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Preface

To our friends and clients:

We are pleased to present the third edition of Software Revenue Recognition: A Roadmap to Applying ASC 985-605. As software technology continues to evolve, entities are continually confronting new challenges in recognizing revenue for software arrangements. In addition, as the FASB and IASB continue to converge their guidance on revenue recognition, many entities have begun to assess how the proposed changes may affect them. This Roadmap equips entities with the knowledge to meet these challenges head on. The following items are new to this edition:

- Updates to the format and accounting literature references to align with the FASB Accounting Standards Codification (ASC or the “Codification”).
- Changes to the literature and Q&As as a result of ASU 2009-14.¹
- Additional Q&As on issues that have arisen since the issuance of the second edition of this Roadmap.
- Preliminary insights into the potential effect of the FASB/IASB joint revenue recognition project on entities that are currently within the scope of ASC 985-605.

Entities that are currently within the scope of ASC 985-605 will arguably be one of the groups most significantly affected by the joint revenue recognition project. Once the project is finalized, substantially all current U.S. GAAP² and IFRSs on revenue recognition will be completely superseded, including ASC 985-605. In their place will be a single, comprehensive model that all entities will be required to apply in reporting information about contracts to provide goods or services to customers.

We hope that the third edition of this Roadmap helps financial statement preparers continue to navigate the literature’s complexity and prepare for the upcoming changes from the joint revenue recognition project.

Sincerely,

Deloitte & Touche LLP

¹ Throughout this publication, short forms of the standards are used. For the full citations, see Appendix F.
² For the full forms of acronyms, see Appendix E.
Acknowledgments

We are grateful for the contributions of Mark Crowley, Wissam Dandan, Ryan Johnson, Eric Knachel, Ignacio Perez, Sean St. Germain, Beth Young, and Amy Zimmerman. In addition, we would like to acknowledge the contributions of Teri Asarito, Lynne Campbell, Jeanine Pagliaro, and Joseph Renouf in our Production group. Stuart Moss supervised the overall preparation of the third edition of this Roadmap and extends his deepest appreciation to all professionals that helped in its development.
Overview

Background

Issued by the AICPA in 1997, SOP 97-2 was the first industry-specific guidance on revenue recognition for software and software-related products. After the issuance of SOP 97-2, standard setters released numerous standards clarifying specific aspects of software revenue recognition — SOP 98-4; SOP 98-9; and various TPAs, EITF Issues, and SEC guidance. With the release of the FASB Accounting Standards Codification on July 1, 2009, SOP 97-2, its related amendments, and the related TPAs were codified in ASC 985-605.

The guidance in ASC 985-605 applies to transactions in which software is more than incidental to the related products and services. As technology evolved, the use of more-than-incidental software in tangible products became more pervasive and more entities found themselves within the scope of ASC 985-605. Some of these entities raised concerns about whether these transactions should be accounted for as sales of software subject to ASC 985-605 or sales of tangible products subject to other revenue recognition guidance. To address these concerns, in 2009 the FASB issued ASU 2009-14, which amends ASC 985-605-15 to exclude from its scope certain tangible products that contain software that functions together with nonsoftware deliverables to provide the tangible product’s essential functionality. (See additional discussion in the Scope section below.)

The amendments in ASU 2009-14 (codified in ASC 985-605-15) were effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, unless an entity elected to adopt the ASU retrospectively in accordance with ASC 250. An entity may have elected earlier application as long as it also applied the guidance in ASU 2009-13 (which amended the guidance on multiple-element arrangements in ASC 605-25). An entity that elected early application in an interim period other than the first period of its fiscal year (e.g., its first quarter) had to apply the guidance as of the beginning of its fiscal year. For all prior reporting periods of that fiscal year, the entity should disclose the effect of the changes on revenue, income before taxes, net income, and earnings per share, as well as the effect of the changes for the appropriate captions presented. Although the overview of this Roadmap only presents the guidance in ASC 985-605 as amended by ASU 2009-14, the affected Q&As have been updated to cover the guidance that entities would apply both before and after the effective date of the Codification amendments.

Entities with multiple-element arrangements that are now outside the scope of the software revenue recognition guidance in ASC 985-605 because of the ASU 2009-14 amendments will be required to apply the separation and allocation guidance in ASC 650-25 (as amended by ASU 2009-13). For guidance on applying the provisions of ASC 605-25, including interpretive guidance (Q&As), see Deloitte’s Multiple-Element Arrangements — A Roadmap to Applying the Revenue Recognition Guidance in ASU 2009-13.

Under IFRSs, there is no specific guidance on software revenue recognition. Therefore, the overall concepts in IAS 18 would apply to software arrangements. That is, revenue is recognized when “it is probable that any future economic benefit . . . will flow to or from the entity” and the benefit can be measured reliably. The uniqueness of products and services sold in the software industry may make it difficult for an entity to apply these overall concepts when determining how to recognize revenue for software arrangements under IFRSs. It may sometimes be appropriate for an entity to consider the guidance in U.S. GAAP when determining the appropriate accounting for software arrangements under IFRSs.
Overview

Software Revenue Recognition: A Roadmap to Applying ASC 985-605

Summary of the Potential Impact of the Revenue Project

As stated in the Preface, entities that are currently within the scope of ASC 985-605 will arguably be one of the groups most significantly affected by the joint revenue recognition project of the FASB and IASB. Once the project is finalized, most current U.S. GAAP and IFRSs on revenue recognition will be completely superseded, including ASC 985-605. In their place will be a single, comprehensive model that all entities will be required to apply in reporting information about contracts to provide goods or services to customers. On November 14, 2011, the FASB and IASB jointly issued their revised ED Revenue From Contracts With Customers.

Although the effective date of the revised ED is subject to change, certain entities that are currently within the scope of ASC 985-605 may be required to start applying the new guidance as soon as fiscal years beginning on or after January 1, 2015. Thus, because of the currently proposed requirement to retrospectively adopt the revised ED (subject to certain transition relief), certain entities may be required to apply the guidance to transactions as early as January 1, 2013 (e.g., a public entity reporting three years of financial statements).

The revised ED’s core principle is that an entity must “recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration that it receives, or expects to receive, in exchange for those goods or services.” The proposal contains a comprehensive five-step model for entities to apply in recognizing revenue for contracts within the revised ED’s scope:

- “Identify the contract with a customer.”
- “Identify the separate performance obligations in the contract.”
- “Determine the transaction price.”
- “Allocate the transaction price to the separate performance obligations in the contract.”
- “Recognize revenue when (or as) the entity satisfies a performance obligation.”

The sections below summarize some of the changes that each of these five steps may make to the current guidance in ASC 985-605. For additional information about these and other potential changes to the current guidance, see Appendix D, which contains a detailed comparison of ASC 985-605 with the revised ED. For a more in-depth look at the revised ED, see Deloitte’s November 15, 2011, Heads Up. In addition, stay tuned for future Deloitte publications and Q&As on the final standard.

Identify the Contract With a Customer

Evaluating a contract with software and software-related elements and determining which revenue guidance applies can be complex. Although entities will now have a single, comprehensive model to apply to all contracts with customers, certain scope exceptions may still cause a good or service in a contract to be within the scope of other guidance (e.g., a lease of a tangible product to host software).

The criteria for what constitutes a contract under the proposed guidance may differ from the criteria for when persuasive evidence of an arrangement exists under ASC 985-605. The proposed criteria may affect the point at which an entity concludes that a contract exists, which could delay revenue recognition, change the timing of an onerous test, or impact disclosures (just to name a few).

Identify the Separate Performance Obligations in the Contract

Under the proposed guidance, an entity does not need VSOE of fair value to separate a contract with a bundle of goods or services into separate accounting units. The proposed separation guidance is less restrictive and will most likely increase the number of accounting units (and decrease the deferral of revenue when VSOE of fair value does not exist) because it will allow for increased flexibility in the separation of performance obligations. For example, when VSOE of fair value does not exist for an undelivered specific additional product or upgrade, entities currently may be required to defer revenue until VSOE can be established or until all elements in the arrangement have been delivered. Under the proposed guidance, however, if an entity determines that a specified additional product or upgrade meets the criteria to be accounted for as a separate performance obligation, the entity would allocate consideration to that obligation on the basis of its relative stand-alone selling price. In addition, there would most likely be fewer instances in which an entity would be required to defer revenue for a bundle of goods or services and recognize revenue ratably over the PCS period.

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1 As currently proposed, the effective date of the revised ED will not be before calendar years beginning on or after January 1, 2015, for public entities, with a minimum of a one-year deferral for nonpublic entities.
Determine the Transaction Price
Many of the rules in ASC 985-605 that affect whether a vendor can conclude that a fee is fixed or determinable would, under the proposed guidance, be reflected in the measurement of the contract’s transaction price rather than affecting the timing of recognition (see the Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation section below). For example, the impact of extended payment terms, which are currently considered when concluding whether to recognize revenue, may instead have an impact on the (1) transaction price when this price is determined to have a significant financing component (requiring a carve-out for the impact of the time value of money) or (2) measurement of potential collection uncertainty (i.e., bad-debt expense).

In a change to current practice, the financial statement presentation of historical bad-debt expense would now be separately presented in the statement of comprehensive income in its own line item immediately after revenue (as contra revenue).

Allocate the Transaction Price to Separate Performance Obligations in the Contract
As with identification of the separate performance obligations in a contract (see discussion above), VSOE of fair value is not required to separately account for a deliverable or to allocate the transaction price to the separate accounting units in the contract. In the absence of observable separate sales, the proposed guidance requires entities to use estimates to determine the stand-alone selling price of a performance obligation. Entities that currently find it challenging to meet the VSOE of fair value requirement will most likely have increased flexibility to use estimates to demonstrate stand-alone selling prices and will thus be less likely to defer revenue when VSOE of fair value does not exist. Further, in certain circumstances, the proposed guidance may allow entities to use a reverse residual allocation method in addition to the current residual allocation method in ASC 985-605.

Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation
The proposed guidance focuses on “control” when determining when to recognize revenue. Entities will need to evaluate each separate performance obligation in a contract and determine whether control is transferred to the customer at a point in time (e.g., a good) or whether it meets the criteria to be transferred over time (e.g., a service). Once control transfers to the customer, the transaction price allocated to the separate performance obligation may be recognized to the extent that such amount is reasonably assured (the revised ED provides specific indicators of when an amount is reasonably assured). Some of the provisions in ASC 985-605 that may currently preclude revenue recognition (e.g., those on reseller arrangements, customer cancellation privileges, fiscal funding clauses) may continue to preclude revenue recognition if these “reasonably assured” indicators are not present. However, the reasonably assured threshold in the proposed guidance may offer greater flexibility than the current rules in ASC 985-605.

Overview of ASC 985-605
This overview section discusses the main topics in ASC 985-605 under the following headings:

- Scope.
- Basic revenue recognition principles.
- Multiple-element arrangements.
- Additional software products, upgrade rights, and discounts.
- Postcontract customer support.
- Services.
- Contract accounting.

Scope
This section focuses on critical considerations in the evaluation of whether an arrangement is within the scope of ASC 985-605.
Software Considered to Be More Than Incidental

In determining whether the software and software-related elements of an arrangement are within the scope of ASC 985-605, a vendor must evaluate whether any software in the arrangement is considered more than incidental to the products or services. To make this determination, a vendor must understand the nature of the products or services being sold (including the terms and conditions of the sale). ASC 985-605-15-3 indicates that an entity must also consider whether (1) the “software is a significant focus of the marketing effort or is sold separately,” (2) the “vendor is providing postcontract customer support,” and (3) the “vendor incurs significant costs that are within the scope of [ASC] 985-20.”

In a speech at the 2004 AICPA National Conference on Current SEC and PCAOB Developments, G. Anthony Lopez, associate chief accountant in the SEC’s Office of the Chief Accountant, stated that an entity should consider the following additional factors when evaluating whether software is more than incidental to the products or services in an arrangement:

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

If an entity determines that the software is more than incidental to a tangible product, it would then need to determine whether the software components and nonsoftware components of the product function together to deliver the product’s essential functionality (discussed further in the next section). If the software is not essential to the functionality of the tangible product, the entity would apply the provisions of ASC 985-605 to all software or software-related elements in the arrangement. For more information about arrangements in which software is more than incidental to the hardware, see Q&A 1-06.

Example

Vendor Z, a manufacturer of high-end reclining chairs with multiple seating positions, recently developed a recliner featuring a built-in device containing software that memorizes seating positions and allows customers to remotely control many common electronic devices. This new software technology is Z’s marketing focus for this product. Vendor Z plans to provide a telephone support line to help customers operate the new recliners. In addition, Z plans to provide software upgrades to its customers and incurs significant costs that are within the scope of ASC 985-20.

Historically, Z’s arrangements have been accounted for in accordance with SAB Topic 13 and have not been within the scope of ASC 985-605. However, the PCS and upgrades Z is providing to customers and its focus on the new software technology in marketing efforts are indicators that the new software is more than incidental to the recliner. Therefore, Z should determine whether the software functions together with the recliner to deliver the product’s essential functionality. If Z determines that the software is not essential to the functionality of the recliner, Z should account for the software sale in accordance with ASC 985-605 and the recliner in accordance with other revenue recognition guidance. See the additional discussion on the concept of “essential functionality” in the next topic of this Overview.

If an entity determines that the software is more than incidental to a service, it would apply the provisions of ASC 985-605 to all software or software-related elements in the arrangement. The service would be within the scope of ASC 985-605 if the software in the arrangement is essential to the functionality of the service.

Software and Nonsoftware That Function Together to Deliver a Tangible Product’s Essential Functionality

Some vendors sell products that contain both nonsoftware and software components. Nonsoftware components are outside the scope of ASC 985-605. Some software elements may also be excluded from ASC 985-605’s scope. Software that is more than incidental to a tangible product is outside the scope of ASC 985-605 if that software functions together with the nonsoftware components to deliver that product’s essential functionality. In these circumstances, the scope of ASC 985-605 excludes both the nonsoftware components and the software. This scope exception also applies to leases of software that include a tangible product (such as property, plant, or equipment).

Software elements related to essential software are also excluded from ASC 985-605’s scope. While ASC 985-605 does not specifically define software and software-related elements, it lists “software products, upgrades or enhancements, postcontract customer support, or services” as examples of software deliverables.
ASC 985-605 provides five considerations and a number of examples to help entities determine whether software is essential to a tangible product’s functionality. The following table summarizes these considerations and matches them with the related examples.

<table>
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<th>Examples (ASC 985-605-55-211 through 55-236)</th>
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| a. Tangible product sold infrequently without software — “If sales of the tangible product without the software elements are infrequent, a rebuttable presumption exists that software elements are essential to the functionality of the tangible product.” | Case A — Computer with operating system included  
Case B — Computer with operating system excluded more than infrequently  
Case C — Computer and multiple operating systems  
Case D — Computer with additional software products included  
Case E — Personal digital assistant |
| b. Products with similar functionality — “A vendor may sell products that provide similar functionality, such as different models of similar products. If the only significant difference between similar products is that one product includes software that the other product does not, the products shall be considered the same product for the purpose of evaluating (a).” | Case K — Similar products |
| c. Separate sale of software — “A vendor may sell software on a standalone basis. The vendor may also sell a tangible product containing that same software. The separate sale of the software shall not cause a presumption that the software is not essential to the functionality of the tangible product.” | Case F — Computer with operating system sold separately  
Case H — Standalone sale of an operating system |
| d. Embedded software — “Software elements do not need to be embedded within the tangible product to be considered essential to the tangible product’s functionality.” | Case J — Networking equipment |
| e. Nonsolution elements and essential functionality — “The nonsolution elements of the tangible product must substantively contribute to the tangible product’s essential functionality. For example, the tangible product should not simply provide a mechanism to deliver the software to the customer.” | Case L — Change in business practice |

ASC 985-605 provides allocation guidance for arrangements that contain deliverables that are within the scope of ASC 985-605 (software deliverables) and deliverables that are outside its scope (nonsoftware deliverables). Software that is considered essential to the functionality of the tangible product is considered a nonsoftware deliverable.

**Example**

Vendor A provides telecommunications equipment to its customers. One of its newest products contains hardware and an operating system. The hardware and operating system function together to deliver the product’s essential functionality. Customers can also choose from a range of application software that can be added to the product. The application software enhances, but is not essential to, the functionality of the product. In this example, the operating system would be considered part of the nonsoftware deliverable and any application software would be considered a separate software deliverable.

In an arrangement that contains both software deliverables and nonsoftware deliverables, an entity should separate deliverables and allocate arrangement consideration to those deliverables in the following manner:

- Separate and allocate total arrangement consideration to software deliverables and nonsoftware deliverables in accordance with the multiple-element revenue recognition guidance in ASC 605-25.
- **Nonsoftware deliverables** — The arrangement consideration allocated to the nonsoftware deliverables as a group is further subject to the separation and allocation guidance in ASC 605-25.
- **Software deliverables** — The arrangement consideration allocated to the software deliverables as a group is further subject to separation and allocation under ASC 985-605.
- If an undelivered element (such as PCS) relates to both the software deliverables and the nonsoftware deliverables, it is bifurcated into a software deliverable (within the scope of ASC 985-605) and a nonsoftware deliverable (outside the scope of ASC 985-605).
Arrangements Including Leased Software and Hardware

Arrangements involving a lease of software and hardware (e.g., property, plant, or equipment), revenue attributable to the hardware should be accounted for in accordance with ASC 840 while revenue attributable to the software, including PCS, should be accounted for in accordance with ASC 985-605 (provided that the software is more than incidental to the arrangement but not essential to the functionality of the combined product). If the software functions together with the hardware to deliver its essential functionality, then the hardware, software, and software-related elements are outside the scope of ASC 985-605 and subject to other accounting guidance (e.g., ASC 840, ASC 605-25, or SAB Topic 13).

Hosting Arrangements

Hosting arrangements are arrangements in which the vendor (or a third party) “hosts” the software application. The end user does not take possession of the software but has a right to use it. Typically, the end user has access to the software application on an as-needed basis through an Internet connection that the vendor provides to its hardware. Under ASC 985-605-55-119 through 55-125, a software element in a hosting arrangement is only within the scope of ASC 985-605 if “(a) [t]he customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty [and] (b) [i]t 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.” If the arrangement does not meet these two criteria, it would be accounted for as a service contract and would be outside the scope of ASC 985-605. For more information about hosting arrangements, see Q&A 1-12, Q&A 1-13, Q&A 1-14, Q&A 1-15, and Q&A 1-16.

Software Requiring Significant Production, Modification, or Customization

ASC 985-605-15-3(e) discusses an arrangement “to deliver software or a software system, either alone or together with other products or services,” in which “significant production, modification, or customization of software” is required. Such an arrangement should be accounted for under ASC 605-35 because the software cannot be accounted for separately from the production, modification, or customization services. Q&A 2-110 gives an example of the process for determining the applicability of ASC 605-35 to a particular arrangement.

Basic Revenue Recognition Principles

ASC 985-605 stipulates that the following four criteria must be met before revenue can be recognized in software arrangements (provided that significant production, modification, or customization of software is not required):

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

While these criteria may be consistent with those in other revenue recognition literature (e.g., SAB Topic 13), an entity may apply them to software arrangements under ASC 985-605 differently than it would to arrangements under other literature. See Q&A 1-03 and Q&A 1-04 for comparisons between ASC 985-605 and SAB Topic 13.

Persuasive Evidence of an Arrangement Exists

Revenue should not be recognized for a transaction unless persuasive evidence of an arrangement exists. In this context, the term “arrangement” means the final understanding between the parties regarding the specific nature and terms of the agreed-upon transaction. 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, 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. Further, vendors 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 affect how revenue is recognized under the arrangement.

Some vendors use master agreements that establish the basic terms and conditions for all transactions with a customer. Many of these agreements require supplementary documentation for specific goods or services. If so, the provisions of both the master agreement and the supplementary documentation must be executed for persuasive evidence of an arrangement to exist.
A vendor may also enter into “side agreements” with customers (as a result of the intense competition in the software market, among other reasons). Side agreements often amend the provisions of the master or other agreements with the customer, which, in turn, may affect the manner in which revenue is recognized. In addition, in side agreements, questions are often raised regarding (1) what constitutes persuasive evidence of an arrangement and (2) when, in fact, an arrangement has been consummated.

When a written contract or agreement between both parties is not obtained, an entity must thoroughly understand the vendor’s history, customary business practices, and the customer’s practices. For more information about persuasive evidence of an arrangement, see Q&A 2-26, Q&A 2-27, Q&A 2-28, and Q&A 2-29.

**Delivery Has Occurred**

Delivery must have occurred before revenue can be recognized. Generally, delivery has occurred when the customer takes title and assumes the risks and rewards of ownership of the products specified in the arrangement. Upon delivery of a product, the customer usually either pays the vendor or becomes obligated to pay. In the software industry, delivery generally entails physical shipment of the product to the customer’s location or electronic delivery of the product. Delivery of services generally occurs as the services are performed (the revenue recognition criteria for services are discussed in the *Services* section). Other factors that are unique to software arrangements may also affect whether delivery has occurred (e.g., unique customer acceptance provisions).

While a product may be physically delivered via a disk or other storage device, vendors often deliver software to customers electronically either by allowing the customer to download the software online or by providing authorization codes for software that is already available to the customer. (ASC 985-605-25-27 through 25-29 provide guidance on using authorization codes or keys that allow access to software that otherwise would be restricted.) In such situations, the delivery criterion is satisfied when the customer has immediate access to the software. However, regardless of whether delivery is physical or electronic, revenue recognition would not be appropriate if the customer is not obligated to pay until it accepts the product (e.g., through online trials or direct market mailings).

It is also important to determine whether the vendor is delivering multiple copies of the software or multiple licenses of the same software. ASC 985-605-25-23 states that when a vendor delivers multiple copies of the same software, “duplication is incidental to the arrangement and the delivery criterion is met upon the delivery of the first copy or product master.” Therefore, in arrangements in which the fee does not vary on the basis of the number of copies of the software provided, delivery is considered to have occurred upon transfer of a product master (or the first copy if a master is not provided). In contrast, when multiple licenses of the same software are sold to a customer, the licensing fee is a function of the number of copies delivered to the customer. Therefore, in these situations, ASC 985-605-25-24 states that “[d]elivery occurs and revenue shall be recognized as the copies are made by the user or sold by the reseller if the other criteria in this Subtopic for revenue recognition are met.”

**Example**

Vendor A enters into an agreement to license its software product to Customer B for a nonrefundable fee of $500,000. The agreement requires A to provide B with a fully functional master copy of the software and to provide (or allow B to reproduce) an additional 100 copies of the software. Vendor A has no further obligations after delivery of the master copy. Because the arrangement meets the criteria in ASC 985-605-25-23, A can recognize the $500,000 fee upon delivery of the master copy of the software (and before duplication of the additional 100 copies of the software), provided that all other criteria for revenue recognition are met.

Software arrangements often include specific customer acceptance provisions. ASC 985-605 indicates that if the customer’s acceptance of the software is uncertain, revenue should not be recognized until acceptance occurs. Further, if payment for the software is tied to customer acceptance, the acceptance provision would be presumed substantive. That is, revenue recognition would be precluded until payment is made or due, unless that presumption is overcome and all other requirements for revenue recognition have been met. (See Q&A 2-37 for an example illustrating customer acceptance provisions.) In arrangements in which the customer has a limited time to accept the software, acceptance is considered to have occurred when the time limit is exceeded.

**Fixed or Determinable Fees**

Under ASC 985-605, an arrangement fee must be fixed or determinable before revenue can be recognized. If a vendor cannot conclude that the fee is fixed or determinable at the outset of an arrangement, revenue would be recognized as payments from the customer become due (provided that all other requirements for revenue recognition are met). Revenue recognition as payments become due is not the same as the cash basis of...
accounting (in which revenue is recognized only when cash is collected from the customer). Under this revenue recognition method, the fee is assumed to be fixed at the time the customer is obligated to pay (the due date) and the timing of the actual cash collection is irrelevant. However, if the due date is not deemed substantive, then the cash-basis method may be appropriate.

Factors that can affect the determination of whether an arrangement fee is fixed or determinable include the following:

- Extended payment terms.
- Modifications to a software license.
- Price-protection clauses.
- Customer cancellation privileges.
- Forfeiture or refund clauses.
- Indemnification clauses.
- Fiscal funding clauses.
- Reseller arrangement terms.

**Extended Payment Terms**

In arrangements with extended payment terms, the vendor may be more likely to provide refunds or other types of concessions to the customer, or the customer may be more likely to renegotiate payment terms (e.g., because the product’s value has diminished as a result of technological obsolescence). In such arrangements, it may therefore be less likely that the vendor will collect the full payment stipulated in the payment terms. Thus, the arrangement fee may not be fixed or determinable. ASC 985-605-25-34 specifies that an arrangement fee is presumed not to be fixed or determinable “if payment of a significant portion of the software licensing fee is not due until after expiration of the license or more than 12 months after delivery.” 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.” Factors to consider in evaluating whether a portion of a license fee is significant include:

- The percentage 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 significantly invested in the arrangement (with the vendor or otherwise).
- Other relevant information used in developing the fee arrangement.

For further discussion of extended payment terms, see Q&A 2-49, Q&A 2-50, Q&A 2-51, and Q&A 2-52.

**Modifications to a Software License**

Other than requiring the vendor to consider the implications of concessions, ASC 985-605 does not specifically discuss modifications to software arrangements. If a modification to a software arrangement is considered a concession, the vendor may need to evaluate whether the original fee was fixed or determinable and consider the impact on the accounting for future arrangements. Generally, previously recognized revenue is not affected and the vendor should determine the impact of a modification prospectively on the basis of the facts and circumstances of the modification. See the example in Q&A 2-44.

**Price-Protection Clauses**

Often, the obsolescence of software products is rapid and vendors are forced, for legitimate business reasons, to significantly reduce prices on their products. Therefore, customers (often resellers) sometimes negotiate price-protection clauses, which 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 customer. Such clauses protect a customer from potentially “overpaying” for a product.
If a vendor offers a customer 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 would not be deemed 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.

**Customer Cancellation Privileges**

ASC 985-605-25-37 states that arrangements that are “cancelable by customers are neither fixed nor determinable until the cancellation privileges lapse.” For example, a fee would not be fixed or determinable if a customer was able to cancel an arrangement pending approval by its board of directors. However, short-term rights of return, such as 30-day money-back guarantees, should not be considered cancellation privileges; the related returns should be accounted for under ASC 605-15.

