclusions," which states:

> AcSEC believes that if an undelivered element is essential to the functionality of a delivered element, the customer does not have full use of the delivered element. Consequently, AcSEC concluded that delivery is considered not to have occurred in such situations.

Further, paragraph 116 in the "Basis for Conclusions" states, in part:

> *Delivery* — AcSEC believes that until delivery of an element has occurred (including delivery of all other items essential to the functionality of the element in question), the customer has not received full use of the element ordered. A customer that has not received full use of the element ordered is likely to withhold payment or require a refund. Therefore, AcSEC believes that requiring collectibility of a receivable, related to the sale or license, acts to verify that the element has been delivered.

Two examples in Appendix A, "Additional Software Products — Price per Copy — Example 1" and "Multiple Element Arrangements — Products — Example 1," describe product deliverables under an arrangement. In both examples, one product is described as "not deliverable" and "not essential to the functionality" of the other delivered products.

To determine whether an undelivered item is essential to the functionality, a vendor should review the terms of the sales contract. For example, if the delivered product was purchased with a promise to deliver an upgrade and the upgrade is not delivered, a portion of the arrangement fee would be considered subject to forfeiture, refund, or another concession (see paragraph 14 of SOP 97-2).

13-3: [Omitted]

13-4: Involvement of Third-Party Vendors

In certain arrangements, a vendor may sell software that requires the use of third-party hardware provided by the vendor or can be purchased directly by the customer. A question arises about whether delivery of the software has occurred if the hardware has not been delivered by the third party.

Question

Under what circumstances should the vendor recognize revenue even if the hardware has not been delivered?

Answer

Provided that all other revenue recognition criteria have been met, revenue should be recognized if:

- The software vendor is not reselling the hardware as part of the arrangement.
- The software vendor is not required to refund any portion of the license fee if the third-party hardware vendor fails to deliver.
- The software vendor does not intend to grant — and has no history of granting — refunds, forfeitures, or other concessions if the third-party hardware vendor fails to deliver the hardware.

13-5: Software Used With Multiple Units of an Electronic Device

A company produces software and related electronic devices (for example, tracking software and electronic devices). The software is more than incidental to the electronic devices, the software has no utility without the electronic devices, and the electronic devices have no utility without the software. The company sells the software with one or more electronic devices, and sells additional devices on a stand-alone basis. According to the guidance in EITF Issue 03-5, the electronic devices (hardware) would be accounted for under SOP 97-2 because the software is essential to its functionality. The system works with one device, but is more cost-effective if multiple devices are used with the software. The arrangement requires that the customer purchase, for a fixed fee, the software and only one electronic device, but permits the customer to purchase a specified number of additional devices at a specified additional price per unit.

Question

If all other criteria for revenue recognition are met, should any portion of the fixed fee be deferred and recognized as the additional devices are delivered?

Answer

No. As long as the additional devices are not being sold at a significant incremental discount, no portion of the fixed fee should be deferred and recognized as the additional devices are delivered (see Q&A 3-1). Because the software can be used once the customer has one electronic device, the company should recognize the fixed fee at the time the company delivers the software and the first electronic device to the customer. Revenue for each additional component sold should be recognized at the time of delivery.

Example

Company L (L) manufactures software to track the location of receivers (via a global positioning satellite system) that are installed in automobiles; L also sells the receivers separately. Under its standard arrangement, L sells a package of the software and one receiver for $500; it sells each additional receiver for $100. Company L should recognize $500 in revenue at the time of the delivery of the first package of the software and receiver and $100 at the time of delivery of each additional receiver, provided that all other revenue recognition requirements have been met.

SOP 97-2

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

- Acknowledgment in the arrangement of products not currently available or not to be delivered currently
- Separate prices stipulated in the arrangement for each deliverable element
- Default and damage provisions as defined in the arrangement
- Enforceable payment obligations and due dates for the delivered elements that are not dependent on the delivery of the future deliverable elements, coupled with the intent of the vendor to enforce rights of payment
- Installation and use of the delivered software
- Support services, such as telephone support, related to the delivered software being provided currently by the vendor

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

14-1: Forfeiture or Refund Clauses

Paragraph 14 of SOP 97-2 states, in part, "No portion of the fee (including amounts otherwise allocated to delivered elements) meets the criterion of collectibility if the portion of the fee allocable to delivered elements is subject to forfeiture, refund, or other concession if any of the undelivered elements are not delivered."

Question

Would the vendor always be required to defer the entire arrangement fee if any portion of the fee is refundable?

Answer

No. Although a literal interpretation of paragraph 14 of SOP 97-2 might support an affirmative answer, the AcSEC's intent was that, in practice, recognition of only the portion of the fee allocated to the delivered item that is subject to refund, forfeiture, or another concession should be precluded. Sometimes the amount subject to refund, forfeiture, or another concession because of failure to deliver an element may be greater than the VSOE of fair value of the undelivered element. In these situations, the vendor would still be required to defer an amount equal to the portion of the fee that is subject to refund, forfeiture, or another concession.

Example

Vendor A enters into a software agreement that calls for the delivery of the following separate elements:

Element	VSOE of Fair Value
X	$ 500
Y	1,000
Z	250

The total fee for the arrangement of $1,750 was paid by the customer at the inception of the agreement. Elements X and Y have been delivered; however, the agreement contains a provision stating that the customer will receive a $400 refund if Element Z is not delivered. In this case, provided that all other requirements for revenue recognition have been met, $400 of the arrangement fee should be deferred until Element Z is delivered and the amount is no longer subject to forfeiture.

14-2: Indemnifications: Effect on Revenue Recognition

Question

As part of its standard software license agreement, a software vendor includes a clause that provides for indemnification for liabilities and damages arising from any claims of patent, copyright, trademark, or trade secret infringement by the software vendor's software. Paragraph 14 of SOP 97-2 indicates that no portion of an arrangement fee meets the criterion of collectibility if the portion of the fee allocable to delivered elements is subject to forfeiture, refund, or other concession if any of the undelivered elements are not delivered. Would an indemnification provision require a vendor to defer revenue recognition under the premise that the fees received may be refundable in certain instances?

Answer

No. As indicated in Q&A 9-3, this type of indemnification is not an element that can be separated from the software; rather, it is an inherent component of the software license itself, similar to a standard warranty. Accordingly, it would not be considered an undelivered element in a software arrangement and it would not affect revenue recognition. An indemnification of this type is addressed in FSP FIN 45-1.

Evidence of an Arrangement

SOP 97-2
15. Practice varies with respect to the use of written contracts. Although a number of sectors of the industry rely upon signed contracts to document arrangements, other sectors of the industry that license software (notably the packaged software sector) do not.
16. If the vendor operates in a manner that does not rely on signed contracts to document the elements and obligations of an arrangement, the vendor should have other forms of evidence to document the transaction (for example, a purchase order from a third party or on-line authorization). If the vendor has a customary business practice of utilizing written contracts, evidence of the arrangement is provided only by a contract signed by both parties.
17. Even if all other requirements set forth in this SOP for the recognition of revenue are met (including delivery), revenue should not be recognized on any element of the arrangement unless persuasive evidence of an arrangement exists.

16-1: Whether a Customer's Letter of Intent Represents Persuasive Evidence of an Arrangement

Paragraph 8 of SOP 97-2 states that revenue should be recognized only when, among other criteria, persuasive evidence of an arrangement exists. If the vendor intends to obtain a signed agreement or has a history of obtaining signed agreements, then the only evidence of an arrangement that would be acceptable would be an agreement signed by both the vendor and the customer.

Question

If a vendor has a history of using signed contracts and an existing customer issues a letter of intent that refers to a previous written contract, would this represent persuasive evidence of an arrangement?

Answer

No. The customer's letter of intent would not provide persuasive evidence of an arrangement if the vendor intends to obtain a written contract or has a history of using written contracts. Even if the customer had sent a signed letter of intent, whether the final terms will mirror the terms in the letter of intent is still uncertain; in such circumstances, therefore, the only acceptable evidence is a contract signed by both parties.

16-2: How Master Agreements Affect Evidence of an Arrangement

Question

How do master agreements affect evidence of an arrangement?

Answer

Some vendors use master agreements that establish the basic terms and conditions for transactions with the customer. However, additional documentation may be required for specific goods or services. For example, a specific purchase order or statement of work may be required. If the vendor's standard practice is to establish the conditions for the delivery of specific goods or services in a document that supplements the master agreement, the provisions of both the master agreement and the supplementary documentation must be executed for there to be persuasive evidence of the arrangement.

16-3: Definition of an Arrangement

Question

What is an arrangement as defined in SOP 97-2?

Answer

SOP 97-2 does not define the term "arrangement." However, the SOP indicates that an arrangement may be explicit or implicit as demonstrated by a vendor's practice, a purchase order, a single contract, or multiple contracts. If a vendor has a history of using signed contracts, then revenue should be deferred until the vendor obtains a valid contract that has been signed by both parties and all other requirements for revenue recognition have been met. In addition, the vendor should be cautious when using a customer-generated standard contract. In such circumstances, the customer's contract may include terms that are different from the vendor's standard terms and that may have a significant impact on revenue recognition.

The following examples illustrate persuasive evidence of an arrangement:

Example 1

Vendor B's (B) customers can access blank order forms and licensing agreements from B's Web site. Vendor B's customers complete these documents and send them in to order software. Upon receipt of the documents, B ships the software and invoices the customers. Vendor B's vice president of sales reviews the documents and signs the license agreements. The vice president of sales may not sign the license agreements for several days after the order is shipped.

As long as all other requirements for revenue recognition have been met, B should not recognize revenue from the above transactions until the vice president of sales has signed the license agreements.

Example 2

Vendor N (N) entered into an agreement with Customer R (R) for the sale of a customized software solution. The parties documented the agreement in a two-page letter of intent. The letter of intent states that the parties intend to formalize the agreement with a contract.

Because the letter of intent states that a contract will be negotiated, the terms of the contract will govern the arrangement and should be used to determine the appropriate revenue recognition for the contract. Vendor N will not meet the criterion for persuasive evidence of an arrangement until the contract is completed and signed by both N and R.

While a contract signed by N and R will meet the criteria for persuasive evidence of an arrangement, the contract needs to sufficiently describe the terms of the arrangement to serve as a basis for revenue recognition. If the contract does not include all the terms (e.g., payment terms) necessary to determine the appropriate revenue recognition for the contract, revenue should not be recognized until all the terms are finalized and all other requirements for revenue recognition have been met.

Example 3

Vendor D (D) develops software for telecommunications service providers. Vendor D has a purchase agreement with Customer P (P) that requires a signed purchase order from P prior to shipment. Before D's year-end, D shipped software in response to an e-mail sent from the manager of purchasing at P notifying D that P had approved the order. Shortly thereafter but after year-end, D received a signed hard copy of the purchase order. Vendor D has a history of shipping to P without a signed purchase order, but P has never returned a product to D.

Provided that all other requirements for revenue recognition have been met, the facts and circumstances of this particular transaction would allow recognition of revenue. SOP 97-2 requires persuasive evidence of an arrangement. In this instance, P's manager of purchasing sent an e-mail authorizing the shipment and the signed purchase order was sent shortly thereafter. The conduct of the companies and the specific facts surrounding this arrangement would allow the e-mail authorization to be considered persuasive evidence of the arrangement.

16-4: Side Agreements

The software industry is intensely competitive, and a vendor's sales and marketing staff may enter into "side agreements" with customers. These side agreements often amend or change the provisions of the master or original agreement with the customer, which, in turn, may affect the recognition of revenue.

Question

How do side agreements affect the evaluation of persuasive evidence of an arrangement?

Answer

Side agreements should be evaluated on a case-by-case basis to determine whether and how they affect the terms of the arrangement and thereby revenue recognition. A practice of entering into side agreements raises questions about what constitutes persuasive evidence of an arrangement and when, in fact, an arrangement has been consummated.

Delivery

SOP 97-2
18. The second criterion in paragraph .08 for revenue recognition is delivery. The principle of not recognizing revenue before delivery applies whether the customer is a **user** or a **reseller**. Except for arrangements in which the fee is a function of the number of copies, delivery is considered to have occurred upon the transfer of the product master or, if the product master is not to be delivered, upon the transfer of the first copy. For software that is delivered electronically, the delivery criterion of paragraph .08 is considered to have been met when the customer either (*a*) takes possession of the software via a download (that is, when the customer takes possession of the electronic data on its hardware), or (*b*) has been provided with access codes that allow the customer to take immediate possession of the software on its hardware pursuant to an agreement or purchase order for the software. In such cases, revenue should be recognized if the other criteria of paragraph .08 have been satisfied.

18-1: Delivery in a Hosting Arrangement Within the Scope of SOP 97-2

Question

When is delivery deemed to occur in a hosting arrangement that is within the scope of SOP 97-2?

Answer

Revenue may not be recognized in a software arrangement if delivery of the software has not yet occurred. EITF Issue 00-3 indicates that when, in a hosting arrangement, the customer has the contractual right to take possession of the software at any time during the term of the arrangement without a significant penalty, "delivery of the software occurs when the customer has the ability to take immediate possession of the software."

Example

Vendor X (X), a software vendor, offers its courseware, a foreign language instruction course, in an online format that the customer can access via a Web site for a one-time $100 up-front fee. The customer has the right to access the Web site for one year, and once a customer purchases a certain language course, the course never changes during the access period. At any time during the arrangement, the customer can also obtain a copy of the course on CD-ROM with a perpetual license for an additional $5. The $5 charge for the CD-ROM equals X's costs and is not considered a significant penalty. The customer can renew the hosting arrangement for one-year increments for $10. The vendor has subcontracted out its obligations to host the software to an ASP, which will place the course on its Web site server and allow the customer to access the courseware at this Web site.

Because the customer has the right to take possession of the software at any time during the term of the arrangement without significant penalty, the arrangement is within the scope of SOP 97-2 and delivery is deemed to have occurred at the time the customer can contractually obtain a copy of the course on CD-ROM. In these circumstances, X meets the criteria to account for the transaction as a sale of separate elements — a software license and a hosting service. In addition, X has established VSOE of fair value of the hosting service. Accordingly, if all other requirements for revenue recognition have been met, X should recognize $90 once the customer has the ability to take possession of the software and $10 over the one-year term of the hosting arrangement.

18-2: Nonrefundable Licensing Fee Example

On December 20, 20X1, Company A (A) enters into an agreement to license its software to Customer B (B) for a five-year period beginning on January 1, 20X2. As dictated by the agreement, B pays a nonrefundable fee of $750,000 upon execution of the agreement on December 20, 20X1. Vendor A delivers the software product on December 25, 20X1, for use by B beginning on January 1, 20X2. PCS is provided separately and is priced at 15 percent of the license fee, renewable on an annual basis. There are no other elements in the arrangement.

Question

When should A recognize the $750,000 fee for the software product license?

Answer

As long as all other criteria for revenue recognition have been met, the $750,000 license fee should be recognized when the license term begins (i.e., on January 1, 20X2), in accordance with TIS Section 5100.70. This is consistent with the guidance in SAB Topic 13.A.3(d). The PCS fee should be recognized over the PCS term, which begins at inception of the license term.

18-3: License Extension Fee Example

Assume the same facts as in Q&A 18-2 except that on December 20, 20X6, Company A (A) and Customer B (B) execute an agreement to extend the license period for another year. Under the agreement, B pays a nonrefundable extension fee of $500,000 on December 20, 20X6.

Question

When should A recognize the $500,000 extension fee for the software product license?

Answer

In accordance with TIS Section 5100.71, the entire fee should be recognized immediately when received or when collectibility is probable, provided that all other requirements for revenue recognition have been met. Since the $500,000 represents an extension fee for the original license, the entire arrangement would be analogous to a six-year license with extended payment terms. Under paragraphs 27–29 of SOP 97-2, the fee is presumed not to be fixed or determinable in such circumstances. If this presumption cannot be overcome, revenue is recognized as payments from the customer become due (as long as all other conditions for revenue recognition are met). In this example, the $500,000 fee would be analogous to an extended payment on the original license. Since the fee would have been presumed not to be fixed or determinable at the inception of the initial license (A and B may or may not have contemplated an extension of the license period but, in any case, negotiated the fee after the inception of the original license agreement), the fee would be recognized when it becomes due. Therefore, A should recognize the fee immediately when paid by B on December 20, 20X6, provided that all other requirements for revenue recognition have been met.

18-4: "Synthetic FOB Destination" Shipping Terms

Certain companies whose terms include FOB shipping have practices or arrangements with their customers that result in the seller's continuing to bear risk of loss or damage while the product is in transit. If damage or loss occurs, the seller is obligated to provide the buyer with replacement products at no additional cost. The seller may insure this risk with a third party or may "self-insure" the risk.

These types of shipping terms are commonly referred to as "synthetic FOB destination." Because the seller has retained risk of loss or damage during transit, not all risks and rewards of ownership have been substantively transferred to the buyer. Therefore, to recognize revenue before the product is delivered to the buyer would not be appropriate.

Question

Does the concept of "synthetic FOB destination" apply when a software license is delivered via a disk or CD-ROM?

Answer

Generally, no. Paragraph 18 of SOP 97-2 notes that delivery does not have to involve a tangible product. Under SOP 97-2, electronic download, or simply providing access codes to facilitate an electronic download, can constitute delivery. Further, the tangible disk or CD-ROM has little to no value in a software license agreement, since the software vendor can replace the disk or file at any time during the agreement, not just during shipment, if it becomes corrupted.

A software license conveys the right to use an intangible product for a specified time. In a software license involving intangible products, unlike one involving tangible products such as disks or CD-ROMs, the concept of risks and rewards of ownership that gives rise to synthetic FOB destination concerns does not apply.

SOP 97-2
19. Paragraphs .20 through .25 provide guidance on determining whether delivery is considered to have occurred in certain kinds of software transactions.

19-1: Electronic Delivery via Download

Question

Paragraph 18 of SOP 97-2 discusses electronic delivery of software. If software is delivered electronically, is delivery considered to have occurred if the customer has not downloaded the software?

Answer

Vendors often provide software to customers electronically. Delivery can be considered to occur even if the customer has not yet actually received (i.e., downloaded) the software as long as the customer has immediate access to the software. However, software that is delivered electronically without any obligation of the customer to pay would be accounted for the same (i.e., no revenue would be recognized) as a disk that is mailed to individuals who are not required to pay for it until they decide to accept it (see paragraph 20 of SOP 97-2).

Delivery — Customer Acceptance

SOP 97-2
20. After delivery, if uncertainty exists about customer acceptance of the software, license revenue should not be recognized until acceptance occurs.

20-1: Customer Acceptance Provisions — Deemed Acceptance

Question

Some contracts include acceptance provisions for deemed acceptance. What is "deemed acceptance"?

Answer

Deemed acceptance contract terms limit the customer's acceptance rights. That is, the customer has limited time to accept the software, Unless the customer indicates, in writing, reasons for nonacceptance, acceptance is deemed to have occurred upon expiration of the predetermined time limit.

20-2: Customer Acceptance Provisions That Are Tied to the Payment Terms

Question

When all other requirements for revenue recognition have been met, would customer acceptance provisions that are tied to the payment terms preclude revenue recognition until payment is made or due?

Answer

It depends. If payment for the product is tied to customer acceptance, then the acceptance provisions would be presumed substantive. Therefore, provided that all other requirements for revenue recognition have been met, revenue recognition would be precluded until payment is made or due unless that presumption is overcome.

20-3: Customer Acceptance Example

Vendor P (P) has entered into an arrangement with Customer S (S) to deliver 10 copies of software to 10 different branch locations of S. The arrangement requires minor modifications to the software; however, the arrangement does not meet the requirements in SOP 97-2 for contract accounting. Once the modifications have been made to the software, a factory acceptance test (FAT) is performed. The FAT consists of loading the software, as modified, onto hardware at P's site to show the customer that all significant performance criteria have been met. Once the FAT is complete and the customer accepts the software, the software is shipped to S's locations and installed. After installation, a site acceptance test (SAT) is performed to ensure that the software functions on the customer's hardware as demonstrated in the FAT. Payment for the software is due upon successful completion of the SAT.

In this example, there are two points at which the vendor demonstrates that the software performs satisfactorily and at which the customer accepts the software. The vendor should assess the uncertainty of successfully completing the SAT to determine whether, provided that all other criteria for revenue recognition have been met, revenue can be recognized at delivery, which occurs subsequent to the FAT but before the SAT, or whether revenue should not be recognized until the SAT is completed. The vendor should also consider the significance of the timing of payment that, in this case, is due only upon successful completion of the SAT.

Delivery — Determining Delivery — Multiple Copies of Software Products Versus Multiple Licenses

SOP 97-2

21. Arrangements to use multiple copies of a software product under **site licenses** with users and to market multiple copies of a software product under similar arrangements with resellers should be distinguished from arrangements to use or market multiple single licenses of the same software.

- In the former kind of arrangement, duplication is incidental to the arrangement and the delivery criterion is met upon the delivery of the first copy or product master. The vendor may be obligated to furnish up to a specified number of copies of the software, but only if the copies are requested by the user. The licensing fee is payable even if no additional copies are requested by the user or reseller. If the other criteria in this SOP for revenue recognition are met, revenue should be recognized upon delivery of the first copy or product master. The estimated costs of duplication should be accrued at that time.
- In the latter kind of arrangement, the licensing fee is a function of the number of copies delivered to, made by, or deployed by the user or reseller. Delivery occurs and revenue should be recognized as the copies are made by the user or sold by the reseller if the other criteria in this SOP for revenue recognition are met.

21-1: Volume Discount

An arrangement may be structured to appear to be an arrangement for multiple single licenses. For example, a contract may state that the customer has agreed to buy 1,000 licenses (or copies of the software) at $100 per copy for an initial fee of $100,000. Once the customer has drawn down its initial licenses, it must then pay $100 per copy for additional copies.

Question

How should the vendor recognize the initial fee of $100,000?

Answer

Unless the customer has a right to a refund for any undeployed copies (or unless the vendor may forfeit a portion of the fee or provide other concessions), the initial fee would be considered a fixed fee that should be recognized upon delivery of the master or first copy of the software, provided that all other criteria for revenue recognition have been met. However, if payment terms are tied to deployment or are extended over the expected period of deployment, the fee is presumed not to be fixed or determinable. Unless this presumption can be overcome, the fee should be recognized as the copies are deployed. For additional discussion, see paragraphs 27–30 of SOP 97-2.

Example

Vendor S (S) sells software and other "high-tech" products that help companies maintain and improve security over their computer systems. A large customer, X, has entered into a contract with S to purchase one of S's most popular products. This contract includes a volume discount arrangement in which the discounts increase in proportion to the number of units X purchases. However, this arrangement does not specify a minimum or maximum number of products to be purchased. The volume discounts specified in the contract are greater than any discounts afforded to S's other customers for this product.

In this case, the amount of the fee earned varies depending on the number of units delivered and the prices of those units. Accordingly, S should recognize the amount realized or realizable on each unit (on the basis of the individual contract amount) when that unit is delivered and all other criteria for revenue recognition have been met.

21-2: Fixed Fee Licensing Example

Vendor A (A) has entered into an agreement to license 5,000 copies of its software product to B for $500,000. The agreement requires A to provide B with a master copy of the software and to duplicate and deliver the remaining additional copies as requested by B. Vendor A has no further obligations after delivery of the master copy, other than the incidental duplication and delivery of the remaining additional copies. The $500,000 fee is paid upon execution of the agreement and is nonrefundable.

Question 1

When should A recognize (1) the $500,000 up-front, nonrefundable fee for the license agreement and (2) the sale of additional copies?

Answer 1

If all other criteria for revenue recognition are met, A should recognize the $500,000 fee upon delivery of the master copy of the software and should accrue any costs expected to be incurred for duplicating and delivering any additional copies (beyond the original 5,000). TIS Section 5100.50 indicates that additional copies of the same product are not considered an undelivered element. Therefore, revenue should be recognized as the rights to additional copies are purchased, depending on the price per copy stipulated in the arrangement.

Question 2

Assume the agreement above gives B the option to purchase additional copies of the software for $50 per copy. When should A recognize these copies as revenue?

Answer 2

If all other criteria for revenue recognition are met, A should recognize revenue at the price per copy upon delivery of each copy.

Delivery — Delivery Other Than to the Customer

SOP 97-2
22. Delivery should not be considered complete unless the destination to which the software is shipped is the customer's place of business or another site specified by the customer. In addition, if a customer specifies an intermediate site but a substantial portion of the fee is not payable until the delivery by the vendor to another site specified by the customer, revenue should not be recognized until the delivery is made to that other site.

22-1: Discussion of the Phrase "Another Site Specified by the Customer"

Question

In paragraph 22 of SOP 97-2, what is the meaning of the phrase "another site specified by the customer"?

Answer

The phrase "another site specified by the customer" applies to specific third-party sites, such as the customer's distributor. The following example illustrates this point:

Example

Vendor C (C) licenses software to Customer Z (Z) for $500,000. Customer Z is moving its corporate headquarters and requests that C deliver the software to one of C's subsidiary locations near Z's new corporate headquarters. Once Z has moved into its new corporate headquarters, Z will request delivery of, and C will be obligated to deliver the software to Z's corporate headquarters.

Vendor C should recognize revenue ($500,000) upon delivery of the software to Z's corporate headquarters and when all other revenue recognition criteria have been met. SOP 97-2 requires delivery to the customer's location or to another site specified by the customer.

In this example, one could argue that because the customer has designated C's subsidiary as the site for delivery, delivery has occurred once the software is delivered to C's subsidiary. Delivery to C's subsidiary location, however, means that C is still in control of the software. In substance, this is no different from C putting the software "aside" to be sent to Z. Vendor C should not recognize revenue until the earnings process is complete, and the earnings process is not complete until C has delivered the software to Z's corporate headquarters.

22-2: Bill-and-Hold Arrangements

Question

How does SOP 97-2 apply to bill-and-hold arrangements?

Answer

SOP 97-2 does not specifically address bill-and-hold arrangements. In its discussion of SOP 91-1 (the predecessor to SOP 97-2), the AcSEC considered a proposal to include bill-and-hold provisions in that SOP. AcSEC members rejected that proposal because, given the nature of software, it is unlikely that there would be a valid business reason for delaying delivery. That is, it is unlikely that a customer would (1) be unable to take delivery of the software and (2) request that the software be "put aside" for later delivery. However, if the software is being delivered as part of a tangible product (e.g., as a component of an equipment delivery), the bill-and-hold provisions of SEC Accounting and Auditing Enforcement Release No. 108 and SAB Topic 13.A.3(a) would apply.

Delivery — Delivery Agents

SOP 97-2
23. Vendors may engage agents, often referred to as fulfillment houses, to either duplicate and deliver or only deliver software products to customers. Revenue from transactions involving delivery agents should be recognized when the software is delivered to the customer. Transferring the fulfillment obligation to an agent of the vendor does not relieve the vendor of the responsibility for delivery. This is the case even if the vendor has no direct involvement in the actual delivery of the software product to the customer.

Delivery — Authorization Codes

SOP 97-2

24. In a number of software arrangements, vendors use **authorization codes**, commonly referred to as *keys*, to permit customer access to software that otherwise would be restricted. Keys are used in a variety of ways and may serve different purposes. For example, permanent keys may be used to control access to the software, or additional permanent keys may be necessary for the duplication of the software. Temporary keys may be used for the same purposes and also may be used to enhance the vendor's ability to collect payment or to control the use of software for demonstration purposes.

25. In software arrangements involving the use of keys, delivery of a key is not necessarily required to satisfy the vendor's delivery responsibility. The software vendor should recognize revenue on delivery of the software if all other requirements for revenue recognition under this SOP and all of the following conditions are met.

    - The customer has licensed the software and the vendor has delivered a version of the software that is fully functional except for the permanent key or the additional keys (if additional keys are used to control the reproduction of the software).
    - The customer's obligation to pay for the software and the terms of payment, including the timing of payment, are not contingent on delivery of the permanent key or additional keys (if additional keys are used to control the reproduction of the software).
    - The vendor will enforce and does not have a history of failing to enforce its right to collect payment under the terms of the original arrangement.

    In addition, if a temporary key is used to enhance the vendor's ability to collect payment, the delivery of additional keys, whether temporary or permanent, is not required to satisfy the vendor's delivery responsibility if (*a*) the above conditions are met and (*b*) the use of a temporary key in such circumstances is a customary practice of the vendor. Selective issuance of temporary keys might indicate that collectibility is not probable or that the software is being used only for demonstration purposes.

Fixed or Determinable Fees and Collectibility

SOP 97-2

26. The other prerequisites in paragraph .08 for revenue recognition are that (*a*) the vendor's fee is fixed or determinable and (*b*) collectibility is probable. A software licensing fee is not fixed or determinable if the amount is based on the number of units distributed or copied, or the expected number of users of the product. Revenue recognition for variable-pricing arrangements is discussed in paragraphs .43 through .47 of this SOP. Additionally, if an arrangement includes (*a*) rights of return or (*b*) rights to refunds without return of the software, FASB Statement No. 48 requires that conditions that must be met in order for the vendor to recognize revenue include that the amount of future returns or refunds can be reasonably estimated.

26-1: Factors to Consider When Assessing Collectibility

Question

Paragraphs 26–33 of SOP 97-2 discuss collectibility and its impact on revenue recognition. What factors should be considered when evaluating collectibility?

Answer

For the most part, SOP 97-2 considers collectibility issues in the context of whether the fee is fixed or determinable. That is, the issues associated with the ability and intent of the customer to pay (i.e., creditworthiness) are not different in the software industry. However, certain factors, unique to the software industry, may be unrelated to the customer's ability or intent to pay. For example, rapid obsolescence of the software and the de minimis incremental cost of delivering additional software may result in a renegotiation of the arrangement fee or the software deliverables, if there are extended payment terms. This is not a collectibility issue; rather, the possibility that the fee or the deliverables might be renegotiated raises questions about whether the fee is fixed or determinable.

Fixed or Determinable Fees and Collectibility — Factors That Affect the Determination of Whether a Fee Is Fixed or Determinable and Collectible

SOP 97-2
27. A number of arrangements that call for fixed or determinable payments, including minimum royalties or license fees from resellers, specify a payment period that is short in relation to the period during which the customer is expected to use or market the related products. Other arrangements have payment terms that extend over a substantial portion of the period during which the customer is expected to use or market the related products. Because a product's continuing value may be reduced due to the subsequent introduction of enhanced products by the vendor or its competitors, the possibility that the vendor still may provide a refund or concession to a creditworthy customer to liquidate outstanding amounts due under the original terms of the arrangement increases as payment terms become longer.
28. For the reason cited in paragraph .27 *any* extended payment terms in a software licensing arrangement may indicate that the fee is not fixed or determinable. Further, if payment of a significant portion of the software licensing fee is not due until after expiration of the license or more than twelve months after delivery, the licensing fee should be *presumed* not to be fixed or determinable. However, this presumption may be overcome by evidence that the vendor has a standard business practice of using long-term or installment contracts and a history of successfully collecting under the original payment terms without making concessions. In such a situation, a vendor should consider such fees fixed or determinable and should recognize revenue upon delivery of the software, provided all other conditions for revenue recognition in this SOP have been satisfied.

28-1: Provisions of Extended Payment Terms

Question

Why does paragraph 28 of SOP 97-2 include provisions concerning extended payment terms?

Answer

These provisions were included because the AcSEC believed the likelihood of vendor refunds or concessions was greater in an arrangement with extended payment terms than in one without such terms. In addition, in arrangements with extended payment terms, customers might have more opportunity to renegotiate contract terms because of other factors, such as the introduction of enhanced products by the vendor or its competitors and technological obsolescence. Paragraphs 110–114 of SOP 97-2, further discuss the AcSEC's reasoning concerning the effect of extended payment terms on the determination of whether a fee is fixed or determinable.

28-2: Circumstances Under Which Extended Payment Terms Cause a Fee Not to Be Fixed or Determinable

Question

In what circumstances would extended payment terms cause a fee not to be fixed or determinable?

Answer

Paragraph 28 of SOP 97-2 identifies three circumstances in which a fee may not be fixed or determinable because of extended payment terms. Two of these circumstances lead to a presumption that the fee is not fixed or determinable. These circumstances apply even though a customer may be wholly creditworthy. The terms are summarized in the following table:

Payment Terms	License Fee May Not Be Fixed or Determinable	License Fee Presumed Not to Be Fixed or Determinable
Any extended payment terms	X	
Significant portion of the license fee not due until after expiration of the license		X
Significant portion of the license fee not due until more than 12 months after delivery		X

28-3: Determination of What Constitutes a Significant Portion of a License Fee

Question

Paragraph 28 of SOP 97-2 discusses situations in which payment of a significant portion of an arrangement fee is not due until after expiration of the license or more than 12 months after delivery. However, SOP 97-2 does not explain what constitutes a significant portion. What factors should be considered in determining whether a portion of the license fee that is due after the expiration of the license or more than 12 months after delivery is a significant portion?

Answer

Factors to consider in evaluating whether a portion of a license fee is significant include, but are not limited to, the percentage the portion of the fee is of the total fee, the business purpose or other reasons for extending payment on the portion of the fee, whether the customer has made a significant investment in the arrangement (with the vendor or otherwise), and any other relevant information used in developing the fee arrangement. Since there is no direct guidance on what represents a significant portion, an analysis of all relevant facts and circumstances is required.

28-4: Extended Payment Term Arrangement — Discussions With SEC Staff

Vendor T (T), a public company, sells integrated products. These products are primarily hardware but include an embedded software component that is essential to the hardware's functionality. Although the software is not sold separately, T believes its value is less than 10 percent of the total arrangement fee. The software is a significant focus of T's marketing effort, which focuses on the future proofing of its products from technical obsolescence through noncustomized software upgrades that will be sold separately. Vendor T also provides PCS for its software. The software is more than incidental to the company's products; therefore, SOP 97-2 applies.

Vendor T recently began offering payment terms that extend beyond one year to some of its customers. Vendor T believes that the arrangement fees for these sales should be considered fixed or determinable, even though it does not yet have the requisite history, discussed in SOP 97-2, to overcome the presumption that the fee is not fixed or determinable. Vendor T has observed that the reason for SOP 97-2's stringent requirements regarding extended payment terms is the concern that the software will become obsolete before all payments have been collected and that the vendor may provide concessions to the customer. Vendor T believes that its software will not become obsolete.

Question

How should T recognize revenue?

Answer

In this situation, T should recognize revenue as payments become due. The software is essential to the functionality of the hardware and is more than incidental to the product; therefore, SOP 97-2 applies to the total arrangement fee. Accordingly, the arrangement fee is presumed not to be fixed or determinable and T has no basis for overcoming that presumption.

Vendor T's position was discussed with the SEC staff. The staff's position was that if (1) the software were not essential to the functionality of the other elements in the arrangement and (2) VSOE of fair value of the software existed, the elements could be accounted for separately. Accordingly, only the portion of the fee allocated to the software would be subject to the presumption that the license fee is not fixed or determinable. However, in T's case (1) the software is essential to the functionality of the hardware and (2) no VSOE of fair value of the software exists. Furthermore, footnote 5 of SAB Topic 13.A.1, states, in part, "The staff notes that paragraphs 27 through 29 [of SOP 97-2] specifically consider software transactions, however, the staff believes that guidance should be considered in other sales transactions in which the risk of technological obsolescence is high."

28-5: Payment Terms Less Than 12 Months

Question

Do payment terms have to extend beyond one year to affect the determination of whether a fee is fixed or determinable?

Answer

No. Any payment terms longer than the vendor's standard billing terms must be considered. For example, the terms "due in 120 days" may require consideration by one vendor and not another because for one they may be nonstandard and for the other they may be standard. Thus, the potential impact of payment terms on revenue recognition must be evaluated on a vendor-specific basis.

Example

Vendor V (V) licenses software to Customer Z (Z) with payment terms of "due in 180 days." Vendor V has been licensing this same software (including upgraded versions as available) over the past two years. Vendor V's typical payment terms for this software are "due in 30 days." However, V has provided payment terms of "due in 180 days" in connection with the sale of this software to about 15 percent of its customers and has no history of providing refunds or other concessions to these customers. With the exception of the payment terms, the license agreement with Z is the same as V's standard license agreement.

Vendor V should consider the license fee to be fixed or determinable and record revenue when all other revenue recognition criteria have been met. Because V has established a past practice of providing extended payment terms and has no history of providing refunds or other concessions, the license fee is considered fixed or determinable. Factors such as the volume of transactions (15 percent in this case) and the similarity between the transaction with Z and previous transactions constitute sufficient evidence that the fee is fixed or determinable.

28-6: Payment Terms Greater Than 12 Months

Question

Does SOP 97-2 prohibit revenue recognition for vendors that provide payment terms exceeding one year when all other requirements for revenue recognition have been met?

Answer

No. The AcSEC recognized that some vendors have established a practice of providing payment terms greater than one year and have demonstrated a history of successfully collecting full payment under the original terms of the arrangement without providing concessions. Typically, these vendors have used extended payment terms solely as a financing vehicle. The AcSEC concluded that it would be inappropriate to preclude vendors who successfully use payment terms in excess of one year from recognizing revenue when all other requirements for revenue recognition have been met. Thus, the application of the provisions on extended payments will vary depending on the vendor's past practice. Accordingly, some will not be required to defer revenue until payments become due because they have an established practice of collecting under extended payment terms. Others, however, will be required to recognize revenue as payments become due unless and until, over time, they establish a business practice of providing payment terms in excess of one year and demonstrate a successful history of collecting full payment under the original terms of the arrangement under extended payment terms without providing concessions.

TIS Section 5100.57 provides guidance on the types of evidence to use in "determining whether the vendor has a history of successfully collecting under the original payment terms without making concessions."

SOP 97-2 discusses payment terms in excess of one year and refers to payment terms that extend beyond the expiration of the license. Payment terms in excess of one year are common in the software industry. Payment terms that extend beyond the license period, however, are rare. Further, the risk of vendor concessions when payment terms extend beyond the license period are significantly greater than with other forms of extended payment terms because of the increased negotiating power that a customer has once the license period has expired. Accordingly, it would be particularly difficult to overcome the presumption that the fee is not fixed or determinable when payment terms extend beyond the expiration of the license.

Example

Two years ago, Vendor V (V) entered into 10 arrangements with customers in which it provided payment terms that extend over five years. Vendor V had no prior history of arrangements with comparable extended payment terms. Over the two-year period, V has collected all payments when due without providing concessions. Vendor V has just consummated a similar arrangement with the same payment terms.

Vendor V is required to recognize payments as they become due for the just-consummated arrangement. Vendor V will not have established a history until it at least completes the full five-year cycle on the original 10 contracts with payment terms that extend over five years.

28-7: Interest on Receivables

Question

Does APB Opinion 21 apply to revenue recognized under SOP 97-2?

Answer

Yes, Opinion 21 would apply to revenue recognized under SOP 97-2 and would require the recognition of revenue at discounted amounts, but only if the fee is determined to be fixed or determinable and either of the following occurs:

- The terms of the contract extend payments beyond the vendor's customary trade terms.
- The payment terms extend beyond one year (and the vendor is still able to conclude that the arrangement fee is fixed or determinable).

If, however, the vendor is unable to conclude that the arrangement fee is fixed or determinable, revenue would be recognized as payments become due at the undiscounted amounts indicated in the contract.

Opinion 21 excludes from its scope "receivables and payables arising from transactions with customers or suppliers in the normal course of business which are due in customary trade terms not exceeding approximately one year." However, the SEC staff, in footnote 41 in Question 1 of SAB Topic 13.A.3(f), takes the position that if extended payment terms are individually negotiated with customers, and those terms exceed the customary trade terms, Opinion 21 would apply even if the terms are for less than one year, provided that the fee is fixed or determinable.

Example

Vendor A (A) sells Customer B a perpetual license to Product X in exchange for $1 million, payable in five annual payments of $200,000.

If A concludes that the fee is fixed or determinable, A would apply the guidance in Opinion 21, record the net present value of the future payment stream as license revenue when the remaining criteria in SOP 97-2 are met, and record interest income for the remaining portion of the total arrangement fee. However, if A concludes that the arrangement fee is neither fixed nor determinable, A would not apply the guidance in Opinion 21 to this arrangement but would record $200,000 of license revenue when each annual payment becomes due.

28-8: Modification of a Software License

Question

How should a vendor account for a modification to a software license arrangement?

Answer

SOP 97-2 does not specifically address modifications to software license arrangements, although paragraph 27 does require that vendors consider the implications of concessions. However, modifications to license arrangements are addressed in SOP 00-2, and that guidance can be extended to software license arrangements. Paragraph 23 of SOP 00-2 states, in part:

> If, at any time during a licensing arrangement, the parties agree to change the provisions of the licensing arrangement, other than by extending the license period [reference omitted], the entity should consider the revised arrangement as a new arrangement and account for it in accordance with the provisions of this SOP. At the time the old arrangement is terminated, the entity should accrue and expense associated costs or reverse previously reported revenue for refunds and concessions . . . to terminate the old arrangement.

In software arrangements, the nature of the modification should be considered. Sometimes previously recognized revenue may not be affected; other times, the accounting described in SOP 00-2 may be appropriate.

Example 1

Vendor V (V) enters into a software license arrangement with Customer C (C) with a term of five years for a nonrefundable fee of $1 million. PCS is bundled for the first year and is renewable at 15 percent of the license fee per year for the remaining term. There were no extended payment terms, and C paid the $1 million fee within 60 days. Vendor V would defer 15 percent of the license fee and recognize the residual as license revenue when all the criteria for revenue recognition have been met. Vendor V recognized the license fee upon delivery of the software, and the PCS fee is being recognized ratably over the 12-month term. If, in year five of the arrangement, V agreed to extend the license term, there would be no change to revenue previously recognized.

Example 2

Assume the same facts as in Example 1, except that after six months V and C decide to terminate the original agreement and replace it with another agreement that provides for a four-year license arrangement with two years of bundled PCS for the same $1 million. Under the new agreement, PCS would still be renewable for the remaining term of the license for 15 percent per year. Vendor V already recognized PCS revenue of $75,000 and license revenue of $850,000.

Under the new agreement, annual PCS would still be $150,000 ($1 million × 15%) per year, so the value allocated to the bundled PCS period would be $300,000. License revenue would be $700,000. Thus, V would have to reverse license revenue of $150,000 already recognized.

Example 3

Assume the same facts as in Example 1, except that after six months V and C terminate the license arrangement and enter into a hosting arrangement. The hosting arrangement will not allow C to take possession of the software at any time during the hosting period. EITF Issue 00-3 requires that such an arrangement be accounted for as a service contract. Instead of providing C with a cash refund, V permits C to use the entire refund as a credit for future purchases of hosting services.

The termination of this arrangement is similar to a sales return. Vendor V should reverse all revenue recognized under the previous software license arrangement in the period in which the license arrangement is terminated. The license fee is, in substance, part of the hosting fee and should be recognized as revenue over the period the hosting services are performed, similarly to a service contract. However, if V had VSOE of fair value for six-month licenses, it would be appropriate to reverse only the revenue associated with the period past the six-month time frame, since C had the use of the software for six months before returning the software license and receiving a credit. Therefore, V earned a portion of the license fee.

28-9: Impact of Letters of Credit on the Evaluation of Extended Payment Terms

Question

Company Z (Z) decides to accept extended payment terms from foreign customers. Since Z previously has not entered into any extended payment term arrangements, it decides to accept these arrangements only from those customers that obtain an LOC from a reputable first-tier bank. How does the LOC affect Z's ability to assess whether the fee charged is fixed or determinable?

Answer

The LOC does not affect Z's evaluation of whether the fees are fixed or determinable. While the LOC may alleviate the credit risk associated with the extended payment terms, the LOC does not obviate the need to evaluate whether Z will be required to (or decide to) offer concessions to its customers. Despite the existence of an LOC, Z might offer a concession to its customer in the hope of securing additional business. Enforcing collection under the LOC, while permissible, may not be practical depending on Z's future circumstances. Accordingly, Z should assess its ability to overcome the presumption in the absence of the LOC.

SOP 97-2
29. If it cannot be concluded that a fee is fixed or determinable at the outset of an arrangement, revenue should be recognized as payments from customers become due (assuming all other conditions for revenue recognition in this SOP have been satisfied).

29-1: Subsequent Changes in Circumstances That Result in a Different Conclusion Regarding Whether a Fee Was Fixed or Determinable at the Inception of the Arrangement

Question

If a vendor concludes at the outset of an arrangement that a fee is not fixed or determinable, but later the circumstances change and the vendor reaches a different conclusion, should the timing of revenue recognition change?

Answer

No. The vendor should determine whether the fee is fixed or determinable at the outset of the arrangement. That decision, provided that all other requirements for revenue recognition are met, determines the timing of revenue recognition for the arrangement and does not change because of subsequent changes in circumstances that might lead to a different conclusion regarding the nature of the fee.

29-2: Sale of Future Revenues

Question

Some vendors that provide extended payment terms are unable to overcome the presumption that the fee is not fixed or determinable. Can a vendor sell these "receivables" for cash to an unrelated third party without recourse to the vendor and thereby transform the customer arrangement into a cash transaction with a fixed fee?

Answer

No. Paragraph 29 of SOP 97-2 requires that the assessment of whether a fee is fixed or determinable be made only at the outset of the arrangement. In addition, this assessment should be based solely on the arrangement between the vendor and the customer. In fact, neither revenue nor a receivable would be recognizable at the outset of the arrangement. The sale of the receivable would be accounted for in accordance with EITF Issue 88-18. Statement 140 would not apply if the SOP 97-2 criteria for recognizing revenue, and thereby, a receivable, are not met, since there is no financial asset to transfer. TIS Section 5100.58 is consistent with this position.

Under Issue 88-18, the transfer of the future revenue stream would be considered an agreement to pay an investor a specified amount of revenue resulting from a particular contractual right. Issue 88-18 states that the presence of any one of six factors independently creates a presumption that the proceeds from the "sale of future revenues" should be classified as debt. The second factor is "significant continuing involvement in the generation of the cash flows due the investor." Because SOP 97-2 requires a presumption that there will be future concessions under a software arrangement that includes payment of a significant portion of the licensing fee beyond one year, the enterprise would be presumed to have significant continuing involvement under Issue 88-18. Therefore, the proceeds received from the transfer of the stream of future payments should be classified as debt in accordance with Issue 88-18.

29-3: Recognition as Payments From Customers Become Due

Question

If a vendor cannot conclude that a fee is fixed or determinable at the outset of an arrangement, revenue should be recognized as payments from customers become due (provided that all other requirements for revenue recognition are met). Does this mean that revenue should not be recognized until cash is collected from the customer?

Answer

No. Recognition of revenue as payments from customers become due (provided that all other requirements for revenue recognition are met) is not the same as using the cash basis of accounting (in which revenue is recognized only when cash is collected from the customer). Recognition of revenue as payments become due (provided that all other requirements for revenue recognition are met) results in the recording of revenue on the due date of the payment from the customer.

29-4: Extended Payment Terms in a Perpetual License With PCS

Question

A software vendor sells software under a perpetual license with one year of bundled PCS. Payment terms are $500 up front, $300 due in six months, and $400 due in 18 months. The vendor cannot overcome the presumption that the fee is not fixed or determinable. VSOE of fair value of PCS, based on the renewal rate, is $200. The vendor will apply the residual method to allocate the fee on this arrangement. If all other criteria for revenue recognition have been met, how should revenue be recognized?

Answer

Two acceptable models for revenue recognition are presented below. For each model, it is presumed that all other revenue recognition criteria have been met. View A, which defers $200 of the initial up-front payment for the one year of bundled PCS, is considered preferable to View B. In these circumstances, the choice of a revenue recognition model is an accounting policy election that a vendor should apply consistently.

View A (Preferable)

Paragraph 29 of SOP 97-2 indicates that when extended payment terms exist and the arrangement fee is determined not to be fixed or determinable, revenue should be recognized as customer payments become due and payable. Proponents of View A believe that the fixed or determinable portion of the fee is limited to the up-front cash payment (i.e., $500) and would apply the residual method to that amount. Accordingly, $200 should be unbundled from the initial payment and recognized ratably over the one-year PCS term, and $300 should be recognized immediately. The remaining payments should be recognized as additional license revenue when due.

View B (Acceptable)

The vendor has the ability to discontinue providing PCS services upon default by the customer, including failure to pay the $300 due in six months; therefore, the vendor is, in substance, obligated to perform PCS for only six months at inception of the contract. Accordingly, using logic similar to View A, proponents of View B believe that while the "PCS bucket" needs to be filled first, it only needs to be filled with an amount sufficient to cover the vendor's obligation for PCS until the next payment becomes due (i.e., executory contract concept). Thus, the vendor would defer only six months of PCS (or $100) and recognize $400 of the up-front $500 payment as license revenue at inception. Note that if the next payment were not sufficient to cover the ongoing PCS obligation (i.e., if the payment in month six were only $50 instead of $300), a greater amount would need to be deferred at inception. The $300 payment due in six months would be recognized as $200 additional license revenue when due, and $100 would be recognized ratably over the remaining six months as PCS. The remaining $400 payment would be recognized as license revenue when due.

SOP 97-2

30. For reseller arrangements, the following factors also should be considered in evaluating whether the fixed or determinable fee and collectibility criteria for revenue recognition are met.

- Business practices, the reseller's operating history, competitive pressures, informal communications, or other factors indicate that payment is substantially contingent on the reseller's success in distributing individual units of the product.[7]
- Resellers are new, undercapitalized, or in financial difficulty and may not demonstrate an ability to honor a commitment to make fixed or determinable payments until they collect cash from their customers.
- Uncertainties about the potential number of copies to be sold by the reseller may indicate that the amount of future returns cannot be reasonably estimated on delivery; examples of such factors include the newness of the product or marketing channel, competitive products, or dependence on the market potential of another product offered (or anticipated to be offered) by the reseller.
- Distribution arrangements with resellers require the vendor to rebate or credit a portion of the original fee if the vendor subsequently reduces its price for a product and the reseller still has rights with respect to that product (sometimes referred to as price protection). If a vendor is unable to reasonably estimate future price changes in light of competitive conditions, or if significant uncertainties exist about the vendor's ability to maintain its price, the arrangement fee is not fixed or determinable. In such circumstances, revenue from the arrangement should be deferred until the vendor is able to reasonably estimate the effects of future price changes and the other conditions of this SOP have been satisfied.

Footnote 7 — Contractual arrangements under which the reseller is obligated to pay only as and if sales are made to users should be accounted for as consignments.

30-1: Price-Protection Clauses in Reseller Arrangements

Because the obsolescence of software products is often rapid, many vendors have been forced, for business reasons, to significantly reduce prices on their products. Price reductions can be particularly harmful to resellers with inventory on hand that they purchased from vendors at prediscount prices.

To protect themselves, many resellers insist on price-protection clauses. These clauses stipulate that if a vendor subsequently reduces its price for a product and the reseller still has that product in its inventory, the vendor is required to rebate/credit a portion of the original fee charged to the reseller.

Question

How does the existence of a price-protection clause affect the fixed or determinable classification of the vendor's fee?

Answer

If a vendor provides a reseller with price protection and cannot reasonably estimate future price changes, or if the vendor's ability to maintain its price is uncertain, the fee is not fixed or determinable. Revenue recognition should be deferred until the vendor's liability under the price-protection clause can be reasonably estimated, provided that all other requirements for revenue recognition are met. While price-protection clauses are most common in reseller arrangements, such clauses also may be provided to end-user customers and would have the same effect on revenue recognition (see Q&A 30-2).

It can be difficult to reasonably estimate future price changes. Consequently, many vendors may be forced to recognize revenue as sales are reported by resellers (sell-through), provided that all other requirements for revenue recognition are met.

Example 1

Vendor D (D) licenses 100 copies of its software to Reseller Z (Z) for $100 per copy. The $10,000 fee is nonrefundable, and D meets all the criteria for revenue recognition except that the arrangement includes a price-protection clause. If D licenses the same software for less than $100 per copy in the next year, D will rebate the difference in price to Z on the basis of Z's on-hand quantities that were acquired at the higher price. The last three products sold by D were discounted after initial release of the product. The price of one product was cut in half after six months, the price of another product was not reduced in the next year, and the price of a third was cut 80 percent two months after the product was initially released because of competitive pressures.

Vendor D should recognize revenue from its arrangement with Z on a sell-through basis until the expiration of the one-year price-protection clause or when the vendor's liability under the price-protection clause can be reasonably estimated. Vendor D has a history of significant price reductions. Because these reductions have varied widely throughout the history of D, there is no reasonable basis for estimating the amount of refund/credit D will have to provide Z under the price-protection clause. Therefore, the fee is not fixed or determinable because it appears likely that D will have to pay Z a rebate, the amount of which cannot be reasonably estimated.

Because Z licenses the software to end users and reduces its inventory quantities subject to the price-protection clause, D should recognize revenue in proportion to Z's licenses to end users (sell-through). That is, if Z were to license 20 copies to end users, D would know that no price-protection liability will be incurred with respect to those 20 copies and should record 20 percent (20 copies out of a total of 100) of the fee received from Z as revenue.

Example 2

Assume the same facts as in the previous example, except that the price protection is capped at 50 percent. Thus, 50 percent of the fee should be recognized upon delivery of the software, provided that all other revenue recognition criteria have been met. The remaining 50 percent should be recognized on a sell-through basis until the vendor's liability under the price-protection clause can be reasonably estimated or until the expiration of the one-year price-protection period. This example illustrates a way in which, given D's prior history, D can offer the reseller a reasonable level of price protection and limit the amount of revenue deferred. The basis for deferring 50 percent of the revenue in this example is consistent with the reasoning discussed in the previous example.

Example 3

Vendor B (B) enters into a three-year enterprise-wide software license with an end user, Customer Y (Y), for a cost of $2 million. Vendor B has been selling this software product for only three months. Previous software products developed by B have not been discounted. A clause in the contract indicates that if, during the licensing period, B offers the software (or any services included in the contract with Y) to another customer for a price less than the prices in the contract, Y is entitled to a proportionate rebate. Except for this price-protection clause, all requirements for revenue recognition have been met. Vendor B should defer the $2 million fee until the earlier of the end of the three-year period (expiration of the price-protection clause) or a time at which the amount of refund due under the price-protection clause can be reasonably estimated. Although B has no history of reducing prices, this is a new product that does not yet have its own history.

Furthermore, given the pace of change in the industry, it is unlikely that B can accurately estimate its pricing strategy and the competitive pressures it will face for the next three years (i.e., the duration of the price-protection clause). Therefore, because B cannot reasonably estimate the amount of rebate to provide to Y, the fee is not fixed or determinable.

Example 4

Vendor T (T) has historically recognized revenue upon shipment to its distributors (provided that all other requirements for revenue recognition are met), accruing for the estimated returns, price-protection refunds, and exchanges. Until the second quarter of 20X0, the charges for these items were consistent with the range of the reserves recorded. In the third and fourth quarters of 20X0, the sell-through of a new product was significantly slower than expected. As a result, T recorded additional reserves in this period for returns, price-protection refunds, and exchanges. However, actual charges substantially exceeded the new amounts reserved (i.e., T was unable to reasonably estimate the impact of returns, price-protection refunds, and exchanges). To recognize revenue at the time of sale, an entity must, under Statement 48, reasonably estimate the amount of future returns. Therefore, starting with the first quarter of 20X1, T began to recognize revenue upon sell-through to the end user for all of its new products (provided that all other requirements for revenue recognition were met).

30-2: Price-Protection Clauses in End-User Arrangements

Because the obsolescence of software products is often rapid, many vendors have been forced, for business reasons, to significantly reduce prices on their products. Some end users have been able to negotiate price-protection clauses. These clauses stipulate that if a vendor subsequently reduces its price for a product, the vendor is required to rebate/credit a portion of the original fee charged to the end user. This would protect an end user from "overpaying" for a product.

Question

What is the effect of a price-protection clause in an end-user arrangement on whether the fee is fixed or determinable?

Answer

As in reseller arrangements, if a vendor offers an end user a price-protection clause and cannot reasonably estimate future price changes, or if the vendor's ability to maintain its price is uncertain, the fee is not fixed or determinable and revenue should be deferred until the vendor's liability under the price-protection clause can be reasonably estimated (provided that all other requirements for revenue recognition are met). Because it is often difficult to reasonably estimate future price changes, many vendors will not recognize revenue until the price-protection clause expires (provided that all other requirements for revenue recognition are met).

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31. *Customer Cancellation Privileges.* Fees from licenses cancelable by customers are neither fixed nor determinable until the cancellation privileges lapse. Fees from licenses with cancellation privileges expiring ratably over the license period are considered to become determinable ratably over the license period as the cancellation privileges lapse. In applying the provisions of this paragraph, obligations related to warranties for defective software, including warranties that are routine, short-term, and relatively minor, should be accounted for in conformity with FASB Statement No. 5. Additionally, short-term rights of return, such as thirty-day money-back guarantees, should not be considered cancellation privileges; the related returns should be accounted for in conformity with FASB Statement No. 48.

31-1: Customer Cancellation Privileges

Question

What are some examples of arrangement terms that allow a customer to cancel an arrangement, resulting in the fee not being fixed or determinable?

Answer

Terms that permit a customer to cancel an arrangement include, but are not limited to, the following:

- The contract is subject to approval by the board of directors of the customer.
- The customer has a stated period in which to arrange financing for the purchase.

Both these provisions (and any similar provision) allow the customer to cancel the contract; therefore, revenue should not be recognized until these provisions lapse and all other requirements for revenue recognition have been met.

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32. *Fiscal Funding Clauses*. Fiscal funding clauses sometimes are found in software license arrangements in which the licensees are governmental units. Such clauses generally provide that the license is cancelable if the legislature or funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligations under the licensing arrangement.
33. Consistent with FASB Technical Bulletin No. 79-10, *Fiscal Funding Clauses in Lease Agreements*, a software licensing arrangement with a governmental unit containing a fiscal funding clause should be evaluated to determine whether the uncertainty of a possible license arrangement cancellation is a remote contingency.[8] If the likelihood is assessed as remote, the software licensing arrangement should be considered noncancelable. Such an assessment should include the factors discussed in paragraphs .27 and .28 of this SOP. If the likelihood is assessed as other than remote, the license should be considered cancelable, thus precluding revenue recognition. A fiscal funding clause with a customer other than a governmental unit that is required to include such a clause creates a contingency that precludes revenue recognition until the requirements of the clause and all other provisions of this SOP have been satisfied.

Footnote 8 — The evaluation of whether the level of uncertainty of possible cancellation is remote should be consistent with FASB Statement No. 5, which defines *remote* as relating to conditions in which "the chance of the future event or events occurring is slight."

33-1: Fiscal Funding Clause With Customers Other Than Government Organizations

Question

Why does paragraph 33 of SOP 97-2 preclude revenue recognition for a customer other than a governmental unit if the likelihood of cancellation under a fiscal funding clause is assessed as remote?

Answer

The fiscal funding clause provision of SOP 97-2 was included in response to a question that arose about whether software licensing arrangements should be covered by Technical Bulletin 79-10.

Fiscal funding clauses are contingencies that raise a question about whether a fee is fixed or determinable. The contingent aspect of a fiscal funding clause, combined with the rapid obsolescence of products in the software industry, creates a concern that a software contract is cancelable or that it may be renegotiated at a future date.

Example

Vendor G (G) enters into a three-year software license agreement with Customer Z (Z), a not-for-profit medical research organization. Vendor G has a long history of enforcing extended payment terms. Under the terms of the agreement, Z will pay G $100,000 each year for three years. Customer Z's board of trustees must approve Z's annual budget each year. In the past 10 years, Z's board of trustees has approved Z's budget, submitted by management, without any changes. Customer Z's agreement with G stipulates that Z's continued use (and payments) under the three-year software agreement is contingent upon annual budgetary approval by Z's board of trustees. Customer Z is financially sound, and Z's management has represented to G that the "trustees always approve the budget that is submitted." Five years ago, Z entered into a five-year software license agreement with one of G's competitors, and Z fulfilled all of its payment obligations (during the five-year period) under that agreement.

Vendor G should recognize $100,000 of revenue each year upon the approval of Z's budget (which includes funding for the software license agreement) by the board of trustees, as long as all other revenue recognition criteria are met. Although there is compelling evidence that Z will fulfill its payment obligations (i.e., nonfulfillment is considered remote) under the software license agreement, G is required to defer revenue until such payments are approved by Z's board of trustees, because G has granted a fiscal funding clause to a nongovernmental entity. Under the terms of the agreement, Z is not obligated to pay if the board of trustees does not give the necessary budgetary approvals. The AcSEC considered this contingency sufficient to prohibit vendors from recognizing revenue even when the vendor and nongovernmental unit customer have a history of honoring such arrangements and all other revenue recognition criteria are met.

Multiple-Element Arrangements

SOP 97-2
34. As discussed in paragraph .09, multiple-element arrangements to which contract accounting does not apply may include customer rights to any combination of additional software deliverables, services, or PCS. If contract accounting does not apply, individual elements in such arrangements should be accounted for in accordance with paragraphs .08 through .14. Paragraphs .35 through .73 provide guidance on the application of those paragraphs to multiple-element arrangements.

34-1: Multiple-Element Arrangements: Overview of Effect of VSOE of Fair Value Recognition and Measurement Requirements

Whether VSOE of fair value is determinable will affect revenue recognition. The table below, based on guidance in SOPs 97-2 and 98-9, summarizes the revenue recognition requirements for various types of multiple-element arrangements, assuming that all other requirements for revenue recognition have been met.

Application of SOPs 97-2 and 98-9 to Software and Software-Related Elements

	Undelivered Element				
	Additional Products				
Fair Value Factors That Affect the Timing and Amount of Revenue Recognized When Software Has Been Delivered	**Unspecified Products**	**Specified Products**	**Upgrade Right**	**Services**	**PCS**
VSOE of fair value of each element exists.	N/A	Recognize amount of arrangement fee allocated to each product when the product is delivered.	Recognize amount of arrangement fee allocated to software when delivered and on upgrade when delivered.	Recognize amount of arrangement fee allocated to software when delivered and amount allocated to services as services are provided.	Recognize amount of arrangement fee allocated to software when delivered and amount allocated to PCS over PCS period.
VSOE of fair value of undelivered element does not exist.	Recognize revenue on a subscription basis (i.e., over time, beginning with delivery of the first product).	No recognition of any portion of the arrangement fee until fair value of undelivered element is determinable or all elements have been delivered.	No recognition of any portion of the arrangement fee until fair value of the upgrade is determinable or upgrade has been delivered.	Arrangement fee recognized as services are provided.	Arrangement fee recognized over PCS period.
VSOE of fair value of undelivered element exists and VSOE of fair value of delivered element does not exist.	N/A	Recognize revenue on delivered element using the residual method. Recognize revenue on other products upon delivery.	Recognize revenue on delivered element using the residual method. Recognize revenue on upgrade right when upgrade is delivered.	Recognize revenue on delivered element using the residual method. Recognize revenue on services as provided.	Recognize revenue on delivered element using the residual method. Recognize revenue on PCS over PCS period.
Arrangement fee is discounted and VSOE of fair value of each element exists.	N/A	Discount is allocated on a pro rata basis to each product.	No amount of discount is applied to the upgrade right; the entire discount is applied to the software license.	Discount is allocated on a pro rata basis to product and services.	Discount is allocated on a pro rata basis to PCS and license fee.

Multiple-Element Arrangements — Additional Software Deliverables and Rights to Exchange or Return Software

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35.	As part of a multiple-element arrangement, a vendor may agree to deliver software currently and to deliver additional software in the future. The additional deliverables may include upgrades/enhancements or additional software products. Additionally, a vendor may provide the customer with the right to exchange or return software, including the right to transfer software from one hardware **platform** or operating system to one or more other platforms or operating systems (a **platform-transfer right**).
36.	*Upgrades/enhancements.* As part of a multiple-element arrangement, a vendor may agree to deliver software currently and provide the customer with an **upgrade right** for a specified upgrade/enhancement. The upgrade right may be evidenced by a specific agreement, commitment, or the vendor's established practice. (Rights to receive *unspecified* upgrades/enhancements on a when-and-if-available basis are PCS, as it has been redefined in this SOP.) The upgrade right should be accounted for as a separate element in accordance with paragraphs .08 through .14. Guidance on the application of those paragraphs to multiple-element software arrangements that include upgrade rights is given in paragraphs .37 and .38.

36-1: Specified Upgrades Implied in an Arrangement

Question

How may a vendor implicitly grant a specified upgrade right to a customer (i.e., an upgrade right that is not specified in the contract)?

Answer

In certain circumstances, sales personnel or marketing materials may refer to specific features or functionality that is expected in future versions of the product. Such statements may lead the customer to expect that these features or functionality will be delivered in the future and that they are, therefore, an implied part of the arrangement. This would require that the vendor allocate a portion of the arrangement fee to the implicitly specified upgrade right. If a vendor publishes statements in sales and marketing brochures that refer to specific features or functionality that are expected in future versions of a product, the vendor should understand the financial and legal implications.

Example

Vendor A (A) is currently negotiating with a customer to sell Customer B (B) a license for Version 2.0 of A's software product. During the negotiations, the sales representative for A learns that B is looking for certain functionality in the product. The sales representative notifies B in writing that (1) while the functionality currently is not available, it will be included in the next version of the product, which is expected to be available within the next three months, and (2) B will be entitled to that version under its PCS arrangement.

Customer B agrees to purchase Version 2.0 along with an annual PCS agreement. The signed agreement does not explicitly discuss the additional functionality promised by the sales representative. However, in the absence of evidence to the contrary, A has implicitly granted a specified upgrade right to B through the correspondence from the sales representative, which created a reasonable expectation in B that the desired functionality would be available in the next version of the product. Accordingly, the specified upgrade right would be treated as a separate element of the arrangement. Revenue would need to be deferred until A has VSOE of fair value of all undelivered elements or until all the elements are delivered and all other requirements for revenue recognition have been met.

36-2: [Omitted]

36-3: Specified Versus Unspecified Products or Upgrades

SOP 97-2 requires vendors to distinguish between specified upgrades/enhancements and unspecified upgrades/enhancements. This determination is important because rights to specified upgrades/enhancements, including those offered on a when-and-if-available basis, must be treated as separate elements of the software arrangement to which revenue must be allocated. Conversely, rights to unspecified upgrades/enhancements on a when-and-if-available basis are considered to be PCS. SOP 97-2 also requires vendors to distinguish between specified and unspecified additional software products, because a right to receive specified additional software products is accounted for as a separate element, while a right to receive unspecified additional software products is accounted for as a subscription. However, SOP 97-2 does not define "specified."

Question

What distinguishes a specified upgrade or product from an unspecified upgrade or product?

Answer

An upgrade or product should be considered "specified" if it is described in enough detail for both the vendor and the customer to determine whether the vendor's obligation to deliver the upgrade or product has been extinguished. The description can range from a detailed report on the upgrade or product's features and functionality to a mere statement of its name or version number.

Sometimes, however, a vendor may specify an upgrade or product without such a description. For example, a vendor may grant a customer the right to receive "the next major release of Product X." In this situation, even though neither the vendor nor the customer may completely understand what features and functionality will ultimately be included, or what the name or version number will be, for the next major release of Product X, both parties will know, once this release has been delivered, that the vendor's obligation has been extinguished. Therefore, the right to receive the next major release of Product X should be considered a specified upgrade.

These conclusions are consistent with the comments made by G. Anthony Lopez, associate chief accountant in the Office of the Chief Accountant of the SEC, at the 2005 AICPA National Conference on Current SEC and PCAOB Developments.

Example

The following are examples of commitments by software vendors that should be considered specified upgrades or products:

- Customer C purchases a perpetual license to Product A from Vendor V, with a one-year bundled PCS agreement. Vendor V also agrees to deliver Product B on a when-and-if-available basis to Customer C. Product B is a specified product.

- Customer C purchases a license to Version 2.2 of Product Z from Vendor V, with a one-year bundled PCS agreement. Vendor V also provides Customer C with a right to receive Version 3.0 of Product Z on an when-and-if-available basis. Vendor V has not yet begun developing Version 3.0 and has not decided on the additional features and functionality to include in it. Version 3.0 is a specified upgrade.

- Customer C purchases a perpetual license to Product A, photo editing software, from Vendor V. The licensing agreement includes one year of PCS services. Vendor V also agrees to develop an enhancement to Product A that will allow users to convert color photos into black and white. Customer C will have the right to receive a copy of the enhancement if it is released during the PCS term. The enhancement to Product A is a specified upgrade.

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37. If a multiple-element arrangement includes an upgrade right, the fee should be allocated between the elements based on vendor-specific objective evidence of fair value. The fee allocated to the upgrade right is the price for the upgrade/enhancement that would be charged to existing users of the software product being updated. If the upgrade right is included in a multiple-element arrangement on which a discount has been offered (see paragraph .11), no portion of the discount should be allocated to the upgrade right. If sufficient vendor-specific evidence exists to reasonably estimate the percentage of customers that are not expected to exercise the upgrade right, the fee allocated to the upgrade right should be reduced to reflect that percentage. This estimated percentage should be reviewed periodically. The effect of any change in that percentage should be accounted for as a change in accounting estimate.

37-1: Prohibition of Allocation of Discounts to Specified Upgrade Rights

Question

Why did the AcSEC include the provisions in paragraph 37 of SOP 97-2, which preclude allocation of discounts to specified upgrade rights even when VSOE of fair value for all elements, including the specified upgrade rights, is available?

Answer

The AcSEC included these provisions because, as discussed in paragraph 117 of SOP 97-2, the Committee believed that customers may be willing to pay full value for the upgraded version of a product but might negotiate a discount for an existing product that will soon be obsolete.

37-2: Specified Upgrade Right Versus Additional Software Product

Paragraphs 11, 37, and 41 of SOP 97-2 discuss the allocation of revenue to the various elements in a multiple-element arrangement. Under the revenue allocation model discussed in these paragraphs, no amount of a discount in an arrangement may be allocated to a specified upgrade right, whereas a portion of the discount should be allocated, on the basis of relative fair value, to specified additional software products. In addition, the vendor may reduce the fee allocated to reflect the percentage of customers that are not expected to exercise the specified upgrade right but may not do so for specified additional software products. Despite the differences in accounting for specified upgrade rights versus rights to specified additional products, SOP 97-2 does not provide any guidance on how to distinguish between an upgrade and a product.

Question

What factors should a vendor consider when determining whether a deliverable under a multiple-element arrangement is a product or an upgrade?

Answer

The following is a list of factors (not all-inclusive) that help a vendor differentiate between a specified product and a specified upgrade:

- **Differences in the Features of the New Deliverable Versus the Features and Functionality of the Vendor's Existing Product** — Significant differences between the new deliverable and the existing product would be an indicator of a new product rather than a specified upgrade. Also, new products may perform functions that existing products cannot perform.

- **Development Effort of the New Deliverable** — A more significant development effort may be an indicator of a new product, not an upgrade.

- **The Price of the New Product Compared With That of the Vendor's Existing Products** — A significantly higher price for the new deliverable would indicate a new product, as would the lack of a significant discount for existing customers. Upgrades are often sold at a significant discount to existing customers.

- **Marketing of the New Deliverable** — Promotional or marketing materials that promote the new deliverable as a new product would indicate that the item may be a new product. Paragraph 54 of SOP 97-2 provides guidance on determining whether products are marketed as the same product.

- **Product Name of the New Deliverable** — Upgrades often have the same name as the existing deliverables.

- **Functionality of the New Deliverable** — Upgrades frequently supersede or replace the previously delivered product, whereas a new product frequently does not.

37-3: Change in the Estimate of the Number of Customers That Are Not Expected to Exercise Their Upgrade Rights

Question

Vendors should periodically review their estimate of the number of customers that are not expected to exercise their upgrade rights. What guidance should a vendor follow to account for changes in this estimate?

Answer

Given the nature of the software industry, it is not unusual for the number of customers that are not expected to exercise their upgrade rights to change. The effects of a change in estimate should be accounted for in accordance with paragraphs 19–21 of Statement 154.

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38. The amount of the fee allocated to the upgrade right should be recognized as revenue when the conditions in paragraphs .08 through .14 are met. If sufficient vendor-specific objective evidence does not exist for the allocation of the fee to the upgrade right, revenue from the arrangement should be deferred until the earlier of the point at which (*a*) such sufficient vendor-specific objective evidence does exist or (*b*) all elements of the arrangement have been delivered.

39. *Additional Software Products.* As part of a multiple-element arrangement, a vendor may agree to deliver software currently and deliver specified additional software products in the future. The rights to these additional products may be included either in the terms of a PCS arrangement or in a separate agreement. Even if the rights to the additional software products are included in a PCS arrangement, the revenue allocable to the additional software products should be accounted for separately from the PCS arrangement as an element of a multiple-element arrangement.

39-1: Specified Upgrade Right Provided in a PCS Arrangement When the Upgrade Is Not Sold Separately

Question

A vendor may license a software product to a customer and, at no additional charge, promise the customer a specified upgrade on a when-and-if-available basis as long as the customer is currently on PCS. The vendor has VSOE of fair value for the software license and for PCS. If the vendor is offering the specified upgrade for free to all of its customers that are currently on PCS, can the vendor account for the specified upgrade as part of PCS?

Answer

No. The specified upgrade is a separate element; it is not PCS. If the vendor does not have VSOE of fair value for the specified upgrade, no revenue should be recognized until one of the following occurs: (a) the specified upgrade is delivered, (b) there is VSOE of fair value for the specified upgrade, or (c) the specified upgrade right expires; and all other requirements for revenue recognition have been met. The residual method would not be applicable because there are two undelivered elements — the specified upgrade and PCS — and the vendor does not have VSOE of fair value for the specified upgrade.

39-2: Example of Determining Whether a PCS Contract Includes a Specified Upgrade

Vendor A (A) sells a standard payroll software product that includes a one-year PCS contract and provides renewal rates for the PCS. As part of the PCS arrangement, A states that it will make updates available for any future changes in the tax laws and regulations.

The right to updates for changes in tax laws and regulations would not be a specified upgrade right. At the outset of the arrangement, it would be difficult to predict (1) when (or if) changes in tax laws and regulations will occur and (2) what changes to the software would be required to comply with any new laws and regulations. As a result, the right to such updates would be more appropriately characterized as a right to unspecified updates on a when-and-if-available basis (i.e., PCS). This view is consistent with the following definition of maintenance in paragraph 52 of Statement 86: "[a]ctivities undertaken after the product is available for general release to customers to correct errors or keep the product updated with current information. Those activities include routine changes and additions."