**Forfeiture or Refund Clauses**

If an arrangement contains a forfeiture or refund clause, the arrangement fee may not be collectible under the original arrangement terms and, therefore, the fee may not be fixed or determinable. ASC 985-605-25-13 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.

ASC 985-605 cautions that a vendor’s historical patterns of offering refunds, forfeitures, or other concessions may be more persuasive evidence of whether the fee is subject to such a concession than actual terms containing these clauses. If, on the basis of such evidence, a portion of the fee is determined to be refundable, that portion should not be recognized. Further, the refundable portion of the arrangement fee may be greater than the VSOE of fair value of the undelivered element. In these situations, the vendor would still be required to defer the entire refundable portion of the arrangement fee. Q&A 2-24 contains an example of the accounting for a forfeiture or refund clause.

**Indemnification Clauses**

A standard software license agreement may include a clause that indemnifies the user for liabilities and damages arising from any claims of patent, copyright, trademark, or trade secret infringement associated with the vendor’s software. Like standard warranties, such indemnification clauses are an inherent component of the software license (i.e., are not separable elements in the arrangement). Therefore, while it may seem that a vendor would be required to defer revenue recognition under ASC 985-605-25-13 when a fee is refundable in connection with such an indemnification clause, the indemnification clause would not be considered an undelivered element in a software arrangement and therefore would not affect whether the fee is fixed or determinable or whether revenue can be recognized. Note that while an indemnification clause may not affect revenue recognition, it may have other accounting implications (e.g., the clause may need to be accounted for as a financial guarantee under ASC 460).

**Fiscal Funding Clauses**

Arrangements may contain clauses that allow the licensee to cancel the agreement if the funding party does not provide sufficient funds for the licensee to fulfill its payment obligations. Such “fiscal funding clauses” commonly involve governmental-unit lessees. ASC 985-605-25-39 and 25-40 state, in part:

> Consistent with paragraph 840-10-25-3, a software licensing arrangement with a governmental unit containing a fiscal funding clause shall be evaluated to determine whether the uncertainty of a possible license arrangement cancellation is a remote contingency. The evaluation of whether the level of uncertainty of possible cancellation is remote shall be consistent with Topic 450, which defines remote as relating to conditions in which the chance of the future event or events occurring is slight.

If the likelihood is assessed as remote, the software licensing arrangement shall be considered noncancelable. If the likelihood is assessed as other than remote, the license shall be considered cancelable, thus precluding revenue recognition. A fiscal funding clause with a customer other than a governmental unit that is required to include such a clause creates a contingency that precludes revenue recognition until the requirements of the clause and all other provisions of this Subtopic have been satisfied.
That is, under a fiscal funding clause, even if the vendor determines that the likelihood that the customer will cancel the license arrangement is remote, the arrangement fee would not be fixed or determinable and the vendor could not recognize revenue (unless the customer is a governmental unit). Q&A 2-63 gives an example of an arrangement that contains a fiscal funding clause.

**Reseller Arrangement Terms**

ASC 985-605-25-36 indicates that an entity should consider the following factors (not individually determinative) when evaluating whether the fee is fixed or determinable in a reseller arrangement (this list is not all-inclusive):

a. Business practices, the reseller’s operating history, competitive pressures, informal communications, or other factors indicate that payment is substantially contingent on the reseller’s success in distributing individual units of the product. Contractual arrangements under which the reseller is obligated to pay only as and if sales are made to users shall be accounted for as consignments.

b. Resellers are new, undercapitalized, or in financial difficulty and may not demonstrate an ability to honor a commitment to make fixed or determinable payments until they collect cash from their customers.

c. Uncertainties about the potential number of copies to be sold by the reseller may indicate that the amount of future returns cannot be reasonably estimated on delivery. Examples of such factors include the newness of the product or marketing channel, competitive products, or dependence on the market potential of another product offered (or anticipated to be offered) by the reseller.

d. Distribution arrangements with resellers require the vendor to rebate or credit a portion of the original fee if the vendor subsequently reduces its price for a product and the reseller still has rights with respect to that product (sometimes referred to as price protection). If a vendor is unable to reasonably estimate future price changes in light of competitive conditions, or if significant uncertainties exist about the vendor’s ability to maintain its price, the arrangement fee is not fixed or determinable. In such circumstances, revenue from the arrangement shall be deferred until the vendor is able to reasonably estimate the effects of future price changes and the other conditions in this Subtopic have been satisfied.

If any of the above factors applies to the reseller arrangement, the vendor may be forced to recognize revenue as sales are made by resellers (i.e., on a sell-through basis). Q&A 2-59, Q&A 2-60, and Q&A 2-61 give examples of reseller arrangements containing the factors discussed above.

**Collectibility**

Under ASC 985-605, the evaluation of collectibility focuses both on whether the customer has the intent and ability to pay (i.e., creditworthiness) and on whether the fee is deemed fixed or determinable. For example, consider an arrangement with extended payment terms, rapid software obsolescence, and the de minimis incremental cost of delivering additional software. In such an arrangement, the fee or the deliverables may be renegotiated, potentially resulting in nonpayment of all or part of the fee by the customer. The customer may be willing and able to pay, but the fee may not be fixed or determinable.

**Multiple-Element Arrangements**

Software arrangements commonly comprise multiple elements or deliverables (i.e., software and any combination of PCS, specified or unspecified future software products or upgrades, additional licenses, or services). A vendor should perform the following steps to separate a multiple-element arrangement:

- Determine the arrangement.
- Separate the arrangement into units of accounting.
- Allocate the arrangement’s consideration to the separate units of accounting.

**Determining the Arrangement**

Multiple-element arrangements can consist of either a single contract with multiple deliverables or a group of separate contracts with the same customer. A vendor that executes more than one contract with a single customer must determine whether one or more of these contracts essentially represent a single arrangement. ASC 985-605-55-4 provides the following guidance on making this determination:

[A] group of contracts or agreements may be so closely related that they are, in effect, parts of a single arrangement and should be viewed as one multiple-element arrangement when determining the appropriate amount of revenue to be recognized in accordance with this Subtopic. The form of an arrangement is not
necessarily the only indicator of the substance of an arrangement. The existence of any of the following factors (which are not all-inclusive) may indicate that a group of contracts should be accounted for as a single multiple-element arrangement:

a. The contracts or agreements are negotiated or executed within a short timeframe of each other.

b. The different elements are closely interrelated or interdependent in terms of design, technology, or function.

c. The fee for one or more contracts or agreements is subject to refund, forfeiture, or other concession if another contract is not completed satisfactorily.

d. One or more elements in one contract or agreement are essential to the functionality of an element in another contract or agreement.

e. Payment terms under one contract or agreement coincide with performance criteria of another contract or agreement.

f. The negotiations are conducted jointly with two or more parties (for example, from different divisions of the same entity) to do what in essence is a single project.

**Separating the Arrangement**

To separate a software arrangement that includes multiple elements, a vendor must establish VSOE of fair value. ASC 985-605-25-6 limits VSOE of fair value to:

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

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

The requirement for a separate sale to validate fair value is more restrictive than that of any existing literature that applies to multiple-element arrangements. It has been particularly onerous to vendors in arrangements with elements that are never (and that never will be) sold separately.

Whether VSOE of fair value can be established for an element may dramatically affect how revenue is recognized in a multiple-element arrangement. Furthermore, software vendors often offer customers discounts from the list price of a product. The list price should only be used as evidence of VSOE of fair value if actual separate sales are at list price.

**Element Sold Separately**

To establish VSOE of fair value, a vendor should use historical pricing information to determine the price charged when the element is sold separately. However, if such prices vary by customer, a vendor needs to demonstrate that the historical prices are sufficiently concentrated around a specific point and within a narrow enough range to allow for reasonable estimation of fair value. For example, if 90 percent of a vendor’s separate sales of PCS during the past 12 months are priced between 15 percent and 17 percent of the license fee in the arrangement, it may be appropriate to conclude that the separate sales prices constitute VSOE of fair value.

In evaluating whether separate sales prices are sufficiently concentrated to establish VSOE of fair value, 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 bigger discounts to higher-volume customers than it does to lower-volume customers. In these situations, the dispersion of separate sales prices for transactions with customers grouped by volume may be much less than the dispersion for the entire population. This would allow for the establishment of a separate VSOE of fair value for each class of customer.

Factors that may affect pricing, and that a vendor should therefore consider in determining whether the population of separate sales should be stratified, include:

- Customer type.
- Distribution channel.
- Transaction size or volume (i.e., license fee, number of users).
- Geographic location.
- Products sold.

The size of the discount granted to a customer would not be a sufficient basis for stratifying the population.
If separate sales prices are sufficiently concentrated for a vendor to establish VSOE of fair value, a reasonable method of establishing fair value is to use the weighted average of the more recent prices charged for actual transactions when there is some variability in the prices charged. In addition, the vendor should carefully evaluate whether infrequent separate sales of an item constitute sufficient VSOE of the current fair value of the element. Specifically, the vendor would need to evaluate the timing of the most recent sales in assessing the relevance of those sales to determining the current fair value of an undelivered item. 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 the current fair value of the element.

**Element Not Yet Sold Separately**

The establishment of VSOE of fair value applies both to existing products that have not been sold separately in the past and to products currently under development. For a price of an element not yet sold separately to qualify as VSOE of fair value, it should be probable (i.e., “likely to occur”) that the element will actually be sold separately for the price established by management. 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 establishment of the price and the expected sale of the product in a separate transaction and (2) whether the vendor has announced the intended price to its customers. The longer the time between the establishment of the price and the expected sale of the product in a stand-alone transaction, the higher the likelihood that the price may be different from the price established by management (and, therefore, the higher the likelihood that the established price may not qualify as VSOE of fair value).

**Example**

Vendor A sells a software license that includes installation services. Vendor A’s management has determined that if the company were to sell the installation services separately, the price charged would be $500. However, A has never sold installation services separately and does not intend to do so in the future. As a result, the $500 would not constitute VSOE of fair value for the installation services.

Certain vendors may have a history of selling two or more elements together. While ASC 985-605 only discusses VSOE of fair value in the context of each individual element in a multiple-element arrangement, a vendor also may consider a group of elements a single element when establishing VSOE of fair value. This concept is consistent with ASC 605-25’s indication that a unit of accounting may consist of more than one deliverable. Q&A 2-09 gives an example of the accounting for multiple elements as a single element.

**Allocating Consideration**

The allocation of consideration to elements in a software multiple-element arrangement and the subsequent recognition of the consideration depend on whether VSOE of fair value has been established.

**Vendor-Specific Objective Evidence of Fair Value Established**

If VSOE of fair value is established, the portion of the fee allocated to an element (on the basis of VSOE of fair value) should be recognized as revenue when the recognition criteria are met for the element (unless an undelivered element in an arrangement is considered essential to the functionality of a delivered element).

However, even when VSOE of fair value is established, allocation of the fee may be affected by a vendor’s decision to offer a discount in an arrangement. A discount should be proportionately allocated to the elements of an arrangement on the basis of VSOE of fair value except when (1) the arrangement includes a specified upgrade right (discussed in the Additional Software Products, Upgrade Rights, and Discounts section) or (2) the residual method is applied to the arrangement. Under the residual method, the arrangement fee is recognized as follows: (1) the total fair value of the undelivered elements, as indicated by VSOE, is deferred, and (2) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements, effectively resulting in allocation of the entire discount to the delivered elements.

**Vendor-Specific Objective Evidence of Fair Value Not Established**

If VSOE of fair value is not established, all revenue from the arrangement must be deferred until the earlier of (1) the establishment of VSOE of fair value or (2) the delivery of all elements in the arrangement. ASC 985-605-25-10 lists the following exceptions to this requirement:

a. If the only undelivered element is postcontract customer support, the entire fee shall be recognized ratably (see paragraphs 985-605-25-66 through 25-75).
b. If the only undelivered element is services that do not involve significant production, modification, or customization of software (for example, training or installation), the entire fee shall be recognized over the period during which the services are expected to be performed (see paragraphs 985-605-25-76 through 25-85).

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

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

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

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

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

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

Additional Software Products, Upgrade Rights, and Discounts

Multiple-element arrangements may include future deliverables in the form of specified or unspecified additional products or enhancements of current products. The evaluation of these future deliverables is important since it will affect the recognition of the arrangement’s consideration. The following is a summary of the accounting for each class of future deliverables:

Specified additional product — Rights to specified additional products, even if offered on a when-and-if-available basis, are considered separate elements to which a portion of the arrangement fee must be allocated (on the basis of VSOE of fair value). Therefore, in such an arrangement, revenue must be deferred unless or until VSOE of fair value is established or all elements in the arrangement have been delivered. (If a specified product is offered on a when-and-if-available basis, revenue must be deferred until the customer’s right to those products lapses.) Unlike the fee allocated to a specified upgrade right (see below), the fee allocated to a specified additional product may not be reduced to reflect the percentage of customers not expected to receive the product.

Unspecified additional product — Rights to unspecified additional products are considered to be a subscription and therefore are treated as a single element. Therefore, revenue allocation to one particular product within the subscription is prohibited. Rather, all software-related revenues should be recognized ratably over the term of the arrangement, beginning with delivery of the first product.

Specified upgrade right — Rights to specified upgrades or enhancements, including those offered on a when-and-if-available basis, are considered separate elements to which a portion of the arrangement fee must be allocated (on the basis of VSOE of fair value, unless a discount is offered in the arrangement). Therefore, in such an arrangement, revenue must be deferred unless or until VSOE of fair value is established or all elements in the arrangement have been delivered. (If a specified upgrade right is offered on a when-and-if-available basis, a vendor may be required to defer all revenue until the customer’s right to receive the upgrade lapses.) The fee allocated to a specified upgrade right may be reduced to reflect the percentage of customers not expected to exercise it.

ASC 985-605-25-45 indicates that no portion of a discount offered in an arrangement can be allocated to a specified upgrade right. AsSec precluded allocation of discounts to specified upgrade rights. even when VSOE of fair value for all elements exists, because 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.
Overview

Software Revenue Recognition: A Roadmap to Applying ASC 985-605

Example

Vendor XYZ sells Version 1 of Product A to a customer along with a right to upgrade to Version 2 for $80. The vendor has established VSOE of fair value for Version 1 of Product A at $80 and for an upgrade right to Version 2 of Product A at $20. Under a relative fair value allocation method, the vendor would allocate $64 to Version 1 and $16 to the upgrade right. However, ASC 985-605 precludes the allocation of any portion of a discount to a specified upgrade right. Therefore, Vendor XYZ must allocate $20 to the specified upgrade right (i.e., Version 2), thereby limiting the amount that can be allocated to Version 1 of Product A to $60.

Unspecified upgrade right — Rights to unspecified upgrades or to enhancements on a when-and-if-available basis are considered to be PCS to which a portion of the arrangement fee should be allocated (provided that VSOE of fair value is established). However, if VSOE of fair value is not established, the entire fee should be recognized ratably over the PCS term.

Despite the differences in accounting for the above future deliverables, ASC 985-605 does not provide guidance on distinguishing between an upgrade right and an additional product. The following factors may help a vendor make the distinction:

- Differences between the features of the new deliverable and 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 associated with the new deliverable — A more significant development effort may be an indicator of a new product, not an upgrade.
- 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 — There may be marketing materials promoting a new product.
- Product name of the new deliverable — Upgrades often have the same name as the existing deliverables.
- Functionality of the new deliverable — An upgrade frequently supersedes or replaces the previously delivered product, whereas a new product often does not.

Although ASC 985-605 does not define “specified,” an upgrade right 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 the product has been extinguished. The description can range from a detailed description of the upgrade’s or product’s features and functionality to a mere statement of its name or version number. The following examples illustrate this concept:

Examples

Specified Upgrade

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 X’s features, functionality, name, or version number will be, both parties will know, once X’s major release has been delivered, that the vendor’s obligation has been extinguished. Therefore, the right to receive the next major release of X should be considered a specified upgrade.

Specified Additional Product

Customer C purchases a perpetual license to Product A from Vendor V, along with a one-year bundled PCS agreement. In addition, V agrees to deliver Product B, on a when-and-if-available basis, to C. In this scenario, B is a specified product and would be accounted for as a separate element.

However, if V agrees to deliver all new products that will be introduced into a family or suite of products over time, C has in effect received the right to unspecified additional products. In this case, all software-related revenue should be accounted for as a subscription over the term of the arrangement (or, if the term is unknown, over the economic life of the products in the arrangement), beginning with delivery of the first product.

Sometimes, an upgrade or enhancement right may be implied. For example, sales personnel or marketing materials may lead customers to expect that certain functionality or features will be available as part of PCS in future versions of the product. Such an implied right would be considered a specified upgrade right and would be accounted for accordingly. Q&A 2-65 gives an example of a specified upgrade implied in an arrangement.
Discounts
As an incentive to enter into an arrangement or for other reasons, a vendor may offer a customer a right to a pricing discount on a future purchase of a product or service. If this discount is more than insignificant, the right to it is considered an additional element in the arrangement. Therefore, the vendor would be required to allocate the amount of the discount to the discount element on the basis of VSOE of fair value of the product or services to which the discount applies. A vendor that has not established this VSOE of fair value may be required to defer all revenues until (1) the VSOE of fair value exists, (2) the customer uses the discount, or (3) the customer’s right to the discount lapses.

Although ASC 985-605 does not define “more than insignificant,” ASC 985-605-15-3(d) states, in part:

More-than-insignificant discounts have all of the following characteristics:
1. Incremental to the range of discounts reflected in the pricing of the other elements of the arrangement
2. Incremental to the range of discounts typically given in comparable transactions

ASC 985-605-15-4 further states that insignificant “[d]iscounts 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 within the scope of ASC 985-605.

Example

Company A enters into an arrangement to provide 1,000 copies of Software Product X to Customer 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 up to 1,000 copies of Software Product Z for $15 per copy (the maximum copies allowed to be purchased at the discounted price). Company A normally sells copies of Z for $30 per copy. Customer B has the right to purchase up to 1,000 copies of Z.

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. (A should assume that the maximum discount will be used.) VSOE of fair value for the total arrangement would be $50,000. The total paid by B is $35,000, so the discount on Z is 50 percent and the overall discount on the arrangement is 30 percent. Therefore, A could recognize $14,000 ($20,000 fixed fee less the 30 percent discount) upon delivery of the first copy of X, provided that all other criteria for revenue recognition are met. Company A could also recognize revenue on Z ($21,000 for 1,000 copies) upon delivery of the first copy of this software product, provided that all other criteria for revenue recognition are met.

Fixed-Fee Arrangements Based on a Price per Copy

Some arrangements give customers the right to reproduce or obtain copies of two or more software products at a specified price per copy up to the total fixed fee. Because a number of the products in the arrangement may not be deliverable or specified at the inception of the arrangement, an allocation of the fee to the products often is not possible.

Such arrangements generally can be divided into those that specify the maximum number of copies allowed and those that do not. Revenue for the two arrangement types should be recognized as follows.

Arrangement specifies maximum number of copies allowed — When the arrangement fee is allocated between delivered and undelivered products in an arrangement that specifies a maximum number of copies, it is assumed that the customer will elect to receive the maximum number of copies of the undelivered product. Therefore, a portion of the arrangement fee should be allocated to the undelivered products on the basis of this assumption.

If duplication of both the delivered and undelivered software products is incidental to the arrangement, the amounts allocated to each product should be recognized as revenue when the product master or first copy of each product is delivered. If, however, the customer reproduces or receives more copies than the amount allocated to the delivered product, such additional revenue should be recognized as copies are reproduced or delivered.
## Example

Vendor A enters into an arrangement with Customer B in which B has the right to make copies of Product X at $500 per copy or copies of Product Z at $200 per copy, up to a combined total of $500,000. Customer B is obligated to pay the $500,000 regardless of whether it makes all the copies it is entitled to. A master copy of X is currently available and has been delivered. Product Z is not available yet, and no master copy has been delivered. The maximum number of copies of Z that can be made is 1,000.

Vendor A should allocate $200,000 (maximum of 1,000 copies × $200 per copy) of the arrangement fee to Z. This amount would be recognized when the master copy of Z is delivered to B. The remaining $300,000 of revenue should be recognized when the master copy of X is delivered to B. If B makes enough copies of X so that the revenue allocable to it exceeds $300,000, the additional revenue should be recognized as the additional copies are made.

Arrangement does not specify a maximum number of copies allowed — In fixed-fee arrangements that do not specify a maximum number of copies allowed, allocation of the arrangement fee to the products is not possible because it depends on the number of copies ultimately made of each product. Revenue is recognized as copies are delivered. However, all unrecognized revenue in the arrangement is recognized when the vendor is not obligated to deliver additional products and either (1) delivery of all products is complete or (2) total revenue resulting from the copies produced equals the arrangement’s fixed fee.

## Example

Vendor A enters into an arrangement with Customer B in which B has the right to make copies of Product X at $500 per copy or copies of Product Z at $200 per copy, up to a combined total of $500,000. Customer B is obligated to pay the $500,000 regardless of whether it makes all the copies it is entitled to. A master copy of X is currently available and has been delivered. Product Z is not available yet, and no master copy has been delivered. The arrangement does not specify a maximum number of copies of Z that can be made by B.

Because the amount of the arrangement fee allocable to Z depends on the number of copies B ultimately makes, A cannot allocate any of the arrangement consideration to Z. Therefore, revenue of $500 per copy can only be recognized as copies of X are made until the master copy of Z is delivered to B. Once the master copy of Z is delivered, all remaining revenue from the arrangement may be recognized.

## Rights to Exchange or Return Software Products

Software arrangements may include a right to return the software or exchange it for other software. Depending on the terms of the arrangement, such rights may be considered an exchange, a return, or an additional product. The following is a summary of these classifications and how they should be accounted for under the ASC 985-605.

**Right of exchange** — A customer’s right to exchange a software product for another software product that has no more-than-minimal differences in price, functionality, or features. (See Q&A 2-80 for factors to consider in determining whether there are more-than-minimal differences between products.) For the transaction to be accounted for as an exchange, the customer should not have the right to continue using the original product. However, in such a transaction, the customer is not required to physically return the original product.

In accounting for a right of exchange, a vendor does not reduce revenue for expected customer exchanges; however, the estimated costs of executing such exchanges should be accrued in accordance with ASC 450. Also, the accounting for these rights assumes the customer is the end user of the product and not a reseller. ASC 985-605 does not permit an exchange right granted to a reseller to be accounted for as an exchange. Rather, it is accounted for as a right of return because a reseller is not the ultimate customer.

**Right of return** — A customer’s right to return a software product for a refund (or to exchange a software product for another product that has more-than-minimal differences in price, functionality, or features). A right of return, like a right of exchange, does not require the customer to physically return the original product.

In accounting for a right of return, a vendor must be able to reasonably estimate expected product returns when recognizing revenue. In a manner consistent with ASC 605-15, revenue recognized should be reduced to reflect the estimated returns and the estimated costs of executing such returns should be accrued in accordance with ASC 450. If the vendor is unable to reasonably estimate returns, revenue must be deferred until a reasonable estimate can be made or the right of return has lapsed. For additional information about the accounting for a return, see Q&A 2-77.
Right to additional product — If the terms of the arrangement allow the customer to continue to use the previously delivered software product upon a return or exchange, the right should not be considered a right of return or right of exchange; rather, it should be considered an additional software product and accounted for accordingly (i.e., it should be considered an additional element in the arrangement that is subject to the allocation requirements in ASC 985-605-25-6 and 25-7).

Platform-Transfer Rights

Platform-transfer rights are rights offered by a vendor to a customer to transfer software from one hardware platform or operating system to another. Depending on the terms of the arrangement, such rights should be classified and accounted for as a return, an exchange, or an additional software product.

If the terms of the arrangement allow the customer to continue to use the previously delivered software product in addition to the software related to the new platform, the platform-transfer right should be considered an additional software product and should be accounted for accordingly (i.e., it should be considered an additional element in the arrangement that is subject to the allocation requirements in ASC 985-605-25-6 and 25-7).

In accordance with ASC 985-605-25-63(c), the platform-transfer right should be considered an exchange if it

1. It is for the same product.
2. It does not increase the number of copies or concurrent users of the software product available under the license arrangement.

ASC 985-605-25-64 further clarifies that products are considered to be “the same” if “there are no more than minimal differences among them in price, features, and functions and if they are marketed as the same product.”

The accounting for platform-transfer rights, like the right to exchange or return software products, assumes that the customer is the end user of the product and not a reseller. ASC 985-605 does not permit a platform-transfer right for a product that is sold to a reseller to be accounted for as an exchange. Rather, it is accounted for as a right of return because a reseller is not the ultimate customer. Further, under ASC 985-605, if a vendor agrees to provide unspecified platform-transfer rights to a reseller, the arrangement must be accounted for as a subscription.

Example

Vendor B licenses software to end user Customer 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.

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.

Postcontract Customer Support

PCS can be defined as an explicit or implicit right to receive certain services, unspecified product upgrades/enhancements, or a combination of both, after the software product has been delivered or the license period has begun. PCS typically includes post-sale services, such as telephone support and correction of errors (bug fixing or debugging not under warranty obligations), and unspecified future upgrades or enhancements to be delivered on a when-and-if-available basis.

PCS rights can be sold separately or as part of the overall arrangement. In addition, these rights do not have to be contractually stated but can be implied as part of a vendor’s standard business practices. That is, if a vendor has a history of providing free services or unspecified upgrades/enhancements, customers may expect that these services or upgrades/enhancements will continue, regardless of whether they are specifically included in the terms of the arrangement. The vendor may continue to be under an implicit PCS obligation until it clearly communicates to customers that it no longer intends to provide the free services or upgrades/enhancements and demonstrates the ability and intent to adhere to its new policy.
Example

Vendor B sells personal financial planning software for home computers and gives customers access to its Web site. Immediately after releasing it, 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. In this example, the history of posting free upgrades to the Web site would constitute an implied PCS element.

Warranty-Related Services

Services that include access to unspecified upgrades/enhancements or other services typically associated with PCS should be considered a PCS element. However, warranties that protect customers from defective software are not considered PCS and should be accounted for in accordance with ASC 450. Further, ASC 985-605-55-78 indicates that correction of errors, such as bug fixes (a common PCS element), should not be considered a PCS element if the “software vendor provides bug fixes (under warranty obligations) without charge that are necessary to maintain compliance with published specifications.”