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40. Multiple-element arrangements that include rights to undelivered additional software products that are not subscriptions (see paragraphs .48 and .49) should be accounted for in accordance with paragraphs .08 through .14 of this SOP. Guidance on the application of those paragraphs to such arrangements is provided in paragraphs .41 through .47 below.
41. The fee from the arrangement should be allocated among the products based on vendor-specific objective evidence of fair value. The allocation should be based on the relative sales prices (determined pursuant to paragraphs .10 and .11 of this SOP) of the products. If vendor-specific objective evidence of fair value does not exist, paragraph .12 of this SOP requires that all revenue from the arrangement be deferred until the earlier of the point at which (*a*) such sufficient vendor-specific objective evidence does exist or (*b*) all elements of the arrangement have been delivered. The fee allocated to the additional software products should not be reduced by the percentage of any customers that are not expected to exercise the right to receive additional software products.
42. If the arrangement is based on a price per product (not a price per copy), the portion of the fee allocated to a product should be recognized as revenue when the product is delivered, assuming all other provisions of paragraphs .08 through .14 of this SOP are met.
43. Some **fixed fee** license or **reseller** arrangements provide customers with the right to reproduce or obtain copies at a specified price per copy (rather than per product) of two or more software products up to the total amount of the fixed fee. A number of the products covered by the arrangement may not be deliverable or specified at the inception of the arrangement. Although the price per copy is fixed at the inception of the arrangement, an allocation of the arrangement fee to the individual products generally cannot be made, because the total revenue allocable to each software product is unknown and depends on the choices to be made by the customer and, sometimes, future development activity while the arrangement is in effect. Nevertheless, as discussed in paragraph .46 of this SOP, in certain situations, revenue can be allocated to the products that are undeliverable or not specified at the inception of the arrangement.

43-1: Examples of PCS and Variable-Fee Arrangements With Resellers

Arrangements with resellers may vary in their structure. They may provide for a fixed fee, a variable fee, or a combination of both. In addition, they may provide for the selling of either limited or unlimited copies during a limited or unlimited period. The examples below illustrate two arrangements that incorporate a variable fee.

Example 1 — Software, PCS, and Variable Fees

Vendor A (A) sells software to Reseller B (B). As part of a one-year contract, A sells B one gold disk for which B pays no cash up front. For every copy sold from the gold disk, B will be obligated to pay $1,000 to A. Vendor A will provide B with unlimited unspecified upgrade rights (PCS), but A does not offer PCS to the end user. Therefore, because the software is sold by B to the end user, A will have no further PCS obligation with respect to copies sold to end users. There is no VSOE of fair value for the PCS provided to B.

Analysis

The fee for this arrangement is a variable fee. That is, the fee is based on a price per copy and the reseller is obligated to pay only as copies are sold to the end user. Accordingly, provided that all other requirements for revenue recognition are met, revenue should be recognized as copies are sold by B to the end user (sell-through method). Although PCS is offered in this arrangement, it does not affect the timing of revenue recognition since B is not obligated to pay until copies are sold to the end user and the PCS provided to B, with respect to the copies sold to the end user, expires at that point.

Example 2 — Fixed Fee With Limited Copies and Variable Fee With Additional Copies

Vendor A (A) sells software to Reseller B (B). As part of a one-year contract, A sells B one gold disk. Reseller B pays a $1 million up-front fee for the first 1,000 copies of the gold disk to be sold (the $1 million is nonrefundable regardless of whether the first 1,000 copies are sold). For every additional copy sold by B after the first 1,000 copies, B must pay A $1,000. Unlimited upgrade rights (PCS) are provided to B, but no PCS is offered on copies sold to the end user. Therefore, because B sells the software to the end user, A has no further PCS obligation with respect to the copies sold. There is no VSOE of fair value for the PCS provided to B.

Analysis

Provided that all other requirements for revenue recognition have been met, A should recognize the fixed fee over the one-year contract period (beginning when the gold disk has been delivered) by taking into account the actual copy sales by B plus amortization on a straight-line basis of the fixed fee on unsold copies (beginning when the first copy is sold).

This is a multiple-element arrangement in which A has sold B both software and PCS. On a per-copy basis, PCS extends only until the sale by B to the end user. Because PCS is not offered separately, no VSOE of fair value of the PCS is included in the contract with B. Therefore, allocation of the fee to the two elements in this arrangement is precluded.

Paragraph 12 of SOP 97-2 requires deferral of revenue if sufficient VSOE does not exist for the allocation of revenue to the various elements of the arrangement, with certain exceptions. One exception is that if the only undelivered element is PCS, the entire fee should be recognized ratably over the PCS period. The maximum PCS period for all unsold copies is one year. Thus, in a worst-case scenario (i.e., no sales by B), revenue would be recognized over the one-year term. However, because there is a price per additional copy in this arrangement, the pattern in which revenue is earned in this contract can be determined. That is, if all 1,000 copies were sold on day one, the entire $1 million fixed fee would have been earned on that day (provided that all other requirements for revenue recognition are met) — i.e., the PCS service period for all 1,000 copies sold would have expired and, accordingly, all elements would have been delivered.

As discussed in Example 1, revenue on additional copies beyond the first 1,000 would be recognized as additional copies are sold by B.

Example 3 — Fixed Fee, Unlimited Copies

Vendor A (A) sells software to Reseller B (B). As part of a one-year contract, A sells B one gold disk. Reseller B pays a $1 million up-front fee for unlimited copies of the gold disk to be sold during the one-year period. Unlimited upgrade rights (PCS) are provided to B, but no PCS is offered to the end user. Therefore, because the software is sold by B to the end user, A has no further PCS obligation with respect to the copies sold. There is no VSOE of fair value for the PCS provided to B.

Analysis

Since there is no VSOE for the PCS provided to B, revenue should be recognized ratably (paragraph 57 of SOP 97-2) over the one-year period, beginning with delivery of the gold disk (provided that all other requirements for revenue recognition are met). Because B is entitled to sell an unlimited number of copies for the $1 million fixed fee, B's sales to end users are unrelated to how A earns revenue under this contract.

Example 4 — Fixed Fee, Unlimited Copies, Unlimited Period

Assume the same facts as in Example 3. However, instead of a one-year contract period, there is an unlimited contract period.

Analysis

A should estimate the useful life of the software. Revenue should be recognized ratably (paragraph 57 of SOP 97-2) over this estimated useful life, beginning when the gold disk has been delivered.

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44. In arrangements in which no allocation can be made, until the first copy or product master of each product covered by the arrangement has been delivered to the customer assuming the provisions of paragraphs .08 through .14 of this SOP are met, revenue should be recognized as copies of delivered products either (*a*) are reproduced by the customer or (*b*) are furnished to the customer if the vendor is duplicating the software. Once the vendor has delivered the product master or the first copy of all products covered by the arrangement, any licensing fees not previously recognized should be recognized. (At that point, only duplication of the software is required to satisfy the vendor's delivery requirement. As discussed in paragraph .21 of this SOP, duplication of the software is incidental to the arrangement, and delivery is deemed to have occurred upon delivery of the product master or first copy.) When the arrangement terminates, the vendor should recognize any licensing fees not previously recognized.

45. The revenue from the kind of arrangements discussed in paragraph .44 should not be recognized fully until at least one of the following conditions is met.

    - Delivery is complete for all products covered by the arrangement.
    - The aggregate revenue attributable to all copies of the software products delivered is equal to the fixed fee, provided that the vendor is not obligated to deliver additional software products under the arrangement.

46. Nevertheless, certain arrangements that include products that are not deliverable at the inception impose a maximum number of copies of the undeliverable product(s) to which the customer is entitled. In such arrangements, a portion of the arrangement fee should be allocated to the undeliverable product(s). This allocation should be made assuming that the customer will elect to receive the maximum number of copies of the undeliverable product(s).

47. The revenue allocated to the delivered products should be recognized when the product master or first copy is delivered. If, during the term of the arrangement, the customer reproduces or receives enough copies of these delivered products so that revenue allocable to the delivered products exceeds the revenue previously recognized, such additional revenue should be recognized as the copies are reproduced or delivered. The revenue allocated to the undeliverable product(s) should be reduced by a corresponding amount.

48. As part of a multiple-element arrangement with a user, a vendor may agree to deliver software currently and to deliver *unspecified* additional software products in the future (including unspecified platform transfer rights that do not qualify for exchange accounting as described in paragraphs .50 through .55). For example, the vendor may agree to deliver all new products to be introduced in a family of products over the next two years. These arrangements are similar to arrangements that include PCS in that future deliverables are unspecified. Nevertheless, they are distinguished from arrangements that include PCS because the future deliverables are products, not unspecified upgrades/enhancements.

49. The software elements of the kinds of arrangements discussed in paragraph .48 should be accounted for as subscriptions. No allocation of revenue should be made among any of the software products, and all software product-related revenue from the arrangement should be recognized ratably over the term of the arrangement beginning with delivery of the first product. If the term of the arrangement is not stated, the revenue should be recognized ratably over the estimated economic life of the products covered by the arrangement, beginning with delivery of the first product. An intent on the part of the vendor not to develop new products during the term of the arrangement does not relieve the vendor of the requirement to recognize revenue ratably over the term of the arrangement, beginning with the delivery of the first product.

49-1: Accounting for Unspecified Software Products

Vendor X (X) develops and distributes self-study information technology training courses. Vendor X enters into an arrangement with Customer Y (Y) under which Y can request any of the courses in X's library during the two-year term of the arrangement. Payment for the arrangement is due 30 days after the execution of the arrangement.

Question

When should X recognize revenue?

Answer

If all other requirements for revenue recognition have been met, X should recognize revenue on the arrangement ratably (paragraph 57 of SOP 97-2) over the term of the arrangement, beginning with the delivery of the first course (i.e., subscription accounting).

SOP 97-2

50. *Rights to Exchange or Return Software.* As part of an arrangement, a software vendor may provide the customer with the right to return software or to exchange software for products with no more than minimal differences in price, functionality, or features. The accounting for returns is significantly different from the accounting for exchanges. Although it is sometimes difficult to determine whether a transaction is a return or exchange of software, the fact that the software is not returned physically does not preclude accounting for the transaction as either an exchange or as a return. If the software is not returned physically and the customer contractually is entitled to continue to use the previously delivered software, the arrangement should be accounted for in the manner prescribed in the section herein entitled "Additional Software Products" (see paragraphs .39 through .49). If the software is not returned physically and the customer contractually is not entitled to continue to use the previously delivered software, the transaction should be accounted for either as a return or as an exchange, as discussed in the following paragraphs.

51. If the rights discussed in the previous paragraph are offered to users (but not resellers), the exchanges are analogous to "exchanges by ultimate customers of one item for another of the same kind, quality, and price . . . [that] are not considered returns" described in footnote 3 of FASB Statement No. 48. Conversely, exchanges by users of software products for dissimilar software products or for similar software products with more than minimal differences in price, functionality, or features are considered returns, and revenue related to arrangements that provide users with the rights to make such exchanges should be accounted for in conformity with FASB Statement No. 48. If the other product(s) is not available at the time the initial product is delivered, there should be persuasive evidence that demonstrates there will be no more than minimal differences in price, features, or functionality among the products in order for the right to qualify as a right to exchange. Additionally, if the vendor expects to incur a significant amount of development costs related to the other product, the other product should be considered to have more than a minimal difference in functionality.

51-1: Right of Exchange Versus Right of Return

Question

What is the difference between a "right of exchange" and a "right of return"?

Answer

An end-user customer's right to exchange that has the attributes described in paragraph 50 of SOP 97-2 (i.e., the products to be exchanged have no more-than-minimal differences in price, functionality, or features) is considered a **right of exchange**. An end-user customer's right to exchange that does not have the attributes described in paragraph 50 of SOP 97-2 (i.e., the products to be exchanged have more-than-minimal differences in price, functionality, or features) is considered a **right of return**.

51-2: Accounting for Return or Exchange Rights in Conformity With Statement 48

Question

What is the appropriate accounting for rights to exchange or return software products?

Answer

Exchanges — No amount is reserved for exchange rights (although any estimated costs for such exchanges should be accrued in accordance with Statement 5).

Returns — In addition to the requirements in paragraph 8 of SOP 97-2 for revenue recognition, a vendor must be able to reasonably estimate and reserve for software products returns at the time of sale in order to be able to recognize revenue at that date. The recorded revenue, provided that all other requirements for revenue recognition have been met, should be reduced to reflect the estimated returns, and any estimated costs for such returns should be accrued in accordance with Statement 5. The other conditions of paragraph 6 of Statement 48 are summarized in the requirements of paragraph 8 of SOP 97-2 and need not be separately addressed. If the vendor is unable to make a reasonable estimate of returns, revenue must be deferred until a reasonable estimate can be made or until the right of return has elapsed. Paragraph 8 of Statement 48 indicates that "the following factors may impair the ability to make a reasonable estimate:

a. The susceptibility of the product to significant external factors, such as technological obsolescence or changes in demand

b. Relatively long periods in which a particular product may be returned

c. Absence of historical experience with similar types of sales of similar products, or inability to apply such experience because of changing circumstances, for example, changes in the selling enterprise's marketing policies or relationships with its customers

d. Absence of a large volume of relatively homogeneous transactions."

Technological obsolescence is likely to be of particular interest for software vendors.

51-3: Changes in License Mix

Question

Is an arrangement that allows a user to change or alternate its mix of multiple products/licenses (license mix) after the products have been delivered an exchange right or a right of return?

Answer

It is neither. TIS Section 5100.45 states that provided that the other criteria for revenue recognition are met, revenue should be recognized upon delivery of the first copy or product master for all products within the license mix. Subsequent remixing is not considered an exchange or a return.

51-4: Product Cost

Question

Under SOP 97-2, does the accounting for returns, additional software products, or exchanges differ if there is little or no cost involved in providing the product to a customer?

Answer

No. Vendors have argued that often there is no "cost" to providing a product to a customer or that there is no business reason to have the customer return a previously delivered software product or to legally preclude a customer from using a software product that was previously delivered. While these arguments may have some merit under a cost approach, they are contrary to the value-to-the-customer approach that is fundamental to SOP 97-2. Revenue is generated when value is transferred to a customer. The vendor cost associated with the value transferred to a customer is irrelevant to the vendor's revenue recognition.

51-5: Factors to Consider in Determining Whether There Are More-Than-Minimal Differences Between Products

Question

Paragraph 51 of SOP 97-2 notes that when a product can be exchanged for another product that is not currently available (the "new product"), to account for that right as an exchange right, there should be persuasive evidence that no more-than-minimal differences will exist between the products. What factors should a vendor consider in determining whether there is persuasive evidence that there will be no more-than-minimal differences between the products?

Answer

The following are factors to consider:

- The functions and features of the undelivered product versus the delivered product.
- The price of each product.
- The marketing approach for each product.
- The level of development effort required, and the development costs incurred and expected to be incurred for the new product.
- The length of time until the new product is expected to be available.

SOP 97-2
52. As part of a multiple-element arrangement, a vendor may grant a user a platform-transfer right. Depending on the circumstances, the exercise of a platform-transfer right may represent an exchange, a return, or additional software products for accounting purposes. If the customer contractually is entitled to continue to use the software that was delivered originally (in addition to the software that is to be delivered for the new platform), the platform transfer right should be accounted for in the manner prescribed in the section herein entitled "Additional Software Products" (see paragraphs .39 through .49).
53. If, as part of a multiple-element arrangement, a vendor offers a user (not a reseller) a platform-transfer right, and the provisions of paragraphs .08 through .14 of this SOP are met, the revenue from the software license should be recognized upon the initial delivery of the software, and the exercise of the platform-transfer right should be treated as an exchange, if the platform-transfer right — • Is for the same product (see paragraph .54) • Does not increase the number of copies or concurrent users of the software product available under the license arrangement.
54. Products are considered to be the same product if there are no more than minimal differences among them in price, features, and functions, and if they are marketed as the same product, even though there may be differences arising from environmental variables such as operating systems, databases, user interfaces, and platform scales. Indicators of "marketed as the same product" include (*a*) the same product name (although version numbers may differ) and (*b*) a focus on the same features and functions.

54-1: Unspecified Platform-Transfer Rights

Question

With regard to unspecified platform-transfer rights, how should the vendor recognize revenue in the following examples?

Example 1

Vendor B licenses software to end-user Customer Y (Y) for $150,000. Customer Y has subsidiary operations in a number of different countries and is looking to expand its operations into new countries. Under the terms of the license agreement, Y has 100 users on Platform 1. In addition, Y is entitled to transfer to other platforms if and when they become commercially available. Customer Y is also permitted to retain the use of the software that runs on Platform 1 and to increase the number of users.

Analysis

The $150,000 software license fee should be recognized ratably (paragraph 49 of SOP 97-2), beginning with delivery of the first product, over the estimated useful life of the products covered by the arrangement (i.e., subscription accounting), because the duration of the arrangement is not defined. The customer is entitled to receive the initial product and additional versions of that product for unspecified platforms for an increasing number of users on a when-and-if-available basis for a fixed fee.

Example 2

Vendor B licenses software to end-user Customer Y (Y) for $150,000. Customer Y has subsidiary operations in a number of different countries and is looking to expand its operations into new countries. Under the terms of the license agreement, Y is permitted to have up to 100 users on Platform 1 and is entitled to transfer to other platforms if and when they become commercially available. Customer Y will retain the use of the software that runs on Platform 1, but the number of users continues to be limited to 100.

Analysis

Provided that the undelivered platform-transfer rights are considered to be the same product, the $150,000 software license fee should be recognized upon delivery of the software as long as all other revenue recognition criteria are met. In this scenario, the platform-transfer right represents an exchange right. Whereas Y retains the right to use the software on Platform 1, the total number of users (i.e., "products") remains the same (i.e., after one transfer, Y could have 50 users on Platform 1 and 50 users on Platform 2). Because Y can exchange one "product" for another similar product, the platform-transfer right represents an exchange right.

SOP 97-2
55. As part of their standard sales terms or as a matter of practice, vendors may grant resellers the rights to exchange unsold software for other software (including software that runs on a different hardware platform or operating system). Because the reseller is not the ultimate customer (see paragraph .51), such exchanges, including those referred to as stock balancing arrangements, should be accounted for as returns. Arrangements that grant rights to make such exchanges should be accounted for in conformity with FASB Statement No. 48, even if the vendors require the resellers to purchase additional software to exercise the exchange rights.

55-1: Transactions With Resellers

Question

Do the provisions of paragraphs 50–54 of SOP 97-2 concerning rights to exchange or return software for end-user customers apply to transactions with resellers?

Answer

Yes, except that SOP 97-2 does not permit software product elements in an arrangement with a reseller to be accounted for as an exchange. All exchange rights and platform-transfer rights granted to resellers are considered rights of return. However, SOP 97-2 requires subscription accounting if the vendor agrees to provide unspecified platform-transfer rights to a reseller.

55-2: Reseller's Right of Return Versus PCS Arrangement

Question

What is the difference between a reseller's right of return and a PCS arrangement with a reseller?

Answer

Under Statement 48, a reseller's right of return would be the right to return unsold software or to exchange unsold software for other similar software. If the reseller has the right to unspecified upgrades or enhancements for unsold software, the arrangement would be considered a PCS arrangement.

55-3: Accounting for a PCS Arrangement With Respect to Upgrades and Enhancements Provided on a When-and-If-Available Basis

Question

If an arrangement with a reseller provides for the right to upgrades and enhancements on a when-and-if-available basis (i.e., PCS) during the term of the arrangement, how should the PCS arrangement be accounted for under SOP 97-2?

Answer

It is in the best interest of both parties that the reseller sell the most current version of the software. Some have argued that these arrangements should be accounted for by analogy to Statement 48 — i.e., treated as a right of return with an accrual for estimated "returns." Under SOP 97-2, however, the arrangement is a multiple-element arrangement that consists of software and PCS. If the VSOE of fair value of the PCS is not available, the vendor should recognize the total arrangement fee ratably (paragraph 57 of SOP 97-2) over the term of the arrangement.

Example

A software vendor enters into a two-year arrangement with a reseller on January 1, 20X7, that permits the reseller to license 10,000 copies of a software product for $1 million. The vendor delivers a gold disk (master) on January 1. The arrangement provides that future gold disks will be delivered when and if the vendor upgrades the software so that the reseller will always be selling the most recent version of the software.

In this arrangement, the value of the vendor's right to unspecified upgrades declines both as copies are sold by the reseller to end users and straight-line over the two-year arrangement period. Therefore, the vendor should recognize revenue, provided that all other requirements for revenue recognition are met, on the basis of (1) the sell-through of copies sold to end users and (2) for unsold copies, straight-line amortization of the related portion of the fixed fee over the two-year term of the arrangement.

Multiple-Element Arrangements — Postcontract Customer Support

SOP 97-2
56. Software arrangements may include the right to PCS. PCS includes the right to receive PCS services or *unspecified* upgrades/enhancements, or both, offered to users or resellers. A vendor may develop historical patterns of regularly providing all customers or certain kinds of customers with the services or unspecified upgrades/enhancements normally associated with PCS, or may anticipate doing so, even though there is no written contractual obligation or the stipulated PCS term commences at some date after delivery. In those situations, an implied PCS arrangement exists that commences upon product delivery. For purposes of applying the guidance in this SOP, PCS includes a vendor's expected performance based on such patterns, even if performance is entirely at the vendor's discretion and not pursuant to a formal agreement.

56-1: Delayed Start for PCS

The PCS term of a software arrangement may not begin at the delivery date of the software (e.g., PCS may begin after installation or the expiration of a warranty period). In such situations, (1) the PCS agreement typically allows the customer to receive any upgrades or enhancements released by the vendor in the period between delivery of the license and the beginning of the PCS term, and (2) an implied PCS arrangement exists that begins upon delivery of the software.

Question

Should a portion of the arrangement fee be allocated to the implied PCS?

Answer

Yes. A portion of the fee should be allocated to the implied PCS arrangement on the basis of VSOE of fair value of the elements in the arrangement. VSOE of fair value for the implied PCS may be derived on a pro rata basis from the VSOE of fair value of the contractual PCS arrangement, particularly PCS renewal rates.

Example

Vendor A (A) enters into an arrangement with Customer B (B) to license software and to provide PCS for a one-year period. The software license includes a six-month warranty period. The PCS term begins at the conclusion of the warranty period, but B is entitled to any upgrades or enhancements that A releases during the warranty period. Vendor A has VSOE of fair value for the 12-month PCS and would determine the VSOE of fair value of the PCS during the warranty period from the annual PCS renewal fee (6 months/12 months × VSOE of fair value for 12 months). As long as all other criteria for revenue recognition have been met, revenue allocated to the license would be recognized upon delivery, the amount allocated to the PCS provided during the warranty period would be recognized over the warranty period, and the amount allocated to the remaining PCS would be recognized beginning at the conclusion of the warranty period over that PCS's one-year term.

56-2: Specified Versus Unspecified Upgrades or Enhancements

Question

Why does paragraph 56 of SOP 97-2 differentiate between specified and unspecified upgrades or enhancements?

Answer

The accounting for specified (upgrade rights) and unspecified (PCS) upgrades or enhancements differs under SOP 97-2. A specified upgrade or enhancement provided in an arrangement would be considered an upgrade right (even if it might have been provided under what would otherwise be a PCS or subscription arrangement) and should be accounted for as a separate element of the arrangement. An unspecified upgrade or enhancement included in an arrangement would be considered PCS.

For marketing purposes, vendors often specify upgrades or enhancements, describing the improved features that they expect to offer customers. However, if the specified upgrade or enhancement is determined to be part of the arrangements, it is a separate element that must be separately valued and considered in determining whether the revenue recognition criteria are met.

56-3: Examples of Specified Versus Unspecified Upgrade Rights in PCS Arrangements That Are Sold Separately (Not Bundled in a Licensing Arrangement)

Example 1

While enrolled in Vendor V's (V) PCS program, a licensee is entitled to enhancements on a when-and-if-available basis. An appendix to the contract lists V's current projects but does not give a timetable for their expected completion. Also, V does not announce what, if any, enhancements it will deliver under its arrangements.

Vendor V should recognize revenue on the PCS arrangement ratably (paragraph 57 of SOP 97-2) over the PCS term, provided that all other requirements for revenue recognition have been met.

Example 2

While enrolled in Vendor V's PCS program, a licensee is entitled to enhancements on a when-and-if-available basis. Customer B's PCS agreement states that Version 2.1 is expected to be available in the second quarter of this year, which is during the PCS term. Version 2.1 will be provided free of charge to those with current PCS, and will be sold separately to others.

The VSOE of fair value of the enhancement (i.e., the price for Version 2.1 when sold separately) should be recognized when the enhancement is delivered and all other revenue recognition criteria have been met. The remaining portion of the PCS fee (i.e., total fee less the amount allocated to the specified enhancement) should be recognized over the PCS term. Vendor V has specified an enhancement that customers would reasonably expect to receive when and if it is available under their current PCS term. Under SOP 97-2, a specified enhancement represents an element. As an element, revenue should be recognized in the amount of the VSOE of fair value of the element when all revenue recognition criteria are met.

Depending on when the revenue recognition criteria are met for the specified enhancement included as part of a PCS arrangement, the recognition of revenue may be accelerated or delayed compared with recognition of PCS without the specified enhancement. For example, assume the PCS arrangement is priced at $120,000. The price of PCS has been consistent over the past few years. In addition, assume that the upgrade right (Version 2.1) will be sold separately to customers not covered by PCS for $30,000 and that everyone covered by PCS will take the upgrade right. The revenue of $120,000 is allocated between the upgrade right ($30,000) and the PCS ($90,000), because no amount of the discount implicit in this arrangement may be allocated to the upgrade right (paragraph 37 of SOP 97-2). If no specified upgrade right had been offered in connection with the PCS arrangement and all other requirements for revenue recognition had been met, revenue would most likely have been recognized evenly at $10,000 per month. Provided that all other requirements for revenue recognition have been met, $30,000 will be recognized with the specified upgrade when it is delivered, and the PCS revenue will be recognized ratably (paragraph 57 of SOP 97-2) over the year at $7,500 per month. Provided that all other requirements for revenue recognition have been met, the timing of the delivery of the upgrade right will either accelerate or delay revenue recognition compared with revenue recognition without the upgrade right.

56-4: Examples of VSOE of Fair Value in Bundled Arrangements

Example 1

Vendor V (V) typically licenses software for $100,000. In an arrangement with Customer C, it licenses the same software with an upgrade right for $105,000. Vendor V has never offered an upgrade right before. It should not be assumed that the VSOE of fair value of the upgrade right is $5,000. If there is a basis for determining the VSOE of fair value of the upgrade right, revenue should be recognized separately for the software and the upgrade right, on the basis of their respective VSOE of fair values, when the revenue recognition criteria for each element have been met.

The VSOE of fair value of the upgrade right should not be calculated as the residual amount on the basis of V's prior sales price of the software. If, for example, V is offering the same upgrade right for sale separately at a price of $7,500, the fair value of the upgrade right would be $7,500 and the fair value of the software is the residual amount of $97,500 (i.e., $105,000 less $7,500), because no portion of the discount should be allocated to the undelivered upgrade right. In this example, there is insufficient VSOE to reasonably estimate the percentage of eligible customers that are not expected to exercise the upgrade right because V has never offered an upgrade right before, and therefore, the fee allocated to the upgraded right should not be adjusted further.

Example 2

Vendor B enters into an arrangement with Customer Z to provide software, maintenance services, and an upgrade right. The fair value based on VSOE of the software, maintenance services, and upgrade right is $100,000, $50,000, and $20,000, respectively. Customer Z buys the software, maintenance services, and upgrade right for $140,000. The revenue attributed to the upgrade right ($20,000) (paragraph 37 of SOP 97-2) should be recognized when the upgrade is delivered and all other revenue recognition criteria have been met. The remaining portion of the fee (i.e., $120,000) should be allocated proportionately to the software and the maintenance services (i.e., two-thirds, or $80,000, to the software and one-third, or $40,000, to the maintenance service). The revenue allocated to the software should be recognized when the software has been delivered and all other revenue recognition criteria have been met. The revenue allocated to the maintenance services should be recognized ratably (paragraph 57 of SOP 97-2) over the period as the services are performed, provided that all other revenue recognition criteria have been met.

Customer Z negotiated a $30,000 discount. The discount, however, is not specifically attributed to any of the elements in the arrangement; rather, it is a discount on the total purchase price. Under SOP 97-2, a proportionate amount of the discount should be applied to each element on the basis of the relative fair value of those elements, except that no portion of the discount should be allocated to the upgrade right (paragraph 37 of SOP 97-2). Accordingly, the amount of revenue attributed to the upgrade right should be the full VSOE of fair value of the upgrade right. The entire discount is allocated, therefore, proportionately to the remaining elements.

56-5: Warranties on Software Licenses

Question

Is a warranty considered an implied PCS element under SOP 97-2?

Answer

It depends. Typically, a vendor offers a warranty in connection with the license of a software product. A warranty that protects the customer from defective software should be accounted for under Statement 5. However, a warranty that includes PCS maintenance services, unspecified upgrades/enhancements released during the warranty period, or both, is an implied PCS element. Unless the implied PCS element (warranty) meets the criteria in paragraph 59 of SOP 97-2 such that the PCS revenue can be recognized upon delivery of the software product (provided that all other requirements for revenue recognition are met), the arrangement must be accounted for as a multiple-element arrangement.

56-6: Examples of Implied PCS

If a vendor has a history of providing free services or unspecified upgrades, customers may expect that such free services or upgrades will continue. Under SOP 97-2, an implied PCS relationship exists in these situations and a portion of the arrangement fee should be allocated to the implied PCS element on the basis of VSOE of fair value.

Example 1 — Warranty Fix

Vendor A sells network management software that includes firewall security. Vendor A recently announced that, because of a programming flaw, hackers could gain access to its customers' servers. Vendor A posted a patch on its Web site that corrected the programming flaw. Vendor A has a history of providing these patches to customers, free of charge, when needed. In this instance, the history of supplying patches for programming flaws would not create an implied PCS element since the purpose is to repair a significant flaw that existed when the software was originally licensed and that could damage the customer's software. These types of patches should be considered warranty fixes and should be accounted for accordingly.

Example 2 — Free Upgrades

Vendor B sells personal financial planning software for home computers and gives customers access to its Web site. Vendor B posted upgrade versions 1.2, 1.3, and 1.4 of the software on its Web site for its customers to use, free of charge, immediately after they were released. In this example, the history of posting of free upgrades to the Web site would represent an implied PCS element. A portion of the arrangement fee should be allocated to the implied PCS element on the basis of VSOE of fair value of all elements in the arrangement. If there were insufficient VSOE of fair value, the entire arrangement fee would be recognized ratably over the implied PCS term in accordance with paragraph 58 of SOP 97-2.

56-7: Termination of an Implicit PCS Arrangement

When a vendor has developed a regular pattern of providing all or certain kinds of customers with the services or unspecified upgrades/enhancements normally associated with PCS, paragraph 56 requires the vendor to account for an implied PCS arrangement.

Question

If a vendor is required to initially account for an implicit PCS arrangement, under what circumstances, if any, can the vendor stop recognizing that implicit obligation?

Answer

A vendor may stop recognizing an implicit PCS arrangement only if it clearly communicates to all affected customers that it no longer intends to provide free PCS on its products and it demonstrates the ability and intent to adhere to that policy decision.

Example

Company R (R), a software company, historically has provided free PCS for its software products to its end customers. Since the implicit PCS arrangement is not sold separately and no stated term is included in the contract, R has been recognizing all revenue on its software arrangements ratably over the life of the respective software products (or over the PCS period if the implied PCS is the only undelivered element). In anticipation of an IPO, R plans to conform its pricing and business practices for PCS to industry norms. Accordingly, R announces, via its Web site, that free PCS will terminate at the end of the current month, at which time PCS will be offered to all existing customers for 20 percent of the original license price (which is assumed to be VSOE).

In this situation, R's announcement and subsequent collection of payments for PCS would enable R to discontinue ratable revenue recognition for all of its existing contracts. Thus, R may record all revenue previously deferred, regardless of whether customers opted to purchase PCS, provided that (1) R represents its intentions to adhere to the new policy and (2) R adheres to its PCS pricing strategy.

However, if R does not adhere to its PCS pricing strategy and reverts back to its old policy of providing PCS for free, then any deferred revenue recognized because of the change in policy should be evaluated, and a cumulative-effect correction for a change in estimate may be required. Accordingly, R's ability to "make good" on its assertions should be scrutinized carefully before any previously deferred revenue is recognized.

SOP 97-2

57. If a multiple-element software arrangement includes explicit or implicit rights to PCS, the total fees from the arrangement should be allocated among the elements based on vendor-specific objective evidence of fair value, in conformity with paragraph .10. The fair value of the PCS should be determined by reference to the price the customer will be required to pay when it is sold separately (that is, the renewal rate). The portion of the fee allocated to PCS should be recognized as revenue ratably over the term of the PCS arrangement, because the PCS services are assumed to be provided ratably. However, revenue should be recognized over the period of the PCS arrangement in proportion to the amounts expected to be charged to expense for the PCS services rendered during the period if —

- Sufficient vendor-specific historical evidence exists demonstrating that costs to provide PCS are incurred on other than a straight-line basis. In making this determination, the vendor should take into consideration allocated portions of cost accounted for as research and development (R&D) costs and the amortization of costs related to the upgrade-enhancement capitalized in conformity with FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*. Such costs should be considered as part of the costs to provide PCS.
- The vendor believes that it is probable that the costs incurred in performing under the current arrangement will follow a similar pattern.

Because the timing, frequency, and significance of unspecified upgrades/enhancements can vary considerably, the point at which unspecified upgrades/enhancements are expected to be delivered should not be used to support income recognition on other than a straight-line basis.

57-1: PCS Renewal Rate

TIS Section 5100.54 states that a one-year PCS renewal rate within a time-based license constitutes VSOE of fair value under SOP 97-2 if the PCS renewal rate and term are substantive. TIS Section 5100.54 also indicates that factors to consider in determining whether the PCS renewal term is substantive include the initial (bundled) PCS term, the aggregate PCS renewal term, and the term of the license.

Question

Should any other factors be considered in determining whether a PCS renewal rate is substantive?

Answer

Yes. The estimated useful life of the software should also be considered. For example, a five-year term license includes two years of bundled PCS and three one-year renewal terms. Under this scenario, the bundled PCS term is for a relatively short period compared with the term of the license. In addition, the aggregate PCS renewal term is greater than the initial (bundled) PCS term. Accordingly, it appears that the PCS renewal term is substantive. However, if the useful life of the software is expected to be only two years, the PCS renewal terms would not be substantive since the period of bundled PCS is greater than the useful life of the software.

57-2: Example of a PCS Arrangement for an Off-the-Shelf Software Product

Vendor V (V) licenses software in arrangements that include delivery of an off-the-shelf software product and PCS in the form of telephone support. The telephone support is offered free of charge if the calls are made during business hours. For calls made outside of business hours, the customer must pay for the call at a preset rate. Vendor V maintains an extensive database of the support calls and prices the arrangement to cover (including a margin) the level of support provided. Vendor V's history demonstrates that, on average, customers make less than one call per license. Vendor V has chosen to unbundle the PCS included in the arrangement on the basis of the average price of the support provided on each license (number of calls expected multiplied by price per call on calls made outside of business hours) and, provided that all other requirements for revenue recognition are met, to recognize this revenue over the life of the product.

The method V uses to measure the fair value of the PCS bundled in the arrangement is acceptable. Paragraph 57 of SOP 97-2 provides guidance on determining the fair value of PCS, stating that "[t]he fair value of the PCS should be determined by reference to the price the customer will be required to pay when it is sold separately (that is the renewal rate)." In this example, the PCS provided during business hours has no renewal rate because the PCS is perpetual. Therefore, fair value is determined by using an acceptable alternative, the rate charged outside of normal business hours multiplied by the estimated number of calls based on vendor-specific historical evidence.

The SOP generally requires the recognition of PCS ratably over the term of the PCS arrangement. Because in V's arrangement the PCS term is unlimited, PCS revenue would be recognized over the estimated life of the off-the-shelf software product (provided that all other requirements for revenue recognition are met).

The SEC staff has indicated that it would not object to the approach described above.

57-3: Bargain Renewal Rates on PCS

Vendor X (X) typically sells PCS to end users at a stated rate of 18 percent of the list price of the software license. However, X enters into an agreement in which it sells software for $1,000 (which equals list) and provides the customer with rights to PCS at a stated rate of 2 percent of list in year 1. In year 2, the customer is given the opportunity to renew PCS at 10 percent of list. In year 3, the customer has to pay 18 percent of list. The contract is silent as to PCS renewals beyond year 3. The expected life of the product is five years.

Question 1

What is the VSOE of fair value of PCS in this arrangement?

Answer 1

The VSOE of fair value of PCS is $180 (18 percent of the list price of the software). This is both the standard renewal rate and the rate charged in year 3 of this arrangement (the last year for which there is a stated renewal rate).

Question 2

In applying the residual method, how much of the initial license fee should X allocate to the software license?

Answer 2

Vendor X should allocate $760 to the software license, calculated as follows:

Initial license fee		$ 1,000
Less:		
Fair value of year 1 PCS ($180) less PCS fee ($20)	$ (160)	
Fair value of year 2 PCS ($180) less PCS fee ($100)	(80)	(240)
		$ 760

Because X has offered the customer the right to a significant and incremental discount on PCS for years 1 and 2, X would be required to unbundle the full fair value of PCS for years 1 and 2 (the discount years), taking into consideration the initial PCS and renewal fees that will be paid. Since X will receive $20 in year 1, and $100 in year 2, for PCS (as long as the customer renews the PCS), X should unbundle $240 of the initial $1,000 ($160 + $80). If the customer does not renew PCS for year 2, the respective deferred amount would be recognized, provided that all other revenue recognition criteria are met, as the PCS renewal right lapses.

Question 3

Assume the same facts, except that the stated renewal rate is 2 percent and does not ramp up over time. In applying the residual method, how much of the initial license fee should X allocate to the software license?

Answer 3

Vendor X should allocate $200 to the software license, calculated as follows:

Initial license fee	$ 1,000
Less:	
Fair value of PCS for 5 years ($900) less PCS fee ($100)	(800)
	$ 200

The 2 percent renewal rate is significantly below the vendor's normal pricing practice and would indicate that the renewal rate is nonsubstantive (see TIS Section 5100.54). Therefore, the vendor would look to the standard price for PCS (18 percent of the list price of the software) as VSOE of the fair value of PCS. Because X has offered the customer the right to a significant and incremental discount on PCS for an undetermined number of years, X would be required to unbundle the full fair value of PCS for the life of the product (maximum discount period), taking into consideration the additional PCS fees. Since the product has an expected life of five years and the customer would be expected to renew PCS at the discounted rate during that period, X should unbundle an additional $800 ([$180 – $20] × 5 years). Should the customer fail to renew PCS during the five-year period, the respective deferred amounts would be recognized as the PCS renewal rights lapse, provided that all other revenue recognition criteria are met.

57-4: Substantive Renewal Rates on PCS

Company E (E) sells software to end users with one year of bundled PCS. To date, E has routinely offered PCS renewal rates at 20 percent of the initial license fee. However, E has a new product that it plans to offer only to select customers. Company E has never sold this product before, but management believes the product will require little or no support and decides to offer PCS at a stated renewal rate of 3 percent of the license fee.

Question

Does the 3 percent stated renewal rate establish VSOE of fair value for PCS on the new product?

Answer

Probably not. Although evaluating the substance of a stated renewal rate is a facts-and-circumstances judgment, the 3 percent stated renewal rate does not appear to be substantive. While E has not sold PCS on this product before, it has sold PCS on other products at a stated rate of 20 percent of the license fee. Further, while not considered VSOE, renewal rates for PCS in the software industry typically range between 10 percent and 20 percent of the software license fee. Accordingly, in the absence of actual renewals (i.e., separately sold transactions), or a compelling business case supporting the divergence from past practice and industry norms, it would appear that E does not have VSOE of fair value for the PCS element included in the contemplated arrangement. Examples of evidence that would be helpful in supporting the divergence from past practice and industry norms include:

- Contemporaneous documentation of the pricing decisions reached by management for the new product, including a discussion of (1) the planned frequency for updates, enhancements, and costs of PCS compared with other products, and (2) pricing used by competitors for similar products.

- Use of similar pricing on a number of concurrent transactions (i.e., proposals, letters of intent, or licensing agreements).

Such evidence might also support immediate recognition of the arrangement fee and accrual of PCS costs in accordance with paragraph 59 of SOP 97-2.

SOP 97-2
58. If sufficient vendor-specific objective evidence does not exist to allocate the fee to the separate elements and the only undelivered element is PCS, the entire arrangement fee should be recognized ratably over (*a*) the contractual PCS period (for those arrangements with explicit rights to PCS) or (*b*) the period during which PCS is expected to be provided (for those arrangements with implicit rights to PCS).

58-1: No VSOE of Fair Value for the Specified Upgrade

Question

If VSOE of fair value does not exist to allocate revenue to a specified upgrade right and to PCS, how should the fee be accounted for under SOP 97-2?

Answer

The total fee must be deferred until VSOE does exist or the upgrade is delivered. If no revenue is recognized until the upgrade is delivered, the amount of revenue to be recognized upon delivery of the upgrade is the prorated portion of the total fee based on the term of the PCS arrangement (provided that all other requirements for revenue recognition have been met). The balance of the revenue should be recognized ratably (paragraph 57 of SOP 97-2) over the remaining PCS term.

Example

A software arrangement includes a one-year-term software license, a specified upgrade on a when-and-if-available basis, and PCS for one year. Management has not yet determined the price at which the specified upgrade will be sold separately. The total arrangement fee is $1,000 and the upgrade is delivered six months into the 12-month PCS period. Because VSOE of fair value for the upgrade does not exist before delivery, the total fee must be deferred until the upgrade is delivered. Therefore, no revenue would be recognized until the upgrade is delivered, at which time, provided that all other requirements for revenue recognition have been met, $500 would be recognized on a straight-line basis because the delivery of the upgrade occurred halfway through the PCS term. The remaining $500 of the arrangement fee would be recognized ratably over the remaining PCS term of six months.

SOP 97-2

59. PCS revenue may be recognized together with the initial licensing fee on delivery of the software if all of the following conditions are met.

a. The PCS fee is included with the initial licensing fee.

b. The PCS included with the initial license is for one year or less.

c. The estimated cost of providing PCS during the arrangement is insignificant.

d. Unspecified upgrades/enhancements offered during PCS arrangements historically have been and are expected to continue to be minimal and infrequent.

If PCS revenue is recognized upon the delivery of the software, the vendor must accrue all estimated costs of providing the services, including upgrades/enhancements. Upgrades/enhancements are not developed solely for distribution to PCS customers; revenues are expected to be earned from providing the enhancements to other customers as well. Therefore, costs should be allocated between PCS arrangements and other licenses.

59-1: Short-Term License With PCS

Software Vendor C's (C's) standard license arrangement includes 90 days of PCS. After the 90-day period expires, C offers the customer a one-year "support service" agreement priced at 20 percent of the initial software license fee. The support service agreement states that it includes PCS and the continued right to use the software. If a customer chooses not to renew the support service agreement, C requires the customer to return the software media and documentation as well as a signed affidavit attesting that the software has been removed from the customer's system. Vendor C does not offer either part of the support service separately (i.e., C does not sell PCS without also selling the continued right to use the software, nor does C allow customers to pay for the continued right to use the software without purchasing PCS). The costs to provide PCS are estimated to be more than insignificant.

Question

How should C record the revenue from the license arrangement and the PCS agreement?

Answer

Vendor C does not have a basis for establishing VSOE of fair value of either the software license or the PCS. Each period of the arrangement is a bundled license/PCS period. In this case, the initial license/PCS period is only 90 days and the customer is paying five times the amount it will pay for the annual license/PCS renewal. Accordingly, it appears that this arrangement is, in substance, a term license with an indeterminable term longer than 90 days. Thus, the up-front fee should be recognized over the expected term of the arrangement (i.e., the expected life of the product). The additional license/PCS fees may be recognized over the one-year period to which they relate, or they may be added to the up-front fee and recognized proportionately over the expected term of the arrangement, with a catch-up adjustment for the expired term.

SOP 97-2
60. A determination that unspecified upgrades/enhancements offered during the PCS arrangement are expected to be minimal and infrequent should be evidenced by the patterns of minimal and infrequent unspecified upgrades/enhancements offered in previous PCS arrangements. A conclusion that unspecified upgrades/enhancements are expected to be minimal and infrequent should not be reached simply because unspecified upgrades/enhancements have been or are expected to be offered less frequently than on an annual basis. Regardless of the vendor's history of offering unspecified upgrades/enhancements to initial licensees, PCS should be accounted for separately from the initial licensing fee if the vendor expects to offer upgrades/enhancements that are greater than minimal or more than infrequent to the users or resellers of the licensed software during the PCS arrangement.

60-1: Minimal and Infrequent Upgrades/Enhancements

Paragraphs 59 and 60 of SOP 97-2 allow for accrual of PCS cost, as opposed to deferral of PCS revenue, if certain criteria are met. One of the criteria is that unspecified upgrades/enhancements offered during PCS arrangements historically have been, and are expected to continue to be, minimal and infrequent.

Question

When these criteria were developed, did the AcSEC expect that entities generally would be able to meet the requirement of minimal and infrequent upgrades/enhancements?

Answer

No. When the criteria for the exception to recognizing PCS revenue ratably (paragraph 57 of SOP 97-2) were developed, it was expected that software vendors generally would not be able to meet the criterion of "minimal and infrequent unspecified upgrades/enhancements." Therefore, recognizing PCS revenue on delivery of the related software and accrual of estimated PCS costs (as opposed to deferral of PCS revenue) is expected to be rare.

SOP 97-2

61. *Postdelivery Telephone Support at No Additional Charge*. Postdelivery telephone support provided to users by the vendor at no additional charge should be accounted for as PCS, in conformity with this SOP, regardless of whether the support is provided explicitly under the licensing arrangement. Although such telephone support may be offered or available for periods exceeding one year, if the vendor has established a history of providing substantially all the telephone support within one year of the licensing or sale of the software, the PCS may be considered to have a term of one year or less in applying paragraph .59, item (*b*) of this SOP. Accordingly, revenue allocable to telephone support may be recognized together with the initial licensing fee on delivery of the software if all the conditions in paragraph .59 of this SOP are met. This provision applies only to telephone support provided at no additional charge. If revenue allocable to telephone support is recognized together with the licensing fee on delivery, the vendor should accrue the estimated cost of providing that support.

61-1: Telephone Support Exceeding One Year

Question

How should postdelivery telephone support that is offered or available for more than one year and that has no VSOE of fair value be accounted for under SOP 97-2?

Answer

A vendor would generally be required to account for the telephone support as PCS and, provided that all other requirements have been met, to recognize the total arrangement fee over the period of telephone support. If the period were perpetual, the vendor would be required to estimate a period during which the support would be provided, usually over the life of the related product. However, paragraph 61 of SOP 97-2 provides an exception, as long as all specified criteria are met, for multiple-element arrangements that include postdelivery telephone support for periods of more than one year at no additional charge.

SOP 97-2

62. *PCS Granted by Resellers.* An arrangement in which a vendor grants a reseller the right to provide unspecified upgrades/enhancements to the reseller's customers is an implied PCS arrangement between the vendor and the reseller, even if the vendor does not provide direct telephone support to the reseller's customers. If sufficient vendor-specific objective evidence does not exist to allocate the fee to the software and the PCS, revenue from both the licensing arrangement and the PCS should be recognized ratably over the period during which PCS is expected to be provided.

62-1: Example of PCS Granted by Resellers

A vendor licenses software to a reseller for a fixed fee of $1 million. The vendor has agreed to provide PCS to the reseller, including PCS for the six months after all sales to the reseller's end users that occur within the next 12 months. The vendor can sell an unlimited number of copies during the 12-month period. Since the number of copies is not fixed, the vendor can sell copies until the 12-month period ends; thus, the maximum PCS period is 18 months.

In this example, a portion of the arrangement fee based on VSOE of fair value should be allocated to the extended PCS term and, provided that all other requirements for revenue recognition have been met, recognized on a straight-line basis over the maximum term (18 months). If, at the end of the initial 12-month period, it becomes apparent that the PCS period is less than the maximum 18 months, the recognition period should be adjusted as a change in estimate to the shorter period.

Multiple-Element Arrangements — Services

SOP 97-2

63. Certain arrangements include both software and service elements (other than PCS-related services). The services may include training, installation, or consulting. Consulting services often include implementation support, software design or development, or the customization or modification of the licensed software.

64. If an arrangement includes such services, a determination must be made as to whether the service element can be accounted for separately as the services are performed. Paragraph .65 discusses the criteria that must be considered in making such a determination. If the nature of the services is such that the service element does not qualify for separate accounting as a service, contract accounting must be applied to both the software and service elements included in the arrangement. Paragraphs .74 through .91 of this SOP address the application of contract accounting to software arrangements.

64-1: Accounting for Services

When a multiple-element software arrangement includes services that fail to meet all criteria for separate accounting, there are two resulting methods of accounting: contract accounting and recognition of the arrangement fee as the services are performed.

Question

When services fail to meet the criteria for separate accounting, when does contract accounting apply and when is the arrangement fee recognized as services are performed?

Answer

Contract accounting applies when the services cannot be accounted for separately. Paragraph 70 of SOP 97-2 gives examples of such services. If, under paragraph 65 of SOP 97-2, the services can be separated, and if all other requirements for revenue recognition have been met except that VSOE of fair value of the services does not exist, the arrangement fee is recognized as services are performed (paragraph 67 of SOP 97-2).

SOP 97-2

65. In order to account separately for the service element of an arrangement that includes both software and services, sufficient vendor-specific objective evidence of fair value must exist to permit allocation of the revenue to the various elements of the arrangement (as discussed in paragraphs .10 and .12). Additionally, the services (*a*) must not be essential to the functionality of any other element of the transaction and (*b*) must be described in the contract such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services.

65-1: Fair Value of Services Within an Arrangement

Question

If services are not stated separately within an arrangement, can they be accounted for as a separate element?

Answer

No. Paragraphs 65, 71, and 127 of SOP 97-2 clarify that in order for the services to be accounted for separately, the service and product elements must be stated separately and described such that the total price of the arrangement would be expected to vary as a result of the inclusion or exclusion of the services.

SOP 97-2
66. If an arrangement includes services that meet the criteria of paragraph .65 for separate accounting, revenue should be allocated among the service and software elements of the contract. This allocation should be based on vendor-specific objective evidence of fair values. (Fair values are not necessarily the same as any separate prices stated for the separate elements of the arrangement.) Revenue allocated to the service element should be recognized as the services are performed or, if no pattern of performance is discernible, on a straight-line basis over the period during which the services are performed.

66-1: Separately Priced Services in a Software Arrangement

Question

If services are priced separately in a software arrangement, is the stated price VSOE of fair value?

Answer

Not necessarily. For example, a fixed-fee contract that consists of software and services could include stated prices that are discounted for the software, the services, or both. Since the contract has an overall fixed fee, the customer would probably not care how each element is priced. The following example illustrates this point.

Example

Vendor A (A) enters into an arrangement with Customer B (B) to provide both software and training for $100,000. The arrangement states that the value of the training is $1,000 and the value of the software is $99,000. However, A licenses the software separately for $90,000 and offers the training separately for $10,000. Customer B could also purchase the training from another vendor for $10,000. Even though the arrangement explicitly states that the price of the software is $99,000, A would record revenue of $90,000 when the software is delivered (provided that all other requirements for revenue recognition have been met) and $10,000 as the training is provided.

SOP 97-2
67. If vendor-specific objective evidence of the fair value does not exist to allocate a portion of the fee to the service element, and the only undelivered element is services that do not involve significant production, modification, or customization of the software (for example, training or installation), the entire arrangement fee should be recognized as the services are performed. If no pattern of performance is discernible, the entire arrangement fee should be recognized on a straight-line basis over the period during which the services are performed.

SOP 97-2

68. An important factor to consider in determining whether the services are essential to the functionality of any other element is whether the software included in the arrangement is considered **core** or **off-the-shelf software**. Core software is software that a vendor uses in creating other software. It is not sold as is because customers cannot use it unless it is customized to meet system objectives or customer specifications. Off-the-shelf software is software that is marketed as a stock item that can be used by customers with little or no customization.

69. Software should be considered off-the-shelf software if it can be added to an arrangement with insignificant changes in the underlying code and it could be used by the customer for the customer's purposes upon installation. Actual use by the customer and performance of other elements of the arrangement is not required to demonstrate that the customer could use the software off-the-shelf. If significant modifications or additions to the off-the-shelf software are necessary to meet the customer's purpose (for example, changing or making additions to the software, or because it would not be usable in its off-the-shelf form in the customer's environment), the software should be considered core software for purposes of that arrangement. If the software that is included in the arrangement is not considered to be off-the-shelf software, or if significant modifications or additions to the off-the-shelf software are necessary to meet the customer's functionality, no element of the arrangement would qualify for accounting as a service, and contract accounting should be applied to both the software and service elements of the arrangement.

69-1: Example of Determining the Applicability of SOP 81-1 to a Software Arrangement

Vendor V (V) sells an integrated equipment and software package to lumber mills that is designed to scan logs and determine the most efficient way to cut them. Generally, V offers only the custom-designed software, which controls the overall system, and third-party vendors provide all remaining equipment. However, V's contracts include terms that provide for delivery of a completed working system to the customer.

The contract for the package consists of four major components: design specifications, delivery, installation of V's software, and start-up. Vendor V designs its systems to function in the remodeled facility, provides the design plans to the customers, ships its portion of the products to the customer, and instructs third-party vendors to ship the hardware to the customer. Upon receipt of the design plans, the customer generally removes old equipment, reconfigures the sawmill, and performs electrical and hardware installations. This process may take anywhere from five days to six months, depending on the level of additional re-engineering or construction the mill is undergoing.

After the customer's hardware installation, V performs the start-up phase, including tests of installed equipment and installation of its controlling software, and makes and tests modifications to the software to configure the system. This process generally takes from two days to two weeks, depending on the product being installed, and is essential to the overall functionality of the system.

During the design and start-up phases, V must significantly customize its software that is included in the system. In addition, the software is a significant portion of the contract since the software is what brings the most value to the new system.

Payment terms are as follows:

- Thirty percent on order.
- Thirty percent on delivery of design specifications to the customer.
- Thirty percent on shipment of the software.

- Ten percent at completion of the start-up phase or 60 days after delivery of the software and hardware, whichever is sooner.

Question

Should V record revenues on the contracts to sell software and hardware packages to sawmills using the percentage-of-completion method?

Answer

Yes. In this case, the software would be considered core software because it is not incidental to the arrangement and it is being significantly modified and customized to meet the customer's required functionality. Therefore, the arrangement should be accounted for under SOP 81-1.

SOP 97-2
70. Factors indicating that the service element is essential to the functionality of the other elements of the arrangement, and consequently should not be accounted for separately, include the following. • The software is not off-the-shelf software. • The services include significant alterations to the features and functionality of the off-the-shelf software. • Building complex interfaces is necessary for the vendor's software to be functional in the customer's environment. • The timing of payments for the software is coincident with performance of the services. • **Milestones** or customer-specific acceptance criteria affect the realizability of the software-license fee.
71. Judgment is required in determining whether the obligation to provide services in addition to the delivery of software should be accounted for separately as a service element. Services that qualify for accounting as a service element of a software arrangement always are stated separately and have one or more of the following characteristics. • The services are available from other vendors. • The services do not carry a significant degree of risk or unique acceptance criteria. • The software vendor is an experienced provider of the services. • The vendor is providing primarily implementation services, such as implementation planning, loading of software, training of customer personnel, data conversion, building simple interfaces, running test data, and assisting in the development and documentation of procedures. • Customer personnel are dedicated to participate in the services being performed.

SOP 97-2

72. *Funded Software-Development Arrangements*. Software-development arrangements that are fully or partially funded by a party other than the vendor that is developing the software typically provide the funding party with some or all of the following benefits:

- Royalties payable to the funding party based solely on future sales of the product by the software vendor (that is, reverse royalties)
- Discounts on future purchases by the funding party of products produced under the arrangement
- A nonexclusive sublicense to the funding party, at no additional charge, for the use of any product developed (a prepaid or paid-up nonexclusive sublicense)

72-1: Product Development for a Single Customer

Question

What factors should be considered in determining whether an agreement with a single customer is (1) a contract to develop software to be accounted for under ARB 45 and SOP 81-1, (2) funded R&D, or (3) an element of an arrangement with that customer?

Answer

Regardless of whether funding is received for a project before or after technological feasibility has been established, if the project is intended to generate a product only for the funding party, except as noted below, the arrangement is a contract with an individual customer and revenue should be recognized in accordance with SOP 81-1.

Vendors often receive funds from customers and characterize these arrangements as funding arrangements or funded R&D. However, some transactions characterized as funding arrangements are, in fact, prepayments for products, a production contract, or some other type of arrangement. To be considered a funded R&D arrangement, the arrangement needs to reflect a best-efforts obligation on behalf of the vendor. If the vendor is obligated to deliver a product or contractually obligated to deliver an element pursuant to the arrangement, the arrangement should not be considered a funded R&D arrangement.

SOP 97-2

73. A funded software-development arrangement within the scope of FASB Statement No. 68, *Research and Development Arrangements,* should be accounted for in conformity with that Statement. If the technological feasibility of the computer software product pursuant to the provisions of FASB Statement No. 86 has been established before the arrangement has been entered into, FASB Statement No. 68 does not apply because the arrangement is not a research and development arrangement. Accounting for costs related to funded software-development arrangements is beyond the scope of this SOP. However, if capitalization of the software-development costs commences pursuant to FASB Statement No. 86, any income from the funding party under a funded software-development arrangement should be credited first to the amount of the development costs capitalized. If the income from the funding party exceeds the amount of development costs capitalized, the excess should be deferred and credited against future amounts that subsequently qualify for capitalization. Any deferred amount remaining after the project is completed (that is, when the software is available for general release to customers and capitalization has ceased) should be credited to income.

73-1: Examples of Software Development Arrangements

The following are examples of funded software development arrangements and the appropriate accounting treatment under the circumstances:

Example 1 — Product Prepayment Arrangement

Vendor V (V) licenses software to Customer Z (Z), an end user. Under a separate agreement with Z, V agrees to develop additional software and deliver it to Z for an additional $10,000, which Z pays up front. The two agreements are not linked in any way (e.g., payment terms, acceptance). Vendor V intends to license the additional software to other users as a separate upgrade for $10,000; this price will most likely not change. The technological feasibility of the software to be developed has been established. Vendor V estimates it will cost an additional $250,000 to develop the software.

The $10,000 fee should be accounted for as a deposit (i.e., deferred revenue) and should be recognized as revenue when the software (upgrade) is delivered to Z and all other revenue recognition criteria are met.

In this example, the additional $10,000 payment is, in substance, a prepayment for the upgrade and not a funded development arrangement. The $10,000 payment is the same as the price for the upgrade that will be sold to other customers, the payment is negligible compared with the estimated cost to develop the product, and the arrangement is not a best-efforts arrangement — V is obligated to deliver the software. Once technological feasibility has been established and R&D activities have ceased, an outside party interested in the product would be unlikely to pay a significant premium for a product that will shortly be commercially available. All of these factors indicate that this transaction is not a funding arrangement but a prepayment for a product to be delivered at a future date. Notwithstanding the significant development required to produce the product in this arrangement, the arrangement is outside the scope of SOP 81-1 because the product will be sold to other customers in the ordinary course of business through the vendor's normal marketing channels. (See paragraph 14 of SOP 81-1.)

Example 2 — Product Development Arrangement With Input From Customer

Vendor V (V) agrees to develop and license software to Customer Z (Z), an end user. Vendor V intends to license the software to other users and to charge $100,000 per license; this price will most likely not change. The technological feasibility of the software has been established, and V expects that it will cost $500,000 to develop the software. Vendor V receives $130,000 from Z. In return for its payment, Z will be able to provide input during the development process. Vendor V has no other obligation under the agreement other than delivery of the software.

The $130,000 fee should be recognized as revenue when the software is delivered to Z and all other revenue recognition criteria are met. The timing of revenue recognition in this example is the same as in the previous example. However, this example is more subjective and involves a number of assumptions that only apply to this particular set of facts and circumstances. Although Z is paying an amount greater than the price that V intends to charge other customers, this is not conclusive evidence that the arrangement is a funding arrangement. Customer Z may be willing to pay a premium to (1) have input into the development process to, for example, "tailor" the products so that they require less customization), or (2) to be the "first on the block" to have the product. Because the product has reached technological feasibility, the product can almost certainly be developed, and V is obligated to deliver the product to Z but has no further substantive obligations.

The conclusion in this example is based on several factors, the most critical of which is that V will be able to sell the product to other customers. If there were significant uncertainty about whether V would be able to sell this product to other customers, the arrangement would be a contract with Z to develop software. Because the estimated development cost is $500,000 and the fee is $130,000, the contract would be accounted for as a loss contract under SOP 81-1.

Example 3 — Funded Development Arrangement

Vendor V (V) enters into an arrangement with Customer F (F), a large hardware manufacturer and software reseller. Vendor V had eight projects under way for new software products. In exchange for a $10 million nonrefundable payment from F, V has agreed, on a solely best-efforts basis, to devote substantially all of its efforts to three of the projects it has already begun (X, Y, and Z, respectively). As a result, the commercial availability of X, Y, and Z is expected, but not committed, to be accelerated by six to nine months. In exchange for its $10 million payment, F will be entitled to unlimited copies of X, Y, and Z for three years and will be entitled to 2 percent of all gross sales by V of products X, Y, and Z. The technological feasibility of X, Y, and Z has not yet been established. The $10 million payment exceeds the expected costs to reach technological feasibility for X, Y, and Z and the commercial release of these products.

The $10 million payment should be accounted for pursuant to Statement 68. If technological feasibility is reached, any remaining portion of the $10 million payment should be offset against costs that would otherwise have been capitalized pursuant to Statement 86, provided that the terms of the arrangement and surrounding conditions indicate that there is no obligation to repay. If all three of the products are released commercially, V should record any remaining portion of the $10 million as revenue at that time.

This arrangement is a best-efforts contract between V and F. While delivery of products and reverse royalty payments are contemplated in the agreement, they are conditional on the commercial release of product X, Y, or Z; therefore, F is not required to record a liability for these potential future obligations.

Contract Accounting

SOP 97-2
74. If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the service element does not meet the criteria for separate accounting set forth in paragraph .65. The entire arrangement should be accounted for in conformity with ARB No. 45, using the relevant guidance in SOP 81-1 [section 10,330]. Nevertheless, transactions that normally are accounted for as product sales should not be accounted for as long-term contracts merely to avoid the delivery requirements normally associated with product sales for revenue recognition.

74-1: Accounting for a Services Element Under SOP 97-2 Versus SOP 81-1

Question

Is there a difference between accounting for the services element of an arrangement in accordance with SOP 97-2 and accounting for the entire arrangement in accordance with SOP 81-1?

Answer

Yes, and sometimes the differences may be significant. In many ways, the guidance in SOP 97-2 is more stringent than that in SOP 81-1 — for example, with respect to extended payment terms and refund provisions.

If an arrangement accounted for under SOP 97-2 includes extended payment terms, and the fee is determined not to be fixed or determinable, the revenue must be recognized as the payments become due (as long as all other criteria have been met). However, if the percentage-of-completion method were used to account for the arrangement in accordance with SOP 81-1, the arrangement's inclusion of payment terms that, for example, extend beyond one year, would not necessarily mean that the fee is not fixed or determinable. For example, it is not unusual for payment terms to extend throughout the performance under a contract and performance may occur over a period longer than one year. However, notwithstanding the application of SOP 81-1, the same concerns about software obsolescence and potential concessions noted in SOP 97-2 also may exist when payment terms extend beyond the completion of performance under an SOP 81-1 contract.

Example

Vendor A (A) entered into an arrangement with Customer B (B) for a database management system. The product will require significant customization. The contract provides that if the software does not meet B's specifications and A does not rectify the situation within 30 days, B is entitled to a full refund of previous payments and is not liable for any other payment under the agreement. The arrangement is being accounted for appropriately under ARB 45 and SOP 81-1.

Vendor A has evaluated the impact of the refund provision under SOP 81-1.

Paragraph 23 of SOP 81-1 states that the percentage-of-completion method is preferable when reasonably dependable estimates can be made and when:

a. The contracts include provisions clearly specifying the enforceable rights regarding the goods or services to be provided/received, the consideration, and the manner and terms of settlement.

b. The buyer can be expected to satisfy its obligations under the contract.

c. The contractor can be expected to perform its obligations under the contract.

The refund provision in the agreement applies if the contractor cannot perform under the contract. This type of refund provision is considered normal. As long as A has a history of providing customization services and experience with the software product sold to B, and given that A has the contractual right to correct any failures within 30 days, it would be reasonable for A to assess the likelihood of a refund as remote.

If it were appropriate for A to account for this arrangement under SOP 97-2, the existence of the refund provision in the agreement would indicate that the arrangement fee does not meet the collectibility criterion discussed in paragraph 14 of SOP 97-2.

SOP 97-2

75. In applying contract accounting, the vendor must use either the percentage-of- completion method or the completed-contract method. The determination of the appropriate method should be made according to the recommendations in paragraphs 21 through 33 of SOP 81-1 [section 10,330.21 through .33].

76. *Segmentation*. Software contracts may have discrete elements that meet the criteria for segmenting in paragraphs 39 through 42 of SOP 81-1 [section 10,330.39 through .42]. If a contract is segmented, each segment is treated as a separate profit center. Progress-to-completion for each segment should be measured in conformity with paragraphs .78 through .80 of this SOP.

77. Some vendors of arrangements that include software combined with services or hardware or both do not identify the elements separately and do not sell them separately because of agreements with their suppliers. Other vendors who are not restricted by such agreements nevertheless bid or negotiate software and other products and services together. Arrangements that do not meet the segmentation criteria in paragraph 40 of SOP 81-1 [section 10,330.40] are prohibited from being segmented, unless the vendor has a history of providing the software and other products and services to customers under separate arrangements and the arrangement meets the criteria in paragraph 41 of SOP 81-1 [section 10,330.41].

78. *Measuring Progress-to-Completion Under the Percentage-of-Completion Method.* Paragraph 46 of SOP 81-1 [section 10,330.46] describes the approaches to measuring progress on contracts (or segments thereof) under the percentage-of-completion method. Those approaches are grouped into input and output measures, as follows.

> Input measures are made in terms of efforts devoted to a contract. They include the methods based on costs and on efforts expended. Output

> measures are made in terms of results achieved. They include methods based on units produced, units delivered, contract milestones, and value added. For contracts under which separate units of output are produced, progress can be measured on the basis of units of work completed.

For software contracts, an example of an input measure is labor hours; an example of an output measure is arrangement milestones, such as the completion of specific program modules.

79. If, as discussed in paragraph .76 of this SOP, a software contract includes a discrete element that meets the segmentation criteria of SOP 81-1 [section 10,330], the method chosen to measure progress-to-completion on the element should be the method that best approximates progress-to-completion. Progress-to-completion on separate elements of the same software arrangement may be measured by different methods. The software vendor should choose measurement methods consistently, however, so that it uses similar methods to measure progress-to-completion on similar elements.

80. Output measures, such as value-added or arrangement milestones, may be used to measure progress-to-completion on software arrangements, but many companies use input measures because they are established more easily. As noted in paragraph 47 of SOP 81-1 [section 10,330.47], "The use of either type of measure requires the exercise of judgment and the careful tailoring of the measure to the circumstances." Further, paragraph 51 of SOP 81-1 [section 10,330.51] states that

> The acceptability of the results of input or output measures deemed to be appropriate to the circumstances should be periodically reviewed and confirmed by alternative measures that involve observation and inspection. For example, the results provided by the measure used to determine the extent of progress may be compared to the results of calculations based on physical observations by engineers, architects, or similarly qualified personnel. That type of review provides assurance somewhat similar to that provided for perpetual inventory records by periodic physical inventory counts.

81. *Input Measures*. Input measures of progress-to-completion on arrangements are made in terms of efforts devoted to the arrangement and, for software arrangements, include methods based on costs, such as cost-to-cost measures, and on efforts expended, such as labor hours or labor dollars. Progress-to-completion is measured indirectly, based on an established or assumed relationship between units of input and productivity. A major advantage of input measures is that inputs expended are easily verifiable. A major disadvantage is that their relationship to progress-to-completion may not hold if inefficiencies exist or if the incurrence of the input at a particular point does not indicate progress-to-completion.

82. Costs incurred should be included in measuring progress-to-completion only to the extent that they relate to contract performance. Items not specifically produced for the arrangement, such as hardware purchased from third parties or off-the-shelf software, should not be included in the measurement of progress-to-completion.

83. Labor hours often are chosen as the basis for measuring progress-to-completion, because they closely approximate the output of labor-intensive processes and often are established more easily than output measures. Core software requires labor-intensive customization. Therefore, labor hours provide a good measure of progress-to-completion on elements of software arrangements that involve the customization of core software.

84. If the measurement of progress-to-completion is based primarily on costs, the contribution to that progress of hardware and software that were produced specifically for the arrangement may be measurable and recognizable before delivery to the user's site. For example, efforts to install, configure, and customize the software may occur at the vendor's site. The costs of such activities are measurable and recognizable at the time the activities are performed.

85. *Output Measures.* Progress on arrangements that call for the production of identifiable units of output

can be measured in terms of the value added or milestones reached. Although progress-to-completion based on output measures is measured directly from results achieved, thus providing a better approximation of progress than is provided by input measures, output measures may be somewhat unreliable because of the difficulties associated with establishing them.

86. In order for the value added to be verifiable, the vendor must identify elements or subcomponents of those elements. If output measures are neither known nor reasonably estimable, they should not be used to measure progress-to-completion.

87. If value added by off-the-shelf software is to be included in the measurement of progress-to-completion, such software cannot require more than minor modifications and must be usable by the customer for the customer's purpose in the customer's environment. If more than minor modifications or additions to the off-the-shelf software are necessary to meet the functionality required under the arrangement terms, either by changing or making additions to the software, or because the software would not be usable by the customer in its off-the-shelf form for the customer's purpose in the customer's environment, it should be accounted for as core software.

88. Value added by the customization of core software should be included in the measurement of progress-to-completion of the customization and installation at the user's site. However, if the installation and customization processes are divided into separate output modules, the value of core software associated with the customization of a module should be included in the measurement of progress-to-completion when that module is completed.

89. Contract milestones may be based on contractual project plans. Contractual provisions generally require the performance of specific tasks with the approval or acceptance by the customer; project plans generally schedule inspections in which the project's status is reviewed and approved by management. The completion of tasks that trigger such inspections are natural milestones because they are subject to relatively independent review as an intrinsic part of the project management process.

90. Considerations other than progress-to-completion affect the amounts that become billable at particular times under many arrangements. Accordingly, although the achievement of contract milestones may cause arrangement revenues to become billable under the arrangement, the amounts billable should be used to measure progress-to-completion only if such amounts indeed indicate such progress.

91. The milestones that are selected to measure progress-to-completion should be part of the management review process. The percentage-of-completion designated for each milestone should be determined considering the experience of the vendor on similar projects.

Effective Date and Transition

SOP 97-2

92. This SOP is effective for transactions entered into in fiscal years beginning after December 15, 1997. Earlier application is encouraged as of the beginning of fiscal years or interim periods for which financial statements or information have not been issued. Retroactive application of the provisions of this SOP is prohibited.

Basis for Conclusions — Background

SOP 97-2
93. SOP 91-1 was issued in December 1991. AcSEC understands that certain provisions of that Statement are being applied inconsistently in practice and that various practice issues have arisen that were not addressed in SOP 91-1. As a result, AcSEC added a project to its agenda in March 1993 to interpret those provisions and provide additional guidance. The key issues identified at the outset of the project related to accounting for arrangements that provided for multiple deliverables (including PCS). The project began as an amendment to SOP 91-1. However, as deliberations progressed, AcSEC determined that it would be more appropriate to supersede SOP 91-1 to (*a*) amend the provisions in question and (*b*) incorporate AcSEC's conclusions on practice issues that had not been addressed in SOP 91-1.

Basis for Conclusions — Basic Principles

SOP 97-2

94. Transfers of rights to software by licenses rather than by outright sales protect vendors from the unauthorized duplication of their products. Nevertheless, the rights transferred under software licenses are substantially the same as those expected to be transferred in sales of other kinds of products. AcSEC believes the legal distinction between a license and a sale should not cause revenue recognition on software products to differ from revenue recognition on the sale of other kinds of products.

95. Arrangements to deliver software or a software system, either alone or together with other products, may include services. AcSEC believes that if those services entail significant production, modification, or customization of the software, such software before those alterations (even if already delivered) is not the product that has been purchased by the customer. Instead, the product purchased by the customer is the software that will result from the alterations. Accordingly, AcSEC concluded that arrangements that include services that entail significant production, modification, or customization of software are construction-type or production-type contracts, and should be accounted for in conformity with ARB No. 45 and SOP 81-1 [section 10,330]. AcSEC concluded that if the services do not entail significant production, modification, or customization of software, the service element should be accounted for as a separate element.

96. AcSEC believes that revenue generally should not be recognized until the element has been delivered. The recognition of revenue from product sales on delivery is consistent with paragraphs 83(b) and 84 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*. Paragraph 83(b) provides the following guidance for recognition of revenues.

> 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. [Footnote omitted] [Emphasis added]

Paragraph 84 states that in recognizing revenues and gains

> [t]he two conditions [for revenue recognition] (being realized or realizable and being earned) are usually met by the time the product or merchandise is delivered . . . to customers, and revenues . . . are commonly recognized at time of sale (usually meaning *delivery*). [Emphasis added]

97. SOP 91-1 did not address arrangements that included software that was deliverable only when-and-if-available. Implementation questions arose as to whether when-and-if-available terms created contingencies that could be disregarded in determining whether an arrangement consists of multiple elements. AcSEC believes that because the when-and-if-available deliverables are bargained for in arrangements, they are of value to the customer. Accordingly, AcSEC concluded that when-and-if-available deliverables should be considered in determining whether an arrangement consists of multiple elements. Thus, the requirements of this SOP with respect to arrangements that consist of multiple elements should be applied to all additional products and services specified in the arrangement, including those described as being deliverable only when-and-if-available.

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

are met, because the earnings process related to that particular element is not considered complete until that time.