Example

Vendor A sells network management software that includes firewall security. Recently, A 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 flaw (A has a history of providing free patches to customers when necessary). In this instance, the history of supplying patches for programming flaws does not constitute an implied PCS element since the purpose is to repair a flaw that existed when the software was originally licensed and that could damage customers' software. Such patches should be considered warranty fixes and should be accounted for under ASC 450.

Revenue Recognition for PCS

Revenue recognition for PCS is generally the same (i.e., ratably over the PCS period), regardless of whether the PCS is sold separately or as part of an overall arrangement. However, if the historical evidence suggests that costs to provide PCS are incurred on other than a straight-line basis and it is probable that the costs incurred under the arrangement will follow a similar pattern, revenue should be recognized in proportion to the amounts expected to be charged for the PCS services.

Because PCS is generally not considered essential to the functionality of other deliverables in an arrangement, it is usually viewed as a separate element. As with other software elements, a portion of the arrangement fee must be allocated to PCS on the basis of VSOE of fair value (and recognized over the PCS period in accordance with ASC 985-605). If VSOE of fair value cannot be established and the PCS is the only remaining undelivered element, the entire arrangement fee must be recognized ratably over the stated PCS period (if explicitly stated in the contract) or the period over which PCS services are expected to be provided (if implicit rights to PCS exist). When VSOE of fair value cannot be established for PCS and there are other undelivered elements, the manner in which revenue is recognized depends on the nature of the other undelivered elements. Q&A 2-14, Q&A 2-15, and Q&A 2-16 provide further guidance on appropriate revenue recognition under these circumstances.

Establishing VSOE of Fair Value for PCS

Two acceptable methods of establishing VSOE of fair value for PCS are (1) separate sales of PCS or (2) substantive renewal rates. While either method is acceptable, the method chosen should be applied consistently to all similar arrangements containing PCS. In certain circumstances, it may be appropriate for a vendor to use different methods of establishing VSOE of fair value for PCS. For example, a vendor may sell Product A and Product B. In such circumstances, it may be appropriate to establish VSOE of fair value for PCS for Product A on the basis of renewal rates and for Product B on the basis of separate sales.

Separate Sales of PCS

VSOE of fair value for PCS is the price for PCS services when the services are sold separately (i.e., without any other products or services). When PCS services are sold separately, a vendor should evaluate whether the prices charged for the separate sales are sufficiently concentrated around a specific point and within a narrow enough range to enable the vendor to reasonably estimate fair value. For example, if a significant portion of a vendor’s separate sales of PCS during the past 12 months priced are within a range of plus or minus 15 percent of a midpoint sales price, it may be appropriate to conclude that this separate sales price analysis demonstrates that VSOE of fair value...
In evaluating whether separate sales prices are sufficiently concentrated to establish VSOE of fair value, 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 PCS. For example, a vendor may provide bigger discounts to higher-volume customers than it does to lower-volume customers. In these situations, the dispersion of separate sales prices for transactions with customers grouped by volume may be much less than the dispersion for the entire population. This would allow for the establishment of a separate VSOE of fair value for each class of customer.

For more information about the evaluation of separate sales to establish VSOE of fair value, see the Element Sold Separately heading in the Multiple-Element Arrangements section.

**Substantive Renewal Rates**

The renewal rate stated in the terms of the agreement may be evidence of VSOE of fair value for PCS services as long as this rate and the related terms are considered substantive. In addition, the vendor should be able to demonstrate from past practices that customers actually purchase PCS pursuant to the stated renewal terms. While ASC 985-605 does not define “substantive,” ASC 985-605-55-63 lists the following factors that may indicate the PCS renewal rate is not substantive:

a. The period of initial (bundled) postcontract customer support services is relatively long compared to the term of the software license (for example, four years of initial postcontract customer support services in connection with a five-year time-based software license, with a specified postcontract customer support renewal rate for the remaining year).

b. The aggregate postcontract customer support renewal term is less than the initial (bundled) postcontract customer support period (for example, a five-year time-based software license with three year bundled postcontract customer support and two annual postcontract customer support renewals).

c. A postcontract customer support renewal rate that is significantly below the vendor’s normal pricing practices in combination with a time-based software license that is for a relatively short period (for example, a two-year time-based software license that includes initial [bundled] postcontract customer support for one year for a total arrangement fee of $1,000,000 and that stipulates a postcontract customer support renewal rate for the second year of $25,000 when the vendor’s normal pricing practices suggest higher renewal rates).

In addition to these factors, a vendor should consider whether the renewal rates are consistent with normal pricing practices. In its evaluation of whether renewal rates are consistent with normal pricing practices, a company may consider various factors, such as industry norms and historical rates. For example, the company may evaluate whether PCS renewal rates are sufficiently concentrated or are priced within a narrow enough range. (This evaluation is similar to the evaluation a vendor performs when using separate sales to establish VSOE of fair value.) If a vendor concludes that a normal pricing practice for PCS renewal rates does not exist, it may not be able to use substantive renewal rates to establish VSOE of fair value.

**Example**

Company 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.

In this example, the 3 percent stated renewal rate probably does not establish VSOE of fair value for PCS on the new product (i.e., 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. 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.

Another factor for a vendor to consider when evaluating whether a PCS renewal rate is substantive is the estimated useful life of the related software product. If the terms of the arrangement indicate that the initial period of PCS is relatively long compared with the estimated useful life of the related software product, the PCS renewal rate may not be considered substantive.
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Software Revenue Recognition: A Roadmap to Applying ASC 985-605

Example
A five-year-term license includes two years of bundled PCS and three one-year renewal terms. In this scenario, the bundled PCS term is sizably shorter than the term of the license. In addition, the aggregate PCS renewal term is greater than the initial (bundled) PCS term. Accordingly, the PCS renewal term appears to be substantive. However, if the useful life of the software were expected to be only two years, the PCS renewal rate would not be substantive since the period of bundled PCS is as long as the expected useful life of the software.

Multiple-Year PCS
Vendors often establish VSOE of fair value for PCS sold with software licenses on the basis of one-year renewals. However, vendors may sometimes bundle perpetual software licenses with PCS for a term of more than one year. ASC 985-605-55-57 and 55-58 indicate that the use of the one-year renewal rate to establish VSOE of fair value for multiple-year PCS is acceptable as long as the one-year PCS renewal rate and term are substantive. This guidance gives an example of a perpetual software license bundled with two-year PCS in which the one-year PCS renewal rate (determined to be substantive) is multiplied by two to establish VSOE of fair value.

Delayed Start for PCS
Sometimes, the PCS term of a software arrangement may not begin on the delivery date of the software (e.g., PCS may begin after installation or the expiration of a warranty period). In such situations, 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. Therefore, an implied PCS arrangement would begin upon delivery of the software. A portion of the fee should be allocated to this arrangement on the basis of the VSOE of fair value for the PCS.

Example
Vendor A enters into an arrangement with Customer 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 for the PCS during the warranty period from the annual PCS renewal fee (6 months/12 months x 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 the PCS’s one-year term.

Recognition of PCS Revenue Upon Delivery of the Related Software Product
PCS revenue can sometimes be recognized upon delivery of the related software product. In accordance with ASC 985-605-25-71, revenue allocated to PCS can “be recognized together with the initial licensing fee on delivery of the software” provided that all of the following criteria are met:

a. The postcontract customer support fee is included with the initial licensing fee.
b. The postcontract customer support included with the initial license is for one year or less.
c. The estimated cost of providing postcontract customer support during the arrangement is insignificant.
d. Unspecified upgrades or enhancements offered during postcontract customer support arrangements historically have been and are expected to continue to be minimal and infrequent.

If these conditions are met and PCS revenue is recognized upon the delivery of the software, the estimated costs of providing the PCS must be accrued (this accrual should include appropriate allocation of the costs of providing any upgrades or enhancements to the PCS customers).

Note that when the criteria for the exception to recognizing PCS revenue ratably were developed, it was expected that software vendors generally would not be able to meet the “minimal and infrequent upgrades/enhancements” criterion. Therefore, recognizing PCS revenue upon delivery of the related software, with an accrual for the estimated costs (as opposed to deferral of the PCS revenue), is expected to be rare.
Postdelivery Telephone Support

ASC 985-605 requires that postdelivery telephone support that is offered or available to customers at no additional charge be accounted for as PCS. Generally, the arrangement consideration allocated to the telephone support would have to be recognized as revenue over the period during which the telephone support is expected to be provided. However, ASC 985-605-25-74 contains an exception to this rule:

Although such telephone support may be offered or available for periods exceeding one year, if the vendor has established a history of providing substantially all the telephone support within one year of the licensing or sale of the software, the postcontract customer support may be considered to have a term of one year or less in applying paragraph 985-605-25-71(b). Accordingly, revenue allocable to telephone support may be recognized together with the initial licensing fee on delivery of the software if all the conditions in paragraph 985-605-25-71 are met. This provision applies only to telephone support provided at no additional charge. If revenue allocable to telephone support is recognized together with the licensing fee on delivery, the vendor shall accrue the estimated cost of providing that support.

That is, to qualify for this exception, a vendor must be able to demonstrate that substantially all telephone support services are performed within one year of the date of software delivery.

PCS Granted by Resellers

When a vendor grants a reseller the right to provide PCS to its customers, an implied PCS arrangement may exist. Therefore, the requirements for establishing VSOE of fair value in nonreseller arrangements would apply to reseller arrangements that include implied PCS. ASC 985-605-25-75 states:

An arrangement in which a vendor grants a reseller the right to provide unspecified upgrades or enhancements to the reseller’s customers is an implied postcontract customer support arrangement between the vendor and the reseller, even if the vendor does not provide direct telephone support to the reseller’s customers. If sufficient vendor-specific objective evidence does not exist to allocate the fee to the software and the postcontract customer support, the vendor shall recognize revenue from both the licensing arrangement and the postcontract customer support ratably over the period during which postcontract customer support is expected to be provided.

Example

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 six months after 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 (i.e., 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 is determined that the PCS period will be less than the maximum 18 months, the recognition period should be adjusted as a change in estimate to the shorter period.

Services

In addition to PCS and hosting-related services, software arrangements commonly include training, installation, and consulting-related services. A vendor must determine whether these services can be accounted for as separate elements in the arrangement.

Separation Criteria for Services Elements

To be accounted for separately, a services element (1) must have an established VSOE of fair value; (2) cannot involve significant production, modification, or customization of software; (3) must not be essential to the functionality of any other element of the transaction; and (4) must be expected to affect the total price of the arrangement, as described in the contract.

VSOE of Fair Value for Services

As with other elements in a multiple-element arrangement, a vendor must establish VSOE of fair value for the services in accordance with ASC 985-605-25-6 before it can separately account for them. If services are priced separately in an arrangement, the stated price may not represent VSOE of fair value (e.g., in a fixed-fee contract).
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Example
Vendor A enters into an arrangement with Customer B to provide both software and training for $100,000. The terms of the arrangement state 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. Even though the arrangement explicitly states that the price of the software is $99,000, A would allocate $90,000 to the software and $10,000 to the training and would recognize both in accordance with ASC 985-605.

Services in a software arrangement are often sold separately at a time-and-materials rate per hour. A vendor may establish VSOE of fair value for services on the basis of this rate as long as it can make reasonably reliable estimates of the hours required to complete the services. The vendor calculates the total charge for the services element by multiplying the time-and-materials rate per hour by the expected hours required to complete the services.

Essential to the Functionality
To qualify for separate accounting, services must not be considered essential to the functionality of the other elements in an arrangement. Under ASC 985-605-25-84, a service element may be essential to the functionality of other elements if the following indicators are present (this list is not all-inclusive):

- 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.

A vendor may find it particularly difficult to evaluate whether its software should be considered to be off-the-shelf software. ASC 985-605-25-81 describes off-the-shelf software as "software that is marketed as a stock item that can be used by customers with little or no customization." Moreover, ASC 985-605 contrasts off-the-shelf software with "core 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." Therefore, in an arrangement containing core software, the services would most likely be considered essential to the functionality of the software (since the vendor must perform the services before the customer can use the software) and generally would not qualify for separate accounting.

In addition to the above indicators, the vendor should consider whether the customer is able to use the software without significant modifications being made to it. If not, the services would be considered essential to the functionality of the software.

When Services Qualify for Separate Accounting
If the criteria for separate accounting for the services are met, a portion of the arrangement fee should be allocated to the services on the basis of VSOE of fair value and recognized as the services are performed (or on a straight-line basis over the service period if no discernible pattern of performance for the services exists).

Example
Vendor A agrees to provide Customer B with payroll software and to provide on-site training for the software to its new employees over the next five years. The fee for the software is $900,000, and the training is $20,000 per year. VSOE of fair value is $850,000 and $70,000 for the software and training, respectively. The training services are not essential to the functionality of the software, and the terms of the arrangement indicate that the arrangement fee would vary if these services were included or excluded.

Because the training services meet the criteria for separate accounting, the portion of the arrangement fee allocated to the training on the basis of VSOE of fair value ($70,000 per year) should be recognized as the services are performed. The portion of the arrangement fee allocated to the software on the basis of VSOE of fair value ($850,000) would be recognized when the requirements for revenue recognition for that element have been met.
When Services Do Not Qualify for Separate Accounting

If the criteria for separate accounting for the services are not met, contract accounting (see the Contract Accounting section below) should be applied to the entire arrangement. However, if the separation criteria are not met because VSOE of fair value does not exist and the services (as long as they do not involve significant production, modification, or customization) are the only undelivered element in an arrangement, the entire arrangement consideration should be recognized as the services are performed (or on a straight-line basis over the service period if no discernible pattern of performance for the services exists). See Q&A 2-14, Q&A 2-15, and Q&A 2-16 for illustrations of the accounting for arrangements in which the undelivered elements are PCS and services.

Example

Vendor ABC enters into an agreement to deliver and install payroll software for Customer XYZ for $750,000. The agreement states that the value of the software and the installation services is $600,000 and $150,000, respectively; however, VSOE of fair value for these elements does not exist. The installation services will begin upon delivery of the payroll software and will take 60 days to complete. The installation services are not essential to the functionality of the software and do not constitute significant production, modification, or customization of the software.

Because the installation services are the only undelivered element in the arrangement and all other criteria are met except for the establishment of sufficient VSOE of fair value for the services, ABC can recognize the arrangement consideration of $750,000 over the 60-day installation period.

In this example, if the installation services were considered essential to the functionality of the payroll software, contract accounting would be required for the entire arrangement.

Q&A 3-01 addresses income statement classification for software arrangements in which the vendor cannot establish VSOE of fair value for services that do not involve significant production, modification, or customization (i.e., the software and services are viewed as a single unit of accounting for recognition purposes).

Funded Software-Development Arrangements

Software-development arrangements, whether fully or partially funded, are common in the software industry. They are typically entered into to accelerate the development of new products or additional features of existing ones. Typically, the funding party gains certain benefits. Income may be recognized for these arrangements in accordance with ASC 605-35, ASC 730-20, or ASC 985-20, depending on whether the software has become technologically feasible. For more information, see Q&A 2-111 and Q&A 2-112.

Contract Accounting

If an arrangement contains software as well as services that involve significant production, modification, or customization of the software, the services cannot be separately recognized from the software. In such cases, a vendor should apply contract accounting under ASC 605-35 to the entire arrangement. ASC 605-35 requires that a vendor use either the percentage-of-completion method or the completed-contract method in accounting for such an arrangement. See Q&A 2-113 for a discussion of the accounting for services under ASC 985-605 versus that under ASC 605-35.

While ASC 605-35 states that the use of either method is an accounting policy decision, ASC 605-35-25-57 states that the “percentage-of-completion method is considered preferable [when] reasonably dependable estimates can be made.” It is also preferable when all of the following conditions exist:

a. Contracts . . . include provisions that clearly specify the enforceable rights regarding goods or services to be provided and received by the parties, the consideration to be exchanged, and the manner and terms of settlement.

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

c. The contractor can be expected to perform [its] contractual obligations.

The Percentage-of-Completion Method

The objective of percentage-of-completion accounting is to reflect the economic substance of a transaction by allocating revenue and profit to the periods in which the work is performed, so that revenue and profit are recognized as earned. Under this approach, performance is considered a continual sale.
**Measurement of Progress**

ASC 605-35 groups methods for determining progress toward completion into input measures and output measures. Input measures are based on the effort devoted to the contract (e.g., labor hours), while output measures are based on the results achieved (e.g., units delivered). Except in unusual circumstances, the method selected should be applied consistently to all contracts with similar characteristics to avoid significant distortions in reported revenue. If a vendor uses a method other than the one in its accounting policy for a particular contract, it must disclose this fact in its financial statements if the contract is material.

**Input Measures**

Input measures in software arrangements are generally in the form of either costs incurred or labor hours expended. Using input measures, the vendor calculates the ratio of costs or labor hours incurred to date to the estimated total costs or labor hours, respectively, to determine the percentage of completion. Because input measures are easily verifiable, they generally result in a precise calculation. However, if a contract contains inefficiencies, input measures may not appropriately reflect the contract’s percentage of completion.

**Output Measures**

Output measures in software arrangements are generally in the form of units produced or delivered. Similarly to its use of input measures, a vendor uses output measures to calculate the contract’s percentage of completion (i.e., the ratio of units produced or delivered to the estimated total in the contract). Unlike the input measures calculation, the output measures calculation is based on actual results achieved and thus generally reflects actual progress complete. However, it may be difficult to identify the outputs of a contract.

A contractual milestone is one output measure commonly used to measure percentage of completion in software or software-related arrangements. When using milestones as an output measure, management must determine the percentage of completion allocable to each milestone in a contract. This amount allocated to a milestone may not equal the amount of consideration received for achievement of that milestone. Milestones are more easily identifiable than other output measures because they are generally based on contractual terms and require the customer to approve or accept specific tasks or performance. However, if a vendor does not have experience with arrangements containing milestones, the use of milestones as an output measure may not be appropriate.

**The Completed-Contract Method**

Under the completed-contract method, all contract revenues and costs for contracts in progress are deferred and are recognized in income only when the contract is complete or substantially complete.

The completed-contract method is based on actual results rather than estimates of percentage of completion. This method may result in irregular income recognition and widely fluctuating gross profit percentages because it does not reflect current performance under enforceable rights when the contract period extends beyond an accounting reporting period. This method should therefore only be used in limited circumstances (e.g., when the criteria in ASC 605-35-25-57 are not met).
Section 1 — Background and Scope

Background

ASC 985-605

05-1 This Subtopic provides guidance on when revenue should be recognized and in what amounts for licensing, selling, leasing, or otherwise marketing computer software.

05-2 [Not used]

05-3 Software arrangements range from those that provide a license for a single software product to those that, in addition to the delivery of software or a software system, require significant production, modification, or customization of software.

Hosting Arrangement

05-4 Structurally, the form of a hosting arrangement may be split into two elements:
   a. The right to use software
   b. The hosting service.

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

1-01 Background of ASC 985-605

SOP 97-2 was issued on October 27, 1997, by the AcSEC 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.

Furthermore, the AICPA staff issued TPAs that provided additional guidance on accounting and reporting issues associated with SOP 97-2 (see Q&A 1-02). On July 1, 2009, the FASB codified SOP 97-2, its related amendments, and the related TPAs in ASC 985-605.

In October 2009, the FASB issued ASU 2009-14, which reflects the consensus of the EITF and amends ASC 985-605 to exclude from its scope tangible products and certain software and software-related elements.

1-02 AICPA Technical Practice Aids — Background and Level of Authority

Question

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

Answer

The TPAs are technical questions and answers. Certain TPAs 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 Statement 162, 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 AcSEC before issuance.

Effective July 1, 2009, the FASB codified the applicable TPAs in ASC 985-605, giving these TPAs the same level of authority as the codified guidance from SOP 97-2.
1-03  Comparison of ASC 985-605 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 criteria in ASC 985-605 that must be met for revenue recognition. Both ASC 985-605 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 free on board shipping terms on revenue recognition. ASC 985-605-55-97 and 55-98 state that free on board shipping terms “are relevant in the assessment of whether software has been delivered.”

- **Customer Acceptance** — ASC 985-605-55-80 and 55-81 contain guidance on the relationship between customer acceptance and revenue recognition. It emphasizes that revenue should not be recognized until the customer acceptance criteria are met. Question 1 of SAB Topic 13.A.3(b) also discusses the four general forms that most customer acceptance criteria take. Question 3 of SAB Topic 13.A.3(b) provides detailed guidance on how the customer acceptance criteria affect revenue recognition.

- **Beginning of License Term** — Both SAB Topic 13.A.3(d) and ASC 985-605-55-103 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** — ASC 985-605 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 1-12).

- **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. ASC 985-605-25-58 and 25-59 discuss the period over which revenue should be recognized for subscriptions and requires 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. ASC 985-605-25-67 through 25-70 discuss contractual PCS and requires 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 2-103).

1-04  Comparison of ASC 985-605 and SAB Topic 13 (Part II)

Question

What are some differences between SAB Topic 13 and ASC 985-605?

Answer

**Bill and Hold** — SAB Topic 13.A.3(a) provides guidance on bill-and-hold transactions, while ASC 985-605 does not. AcSEC had considered a proposal to include bill-and-hold provisions in SOP 91-1 (software revenue recognition guidance prior to SOP 97-2). 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 2-42).
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. ASC 985-605-55-15 and ASC 985-605-55-22 through 55-33 discuss revenue recognition for arrangements with extended payment terms. Nonsoftware arrangements with such terms are subject to ASC 835-30 (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 paragraph 26 (codified in ASC 985-605-25-30 and 25-31) and paragraphs 30–33 (codified in ASC 985-605-25-36 through 25-40) of SOP 97-2 to apply to sales transactions. Footnote 5 also indicates that entities should consider paragraphs 27–29 of SOP 97-2 (codified in ASC 985-605-25-33 through 25-35) in transactions involving a high risk of technological obsolescence.

Scope

ASC 985-605

Overall Guidance

15-1 This Subtopic follows the same Scope and Scope Exceptions as outlined in the Overall Subtopic, see Section 985-10-15, with specific qualifications and exceptions noted below.

Entities

15-2 The guidance in this Subtopic applies to all entities.

Transactions

15-3 The guidance in this Subtopic applies to the following transactions and activities:

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

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

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

1. The software is a significant focus of the marketing effort or is sold separately.
2. The vendor is providing postcontract customer support.
3. The vendor incurs significant costs that are within the scope of Subtopic 985-20.

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

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

1. Incremental to the range of discounts reflected in the pricing of the other elements of the arrangement
2. Incremental to the range of discounts typically given in comparable transactions

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

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

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

15-4  The guidance in this Subtopic does not apply to the following transactions and activities:
   a. Arrangements for products or services containing software that is incidental to the products or services as a whole
   b. Leases of software that include a tangible product (such as property, plant, or equipment), if the software is incidental to the tangible product as a whole or the software and nonsoftware components of the tangible product function together to deliver the tangible product’s essential functionality
   c. Marketing and promotional activities not unique to software transactions, such as the following:
      1. Insignificant discounts on future purchases that are offered by a vendor in a software arrangement. For example, a vendor may offer a small discount (a coupon or other form of offer for 5 percent off) on additional licenses of the licensed product or other products that exist at the time of the offer but are not part of the arrangement.
      2. Discounts that are not incremental to discounts typically given in comparable transactions (for example, volume purchase discounts comparable to those generally provided in comparable transactions).
   d. Nonsoftware components of tangible products
   e. Software components of tangible products that are sold, licensed, or leased with tangible products when the software components and nonsoftware components of the tangible product function together to deliver the tangible product’s essential functionality
   f. Undelivered elements that relate to software that is essential to the tangible product’s functionality in (e).

15-4A  In determining whether a tangible product is delivered with software components and nonsoftware components that function together to deliver the tangible product’s essential functionality, a vendor shall consider all of the following:
   a. If sales of the tangible product without the software elements are infrequent, a rebuttable presumption exists that software elements are essential to the functionality of the tangible product.
   b. A vendor may sell products that provide similar functionality, such as different models of similar products. If the only significant difference between similar products is that one product includes software that the other product does not, the products shall be considered the same product for the purpose of evaluating (a).
   c. A vendor may sell software on a standalone basis. The vendor may also sell a tangible product containing that same software. The separate sale of the software shall not cause a presumption that the software is not essential to the functionality of the tangible product.
   d. Software elements do not need to be embedded within the tangible product to be considered essential to the tangible product’s functionality.
   e. The nonsoftware elements of the tangible product must substantively contribute to the tangible product’s essential functionality. For example, the tangible product should not simply provide a mechanism to deliver the software to the customer.

1-05  Entities That Have Arrangements Within the Scope of ASC 985-605

Question
What types of entities may have arrangements that are within the scope of ASC 985-605?

Answer

Before ASU 2009-14

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 ASC 985-605. This list may lengthen as products and services become “smarter” through technology. The application of ASC 985-605 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.
ASC 985-605-15-3 contains guidance on making the scope determination. ASC 985-605-15-3(c) states the following in connection with an arrangement that includes software that is more than incidental to the products or services as a whole:

In such arrangements, the guidance in this Subtopic applies to the software and software-related elements. Software-related elements include software products and services such as those listed in paragraph 985-605-25-5 as well as any nonsoftware deliverable or deliverables for which a software deliverable is essential to their functionality. For example, in an arrangement that includes software, computer hardware that will contain the software, and additional unrelated equipment, if the software is essential to the functionality of the hardware, the hardware would be considered software-related. However, if the software is not essential to the functionality of the additional unrelated equipment, the equipment would not be considered software-related.

After ASU 2009-14

ASC 985-605-15-3 contains guidance on making the scope determination. ASC 985-605-15-3(c) states the following in connection with an arrangement that includes software that is more than incidental to the products or services as a whole:

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

ASC 985-605-15-4 provides several scope exceptions. In particular, if software is sold, licensed, or leased with a tangible product, the software is excluded from the scope of ASC 985-605 if the software components function together with nonsoftware components to deliver a tangible product’s essential functionality. In these circumstances, the undelivered elements related to the software (e.g., specified upgrades, postcontract customer support) would also be excluded from the scope of ASC 985-605. Nonsoftware components, hardware, and other tangible products are outside the scope ASC 985-605.

1-06 Additional Considerations in the Determination of Whether Software Is More Than Incidental

The following Q&A only applies to entities that have not adopted ASU 2009-14.

Question

Should an entity consider factors other than the indicators noted in ASC 985-605-15-3(c) when determining whether software is more than incidental to an arrangement?