99. In paragraph .10 of this SOP, AcSEC concluded that the revenue from an arrangement should be allocated to the separate elements based on vendor-specific objective evidence of fair value, regardless of any separate prices stated in the contract for each element. AcSEC believes that separate prices stated in a contract may not represent fair value and, accordingly, might result in an unreasonable allocation of revenue. AcSEC believes that basing the allocation on fair values is consistent with the accounting for commingled revenue. An example is the following discussion in paragraph 12 of FASB Statement No. 45, *Accounting for Franchise Fee Revenue*.

> The franchise agreement ordinarily establishes a single initial franchise fee as consideration for the franchise rights and the initial services to be performed by the franchisor. Sometimes, however, the fee also may cover tangible property, such as signs, equipment, inventory, and land and building. In those circumstances, the portion of the fee applicable to the tangible assets shall be based on the fair value of the assets.

100. AcSEC considered allowing the use of surrogate prices such as competitor prices for similar products or industry averages to determine fair value. However, AcSEC believes that inherent differences exist between elements offered by different vendors. These inherent differences led AcSEC to conclude that only vendor-specific evidence of fair value can be considered sufficiently objective to allow the allocation of the revenue to the various elements of the arrangement.

101. AcSEC believes that the best evidence of the fair value of an element is the price charged if that element is sold separately. Still, an arrangement may include elements that are not yet being sold separately. As discussed in the previous paragraph, because of inherent differences between the elements offered by different vendors, AcSEC concluded that companies should not use surrogate prices, such as competitor prices for similar products or industry averages, as evidence of the fair value for an element. AcSEC believes, however, that if a price for the element has been established by management having the relevant authority, such a price represents evidence of the fair value for that element. To meet the criterion of objectivity, it must be probable that the established price will not change before the introduction of the element to the marketplace. Thus, the internally established prices should be factual and not estimates. For this reason, AcSEC concluded that the allocations may not be adjusted subsequently.

102. AcSEC is aware that the pricing structure of certain arrangements is not limited to the prices charged for the separate elements. Pricing may be based on many different factors or combinations thereof. For example, certain arrangements are priced based on a combination of (*a*) the prices of products to be licensed and (*b*) the number of users that will be granted access to the licensed products. In some of these arrangements, the vendor requires a minimum number of users.

103. The products contained in such arrangements are not available to the customer at the prices charged in the arrangement unless the customer also pays for the minimum number of users. Therefore, the prices contained in the arrangement do not represent the prices charged for the product when sold separately. AcSEC believes that it would be inappropriate to determine the fair values of the products (as discussed in paragraph .10) without giving consideration to the impact of the user-based portion of the fee. For this reason, AcSEC concluded in paragraph .10 that when a vendor's pricing is based on multiple factors such as the number of products and the number of users, the price charged for the same element when sold separately must consider all factors of the vendor's pricing structure.

104. Often, multiple element arrangements are sold at a discount rather than at the sum of the list prices for each element. If the amounts deferred for undelivered elements were based on list prices, the amount of revenue recognized for delivered elements would be understated. Accordingly, AcSEC concluded that relative sales prices should be used in determining the amount of revenue to be allocated to the elements of an arrangement.

105. AcSEC believes that if an undelivered element is essential to the functionality of a delivered element,

the customer does not have full use of the delivered element. Consequently, AcSEC concluded that delivery is considered not to have occurred in such situations.

106. AcSEC believes that the earnings process with respect to delivered products is not complete if fees allocated to those products are subject to forfeiture, refund, or other concession if the vendor does not fulfill its delivery responsibilities. AcSEC believes that the potential concessions indicate the customer would not have licensed the delivered products without also licensing the undelivered products. Accordingly, AcSEC concluded that in order to recognize revenue, persuasive evidence should exist that fees allocated to delivered products are *not* subject to forfeiture, refund, or other concession. In determining the persuasiveness of the evidence, AcSEC believes that a vendor's history of making concessions that were not required by the provisions of an arrangement is more persuasive than terms included in the arrangement that indicate that no concessions are required.

Basis for Conclusions — Delivery

SOP 97-2

107. In paragraph .18 of this SOP, AcSEC concluded that for software that is delivered electronically, the delivery criterion of paragraph .08 is deemed to have been met when the customer either (*a*) takes possession of the software via a download or (*b*) has been provided with access codes that allow the customer to take immediate possession of the software on its hardware pursuant to an agreement or purchase order for the software. AcSEC believes that the delivery criterion is met by use of access codes only when software is being delivered electronically.

108. AcSEC believes that if the fee is not based on the number of copies to be delivered to or made or deployed by the customer, duplication of the software may be incidental to the arrangement. Paragraph .21 of this SOP describes circumstances (arrangements in which duplication is required only if additional copies are requested by the customer; arrangements in which the licensing fee is payable even if no additional copies are requested) that would lead to a conclusion that duplication is incidental to the arrangement. In other arrangements, vendors insist on duplicating the software to maintain quality control or to protect software transmitted by telecommunications. Others agree to duplicate the software as a matter of convenience to the customer.

109. In arrangements in which duplication is considered incidental, AcSEC believes the vendor has fulfilled its delivery obligation as soon as the first copy or product master of the software has been delivered. Therefore, AcSEC concluded that in such instances, the vendor should not be precluded from recognizing revenue if the customer has not requested additional copies (particularly since the fee is payable regardless of whether such additional copies are requested by the customer). However, the estimated costs of duplicating the software should be accrued when the revenue is recognized.

Basis for Conclusions — Fixed or Determinable Fees and Collectibility

SOP 97-2

110. In paragraphs .27 through .30, in the discussion of factors that affect the determination of whether a fee is fixed or determinable, AcSEC sought to clarify — but not change — similar provisions in SOP 91-1. In practice, some had interpreted those provisions to mean the following.

- Extended payment considerations could be overcome if customers were creditworthy.
- A fee could never be considered fixed or determinable if payment terms extended for more than twelve months after delivery.

111. Others had interpreted these provisions to mean the following.

- If payment terms extended beyond customary terms but were twelve months or less, they were fixed or determinable.
- If payment terms exceeded twelve months, a vendor could recognize amounts due in the first twelve months as revenue at the time of the license. Additional revenue would be recognized based on the passage of time such that, at any point, any amounts due within one year would have been recognized as revenue (the *rolling twelve months* approach).

Paragraphs .112 through .114 of this SOP —

- Explain that the concern with extended payment terms is technological obsolescence and similar factors, not customer creditworthiness.
- Describe circumstances in which the presumption that a fee is not fixed or determinable because of extended payment terms may be overcome.
- Confirm that any extended payment terms, even if for less than twelve months, must be assessed for their effects on the fixed or determinable aspects of the fee.
- Clarify that the rolling twelve months approach should not be used.

112. AcSEC believes that, given the susceptibility of software to significant external factors (in particular, technological obsolescence), the likelihood of vendor refunds or concessions is greater in an arrangement with extended payment terms than in an arrangement without extended payment terms. This is true regardless of the creditworthiness of the customer. Because of this greater likelihood of refunds or concessions, AcSEC believes that *any* extended payment terms outside of a vendor's normal business practices may indicate that the fee is not fixed or determinable.

113. In paragraph .28 of this SOP, AcSEC concluded that if payment of a significant portion of a licensing fee is not due until after the expiration of the license or more than twelve months after delivery, the fee should be *presumed* not to be fixed or determinable. This conclusion is based on AcSEC's belief that payment terms of such extended duration indicate that vendor refunds or concessions are more likely than not. AcSEC acknowledges that the one-year provision is arbitrary. However, AcSEC concluded that such a limitation is needed to provide greater comparability within the industry.

114. In considering the "rolling twelve months" approach found in practice, AcSEC considered the guidance in Chapter 1A of ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, paragraph 1, which states that "Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably

assured." Accordingly, if a fee is considered fixed or determinable, it should be recognized as revenue when the sale is effected. If not, AcSEC believes that it should be recognized as revenue as payments from customers become due.

115. In paragraph .08 of this SOP, AcSEC concluded that collectibility must be probable before revenue may be recognized. This conclusion is based on paragraph 84g of FASB Concepts Statement No. 5, which reads

> If collectibility of assets received for product, services, or other assets is doubtful, revenues and gains may be recognized on the basis of cash received.

116. AcSEC notes that requiring collectibility enhances the verifiability of the other revenue recognition criteria of paragraph .08, as discussed below.

- *Persuasive evidence of an arrangement* — AcSEC included this criterion in order to prevent revenue recognition on delivery of elements which, in fact, had not been ordered by a customer. AcSEC believes it is unlikely that a customer would pay for an element that had not been ordered. Therefore, AcSEC believes that requiring collectibility of a receivable related to the sale or license acts to verify that an arrangement does exist.

- *Delivery* — AcSEC believes that until delivery of an element has occurred (including delivery of all other items essential to the functionality of the element in question), the customer has not received full use of the element ordered. A customer that has not received full use of the element ordered is likely to withhold payment or require a refund. Therefore, AcSEC believes that requiring collectibility of a receivable related to the sale or license acts to verify that the element has been delivered.

- *Fixed or determinable fee* — Much of AcSEC's concern related to fixed or determinable fees relates to arrangements with extended payment terms. In the software industry, requiring collectibility of a receivable prior to revenue recognition is important because of the frequency with which upgrades, enhancements, or new versions are released. As discussed elsewhere in this SOP, in certain instances it may be difficult to determine which version of an element induced a customer to enter into an arrangement. By requiring collectibility, AcSEC sought to prevent revenue recognition on sales or licenses of an element in situations in which circumstances may prompt the vendor to make subsequent adjustments to the price of a customer's purchase or license of a subsequent version of that element.

  The likelihood that subsequent versions will be released is greater over the long term than over the short term. Therefore, concerns related to concessions increase in arrangements with extended payment terms. AcSEC notes that prohibiting revenue recognition in circumstances in which the price adjustments discussed above could occur serves to ensure that the portion of the fee allocated to each element is fixed or determinable. That is, if the price on a subsequent element cannot be adjusted for concessions, and the amount allocated to the initial element must be collected in full, neither amount is subject to adjustment. Therefore, AcSEC believes that requiring collectibility of a receivable related to the sale or license acts to verify that the fees are fixed or determinable.

Basis for Conclusions — Multiple-Element Arrangements — Additional Software Deliverables and Right to Exchange or Return Software

SOP 97-2

117. *Upgrades/enhancements*. In paragraph .37 of this SOP, AcSEC concluded that the portion of the arrangement fee allocated to an upgrade right should be based on the price for the upgrade/enhancement that would be charged to existing users of the software product being updated. AcSEC believes that in arrangements that include upgrade rights, it may be difficult to determine which version of the software induced the customer to enter into the arrangement. For example, a customer licensing an existing version of the software may have done so to facilitate obtaining the updated version upon its introduction. To eliminate the possibility of allocating too much revenue to the delivered software (and thereby accelerating recognition), AcSEC concluded that the upgrade price (without the allocation of any discount on the arrangement) should be used to determine the amount to be deferred. The residual amount, if any, is considered to be the fair value of the original product.

118. AcSEC believes that upgrades/enhancements do not necessarily contain improvements that all customers would desire. A customer may not exercise an upgrade right for various reasons, including any of the following.

    a. The benefits to be gained from the related upgrade/enhancement may not be important to that customer.

    b. The customer may not wish to learn new commands for what may be perceived by that customer as marginal improvements.

    c. The upgrade/enhancement would require more hardware functionality than the customer currently has.

    Consequently, AcSEC concluded that amounts allocated to upgrade rights should be reduced to reflect the percentage of customers not expected to exercise the upgrade right, based on vendor-specific evidence.

119. *Additional Software Products*. As stated in paragraph .118, AcSEC believes that not all customers entitled to an upgrade/enhancement will exercise their upgrade rights. AcSEC believes, however, that it is probable that all customers will choose to receive additional software products. Consequently, AcSEC concluded that the fee allocated to additional software products should not be reduced by the percentage of any customers not expected to exercise the right to receive the additional products.

120. Paragraphs .48 and .49 of this SOP discuss accounting for software arrangements in which vendors agree to deliver unspecified additional software products in the future. AcSEC concluded that such arrangements should be accounted for as subscriptions, and that the fee from the arrangement should be recognized ratably as revenue over the term of the arrangement. AcSEC notes that, because the vendor is obligated to deliver these items only if they become available during the term of the arrangement, in some situations, the delivery of additional products will not be required. AcSEC believes that because these items are unspecified, vendor-specific objective evidence of fair value of each unspecified additional product cannot exist. However, AcSEC believes that requiring the deferral of all revenue until the end of the arrangement is too onerous because of the following.

    a. All other revenue-recognition conditions in paragraphs .08 through .14 of this SOP have been met.

    b. The additional software products in fact may never be delivered.

    However, AcSEC also was concerned that if revenue recognition were permitted to begin at the inception of the arrangement, revenue may be recognized too early, particularly in arrangements in which the first product was not delivered for some time after inception. Accordingly, AcSEC concluded that revenue from the arrangement should be recognized ratably over the term of the arrangement beginning with the delivery of the first product.

121. *Rights to Exchange or Return Software*. AcSEC believes that the rights to exchange or return software (including platform transfer rights) are subject to the provisions of FASB Statement No. 48, even if the software is not returned physically. Accordingly, AcSEC concluded that the accounting for exchanges of software for products with no more than minimal differences in price, functionality, and features by users qualify for exchange accounting because, as discussed in footnote 3 to FASB Statement No. 48, (*a*) users are "ultimate customers" and (*b*) exchanges of software with no more than minimal differences in price, functionality, and features represent "exchanges . . . of one item for another of the same kind, quality, and price." AcSEC concluded that because resellers are not "ultimate customers," such exchanges by resellers should be considered returns.

122. AcSEC reached similar conclusions related to certain platform-transfer rights. Additionally, AcSEC concluded that in situations in which customers are entitled to continue using the software that was originally delivered (in addition to the software that is to be delivered for the new platform), the customer has received additional software products, and the platform-transfer right should be accounted for as such. Other platform-transfer rights do not allow customers to continue to use the software on the original platform. Those platform-transfer rights should be accounted for as exchange rights or rights of return.

123. It is possible that exchange rights may be granted for software that has not been developed for other platforms at the time revenue from the arrangement is recorded. AcSEC did not address the issue of whether such future development costs related to deliverable software, for which no further revenue will be received, should be capitalized pursuant to FASB Statement No. 86 because it was believed that such costs would not be significant. Accordingly, AcSEC concluded that in the event of significant development costs, the vendor would not be likely to be able to demonstrate persuasively that the future software would have similar pricing, features, and functionality, and would be marketed as the same product (that is, qualify as an exchange for accounting purposes). In that event, the vendor has granted a return right that must be accounted for pursuant to FASB Statement No. 48.

Basis for Conclusions — Multiple-Element Arrangements — Postcontract Customer Support

SOP 97-2

124. An obligation to perform PCS is incurred at the inception of a PCS arrangement and is discharged by delivering unspecified upgrades/enhancements, performing services, or both over the period of the PCS arrangement. The obligation also may be discharged by the passage of time. AcSEC concluded that because estimating the timing of expenditures under a PCS arrangement usually is not practicable, revenue from PCS generally should be recognized on a straight-line basis over the period of the PCS arrangement. However, AcSEC also concluded that if there is sufficient vendor-specific historical evidence that costs to provide the support are incurred on other than a straight-line basis, the vendor should recognize revenue in proportion to the amounts expected to be charged to the PCS services rendered during the period.

125. SOP 91-1 required that revenue from both the PCS and the initial licensing fee be recognized ratably over the period of the PCS arrangement if no basis existed to derive separate prices for the PCS and the initial licensing fee. Diversity in practice arose as to what constituted a sufficient basis in arrangements involving vendors that did not have a basis to derive a separate price for the PCS. In this SOP, AcSEC has concluded that arrangement fees must be allocated to elements of the arrangement based on vendor-specific objective evidence of fair value. Because AcSEC determined that the evidence should be limited to that which is specific to the vendor, AcSEC believes that vendors that do not sell PCS

separately have no basis on which to allocate fair values. AcSEC concluded that the total arrangement fee should be recognized in accordance with the provisions on recognition of PCS revenues. AcSEC also believes that, because a substantial portion of the arrangement fee typically is represented by the delivered software (rather than the performance of support), requiring the deferral of all revenues until the PCS obligation is fully satisfied would be too onerous. Accordingly, AcSEC concluded that, as discussed in the previous paragraph, the total arrangement fee generally should be recognized ratably over the period of the PCS arrangement.

Basis for Conclusions — Multiple-Element Arrangements — Services

SOP 97-2

126. Certain software arrangements include both a software element and an obligation to perform non-PCS services. SOP 91-1 provided guidance on the conditions that must be met in order to account for the obligation to provide services separately from the software component. AcSEC is aware that this guidance has been interpreted in varying ways, leading to a diversity in practice. During its deliberations on this SOP, AcSEC reached conclusions intended to clarify this issue, but did not redeliberate the other conclusions related to services that were included in SOP 91-1.

127. AcSEC believes the service element should be accounted for separately if the following occur.

a. All other revenue allocation provisions of this SOP are met.

b. The services are not essential to the functionality of any other element in the arrangement.

c. The service and product elements are stated separately such that the total price of the arrangement would vary as a result of inclusion or exclusion of the services.

Accordingly, AcSEC concluded that a service element need not be *priced* separately in an agreement in order to account for the services separately. AcSEC believes that this conclusion represents the original intent of SOP 91-1, and wishes to clarify the language at this time.

128. Paragraphs .129 through .132 of this SOP are carried forward from SOP 91-1 with certain editorial changes.

129. *Service Elements.* Footnote 1 to paragraph 11 of SOP 81-1 [section 10,330.11, footnote 1] excludes service transactions from the scope of the SOP, as follows.

> This statement is not intended to apply to "service transactions" as defined in the FASB's October 23, 1978 Invitation to Comment, Accounting for Certain Service Transactions. However, it applies to separate contracts to provide services essential to the construction or production of tangible property, such as design . . . [and] engineering. . . .

130. The previously mentioned Invitation to Comment, which was based on an AICPA-proposed SOP, was issued in 1978. The FASB later included service transactions as part of its project to develop general concepts for revenue recognition and measurement. The resulting FASB Concepts Statement No. 5, however, does not address service transactions in detail. Nevertheless, some of the concepts on service transactions developed in the Invitation to Comment are useful in accounting for certain software transactions.

131. A service transaction is defined in paragraphs 7 and 8 of the Invitation to Comment as follows.

> A transaction between a seller and a purchaser in which, for a mutually agreed price, the seller performs . . . an act or acts . . . that do not alone

> produce a tangible commodity or product as the principal intended result . . . A service transaction may involve a tangible product that is sold or consumed as an incidental part of the transaction or is clearly identifiable as secondary or subordinate to the rendering of the service.

The term *service transaction* is used in the same sense in this SOP but, as used in this SOP, does not apply to PCS. Items classified as tangible products in software service transactions generally should be limited to off-the-shelf software or hardware.

132. This SOP, like the Invitation to Comment, recommends the separation of such arrangements with discrete elements into their product and service elements. Paragraph 8(b) of the Invitation to Comment states the following.

> If the seller of a product offers a related service to purchasers of the product but separately states the service and product elements in such a manner that the total transaction price would vary as a result of the inclusion or exclusion of the service, the transaction consists of two components: a product transaction that should be accounted for separately as such and a service transaction . . . .

Basis for Conclusions — Contract Accounting

SOP 97-2

133. SOP 91-1 included guidance on the application of contract accounting to software transactions. Questions arose as to whether output measures could be used to measure progress-to-completion if the amounts recorded would differ from those that would have been reported had input measures been used. During its deliberations of this SOP, AcSEC reached conclusions intended to clarify this issue, but did not redeliberate the other conclusions related to services that were included in SOP 91-1.

134. AcSEC believes that the method chosen to measure progress-to-completion on an individual element of a contract should be the method that best approximates progress-to-completion on that element. Accordingly, AcSEC concluded that output measures may be used to measure progress-to-completion, provided that the use of output measures results in "the method that best approximates progress-to-completion."

135. Paragraphs .136 through .142 of this SOP are carried forward from SOP 91-1 with certain editorial changes.

136. ARB No. 45 established the basic principles for measuring performance on contracts for the construction of facilities or the production of goods or the provision of related services with specifications provided by the customer. Those principles are supplemented by the guidance in SOP 81-1 [section 10,330].

Basis for Conclusions — Contract Accounting — Distinguishing Transactions Accounted for Using Contract Accounting From Product Sales

SOP 97-2

137. SOP 81-1 [section 10,330] suggests that transactions that normally are accounted for as product sales should not be accounted for using contract accounting merely to avoid the delivery requirements for revenue recognition normally associated with product sales. Paragraph 14 of SOP 81-1 [section 10,330.14] states the following:

> Contracts not covered . . . include . . . [s]ales by a manufacturer of goods produced in a standard manufacturing operation, even if produced to buyers' specifications, and sold in the ordinary course of business through the manufacturer's regular marketing channels if such sales are normally recognized as revenue in accordance with the realization principle for sales of products and if their costs are accounted for in accordance with generally accepted principles of inventory costing.

Basis for Conclusions — Contract Accounting — Application of ARB No. 45 and SOP 81-1

SOP 97-2

138. SOP 81-1 [section 10,330] provides guidance on the application of ARB No. 45 that applies to a broad range of contractual arrangements. Paragraph 1 of SOP 81-1 [section 10,330.01] describes contracts that are similar in nature to software arrangements, and paragraph 13 [section 10,330.13] includes the following kinds of contracts within the scope of that SOP:

- Contracts to design, develop, manufacture, or modify complex . . . electronic equipment to a buyer's specification or to provide services related to the performance of such contracts
- Contracts for services performed by . . . engineers . . . or engineering design firms

139. ARB No. 45 presumes that percentage-of-completion accounting should be used when the contractor is capable of making reasonable estimates. Paragraph 15 of ARB No. 45 states the following:

> [I]n general when estimates of costs to complete and extent of progress toward completion of long-term contracts are reasonably dependable, the percentage-of-completion method is preferable. When lack of dependable estimates or inherent hazards cause forecasts to be doubtful, the completed-contract method is preferable.

Evidence to consider in assessing the presumption that the percentage-of-completion method of accounting should be used includes the technological risks and the reliability of cost estimates, as described in paragraphs 25, 26, 27, 32, and 33 of SOP 81-1 [section 10,330.25, .26, .27, .32, and .33].

140. Paragraph 24 of SOP 81-1 [section 10,330.24] specifies a further presumption that a contractor is capable of making reasonable estimates and states the following:

> [T]he presumption is that [entities] . . . have the ability to make estimates that are sufficiently dependable to justify the use of the percentage-of-

completion method of accounting. Persuasive evidence to the contrary is necessary to overcome that presumption. [Footnote omitted]

141. Although cost-to-cost measures may be verified easily, they tend to attribute excessive profit to the hardware elements of arrangements with combined software and hardware elements for contracts under which segmentation is not permitted. Although the hardware elements of such arrangements have high cost bases, they generally yield relatively low profit margins to vendors. Furthermore, if excessive revenue is attributed to the hardware element, revenue recognition on the arrangement becomes overly dependent on when that element is included in the measurement of progress-to-completion.

142. For off-the-shelf software elements, the application of the cost-to-cost method produces the opposite effect. The book basis of the software tends to be low, because most of the costs associated with software development frequently are charged to expense when incurred in conformity with FASB Statement No. 86. Although the profit margins associated with software are generally higher than those for other elements of the arrangement, the application of cost-to-cost measures with a single profit margin for the entire arrangement would attribute little or no profit to the off-the-shelf software. Similarly, the application of the cost-to-cost method to arrangements that include core software, which also has a relatively low cost basis, would attribute a disproportionately small amount of profit to the software.

Basis for Conclusions — Effective Date and Transition

SOP 97-2

143. AcSEC concluded that the provisions of this SOP should be applied prospectively and that retroactive application should be prohibited. AcSEC recognizes the benefits of comparable financial statements but is concerned that the application of the provisions of this SOP to contracts existing in prior periods would require a significant amount of judgment. The application of that judgment likely would be impacted by the hindsight a company would have, resulting in judgments based on information that did not exist at the time of the initial judgment but that would be called for if the SOP were to be applied retroactively.

144. Additionally, AcSEC concluded that some entities would be required to incur large expenditures in determining restated amounts or the cumulative effect of adoption. AcSEC concluded that the cost of calculating such amounts likely would exceed the related benefit of that information. This SOP does not preclude an entity from disclosing in the notes to the financial statements the effect of initially applying this SOP if an entity believes it is practicable to do so.

Basis for Conclusions — Items Not Retained From SOP 91-1

SOP 97-2

145. AcSEC believes that the guidance included in SOP 91-1 related to discounting receivables and the collectibility of receivables (discussed in paragraphs 56 and 78, respectively, of SOP 91-1) is not specific to the software industry and thus does not need to be retained in this SOP.

Examples of the Application of Certain Provisions of This Statement of Position (Appendix A of SOP 97-2)

SOP 97-2

SCOPE — EXAMPLE 1

Facts

An automobile manufacturer installs software into an automobile model. This software is used solely in connection with operating the automobile and is not sold or marketed separately. Once installed, the software is not updated for new versions that the manufacturer subsequently develops. The automobile manufacturer's costs for the development of the software that are within the scope of FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed* and the production costs of such software are insignificant relative to the other development and production costs of the automobile.

Applicability

The Statement of Position (SOP) is not applicable to such software because the software is deemed incidental to the product as a whole.

Discussion

Although the software may be critical to the operations of the automobile, the software itself is not the focus of the marketing effort, nor is it what the customer perceives he or she is obtaining. The development and production costs of the software as a component of the cost of the automobile is incidental.

SCOPE — EXAMPLE 2

Facts

An entity develops interactive training courses for sale or licensing to customers. These courses are delivered on a compact disc, which is loaded onto a customer's computer. The courses are developed such that, based on the responses received to a particular question, different questions are generated and content of the course material that is displayed is determined in a manner that directs the user's learning experience in a more focused way. The course developer's costs for the development of the software content are within the scope of FASB Statement No. 86 and are significant. The interactive nature of the courses is mentioned prominently in the marketing efforts.

Applicability

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

Discussion

Although some might say that the product is educational services, the marketing of the product focuses on the software-reliant interactive features. In addition, the course developer incurs significant costs that are within the scope of FASB Statement No. 86. The nature of the relationship between the vendor and the customer is not one in which the customer would have a need for post-contract services. Consequently, the absence of PCS is not presumptive that software is incidental to the product. Accordingly, a conclusion is reached that the software is not incidental to the product as a whole. Therefore, the provisions of this SOP apply.

ADDITIONAL SOFTWARE PRODUCTS: PRICE PER COPY — EXAMPLE 1

Facts

A vendor enters into an arrangement under which a customer has the right to make copies of Product A at $100 a copy, copies of Product B at $200 a copy, or copies of Product C at $50 a copy until such time as the customer has made copies aggregating $100,000 based on the per copy prices. The customer is obligated to pay the $100,000 whether or not the customer makes all the copies to which it is entitled under the arrangement. In all other respects, the $100,000 is considered to meet the criteria of a fixed fee, as described in this Statement of Position.

Master copies of products A and B are available currently and have been delivered. Product C is not available yet; therefore, no master copy has been delivered. The contract is clear that no portion of the fee allocable to copies made of products A and B is refundable if Product C is not delivered, nor is there any further obligation to deliver product C if copies of products A and B aggregating $100,000 have been made. The per copy prices included in the arrangement for Products A and B are the per copy prices included in the company's price list, and the company has already approved the per copy price list for Product C to be $50 per copy. Product C is not essential to the functionality of Products A or B.

The maximum number of copies of Product C that can be made is 500.

Revenue Recognition

The vendor should allocate $25,000 of the arrangement fee to Product C. The remaining $75,000 of revenue should be recognized when the master copies of Products A and B are delivered to the customer. The $25,000 allocated to Product C would be recognized when the master copy of Product C is delivered to the customer. If the customer duplicates enough copies of Products A and B so that the revenue allocable to those products exceeds $75,000, the additional revenue should be recognized as the additional copies are made.

Discussion

As discussed in paragraph .43 of this SOP, in an arrangement in which a number of products are not deliverable or specified at the inception of the arrangement, an allocation of the arrangement fee generally cannot be made, because the total revenue allocable to each software product is unknown and depends on choices to be made by the customer and, sometimes, future development activity. As discussed in paragraph .46 of this SOP however, if such an arrangement specifies a maximum number of copies of the undeliverable or unspecified product, a portion of the arrangement fee should be allocated to the undeliverable product(s). This allocation should be made assuming the customer elects to receive the maximum number of copies of the undeliverable product(s).

Because the arrangement states a maximum number of copies of Product C that can be made, a basis for allocating the fair value to each product of the arrangement exists. The amount allocated to the undelivered product is the maximum amount that can be allocable to that product, based on the maximum number of copies of Product C that can be made (500) and the fee per copy ($50). Accordingly, $25,000 should be allocated to Product C and deferred until delivery of the product master. Because all other conditions for revenue recognition in this SOP have been met, revenue related to Products A and B may be recognized upon delivery of the masters of those products as discussed in paragraph .44 of this SOP.

ADDITIONAL SOFTWARE PRODUCTS: PRICE PER COPY — EXAMPLE 2

Facts

Assume the same facts as in the preceding example, except the arrangement does not state a maximum number of copies of Product C that can be made.

Revenue Recognition

Revenue should be recognized as copies of Products A ($100 of revenue per copy) and B ($200 of revenue per copy) are made, until the master of Product C is delivered to the customer. Any remaining revenue should be recognized upon delivery of the master of Product C.

Discussion

As discussed in paragraph .43 of this SOP, although the fee per copy is fixed at the inception of the arrangement and the cost of duplication is incidental, the total fee allocated to the undelivered software (Product C) is unknown and will depend on the choices made by the customers as to how many copies of each product will be utilized.

AUTHORIZATION CODES — EXAMPLE 1

Facts

A vendor includes ten optional functions on a compact disc (CD-ROM) on which its software product is licensed. Access to those optional functions is not available without a permanent key. Users can order the optional functions and receive permanent keys to enable the full use of those functions.

Revenue Recognition

Revenue for each individual optional function should be recognized by the vendor when the user purchases it by placing an order, evidence of such order exists, and the key is delivered to the user.

Discussion

Although the user has received a fully functional version (except for the keys) of the optional functions on the CD-ROM, the user has not agreed to license them. Because no evidence of an arrangement exists (as discussed in paragraphs .15 through .17 of this SOP), revenue for the optional functions may not be recognized when the CD-ROM is delivered.

AUTHORIZATION CODES — EXAMPLE 2

Facts

A software vendor's products run on two different levels of central processing units (CPU) of the same manufacturer — Model X and Model Y (both of which are on the same platform). The vendor enters into a license arrangement with a user whereby the user licenses the vendor's products to run on Model X but allows the user to move to Model Y at no additional charge. The vendor delivers the product in the form of a disc pack along with a CPU authorization code. At the time the user chooses to move to Model Y, the user does not receive a new disc pack; rather the vendor gives the user a new CPU authorization code.

Revenue Recognition

Revenue should be recognized on the delivery of the disc pack.

Discussion

Delivery of the authorization code to move to another CPU is not considered to be an additional software deliverable.

MULTIPLE ELEMENT ARRANGEMENTS: PRODUCTS — EXAMPLE 1

Facts

A vendor licenses a user one license covering a single copy of products A, B, C, and D for a nonrefundable fixed fee of $80, with no stated price per product. Products A, B, and C are deliverable. Product D is not deliverable and is not essential to the functionality of products A, B, or C. Persuasive evidence exists that indicates that the revenue related to products A, B, or C is not subject to refund, forfeiture, other concessions if product D is not delivered. The vendor has a history of sales prices for products A, B, and C of $25 each. The vendor's pricing committee has established a price for product D of $25. It is probable that the price established by the pricing committee for product D will not change before introduction. Therefore, the vendor is able to derive its specific price for the undelivered software.

Revenue Recognition

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

Discussion

Revenue allocated to each product should be recognized upon the delivery of that product if the criteria in paragraphs .08 through .14 of this SOP have been met.

The allocation of revenue to each product is based on the relative fair value of each product. As discussed in paragraph .12 of this SOP, sufficient vendor-specific objective evidence must exist to determine allocation. In this example, sufficient vendor-specific objective evidence exists to determine that the fair value of each product on a stand-alone basis is $25. Therefore, in accordance with paragraph .41 of this SOP, the discount should be allocated evenly to each product, and revenue of $20 per product should be recognized when each product is delivered.

MULTIPLE ELEMENT ARRANGEMENTS: PRODUCTS — EXAMPLE 2

Facts

The transaction is the same as that outlined in the prior example. The contract is silent about penalties for the nondelivery of product D, but the proposal and other communications indicate that it is a required capability of the offering and that the user does not want any of the vendor's products unless product D is delivered.

Revenue Recognition

All revenue must be deferred until delivery of product D.

Discussion

Because revenue allocable to the delivered software is subject to forfeiture, refund, or other concession if product D is not delivered, all revenue under the agreement should be deferred until product D is delivered, in accordance with paragraph .13 of this SOP.

MULTIPLE ELEMENT ARRANGEMENTS: PRODUCTS — EXAMPLE 3

Facts

A vendor licenses version 1.0 of a software product to 100 customers for $300 per copy with a right to receive version 2.0 at no additional cost when it becomes available. The pricing committee has not yet decided whether version 2.0 will be offered to users of version 1.0 for $100 or for $200.

Revenue Recognition

All revenue should be deferred until the pricing committee makes its decision and it is probable that the price established will be the price charged upon introduction.

Discussion

Because the pricing committee has not yet decided whether version 2.0 will be offered at $100 or at $200, sufficient vendor-specific objective evidence does not yet exist supporting the price of the undelivered software. As discussed in paragraph .12 of this SOP, if sufficient vendor-specific objective evidence does not exist to determine the allocation of revenue, all revenue should be deferred until sufficient vendor-specific objective evidence exists.

MULTIPLE ELEMENT ARRANGEMENTS: PRODUCTS — EXAMPLE 4

Facts

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

Revenue Recognition

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

Discussion

The portion of the arrangement fee allocated to the upgrade right is equal to the price for the upgrade/enhancement determined pursuant to paragraph .37 of this SOP. This amount should be deferred and recognized on the delivery of version 2.0. The amount deferred for the specific upgrade/enhancement should be reduced to reflect the percentage of customers that, based on experience, are not expected to exercise the upgrade right (see paragraph .37 of this SOP).

Accordingly, the $10,000 revenue allocated to the upgrade right should be reduced by $4,000 (40 percent of the allocated revenue).

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

MULTIPLE ELEMENT ARRANGEMENTS: PRODUCTS AND SERVICES — EXAMPLE 1

Facts

A vendor has entered into an arrangement to provide a customer with its off-the-shelf software product and related implementation services. The software and service elements of the contract are stated separately and the company has a history of selling these services separately such that the revenue allocation criteria of paragraphs .08 through .14 of this SOP can be satisfied. The software license fees are due under the company's normal trade terms, which are net 30 days. The services are expected to be provided over the next 90 days and are of the type performed routinely by the vendor. The features and functionality of the software are not altered to more than a minor degree as a result of these services.

Revenue Recognition

The vendor should recognize the license revenue allocated to the software element upon its delivery and the revenue allocated to the service element as such services are performed.

Discussion

When license arrangements have multiple elements, revenue should be allocated to each of the elements and recognized when the related element is delivered and the following occur.

1. The undelivered elements are not essential to the functionality of the delivered elements.
2. The revenue allocated to the delivered elements is not subject to forfeiture, refund, or other concession if the undelivered elements are not delivered.
3. Sufficient company-specific objective evidence exists to allocate separate prices to each of the elements.

The service element in this arrangement is not deemed to be essential to the functionality of the software element because the features and functionality of the software are not altered to more than a minor degree as a result of the services.

MULTIPLE ELEMENT ARRANGEMENTS: PRODUCTS AND SERVICES — EXAMPLE 2

Facts

Assume the same transaction as described above except that the vendor agrees to make more than minor modifications to the functionality of the product to meet needs as defined by the user. Payment terms are 10 percent upon installation of the software, with the remainder according to a time line, and the final 25 percent withheld until acceptance. The desired modifications are not unusual; the vendor has made similar modifications to the product many times and is certain that the planned modifications will meet the user's needs.

Revenue Recognition

This arrangement should be accounted for pursuant to the guidance on contract accounting (using either the percentage-of-completion or completed-contract method, depending on the facts and circumstances) included in paragraphs .74 through .91 of this SOP.

Discussion

The new conditions would preclude service transaction accounting because the functionality of the software product is being altered in more than a minor way, the payment of the fees is coincident with the services being performed, and the software is subject to the user's unique acceptance criteria.

MULTIPLE ELEMENT ARRANGEMENTS: PRODUCTS AND SERVICES — EXAMPLE 3

Facts

Assume the same transaction as described in "Multiple-Element Arrangements: Products and Services — Example 1," except that the vendor never sells implementation services separately. The implementation services do not involve significant customization of the software.

Revenue Recognition

The vendor should recognize all revenue from the arrangement over the 90 day period during which the services are expected to be performed, commencing with delivery of the software product.

Discussion

The criteria for vendor-specific objective evidence of the fair value require that the element be sold separately or be planned to be sold separately. Because implementation services are neither sold separately nor planned to be sold separately, and upon delivery of the software product such services are the only undelivered elements, paragraph .67 of this SOP requires that all revenue be recognized over the period during which the implementation services are expected to be provided.

MULTIPLE ELEMENT ARRANGEMENTS: PRODUCTS AND SERVICES — EXAMPLE 4

Facts

A vendor sells software product A for $950. The license arrangement for product A always includes one year of "free" PCS. The annual renewal price of PCS is $150.

Revenue Recognition

Assuming that, apart from the lack of vendor-specific objective evidence of the fair value of the delivered software element, all applicable revenue recognition criteria in this SOP are met, revenue in the amount of $150 should be deferred and recognized in income over the one-year PCS service period. Revenue of $800 should be allocated to the software element and recognized upon delivery of the software.

Discussion

Vendor-specific objective evidence of the fair value of the software does not exist because the software is never sold separately. Consequently, sufficient vendor-specific objective evidence of fair value does not exist for the allocation of revenue to the various elements based on their relative fair values. Paragraph .12 of this SOP states, however, that the residual method should be used when there is vendor-specific objective evidence of the fair values of *all* undelivered elements; all other applicable revenue recognition criteria in this SOP are met; and the fair value of all of the undelivered elements is less than the total arrangement fee.

If there had been vendor-specific objective evidence of the fair value of the delivered software but not of the undelivered PCS, the entire arrangement fee would be deferred and recognized ratably over the contractual PCS period in accordance with paragraphs .12 and .58 of this SOP.

MULTIPLE ELEMENT ARRANGEMENTS: PRODUCTS AND DISCOUNTED PCS — EXAMPLE 1

Facts

A software vendor has entered into an arrangement under which it has licensed software that has a list price of $1 million to a customer for $600,000 (which is the price being charged for the software when sold separately under other arrangements). The arrangement also includes annual PCS, priced for the first year at 15 percent of the discounted license fee, or $90,000 (rather than 15 percent of the list price of the licensed software). After the first year, the customer will have the right to renew annual maintenance on the licensed software at 15 percent of the list price of the software (or $150,000).

There are no other undelivered elements. All revenue recognition conditions of this SOP have been satisfied.

The vendor does not have sufficient vendor-specific historical evidence that costs of providing PCS are incurred on other than a straight-line basis.

Revenue Recognition

In Year 1, the total arrangement fee is $690,000. Of this amount, $552,000 should be allocated to the software element and recognized upon delivery of the software element. The remaining $138,000 should be allocated to the PCS element and recognized ratably over the period during which the PCS services are expected to be performed. The allocation of the $690,000 arrangement fee is determined as shown in the following table.

Fair value when sold separately:

Software Element	$ 600,000	80%
PCS Element	150,000	20
	$ 750,000	100%

Allocation:

PCS element	$ 690,000 × .20 = $ 138,000
Software element	$ 690,000 × .80 = $ 552,000

Discussion

In allocating the arrangement fee to the PCS element, the vendor should look first to the price the customer will pay for the PCS when it is sold separately as a renewal under the arrangement. In this example, that price is $150,000. This price is considered the vendor-specific objective evidence of the fair value for the PCS element, as discussed in paragraph .10.

If the customer were entitled to the PCS in subsequent years at the same price at which it had been included in the initial year of the arrangement (that is, $90,000), and the vendor's pricing practices were such that renewals of PCS were based on the discounted value of license fees, no additional fees would have been allocated from the software element to the PCS element. Therefore, the vendor would have allocated $600,000 to the software element and $90,000 to the PCS element.]

[As amended, effective for transactions entered into in fiscal years beginning after March 15, 1999, by Statement of Position 98-9.]

Response to Comments Received (Appendix B of SOP 97-2)

SOP 97-2

B.1. An exposure draft of a proposed Statement of Position (SOP), Software Revenue Recognition, was issued for public comment on June 14, 1996.

B.2. The majority of the comments received related to the basic principles of the exposure draft, particularly the provisions requiring the allocation of the arrangement fee to individual elements in a multiple-element arrangement based on vendor-specific objective evidence of the fair value. Several commentators requested clarification of the wording in the exposure draft related to extended payment terms and the effect of such terms on the determination of whether a fee is fixed and determinable or collectible. Some commentators requested guidance on the application of the provisions of the SOP to marketing arrangements in which coupons or other price incentives are offered. Other commentators requested the reconsideration of the transition provisions of the exposure draft, which required a cumulative-effect adjustment.

B.3. These comments and the Accounting Standards Executive Committee's (AcSEC's) response to them are discussed below.

Multiple-Element Arrangements

B.4. Several commentators responded that the limitations on what constitutes vendor- specific objective evidence of the fair value were too onerous. These commentators stated that many instances exist in which elements are not priced separately, and that because of these limitations, revenue related to delivered elements would be deferred even though the customer received the element. Additionally, several commentators expressed concern that the requirement to allocate revenue to all elements, particularly those deliverable "when and if available" was not meaningful. (Obligations to deliver "when and if available" elements were considered by the commentators to be either insignificant vendor obligations or not vendor obligations at all.)

B.5. AcSEC considered these comments but continues to support the provisions of the exposure draft. AcSEC noted that these comments had been considered in the process leading to the exposure draft. Although AcSEC agrees that the provisions of the SOP may be troublesome to some companies, AcSEC notes that commentators did not suggest alternatives that AcSEC considered adequate to meet the criteria of objective evidence of fair value.

B.6. AcSEC continues to believe that the allocation of the arrangement fee to all elements, including those deliverable on a when-and-if-available basis, is meaningful. AcSEC believes that these elements are bargained for by the customer and should be accounted for. Furthermore, AcSEC believes that the concept of significant versus insignificant obligations should not be used to determine whether revenue should be allocated to an element. This concept had been included in SOP 91-1 and had resulted in varying interpretations in practice. AcSEC further notes that these comments had been considered previously by AcSEC during the process leading to the exposure draft.

B.7. Several commentators stated that the limitations on vendor-specific objective evidence of fair value should be expanded to permit the use of prices in published price lists. AcSEC believes that the price for an element as included in a price list does not necessarily represent the fair value of that element.

Extended Payment Terms

B.8. The exposure draft stated that a software licensing fee should not be considered fixed or determinable if the payment of a significant portion of the licensing fee is not due until after the expiration of the license or more than twelve months after delivery. Exceptions were permitted for vendors that have a business practice of using installment contracts and an extended history of entering into contracts with terms in excess of twelve months and successfully enforcing payment terms without making concessions. Several commentators requested clarification of these provisions.

B.9. AcSEC considered these comments and agreed that clarification was needed. Relevant clarifications were made to paragraphs .27 through .29 of the SOP. The revised provisions now state that *any* extended payment terms in a software licensing arrangement may indicate that the fee is not fixed or determinable, particularly if the use of extended payment terms is not the vendor's customary practice. Further, if the payment of a significant portion of the software licensing fee is not due until after the expiration of the license or more than twelve months after delivery, the licensing fee should be *presumed* not to be fixed or determinable. However, this presumption may be overcome by evidence that the vendor has a standard business practice of using long-term or installment contracts and a history of successfully collecting under the original payment terms without making concessions. Such a vendor should consider such fees fixed or determinable and should recognize revenue upon the delivery of the software, provided all other conditions for revenue recognition in this SOP have been satisfied.

B.10. Several commentators requested guidance on the application of the SOP to arrangements in which discounts are offered on subsequent licenses of software. The exposure draft did not have provisions addressing such arrangements.

B.11. AcSEC has added wording to the scope section (paragraph .03) of the SOP to address these questions. The new wording states that arrangements in which a vendor offers a small discount on additional licenses of the licensed product or other products that exist at the time of the offer represent marketing and promotional activities that are not unique to software and, therefore, are not included in the scope of this SOP. However, judgment will be required to assess whether price-off and other concessions are so significant that, in substance, additional elements are being offered in the arrangement.

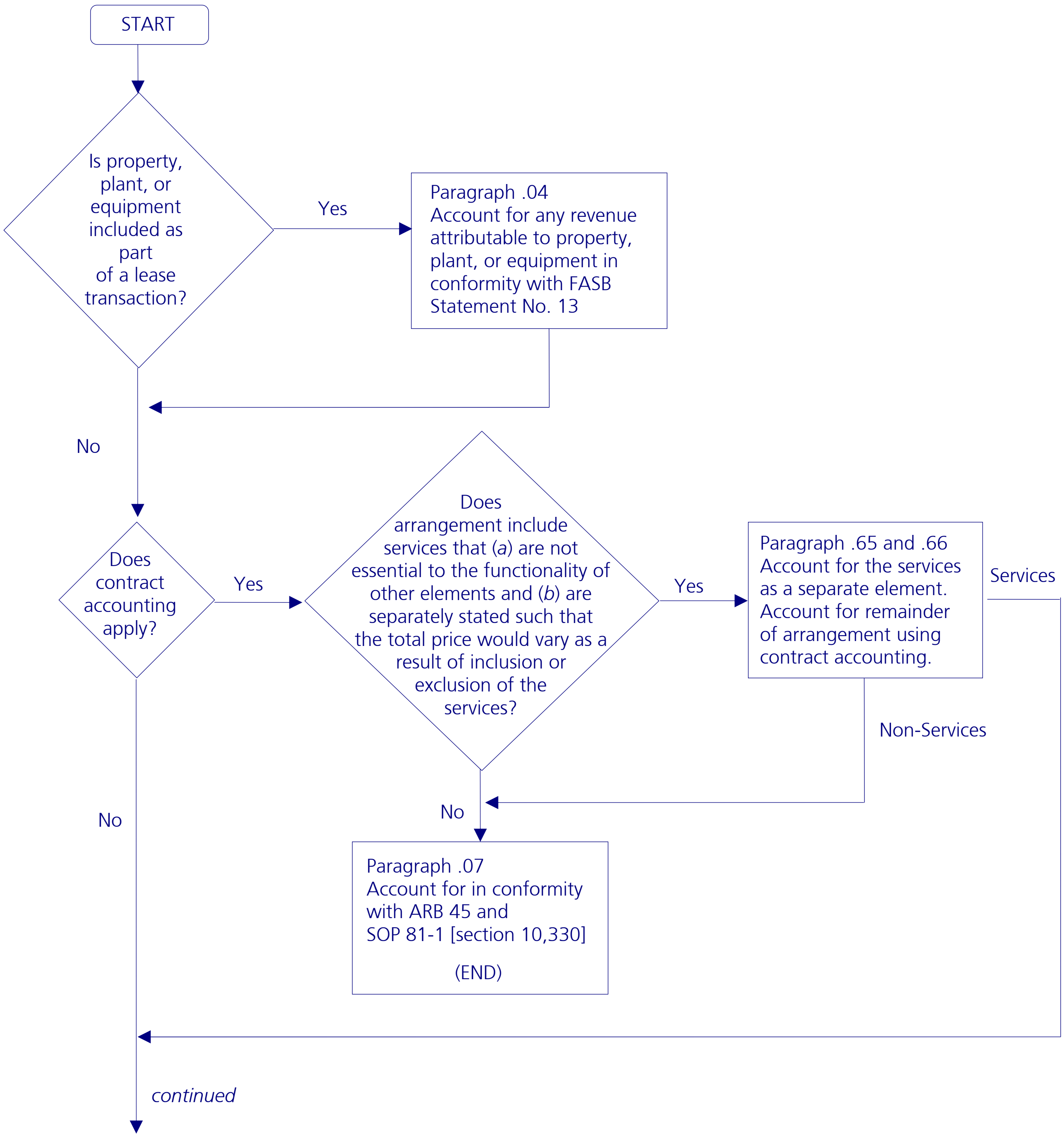
Transition

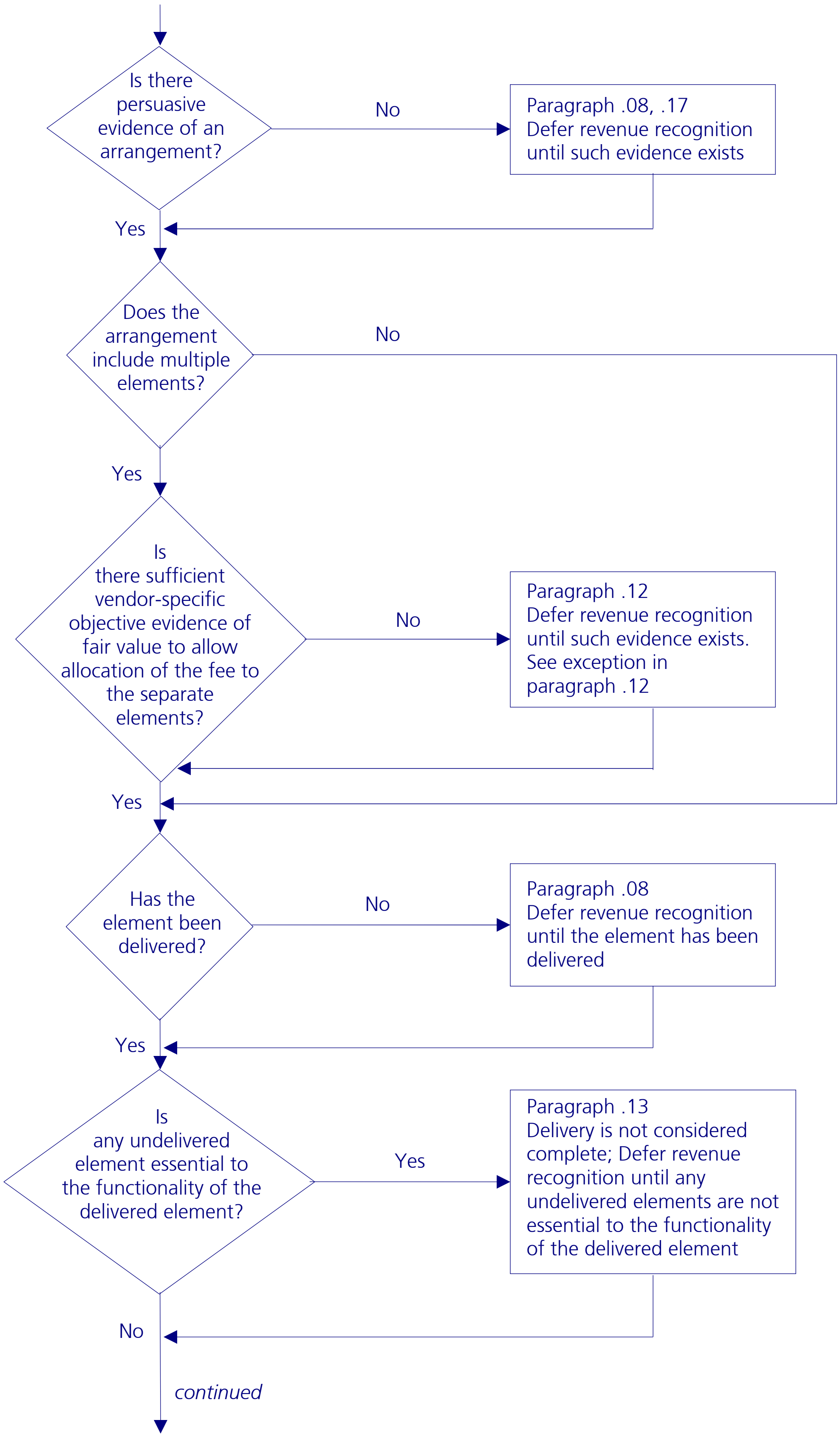
B.12. The exposure draft required a cumulative-effect adjustment for the adoption of the SOP. Several commentators noted that considerable effort would be required on the part of many vendors to measure the cumulative effect. Additionally, it was noted that in many instances, the application of the provisions of this SOP to contracts existing in prior periods would require a significant amount of judgment. AcSEC was concerned that the application of that judgment likely would be impacted by the hindsight a company would have, resulting in judgments based on information that did not exist at the time of the initial judgment but that would be called for if the SOP were to be applied retroactively.

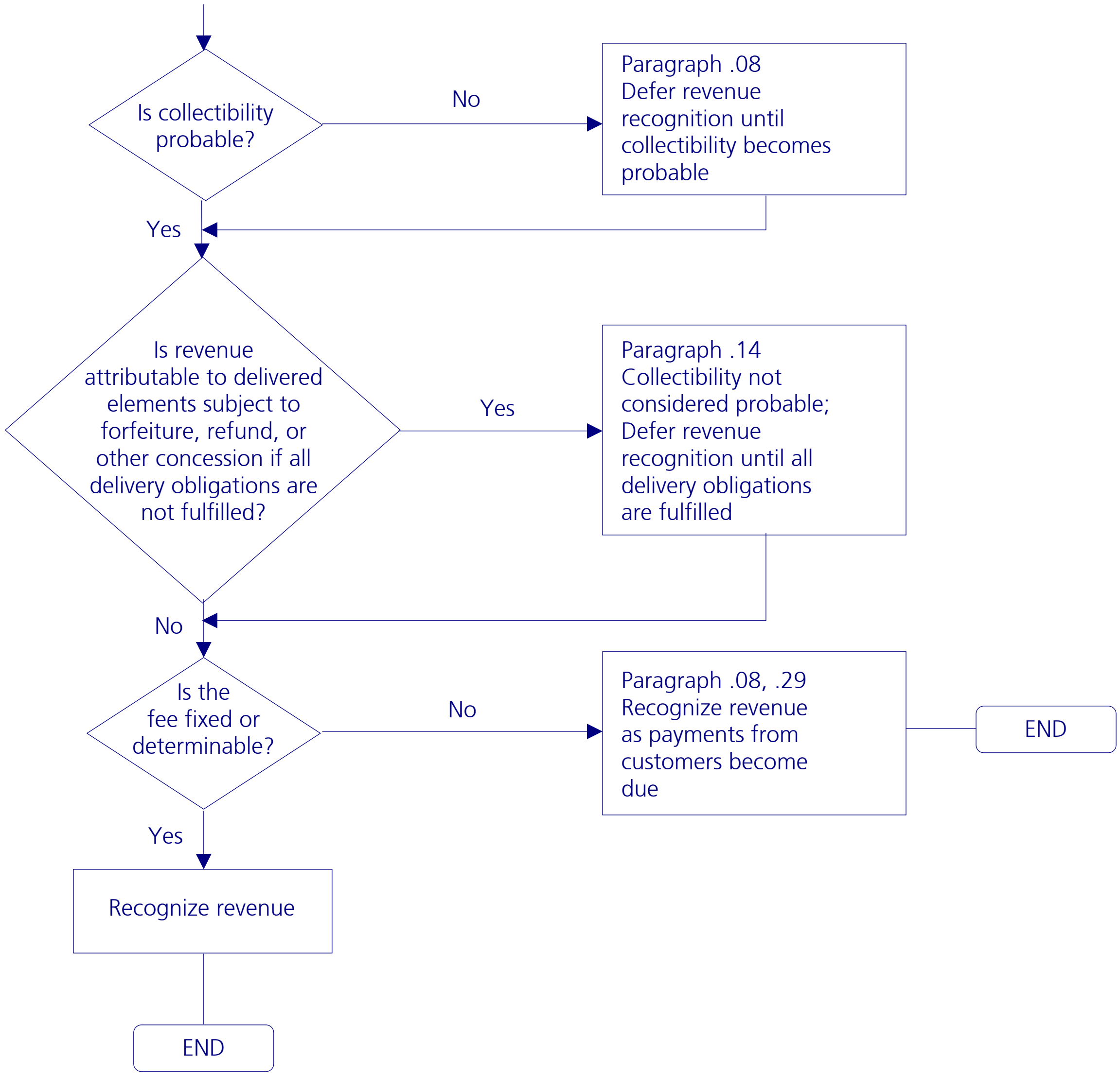
B.13. AcSEC considered these issues and determined that the transition requirements of the SOP should be amended to require prospective application.

Revenue Recognition on Software Arrangements (Appendix C of SOP 97-2)

The following flowchart illustrates a decision process for recognizing revenue on software arrangements. The flowchart is intended to illustrate the basic principle of revenue recognition and does not address the difference in accounting depending upon the type of element (services, upgrade rights, additional software products, or post-contract customer support) included in the arrangement. The flowchart summarizes certain guidance in this SOP and is not intended as a substitute for the SOP.


START
Is property, plant, or equipment included as part of a lease transaction?
Yes
Paragraph .04
Account for any revenue attributable to property, plant, or equipment in conformity with FASB Statement No. 13
No
Does contract accounting apply?
Yes
Does arrangement include services that (a) are not essential to the functionality of other elements and (b) are separately stated such that the total price would vary as a result of inclusion or exclusion of the services?
Yes
Paragraph .65 and .66
Account for the services as a separate element. Account for remainder of arrangement using contract accounting.
Services
Non-Services
No
Paragraph .07
Account for in conformity with ARB 45 and SOP 81-1 [section 10,330]
(END)
No
continued


Is there persuasive evidence of an arrangement?
No
Paragraph .08, .17
Defer revenue recognition until such evidence exists
Yes
Does the arrangement include multiple elements?
No
Yes
Is there sufficient vendor-specific objective evidence of fair value to allow allocation of the fee to the separate elements?
No
Paragraph .12
Defer revenue recognition until such evidence exists. See exception in paragraph .12
Yes
Has the element been delivered?
No
Paragraph .08
Defer revenue recognition until the element has been delivered
Yes
Is any undelivered element essential to the functionality of the delivered element?
Yes
Paragraph .13
Delivery is not considered complete; Defer revenue recognition until any undelivered elements are not essential to the functionality of the delivered element
No
continued


Is collectibility probable?
No
Paragraph .08
Defer revenue recognition until collectibility becomes probable
Yes
Is revenue attributable to delivered elements subject to forfeiture, refund, or other concession if all delivery obligations are not fulfilled?
Yes
Paragraph .14
Collectibility not considered probable; Defer revenue recognition until all delivery obligations are fulfilled
No
Is the fee fixed or determinable?
No
Paragraph .08, .29
Recognize revenue as payments from customers become due
END
Yes
Recognize revenue
END

Glossary (From SOP 97-2)

SOP 97-2

Authorization Codes (Keys)

A vehicle used by vendors to permit customers access to, use of, or duplication of software that would otherwise be restricted.

Core Software

An inventory of software that vendors use in creating other software. Core software is not delivered as is because customers cannot use it unless it is customized to meet system objectives or customer specifications.

Customer

A user or reseller.

Delivery

A transfer of software accompanied by documentation to the customer. The transfer may be by the following:

a. A physical transfer of tape, disk, integrated circuit, or other medium

b. Electronic transmission

c. Making available to the customer software that will not be physically transferred, such as through the facilities of a computer service bureau

d. Authorization for duplication of existing copies in the customer's possession

If a licensing agreement provides a customer with the right to multiple copies of a software product in exchange for a fixed fee, delivery means transfer of the product master, or the first copy if the product master is not to be transferred.

Fixed Fee

A fee required to be paid at a set amount that is not subject to refund or adjustment. A fixed fee includes amounts designated as minimum royalties.

Licensing

Granting the right to use but not to own software through leases or licenses.

Milestone

A task associated with long-term contracts that, when completed, provides management with a reliable indicator of progress-to-completion on those contracts.

Off-the-Shelf Software

Software marketed as a stock item that customers can use with little or no customization.

Platform

The hardware architecture of a particular model or family of computers, the system software, such as the operating system, or both.

Platform-Transfer Right

A right granted by a vendor to transfer software from one hardware platform or operating system to one or more other hardware platforms or operating systems.

Postcontract Customer Support (PCS)

The right to receive services (other than those separately accounted for as described in paragraphs .65 and .66 of this Statement of Position) or unspecified product upgrades/enhancements, or both, offered to users or resellers, after the software license period begins, or after another time as provided for by the PCS arrangement. Unspecified upgrades/enhancements are PCS only if they are offered on a when-and-if-available basis. PCS does not include the following:

- Installation or other services directly related to the initial license of the software
- Upgrade rights as defined in this Statement of Position
- Rights to additional software products

PCS may be included in the license fee or offered separately. PCS is generally referred to in the software industry as maintenance, a term that is defined, as follows, in paragraph 52 of FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*:

> Activities undertaken after the product is available for general release to customers to correct errors or keep the product updated with current information. Those activities include routine changes and additions.

However, the term *maintenance* is not used in this Statement of Position for the following reasons.

1. It has taken on a broader meaning in the industry than the one described in FASB Statement No. 86.
2. It may be confused with hardware maintenance as it is used elsewhere in accounting literature.
3. Its meaning varies from company to company.

The right to receive services and unspecified upgrades/enhancements provided under PCS is generally described by the PCS arrangement. Typical arrangements include services, such as telephone support and correction of errors (bug fixing or debugging), and unspecified product upgrades/enhancements developed by the vendor during the period in which the PCS is provided. PCS arrangements include patterns of providing services or unspecified upgrades/enhancements to users or resellers, although the arrangements may not be evidenced by a written contract signed by the vendor and the customer.

Reseller

Entity licensed by a software vendor to market the vendor's software to users or other resellers. Licensing agreements with resellers typically include arrangements to sublicense, reproduce, or distribute software. Resellers may be distributors of software, hardware, or turnkey systems, or they may be other entities that include software with the products or services they sell.

Site License

A license that permits a customer to use either specified or unlimited numbers of copies of a software product either throughout a company or at a specified location.

Upgrade/Enhancement

An improvement to an existing product that is intended to extend the life or improve significantly the marketability of the original product through added functionality, enhanced performance, or both. The terms upgrade and enhancement are used interchangeably to describe improvements to software products; however, in different segments of the software industry, those terms may connote different levels of packaging or improvements. This definition does not include platform-transfer rights.

Upgrade Right

The right to receive one or more specific upgrades/enhancements that are to be sold separately. The upgrade right may be evidenced by a specific agreement, commitment, or the vendor's established practice.

User

Party that ultimately uses the software in an application.

When-and-if-Available

An arrangement whereby a vendor agrees to deliver software only when or if it becomes deliverable while the arrangement is in effect. When-and-if-available is an industry term that is commonly used to describe a broad range of contractual commitments. The use of the term when-and-if-available within an arrangement should not lead to a presumption that an obligation does not exist.

Appendix A — Technical Practice Aids Applicable to Software Revenue Recognition

Subsequent Event Related to Establishing Vendor-Specific Objective Evidence for Software Revenue Recognition — TIS Section 5100.38

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.

Software Revenue Recognition for Multiple-Element Arrangements — TIS Section 5100.39

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.

Software Revenue Recognition Related to Year 2000 Compliant Software — TIS Section 5100.40

Inquiry — Is a commitment to deliver in the future a Year 2000 compliant version of a software product to an existing customer or to a customer that is acquiring a non-Year 2000 compliant version considered an upgrade right or specified upgrade in accordance with SOP 97-2, *Software Revenue Recognition* (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.

Effect of Prepayments on Software Revenue Recognition — TIS Section 5100.41

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.

Extended Payment Terms and Software Revenue Recognition — TIS Section 5100.42

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.

Corrections of Errors in Computer Software (Bug Fixes) — TIS Section 5100.43

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).

Postcontract Customer Support During the Deployment Phase of Computer Software — TIS Section 5100.44

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.

Effect of Change in License Mix on Software Revenue Recognition — TIS Section 5100.45

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.

Nonmonetary Exchanges of Software (Part I) — TIS Section 5100.46

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."

Nonmonetary Exchanges of Software (Part II) — TIS Section 5100.47

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 non-monetary asset transferred nor the fair value of a non-monetary asset received in exchange is determinable within reasonable limits, the recorded amount of the non-monetary 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)[1]	Technology to be held for sale in the ordinary course of business (i.e., inventory)[2]	1. Yes	1. Record at historical cost
		2. No	2. Record at fair value[3]
Software product held for sale in the ordinary course of business (i.e., inventory)	Internal-use software[4]	N/A	Record at fair value [3]

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.

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.

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

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.

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.

Application of Contract Accounting in Software Arrangements (Part I) — TIS Section 5100.48

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.

Application of Contract Accounting in Software Arrangements (Part II) — TIS Section 5100.49

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).

Definition of More-Than-Insignificant Discount and Software Revenue Recognition — TIS Section 5100.50

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.

Accounting for Significant Incremental Discounts in Software Revenue Recognition — TIS Section 5100.51

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.

Fair Value of PCS in a Perpetual License and Software Revenue Recognition — TIS Section 5100.52

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).

Fair Value of PCS in a Short-Term Time-Based License and Software Revenue Recognition — TIS Section 5100.53

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.

Fair Value of PCS in a Multi-Year Time-Based License and Software Revenue Recognition — TIS Section 5100.54

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).

Fair Value of PCS With a Consistent Renewal Percentage (but Varying Renewal Dollar Amounts) and Software Revenue Recognition — TIS Section 5100.55

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.

Concessions and Software Revenue Recognition — TIS Section 5100.56

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.

Overcoming Presumption of Concessions in Extended Payment Term Arrangements and Software Revenue Recognition — TIS Section 5100.57

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.

Effect of Prepayments on Software Revenue Recognition (Part II) — TIS Section 5100.58

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.

Subsequent Cash Receipt in an Extended Payment Term Arrangement for Software Revenue Recognition — TIS Section 5100.59

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*).

Customer Financing With No Software Vendor Participation and Software Revenue Recognition — TIS Section 5100.60

(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.

Effect of Prepayments on Software Revenue Recognition When Vendor Participates in Customer Financing — TIS Section 5100.61

(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.

Indicators of Incremental Risk and Their Effect on the Evaluation of Whether a Fee Is Fixed or Determinable and Software Revenue Recognition — TIS Section 5100.62

(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.

Overcoming the Presumption That a Fee Is Not Fixed or Determinable When Vendor Participates in Customer Financing and Software Revenue Recognition — TIS Section 5100.63

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).

Indicators of Vendor Participation in Customer Financing That Do Not Result in Incremental Risk and Software Revenue Recognition — TIS Section 5100.64

(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.

Software Vendor Interest Rate Buy Downs on Customer Financing and Software Revenue Recognition — TIS Section 5100.65

(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.

Consideration of Other TPAs on Customer Borrowing When Customer is a Reseller and Software Revenue Recognition — TIS Section 5100.66

(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.

Customer Acceptance and Software Revenue Recognition — TIS Section 5100.67

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.

Fair Value of PCS in Perpetual and Multi-Year Time-Based Licenses and Software Revenue Recognition — TIS Section 5100.68

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.

Delivery Terms and Software Revenue Recognition — TIS Section 5100.69

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.

Effect of Commencement of an Initial License Term and Software Revenue Recognition — TIS Section 5100.70

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.

Effect of Commencement of an Extension/Renewal License Term and Software Revenue Recognition — TIS Section 5100.71

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.

Effect of Additional Product(s) in an Extension/Renewal of License Term and Software Revenue Recognition — TIS Section 5100.72

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.

Software Revenue Recognition for an Arrangement Containing an Option to Extend a Time-Based License Indefinitely — TIS Section 5100.73

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.

Effect of Discounts on Future Products on the Residual Method and Software Revenue Recognition — TIS Section 5100.74

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*) Published List Price	(*b*) Addt'l Discount	(*a*)*(*b*)= (*c*) Revenue Deferral for Additional Discount	(*d*) Revenue Deferral for PCS	(*c*)+(*d*)=(*e*) Total Revenue Deferral	(*f*) Arrangement Fee	(*f*)–(*e*) 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).

Fair Value of PCS Renewals Based on Users Deployed and Software Revenue Recognition — TIS Section 5100.75

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.

Fair Value in Multiple-Element Arrangements That Include Contingent Usage-Based Fees and Software Revenue Recognition — TIS Section 5100.76

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.

Appendix B — SEC Staff Accounting Bulletin Topic 13, "Revenue Recognition"

A. Selected Revenue Recognition Issues

1. Revenue Recognition — General

The accounting literature on revenue recognition includes both broad conceptual discussions as well as certain industry-specific guidance.[1] If a transaction is within the scope of specific authoritative literature that provides revenue recognition guidance, that literature should be applied. However, in the absence of authoritative literature addressing a specific arrangement or a specific industry, the staff will consider the existing authoritative accounting standards as well as the broad revenue recognition criteria specified in the FASB's conceptual framework that contain basic guidelines for revenue recognition.

Based on these guidelines, revenue should not be recognized until it is realized or realizable and earned.[2] Concepts Statement 5, paragraph 83(b) states that "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" [footnote reference omitted]. Paragraph 84(a) continues "the two conditions (being realized or realizable and being earned) are usually met by the time product or merchandise is delivered or services are rendered to customers, and revenues from manufacturing and selling activities and gains and losses from sales of other assets are commonly recognized at time of sale (usually meaning delivery)" [footnote reference omitted]. In addition, paragraph 84(d) states that "If services are rendered or rights to use assets extend continuously over time (for example, interest or rent), reliable measures based on contractual prices established in advance are commonly available, and revenues may be recognized as earned as time passes."

The staff believes that revenue generally is realized or realizable and earned when all of the following criteria are met:

- Persuasive evidence of an arrangement exists,[3]
- Delivery has occurred or services have been rendered,[4]

[1] The February 1999 AICPA publication "Audit Issues in Revenue Recognition" provides an overview of the authoritative accounting literature and auditing procedures for revenue recognition and identifies indicators of improper revenue recognition.

[2] Concepts Statement 5, paragraphs 83–84; ARB 43, Chapter 1A, paragraph 1; Opinion 10, paragraph 12. The citations provided herein are not intended to present the complete population of citations where a particular criterion is relevant. Rather, the citations are intended to provide the reader with additional reference material.

[3] Concepts Statement 2, paragraph 63 states "Representational faithfulness is correspondence or agreement between a measure or description and the phenomenon it purports to represent." The staff believes that evidence of an exchange arrangement must exist to determine if the accounting treatment represents faithfully the transaction. See also SOP 97-2, paragraph 8. The use of the term "arrangement" in this SAB Topic is meant to identify the final understanding between the parties as to the specific nature and terms of the agreed-upon transaction.

[4] Concepts Statement 5, paragraph 84(a), (b), and (d). Revenue should not be recognized until the seller has substantially accomplished what it must do pursuant to the terms of the arrangement, which usually occurs upon delivery or performance of the services.

- The seller's price to the buyer is fixed or determinable,[5] and
- Collectibility is reasonably assured.[6]

Some revenue arrangements contain multiple revenue-generating activities. The staff believes that the determination of the units of accounting within an arrangement should be made prior to the application of the guidance in this SAB Topic by reference to the applicable accounting literature.[7]

2. Persuasive Evidence of an Arrangement

Question 1

Facts: Company A has product available to ship to customers prior to the end of its current fiscal quarter. Customer Beta places an order for the product, and Company A delivers the product prior to the end of its current fiscal quarter. Company A's normal and customary business practice for this class of customer is to enter into a written sales agreement that requires the signatures of the authorized representatives of the Company and its customer to be binding. Company A prepares a written sales agreement, and its authorized representative signs the agreement before the end of the quarter. However, Customer Beta does not sign the agreement because Customer Beta is awaiting the requisite approval by its legal department. Customer Beta's purchasing department has orally agreed to the sale and stated that it is highly likely that the contract will be approved the first week of Company A's next fiscal quarter.

Question: May Company A recognize the revenue in the current fiscal quarter for the sale of the product to Customer Beta when (1) the product is delivered by the end of its current fiscal quarter and (2) the final written sales agreement is executed by Customer Beta's authorized representative within a few days after the end of the current fiscal quarter?

Interpretive Response: No. Generally the staff believes that, in view of Company A's business practice of requiring a written sales agreement for this class of customer, persuasive evidence of an arrangement would require a final agreement that has been executed by the properly authorized personnel of the customer. In the staff's view, Customer Beta's execution of the sales agreement after the end of the quarter causes the transaction to be considered a transaction of the subsequent period.[8] Further, if an arrangement is subject to subsequent approval (e.g., by the management committee or board of directors) or execution of another agreement, revenue recognition would be inappropriate until that subsequent approval or agreement is complete.

Customary business practices and processes for documenting sales transactions vary among companies and industries. Business practices and processes may also vary within individual companies (e.g., based on the class of customer, nature of product or service, or other distinguishable factors). If a company does not have a standard or customary business practice of relying on written contracts to document a sales arrangement, it usually would be expected to have other forms of written or electronic evidence to document the transaction. For example, a company may not use written contracts but instead may rely on binding purchase orders from third parties or on-line authorizations that include the terms of the sale and that are binding on the customer. In that situation, that documentation could represent persuasive evidence of an arrangement.

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5 Concepts Statement 5, paragraph 83(a); Statement 48, paragraph 6(a); SOP 97-2, paragraph 8. SOP 97-2 defines a "fixed fee" as a "fee required to be paid at a set amount that is not subject to refund or adjustment. A fixed fee includes amounts designated as minimum royalties." Paragraphs 26–33 of SOP 97–2 discuss how to apply the fixed or determinable fee criterion in software transactions. The staff believes that the guidance in paragraphs 26 and 30–33 is appropriate for other sales transactions where authoritative guidance does not otherwise exist. The staff notes that paragraphs 27 through 29 specifically consider software transactions, however, the staff believes that guidance should be considered in other sales transactions in which the risk of technological obsolescence is high.

6 ARB 43, Chapter 1A, paragraph 1 and Opinion 10, paragraph 12. See also Concepts Statement 5, paragraph 84(g) and SOP 97-2, paragraph 8.

7 See EITF Issue 00-21 paragraph 4 for additional discussion.

8 AU Section 560.05.

The staff is aware that sometimes a customer and seller enter into "side" agreements to a master contract that effectively amend the master contract. Registrants should ensure that appropriate policies, procedures, and internal controls exist and are properly documented so as to provide reasonable assurances that sales transactions, including those affected by side agreements, are properly accounted for in accordance with GAAP and to ensure compliance with Section 13 of the Securities Exchange Act of 1934 (i.e., the Foreign Corrupt Practices Act). Side agreements could include cancellation, termination, or other provisions that affect revenue recognition. The existence of a subsequently executed side agreement may be an indicator that the original agreement was not final and revenue recognition was not appropriate.