Answer

Yes. In a speech at the 2004 AICPA National Conference on Current SEC and PCAOB Developments, G. Anthony Lopez, associate chief accountant in the SEC’s Office of the Chief Accountant, stated that an entity should consider the following additional factors (not all-inclusive) when determining whether software is more than incidental to an arrangement:

- Do the rights to use the software remain solely with the vendor or are the rights transferred to the customer as a part of the product or service offering? If the rights to use the software survive cessation of the service or sale of the product, that is an indicator that the software is more-than-incidental.

- Does the licensed software require the customer to provide dedicated information technology (IT) support? If the customer must maintain and troubleshoot the underlying software, it may be more-than-incidental.

Example 1

Vendor X designs, develops, manufactures, and installs broadband base stations, base station controllers, and related wireless infrastructure components for wireless telecommunications. Although X’s products contain embedded software, X does not consider itself to be a software company and therefore does not separately market its software or future software upgrades. In addition, X does not provide PCS for its products and the costs for software R&D are insignificant in relation to other development and production costs (note that this cost comparison should be evaluated on an individual product basis).

On the basis of the above facts, the sales of X’s products would not be within the scope of ASC 985-605, because (1) the embedded software does not play an integral role in X’s marketing efforts, (2) X does not offer PCS, and (3) X does not incur significant software R&D costs that are within the scope of ASC 985-20.
Example 2
Vendor 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.

Even though the rights to the software are not transferred to the customer (i.e., the software is embedded in Z’s hardware and will not work without the accompanying hardware), Z’s products would be within the scope of ASC 985-605. In this example, 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 ASC 985-20.

Example 3
Company 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, and customers are responsible for any maintenance or troubleshooting on the software. In addition, A offers customers PCS and the software is a significant focus of its marketing efforts.

Company A’s products would be within the scope of ASC 985-605. In this example, 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. In addition, the fact that the customer must provide its own software support and maintenance strongly indicates that the software is more than incidental to the arrangement.

1-07 License Versus Sale of Software
The scope of ASC 985-605 encompasses revenue recognition for both licenses and sales of software.

Question
Under ASC 985-605, 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.

1-08 Software Upgrade for Hardware
Company F produces hardware that is being upgraded to a new version. Because F still has numerous units of the current version of the hardware, it has created a software program to upgrade the current version 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. Company F 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 ASC 985-605?

Answer
Before ASU 2009-14
No. As noted in ASC 985-605-15-3(c), software that is more than incidental to the products in an arrangement as a whole is within the scope of ASC 985-605. Indicators of software that is more than incidental to other products include software that is a significant focus of marketing efforts, software that is sold separately, PCS, and significant
costs incurred that are within the scope of ASC 985-20. None of these indicators are present in the case of the software upgrade provided by F. Therefore, the upgrade is deemed incidental to the hardware sold by F and would not be accounted for under ASC 985-605.

**After ASU 2009-14**

No. As noted in ASC 985-605-15-3(c), software that is more than incidental to the products in an arrangement as a whole is within the scope of ASC 985-605, except in certain arrangements specified in ASC 985-605-15-4. Indicators of software that is more than incidental to other products include software that is a significant focus of marketing efforts, software that is sold separately, PCS, and significant costs incurred that are within the scope of ASC 985-20. None of these indicators are present in the case of the software upgrade provided by F. Therefore, the upgrade is deemed incidental to the hardware sold by F and would not be accounted for under ASC 985-605.

1-09 **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**

**Before ASUs 2009-13 and 2009-14**

ASC 840-10 provides guidance on allocating consideration in leases involving real estate. This guidance also applies to other arrangements involving leased equipment. ASC 840-10-25-19 and 25-20 state:

> 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**. [Emphasis added]

The equipment shall be considered separately for purposes of applying the lease classification criteria in paragraphs 840-10-25-1, 840-10-25-31, and 840-10-25-41 through 25-44 and shall be accounted for separately according to its classification by both lesses and lessors.

In addition, ASC 605-25-15-3A states, in part:

> Solely for purposes of the allocation between deliverables within the scope of another Topic and deliverables not within the scope of that Topic, 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.

ASC 605-25-55-3 gives an example involving leased equipment, stating:

> For example, leased assets are required to be accounted for separately under the guidance in Subtopics 840-20 and 840-30. 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 deliverables subject to the guidance in Subtopic 840-20 and the other deliverables on a relative fair value basis using the entity’s best estimate of fair value of the deliverables. (Although that Subtopic 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 deliverables subject to the guidance in that Subtopic.) The guidance in that Subtopic would then be applied to separate the maintenance from the leased equipment and to allocate the related arrangement consideration to those two deliverables. This Subtopic would be applied to further separate any deliverables not subject to the guidance in that Subtopic and to allocate the related arrangement consideration.

Accordingly, given the absence of specific guidance in ASC 985-605, the guidance in ASC 840-10 and ASC 605-25 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 ASC 985-605, including the requirement for VSOE of fair value if there are multiple software elements. However, the hardware would be accounted for under ASC 840-10, including the requirements for lease classification in ASC 840-10-25-1, ASC 840-10-25-31, and ASC 840-10-25-41 through 25-44.
After ASUs 2009-13 and 2009-14

ASC 840-10 provides guidance on allocating consideration in leases involving real estate. This guidance also applies to other arrangements involving leased equipment. ASC 840-10-25-19 and 25-20 state:

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. [Emphasis added]

The equipment shall be considered separately for purposes of applying the lease classification criteria in paragraphs 840-10-25-1, 840-10-25-31, and 840-10-25-41 through 25-44 and shall be accounted for separately according to its classification by both lessees and lessors.

In addition, ASC 605-25-15-3A states, in part:

For purposes of the allocation between deliverables within the scope of another Topic and deliverables not within the scope of that other Topic, the selling price shall be determined using the guidance as discussed in paragraphs 605-25-30-6A through 30-6B.

These paragraphs discuss how an entity should establish selling price by using the selling price hierarchy, which includes VSOE, third-party evidence, and best estimate of selling price.

ASC 605-25-55-3 gives an example involving leased equipment, stating:

For example, leased assets are required to be accounted for separately under the guidance in Subtopics 840-20 and 840-30. 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 deliverables subject to the guidance in Subtopic 840-20 and the other deliverables using the relative selling price method. (Although Topic 840 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 deliverables subject to the guidance in that Topic.) The guidance in Topic 840 would then be applied to separate the maintenance from the leased equipment and to allocate the related arrangement consideration to those two deliverables. This Subtopic would be applied to further separate any deliverables not subject to the guidance Topic 840 and to allocate the related arrangement consideration.

Accordingly, given the absence of specific guidance in ASC 985-605, the guidance in ASC 840-10 and ASC 605-25 should be applied to software arrangements that include leased equipment. To estimate the minimum lease payments, the vendor should use the relative selling price method to allocate the arrangement consideration between the equipment and software elements.

The hardware would be accounted for under ASC 840-10, including the requirements for lease classification in ASC 840-10-25-1, ASC 840-10-25-31, and ASC 840-10-25-41 through 25-44. If the software does not qualify for the scope exception in ASC 985-605-15-4, amounts attributable to the software would be accounted for pursuant to ASC 985-605, including the requirement for VSOE of fair value if there are multiple software elements.

However, if the software functions together with the leased equipment to deliver the product’s essential functionality (as discussed in ASC 985-605-15-4 and 15-4A), then the hardware, software, and software-related elements would be outside the scope of ASC 985-605 and subject to other applicable accounting guidance (e.g., ASC 840, ASC 605-25, or SAB Topic 13).

1-10 Nonmonetary Transactions

Question

Does ASC 985 address arrangements involving nonmonetary transactions?

Answer

Yes. ASC 985 addresses the application of ASC 845-10 to the exchange of software licenses between entities. ASC 985-845-25-1 through 25-7 and ASC 985-845-55-1 through 55-8 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.

1-11 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:

"Changes 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 [ASC 985-605], 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 [ASC 985-605]."

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]

Scope — Hosting Arrangements

1-12 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). ASC 985-605-55-121 requires that hosting arrangements be accounted for in accordance with ASC 985-605 if “[a] The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty [and] (b) It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.” If these conditions are met, the software element is within the scope of ASC 985-605.

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 (codified in ASC 720-15). 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.

1-13 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 ASC 985-605?

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 Q or its partners. Therefore, in accordance with ASC 985-605-55-121 the arrangement is not within the scope of ASC 985-605. Entity Q should recognize the $200 over the one-year term of the arrangement once the customer has access to the software.

1-14 Determination of Whether Significant Costs Are Incurred in a Hosting Arrangement

ASC 985-605-55-121 states that “A software element subject to this Subtopic is only present in a hosting arrangement if . . . (a) The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty [and] (b) It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.” ASC 985-605-55-122 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 Subtopics, amounts above 10 percent would be considered significant under ASC 985-605-55-122. 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 1-15 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 enters into hosting arrangements with end customers. Assume that X enters into a contract with the following characteristics:

- Three-year hosting contract.
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1-15 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 ASC 985-605-55-121 this hosting arrangement would not contain a software element covered by ASC 985-605 and would be accounted for as a service contract.

1-16 Hosting Penalties When a Customer Takes Possession of the Software Without Incurring Significant Cost

Assume that the contract in Q&A 1-12 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 ASC 985-605-55-122 (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 in accordance with ASC 985-605-55-123.

Scope — Discounts

1-17 Significant Incremental Discounts

Question
How should significant incremental discounts be accounted for under ASC 985-605?
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Answer
ASC 985-605-55-82 through 55-85 provide guidance, and ASC 985-605-55-185 through 55-200 include examples on how a vendor should account for significant incremental discounts within the scope of ASC 985-605. The examples in ASC 985-605-55-185 through 55-200 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 ASC 985-605-15-3 if this discount is typical.

1-18 Example of a Discount Offered on the Future Purchase of Additional Copies of a Software Product in an Arrangement
Company A enters into an arrangement to provide 1,000 copies of Software Product X to Customer 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 for $15 per copy. Company A normally sells copies of Z for $30 per copy. Customer B has the right to purchase up to 1,000 copies of Z.

Question
In accounting for this arrangement, should A allocate a portion of the $15 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 $35,000, so the discount on Z is 50 percent, and the overall discount on the arrangement is 30 percent.

Therefore, A could recognize $14,000 ($20,000 fixed fee less the 30 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 ($21,000 for 1,000 copies) upon delivery of the first copy of this software product, provided that all other criteria for revenue recognition are met.

1-19 Discounts on Future Upgrades and Enhancements
Company 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 ASC 985-605-15-3(d)?

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.

1-20 Early Renewal of Term Arrangement Without VSOE of Fair Value of PCS
Company 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.

ASC 605-50 addresses the accounting for sales incentives. ASC 605-50-45-1 through 45-5 address 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.

ASC 605-50-25-3 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
ASC 985-605-55-88 through 55-92, ASC 985-605-55-101 through 55-118, and ASC 985-605-55-199 through 55-203 provide accounting guidance for term licenses when VSOE of fair value exists for PCS.
Section 2 — Recognition

Basic Principles

ASC 985-605

25-1 Software arrangements range from those that provide a license for a single software product to those that, in addition to the delivery of software or a software system, require significant production, modification, or customization of software.

Software Requiring Significant Production, Modification, or Customization

25-2 If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the entire arrangement shall be accounted for in conformity with Subtopic 605-35, using the relevant guidance in paragraphs 985-605-25-88 through 25-107 on applying contract accounting to certain arrangements involving software.

Software Not Requiring Significant Production, Modification, or Customization

25-3 If the arrangement does not require significant production, modification, or customization of software, revenue shall be recognized when all of the following criteria are met:


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

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

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

25-4 The term probable is used in this Subtopic with the same definition as used in Topic 450.

Multiple-Element Arrangements

25-5 Software arrangements may provide licenses for multiple software deliverables (for example, software products, upgrades or enhancements, postcontract customer support, or services), which are termed multiple elements. A number of the elements may be described in the arrangement as being deliverable only on a when-and-if-available basis. When-and-if-available deliverables shall be considered in determining whether an arrangement includes multiple elements. Accordingly, the requirements of this Subtopic with respect to arrangements that consist of multiple elements shall be applied to all additional products and services specified in the arrangement, including those described as being deliverable only on a when-and-if-available basis.

25-6 If an arrangement includes multiple elements, the fee shall be allocated to the various elements based on vendor-specific objective evidence of fair value, regardless of any separate prices stated in the contract for each element. Vendor-specific objective evidence of fair value is limited to the following:

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

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

25-7 The amount allocated to undelivered elements is not subject to later adjustment. (This does not apply to changes in the estimated percentage of customers not expected to exercise an upgrade right. See paragraph 985-605-25-45.) However, if it becomes probable that the amount allocated to an undelivered element will result in a loss on that element of the arrangement, the loss shall be recognized pursuant to Topic 450. When a vendor’s pricing is based on multiple factors such as the number of products and the number of users, the amount allocated to the same element when sold separately shall consider all the factors of the vendor’s pricing structure.
ASC 985-605 (continued)

25-8 If a discount is offered in a multiple-element arrangement, a proportionate amount of that discount shall be applied to each element included in the arrangement based on each element’s fair value without regard to the discount. However, as discussed in paragraph 985-605-25-45, no portion of the discount shall be allocated to any upgrade rights. Moreover, to the extent that a discount exists, the residual method described in paragraphs 985-605-25-10 through 25-11 attributes that discount entirely to the delivered elements.

25-9 Except as provided in the following paragraph, if sufficient vendor-specific objective evidence does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement shall be deferred until the earlier of the point at which:

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

   b. All elements of the arrangement have been delivered.

25-10 The following are exceptions to the guidance in the preceding paragraph:

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

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

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

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

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

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

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

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

25-11 The residual method described in (e) in the preceding paragraph shall be applied only if both of the following conditions are met:

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

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

25-12 The portion of the fee allocated to an element shall be recognized as revenue when the criteria in paragraph 985-605-25-3 are met with respect to the element. In applying those criteria, the delivery of an element is considered not to have occurred if there are undelivered elements that are essential to the functionality of the delivered element, because the customer would not have the full use of the delivered element.
**ASC 985-605 (continued)**

25-13 No portion of the fee (including amounts otherwise allocated to delivered elements) meets the criterion of collectibility if the portion of the fee allocable to delivered elements is subject to forfeiture, refund, or other concession if any of the undelivered elements are not delivered. For the revenue related to an arrangement to be considered not subject to forfeiture, refund, or other concession, management must intend not to provide refunds or concessions that are not required under the provisions of the arrangement. All available evidence shall be considered to determine whether the evidence persuasively indicates that the revenue is not subject to forfeiture, refund, or other concession. Although no single item of evidence may be persuasive, all of the following additional items shall be considered:

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

25-14 Regardless of the guidance in the preceding paragraph, the vendor’s historical pattern of making refunds or other concessions that were not required under the original provisions (contractual or other) of other arrangements shall be considered more persuasive than terms included in the arrangement that indicate that no concessions are required.

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**2-01 Definition of a Software Element**

**Question**

Under ASC 985-605, what is a software element?

**Answer**

**Before ASU 2009-14**

“Software element” is not specifically defined in ASC 985-605. ASC 985-605-25-5 lists “software products, upgrades or enhancements, postcontract customer support, or services” as examples of software elements but does not define the term. ASC 985-605-15-3 provides further clarification, stating that software-related elements include software products and services such as those listed in ASC 985-605-25-5 as well as any nonsoftware deliverable 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 ASC 985-605. 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 ASC 985-605.

**After ASU 2009-14**

“Software element” is not specifically defined in ASC 985-605. ASC 985-605-25-5 lists “software products, upgrades or enhancements, postcontract customer support, or services” as examples of software elements but does not define the term. ASC 985-605-15-3 also clarifies that a service is within the scope of ASC 985-605 “if software in the arrangement is essential to the functionality of that service.”

Tangible products are outside the scope of ASC 985-605. When a tangible product contains software components and nonsoftware components that function together to deliver the tangible product’s essential functionality, the software components are also outside the scope of ASC 985-605. ASC 985-605-15-4A provides guidance to assist entities in determining whether software components and nonsoftware components function together to deliver a tangible product’s essential functionality.

**2-02 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 free software offered 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 the accounting for the arrangement under ASC 985-605 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 the evaluation of 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 produces hardware consoles that are sold with software included; the software is more than incidental to the product but not essential to its functionality. Vendor V also posts the 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 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 and 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 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.

Note that after adopting ASU 2009-14, V should also determine whether the software and hardware function together to deliver the tangible product’s essential functionality. If V determines that this is the case, then the software would be outside of the scope of ASC 985-605.

**2-03 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 ASC 985-605-25-5?

**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 2-25).
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2-04 VSOE of Fair Value for Elements Not Sold Separately

*Question*
ASC 985-605-25-6 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. The requirement in ASC 985-605 for a separate sale to validate fair value was controversial throughout the development of the guidance. 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 and codified in ASC 985-605). 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 ASC 985-605, 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, ASC 985-605-25-67 clarifies that PCS “shall be determined by reference to the price the customer will be required to pay when it is sold separately (that is, the renewal rate).” 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 ASC 985-605-25-6. See Q&A 2-06 for other factors to consider when determining VSOE of fair value.

2-05 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. See Q&A 2-06 for other factors to consider when determining VSOE of fair value.

2-06 Other Considerations in Determining VSOE of Fair Value

*Question*
Should vendors consider factors other than those described in Q&A 2-04 and Q&A 2-05 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:

- **Items sold separately** — A vendor could use historical pricing information for items sold separately. 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 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:
Section 2 — Recognition

Software Revenue Recognition: A Roadmap to Applying ASC 985-605

<table>
<thead>
<tr>
<th>Sales Price as a Percentage of Net License Fee</th>
<th>Percentage of Separate Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>2% to 5%</td>
<td>20%</td>
</tr>
<tr>
<td>5% to 10%</td>
<td>30%</td>
</tr>
<tr>
<td>10% to 15%</td>
<td>35%</td>
</tr>
<tr>
<td>15% to 20%</td>
<td>15%</td>
</tr>
</tbody>
</table>

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.

The size of the discount granted to a customer would not be a sufficient basis for stratifying the population.

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 there is some variability in the prices charged.

• **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 sells a software license that includes installation services. Vendor A’s management has determined that if the company were to sell the installation services separately, the price charged would be $500. However, A has never sold installation services separately and does not intend to do so in the future. As a result, the $500 would not constitute VSOE of fair value for the installation services.

• **New products versus existing products** — The provisions of ASC 985-605 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).

Determining whether VSOE of fair value exists is not always intuitive and can require significant judgment, especially when one or more of the following circumstances are present:

• The element is infrequently sold separately.
• The element is not sold separately (or there are limited sales), and VSOE is determined on the basis of the price established by “management having the relevant authority” under ASC 985-605-25-6.
• Stand-alone pricing is not clearly concentrated around a single price point, or significant judgment is needed in the assessment of whether sufficient concentration of pricing exists.
• There is a lack of clarity about whether the analysis of stand-alone pricing is complete or representative of all stand-alone sales.
• There is a deviation from an entity’s established policy for determining VSOE of fair value.
• There have been recent changes to existing pricing practices.
• VSOE of fair value is determined on the basis of a substantive renewal rate, and significant judgment is needed in the determination of whether the renewal rate is substantive.

Since a determination that VSOE of fair value exists can significantly affect revenue recognition in a software arrangement, practitioners are encouraged to consult with their professional accounting advisers (and audit engagement teams are encouraged to consult with their engagement quality control reviewers) in making such determination (especially when one or more of the circumstances noted above are present).

2-07  List Price Used as VSOE of Fair Value

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

Answer
The list price (or contractually stated price) of a product or service should not be presumed to be representative of VSOE of fair value. VSOE of fair value should be determined in accordance with ASC 985-605-25-6. See Q&A 2-06 for further discussion about determining VSOE of fair value. Also, see Q&A 2-12 on allocation of discounts in multiple-element arrangements.

2-08  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 2-06 for further discussion about determining VSOE of fair value and Q&A 2-07 for discussion of when list price may represent VSOE of fair value.

2-09  Multiple Elements Accounted for as a Single Element

Question
ASC 985-605-25-6 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 ASC 985-605?

Answer
Yes. Although ASC 605-25 excludes software elements included in multiple-element arrangements, its guidance is applicable by analogy. The guidance in ASC 605-25 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.
2-10  VSOE of Fair Value for Nonsoftware Elements

**Question**

Do the VSOE rules in ASC 985-605-25-6 apply to nonsoftware elements of an arrangement in which software elements are more than incidental?

**Answer**

No. ASC 985-605-15-3 states that in an arrangement that contains nonsoftware deliverables, only software and software-related elements are within the scope of ASC 985-605. Accordingly, elements not defined as software or software-related elements (as defined in ASC 985-605-15-3) should be separated from the software elements in accordance with ASC 605-25.

2-11  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 ASC 985-605-25-10(e) (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 ASC 985-605-25-6.

2-12  Allocation of Discounts in Multiple-Element Arrangements

ASC 985-605-25-8 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.

2-13  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 of the elements in the arrangement?

**Answer**

Yes, with two exceptions:

- Multiple-element arrangements that include a specified upgrade right. ASC 985-605-25-45 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.
Accounting for an Arrangement in Which the Undelivered Elements Are PCS and Services and VSOE of Fair Value Exists for Neither Element

ASC 985-605-25-9 and 25-10 provide guidance on how a vendor should recognize revenue in a software arrangement in which sufficient VSOE of fair value does not exist. ASC 985-605-25-9 and 25-10 require, among other things, that all revenue from the arrangement (including fees associated with delivered elements) be deferred until (1) PCS is the only undelivered element; (2) services that do not involve significant production, modification, or customization of software (“services”) are the only undelivered element; or (3) VSOE of fair value exists for all undelivered elements. However, ASC 985-605-25-9 and 25-10 do not specifically address how to account for the fee in an arrangement that contains both PCS and services when VSOE of fair value exists for neither element.

Question

How is an arrangement fee recognized in an arrangement that contains undelivered PCS and services when VSOE of fair value exists for neither undelivered element?

Answer

The following are two acceptable methods for recognizing the fee in an arrangement that contains PCS and services (provided that all other revenue recognition criteria are met) when VSOE of fair value does not exist for either element:

1. If both the PCS and the services have commenced and the services can be recognized ratably, the PCS element and the services element are combined into a single services element and the arrangement fee is recognized ratably over the combined service period (i.e., the longer of the PCS period or the services period). In a speech at the 2007 AICPA National Conference on Current SEC and PCAOB Developments, Sandie E. Kim, a professional accounting fellow in the SEC’s Office of the Chief Accountant, indicated that under this recognition method, “there is no inappropriate front-loading of revenue since revenue, including any significant discount that may be included in the arrangement, is recognized over the longest period of performance.”

2. Recognition of the arrangement fee is deferred until either the PCS element or the services element is the only undelivered element in the arrangement. Upon completion of either the PCS element or the services element, a vendor can record a cumulative catch-up of revenue in an amount equal to the total arrangement fee less the pro rata portion that applies to the remaining service period. The remaining amount of the arrangement fee can be recognized ratably over the remaining PCS period or over the services period as services are performed.

The choice of either of the above revenue recognition methods is an accounting policy election that a vendor should apply consistently.

Example

Company M enters into a software license arrangement that includes (1) the software license; (2) implementation services that do not involve significant production, modification, or customization of software; and (3) one year of PCS, which begins upon delivery of the software license. The implementation services are not essential to the functionality of the software, are delivered ratably (delivery of the services begins when the software license is delivered), and take two years to complete. Company M has not established VSOE of fair value for the implementation services or the PCS. Therefore, the entire arrangement, including the software license, must be accounted for as a single unit of accounting.

Because M’s policy is to combine the implementation services and the PCS into a single services element, the entire arrangement fee is recognized ratably over two years (the period over which the implementation services are performed). However, it may not be acceptable for M to use this method if the services are not delivered ratably. For example, if M’s policy were to perform the majority of the services in the second year of the arrangement, it might be premature for M to recognize revenue.

Conversely, if M’s policy were not to combine the implementation services with the PCS, M would defer recognition of the entire arrangement fee until either the implementation services or the PCS is the only remaining undelivered element. At that point, M could record a cumulative catch-up of revenue as described previously and recognize the remainder of the arrangement fee over the period in which the remaining element is delivered.
Accounting for an Arrangement in Which the Undelivered Elements Are PCS and Services and VSOE of Fair Value Only Exists for PCS

2-15

ASC 985-605-25-9 and 25-10 provide guidance on how a vendor should recognize revenue in a software arrangement in which sufficient VSOE of fair value does not exist. ASC 985-605-25-9 and 25-10 require, among other things, that all revenue from the arrangement (including fees associated with delivered elements) be deferred until (1) PCS is the only undelivered element; (2) services that do not involve significant production, modification, or customization of software (“services”) are the only undelivered element; or (3) VSOE of fair value exists for all undelivered elements. However, ASC 985-605-25-9 and 25-10 do not specifically address how to account for the fee in an arrangement that contains both PCS and services when VSOE of fair value only exists for the PCS.

Question

How is an arrangement fee recognized in an arrangement that contains PCS and services when VSOE of fair value only exists for the PCS?

Answer

The following are two acceptable methods for recognizing the fee in an arrangement that contains PCS and services (provided that all other revenue recognition criteria are met) when VSOE of fair value only exists for the PCS:

1. If both the PCS and services have commenced and the services can be recognized ratably, the PCS element and the services element are combined into a single services element and the arrangement fee is recognized ratably over the combined service period (i.e., the longer of the PCS period or the services period). If the services are completed before the end of the PCS period, (1) the difference between the remaining deferred revenue and the VSOE of fair value for the remaining PCS can be recognized as revenue and (2) the remaining deferred revenue (based on VSOE) would be recognized ratably over the remaining PCS period. In a speech at the 2007 AICPA National Conference on Current SEC and PCAOB Developments, Sandie E. Kim, a professional accounting fellow in the SEC’s Office of the Chief Accountant, indicated that under this recognition method, “there is no inappropriate front-loading of revenue since revenue, including any significant discount that may be included in the arrangement, is recognized over the longest period of performance.”

2. Recognition of the arrangement fee is deferred until either the PCS element or the services element is the only undelivered element in the arrangement. If the services are completed before the end of the PCS period, (1) the difference between the remaining deferred revenue and the VSOE of fair value for the remaining PCS can be recognized as revenue and (2) the remaining deferred revenue (based on VSOE) would be recognized ratably over the remaining PCS period. If the PCS is completed before the completion of the services, the portion of the arrangement consideration related to the elapsed period can be recognized as revenue and the difference recognized over the remaining service period as the services are performed.