Question 2

Facts: Company Z enters into an arrangement with Customer A to deliver Company Z's products to Customer A on a consignment basis. Pursuant to the terms of the arrangement, Customer A is a consignee, and title to the products does not pass from Company Z to Customer A until Customer A consumes the products in its operations. Company Z delivers product to Customer A under the terms of their arrangement.

Question: May Company Z recognize revenue upon delivery of its product to Customer A?

Interpretive Response: No. Products delivered to a consignee pursuant to a consignment arrangement are not sales and do not qualify for revenue recognition until a sale occurs. The staff believes that revenue recognition is not appropriate because the seller retains the risks and rewards of ownership of the product and title usually does not pass to the consignee.

Other situations may exist where title to delivered products passes to a buyer, but the substance of the transaction is that of a consignment or a financing. Such arrangements require a careful analysis of the facts and circumstances of the transaction, as well as an understanding of the rights and obligations of the parties, and the seller's customary business practices in such arrangements. The staff believes that the presence of one or more of the following characteristics in a transaction precludes revenue recognition even if title to the product has passed to the buyer:

1. The buyer has the right to return the product and:

    (a) the buyer does not pay the seller at the time of sale, and the buyer is not obligated to pay the seller at a specified date or dates.[9]

    (b) the buyer does not pay the seller at the time of sale but rather is obligated to pay at a specified date or dates, and the buyer's obligation to pay is contractually or implicitly excused until the buyer resells the product or subsequently consumes or uses the product,[10]

    (c) the buyer's obligation to the seller would be changed (e.g., the seller would forgive the obligation or grant a refund) in the event of theft or physical destruction or damage of the product,[11]

    (d) the buyer acquiring the product for resale does not have economic substance apart from that provided by the seller,[12] or

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[9] Statement 48, paragraphs 6(b) and 22.

[10] Statement 48, paragraphs 6(b) and 22. The arrangement may not specify that payment is contingent upon subsequent resale or consumption. However, if the seller has an established business practice permitting customers to defer payment beyond the specified due date(s) until the products are resold or consumed, then the staff believes that the seller's right to receive cash representing the sales price is contingent.

[11] Statement 48, paragraph 6(c).

[12] Statement 48, paragraph 6(d).

(e) the seller has significant obligations for future performance to directly bring about resale of the product by the buyer.[13]

2. The seller is required to repurchase the product (or a substantially identical product or processed goods of which the product is a component) at specified prices that are not subject to change except for fluctuations due to finance and holding costs,[14] and the amounts to be paid by the seller will be adjusted, as necessary, to cover substantially all fluctuations in costs incurred by the buyer in purchasing and holding the product (including interest).[15] The staff believes that indicators of the latter condition include:

   (a) the seller provides interest-free or significantly below market financing to the buyer beyond the seller's customary sales terms and until the products are resold,

   (b) the seller pays interest costs on behalf of the buyer under a third-party financing arrangement, or

   (c) the seller has a practice of refunding (or intends to refund) a portion of the original sales price representative of interest expense for the period from when the buyer paid the seller until the buyer resells the product.

3. The transaction possesses the characteristics set forth in EITF Issue 95-1 and does not qualify for sales-type lease accounting.

4. The product is delivered for demonstration purposes.[16]

This list is not meant to be a checklist of all characteristics of a consignment or a financing arrangement, and other characteristics may exist. Accordingly, the staff believes that judgment is necessary in assessing whether the substance of a transaction is a consignment, a financing, or other arrangement for which revenue recognition is not appropriate. If title to the goods has passed but the substance of the arrangement is not a sale, the consigned inventory should be reported separately from other inventory in the consignor's financial statements as "inventory consigned to others" or another appropriate caption.

Question 3

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

Question: Is it acceptable to recognize revenue in these transactions before payment is made and title has transferred?

Interpretive Response: Presuming all other revenue recognition criteria have been met, the staff would not object to revenue recognition at delivery if the only rights that a seller retains with the title are those enabling recovery of the goods in the event of customer default on payment. This limited form of ownership may exist in some foreign jurisdictions where, despite technically holding title, the seller is not entitled to direct the disposition of the goods, cannot rescind the transaction, cannot prohibit its customer from moving, selling, or otherwise using the goods in the ordinary course of business, and has no other rights that rest with a titleholder of property that is subject to a lien under the U.S. UCC. On the other hand, if retaining title results in the seller retaining rights normally held by an owner of goods, the situation is

[13] Statement 48, paragraph 6(e).

[14] Statement 49, paragraph 5(a). Paragraph 5(a) provides examples of circumstances that meet this requirement. As discussed further therein, this condition is present if (a) a resale price guarantee exists, (b) the seller has an option to purchase the product, the economic effect of which compels the seller to purchase the product, or (c) the buyer has an option whereby it can require the seller to purchase the product.

[15] Statement 49, paragraph 5(b).

[16] See SOP 97-2, paragraph 25.

not sufficiently different from a delivery of goods on consignment. In this particular case, revenue should not be recognized until payment is received. Registrants and their auditors may wish to consult legal counsel knowledgeable of the local law and customs outside the U.S. to determine the seller's rights.

3. Delivery and Performance

a. Bill and Hold Arrangements

Facts: Company A receives purchase orders for products it manufactures. At the end of its fiscal quarters, customers may not yet be ready to take delivery of the products for various reasons. These reasons may include, but are not limited to, a lack of available space for inventory, having more than sufficient inventory in their distribution channel, or delays in customers' production schedules.

Question: May Company A recognize revenue for the sale of its products once it has completed manufacturing if it segregates the inventory of the products in its own warehouse from its own products?

May Company A recognize revenue for the sale if it ships the products to a third-party warehouse but (1) Company A retains title to the product and (2) payment by the customer is dependent upon ultimate delivery to a customer-specified site?

Interpretative Response: Generally, no. The staff believes that delivery generally is not considered to have occurred unless the customer has taken title and assumed the risks and rewards of ownership of the products specified in the customer's purchase order or sales agreement. Typically this occurs when a product is delivered to the customer's delivery site (if the terms of the sale are "FOB destination") or when a product is shipped to the customer (if the terms are "FOB shipping point").

The Commission has set forth criteria to be met in order to recognize revenue when delivery has not occurred.[17] These include:

1. The risks of ownership must have passed to the buyer;
2. The customer must have made a fixed commitment to purchase the goods, preferably in written documentation;
3. The buyer, not the seller, must request that the transaction be on a bill and hold basis.[18] The buyer must have a substantial business purpose for ordering the goods on a bill and hold basis;
4. There must be a fixed schedule for delivery of the goods. The date for delivery must be reasonable and must be consistent with the buyer's business purpose (e.g., storage periods are customary in the industry);
5. The seller must not have retained any specific performance obligations such that the earning process is not complete;
6. The ordered goods must have been segregated from the seller's inventory and not be subject to being used to fill other orders; and
7. The equipment [product] must be complete and ready for shipment.

[17] See In the Matter of Stewart Parness, AAER 108 (August 5, 1986); SEC v. Bollinger Industries, Inc., et al, LR 15093 (September 30, 1996); In the Matter of Laser Photonics, Inc., AAER 971 (September 30, 1997); In the Matter of Cypress Bioscience Inc., AAER 817 (September 19, 1996). Also see Concepts Statement 5, paragraph 84(a). and SOP 97-2, paragraph 22.

[18] Such requests typically should be set forth in writing by the buyer.

The above listed conditions are the important conceptual criteria that should be used in evaluating any purported bill and hold sale. This listing is not intended as a checklist. In some circumstances, a transaction may meet all factors listed above but not meet the requirements for revenue recognition. The Commission also has noted that in applying the above criteria to a purported bill and hold sale, the individuals responsible for the preparation and filing of financial statements also should consider the following factors:[19]

1. The date by which the seller expects payment, and whether the seller has modified its normal billing and credit terms for this buyer;[20]

2. The seller's past experiences with and pattern of bill and hold transactions;

3. Whether the buyer has the expected risk of loss in the event of a decline in the market value of goods;

4. Whether the seller's custodial risks are insurable and insured;

5. Whether extended procedures are necessary in order to assure that there are no exceptions to the buyer's commitment to accept and pay for the goods sold (i.e., that the business reasons for the bill and hold have not introduced a contingency to the buyer's commitment).

Delivery generally is not considered to have occurred unless the product has been delivered to the customer's place of business or another site specified by the customer. If the customer specifies an intermediate site but a substantial portion of the sales price is not payable until delivery is made to a final site, then revenue should not be recognized until final delivery has occurred.[21]

b. Customer Acceptance

After delivery of a product or performance of a service, if uncertainty exists about customer acceptance, revenue should not be recognized until acceptance occurs.[22] Customer acceptance provisions may be included in a contract, among other reasons, to enforce a customer's rights to (1) test the delivered product, (2) require the seller to perform additional services subsequent to delivery of an initial product or performance of an initial service (e.g., a seller is required to install or activate delivered equipment), or (3) identify other work necessary to be done before accepting the product. The staff presumes that such contractual customer acceptance provisions are substantive, bargained-for terms of an arrangement. Accordingly, when such contractual customer acceptance provisions exist, the staff generally believes that the seller should not recognize revenue until customer acceptance occurs or the acceptance provisions lapse.

Question 1

Question: Do circumstances exist in which formal customer sign-off (that a contractual customer acceptance provision is met) is unnecessary to meet the requirements to recognize revenue?

Interpretive Response: Yes. Formal customer sign-off is not always necessary to recognize revenue provided that the seller objectively demonstrates that the criteria specified in the acceptance provisions are satisfied. Customer acceptance

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[19] See Note 17, supra.

[20] Such individuals should consider whether Opinion 21 pertaining to the need for discounting the related receivable, is applicable. Opinion 21, paragraph 3(a), indicates that the requirements of that Opinion to record receivables at a discounted value are not intended to apply to "receivables and payables arising from transactions with customers or suppliers in the *normal course of business which are due in customary trade terms* not exceeding approximately one year" (emphasis added).

[21] SOP 97-2, paragraph 22.

[22] SOP 97-2, paragraph 20. Also, Concepts Statement 5, paragraph 83(b) states "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." If an arrangement expressly requires customer acceptance, the staff generally believes that customer acceptance should occur before the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues, especially when the seller is obligated to perform additional steps.

provisions generally allow the customer to cancel the arrangement when a seller delivers a product that the customer has not yet agreed to purchase or delivers a product that does not meet the specifications of the customer's order. In those cases, revenue should not be recognized because a sale has not occurred. In applying this concept, the staff observes that customer acceptance provisions normally take one of four general forms. Those forms, and how the staff generally assesses whether customer acceptance provisions should result in revenue deferral, are described below:

(a) *Acceptance provisions in arrangements that purport to be for trial or evaluation purposes*.[23] In these arrangements, the seller delivers a product to a customer, and the customer agrees to receive the product, solely to give the customer the ability to evaluate the delivered product prior to acceptance. The customer does not agree to purchase the delivered product until it accepts the product. In some cases, the acceptance provisions lapse by the passage of time without the customer rejecting the delivered product, and in other cases affirmative acceptance from the customer is necessary to trigger a sales transaction. Frequently, the title to the product does not transfer and payment terms are not established prior to customer acceptance. These arrangements are, in substance, consignment arrangements until the customer accepts the product as set forth in the contract with the seller. Accordingly, in arrangements where products are delivered for trial or evaluation purposes, revenue should not be recognized until the earlier of when acceptance occurs or the acceptance provisions lapse.

In contrast, other arrangements do not purport to be for trial or evaluation purposes. In these instances, the seller delivers a specified product pursuant to a customer's order, establishes payment terms, and transfers title to the delivered product to the customer. However, customer acceptance provisions may be included in the arrangement to give the purchaser the ability to ensure the delivered product meets the criteria set forth in its order. The staff evaluates these provisions as follows:

(b) *Acceptance provisions that grant a right of return or exchange on the basis of subjective matters*. An example of such a provision is one that allows the customer to return a product if the customer is dissatisfied with the product.[24] The staff believes these provisions are not different from general rights of return and should be accounted for in accordance with Statement 48. Statement 48 requires that the amount of future returns must be reasonably estimable in order for revenue to be recognized prior to the expiration of return rights.[25] That estimate may not be made in the absence of a large volume of homogeneous transactions or if customer acceptance is likely to depend on conditions for which sufficient historical experience is absent.[26] Satisfaction of these requirements may vary from product-to-product, location-to-location, customer-to-customer, and vendor-to-vendor.

(c) *Acceptance provisions based on seller-specified objective criteria*. An example of such a provision is one that gives the customer a right of return or replacement if the delivered product is defective or fails to meet the vendor's published specifications for the product.[27] Such rights are generally identical to those granted to all others within the same class of customer and for which satisfaction can be generally assured without consideration of conditions specific to the customer. Provided the seller has previously demonstrated that the product meets the specified criteria, the staff believes that these provisions are not different from general or specific warranties and should be accounted for as warranties in accordance with Statement 5. In this case, the cost of potentially defective goods must be reliably estimable based on a demonstrated history of substantially similar transactions.[28] However, if the seller has not previously demonstrated that the delivered product meets the seller's specifications, the staff believes that revenue should be deferred until the specifications have been objectively achieved.

[23] See, for example, SOP 97-2, paragraph 25.

[24] Statement 48, paragraph 13.

[25] Statement 48, paragraph 6(f).

[26] Statement 48, paragraphs 8(c) and 8(d).

[27] Statement 5, paragraph 24 and Statement 48, paragraph 4(c).

[28] Statement 5, paragraph 25.

(d) *Acceptance provisions based on customer-specified objective criteria*. These provisions are referred to in this document as "customer-specific acceptance provisions" against which substantial completion and contract fulfillment must be evaluated. While formal customer sign-off provides the best evidence that these acceptance criteria have been met, revenue recognition also would be appropriate, presuming all other revenue recognition criteria have been met, if the seller reliably demonstrates that the delivered products or services meet all of the specified criteria prior to customer acceptance. For example, if a seller reliably demonstrates that a delivered product meets the customer-specified objective criteria set forth in the arrangement, the delivery criterion would generally be satisfied when title and the risks and rewards of ownership transfers unless product performance may reasonably be different under the customer's testing conditions specified by the acceptance provisions. Further, the seller should consider whether it would be successful in enforcing a claim for payment even in the absence of formal sign-off. Whether the vendor has fulfilled the terms of the contract before customer acceptance is a matter of contract law, and depending on the facts and circumstances, an opinion of counsel may be necessary to reach a conclusion.

Question 2

Facts: Consider an arrangement that calls for the transfer of title to equipment upon delivery to a customer's site. However, customer-specific acceptance provisions permit the customer to return the equipment unless the equipment satisfies certain performance tests. The arrangement calls for the vendor to perform the installation. Assume the equipment and the installation are separate units of accounting under EITF Issue 00-21.[29]

Question: Must revenue allocated to the equipment always be deferred until installation and on-site testing are successfully completed?

Interpretive Response: No. The staff would not object to revenue recognition for the equipment upon delivery (presuming all other revenue recognition criteria have been met for the equipment) if the seller demonstrates that, at the time of delivery, the equipment already meets all of the criteria and specifications in the customer-specific acceptance provisions. This may be demonstrated if conditions under which the customer intends to operate the equipment are replicated in pre-shipment testing, unless the performance of the equipment, once installed and operated at the customer's facility, may reasonably be different from that tested prior to shipment.

Determining whether the delivered equipment meets all of a product's criteria and specifications is a matter of judgment that must be evaluated in light of the facts and circumstances of a particular transaction. Consultation with knowledgeable project managers or engineers may be necessary in such circumstances.

For example, if the customer acceptance provisions were based on meeting certain size and weight characteristics, it should be possible to determine whether those criteria have been met before shipment. Historical experience with the same specifications and functionality of a particular machine that demonstrates that the equipment meets the customer's specifications also may provide sufficient evidence that the currently shipped equipment satisfies the customer-specific acceptance provisions.

If an arrangement includes customer acceptance criteria or specifications that cannot be effectively tested before delivery or installation at the customer's site, the staff believes that revenue recognition should be deferred until it can be demonstrated that the criteria are met. This situation usually will exist when equipment performance can vary based on how the equipment works in combination with the customer's other equipment, software, or environmental conditions. In these situations, testing to determine whether the criteria are met cannot be reasonably performed until the products are installed or integrated at the customer's facility.

Although the following questions provide several examples illustrating how the staff evaluates customer acceptance, the determination of when customer-specific acceptance provisions of an arrangement are met in the absence of the

[29] This fact is provided as an assumption to facilitate an analysis of revenue recognition in this fact pattern. No interpretation of Issue 00-21 is intended.

customer's formal notification of acceptance depends on the weight of the evidence in the particular circumstances. Different conclusions could be reached in similar circumstances that vary only with respect to a single variable, such as complexity of the equipment, nature of the interface with the customer's environment, extent of the seller's experience with the same type of transactions, or a particular clause in the agreement. The staff believes management and auditors are uniquely positioned to evaluate the facts and arrive at a reasoned conclusion. The staff will not object to a determination that is well reasoned on the basis of this guidance.

Question 3

Facts: Company E is an equipment manufacturer whose main product is generally sold in a standard model. The contracts for sale of that model provide for customer acceptance to occur after the equipment is received and tested by the customer. The acceptance provisions state that if the equipment does not perform to Company E's published specifications, the customer may return the equipment for a full refund or a replacement unit, or may require Company E to repair the equipment so that it performs up to published specifications. Customer acceptance is indicated by either a formal sign-off by the customer or by the passage of 90 days without a claim under the acceptance provisions. Title to the equipment passes upon delivery to the customer. Company E does not perform any installation or other services on the equipment it sells and tests each piece of equipment against its specifications before shipment. Payment is due under Company E's normal payment terms for that product 30 days after customer acceptance.

Company E receives an order from a new customer for a standard model of its main product. Based on the customer's intended use of the product, location and other factors, there is no reason that the equipment would operate differently in the customer's environment than it does in Company E's facility.

Question: Assuming all other revenue recognition criteria are met (other than the issue raised with respect to the acceptance provision), when should Company E recognize revenue from the sale of this piece of equipment?

Interpretive Response: While the staff presumes that customer acceptance provisions are substantive provisions that generally result in revenue deferral, that presumption can be overcome as discussed above. Although the contract includes a customer acceptance clause, acceptance is based on meeting Company E's published specifications for a standard model. Company E demonstrates that the equipment shipped meets the specifications before shipment, and the equipment is expected to operate the same in the customer's environment as it does in Company E's. In this situation, Company E should evaluate the customer acceptance provision as a warranty under Statement 5. If Company E can reasonably and reliably estimate the amount of warranty obligations, the staff believes that it should recognize revenue upon delivery of the equipment, with an appropriate liability for probable warranty obligations.

Question 4

Facts: Assume the same facts about Company E's equipment, contract terms and customary practices as in Question 3 above. Company E enters into an arrangement with a new customer to deliver a version of its standard product modified as necessary to fit into a space of specific dimensions while still meeting all of the published vendor specifications with regard to performance. In addition to the customer acceptance provisions relating to the standard performance specifications, the customer may reject the equipment if it does not conform to the specified dimensions. Company E creates a testing chamber of the exact same dimensions as specified by the customer and makes simple design changes to the product so that it fits into the testing chamber. The equipment still meets all of the standard performance specifications.

Question: Assuming all other revenue recognition criteria are met (other than the issue raised with respect to the acceptance provision), when should Company E recognize revenue from the sale of this piece of equipment?

Interpretive Response: Although the contract includes a customer acceptance clause that is based, in part, on a customer specific criterion, Company E demonstrates that the equipment shipped meets that objective criterion, as well as the published specifications, before shipment. The staff believes that the customer acceptance provisions related to the standard performance specifications should be evaluated as a warranty under Statement 5. If Company E can reasonably and reliably estimate the amount of warranty obligations, it should recognize revenue upon delivery of the equipment, with an appropriate liability for probable warranty obligations.

Question 5

Facts: Assume the same facts about Company E's equipment, contract terms and customary practices as in Question 3 above. Company E enters into an arrangement with a new customer to deliver a version of its standard product modified as necessary to be integrated into the customer's new assembly line while still meeting all of the standard published vendor specifications with regard to performance. The customer may reject the equipment if it fails to meet the standard published performance specifications or cannot be satisfactorily integrated into the new line. Company E has never modified its equipment to work on an integrated basis in the type of assembly line the customer has proposed. In response to the request, Company E designs a version of its standard equipment that is modified as believed necessary to operate in the new assembly line. The modified equipment still meets all of the standard published performance specifications, and Company E believes the equipment will meet the requested specifications when integrated into the new assembly line. However, Company E is unable to replicate the new assembly line conditions in its testing.

Question: Assuming all other revenue recognition criteria are met (other than the issue raised with respect to the acceptance provision), when should Company E recognize revenue from the sale of this piece of equipment?

Interpretive Response: This contract includes a customer acceptance clause that is based, in part, on a customer specific criterion, and Company E cannot demonstrate that the equipment shipped meets that criterion before shipment. Accordingly, the staff believes that the contractual customer acceptance provision has not been met at shipment. Therefore, the staff believes that Company E should wait until the product is successfully integrated at its customer's location and meets the customer-specific criteria before recognizing revenue. While this is best evidenced by formal customer acceptance, other objective evidence that the equipment has met the customer-specific criteria may also exist (e.g., confirmation from the customer that the specifications were met).

c. Inconsequential or Perfunctory Performance Obligations

Question 1

Question: Does the failure to complete all activities related to a unit of accounting preclude recognition of revenue for that unit of accounting?

Interpretive Response: No. Assuming all other recognition criteria are met, revenue for the unit of accounting may be recognized in its entirety if the seller's remaining obligation is inconsequential or perfunctory.

A seller should substantially complete or fulfill the terms specified in the arrangement related to the unit of accounting at issue in order for delivery or performance to have occurred.[30] When applying the substantially complete notion, the staff believes that only inconsequential or perfunctory actions may remain incomplete such that the failure to complete the actions would not result in the customer receiving a refund or rejecting the delivered products or services performed to date. In addition, the seller should have a demonstrated history of completing the remaining tasks in a timely manner and reliably estimating the remaining costs. If revenue is recognized upon substantial completion of the terms specified in the arrangement related to the unit of accounting at issue, all related costs of performance or delivery should be accrued.

Question 2

Question: What factors should be considered in the evaluation of whether a remaining obligation related to a unit of accounting is inconsequential or perfunctory?

[30] Concepts Statement 5, paragraph 83(b) states "revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled the benefits represented by the revenues."

Interpretive Response: A remaining performance obligation is not inconsequential or perfunctory if it is essential to the functionality of the delivered products or services. In addition, remaining activities are not inconsequential or perfunctory if failure to complete the activities would result in the customer receiving a full or partial refund or rejecting (or a right to a refund or to reject) the products delivered or services performed to date. The terms of the sales contract regarding both the right to a full or partial refund and the right of return or rejection should be considered when evaluating whether a portion of the purchase price would be refundable. If the company has a historical pattern of granting such rights, that historical pattern should also be considered even if the current contract expressly precludes such rights. Further, other factors should be considered in assessing whether remaining obligations are inconsequential or perfunctory. For example, the staff also considers the following factors, which are not all-inclusive, to be indicators that a remaining performance obligation is substantive rather than inconsequential or perfunctory:

- The seller does not have a demonstrated history of completing the remaining tasks in a timely manner and reliably estimating their costs.

- The cost or time to perform the remaining obligations for similar contracts historically has varied significantly from one instance to another.

- The skills or equipment required to complete the remaining activity are specialized or are not readily available in the marketplace.

- The cost of completing the obligation, or the fair value of that obligation, is more than insignificant in relation to such items as the contract fee, gross profit, and operating income allocable to the unit of accounting.

- The period before the remaining obligation will be extinguished is lengthy. Registrants should consider whether reasonably possible variations in the period to complete performance affect the certainty that the remaining obligations will be completed successfully and on budget.

- The timing of payment of a portion of the sales price is coincident with completing performance of the remaining activity.

Registrants' determinations of whether remaining obligations are inconsequential or perfunctory should be consistently applied.

Question 3

Facts: Consider a unit of accounting that includes both equipment and installation because the two deliverables do not meet the separation criteria under EITF Issue 00-21. This may be because the equipment does not have value to the customer on a standalone basis, there is no objective and reliable evidence of fair value for the installation or there is a general right of return when the installation is not considered probable and in control of the vendor.

Question: In this situation, must all revenue be deferred until installation is performed?

Interpretive Response: Yes, if installation is essential to the functionality of the equipment.[31] Examples of indicators that installation is essential to the functionality of equipment include:

- The installation involves significant changes to the features or capabilities of the equipment or building complex interfaces or connections;

- The installation services are unavailable from other vendors.[32]

[31] See SOP 97-2, paragraph 13.

[32] See SOP 97-2, paragraphs 68–71 for analogous guidance.

Conversely, examples of indicators that installation is not essential to the functionality of the equipment include:

- The equipment is a standard product;
- Installation does not significantly alter the equipment's capabilities;
- Other companies are available to perform the installation.[33]

If it is determined that the undelivered service is not essential to the functionality of the delivered product but a portion of the contract fee is not payable until the undelivered service is delivered, the staff would not consider that obligation to be inconsequential or perfunctory. Generally, the portion of the contract price that is withheld or refundable should be deferred until the outstanding service is delivered because that portion would not be realized or realizable.[34]

d. License Fee Revenue

Facts: Assume that intellectual property is physically delivered and payment is received on December 20, upon the registrant's consummation of an agreement granting its customer a license to use the intellectual property for a term beginning on the following January 1.

Question: Should the license fee be recognized in the period ending December 31?

Interpretive Response: No. In licensing and similar arrangements (e.g., licenses of motion pictures, software, technology, and other intangibles), the staff believes that delivery does not occur for revenue recognition purposes until the license term begins.[35] Accordingly, if a licensed product or technology is physically delivered to the customer, but the license term has not yet begun, revenue should not be recognized prior to inception of the license term. Upon inception of the license term, revenue should be recognized in a manner consistent with the nature of the transaction and the earnings process.

e. Layaway Sales Arrangements

Facts: Company R is a retailer that offers "layaway" sales to its customers. Company R retains the merchandise, sets it aside in its inventory, and collects a cash deposit from the customer. Although Company R may set a time period within which the customer must finalize the purchase, Company R does not require the customer to enter into an installment note or other fixed payment commitment or agreement when the initial deposit is received. The merchandise generally is not released to the customer until the customer pays the full purchase price. In the event that the customer fails to pay the remaining purchase price, the customer forfeits its cash deposit. In the event the merchandise is lost, damaged, or destroyed, Company R either must refund the cash deposit to the customer or provide replacement merchandise.

Question: In the staff's view, when may Company R recognize revenue for merchandise sold under its layaway program?

Interpretive Response: Provided that the other criteria for revenue recognition are met, the staff believes that Company R should recognize revenue from sales made under its layaway program upon delivery of the merchandise to the customer. Until then, the amount of cash received should be recognized as a liability entitled such as "deposits received from customers for layaway sales" or a similarly descriptive caption. Because Company R retains the risks of ownership of the merchandise, receives only a deposit from the customer, and does not have an enforceable right to the remainder of the purchase price, the staff would object to Company R recognizing any revenue upon receipt of the cash deposit. This is consistent with item two (2) in the Commission's criteria for bill-and-hold transactions which states "the customer must have made a fixed commitment to purchase the goods."

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[33] Ibid.

[34] Concepts Statement 5, paragraph 83(a) and Statement 48, paragraph 6(b).

[35] SOP 00-2, paragraph 7.

f. Nonrefundable Up-Front Fees

Question 1

Facts: Registrants may negotiate arrangements pursuant to which they may receive nonrefundable fees upon entering into arrangements or on certain specified dates. The fees may ostensibly be received for conveyance of a license or other intangible right or for delivery of particular products or services. Various business factors may influence how the registrant and customer structure the payment terms. For example, in exchange for a greater up-front fee for an intangible right, the registrant may be willing to receive lower unit prices for related products to be delivered in the future. In some circumstances, the right, product, or service conveyed in conjunction with the nonrefundable fee has no utility to the purchaser separate and independent of the registrant's performance of the other elements of the arrangement. Therefore, in the absence of the registrant's continuing involvement under the arrangement, the customer would not have paid the fee. Examples of this type of arrangement include the following:

- A registrant sells a lifetime membership in a health club. After paying a nonrefundable "initiation fee," the customer is permitted to use the health club indefinitely, so long as the customer also pays an additional usage fee each month. The monthly usage fees collected from all customers are adequate to cover the operating costs of the health club.

- A registrant in the biotechnology industry agrees to provide research and development activities for a customer for a specified term. The customer needs to use certain technology owned by the registrant for use in the research and development activities. The technology is not sold or licensed separately without the research and development activities. Under the terms of the arrangement, the customer is required to pay a nonrefundable "technology access fee" in addition to periodic payments for research and development activities over the term of the contract.

- A registrant requires a customer to pay a nonrefundable "activation fee" when entering into an arrangement to provide telecommunications services. The terms of the arrangement require the customer to pay a monthly usage fee that is adequate to recover the registrant's operating costs. The costs incurred to activate the telecommunications service are nominal.

- A registrant charges users a fee for non-exclusive access to its web site that contains proprietary databases. The fee allows access to the web site for a one-year period. After the customer is provided with an identification number and trained in the use of the database, there are no incremental costs that will be incurred in serving this customer.

- A registrant charges a fee to users for advertising a product for sale or auction on certain pages of its web site. The company agrees to maintain the listing for a period of time. The cost of maintaining the advertisement on the web site for the stated period is minimal.

- A registrant charges a fee for hosting another company's web site for one year. The arrangement does not involve exclusive use of any of the hosting company's servers or other equipment. Almost all of the projected costs to be incurred will be incurred in the initial loading of information on the host company's internet server and setting up appropriate links and network connections.

Question: Assuming these arrangements qualify as single units of accounting under EITF Issue 00-21,[36] when should the revenue relating to nonrefundable, up-front fees in these types of arrangements be recognized?

Interpretive Response: The staff believes that registrants should consider the specific facts and circumstances to determine the appropriate accounting for nonrefundable, up-front fees. Unless the up-front fee is in exchange for

[36] The staff believes that the vendor activities associated with the up-front fee, even if considered a deliverable to be evaluated under EITF Issue 00-21, will rarely provide value to the customer on a standalone basis.

products delivered or services performed that represent the culmination of a separate earnings process,[37] the deferral of revenue is appropriate.

In the situations described above, the staff does not view the activities completed by the registrants (i.e., selling the membership, signing the contract, enrolling the customer, activating telecommunications services or providing initial set-up services) as discrete earnings events.[38] The terms, conditions, and amounts of these fees typically are negotiated in conjunction with the pricing of all the elements of the arrangement, and the customer would ascribe a significantly lower, and perhaps no, value to elements ostensibly associated with the up-front fee in the absence of the registrant's performance of other contract elements. The fact that the registrants do not sell the initial rights, products, or services separately (i.e., without the registrants' continuing involvement) supports the staff's view. The staff believes that the customers are purchasing the on-going rights, products, or services being provided through the registrants' continuing involvement. Further, the staff believes that the earnings process is completed by performing under the terms of the arrangements, not simply by originating a revenue-generating arrangement.

While the incurrence of nominal up-front costs helps make it clear that there is not a separate earnings event in the telecommunications example above, incurrence of substantive costs, such as in the web hosting example above, does not necessarily indicate that there is a separate earnings event. Whether there is a separate earnings event should be evaluated on a case-by-case basis. Some have questioned whether revenue may be recognized in these transactions to the extent of the incremental direct costs incurred in the activation. Because there is no separable deliverable or earnings event, the staff would generally object to that approach, except where it is provided for in the authoritative literature (e.g., Statement 51).

Supply or service transactions may involve the charge of a nonrefundable initial fee with subsequent periodic payments for future products or services. The initial fees may, in substance, be wholly or partly an advance payment for future products or services. In the examples above, the on-going rights or services being provided or products being delivered are essential to the customers receiving the expected benefit of the up-front payment. Therefore, the up-front fee and the continuing performance obligation related to the services to be provided or products to be delivered are assessed as an integrated package. In such circumstances, the staff believes that up-front fees, even if nonrefundable, are earned as the products and/or services are delivered and/or performed over the term of the arrangement or the expected period of performance[39] and generally should be deferred and recognized systematically over the periods that the fees are earned.[40]

Some propose that revenue should be recognized when the initial set-up is completed in cases where the on-going obligation involves minimal or no cost or effort and should, therefore, be considered perfunctory or inconsequential. However, the staff believes that the substance of each of these transactions indicates that the purchaser is paying for a service that is delivered over time. Therefore, revenue recognition should occur over time, reflecting the provision of service.[41]

[37] See Concepts Statement 5, footnote 51, for a description of the "earning process."

[38] In a similar situation, lenders may collect nonrefundable loan origination fees in connection with lending activities. The FASB concluded in Statement 91 that loan origination is not a separate revenue-producing activity of a lender, and therefore, those nonrefundable fees collected at the outset of the loan arrangement are not recognized as revenue upon receipt but are deferred and recognized over the life of the loan (paragraphs 5 and 37).

[39] The revenue recognition period should extend beyond the initial contractual period if the relationship with the customer is expected to extend beyond the initial term and the customer continues to benefit from the payment of the up-front fee (e.g., if subsequent renewals are priced at a bargain to the initial up-front fee).

[40] A systematic method would be on a straight-line basis, unless evidence suggests that revenue is earned or obligations are fulfilled in a different pattern, in which case that pattern should be followed.

[41] Concepts Statement 5, paragraph 84(d).

Question 2

Facts: Company A provides its customers with activity tracking or similar services (e.g., tracking of property tax payment activity, sending delinquency letters on overdue accounts, etc.) for a ten-year period. Company A requires customers to prepay for all the services for the term specified in the arrangement. The on-going services to be provided are generally automated after the initial customer set-up. At the outset of the arrangement, Company A performs set-up procedures to facilitate delivery of its on-going services to the customers. Such procedures consist primarily of establishing the necessary records and files in Company A's pre-existing computer systems in order to provide the services. Once the initial customer set-up activities are complete, Company A provides its services in accordance with the arrangement. Company A is not required to refund any portion of the fee if the customer terminates the services or does not utilize all of the services to which it is entitled. However, Company A is required to provide a refund if Company A terminates the arrangement early. Assume Company A's activities are not within the scope of Statement 91 and that this arrangement qualifies as a single unit of accounting under EITF Issue 00-21.[42]

Question: When should Company A recognize the service revenue?

Interpretive Response: The staff believes that, provided all other revenue recognition criteria are met, service revenue should be recognized on a straight-line basis, unless evidence suggests that the revenue is earned or obligations are fulfilled in a different pattern, over the contractual term of the arrangement or the expected period during which those specified services will be performed,[43] whichever is longer. In this case, the customer contracted for the on-going activity tracking service, not for the set-up activities. The staff notes that the customer could not, and would not, separately purchase the set-up services without the on-going services. The services specified in the arrangement are performed continuously over the contractual term of the arrangement (and any subsequent renewals). Therefore, the staff believes that Company A should recognize revenue on a straight-line basis, unless evidence suggests that the revenue is earned or obligations are fulfilled in a different pattern, over the contractual term of the arrangement or the expected period during which those specified services will be performed, whichever is longer.

In this situation, the staff would object to Company A recognizing revenue in proportion to the costs incurred because the set-up costs incurred bear no direct relationship to the performance of services specified in the arrangement. The staff also believes that it is inappropriate to recognize the entire amount of the prepayment as revenue at the outset of the arrangement by accruing the remaining costs because the services required by the contract have not been performed.

Question 3

Facts: Assume the same facts as in Question 2 above.

Question: Are the initial customer set-up costs incurred by Company A within the scope of SOP 98-5?

Interpretive Response: Footnote 1 of SOP 98-5 states that "this SOP does not address the financial reporting of costs incurred related to ongoing customer acquisition, such as policy acquisition costs in Statement 60 . . . and loan origination costs in Statement 91 . . . The SOP addresses the more substantive one-time efforts to establish business with an entirely new class of customers (for example, a manufacturer who does all of its business with retailers attempts to sell merchandise directly to the public)." As such, the set-up costs incurred in this example are not within the scope of SOP 98-5.

The staff believes that the incremental direct costs (Statement 91 provides an analogous definition) incurred related to the acquisition or origination of a customer contract in a transaction that results in the deferral of revenue, unless specifically provided for in the authoritative literature, may be either expensed as incurred or accounted for in accordance with paragraph 4 of Technical Bulletin 90-1 or paragraph 5 of Statement 91. The staff believes the accounting policy chosen for these costs should be disclosed and applied consistently.

[42] See Note 36, supra.

[43] See Note 39, supra.

Question 4

Facts: Assume the same facts as in Question 2 above.

Question: What is the staff's view of the pool of contract acquisition and origination costs that are eligible for capitalization?