The choice of either of the above revenue recognition methods is an accounting policy election that a vendor should apply consistently.

Example

Company M enters into a software license arrangement that includes (1) a perpetual software license; (2) implementation services that do not involve significant production, modification, or customization of software; and (3) one year of renewable PCS, which begins upon delivery of the software license. The total arrangement fee of $6 million is due at inception (January 1), and the one-year PCS can be renewed annually at a stated renewal rate of $1.5 million (the stated renewal rate establishes VSOE of fair value for the PCS). The implementation services begin on January 1, take six months to complete, will be provided ratably over the six-month period, and are not essential to the functionality of the software.
Application of Recognition Method 1
The PCS and services elements are combined into a single services element, and the total arrangement fee is recognized ratably; recognition begins once both the services and PCS terms have commenced. As a result, revenue of $500,000 is recognized for every month the combined service element exists (January to June). Upon completion of the implementation services, the remaining VSOE of fair value for the PCS is determined to be $750,000 ($1.5 million × 6/12 months). Therefore, upon completion of the implementation services and in addition to revenue previously recognized, $2.25 million ([$6 million – $3 million] – $750,000) is recognized as revenue and $750,000 will be recognized over the remaining PCS period.

Application of Recognition Method 2
The arrangement fee is deferred until the implementation services are completed (at which point PCS would be the only undelivered element). Upon completion of the implementation services, the remaining VSOE of fair value for the PCS is $750,000 ($1.5 million × 6/12 months). Therefore, upon completion of the implementation services, $5.25 million ($6 million – $750,000) is recognized as revenue and $750,000 will be recognized over the remaining PCS period.

2-16  Accounting for an Arrangement in Which the Undelivered Elements Are PCS and Services and VSOE of Fair Value Only Exists for the Services
ASC 985-605-25-9 and 25-10 provide guidance on how a vendor should recognize revenue in a software arrangement in which sufficient VSOE of fair value does not exist. ASC 985-605-25-9 and 25-10 require, among other things, that all revenue from the arrangement (including fees associated with delivered elements) be deferred until (1) PCS is the only undelivered element; (2) services that do not involve significant production, modification, or customization of software (“services”) are the only undelivered element; or (3) VSOE of fair value exists for all undelivered elements. However, ASC 985-605-25-9 and 25-10 do not specifically address how to account for the fee in an arrangement that contains both PCS and services when VSOE of fair value only exists for the services.

Question
How is an arrangement fee recognized in an arrangement that contains PCS and services when VSOE of fair value only exists for the services?

Answer
The following are two acceptable methods for recognizing the fee in an arrangement that contains PCS and services (provided that all other revenue recognition criteria are met) when VSOE of fair value only exists for the services:

1. If both the PCS and services have commenced and the services can be recognized ratably, the PCS element and the services element are combined into a single services element and the arrangement fee is recognized ratably over the combined service period (i.e., the longer of the PCS period or the services period). If the PCS is completed before the end of the services period, (1) the difference between the remaining deferred revenue and the VSOE of fair value for the remaining services can be recognized as revenue and (2) the remaining deferred revenue (based on VSOE) would be recognized ratably over the remaining services period. In a speech at the 2007 AICPA National Conference on Current SEC and PCAOB Developments, Sandie E. Kim, a professional accounting fellow in the SEC’s Office of the Chief Accountant, indicated that under this recognition method, “there is no inappropriate front-loading of revenue since revenue, including any significant discount that may be included in the arrangement, is recognized over the longest period of performance.”

2. Recognition of the arrangement fee is deferred until either the PCS element or the services element is the only undelivered element in the arrangement. If the PCS is completed before the end of the services period, (1) the difference between the remaining deferred revenue and the VSOE of fair value for the remaining services can be recognized as revenue and (2) the remaining deferred revenue (based on VSOE) would be recognized ratably over the remaining services period or as the services are performed. If the services are completed before the completion of the PCS, a vendor can record a cumulative catch-up of revenue in an amount equal to the total arrangement fee less the pro rata portion that applies to the remaining service period. The remaining amount of the arrangement fee would be recognized ratably over the remaining PCS period.
The choice of either of the above revenue recognition methods is an accounting policy election that a vendor should apply consistently.

**Example**

Company M enters into a software license arrangement that includes (1) a one-year time-based software license; (2) implementation services that do not involve significant production, modification, or customization of software; and (3) one year of PCS, which begins upon delivery of the software license. The total arrangement fee of $6 million is due at inception (January 1) when the implementation services begin. The implementation services take two years to complete and are not essential to the functionality of the software. Company M has historically sold these services separately and therefore has determined that VSOE of fair value for the implementation services is $5.4 million.

**Application of Recognition Method 1**

If the services can be recognized ratably, the PCS and services elements are combined into a single services element and the total arrangement fee is recognized ratably once both the PCS and services have commenced. As a result, revenue of $250,000 is recognized for every month the combined services element exists (all of year 1). Upon completion of the PCS, the remaining VSOE of fair value for the services is determined to be $2.7 million ($5.4 million × 12/24 months). Therefore, upon completion of the PCS and in addition to revenue previously recognized, $300,000 ([($6 million – $3 million] – $2.7 million) is recognized as revenue and $2.7 million will be recognized over the remaining services period.

**Application of Recognition Method 2**

The arrangement fee is deferred until the PCS is completed (at which point the implementation services would be the only undelivered element). Upon completion of the PCS, the remaining VSOE of fair value for the implementation services is $2.7 million ($5.4 million × 12/24 months). Therefore, upon completion of the PCS, $3.3 million ($6 million – $2.7 million) is recognized as revenue and $2.7 million will be recognized over the remaining implementation services period.

**2-17 Bifurcation of PCS Between Software Deliverables and Non-Software Deliverables**

*The following Q&A only applies to entities that have adopted ASU 2009-14.*

Vendor X sells equipment bundled with software that is essential to the functionality of the equipment (software A) and software that enhances, but is not essential to, the functionality of the equipment (software B). The arrangement includes PCS for both software A and software B. Vendor X has established VSOE of selling price for the PCS on the bundled software products. Upon adopting ASU 2009-14, X concludes that software A would be considered part of the nonsoftware deliverable and software B would be considered a separate software deliverable.

Vendor X continues to offer PCS on the bundle of software products (one of which will now be outside the scope of ASC 985-605 and one of which will remain within the scope of ASC 985-605. In accordance with ASC 985-605-25-10, as amended by ASU 2009-14, the vendor would bifurcate the PCS into two deliverables: (1) PCS for the “nonsoftware deliverables” outside the scope of ASC 985-605 and (2) PCS for the “software deliverables” accounted for under ASC 985-605.

**Question**

If VSOE of selling price exists for the PCS on the bundled software products, is it acceptable for X to conclude that VSOE of selling price exists for the separate bifurcated portions of PCS even though X does not sell the bifurcated portions of PCS separately?

**Answer**

Generally, yes. The determination of whether VSOE of selling price exists requires the use of professional judgment and depends on an analysis of the specific facts and circumstances unique to each arrangement. If VSOE of selling price exists for the PCS deliverable as a whole, it would generally be acceptable to conclude that VSOE of selling price exists for the bifurcated portions of PCS. The bifurcation guidance in ASC 985-605-25 was not intended to require vendors to separately sell each bifurcated component of PCS to establish VSOE of selling price.
Accounting for Arrangements in Which Undelivered Elements Are Essential to the Functionality of the Delivered Elements

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 ASC 605-35. (For further discussion of the circumstances in which application of ASC 605-35 is, or may be, appropriate, see ASC 985-605-25-2, ASC 985-605-25-77, ASC 985-605-25-83, and ASC 985-605-25-88, as well as other related paragraphs included in SOP 97-2’s Basis for Conclusions.)

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 ASC 985-605 focuses on “essential to the functionality” in the context of services, it is clear from the general guidance and the examples in ASC 985-605-55 that vendors are also required to consider whether additional undelivered products are essential to the functionality of the delivered elements.

ASC 985-605-25-12 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 element, 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’s 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 of 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, “Example 3: Additional Software Products — Price per Copy” in ASC 985-605-55-134 through 55-141 and “Example 6: Multiple-Element Arrangements — Products” in ASC 985-605-55-152 through 55-158, 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 ASC 985-605-25-13).

Additional Literature on the Concept of “Essential to the Functionality”

Question
In addition to ASC 985-605 should other sources of literature be considered in determining what constitutes “essential to the functionality” with respect to products or services?
Answer
Yes, however the guidance in those sources differs only subtly from that in ASC 985-605. SAB Topic 13 incorporated many of the principles in ASC 985-605, and while SAB Topic 13 does not address all elements of revenue recognition relating to multiple element arrangements, it does mention the topic. SAB Topic 13 discusses the concept of "essential to the functionality" in the context of up-front fees paid by customers in service transactions and provides indicators that may be useful in evaluating the concept in software and software-related arrangements.

SAB Topic 13.A.3(c) states:

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. [Footnote omitted]

The SAB goes on to state:

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. [Emphasis added and footnote omitted]

2-21 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.

2-22 Software Used With Multiple Units of an Electronic Device

The following Q&A only applies to entities that have adopted ASU 2009-14.

Certain products consist of software and related electronic devices (e.g., tracking software and its related electronic devices) in which (1) the software is more than incidental to the electronic devices, (2) the software has no utility without the electronic devices, and (3) the electronic devices have no utility without the software. Such software is often sold with one or more electronic devices, with additional devices available on a stand-alone basis. Because in such cases the electronic devices (hardware) and software function together to deliver the product’s essential functionality, both would be outside the scope of ASC 985-605 and subject to other applicable revenue guidance (e.g., ASC 605-25 or SAB Topic 13).

In these arrangements the software works with one device, but it is usually more cost-effective if multiple devices are used with it. An arrangement may require that a customer purchase, for a fixed fee, the software and only one electronic device but permit the customer to purchase a specified number of additional devices at a specified additional price per unit.

Question

In such an arrangement, 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. Because the software can be used once the customer has one electronic device, the seller should recognize the fixed fee when it delivers the software and the first electronic device to the customer. Revenue for each additional optional device sold should be recognized at the time of delivery.

**Example**

Company 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.

**2-23 Revenue Recognition for Hardware Deliverables in Software Arrangements**

The following Q&A only applies to entities that have not adopted ASU 2009-14.

As technology continues to advance, hardware deliverables are increasingly within the scope of ASC 985-605 because either (1) more-than-incidental software is embedded in the hardware product or (2) separate software is essential to the functionality of the hardware product. Vendors may sometimes deliver, over a long period, multiple hardware units for which VSOE of fair value does not exist.

**Question**

For undelivered units of hardware within the scope of ASC 985-605 for which VSOE does not exist, can revenue be recognized proportionately as units are delivered?

**Answer**

Yes. The SEC staff has accepted the view that when the remaining deliverables of a software arrangement are multiple units of the same hardware product, a vendor may recognize revenue proportionately as the hardware units are delivered.

Sandie E. Kim, professional accounting fellow in the SEC’s Office of the Chief Accountant, expressed this view in a speech at the 2007 AICPA National Conference on Current SEC and PCAOB Developments. Ms. Kim indicated in prepared marks that, by analogy to the treatment of PCS and services under ASC 985-605-25-10, she believes that a “reasonable application of the provisions of SOP 97-2 [codified as ASC 985-605] can result in proportionate recognition of revenue for hardware without VSOE of fair value if the remaining deliverables are multiple units of the same product.” She gave the following example:

> [A] company has an arrangement in which the remaining deliverables are 100 units of Hardware Product A and 200 units of Hardware Product B. VSOE of fair value does not exist for either hardware product and both hardware products are in the scope of SOP 97-2 [codified as ASC 985-605]. In this fact pattern, the staff would not object if revenue were recognized based on a consistent ratio of both products (that is, one unit of Product A for every two units of Product B). This methodology ensures that revenue is not prematurely recognized and that any discount in the arrangement is recognized proportionately.

Continuing on with the example, if four units of Product A were delivered at $10 per unit and four units of Product B were delivered at $15 per unit in a particular period, revenue would be limited to two units of Product A ($20) and four units of Product B ($60). If instead, two units of Product A were delivered and six units of Product B were delivered, revenue would likewise be limited to two units of Product A ($20) and four units of Product B ($60).

**2-24 Forfeiture or Refund Clauses**

ASC 985-605-25-13 states, in part, “[n]o 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 ASC 985-605-25-13 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:

<table>
<thead>
<tr>
<th>Element</th>
<th>VSOE of Fair Value</th>
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<tbody>
<tr>
<td>X</td>
<td>$500</td>
</tr>
<tr>
<td>Y</td>
<td>1,000</td>
</tr>
<tr>
<td>Z</td>
<td>250</td>
</tr>
</tbody>
</table>

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 (even though VSOE at fair value for Element Z is $250).

2-25 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. ASC 985-605-25-13 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 2-03, 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 ASC 460-10-55-31 through 55-33.

Evidence of an Arrangement

ASC 985-605

25-15 Practice varies with respect to the use of written contracts. Although a number of sectors of the industry rely upon signed contracts to document arrangements, other sectors of the industry that license software (notably the packaged software sector) do not.

25-16 If the vendor operates in a manner that does not rely on signed contracts to document the elements and obligations of an arrangement, the vendor should have other forms of evidence to document the transaction (for example, a purchase order from a third party or online authorization). If the vendor has a customary business practice of using written contracts, evidence of the arrangement is provided only by a contract signed by both parties.

25-17 Even if all other requirements set forth in this Subtopic for the recognition of revenue are met (including delivery), revenue shall not be recognized on any element of the arrangement unless persuasive evidence of an arrangement exists.
Whether a Customer’s Letter of Intent Represents Persuasive Evidence of an Arrangement

ASC 985-605-25-3 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.

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.

Definition of an Arrangement

Question

What is an arrangement as defined in ASC 985-605?

Answer

ASC 985-605 does not define the term “arrangement.” However, such literature 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 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 entered into an agreement with Customer 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 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 develops software for telecommunications service providers. Vendor D has a purchase agreement with Customer 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. ASC 985-605 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.

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 Has Occurred

ASC 985-605

25-18 The second criterion in paragraph 985-605-25-3 for revenue recognition is delivery. The principle of not recognizing revenue before delivery applies whether the customer is a user or a reseller. Except for arrangements in which the fee is a function of the number of copies, delivery is considered to have occurred upon the transfer of the product master or, if the product master is not to be delivered, upon the transfer of the first copy. For software that is delivered electronically, the delivery criterion in that paragraph is considered to have been met when either of the following has occurred:

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

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

25-19 In cases of electronic delivery such as described in the preceding paragraph, revenue shall be recognized if the other criteria in paragraph 985-605-25-3 have been satisfied.
2-30 Delivery in a Hosting Arrangement Within the Scope of ASC 985-605

**Question**
When is delivery deemed to occur in a hosting arrangement that is within the scope of ASC 985-605?

**Answer**
Revenue may not be recognized in a software arrangement if delivery of the software has not yet occurred. ASC 985-605-55-124 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, 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 ASC 985-605 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. 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.

2-31 Nonrefundable Licensing Fee Example

On December 20, 20X1, Company A enters into an agreement to license its software to Customer 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 ASC 985-605-55-103. This is consistent with the guidance in SAB Topic 13.A.3(d) (SAB 101 and SAB 104). The PCS fee should be recognized over the PCS term, which begins at inception of the license term.
2-32 License Extension Fee Example
Assume the same facts as in Q&A 2-31, except that on December 20, 20X3, Company A and Customer B execute an agreement to extend the license period for an additional two years. Under the agreement, B agrees to pay a nonrefundable extension fee of $500,000 due on December 20, 20X6. Normal payment terms for A are 30 days.

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

**Answer**
In accordance with ASC 985-605-55-105 through 55-109, 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 seven-year license. The date that the extension agreement is executed should be used to determine whether the arrangement contains extended payment terms. In this example, the extension agreement is signed as of December 20, 20X3, and the payment is not due until December 20, 20X6. Under ASC 985-605-25-33 through 25-35, 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). Since the fee would have been presumed not to be fixed or determinable at the date of the execution of the extension agreement, the fee would be recognized when it becomes due. Therefore, A should recognize the fee, less an appropriate deferral amount for PCS, when payment is due by B on December 20, 20X6, provided that all other requirements for revenue recognition have been met.

2-33 “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. ASC 985-605-25-18 notes that delivery does not have to involve a tangible product. Under ASC 985-605, 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.

2-34 Electronic Delivery via Download

**Question**
ASC 985-605-25-18 and 25-19 discuss 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 ASC 985-605-25-21).

**Delivery Has Occurred — Customer Acceptance**

**ASC 985-605**

25-21  After delivery, if uncertainty exists about customer acceptance of the software, license revenue shall not be recognized until acceptance occurs.

**2-35  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.

**2-36  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.

**2-37  Customer Acceptance Example**

**Example**

Vendor P has entered into an arrangement with Customer S for 10 copies of software to be delivered to 10 different branch locations of S. The arrangement requires minor modifications to be made to the software; however, the arrangement does not meet the requirements in ASC 985-605 for contract accounting. Once the modifications have been made to the software, a FAT is completed. The FAT consists of loading the software, as modified, onto hardware at P’s site to demonstrate to the customer that all significant performance criteria have been met. Once the FAT is completed and the customer accepts the software, the software is shipped to the S locations and installed. Subsequent to installation, a SAT is completed. The SAT is performed to ensure that the software, once installed on the customer’s hardware, functions 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, assuming all of the 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, also, should consider the significance of the timing of payment that, in this case, is due only upon successful completion of the SAT.
Delivery Has Occurred — Multiple Copies of Software Products Versus Multiple Licenses

ASC 985-605

25-22 Arrangements to use multiple copies of a software product under site licenses with users and to market multiple copies of a software product under similar arrangements with resellers shall be distinguished from arrangements to use or market multiple single licenses of the same software.

25-23 In a multiple copy arrangement, duplication is incidental to the arrangement and the delivery criterion is met upon the delivery of the first copy or product master. The vendor may be obligated to furnish up to a specified number of copies of the software, but only if the copies are requested by the user. The licensing fee is payable even if no additional copies are requested by the user or reseller. If the other criteria in this Subtopic for revenue recognition are met, revenue shall be recognized upon delivery of the first copy or product master. The estimated costs of duplication shall be accrued at that time.

25-24 In a multiple license arrangement, the licensing fee is a function of the number of copies delivered to, made by, or deployed by the user or reseller. Delivery occurs and revenue shall be recognized as the copies are made by the user or sold by the reseller if the other criteria in this Subtopic for revenue recognition are met.

2-38 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 ASC 985-605-25-33 through 25-36.

Example

Vendor S sells software that helps companies maintain and improve security over their computer systems. A large customer, X, has entered into a contract with S to purchase S’s software. This contract includes a volume discount arrangement in which the discounts increase in proportion to the number of copies of the software X purchases. However, this arrangement does not specify a minimum or maximum number of copies of software to be purchased. The volume discounts specified in the contract are greater than any discounts afforded to S’s other customers for this software.

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

2-39 Fixed Fee Licensing Example (Part I)

Vendor 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. In addition, B can purchase additional copies of the software (i.e., in excess of 5,000) for $50 per copy. 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

When should A recognize the $500,000 up-front, nonrefundable fee for the license agreement?
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Answer
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. ASC 985-605-55-87 indicates that additional copies of the same product are not considered an undelivered element.

2-40 Fixed Fee Licensing Example (Part II)
Vendor 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
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
If all other criteria for revenue recognition are met, A should recognize revenue at the price per copy upon delivery of each copy.

Delivery Has Occurred — Delivery Other Than to the Customer

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<th>ASC 985-605</th>
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2-41 Discussion of the Phrase “Another Site Specified by the Customer”

Question
In ASC 985-605-25-25, 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 licenses software to Customer 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. ASC 985-605 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.
2-42 Bill-and-Hold Arrangements

Question
How does ASC 985-605 apply to bill-and-hold arrangements?

Answer
ASC 985-605 does not specifically address bill-and-hold arrangements. In its discussion of SOP 91-1 (the predecessor to SOP 97-2 which was codified in ASC 985-605), 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 AAER No. 108 and SAB Topic 13.A.3(a), would apply.

Delivery Has Occurred — Delivery Agents and Authorization Codes

ASC 985-605

Delivery Agents

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

Authorization Codes

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.

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

a. The customer has licensed the software and the vendor has delivered a version of the software that is fully functional except for the permanent key or the additional keys (if additional keys are used to control the reproduction of the software).

b. The customer’s obligation to pay for the software and the terms of payment, including the timing of payment, are not contingent on delivery of the permanent key or additional keys (if additional keys are used to control the reproduction of the software).

c. The vendor will enforce and does not have a history of failing to enforce its right to collect payment under the terms of the original arrangement.

In addition, if a temporary key is used to enhance the vendor’s ability to collect payment, the delivery of additional keys, whether temporary or permanent, is not required to satisfy the vendor’s delivery responsibility if both of the following conditions are met:

a. The conditions in the preceding paragraph are met.

b. The use of a temporary key in such circumstances is a customary practice of the vendor.

Selective issuance of temporary keys may indicate that collectibility is not probable or that the software is being used only for demonstration purposes.

Fixed or Determinable Fees and Collectibility

ASC 985-605

The other prerequisite in paragraph 985-605-25-3 for revenue recognition is that both of the following conditions be met:

a. The vendor’s fee is fixed or determinable.

b. Collectibility is probable
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2-43 Factors to Consider When Assessing Collectibility

Question
ASC 985-605-25-30 through 25-40 discuss collectibility and its impact on revenue recognition. What factors should be considered when evaluating collectibility?

Answer
For the most part, ASC 985-605 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.

2-44 Modification of a Software License

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

Answer
ASC 985-605 does not specifically address modifications to software license arrangements, although ASC 985-605-25-33 does require that vendors consider the implications of concessions. Generally, previously recognized revenue is not affected and the vendor should determine the impact of a modification prospectively.

Example
Vendor V enters into a software license arrangement with Customer 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.
2-45 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.

2-46 Most-Favored-Customer Clauses

**Question**
Some vendors may include “most-favored-customer” pricing clauses in software licensing arrangements. These clauses guarantee that the price of software or other elements sold to a customer will not exceed the lowest price offered to any other customer. Do such clauses preclude vendors from concluding that fees are fixed or determinable at the outset of these arrangements?

**Answer**
Not necessarily. If a clause stipulates that most-favored-customer pricing applies only to transactions after a price change (i.e., the clause’s purpose is to ensure that the customer receives favorable pricing on future transactions rather than to entitle the customer to a refund on prior purchases), a vendor may conclude that the fees are fixed or determinable at the outset of the arrangement.

However, if the clause entitles the customer to a refund of a portion of the original fee in previous transactions in the event that the vendor subsequently reduces prices, the vendor may not be able to conclude that the arrangement fee is fixed or determinable at the outset of the arrangement (e.g., if the vendor cannot reasonably estimate future price changes or the vendor’s ability to maintain its price is uncertain). Such a clause would be considered a price-protection clause. For more information about price-protection clauses, see Q&A 2-60.

**Fixed or Determinable Fees and Collectibility — Extended Payment Terms**

**ASC 985-605**

25-33 A number of arrangements that call for fixed or determinable payments, including minimum royalties or license fees from resellers, specify a payment period that is short in relation to the period during which the customer is expected to use or market the related products. Other arrangements have payment terms that extend over a substantial portion of the period during which the customer is expected to use or market the related products. Because a product’s continuing value may be reduced due to the subsequent introduction of enhanced products by the vendor or its competitors, the possibility that the vendor still may provide a refund or concession to a creditworthy customer to liquidate outstanding amounts due under the original terms of the arrangement increases as payment terms become longer.

25-34 For the reason cited in the preceding paragraph, any extended payment terms in a software licensing arrangement may indicate that the fee is not fixed or determinable. Further, if payment of a significant portion of the software licensing fee is not due until after expiration of the license or more than 12 months after delivery, the licensing fee shall be presumed not to be fixed or determinable. However, this presumption may be overcome by evidence that the vendor has a standard business practice of using long-term or installment contracts and a history of successfully collecting under the original payment terms without making concessions. In such a situation, a vendor shall consider such fees fixed or determinable and shall recognize revenue upon delivery of the software, provided all other conditions for revenue recognition in this Subtopic have been satisfied.

25-35 If it cannot be concluded that a fee is fixed or determinable at the outset of an arrangement, revenue shall be recognized as payments from customers become due (assuming all other conditions for revenue recognition in this Subtopic have been satisfied).
2-47 Provisions of Extended Payment Terms

**Question**
Why does ASC 985-605-25-34 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 through 114 of the Basis for Conclusions of SOP 97-2 (which was codified in ASC 985-605) further discuss the AcSEC’s reasoning concerning the effect of extended payment terms on the determination of whether a fee is fixed or determinable.

2-48 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**
ASC 985-605-25-34 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:

<table>
<thead>
<tr>
<th>Payment Terms</th>
<th>License Fee May Not Be Fixed or Determinable</th>
<th>License Fee Presumed Not to Be Fixed or Determinable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Any extended payment terms</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Significant portion of the license fee not due</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>(expiration of the license)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Significant portion of the license fee not due</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>(more than 12 months after delivery)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2-49 Determination of What Constitutes a Significant Portion of a License Fee

**Question**
ASC 985-605-25-34 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, ASC 985-605 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.

2-50 Extended Payment Term Arrangement — Discussions With SEC Staff

Vendor T, a public company, sells integrated products. These products are primarily hardware but include an embedded software component. The software and hardware function together to deliver the products’ essential functionality. Because the software is essential to the integrated products’ functionality, the integrated products (including the software) are outside the scope of ASC 985-605. Before ASU 2009-14, T had accounted for this arrangement under ASC 985-605.
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 T does not yet have the requisite history of collecting the payments as they become due. Vendor T believes that its software will not become obsolete.

**Question**
How should T recognize revenue?

**Answer**

**Before ASU 2009-14**

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, ASC 985-605 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, now codified in ASC 985-605-25-33 through 25-35] 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.”

**After ASU 2009-14**

In this situation, T may need to recognize revenue as payments become due. Although this transaction is not within the scope of ASC 985-605, the guidance in ASC 985-605 may be considered by analogy. Furthermore, the SEC provided guidance in footnote 5 of SAB Topic 13.A.1, which states, in part:

> FASB ASC paragraphs 985-605-25-30 through 985-605-25-40 discuss how to apply the fixed or determinable fee criterion in software transactions. The staff believes that the guidance in FASB ASC paragraphs 985-605-25-30 through 985-605-25-31 and 985-605-25-36 through 985-605-25-40 is appropriate for other sales transactions where authoritative guidance does not otherwise exist. The staff notes that FASB ASC paragraphs 985-605-25-33 through 985-605-25-35 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. [Emphasis added]

Accordingly, the arrangement fee may not be considered fixed or determinable. On the basis of the specific facts listed above and without a history of collecting payments as they become due, T may not be able to support a presumption that it will not offer concessions if the software becomes obsolete before all of the contractual payments are received. As a result, T may need to recognize revenue as payments become due.

### 2-51 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 licenses software to Customer 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.

2-52 Payment Terms Greater Than 12 Months

Question

Does ASC 985-605 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.

ASC 985-605-55-22 through 55-25 provide 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.”

ASC 985-605 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 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.

2-53 Interest on Receivables

Question

Does ASC 835-30 apply to revenue recognized under ASC 985-605?
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**Answer**
Yes, ASC 835-30 would apply to revenue recognized under ASC 985-605 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.

ASC 835-30 (per ASC 835-30-15-3) excludes from its scope “[r]eceivables and payables arising from transactions with customers or suppliers in the normal course of business that 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, ASC 835-30 would apply even if the terms are for less than one year, provided that the fee is fixed or determinable.

**Example**
Vendor 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 ASC 835-30, record the net present value of the future payment stream as license revenue when the remaining criteria in ASC 985-605 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 ASC 835-30 to this arrangement but would record $200,000 of license revenue when each annual payment becomes due.

2-54 **Impact of Letters of Credit on the Evaluation of Extended Payment Terms**

**Question**
Company 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.

2-55 **Evaluating the Effect of Granting Concessions in Arrangements With Extended Payment Terms**

**Question**
What is the effect of granting concessions in arrangements with extended payment terms?

**Answer**
Regarding an arrangement for which a concession was granted, the vendor should evaluate whether the original fee continues to be fixed or determinable. If the vendor determines that the fee is no longer fixed or determinable, revenue would be recognized as payments become due (provided that all other criteria for revenue recognition are met). Generally, previously recognized revenue would not be affected. It may be difficult for the vendor to conclude that the fee continues to be fixed or determinable once a concession has been granted.
Regarding other existing and future arrangements with extended payment terms, ASC 985-605-25-34 indicates that a vendor must demonstrate a “history of successfully collecting under the original payment terms without making concessions” to overcome the presumption that a software license fee in an arrangement with extended payment terms is not fixed or determinable at the inception of the arrangement.

When evaluating whether granting concessions would preclude a determination that the arrangement fee is fixed or determinable at the outset of the arrangement, a vendor should consider the following factors:

- The **nature** of concessions made (i.e., why the vendor granted the concession).
- The **frequency** of concessions granted in relation to the overall volume of extended payment term arrangements in which the vendor collected without making concessions.
- The **significance** of concessions in relation to the total value of the arrangement.

Further, ASC 985-605-55-22 through 55-25 provide factors to consider in determining whether the vendor has “a history of successfully collecting under the original payment terms without making concessions.”

If a pattern of offering concessions develops, the vendor may not be able to demonstrate a successful collection history under the original terms of an arrangement. A pattern of making concessions would preclude the vendor from concluding that fees pursuant to extended payment arrangements are fixed or determinable at arrangement inception.

### 2-56 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. ASC 985-605-25-35 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 ASC 470-10-25-1 and 25-2. ASC 860-10 would not apply if the criteria in ASC 985-605 for recognizing revenue, and thereby, a receivable, are not met, since there is no financial asset to transfer. ASC 985-605-55-31 and 55-32 are consistent with this position.

Under ASC 470-10-25-1 and 25-2, 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. ASC 470-10-25-2 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 ASC 985-605 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 ASC 470-10-25-2. Therefore, the proceeds received from the transfer of the stream of future payments should be classified as debt in accordance with ASC 470-10-25-1 and 25-2.

### 2-57 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.
2-58  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)**
ASC 985-605-25-35 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.

**Fixed or Determinable Fees and Collectibility — Reseller Arrangements**

<table>
<thead>
<tr>
<th>ASC 985-605</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-36 For reseller arrangements, if any of the following factors or conditions exist, they also shall be considered in evaluating whether the fixed or determinable fee and collectibility criteria for revenue recognition are met:</td>
</tr>
<tr>
<td>a. Business practices, the reseller’s operating history, competitive pressures, informal communications, or other factors indicate that payment is substantially contingent on the reseller’s success in distributing individual units of the product. Contractual arrangements under which the reseller is obligated to pay only as and if sales are made to users shall be accounted for as consignments.</td>
</tr>
<tr>
<td>b. Resellers are new, undercapitalized, or in financial difficulty and may not demonstrate an ability to honor a commitment to make fixed or determinable payments until they collect cash from their customers.</td>
</tr>
<tr>
<td>c. Uncertainties about the potential number of copies to be sold by the reseller may indicate that the amount of future returns cannot be reasonably estimated on delivery. Examples of such factors include the newness of the product or marketing channel, competitive products, or dependence on the market potential of another product offered (or anticipated to be offered) by the reseller.</td>
</tr>
</tbody>
</table>
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d. Distribution arrangements with resellers require the vendor to rebate or credit a portion of the original fee if the vendor subsequently reduces its price for a product and the reseller still has rights with respect to that product (sometimes referred to as price protection). If a vendor is unable to reasonably estimate future price changes in light of competitive conditions, or if significant uncertainties exist about the vendor’s ability to maintain its price, the arrangement fee is not fixed or determinable. In such circumstances, revenue from the arrangement shall be deferred until the vendor is able to reasonably estimate the effects of future price changes and the other conditions in this Subtopic have been satisfied.

2-59 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 2-60).

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 licenses 100 copies of its software to Reseller 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.

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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 enters into a three-year enterprise-wide software license with an end user, Customer 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 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 ASC 605-15 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).

2-60 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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2-61 Recognition of Fees in Arrangements Involving Newly Established or Undercapitalized Resellers

ASC 985-605-25-36 lists factors for a vendor to consider in evaluating whether fees associated with reseller arrangements meet the fixed-or-determinable and collectibility criteria for revenue recognition. One of those factors is whether the reseller is new or undercapitalized and, therefore, whether it can demonstrate an ability to honor the payment commitments under the arrangement.

Question
How should a vendor recognize fees in an arrangement involving new or undercapitalized resellers that cannot demonstrate an ability to honor payment commitments under the arrangement?

Answer
In an arrangement in which a new or undercapitalized reseller cannot demonstrate an ability to honor payment commitments under the arrangement, a vendor may need to defer recognition of arrangement fees until the vendor collects cash from an undercapitalized reseller.

If the reseller is new, it may not have the ability to pay the vendor until it collects cash from its customers. In addition, the vendor has yet to establish a history of successfully collecting from the reseller without granting concessions, refunds, or forfeitures. Also, if the reseller is undercapitalized, it may not have the ability to honor all, or a portion, of its payment obligations that require the vendor to potentially grant concessions to the reseller. In such cases, it may be inappropriate for the vendor to recognize revenue before cash collection until a history of successfully collecting from the reseller is established.

Fixed or Determinable Fees and Collectibility — Customer Cancellation Privileges

ASC 985-605

25-37 Fees from licenses cancelable by customers are neither fixed nor determinable until the cancellation privileges lapse. Fees from licenses with cancellation privileges expiring ratably over the license period are considered to become determinable ratably over the license period as the cancellation privileges lapse. In applying the provisions of this paragraph, obligations related to warranties for defective software, including warranties that are routine, short-term, and relatively minor, shall be accounted for in conformity with Topic 450. Additionally, short-term rights of return, such as 30-day money-back guarantees, shall not be considered cancellation privileges; the related returns shall be accounted for in conformity with that Topic.

2-62 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.

Fixed or Determinable Fees and Collectibility — Fiscal Funding Clauses

ASC 985-605

25-38 Fiscal funding clauses sometimes are found in software license arrangements in which the licensees are governmental units. Such clauses generally provide that the license is cancelable if the legislature or funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligations under the licensing arrangement.
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ASC 985-605 (continued)

25-39 Consistent with paragraph 840-10-25-3, a software licensing arrangement with a governmental unit containing a fiscal funding clause shall be evaluated to determine whether the uncertainty of a possible license arrangement cancellation is a remote contingency. The evaluation of whether the level of uncertainty of possible cancellation is remote shall be consistent with Topic 450, which defines remote as relating to conditions in which the chance of the future event or events occurring is slight.

25-40 If the likelihood is assessed as remote, the software licensing arrangement shall be considered noncancelable. Such an assessment shall include the factors discussed in paragraphs 958-605-25-33 through 25-34. If the likelihood is assessed as other than remote, the license shall be considered cancelable, thus precluding revenue recognition. A fiscal funding clause with a customer other than a governmental unit that is required to include such a clause creates a contingency that precludes revenue recognition until the requirements of the clause and all other provisions of this Subtopic have been satisfied.

2-63 Fiscal Funding Clause With Customers Other Than Government Organizations

Question
Why do ASC 985-605-25-39 and 25-40 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 ASC 985-605 was included in response to a question that arose about whether software licensing arrangements should be covered by ASC 840-10-25-3. 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 enters into a three-year software license agreement with Customer 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

ASC 985-605

25-41 As discussed in paragraph 985-605-25-5, multiple-element arrangements to which contract accounting does not apply may include customer rights to any combination of additional software deliverables, services, or postcontract customer support. If contract accounting does not apply, individual elements in such arrangements shall be accounted for in accordance with paragraphs 985-605-25-3 through 25-14.
ASC 985-605 (continued)

25-42 The following guidance addresses various considerations related to multiple-element arrangements, specifically:

a. Additional software deliverables and rights to exchange or return software (see paragraphs 985-605-25-43 through 25-65), including:
   1. Upgrades or enhancements (see paragraphs 985-605-25-44 through 25-46)
   2. Additional software products (see paragraphs 985-605-25-47 through 25-59)
   3. Rights to exchange or return software (see paragraphs 985-605-25-60 through 25-65).

b. Postcontract customer support (see paragraphs 985-605-25-66 through 25-75), including:
   1. Postdelivery telephone support at no additional charge (see paragraph 985-605-25-74)
   2. Postcontract customer support granted to resellers (see paragraph 985-605-25-75).

c. Services (see paragraphs 985-605-25-76 through 25-87), including:
   1. Funded software-development arrangements (see paragraphs 985-605-25-86 through 25-87).

2-64 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 ASC 985-605, 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 ASC 985-605 to Software and Software Related Elements

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


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Application of ASC 985-605 to Software and Software Related Elements (continued)

<table>
<thead>
<tr>
<th>Fair Value Factors That Affect the Timing and Amount of Revenue Recognized When Software Has Been Delivered</th>
<th>Undelivered Elements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional Products</td>
<td></td>
</tr>
<tr>
<td>Unspecified Products</td>
<td>Specified Products</td>
</tr>
<tr>
<td>Arrangement fee is discounted and VSOE of fair value of each element exists.</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Multiple Element Arrangements — Upgrades or Enhancements

ASC 985-605

25-43 As part of a multiple-element arrangement, a vendor may agree to deliver software currently and to deliver additional software in the future. The additional deliverables may include upgrades, enhancements, or additional software products. Additionally, a vendor may provide the customer with the right to exchange or return software, including the right to transfer software from one hardware platform or operating system to one or more other platforms or operating systems (a platform-transfer right).

Upgrades or Enhancements

25-44 As part of a multiple-element arrangement, a vendor may agree to deliver software currently and provide the customer with an upgrade right for a specified upgrade or enhancement. The upgrade right may be evidenced by a specific agreement, commitment, or the vendor’s established practice. (Rights to receive unspecified upgrades or enhancements on a when-and-if-available basis are postcontract customer support.) The upgrade right shall be accounted for as a separate element in accordance with paragraphs 985-605-25-3 through 25-14. Guidance on the application of those paragraphs to multiple-element software arrangements that include upgrade rights is in paragraphs 985-605-25-45 through 25-46.

25-45 If a multiple-element arrangement includes an upgrade right, the fee shall be allocated between the elements based on vendor-specific objective evidence of fair value. The fee allocated to the upgrade right is the price for the upgrade or enhancement that would be charged to existing users of the software product being updated. If the upgrade right is included in a multiple-element arrangement on which a discount has been offered (see paragraph 985-605-25-8), no portion of the discount shall be allocated to the upgrade right. If sufficient vendor-specific evidence exists to reasonably estimate the percentage of customers that are not expected to exercise the upgrade right, the fee allocated to the upgrade right shall be reduced to reflect that percentage. This estimated percentage shall be reviewed periodically. The effect of any change in that percentage shall be accounted for as a change in accounting estimate.

25-46 The amount of the fee allocated to the upgrade right shall be recognized as revenue when the conditions in paragraphs 985-605-25-3 through 25-14 are met. If sufficient vendor-specific objective evidence does not exist for the allocation of the fee to the upgrade right, revenue from the arrangement shall be deferred until the earlier of either:

a. The point at which such sufficient vendor-specific objective evidence does exist.

b. The point at which all elements of the arrangement have been delivered.

2-65 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 is currently negotiating with a customer to sell Customer 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.

2-66 Specified Versus Unspecified Products or Upgrades
ASC 985-605 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. ASC 985-605 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, ASC 985-605 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 a 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.

2-67 Product Roadmaps
A product “roadmap” is a marketing tool that provides existing and potential customers with information about future development plans, including information about future upgrades or enhancements to the product.

Question
What is the accounting implication of a vendor’s providing a product roadmap to customers?

Answer
Determining the accounting implications of a product roadmap requires a significant amount of judgment in evaluating whether a vendor has promised to provide a future product or service. One factor, in and of itself, is not necessarily conclusive. However if the product roadmap implies that the vendor has promised to provide future products or services, the vendor should determine whether those products or services represent additional elements in the arrangement.

For instance, a product roadmap may describe a future upgrade in sufficient detail to communicate the specific features, functionality, and release date to a customer. In addition, the product roadmap may specifically apply to one customer or a few customers. Such circumstances may lead the customer(s) to expect the vendor to deliver the upgrade as part of an arrangement. In such cases, an implicit specified upgrade right may be deemed to exist, requiring the vendor to treat the upgrade right as a separate element in the arrangement.

In other circumstances, the vendor may include caveat language in the product roadmap that explicitly states that the roadmap does not represent a commitment, obligation, or promise to deliver any products to the customer. The roadmap may also state that it is merely intended to outline the general product development plans and that customers should not rely on it when making a purchasing decision. While not determinative, such caveat language, combined with other factors, may represent circumstances that may not lead the customer to expect that he or she will receive the products. In addition, the vendor may have a history of separately charging a substantive amount for the upgrades included in the product roadmap. In such cases, the future delivery of an upgrade may be significantly uncertain and the upgrade right may not be a separate element in the arrangement.

2-68 Example of Determining Whether a PCS Contract Includes a Specified Upgrade
Vendor 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 ASC 985-20-20: “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.”
2-69  Upgrades to Software for Compliance With Internet Protocol Version 6

Internet Protocol version 4 (IPv4) is currently the primary IP technology used to transfer data on the Internet. IPv4 is in the process of being replaced by a new version, IPv6. Software products that use IPv4 technology to transfer data will need to be upgraded to support IPv6 to communicate with and transfer data to other applications. (Note that certain software products, such as those that use domain name servers instead of IP technology to transfer data, will not require an upgrade.)

**Question**

Is a commitment to deliver an IPv6-compliant software product (or upgrade) in the future to an existing customer, or to a customer that is acquiring a non-IPv6 version of the product, considered a specified upgrade?

**Answer**

Yes. The required software upgrades for IPv6 technology are similar to the required upgrades for Year 2000 compliant software in AICPA TIS Section 5100.40† and would be accounted for in accordance with ASC 985-605-25-44 through 25-46 as specified upgrades to the extent that they are included as a deliverable in a software arrangement, even if the commitment is contained under a warranty provision.

2-70  Prohibition of Allocation of Discounts to Specified Upgrade Rights

**Question**

Why did the AcSEC include the provisions in paragraph 37 of SOP 97-2 (codified at ASC 985-605-25-45), 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 the Basis for Conclusions to 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.

The following example illustrates how to allocate a discount in a multiple-element arrangement that includes a specified upgrade right.

**Example**

Vendor A licenses Version 1.0 of a foreign language translation software program to Customer B for $10,000. The licensing agreement is bundled with a one-year PCS agreement. Version 1.1 of the software, which includes 30 additional languages, will soon be available. Under the terms of the arrangement, B has a right to receive the upgrade for no additional fee.

VSOE of fair value for the Version 1.0 license and the Version 1.1 upgrade (for existing users) is $9,000 and $4,000, respectively. VSOE of fair value for the PCS is $1,000.

Under ASC 985-605, A would not be permitted to allocate the discount of $4,000 to the specified upgrade rights. Rather, A should apply a proportional amount of the discount to the remaining elements on the basis of their relative fair values. That is, A should apply $3,600 (90% × $4,000) of the discount to the Version 1.0 license and $400 (10% × $4,000) to the PCS. Therefore, Vendor A would allocate $5,400 ($9,000 – $3,600) of the arrangement consideration to the Version 1.0 license, $600 ($1,000 – $400) to the PCS, and $4,000 to the specified upgrade right to Version 1.1.

Further, in accordance with ASC 985-605-25-9, if VSOE of fair value for the right to Version 1.1 does not exist, A would defer revenue for the entire arrangement until the earlier of (1) the delivery of Version 1.1 or (2) the establishment of VSOE of fair value for Version 1.1.

2-71  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 the estimate of the number of customers that are not expected to exercise their upgrade rights?

1 AICPA TIS Section 5100.40 was not codified in the FASB Accounting Standards Codification since it no longer applies to current accounting.
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 ASC 250-10-45-17 through 45-20.

2-72 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: (1) the specified upgrade is delivered, (2) there is VSOE of fair value for the specified upgrade, or (3) 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.

Multiple Element Arrangements — Additional Software Products

<table>
<thead>
<tr>
<th>ASC 985-605</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Additional Software Products</strong></td>
</tr>
<tr>
<td>25-47 As part of a multiple-element arrangement, a vendor may agree to deliver software currently and deliver specified additional software products in the future. The rights to these additional products may be included either in the terms of a postcontract customer support arrangement or in a separate agreement. Even if the rights to the additional software products are included in a postcontract customer support arrangement, the revenue allocable to the additional software products shall be accounted for separately from the postcontract customer support arrangement as an element of a multiple-element arrangement.</td>
</tr>
<tr>
<td>25-48 Multiple-element arrangements that include rights to undelivered additional software products that are not subscriptions (see paragraphs 985-605-25-58 through 25-59) shall be accounted for in accordance with paragraphs 985-605-25-3 through 25-14. Guidance on the application of those paragraphs to such arrangements is provided in paragraphs 985-605-25-49 through 25-57.</td>
</tr>
<tr>
<td>25-49 The fee from the arrangement shall be allocated among the products based on vendor-specific objective evidence of fair value. The allocation shall be based on the relative sales prices of the products, determined pursuant to paragraphs 985-605-25-6 through 25-8. If vendor-specific objective evidence of fair value does not exist, paragraph 985-605-25-9 requires that all revenue from the arrangement be deferred until the earlier of either:</td>
</tr>
<tr>
<td>a. The point at which such sufficient vendor-specific objective evidence does exist.</td>
</tr>
<tr>
<td>b. The point at which all elements of the arrangement have been delivered.</td>
</tr>
<tr>
<td>25-50 The fee allocated to the additional software products shall not be reduced by the percentage of any customers that are not expected to exercise the right to receive additional software products.</td>
</tr>
<tr>
<td>25-51 If the arrangement is based on a price per product (not a price per copy), the portion of the fee allocated to a product shall be recognized as revenue when the product is delivered, assuming all other provisions of paragraph 985-605-25-3 through 25-14 are met.</td>
</tr>
<tr>
<td>25-52 Some fixed fee license or reseller arrangements provide customers with the right to reproduce or obtain copies at a specified price per copy (rather than per product) of two or more software products up to the total amount of the fixed fee. A number of the products covered by the arrangement may not be deliverable or specified at the inception of the arrangement. Although the price per copy is fixed at the inception of the arrangement, an allocation of the arrangement fee to the individual products generally cannot be made, because the total revenue allocable to each software product is unknown and depends on the choices to be made by the customer and, sometimes, future development activity while the arrangement is in effect. Nevertheless, as discussed in paragraph 985-605-25-56, in certain situations, revenue can be allocated to the products that are undeliverable or not specified at the inception of the arrangement.</td>
</tr>
</tbody>
</table>
Section 2 — Recognition
Software Revenue Recognition: A Roadmap to Applying ASC 985-605

ASC 985-605 (continued)

25-53 In arrangements in which no allocation can be made, until the first copy or product master of each product covered by the arrangement has been delivered to the customer assuming the provisions of paragraphs 985-605-25-3 through 25-14 are met, revenue shall be recognized as copies of delivered products either:

   a. Are reproduced by the customer.

   b. Are furnished to the customer if the vendor is duplicating the software.

25-54 Once the vendor has delivered the product master or the first copy of all products covered by the arrangement, any licensing fees not previously recognized shall be recognized. (At that point, only duplication of the software is required to satisfy the vendor’s delivery requirement. As discussed in paragraphs 985-605-25-22 through 25-24, duplication of the software is incidental to the arrangement, and delivery is deemed to have occurred upon delivery of the product master or first copy.) When the arrangement terminates, the vendor shall recognize any licensing fees not previously recognized.

25-55 The revenue from the kind of arrangements discussed in the preceding two paragraphs shall not be recognized fully until either of the following conditions is met:

   a. Delivery is complete for all products covered by the arrangement.

   b. The aggregate revenue attributable to all copies of the software products delivered is equal to the fixed fee, provided that the vendor is not obligated to deliver additional software products under the arrangement.

25-56 Nevertheless, certain arrangements that include products that are not deliverable at the inception impose a maximum number of copies of the undeliverable product(s) to which the customer is entitled. In such arrangements, a portion of the arrangement fee shall be allocated to the undeliverable product(s). This allocation shall be made assuming that the customer will elect to receive the maximum number of copies of the undeliverable product(s).

25-57 The revenue allocated to the delivered products shall be recognized when the product master or first copy is delivered. If, during the term of the arrangement, the customer reproduces or receives enough copies of these delivered products so that revenue allocable to the delivered products exceeds the revenue previously recognized, such additional revenue shall be recognized as the copies are reproduced or delivered. The revenue allocated to the undeliverable product(s) shall be reduced by a corresponding amount.

25-58 As part of a multiple-element arrangement with a user, a vendor may agree to deliver software currently and to deliver unspecified additional software products in the future (including unspecified platform transfer rights that do not qualify for exchange accounting as described in paragraphs 985-605-25-60 through 25-65). For example, the vendor may agree to deliver all new products to be introduced in a family of products over the next two years. These arrangements are similar to arrangements that include postcontract customer support in that future deliverables are unspecified. Nevertheless, they are distinguished from arrangements that include postcontract customer support because the future deliverables are products, not unspecified upgrades or enhancements.

25-59 The software elements of the kinds of arrangements discussed in paragraph 985-605-25-58 shall be accounted for as subscriptions. No allocation of revenue shall be made among any of the software products, and all software product-related revenue from the arrangement shall be recognized ratably over the term of the arrangement beginning with delivery of the first product. If the term of the arrangement is not stated, the revenue shall be recognized ratably over the estimated economic life of the products covered by the arrangement, beginning with delivery of the first product. An intent on the part of the vendor not to develop new products during the term of the arrangement does not relieve the vendor of the requirement to recognize revenue ratably over the term of the arrangement, beginning with the delivery of the first product.

2-73 Specified Upgrade Right Versus Additional Software Product

ASC 985-605-25-8, ASC 985-605-25-45, and ASC 985-605-25-49 and 25-50 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, ASC 985-605 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. ASC 985-605-25-64 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.

2-74 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 sells software to Reseller 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 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 sells software to Reseller 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.

ASC 985-605-25-9 and 25-10 require 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 sells software to Reseller 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 (ASC 985-605-25-67) 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
Vendor A should estimate the useful life of the software. Revenue should be recognized ratably (ASC 985-605-25-67) over this estimated useful life, beginning when the gold disk has been delivered.

2-75 Accounting for Unspecified Software Products
Vendor X develops and distributes self-study information technology training courses. Vendor X enters into an arrangement with Customer 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 (ASC 985-605-25-59) over the term of the arrangement, beginning with the delivery of the first course (i.e., subscription accounting).
### Multiple Element Arrangements — Rights to Exchange or Return Software

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#### Rights to Exchange or Return Software

25-60 As part of an arrangement, a software vendor may provide the customer with the right to return software or to exchange software for products with no more than minimal differences in price, functionality, or features. The accounting for returns is significantly different from the accounting for exchanges. Although it is sometimes difficult to determine whether a transaction is a return or exchange of software, the fact that the software is not returned physically does not preclude accounting for the transaction as either an exchange or as a return. If the software is not returned physically and the customer contractually is entitled to continue to use the previously delivered software, the arrangement shall be accounted for in the manner prescribed in paragraphs 985-605-25-47 through 25-59. If the software is not returned physically and the customer contractually is not entitled to continue to use the previously delivered software, the transaction shall be accounted for either as a return or as an exchange, as discussed in paragraphs 985-605-25-61 through 25-65.

25-61 If the rights discussed in the preceding paragraph are offered to users (but not resellers), the exchanges are analogous to exchanges by ultimate customers of one item for another of the same kind, quality, and price that are not considered returns described in paragraph 605-15-25-1(f). Conversely, exchanges by users of software products for dissimilar software products or for similar software products with more than minimal differences in price, functionality, or features are considered returns, and revenue related to arrangements that provide users with the rights to make such exchanges shall be accounted for in conformity with Subtopic 605-15. If the software is not returned physically and the customer contractually is not entitled to continue to use the previously delivered software, the transaction shall be accounted for either as a return or as an exchange, as discussed in paragraphs 985-605-25-61 through 25-65.