Interpretive Response: As noted in Question 3 above, Statement 91 includes a definition of incremental direct costs in its glossary. Paragraph 6 of Statement 91 provides further guidance on the types of costs eligible for capitalization as customer acquisition costs indicating that only costs that result from successful loan origination efforts are capitalized. The FASB staff has published an Implementation Guide on Statement 91 that provides additional guidance on the costs that qualify for capitalization as customer acquisition costs. Further, Technical Bulletin 90-1 also requires capitalization of incremental direct customer acquisition costs and requires that those costs be "identified consistent with the guidance in paragraph 6 of Statement 91." Although the facts of a particular situation should be analyzed closely to capture those costs that are truly direct and incremental, the staff generally would not object to an accounting policy that results in the capitalization of costs in accordance with paragraph 6(a) and (b) of Statement 91 or Technical Bulletin 90-1. Registrants should disclose their policies for determining which costs to capitalize as contract acquisition and origination costs.

Question 5

Facts: Assume the same facts as in Question 2 above. Based on the guidance in Questions 2, 3 and 4 above, Company A has capitalized certain direct and incremental customer set-up costs associated with the deferred revenue.

Question: Over what period should Company A amortize these costs?

Interpretive Response: When both costs and revenue (in an amount equal to or greater than the costs) are deferred, the staff believes that the capitalized costs should be charged to expense proportionally and over the same period that deferred revenue is recognized as revenue.[44]

g. Deliverables Within an Arrangement

Question: If a company (the seller) has a patent to its intellectual property which it licenses to customers, the seller may represent and warrant to its licensees that it has a valid patent, and will defend and maintain that patent. Does that obligation to maintain and defend patent rights, in and of itself, constitute a deliverable to be evaluated under EITF Issue 00-21?

Interpretive Response: No. Provided the seller has legal and valid patents upon entering the license arrangement, existing GAAP on licenses of intellectual property (e.g., SOP 97-2, SOP 00-2, and SFAS No. 50) does not indicate that an obligation to defend valid patents represents an additional deliverable to which a portion of an arrangement fee should be allocated in an arrangement that otherwise qualifies for sales-type accounting. While this clause may obligate the licenser to incur costs in the defense and maintenance of the patent, that obligation does not involve an additional deliverable to the customer. Defending the patent is generally consistent with the seller's representation in the license that such patent is legal and valid. Therefore, the staff would not consider a clause like this to represent an additional deliverable in the arrangement.[45]

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[44] Technical Bulletin 90-1, paragraph 4.

[45] Note, however, the staff believes that this obligation qualifies as a guarantee within the scope of FIN 45, subject to a scope exception from the initial recognition and measurement provisions.

4. Fixed or Determinable Sales Price

a. Refundable Fees for Services

A company's contracts may include customer cancellation or termination clauses. Cancellation or termination provisions may be indicative of a demonstration period or an otherwise incomplete transaction. Examples of transactions that financial management and auditors should be aware of and where such provisions may exist include "side" agreements and significant transactions with unusual terms and conditions. These contractual provisions raise questions as to whether the sales price is fixed or determinable. The sales price in arrangements that are cancelable by the customer is neither fixed nor determinable until the cancellation privileges lapse.[46] If the cancellation privileges expire ratably over a stated contractual term, the sales price is considered to become determinable ratably over the stated term.[47] Short-term rights of return, such as thirty-day money-back guarantees, and other customary rights to return products are not considered to be cancellation privileges, but should be accounted for in accordance with Statement 48.[48]

Question 1

Facts: Company M is a discount retailer. It generates revenue from annual membership fees it charges customers to shop at its stores and from the sale of products at a discount price to those customers. The membership arrangements with retail customers require the customer to pay the entire membership fee (e.g., $35) at the outset of the arrangement. However, the customer has the unilateral right to cancel the arrangement at any time during its term and receive a full refund of the initial fee. Based on historical data collected over time for a large number of homogeneous transactions, Company M estimates that approximately 40% of the customers will request a refund before the end of the membership contract term. Company M's data for the past five years indicates that significant variations between actual and estimated cancellations have not occurred, and Company M does not expect significant variations to occur in the foreseeable future.

Question: May Company M recognize in earnings the revenue for the membership fees and accrue the costs to provide membership services at the outset of the arrangement?

Interpretive Response: No. In the staff's view, it would be inappropriate for Company M to recognize the membership fees as earned revenue upon billing or receipt of the initial fee with a corresponding accrual for estimated costs to provide the membership services. This conclusion is based on Company M's remaining and unfulfilled contractual obligation to perform services (i.e., make available and offer products for sale at a discounted price) throughout the membership period. Therefore, the earnings process, irrespective of whether a cancellation clause exists, is not complete.

In addition, the ability of the member to receive a full refund of the membership fee up to the last day of the membership term raises an uncertainty as to whether the fee is fixed or determinable at any point before the end of the term. Generally, the staff believes that a sales price is not fixed or determinable when a customer has the unilateral right to terminate or cancel the contract and receive a cash refund. A sales price or fee that is variable until the occurrence of future events (other than product returns that are within the scope of Statement 48) generally is not fixed or determinable until the future event occurs. The revenue from such transactions should not be recognized in earnings until the sales price or fee becomes fixed or determinable. Moreover, revenue should not be recognized in earnings by assessing the probability that significant, but unfulfilled, terms of a contract will be fulfilled at some point in the future. Accordingly, the revenue from such transactions should not be recognized in earnings prior to the refund privileges expiring. The amounts received from customers or subscribers (i.e., the $35 fee mentioned above) should be credited to a monetary liability account such as "customers' refundable fees."

[46] SOP 97-2, paragraph 31.

[47] Ibid.

[48] Ibid.

The staff believes that if a customer has the unilateral right to receive both (1) the seller's substantial performance under an arrangement (e.g., providing services or delivering product) and (2) a cash refund of prepaid fees, then the prepaid fees should be accounted for as a monetary liability. In consideration of whether the monetary liability can be derecognized, Statement 140 provides that liabilities may be derecognized only if (1) the debtor pays the creditor and is relieved of its obligation for the liability (paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities) or (2) the debtor is legally released from being the primary obligor under the liability.[49] If a customer has the unilateral right to receive both (1) the seller's substantial performance under the arrangement and (2) a cash refund of prepaid fees, then the refund obligation is not relieved upon performance of the service or delivery of the products. Rather, the seller's refund obligation is relieved only upon refunding the cash or expiration of the refund privilege.

Some have argued that there may be a limited exception to the general rule that revenue from membership or other service transaction fees should not be recognized in earnings prior to the refund privileges expiring. Despite the fact that Statement 48 expressly does not apply to the accounting for service revenue if part or all of the service fee is refundable under cancellation privileges granted to the buyer,[50] they believe that in certain circumstances a potential refund of a membership fee may be seen as being similar to a right of return of products under Statement 48. They argue that revenue from membership fees, net of estimated refunds, may be recognized ratably over the period the services are performed whenever pertinent conditions of Statement 48 are met, namely, there is a large population of transactions that grant customers the same unilateral termination or cancellation rights and reasonable estimates can be made of how many customers likely will exercise those rights.

The staff believes that, because service arrangements are specifically excluded from the scope of Statement 48, the most direct authoritative literature to be applied to the extinguishment of obligations under such contracts is Statement 140. As noted above, because the refund privilege extends to the end of the contract term irrespective of the amount of the service performed, Statement 140 indicates that the liability would not be extinguished (and therefore no revenue would be recognized in earnings) until the cancellation or termination and related refund privileges expire. Nonetheless, the staff recognizes that over the years the accounting for membership refunds evolved based on analogy to Statement 48 and that practice did not change when Statement 140 became effective. Reasonable people held, and continue to hold, different views about the application of the accounting literature.

Pending further action in this area by the FASB, the staff will not object to the recognition of refundable membership fees, net of estimated refunds, as earned revenue over the membership term in the limited circumstances where all of the following criteria have been met:[51]

- The estimates of terminations or cancellations and refunded revenues are being made for a large pool of homogeneous items (e.g., membership or other service transactions with the same characteristics such as terms, periods, class of customers, nature of service, etc.).

- Reliable estimates of the expected refunds can be made on a timely basis.[52] Either of the following two items would be considered indicative of an inability to make reliable estimates: (1) recurring, significant differences between actual experience and estimated cancellation or termination rates (e.g., an actual cancellation rate of 40% versus an estimated rate of 25%) even if the impact of the difference on the amount of estimated refunds is not material to the consolidated financial statements[53] or (2) recurring variances between the

[49] Statement 140, paragraph 16.

[50] Statement 48, paragraph 4.

[51] The staff will question further analogies to the guidance in Statement 48 for transactions expressly excluded from its scope.

[52] Reliability is defined in Concepts Statement 2 as "the quality of information that assures that information is reasonably free from error and bias and faithfully represents what it purports to represent." Paragraph 63 of Concepts Statement 5 reiterates the definition of reliability, requiring that "the information is representationally faithful, verifiable, and neutral."

[53] For example, if an estimate of the expected cancellation rate varies from the actual cancellation rate by 100% but the dollar amount of the error is immaterial to the consolidated financial statements, some would argue that the estimate could still be viewed as reliable. The staff disagrees with that argument.

actual and estimated amount of refunds that are material to either revenue or net income in quarterly or annual financial statements. In addition, the staff believes that an estimate, for purposes of meeting this criterion, would not be reliable unless it is remote[54] that material adjustments (both individually and in the aggregate) to previously recognized revenue would be required. The staff presumes that reliable estimates cannot be made if the customer's termination or cancellation and refund privileges exceed one year.

- There is a sufficient company-specific historical basis upon which to estimate the refunds,[55] and the company believes that such historical experience is predictive of future events. In assessing these items, the staff believes that estimates of future refunds should take into consideration, among other things, such factors as historical experience by service type and class of customer, changing trends in historical experience and the basis thereof (e.g., economic conditions), the impact or introduction of competing services or products, and changes in the customer's "accessibility" to the refund (i.e., how easy it is for customers to obtain the refund).
- The amount of the membership fee specified in the agreement at the outset of the arrangement is fixed, other than the customer's right to request a refund.

If Company M does not meet all of the foregoing criteria, the staff believes that Company M should not recognize in earnings any revenue for the membership fee until the cancellation privileges and refund rights expire.

If revenue is recognized in earnings over the membership period pursuant to the above criteria, the initial amounts received from customer or subscribers (i.e., the $35 fee mentioned above) should be allocated to two liability accounts. The amount of the fee representing estimated refunds should be credited to a monetary liability account, such as "customers' refundable fees," and the remaining amount of the fee representing unearned revenue should be credited to a nonmonetary liability account, such as "unearned revenues." For each income statement presented, registrants should disclose in the footnotes to the financial statements the amounts of (1) the unearned revenue and (2) refund obligations as of the beginning of each period, the amount of cash received from customers, the amount of revenue recognized in earnings, the amount of refunds paid, other adjustments (with an explanation thereof), and the ending balance of (1) unearned revenue and (2) refund obligations.

If revenue is recognized in earnings over the membership period pursuant to the above criteria, the staff believes that adjustments for changes in estimated refunds should be recorded using a retrospective approach whereby the unearned revenue and refund obligations are remeasured and adjusted at each balance sheet date with the offset being recorded as earned revenue.[56]

Companies offering memberships often distribute membership packets describing and discussing the terms, conditions, and benefits of membership. Packets may include vouchers, for example, that provide new members with discounts or other benefits from third parties. The costs associated with the vouchers should be expensed when distributed. Advertising costs to solicit members should be accounted for in accordance with SOP 93-7. Incremental direct costs incurred in connection with enrolling customers (e.g., commissions paid to agents) should be accounted for as follows: (1) if revenue is deferred until the cancellation or termination privileges expire, incremental direct costs should be either (a) charged to expense when incurred if the costs are not refundable to the company in the event the customer obtains a refund of the membership fee, or (b) if the costs are refundable to the company in the event the customer obtains a refund of the membership fee, recorded as an asset until the earlier of termination or cancellation or refund; or (2) if revenue, net of estimated refunds, is recognized in earnings over the membership period, a like percentage of incremental

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[54] The term "remote" is used here with the same definition as used in Statement 5.

[55] Paragraph 8 of Statement 48 notes various factors that may impair the ability to make a reasonable estimate of returns, including the lack of sufficient historical experience. The staff typically expects that the historical experience be based on the particular registrant's historical experience for a service and/or class of customer. In general, the staff typically expects a start-up company, a company introducing new services, or a company introducing services to a new class of customer to have at least two years of experience to be able to make reasonable and reliable estimates.

[56] The staff believes deferred costs being amortized on a basis consistent with the deferred revenue should be similarly adjusted. Such an approach is generally consistent with the amortization methodology in Statement 91, paragraph 19.

direct costs should be deferred and recognized in earnings in the same pattern as revenue is recognized, and the remaining portion should be either (a) charged to expense when incurred if the costs are not refundable to the company in the event the customer obtains a refund of the membership fee, or (b) if the costs are refundable to the company in the event the customer obtains a refund of the membership fee, recorded as an asset until the refund occurs.[57] All costs other than incremental direct costs (e.g., indirect costs) should be expensed as incurred.

Question 2

Question: Will the staff accept an analogy to Statement 48 for service transactions subject to customer cancellation privileges other than those specifically addressed in the previous question?

Interpretive Response: The staff has accepted the analogy in limited circumstances due to the existence of a large pool of homogeneous transactions and satisfaction of the criteria in the previous question. Examples of other arrangements involving customer cancellation privileges and refundable service fees that the staff has addressed include the following:

- a leasing broker whose commission from the lessor upon a commercial tenant's signing of a lease agreement is refundable (or in some cases, is not due) under lessor cancellation privileges if the tenant fails to move into the leased premises by a specified date.

- a talent agent whose fee receivable from its principal (i.e., a celebrity) for arranging a celebrity endorsement for a five-year term is cancelable by the celebrity if the celebrity breaches the endorsement contract with its customer.

- an insurance agent whose commission received from the insurer upon selling an insurance policy is refundable in whole for the 30-day period that state law permits the consumer to repudiate the contract and then refundable on a declining pro rata basis until the consumer has made six monthly payments.

In the first two of these cases, the staff advised the registrants that the portion of revenue subject to customer cancellation and refund must be deferred until no longer subject to that contingency because the registrants did not have an ability to make reliable estimates of customer cancellations due to the lack of a large pool of homogeneous transactions. In the case of the insurance agent, however, the particular registrant demonstrated that it had a sufficient history of homogeneous transactions with the same characteristics from which to reliably estimate contract cancellations and satisfy all the criteria specified in the previous question. Accordingly, the staff did not object to that registrant's policy of recognizing its sales commission as revenue when its performance was complete, with an appropriate allowance for estimated cancellations.

Question 3

Question: Must a registrant analogize to Statement 48, or may it choose to defer all revenue until the refund period lapses as suggested by Statement 140 even if the criteria above for analogy to Statement 48 are met?

Interpretive Response: The analogy to Statement 48 is presented as an alternative that would be acceptable to the staff when the listed conditions are met. However, a registrant may choose to defer all revenue until the refund period lapses. The policy chosen should be disclosed and applied consistently.

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[57] Statement 91, paragraph 5 and Technical Bulletin 90-1, paragraph 4 both provide for the deferral of incremental direct costs associated with acquiring a revenue-producing contract. Even though the revenue discussed in this example is refundable, if a registrant meets the aforementioned criteria for revenue recognition over the membership period, the staff would analogize to this guidance. However, if neither a nonrefundable contract nor a reliable basis for estimating net cash inflows under refundable contracts exists to provide a basis for recovery of incremental direct costs, the staff believes that such costs should be expensed as incurred. See SAB Topic 13.A.3.f. Question 3.

Question 4

Question: May a registrant that meets the above criteria for reliable estimates of cancellations choose at some point in the future to change from the Statement 48 method to the Statement 140 method of accounting for these refundable fees? May a registrant change from the Statement 140 method to the Statement 48 method?

Interpretive Response: The staff believes that Statement 140 provides a preferable accounting model for service transactions subject to potential refunds. Therefore, the staff would not object to a change from the Statement 48 method to the Statement 140 method. However, if a registrant had previously chosen the Statement 140 method, the staff would object to a change to the Statement 48 method.

Question 5

Question: Is there a minimum level of customers that must be projected not to cancel before use of Statement 48 type accounting is appropriate?

Interpretive Response: Statement 48 does not include any such minimum. Therefore, the staff does not believe that a minimum must apply in service transactions either. However, as the refund rate increases, it may be increasingly difficult to make reasonable and reliable estimates of cancellation rates.

Question 6

Question: When a registrant first determines that reliable estimates of cancellations of service contracts can be made (e.g., two years of historical evidence becomes available), how should the change from the complete deferral method to the method of recognizing revenue, net of estimated cancellations, over time be reflected?

Interpretive Response: Changes in the ability to meet the criteria set forth above should be accounted for in the manner described in paragraph 6 of Statement 48, which addresses the accounting when a company experiences a change in the ability to make reasonable estimates of future product returns.

b. Estimates and Changes in Estimates

Accounting for revenues and costs of revenues requires estimates in many cases; those estimates sometimes change. Registrants should ensure that they have appropriate internal controls and adequate books and records that will result in timely identification of necessary changes in estimates that should be reflected in the financial statements and notes thereto.

Question 1

Facts: Paragraph 8 of Statement 48 lists a number of factors that may impair the ability to make a reasonable estimate of product returns in sales transactions when a right of return exists.[58] The paragraph concludes by stating "other factors may preclude a reasonable estimate."

Question: What "other factors," in addition to those listed in paragraph 8 of Statement 48, has the staff identified that may preclude a registrant from making a reasonable and reliable estimate of product returns?

Interpretive Response: The staff believes that the following additional factors, among others, may affect or preclude the ability to make reasonable and reliable estimates of product returns: (1) significant increases in or excess levels of inventory in a distribution channel (sometimes referred to as "channel stuffing"), (2) lack of "visibility" into or the inability to determine or observe the levels of inventory in a distribution channel and the current level of sales to end users, (3)

[58] These factors include "a) the susceptibility of the product to significant external factors, such as technological obsolescence or changes in demand, b) relatively long periods in which a particular product may be returned, c) absence of historical experience with similar types of sales of similar products, or inability to apply such experience because of changing circumstances, for example, changes in the selling enterprise's marketing policies and relationships with its customers, and d) absence of a large volume of relatively homogeneous transactions."

expected introductions of new products that may result in the technological obsolescence of and larger than expected returns of current products, (4) the significance of a particular distributor to the registrant's (or a reporting segment's) business, sales and marketing, (5) the newness of a product, (6) the introduction of competitors' products with superior technology or greater expected market acceptance, and (7) other factors that affect market demand and changing trends in that demand for the registrant's products. Registrants and their auditors should carefully analyze all factors, including trends in historical data, which may affect registrants' ability to make reasonable and reliable estimates of product returns.

The staff reminds registrants that if a transaction fails to meet all of the conditions of paragraphs 6 and 8 in Statement 48, no revenue may be recognized until those conditions are subsequently met or the return privilege has substantially expired, whichever occurs first.[59] Simply deferring recognition of the gross margin on the transaction is not appropriate.

Question 2

Question: Is the requirement cited in the previous question for "reliable" estimates meant to imply a new, higher requirement than the "reasonable" estimates discussed in Statement 48?

Interpretive Response: No. "Reliability" of financial information is one of the qualities of accounting information discussed in Concepts Statement 2. The staff's expectation that estimates be reliable does not change the existing requirement of Statement 48. If management cannot develop an estimate that is sufficiently reliable for use by investors, the staff believes it cannot make a reasonable estimate meeting the requirements of that standard.

Question 3

Question: Does the staff expect registrants to apply the guidance in Question 1 of Topic 13.A.4(a) above to sales of tangible goods and other transactions specifically within the scope of Statement 48?

Interpretive Response: The specific guidance above does not apply to transactions within the scope of Statement 48. The views set forth in Question 1 of Topic 13.A.4(a) are applicable to the service transactions discussed in that Question. Service transactions are explicitly outside the scope of Statement 48.

Question 4

Question: Question 1 of Topic 13.A.4(a) above states that the staff would expect a two-year history of selling a new service in order to be able to make reliable estimates of cancellations. How long a history does the staff believe is necessary to estimate returns in a product sale transaction that is within the scope of Statement 48?

Interpretive Response: The staff does not believe there is any specific length of time necessary in a product transaction. However, Statement 48 states that returns must be subject to reasonable estimation. Preparers and auditors should be skeptical of estimates of product returns when little history with a particular product line exists, when there is inadequate verifiable evidence of historical experience, or when there are inadequate internal controls that ensure the reliability and timeliness of the reporting of the appropriate historical information. Start-up companies and companies selling new or significantly modified products are frequently unable to develop the requisite historical data on which to base estimates of returns.

Question 5

Question: If a company selling products subject to a right of return concludes that it cannot reasonably estimate the actual return rate due to its limited history, but it can conservatively estimate the maximum possible returns, does the staff believe that the company may recognize revenue for the portion of the sales that exceeds the maximum estimated return rate?

[59] Statement 48, paragraph 6.

Interpretive Response: No. If a reasonable estimate of future returns cannot be made, Statement 48 requires that revenue not be recognized until the return period lapses or a reasonable estimate can be made.[60] Deferring revenue recognition based on the upper end of a wide range of potential return rates is inconsistent with the provisions of Statement 48.

c. Contingent Rental Income

Facts: Company A owns and leases retail space to retailers. Company A (lessor) renews a lease with a customer (lessee) that is classified as an operating lease. The lease term is one year and provides that the lease payments are $1.2 million, payable in equal monthly installments on the first day of each month, plus one percent of the lessee's net sales in excess of $25 million if the net sales exceed $25 million during the lease term (i.e., contingent rental). The lessee has historically experienced annual net sales in excess of $25 million in the particular space being leased, and it is probable that the lessee will generate in excess of $25 million net sales during the term of the lease.

Question: In the staff's view, should the lessor recognize any rental income attributable to the one percent of the lessee's net sales exceeding $25 million before the lessee actually achieves the $25 million net sales threshold?

Interpretive Response: No. The staff believes that contingent rental income "accrues" (i.e., it should be recognized as revenue) when the changes in the factor(s) on which the contingent lease payments is (are) based actually occur.[61]

Statement 13 paragraph 19(b) states that lessors should account for operating leases as follows: "Rent shall be reported in income over the lease term as it becomes receivable according to the provisions of the lease. However, if the rentals vary from a straight-line basis, the income shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit from the leased property is diminished, in which case that basis shall be used."

Statement 29 amended Statement 13 and clarifies that "lease payments that depend on a factor that does not exist or is not measurable at the inception of the lease, such as future sales volume, would be contingent rentals in their entirety and, accordingly, would be excluded from minimum lease payments and included in the determination of income as they accrue." [Summary] Paragraph 17 of Statement 29 provides the following example of determining contingent rentals:

> A lease agreement for retail store space could stipulate a monthly base rental of $200 and a monthly supplemental rental of one-fourth of one percent of monthly sales volume during the lease term. Even if the lease agreement is a renewal for store space that had averaged monthly sales of $25,000 for the past 2 years, minimum lease payments would include only the $200 monthly base rental; the supplemental rental is a contingent rental that is excluded from minimum lease payments. The future sales for the lease term do not exist at the inception of the lease, and future rentals would be limited to $200 per month if the store were subsequently closed and no sales were made thereafter.

Technical Bulletin 85-3 addresses whether it is appropriate for lessors in operating leases to recognize scheduled rent increases on a basis other than as required in Statement 13, paragraph 19(b). Paragraph 2 of Technical Bulletin 85-3 states "using factors such as the time value of money, anticipated inflation, or *expected future revenues* [emphasis added] to allocate scheduled rent increases is inappropriate because these factors do not relate to the *time pattern* of the physical usage of the leased property. However, such factors may affect the periodic reported rental income or expense if the lease agreement involves contingent rentals, which are excluded from minimum lease payments and accounted for separately under Statement 13, as amended by Statement 29." In developing the basis for why scheduled rent increases should be recognized on a straight-line basis, the FASB distinguishes the accounting for scheduled rent increases from contingent rentals. Paragraph 13 states "There is an important substantive difference between lease rentals that are

[60] Statement 48, paragraph 6(f).

[61] Lessees should follow the guidance established in EITF Issue 98-9.

contingent upon some specified future event and scheduled rent increases that are unaffected by future events; the accounting under Statement 13 reflects that difference. If the lessor and lessee eliminate the risk of variable payments by agreeing to scheduled rent increases, the accounting should reflect those different circumstances."

The example provided in Statement 29 implies that contingent rental income in leases classified as sales-type or direct-financing leases becomes "accruable" when the changes in the factors on which the contingent lease payments are based actually occur. Technical Bulletin 85-3 indicates that contingent rental income in operating leases should not be recognized in a manner consistent with scheduled rent increases (i.e., on a straight-line basis over the lease term or another systematic and rational allocation basis if it is more representative of the time pattern in which the leased property is physically employed) because the risk of variable payments inherent in contingent rentals is substantively different than scheduled rent increases. The staff believes that the reasoning in Technical Bulletin 85-3 supports the conclusion that the risks inherent in variable payments associated with contingent rentals should be reflected in financial statements on a basis different than rental payments that adjust on a scheduled basis and, therefore, operating lease income associated with contingent rents would not be recognized as time passes or as the leased property is physically employed. Furthermore, prior to the lessee's achievement of the target upon which contingent rentals are based, the lessor has no legal claims on the contingent amounts. Consequently, the staff believes that it is inappropriate to anticipate changes in the factors on which contingent rental income in operating leases is based and recognize rental income prior to the resolution of the lease contingencies.

Because Company A's contingent rental income is based upon whether the customer achieves net sales of $25 million, the contingent rentals, which may not materialize, should not be recognized until the customer's net sales actually exceed $25 million. Once the $25 million threshold is met, Company A would recognize the contingent rental income as it becomes accruable, in this case, as the customer recognizes net sales. The staff does not believe that it is appropriate to recognize revenue based upon the probability of a factor being achieved. The contingent revenue should be recorded in the period in which the contingency is resolved.

d. Claims Processing and Billing Services

Facts: Company M performs claims processing and medical billing services for healthcare providers. In this role, Company M is responsible for preparing and submitting claims to third-party payers, tracking outstanding billings, and collecting amounts billed. Company M's fee is a fixed percentage (e.g., five percent) of the amount collected. If no collections are made, no fee is due to Company M. Company M has historical evidence indicating that the third-party payers pay 85 percent of the billings submitted with no further effort by Company M. Company M has determined that the services performed under the arrangement are a single unit of accounting.

Question: May Company M recognize as revenue its five percent fee on 85 percent of the gross billings at the time it prepares and submits billings, or should it wait until collections occur to recognize any revenue?

Interpretive Response: The staff believes that Company M must wait until collections occur before recognizing revenue. Before the third-party payer has remitted payment to Company M's customers for the services billed, Company M is not entitled to any revenue. That is, its revenue is not yet realized or realizable.[62] Until Company M's customers collect on the billings, Company M has not performed the requisite activity under its contract to be entitled to a fee.[63] Further, no amount of the fee is fixed or determinable or collectible until Company Ms' customers collect on the billings.

[62] Concepts Statement 5, paragraph 83(a).

[63] Concepts Statement 5, paragraph 83(b).

B. Disclosures

Question 1

Question: What disclosures are required with respect to the recognition of revenue?

Interpretive Response: A registrant should disclose its accounting policy for the recognition of revenue pursuant to Opinion 22. Paragraph 12 thereof states that "the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue . . . ." Because revenue recognition generally involves some level of judgment, the staff believes that a registrant should always disclose its revenue recognition policy. If a company has different policies for different types of revenue transactions, including barter sales, the policy for each material type of transaction should be disclosed. If sales transactions have multiple units of accounting, such as a product and service, the accounting policy should clearly state the accounting policy for each unit of accounting as well as how units of accounting are determined and valued. In addition, the staff believes that changes in estimated returns recognized in accordance with Statement 48 should be disclosed, if material (e.g., a change in estimate from two percent of sales to one percent of sales).

Regulation S-X requires that revenue from the sales of products, services, and other products each be separately disclosed on the face of the income statement.[64] The staff believes that costs relating to each type of revenue similarly should be reported separately on the face of the income statement.

MD&A requires a discussion of liquidity, capital resources, results of operations and other information necessary to an understanding of a registrant's financial condition, changes in financial condition and results of operations.[65] This includes unusual or infrequent transactions, known trends or uncertainties that have had, or might reasonably be expected to have, a favorable or unfavorable material effect on revenue, operating income or net income and the relationship between revenue and the costs of the revenue. Changes in revenue should not be evaluated solely in terms of volume and price changes, but should also include an analysis of the reasons and factors contributing to the increase or decrease. The Commission stated in FRR 36 that MD&A should "give investors an opportunity to look at the registrant through the eyes of management by providing a historical and prospective analysis of the registrant's financial condition and results of operations, with a particular emphasis on the registrant's prospects for the future."[66] Examples of such revenue transactions or events that the staff has asked to be disclosed and discussed in accordance with FRR 36 are:

- Shipments of product at the end of a reporting period that significantly reduce customer backlog and that reasonably might be expected to result in lower shipments and revenue in the next period.
- Granting of extended payment terms that will result in a longer collection period for accounts receivable (regardless of whether revenue has been recognized) and slower cash inflows from operations, and the effect on liquidity and capital resources. (The fair value of trade receivables should be disclosed in the footnotes to the financial statements when the fair value does not approximate the carrying amount.)[67]
- Changing trends in shipments into, and sales from, a sales channel or separate class of customer that could be expected to have a significant effect on future sales or sales returns.
- An increasing trend toward sales to a different class of customer, such as a reseller distribution channel that has a lower gross profit margin than existing sales that are principally made to end users. Also, increasing service revenue that has a higher profit margin than product sales.

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[64] See Regulation S-X, Article 5-03(b)(1) and (2).

[65] See Regulation S-K, Article 303 and FRR 36.

[66] FRR 36, also see In the Matter of Caterpillar Inc., AAER 363 (March 31, 1992).

[67] Statement 107.

- Seasonal trends or variations in sales.
- A gain or loss from the sale of an asset(s).[68]

Question 2

Question: Will the staff expect retroactive changes by registrants to comply with the accounting described in this bulletin?

Interpretive Response: All registrants are expected to apply the accounting and disclosures described in this bulletin. The staff, however, will not object if registrants that have not applied this accounting do not restate prior financial statements provided they report a change in accounting principle in accordance with Opinion 20 and Statement 3 no later than the fourth fiscal quarter of the fiscal year beginning after December 15, 1999. In periods subsequent to transition, registrants should disclose the amount of revenue (if material to income before income taxes) recognized in those periods that was included in the cumulative effect adjustment. If a registrant files financial statements with the Commission before applying the guidance in this bulletin, disclosures similar to those described in SAB Topic 11.M should be provided.

However, if registrants have not previously complied with GAAP, for example, by recording revenue for products prior to delivery that did not comply with the applicable bill-and-hold guidance, those registrants should apply the guidance in Opinion 20 for the correction of an error.[69] In addition, registrants should be aware that the Commission may take enforcement action where a registrant in prior financial statements has violated the antifraud or disclosure provisions of the securities laws with respect to revenue recognition.

Question 3

Question: The previous question indicates that the staff will not object to cumulative effect-type transition so long as the prior accounting does not represent an error. Could a company whose prior accounting does not represent an error voluntarily adopt a new method consistent with this SAB Topic by restatement of prior periods, rather than through a cumulative catch-up adjustment?

Interpretive Response: In most instances, no. Opinion 20 does not permit restatement of financial statements for a change in accounting principle that does not represent correction of an error, except in very rare circumstances.[70] An exception is a company that is filing publicly for the first time. As stated in paragraph 29 of Opinion 20, those companies are permitted to reflect the adoption of the new policy via a restatement, and the staff believes that approach is usually necessary to avoid confusing investors in an initial public offering.

Question 4

Question: Should a registrant reporting a change in accounting principle as a result of this SAB Topic file a preferability letter?

Interpretive Response: No preferability letter is required if an accounting change is made in response to a newly issued Staff Accounting Bulletin.

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[68] Gains or losses from the sale of assets should be reported as "other general expenses" pursuant to Regulation S-X, Article 5-03(b)(6). Any material item should be stated separately.

[69] Opinion 20, paragraph 13 and paragraphs 36-37 describe and provide the accounting and disclosure requirements applicable to the correction of an error in previously issued financial statements. Because the term "error" as used in Opinion 20 includes "oversight or misuse of facts that existed at the time that the financial statements were prepared," that term includes both unintentional errors as well as intentional fraudulent financial reporting and misappropriation of assets as described in SAS 99.

[70] See, for example, Opinion 20, paragraph 27.

Question 5

Question: If a company had not previously adjusted sales revenues, but deferred recognition of the gross margin of estimated returns for a transaction subject to Statement 48, how should it present a current change in accounting to reduce revenue and cost of sales for estimated returns?

Interpretive Response: Paragraph 7 of Statement 48 states that "sales revenue and cost of sales reported in the income statement *shall be reduced* to reflect estimated returns." Statement 48 does not provide for recognition of sales and costs of sales while deferring gross margin under any circumstance. This SAB Topic provides no new guidance on this point. If a registrant has failed to comply with GAAP, the registrant should retroactively revise prior financial statements in the manner set forth in Opinion 20 and Statement 16.

Appendix C — Abbreviations

AcSEC: Accounting Standards Executive Committee

AICPA: American Institute of Certified Public Accountants

ASP: application service provider

EITF: Emerging Issues Task Force

FASB: Financial Accounting Standards Board

FOB: free on board

GAAP: generally accepted accounting principles

IPO: initial public offering

PCAOB: Public Company Accounting Oversight Board

PCS: postcontract customer support

R&D: research and development

SAS: Statement on Auditing Standards

SEC: Securities and Exchange Commission

SOP: Statement of Position

TIS: Technical Information Service

TPA: Technical Practice Aid

VSOE: vendor-specific objective evidence

Appendix D — Glossary of Standards

FASB Statement No. 5, *Accounting for Contingencies*

FASB Statement No. 13, *Accounting for Leases*

FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*

FASB Statement No. 68, *Research and Development Arrangements*

FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

FASB Statement No. 153, *Exchanges of Nonmonetary Assets* — an amendment of APB Opinion No. 29

FASB Statement No. 154, *Accounting Changes and Error Corrections*

FASB Staff Position No. FIN 45-1, "Accounting for Intellectual Property Infringement Indemnifications Under FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*"

FASB Technical Bulletin No. 79-10, *Fiscal Funding Clauses in Lease Agreements*

EITF Issue No. 88-18, "Sales of Future Revenues"

EITF Issue No. 00-3, "Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware"

EITF Issue No. 00-21, "Revenue Arrangements With Multiple Deliverables"

EITF Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)"

EITF Issue No. 03-5, "Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software"

APB Opinion No. 21, *Interest on Receivables and Payables*

APB Opinion No. 29, *Accounting for Nonmonetary Transactions*

Accounting Research Bulletin No. 45, *Long-Term Construction-Type Contracts*

AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*

AICPA Statement of Position 97-2, *Software Revenue Recognition*

AICPA Statement of Position 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2*, Software Revenue Recognition

AICPA Statement of Position 98-5, *Reporting on the Costs of Start-up Activities*

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

AICPA Statement of Position 00-2, *Accounting by Producers or Distributors of Films*

AICPA Statement on Auditing Standards No. 69 (AU Section 411), *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*

AICPA Technical Practice Aids, TIS Section 5100.41, "Effect of Prepayments on Software Revenue Recognition"

AICPA Technical Practice Aids, TIS Section 5100.45, "Effect of Change in License Mix on Software Revenue Recognition"

AICPA Technical Practice Aids, TIS Section 5100.46–.47, "Nonmonetary Exchanges of Software"

AICPA Technical Practice Aids, TIS Section 5100.50, "Definition of More-Than-Insignificant Discount and Software Revenue Recognition"

AICPA Technical Practice Aids, TIS Section 5100.51, "Accounting for Significant Incremental Discounts in Software Revenue Recognition"

AICPA Technical Practice Aids, TIS Section 5100.54, "Fair Value of PCS in a Multi-Year Time-Based License and Software Revenue Recognition"

AICPA Technical Practice Aids, TIS Section 5100.57, "Overcoming Presumption of Concessions in Extended Payment Term Arrangements and Software Revenue Recognition"

AICPA Technical Practice Aids, TIS Section 5100.58, "Effect of Prepayments on Software Revenue Recognition (Part II)"

AICPA Technical Practice Aids, TIS Section 5100.67, "Customer Acceptance and Software Revenue Recognition"

AICPA Technical Practice Aids, TIS Section 5100.69, "Delivery Terms and Software Revenue Recognition"

AICPA Technical Practice Aids, TIS Section 5100.70, "Effect of Commencement of an Initial License Term and Software Revenue Recognition"

AICPA Technical Practice Aids, TIS Section 5100.71, "Effect of Commencement of an Extension/Renewal License Term and Software Revenue Recognition"

SEC Staff Accounting Bulletin Topic 13, "Revenue Recognition"

SEC Staff Accounting Bulletin Topic 13.A.1, "Revenue Recognition — General"

SEC Staff Accounting Bulletin Topic 13.A.2, "Persuasive Evidence of an Arrangement"

SEC Staff Accounting Bulletin Topic 13.A.3(a), "Bill and Hold Arrangements"

SEC Staff Accounting Bulletin Topic 13.A.3(b), "Customer Acceptance"

SEC Staff Accounting Bulletin Topic 13.A.3(d), "License Fee Revenue"

SEC Staff Accounting Bulletin Topic 13.A.3(f), "Nonrefundable Up-Front Fees"

SEC Staff Accounting Bulletin Topic 13.A.4(a), "Refundable Fees for Services"

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