25-62 As part of a multiple-element arrangement, a vendor may grant a user a platform-transfer right. Depending on the circumstances, the exercise of a platform-transfer right may represent an exchange, a return, or additional software products for accounting purposes. If the customer contractually is entitled to continue to use the software that was delivered originally (in addition to the software that is to be delivered for the new platform), the platform transfer right shall be accounted for in the manner prescribed in paragraphs 985-605-25-47 through 25-59.

25-63 The guidance in the following paragraph applies if all of the following conditions are met:

a. As part of a multiple-element arrangement, a vendor offers a user (not a reseller) a platform-transfer right.

b. The provisions of paragraphs 985-605-25-3 through 25-14 are met.

c. The platform-transfer right meets both of the following conditions:
   1. It is for the same product (see paragraph 985-605-25-64).
   2. It does not increase the number of copies or concurrent users of the software product available under the license arrangement.

25-63A If all of the conditions in the preceding paragraph are met, the entity shall do both of the following:

a. Recognize the revenue from the software license upon the initial delivery of the software.

b. Treat the exercise of the platform-transfer right as an exchange.

25-64 Products are considered to be the same product if there are no more than minimal differences among them in price, features, and functions, and if they are marketed as the same product, even though there may be differences arising from environmental variables such as operating systems, databases, user interfaces, and platform scales. Indicators that products are marketed as the same product include the same product name (although version numbers may differ) and a focus on the same features and functions.

25-65 As part of their standard sales terms or as a matter of practice, vendors may grant resellers the rights to exchange unsold software for other software, including software that runs on a different hardware platform or operating system. Because the reseller is not the ultimate customer (see paragraph 985-605-25-61), such exchanges, including those referred to as stock balancing arrangements, shall be accounted for as returns. Arrangements that grant rights to make such exchanges shall be accounted for in conformity with Subtopic 605-15, even if the vendors require the resellers to purchase additional software to exercise the exchange rights.

### 2-76 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 ASC 985-605-25-60 (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 ASC 985-605-25-60 (i.e., the products to be exchanged have more-than-minimal differences in price, functionality, or features) is considered a **right of return**.

2-77 **Accounting for Return or Exchange Rights in Conformity With ASC 605-15**

**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 ASC 450).

**Returns** — In addition to the requirements in ASC 985-605-25-3 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 ASC 450. The other conditions of ASC 605-15-25-1 are summarized in the requirements of ASC 985-605-25-3 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. ASC 605-15-25-3 indicates:

- Any of the following factors may impair the ability to make a reasonable estimate:
  - The susceptibility of the product to significant external factors, such as technological obsolescence or changes in demand
  - Relatively long periods in which a particular product may be returned
  - 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 entity’s marketing policies or relationships with its customers
  - Absence of a large volume of relatively homogeneous transactions.

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

2-78 **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. ASC 985-605-55-100 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 of the products within the license mix.” Subsequent remixing is not considered an exchange or a return.

2-79 **Product Cost**

**Question**

Under ASC 985-605 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 ASC 985-605. 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.

2-80 Factors to Consider in Determining Whether There Are More-Than-Minimal Differences Between Products

Question

ASC 985-605-25-61 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, a vendor should have persuasive evidence that no more-than-minimal differences will exist between the price, features, and functions of the two 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

A vendor should consider the following factors in making this determination:

- The functions and features of the undelivered product versus those of the delivered product.
- The price of each product.
- The marketing approach for each product (including the name of the 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.

It may be difficult to find persuasive evidence that products whose development has not yet commenced or that are in a very early stage will not have more-than-minimal differences. Therefore, circumstances in which exchange accounting applies are expected to be rare.

Example 1

Vendor A licenses anti-virus software (Product Y) to customers for $100. Vendor A offers new customers who purchase Y the opportunity to exchange the purchased product for the next version of Y currently being developed.

In the absence of persuasive evidence that there will be no more-than-minimal differences between the new product and Y, the right to exchange Y for the new product should be accounted for as a right of return. It is unlikely that customers would want to exchange their existing product for a new product unless there are more-than-minimal differences in functionality and features. As a result, in accordance with ASC 985-605-25-61, such a right would be accounted for in conformity with ASC 605-15-25-1 through 25-4.

Example 2

Assume the same facts as in Example 1 except that the customer maintains the contractual ability to use Y after it has received the new product. In this case, A should account for the right as an additional product in the arrangement. Therefore, a portion of the arrangement fee should be allocated (on the basis of VSOE) to the additional product. If VSOE is not established for that additional product, revenue from the arrangement should be deferred until VSOE is established for the additional product or all elements in the arrangement have been delivered. When VSOE exists for the additional product, the fee allocated to the additional product may not be reduced to reflect the percentage of customers not expected to receive it.

2-81 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 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 (ASC 985-605-25-59), 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 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.

2-82 Transactions With Resellers

**Question**

Do the provisions of ASC 985-605-25-60 through 25-65 concerning rights to exchange or return software for end-user customers apply to transactions with resellers?

**Answer**

Yes, except that ASC 985-605 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, ASC 985-605 requires subscription accounting if the vendor agrees to provide unspecified platform-transfer rights to a reseller.

2-83 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 ASC 605-15, 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.
Multiple Element Arrangements — Postcontract Customer Support

**ASC 985-605**

**Postcontract Customer Support**

25-66 Software arrangements may include the right to postcontract customer support. Postcontract customer support includes the right to receive postcontract customer support services or unspecified upgrades or enhancements, or both, offered to users or resellers. A vendor may develop historical patterns of regularly providing all customers or certain kinds of customers with the services or unspecified upgrades or enhancements normally associated with postcontract customer support, or may anticipate doing so, even though there is no written contractual obligation or the stipulated postcontract customer support term commences at some date after delivery. In those situations, an implied postcontract customer support arrangement exists that commences upon product delivery. For purposes of applying the guidance in this Subtopic, postcontract customer support includes a vendor’s expected performance based on such patterns, even if performance is entirely at the vendor’s discretion and not pursuant to a formal agreement.

25-67 If a multiple-element software arrangement includes explicit or implicit rights to postcontract customer support, the total fees from the arrangement shall be allocated among the elements based on vendor-specific objective evidence of fair value, in conformity with paragraphs 985-605-25-6 through 25-7. The fair value of the postcontract customer support shall be determined by reference to the price the customer will be required to pay when it is sold separately (that is, the renewal rate). The portion of the fee allocated to postcontract customer support shall be recognized as revenue ratably over the term of the postcontract customer support arrangement, because the postcontract customer support services are assumed to be provided ratably.

25-68 However, revenue shall be recognized over the period of the postcontract customer support arrangement in proportion to the amounts expected to be charged to expense for the postcontract customer support services rendered during the period if both of the following conditions exist:

a. Sufficient vendor-specific historical evidence exists demonstrating that costs to provide postcontract customer support are incurred on other than a straight-line basis. In making this determination, the vendor shall take into consideration allocated portions of cost accounted for as research and development costs and the amortization of costs related to the upgrade or enhancement capitalized in conformity with Subtopic 985-20. Such costs shall be considered as part of the costs to provide postcontract customer support.

b. The vendor believes that it is probable that the costs incurred in performing under the current arrangement will follow a similar pattern.

25-69 Because the timing, frequency, and significance of unspecified upgrades or enhancements can vary considerably, the point at which unspecified upgrades or enhancements are expected to be delivered shall not be used to support income recognition on other than a straight-line basis.

25-70 If sufficient vendor-specific objective evidence does not exist to allocate the fee to the separate elements and the only undelivered element is postcontract customer support, the entire arrangement fee shall be recognized ratably over either of the following:

a. The contractual postcontract customer support period for those arrangements with explicit rights to postcontract customer support

b. The period during which postcontract customer support is expected to be provided for those arrangements with implicit rights to postcontract customer support.

25-71 Postcontract customer support revenue may be recognized together with the initial licensing fee on delivery of the software if all of the following conditions are met:

a. The postcontract customer support fee is included with the initial licensing fee.

b. The postcontract customer support included with the initial license is for one year or less.

c. The estimated cost of providing postcontract customer support during the arrangement is insignificant.

d. Unspecified upgrades or enhancements offered during postcontract customer support arrangements historically have been and are expected to continue to be minimal and infrequent.

25-72 If postcontract customer support revenue is recognized upon the delivery of the software, the vendor shall accrue all estimated costs of providing the services, including upgrades or enhancements. Upgrades or enhancements are not developed solely for distribution to postcontract customer support customers; revenues are expected to be earned from providing the enhancements to other customers as well. Therefore, costs shall be allocated between postcontract customer support arrangements and other licenses.

25-73 A determination that unspecified upgrades or enhancements offered during the postcontract customer support arrangement are expected to be minimal and infrequent shall be evidenced by the patterns of minimal and infrequent unspecified upgrades or enhancements offered in previous postcontract customer support arrangements. A conclusion that unspecified upgrades or enhancements are expected to be minimal and infrequent shall not be reached simply because unspecified upgrades or enhancements have been or are expected to be offered less frequently than on an annual basis. Regardless of the vendor’s history of offering unspecified upgrades or enhancements to initial licensees, postcontract customer support shall be accounted for separately from the initial licensing fee if the vendor expects to offer upgrades or enhancements that are greater than minimal or more than infrequent to the users or resellers of the licensed software during the postcontract customer support arrangement.
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 enters into an arrangement with Customer 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.

Specified Versus Unspecified Upgrades or Enhancements

Question
Why does ASC 985-605-25-66 differentiate between specified and unspecified upgrades or enhancements?

Answer
The accounting for specified (upgrade rights) and unspecified (PCS) upgrades or enhancements differs under ASC 985-605. 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.

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 postcontract customer support 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 (ASC 985-605-25-67) 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 ASC 985-605, 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 (ASC 985-605-25-45). 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 (ASC 985-605-25-67) 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.

2-87 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., postcontract customer support or PCS) during the term of the arrangement, how should the PCS arrangement be accounted for under ASC 985-605?

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 ASC 605-15 — i.e., treated as a right of return with an accrual for estimated “returns.” Under ASC 985-605, 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 (ASC 985-605-25-67) 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.
Examples of VSOE of Fair Value in Bundled Arrangements

Example 1
Vendor 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) (ASC 985-605-25-45) 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 (ASC 985-605-25-67) 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 ASC 985-605, 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 (ASC 985-605-25-45). 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.

Warranties on Software Licenses

Question
Is a warranty considered an implied PCS element under ASC 985-605?

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 ASC 450. 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 ASC 985-605-25-71 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.

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 ASC 985-605 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 withASC 985-605-25-70.

### 2-91 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 postcontract customer support, ASC 985-605-25-66 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, 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.

### 2-92 Determining the Method to Use in Establishing VSOE of Fair Value for PCS
Historically, Vendor V has used the stated PCS renewal rate in its software arrangements to establish VSOE of fair value.

**Question**
If V enters an arrangement without a stated or a substantive renewal rate, can V use another method to establish VSOE of fair value for PCS?
Answer
Yes. If V cannot establish VSOE of fair value by using a substantive renewal rate, V can establish VSOE by using separate sales if such sales are priced within a reasonably narrow range (see Q&A 2-06).

ASC 985-605-25-6 limits VSOE of fair value to “the price charged when the same element is sold separately.” Further, ASC 985-605-25-67 states that “[t]he fair value of the postcontract customer support shall be determined by reference to the price the customer will be required to pay when it is sold separately (that is, the renewal rate).”

If V enters into an arrangement with a renewal rate that is either not stated or not substantive, but can demonstrate that separate sales are highly concentrated around a specific point and within a narrow range, V could establish VSOE of fair value on that basis.

2-93 PCS Renewal Term

ASC 985-605-55-62 states that a one-year PCS renewal rate within a time-based license constitutes VSOE of fair value under ASC 985-605 if the PCS renewal rate and term are substantive. ASC 985-605-55-63 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 term 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.

2-94 Example of a PCS Arrangement for an Off-the-Shelf Software Product

Vendor 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. ASC 985-605-25-67 provides guidance on determining the fair value of PCS, stating that “[t]he fair value of the postcontract customer support shall be determined by reference to the price the customer will be required to pay when it is sold separately (that is, the renewal rate).” 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 guidance 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.

2-95 Bargain Renewal Rates on PCS (Part I)

Vendor 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.
2-96 Bargain Renewal Rates on PCS (Part II)

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

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
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<tbody>
<tr>
<td>Initial license fee</td>
<td>$1,000</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Fair value of Year 1 PCS ($180) less PCS fee ($20)</td>
<td>$(160)</td>
</tr>
<tr>
<td>Fair value of Year 2 PCS ($180) less PCS fee ($100)</td>
<td>$(240)</td>
</tr>
<tr>
<td></td>
<td>$760</td>
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</tbody>
</table>

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.

2-97 Bargain Renewal Rates on PCS (Part III)

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
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</thead>
<tbody>
<tr>
<td>Initial license fee</td>
<td>$1,000</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Fair value of Year 5 PCS ($900) less PCS fee ($100)</td>
<td>$(800)</td>
</tr>
<tr>
<td></td>
<td>$200</td>
</tr>
</tbody>
</table>
The 2 percent renewal rate is significantly below the vendor’s normal pricing practice and would indicate that the renewal rate is nonsubstantive (see ASC 985-605-55-62 and 55-63). 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.

2-98  Substantive Renewal Rates on PCS

Company 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. A vendor should evaluate whether the renewal rates are consistent with normal pricing practices. As part of this evaluation, a vendor may consider various factors, such as industry norms and historical rates. For example, the vendor may evaluate whether PCS renewal rates are sufficiently concentrated or are priced within a narrow enough range. (This evaluation is similar to the evaluation a vendor performs when using separate sales to establish VSOE of fair value. See Q&A 2-06 for additional discussion.) 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 pricing 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 pricing 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 ASC 985-605-25-71 and 25-72.

If a vendor concludes that a normal pricing practice for PCS renewal rates does not exist, it may not be able to use substantive renewal rates to establish VSOE of fair value. For nonsubstantive renewals, vendors should evaluate whether renewals are at significant incremental discounts. In such cases, if VSOE of fair value cannot be demonstrated by other means, revenue from the initial license fee would generally be recognized ratably over the initial PCS period with the revenue from the PCS fee.

2-99  VSOE of Fair Value for PCS Over a Deployment Period (Part I)

Vendor Z enters into an arrangement with Customer A to provide A with software and related PCS for three years. The software is deployed in stages over the same three-year period. The PCS fee increases as the software is deployed: the fee in year one is $2,000; year two, $3,000; and year three, $4,000. After the deployment period, the customer may renew PCS at a rate of $5,000 per year.

Question

What rate must Z use to establish VSOE of fair value for PCS (assuming Z uses renewal rates to establish VSOE)?
Answer
Vendor Z should use the predetermined renewal rate of $5,000 to establish VSOE of fair value for PCS. In accordance with the implementation guidance in ASC 985-605-55-53 through 55-55, the fully deployed renewal rate in this example is the only indicator of fair value because it is the only price at which Z will sell PCS separately to the customer.

2-100 VSOE of Fair Value for PCS Over a Deployment Period (Part II)
Vendor Z enters into an arrangement with Customer A to provide A with software and related PCS for three years. The software is deployed in stages over the same three-year period. The PCS fee increases as the software is deployed: the fee in year one is $2,000; year two, $3,000; and year three, $4,000. After the deployment period, the customer may renew PCS at a rate of $5,000 per year.

Question
Assume that PCS during the three-year deployment period is optional. How does optional PCS affect the VSOE of fair value?

Answer
Vendor Z would not be able to establish VSOE of fair value for PCS on the basis of the renewal rates in the arrangement. Because the first three years of PCS are optional, Z is essentially offering PCS separately at four different rates. Although the renewal rate in year four represents the “ultimate renewal rate,” this rate is not the only price at which the PCS can be purchased separately.

However, in accordance with the implementation guidance in ASC 985-605-55-70 through 55-73, if Z can provide sufficient objective evidence that the $5,000 renewal rate in year four is comparable to that in similar arrangements in which Z separately sells PCS, the rates in the first three years would be deemed to be discounted. Therefore, Z would establish VSOE of fair value at $5,000 for PCS and would apply the discount proportionately to the delivered elements in the arrangement.

2-101 VSOE of Fair Value for a PCS Renewal Rate That Changes on the Basis of an Inflation Index

Question
Would an annual increase in a PCS renewal rate on the basis of an inflation index, such as the CPI, preclude establishment of VSOE of fair value for the PCS?

Answer
Generally, no. As long as the increase in the PCS renewal rate is meant to approximate inflation (e.g., the renewal rate is based on an inflationary index such as the CPI), it would still be appropriate for a vendor to establish VSOE of fair value. However, a vendor should carefully evaluate the terms of the arrangement to ensure that the increase is based on inflationary factors alone.

Example 1
A vendor enters into an arrangement to license software and provide PCS. The PCS renewal rate is $100,000 and is subject to an automatic annual price increase that is based on the CPI. The annual increase in this case would not preclude the vendor from establishing VSOE of fair value for PCS because it is based solely on inflation. Thus, VSOE in year five is essentially the same as VSOE in year one and the vendor should establish VSOE on the basis of the initial renewal fee.

Example 2
Assume the same facts as in Example 1, except that the PCS renewal rate is subject to an automatic annual increase of 10 percent. Even though the purpose of the annual increase may be to compensate the vendor for potential increases in costs, establishing VSOE on the basis of the initial renewal fee would not be appropriate because the annual increases are not necessarily based on inflationary factors alone.
2-102 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 ASC 985-605?

**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 (ASC 985-605-25-67 and 25-68) 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.

2-103 Short-Term License With Mandatory PCS

Certain software arrangements contain provisions that require the customer to renew PCS at the end of the initial contractual period or lose the continued right to use the software.

**Question**

How should a vendor account for software arrangements with mandatory PCS renewals?

**Answer**

In software arrangements with mandatory PCS renewals, the continued use of the software depends on renewal of the PCS (i.e., the software is not sold separately from the PCS). Thus, the vendor cannot establish VSOE of fair value for either the software license or the PCS under ASC 985-605-25-67 which requires vendors to determine the fair value of PCS “by reference to the price the customer will be required to pay when it is sold separately” (emphasis added).

Therefore, the vendor should treat the arrangement as one bundled element and recognize the entire arrangement, including expected renewals, ratably over the expected life of the product. However, if the initial contractual PCS term is deemed substantive in accordance with ASC 985-605-55-62 and 55-63, the arrangement would essentially be considered a series of term licenses. In this case, the vendor may recognize the initial fee ratably over the initial contractual period (usually one year or more) and recognize subsequent renewal fees over the respective contractual renewal periods.

**Example**

Vendor 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.
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.

2-104 Minimal and Infrequent Upgrades/Enhancements

ASC 985-605-25-71 through 25-73 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 (ASC 985-605-25-68) were developed, it was expected that software vendors generally would not be able to meet the criterion of “minimal and infrequent unspecified upgrades or 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.

Multiple Element Arrangements — Postdelivery Telephone Support at No Additional Charge

<table>
<thead>
<tr>
<th>ASC 985-605</th>
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</thead>
<tbody>
<tr>
<td><strong>Postdelivery Telephone Support at No Additional Charge</strong></td>
</tr>
<tr>
<td><strong>25-74</strong> Postdelivery telephone support provided to users by the vendor at no additional charge shall be accounted for as postcontract customer support, in conformity with this Subtopic, regardless of whether the support is provided explicitly under the licensing arrangement. Although such telephone support may be offered or available for periods exceeding one year, if the vendor has established a history of providing substantially all the telephone support within one year of the licensing or sale of the software, the postcontract customer support may be considered to have a term of one year or less in applying paragraph 985-605-25-71(b). Accordingly, revenue allocable to telephone support may be recognized together with the initial licensing fee on delivery of the software if all the conditions in paragraph 985-605-25-71 are met. This provision applies only to telephone support provided at no additional charge. If revenue allocable to telephone support is recognized together with the licensing fee on delivery, the vendor shall accrue the estimated cost of providing that support.</td>
</tr>
</tbody>
</table>

2-105 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 ASC 985-605?

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, ASC 985-605-25-74 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.
Multiple Element Arrangements — Postcontract Customer Support Granted to Resellers

ASC 985-605

Postcontract Customer Support Granted to Resellers

25-75 An arrangement in which a vendor grants a reseller the right to provide unspecified upgrades or enhancements to the reseller’s customers is an implied postcontract customer support arrangement between the vendor and the reseller, even if the vendor does not provide direct telephone support to the reseller’s customers. If sufficient vendor-specific objective evidence does not exist to allocate the fee to the software and the postcontract customer support, the vendor shall recognize revenue from both the licensing arrangement and the postcontract customer support ratably over the period during which postcontract customer support is expected to be provided.

2-106 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 is determined 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

ASC 985-605

25-76 Certain arrangements include both software and service elements (other than postcontract customer support-related related services). The services may include training, installation, or consulting. Consulting services often include implementation support, software design or development, or the customization or modification of the licensed software.

25-77 If an arrangement includes such services, a determination shall be made as to whether the service element can be accounted for separately as the services are performed. Paragraph 985-605-25-78 discusses the criteria that must be considered in making such a determination. If the nature of the services is such that the service element does not qualify for separate accounting as a service, contract accounting shall be applied to both the software and service elements included in the arrangement. Paragraphs 985-605-25-88 through 25-107 address the application of contract accounting to software arrangements.

25-78 To account separately for the service element of an arrangement that includes both software and services, sufficient vendor-specific objective evidence of fair value shall exist to permit allocation of the revenue to the various elements of the arrangement (as discussed in paragraphs 985-605-25-6 through 25-7 and 985-605-25-9 through 25-11). Additionally, both of the following conditions shall be met:

a. The services are not essential to the functionality of any other element of the transaction.

b. The services are described in the contract such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services.

25-79 If an arrangement includes services that meet the criteria of paragraph 985-605-25-78 for separate accounting, revenue shall be allocated among the service and software elements of the contract. This allocation should be based on vendor-specific objective evidence of fair values. (Fair values are not necessarily the same as any separate prices stated for the separate elements of the arrangement.) Revenue allocated to the service element shall be recognized as the services are performed or, if no pattern of performance is discernible, on a straight-line basis over the period during which the services are performed.

25-80 If vendor-specific objective evidence of the fair value does not exist to allocate a portion of the fee to the service element, and the only undelivered element is services that do not involve significant production, modification, or customization of the software (for example, training or installation), the entire arrangement fee shall be recognized as the services are performed. If no pattern of performance is discernible, the entire arrangement fee shall be recognized on a straight-line basis over the period during which the services are performed.
An important factor in determining whether the services are essential to the functionality of any other element is whether the software included in the arrangement is considered core or off-the-shelf software. Core software is software that a vendor uses in creating other software. It is not sold as is because customers cannot use it unless it is customized to meet system objectives or customer specifications. Off-the-shelf software is software that is marketed as a stock item that can be used by customers with little or no customization.

Software shall be considered off-the-shelf software if it can be added to an arrangement with insignificant changes in the underlying code and it could be used by the customer for the customer’s purposes upon installation. Actual use by the customer and performance of other elements of the arrangement are not required to demonstrate that the customer could use the software off-the-shelf.

If significant modifications or additions to the off-the-shelf software are necessary to meet the customer’s purpose — for example, changing or making additions to the software, or because the software would not be usable in its off-the-shelf form in the customer’s environment—the software shall be considered core software for purposes of that arrangement. If the software that is included in the arrangement is not considered to be off-the-shelf software, or if significant modifications or additions to the off-the-shelf software are necessary to meet the customer’s functionality, no element of the arrangement would qualify for accounting as a service, and contract accounting shall be applied to both the software and service elements of the arrangement.

Factors indicating that the service element is essential to the functionality of the other elements of the arrangement, and consequently shall not be accounted for separately, include the following:

a. The software is not off-the-shelf software.
b. The services include significant alterations to the features and functionality of the off-the-shelf software.
c. Building complex interfaces is necessary for the vendor’s software to be functional in the customer’s environment.
d. The timing of payments for the software is coincident with performance of the services.
e. Milestones or customer-specific acceptance criteria affect the realizability of the software-license fee.

Judgment is required to determine whether the obligation to provide services in addition to the delivery of software should be accounted for separately as a service element. Services that qualify for accounting as a service element of a software arrangement always are stated separately and have any of the following characteristics:

a. The services are available from other vendors.
b. The services do not carry a significant degree of risk or unique acceptance criteria.
c. The software vendor is an experienced provider of the services.
d. The vendor is providing primarily implementation services, such as implementation planning, loading of software, training of customer personnel, data conversion, building simple interfaces, running test data, and assisting in the development and documentation of procedures.
e. Customer personnel are dedicated to participate in the services being performed.

**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. ASC 985-605-25-84 gives examples of such services. If, under ASC 985-605-25-78, 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 (ASC 985-605-25-80).

**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. ASC 985-605-25-78 and ASC 985-605-25-85 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.

2-109  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 enters into an arrangement with Customer 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.

2-110  Example of Determining the Applicability of ASC 605-35 to a Software Arrangement

Vendor 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 ASC 605-35.

### Funded Software-Development Arrangements

<table>
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<tr>
<th>ASC 985-605</th>
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<td><strong>25-86</strong> 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:</td>
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<td>a. Royalties payable to the funding party based solely on future sales of the product by the software vendor (that is, reverse royalties)</td>
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<tr>
<td>b. Discounts on future purchases by the funding party of products produced under the arrangement</td>
</tr>
<tr>
<td>c. A nonexclusive sublicense to the funding party, at no additional charge, for the use of any product developed (a prepaid or paid-up nonexclusive sublicense).</td>
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**25-87** A funded software-development arrangement within the scope of Subtopic 730-20 shall be accounted for in conformity with that Subtopic. If the technological feasibility of the computer software product pursuant to the provisions of Subtopic 985-20 has been established before the arrangement has been entered into, Subtopic 730-20 does not apply because the arrangement is not a research and development arrangement. Accounting for costs related to funded software-development arrangements is beyond the scope of this Subtopic. However, if capitalization of the software-development costs commences pursuant to Subtopic 985-20, any income from the funding party under a funded software-development arrangement shall be credited first to the amount of the development costs capitalized. If the income from the funding party exceeds the amount of development costs capitalized, the excess shall be deferred and credited against future amounts that subsequently qualify for capitalization. Any deferred amount remaining after the project is completed (that is, when the software is available for general release to customers and capitalization has ceased) shall be credited to income.

### 2-111 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 ASC 605-35, (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 ASC 605-35.

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.

### 2-112 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 licenses software to Customer 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 ASC 605-35 because the product will be sold to other customers in the ordinary course of business through the vendor’s normal marketing channels (see ASC 605-35-15-6(a)).

Example 2 — Product Development Arrangement With Input From Customer

Vendor V agrees to develop and license software to Customer 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 ASC 605-35.

Example 3 — Funded Development Arrangement

Vendor V enters into an arrangement with Customer 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 ASC 730-20. 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 ASC 985-20; 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**

**ASC 985-605**

25-88 If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the service element does not meet the criteria for separate accounting set forth in paragraph 985-605-25-78. The entire arrangement shall be accounted for in conformity with the relevant guidance in Subtopic 605-35. Nevertheless, transactions that normally are accounted for as product sales shall not be accounted for as long-term contracts merely to avoid the delivery requirements normally associated with product sales for revenue recognition.

25-89 In applying contract accounting, the vendor shall use either the percentage-of-completion method or the completed-contract method. The determination of the appropriate method shall be made using the guidance in paragraphs 605-35-25-56 through 25-61 and 605-35-25-90 through 25-93.

25-90 The following guidance addresses various considerations related to contract accounting, specifically:

a. Segmentation (see paragraphs 985-605-25-91 through 25-92)

b. Measuring progress-to-completion under the percentage-of-completion method (see paragraphs 985-605-25-93 through 25-96)

c. Input measures (see paragraphs 985-605-25-97 through 25-100)


**Segmentation**

25-91 Software contracts may have discrete elements that meet the criteria for segmenting in paragraphs 605-35-25-10 through 25-14. If a contract is segmented, each segment is treated as a separate profit center. Progress-to-completion for each segment shall be measured in conformity with paragraphs 985-605-25-93 through 25-96.

25-92 Some vendors of arrangements that include software combined with services or hardware or both do not identify the elements separately and do not sell them separately because of agreements with their suppliers. Other vendors who are not restricted by such agreements nevertheless bid or negotiate software and other products and services together. Arrangements that do not meet the segmentation criteria in paragraph 605-35-25-12 are prohibited from being segmented, unless the vendor has a history of providing the software and other products and services to customers under separate arrangements and the arrangement meets the criteria in paragraph 605-35-25-13.

**Measuring Progress-to-Completion Under the Percentage-of-Completion Method**

25-93 Paragraph 605-35-25-70 describes the approaches to measuring progress on contracts (or segments thereof) under the percentage-of-completion method. Those approaches are grouped into input and output measures, as follows:

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

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

25-94 For software contracts, an example of an input measure is labor hours. An example of an output measure is arrangement milestones, such as the completion of specific program modules.

25-95 If, as discussed in paragraph 985-605-25-91, a software contract includes a discrete element that meets the segmentation criteria of Subtopic 605-35, the method chosen to measure progress-to-completion on the element shall be the method that best approximates progress-to-completion. Progress-to-completion on separate elements of the same software arrangement may be measured by different methods. The software vendor shall choose measurement methods consistently, however, so that it uses similar methods to measure progress-to-completion on similar elements. Output measures, such as value-added or arrangement milestones, may be used to measure progress-to-completion on software arrangements, but many entities use input measures because they are established more easily. Related guidance is provided in paragraphs 605-35-25-70 through 25-78.

**Input Measures**

25-97 Input measures of progress-to-completion on arrangements are made in terms of efforts devoted to the arrangement and, for software arrangements, include methods based on costs, such as cost-to-cost measures, and on efforts expended, such as labor hours or labor dollars. Progress-to-completion is measured indirectly, based on an established or assumed relationship between units of input and productivity. A major advantage of input measures is that inputs expended are easily verifiable. A major disadvantage is that their relationship to progress-to-completion may not hold if inefficiencies exist or if the occurrence of the input at a particular point does not indicate progress-to-completion.

25-98 Costs incurred shall be included in measuring progress-to-completion only to the extent that they relate to contract performance. Items not specifically produced for the arrangement, such as hardware purchased from third parties or off-the-shelf software, shall not be included in the measurement of progress-to-completion.
**25-99** Labor hours often are chosen as the basis for measuring progress-to-completion, because they closely approximate the output of labor-intensive processes and are often 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.

**25-100** If the measurement of progress-to-completion is based primarily on costs, the contribution to that progress of hardware and software that were produced specifically for the arrangement may be measurable and recognizable before delivery to the user’s site. For example, efforts to install, configure, and customize the software may occur at the vendor’s site. The costs of such activities are measurable and recognizable at the time the activities are performed.

**Output Measures**

**25-101** Progress on arrangements that call for the production of identifiable units of output can be measured in terms of the value added or milestones reached. Although progress-to-completion based on output measures is measured directly from results achieved, thus providing a better approximation of progress than is provided by input measures, output measures may be unreliable because of the difficulties associated with establishing them.

**25-102** For the value added to be verifiable, the vendor must identify elements or subcomponents of those elements. If output measures are neither known nor reasonably estimable, they shall not be used to measure progress-to-completion.

**25-103** If value added by off-the-shelf software is to be included in the measurement of progress-to-completion, such software cannot require more than minor modifications and must be usable by the customer for the customer’s purpose in the customer’s environment. If more than minor modifications or additions to the off-the-shelf software are necessary to meet the functionality required under the arrangement terms, either by changing or making additions to the software, or because the software would not be usable by the customer in its off-the-shelf form for the customer’s purpose in the customer’s environment, it shall be accounted for as core software.

**25-104** Value added by the customization of core software shall be included in the measurement of progress-to-completion of the customization and installation at the user’s site. However, if the installation and customization processes are divided into separate output modules, the value of core software associated with the customization of a module shall be included in the measurement of progress-to-completion when that module is completed.

**25-105** Contract milestones may be based on contractual project plans. Contractual provisions generally require the performance of specific tasks with the approval or acceptance by the customer. Project plans generally schedule inspections in which the project’s status is reviewed and approved by management. The completion of tasks that trigger such inspections are natural milestones because they are subject to relatively independent review as an intrinsic part of the project management process.

**25-106** Considerations other than progress-to-completion affect the amounts that become billable at particular times under many arrangements. Accordingly, although the achievement of contract milestones may cause arrangement revenues to become billable under the arrangement, the amounts billable shall be used to measure progress-to-completion only if such amounts indeed indicate such progress.

**25-107** The milestones selected to measure progress-to-completion shall be part of the management review process. The percentage-of-completion designated for each milestone shall be determined considering the experience of the vendor on similar projects.

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### Question

Is there a difference between accounting for the services element of an arrangement in accordance with ASC 985-605 and accounting for the entire arrangement in accordance with ASC 605-35?

### Answer

Yes, and sometimes the differences may be significant. In many ways, the guidance in ASC 985-605 is more stringent than that in ASC 605-35 — for example, with respect to extended payment terms and refund provisions.

If an arrangement accounted for under ASC 985-605 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 ASC 605-35, 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 ASC 605-35, the same concerns about software obsolescence and potential concessions noted in ASC 985-605 also may exist when payment terms extend beyond the completion of performance under an ASC 605-35 contract.
2-114 Arrangements Accounted for Under Contract Accounting in Which VSOE of Fair Value for PCS Cannot Be Established

Under ASC 985-605-25-88, vendors must use contract accounting in software arrangements that require significant production, modification, or customization of the software. Along with other products and services, certain arrangements may provide services related to PCS. ASC 985-605-55-75 states that PCS-related services may be separated from the arrangement if VSOE exists for such services (see Q&A 2-115).

**Question**

If VSOE of fair value for PCS does not exist in a software arrangement that requires significant production, modification, or customization of software, how should a vendor account for the arrangement?

**Answer**

The vendor should account for the entire arrangement under contract accounting. ASC 605-35 discusses two acceptable methods of revenue recognition under contract accounting: the percentage-of-completion method and the completed-contract method. Under the percentage-of-completion method, the vendor must make reasonably dependable estimates of (1) the extent of progress toward completion, (2) contract revenues, and (3) contract costs. Because it may be difficult for a vendor to make reasonably dependable estimates of PCS-related costs (such as when-and-if-available upgrades, phone support, and bug fixes), the completed-contract method is often appropriate in arrangements that provide PCS.

Under the completed-contract method, income is recognized only when a contract is completed or substantially completed. However, in accordance with ASC 985-605-25-10, it would be appropriate for a vendor to recognize revenue on the overall contract ratably over the PCS period beginning with delivery of the customized software product.

**Example**

Vendor A enters into an arrangement to sell software with significant customization to Customer B on January 1, 20X1 for $10 million. The vendor expects to deliver the completed software product on July 1, 20X3. As part of the arrangement, A includes PCS for a two-year period. Vendor A cannot reasonably estimate costs associated with PCS. Accordingly, A would defer the entire $10 million until the delivery of the customized software product. Upon delivery, A would recognize the $10 million ratably over the two-year PCS term.

2-115 Separate Accounting for PCS in Arrangements Accounted for Under Contract Accounting?

Under ASC 985-605-25-88, vendors must use contract accounting in software arrangements that require significant production, modification, or customization of the software. Along with other products and services, certain arrangements may provide services related to PCS.

**Question**

Can a vendor separate PCS from an arrangement accounted for under contract accounting?

**Answer**

Yes, but only if VSOE of fair value exists for the PCS-related services. ASC 985-605-55-75 states:

If the vendor has vendor-specific objective evidence of the fair value of such PCS-related services determined pursuant to paragraphs 985-605-25-67 through 25-69, those related services shall be accounted for separately from the balance of the arrangement that is being accounted for in conformity with Subtopic 605-35.

If VSOE of fair value exists for the PCS-related services, the vendor would separate PCS-related fees from the arrangement and recognize that revenue ratably over the PCS period. Contract accounting would apply to the remaining elements of the arrangement.

**Example**

Vendor V enters into an arrangement to sell significantly customized software to a customer on January 1, 20X1, for $10 million. Vendor V expects to deliver the completed software product on July 1, 20X3. As part of the arrangement, V includes PCS for a two-year period and determines that VSOE of the fair value of the PCS is $2 million.
Because VSOE of fair value exists for the PCS-related services, upon delivery of the customized software product V should separate PCS from the arrangement and recognize $2 million ratably over the two-year PCS term. Vendor V would recognize the remaining $8 million related to the customized software under contract accounting.

### Nonmonetary Exchange

**ASC 985-845**

25-1 A software vendor may exchange a license of its software to a customer in exchange for a license to the customer’s technology that permits the software vendor to sublicense the customer’s technology to other customers as a component of the software vendor’s products or as a standalone additional product.

25-2 Paragraph 845-10-30-3 states that, if certain conditions apply, a nonmonetary exchange shall be measured based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) of the nonmonetary asset relinquished, and not on the fair values of the exchanged assets. One of those conditions is an exchange to facilitate sales to customers, that is, an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange.

25-3 Therefore, if the technology or products received by the software vendor in the exchange are sold, licensed, or leased in the same line of business as the software vendor’s technology or products delivered in the exchange, the software vendor shall measure the exchange based on the recorded (carryover) amount of the software issued in exchange.

25-4 However, if the technology or products received by the software vendor in the exchange are sold, licensed, or leased in a different line of business from the software vendor’s technology or products delivered in the exchange, the exchange shall be measured based on the fair values of the exchanged technology or products, if both of the following conditions exist:

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

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

25-5 If neither the fair value of the technology or products exchanged nor the fair value of the technology or products received is determinable within reasonable limits, the exchange shall be measured based on the recorded (carryover) amount of the technology or products relinquished in exchange. Paragraph 845-10-30-8 indicates that if neither the fair value of a nonmonetary asset transferred nor the fair value of a nonmonetary asset received in exchange is determinable within reasonable limits, the recorded amount of the nonmonetary asset transferred from the entity may be the only available measure of the transaction.

**Exchange Transactions for Software for Internal Use**

25-6 A software vendor may also exchange a license of its software to a customer in exchange for a license to the customer’s technology that the software vendor intends for internal use.

25-7 If the fair value of either of the nonmonetary assets involved in the transaction is determinable within reasonable limits, the software vendor shall measure the exchange based on the fair values of the assets exchanged, consistent with the guidance in paragraph 845-10-30-1.

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2-116 Nonmonetary Transactions

**Question**

Does ASC 985 address arrangements involving nonmonetary transactions?

**Answer**

Yes. ASC 985 addresses the application of ASC 845-10 to the exchange of software licenses between entities. ASC 985-845-25-1 through 25-7 and ASC 985-845-55-1 through 55-8 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.
Section 3 — Disclosure

3-01 Income Statement Classification of Revenues Earned From Arrangements Containing Software and Services Elements

Question
SEC Regulation S-X, Rule 5-03(b), requires, among other things, that product and services revenues be displayed separately in the income statement when certain criteria are met. However, there may be instances in which elements in an arrangement containing both software products and services cannot be separated for revenue recognition purposes. How should revenues be presented in the income statement under such circumstances?

Answer
One acceptable method would be to present the revenues related to both the software products and the services on a combined basis in a separate income statement line item. Therefore, revenues from such arrangements would be reported separately from other product and services revenues. For example, this line item could be labeled “Revenues From Product Sales and Services” or “Combined Products and Services Revenues,” with disclosure describing what the line item represents.

Another acceptable method would be to separate revenues earned from both software products and services and present them separately within the products and services income statement line items, respectively, if a reasonable basis for separation exists. Mark Barrysmith, professional accounting fellow in the Office of the Chief Accountant, supported this method at the 2007 AICPA National Conference on Current SEC and PCAOB Developments. Mr. Barrysmith indicated that these revenues could be separately presented “when a vendor has a reasonable basis for developing a separation methodology, so long as the method of separating is consistently applied, clearly disclosed and not misleading.”

However, Mr. Barrysmith cautioned preparers that establishing a separation method for presentation purposes must not only be systematic but should be based on rational methods. For example, he stated, “Purely a systematic allocation with no basis other than consistency or one based on contractually stated amounts would seem insufficient.” However, he added that “estimates based on verifiable inputs used to derive a reasonable approximation of fair value of deliverables . . . may result in a reasonable allocation of product and service revenue.” For example, third-party evidence of fair value, while not sufficient for separation purposes in software arrangements, may be appropriate for establishing a reasonable allocation of revenues related to software products and services.

3-02 Examples of SEC Comments on ASC 985-605

Question
What are some of the comments registrants have received from the SEC staff regarding the application of ASC 985-605 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 ASC 985-605:

General
- How did you decide that ASC 985-605 or ASC 605-35 was (not) applicable?
- How do you meet each of the requirements in ASC 985-605-25-3?
- 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 ASC 985-605.
- 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 versus 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.

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?
- ASC 985-605 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 ASC 985-605.

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 ASC 985-605-25-46.
Section 4 — Implementation Guidance and Illustrations

ASC 985-605 — Implementation Guidance

Flowchart of Revenue Recognition on Software Arrangements

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 postcontract customer support) included in the arrangement. The flowchart summarizes certain guidance in this Subtopic and is not intended as a substitute for the guidance in this Subtopic.
Is property, plant, or equipment included as part of a lease transaction?

Yes

Paragraph 985-605-15-3
Account for any revenue attributable to property, plant, or equipment in conformity with Topic 840.

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

Paragraphs 985-605-25-78 through 25-79
Account for the services as a separate element. Account for remainder of arrangement using contract accounting.

No

Paragraphs 985-605-25-1 through 25-2
Account for in conformity with Subtopic 605-35.

(END)

No

Is there persuasive evidence of an arrangement?

No

Paragraphs 985-605-25-3 and 985-605-25-17
Defer revenue recognition until such evidence exists.

Yes

Does the arrangement include multiple elements?

No

Paragraphs 985-605-25-9 through 25-11
Defer revenue recognition until such evidence exists. See exceptions in paragraph 985-605-25-10.

Yes

Is there sufficient vendor-specific objective evidence of fair value to allow allocation of the fee to the separate elements?

No

continued

Yes
Section 4 — Implementation Guidance and Illustrations
Software Revenue Recognition: A Roadmap to Applying ASC 985-605

Is collectibility probable?

- Yes: Defer revenue recognition until collectibility becomes probable. (Paragraph 985-605-25-3)

- No: Defer revenue recognition until all delivery obligations are fulfilled. (Paragraphs 985-605-25-3 through 25-14)

Is any undelivered element essential to the functionality of the delivered element?

- Yes: Delivery is not considered complete; Defer revenue recognition until any undelivered elements are not essential to the functionality of the delivered element. (Paragraph 985-605-25-12)

- No: Defer revenue recognition until the element has been delivered. (Paragraph 985-605-25-3)

Is the fee fixed or determinable?

- Yes: Recognize revenue as payments from customers become due. (Paragraphs 985-605-25-3 through 25-35)

- No: Collectibility not considered probable; Defer revenue recognition until all delivery obligations are fulfilled. (Paragraphs 985-605-25-13 through 25-14)
### ASC 985-605 — Implementation Guidance (continued)

#### Multiple-Element Arrangements

55-3 The following provides implementation guidance related to arrangements with multiple elements (see paragraphs 985-605-25-5 through 25-7):

- **a.** Effect of multiple contracts or agreements
- **b.** Arrangements that include usage-based fees
  1. Separate fees for license, usage, and renewal of postcontract customer support
  2. Postcontract customer support included in usage-based fee
  3. All fees usage-based.

#### Effect of Multiple Contracts or Agreements

55-4 Software vendors may execute more than one contract or agreement with a single customer. However, a group of contracts or agreements may be so closely related that they are, in effect, parts of a single arrangement and should be viewed as one multiple-element arrangement when determining the appropriate amount of revenue to be recognized in accordance with this Subtopic. The form of an arrangement is not necessarily the only indicator of the substance of an arrangement. The existence of any of the following factors (which are not all-inclusive) may indicate that a group of contracts should be accounted for as a single multiple-element arrangement:

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

#### Arrangements That Include Usage-Based Fees

55-5 Software vendors may enter into arrangements for licensing rights and postcontract customer support that include contingent usage-based fees. Usage-based fees are determined based on applying a constant multiplier to the frequency that the licensee uses the software. For example, a vendor may license customer call center software whereby a fee of $.01 is charged for each call handled. That fee structure is different from fees that are determined based on the number of individuals or workstations that use or employ the software (that is, user-based fees). If usage-based fees are not paid timely, the licensee’s perpetual license to use the software is vacated and the vendor has no continuing obligation to provide postcontract customer support.

55-6 Usage-based fees are not specifically addressed in this Subtopic. However, paragraph 985-605-25-7, which provides guidance as to what constitutes vendor-specific objective evidence of fair value of the elements of a software arrangement, states, in part, that when a vendor’s pricing is based on multiple factors such as the number of products and the number of users, the amount allocated to the same element when sold separately must consider all the factors of the vendor’s pricing structure. Accordingly, usage-based fees should be considered in determining whether there is sufficient vendor-specific objective evidence of fair value of all the elements of an arrangement.

55-7 The following examples focus on circumstances in which software is used by the licensee only in the activity that underlies the measurement of the usage-based fee; that is, the software provides the licensee with no internal-use functionality for which a usage-based fee would not be charged. The examples illustrate how a software vendor would recognize revenue for the perpetual license, postcontract customer support, and contingent usage-based fee elements.

#### Separate Fees for License, Usage, and Renewal of Postcontract Customer Support

55-8 An arrangement may provide for a nonrefundable initial fee for the perpetual license and contingent usage-based fees determined monthly or quarterly and due shortly thereafter. Postcontract customer support is provided at no additional charge for the first year and the licensee may purchase renewal postcontract customer support annually thereafter for a fixed amount that is deemed substantive (the renewal rate).
The existence of a substantive renewal rate for postcontract customer support allows for the determination of the portion of the initial fee that should be allocated to the perpetual license through the application of the residual method described in paragraphs 985-605-25-10 through 25-11. That amount should be recognized as revenue when the criteria in paragraph 985-605-25-3 are satisfied. The amount allocated to postcontract customer support would be recognized pursuant to the requirements of paragraph 985-605-25-67 through 25-69. The usage-based fee should be recognized at the time a reliable estimate can be made of the actual usage that has occurred (estimates may be used, for example, if there is a lag in the reporting of actual usage), provided collectibility is probable.

Postcontract Customer Support Included in Usage-Based Fee

An arrangement may provide for a nonrefundable initial fee for the perpetual license and contingent usage-based fees determined monthly or quarterly and due shortly thereafter. Postcontract customer support is provided at no additional stated charge (or the pricing of postcontract customer support is stated as being included in the contingent usage-based fee).

Because there is no substantive renewal rate for postcontract customer support, there is no vendor-specific objective evidence of fair value of the postcontract customer support that is to be provided, which precludes application of the residual method to determine the portion of the initial fee allocable to the perpetual license. Further, there is not sufficient objective evidence to demonstrate that some portion of the initial fee does not represent payment for future postcontract customer support. Accordingly, pursuant to paragraphs 985-605-25-9 through 25-11 and 985-605-25-70, the initial fee should be recognized ratably over the period that the vendor expects to provide postcontract customer support because there is no contractual term for the postcontract customer support. The usage-based fee would be recognized at the time a reliable estimate can be made of the actual usage that has occurred, provided collectibility is probable.

All Fees Usage-Based

An arrangement may provide for a perpetual license solely in exchange for contingent usage-based fees determined monthly or quarterly and due shortly thereafter. Postcontract customer support is provided at no additional stated charge.

The usage-based fee represents payment for both the perpetual license right and postcontract customer support. However, that fee becomes fixed or determinable only at the time actual usage occurs. Therefore, revenue should be recognized at the time a reliable estimate can be made of the actual usage that has occurred, provided collectibility is probable.

Extended Payment Terms

The following provides implementation guidance related to extended payment terms and their effect on the determination of whether a fee is fixed or determinable and collectible (see paragraphs 985-605-25-33 through 25-37):

a. Effect of prepayments
b. Illustration of extended payment terms
c. Concessions by a software vendor to customers
d. Overcoming the presumption of concessions in arrangements with extended terms
e. Subsequent cash receipt when vendor does not have a practice of providing extended terms
f. Transfer by vendor of extended payment rights to independent third party without recourse
g. Effect of customer financing of extended payments.

Effect of Prepayments

Paragraph 985-605-25-35 states that, if a fee on a software arrangement with extended payment terms is not fixed or determinable at the outset of an arrangement, revenue shall be recognized as payments become due. A vendor may receive payments related to an arrangement with extended payment terms directly from customers in advance of scheduled payments without the software vendor’s participation in its customers’ financing arrangements. The software vendor should recognize such payments as revenue when received, in advance of scheduled payments, provided all other requirements of revenue recognition in this Subtopic are met.

Illustration of Extended Payment Terms

A software vendor (with a fiscal year ending September 30) may enter into a licensing arrangement and simultaneously deliver its product to a customer on September 29. Payment terms are $600,000 due 30 days from September 29, and $400,000 due 13 months from September 29. The licensing fee is not fixed or determinable because a significant portion of the fee is due more than one year after delivery of the software and the vendor cannot overcome the presumption in paragraph 985-605-25-34.

Paragraph 985-605-25-35 requires that the vendor recognize revenue as payments from customers become due (assuming all other conditions for revenue recognition in this Subtopic are met). In this situation, $600,000 would be recognized as revenue on October 29 when the payment becomes due and the remaining $400,000 would be recognized 12 months later on October 29 of the following fiscal year.
## ASC 985-605 — Implementation Guidance (continued)

### Concessions by a Software Vendor to Customers

**55-18** Paragraph 985-605-25-33 states that because a product's continuing value may be reduced due to the subsequent introduction of enhanced products by the vendor or its competitors, the possibility that the vendor still may provide a refund or concession to a creditworthy customer to liquidate outstanding amounts due under the original terms of the arrangement increases as payment terms become longer. Concessions by a software vendor may take many forms and include, but are not limited to, any of the following kinds of changes to the terms of an arrangement:

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

**55-19** Examples of concessions by a software vendor that reduce an arrangement fee or extend the terms of payment include the following:

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

**55-20** Examples of concessions by a software vendor that increase the deliverables include the following:

- a. Providing discounted or free postcontract customer support that was not included in the original arrangement
- b. Providing various types of other discounted or free services (beyond those provided as part of the vendor’s normal product offerings or warranty provisions), upgrades, or products that were not included in the original arrangement
- c. Allowing the customer access to products not licensed under the original arrangement without an appropriate increase in the arrangement fee
- d. For term licenses, extending the time for a reseller to sell the software or an end user to use the software
- e. For limited licenses, extending the geographic area in which a reseller is allowed to sell the software, or the number of locations in which an end user can use the software.

**55-21** Although the nature of a concession may vary by type of arrangement, many of the concessions described in the preceding two paragraphs could be granted for any type of license arrangement regardless of its form (that is, term arrangement, perpetual arrangement, site license arrangement, enterprise license arrangement, and so forth). Examples of changes to the terms of an arrangement that are not concessions include the following:

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

### Overcoming the Presumption of Concessions in Arrangements With Extended Terms

**55-22** Paragraph 985-605-25-34 indicates that, if a significant portion of the software licensing fee is not due until after expiration of the license or more than 12 months after delivery, the licensing fee shall be presumed not to be fixed or determinable. That presumption may be overcome by evidence that the vendor has a standard business practice of using long-term or installment contracts and a history of successfully collecting under the original payment terms without making concessions.

**55-23** To have a history of successfully collecting under the original payment terms without making concessions, a vendor would have to have collected all payments as due under comparable arrangements without providing concessions. For example, one year of payments under three-year payment arrangements would not provide sufficient history because all of the payments under the contracts would not yet have been paid as due.

**55-24** In addition to a history of collecting payments as due without making concessions, paragraphs 985-605-25-13 through 25-14 require that the software vendor not intend to provide refunds or concessions that are beyond the provisions of the arrangement.
**ASC 985-605 — Implementation Guidance (continued)**

**55-25** In evaluating a vendor’s history, the historical arrangements should be comparable to the current arrangement relative to terms and circumstances to conclude that the history is relevant. Examples of factors that should be assessed in this evaluation include the following:

a. Similarity of customers, for example:
   1. Type or class of customer. New arrangements with substantially the same types and class of customer indicate that the history is relevant. Significant differences call into question the relevance of the history.

b. Similarity of products included, for example:
   1. Types of products. Similarity in the types of products included under the new license arrangement (for example, financial systems, production planning, and human resources) indicate that the history is relevant.
   2. Stage of product life cycle. Product maturity and overall stage within its product life cycle should be considered when assessing the relevance of history. The inclusion of new products in a license arrangement would not automatically preclude the vendor from concluding that the software products are comparable. For example, if substantially all of the products under one license arrangement are mature products, the inclusion of a small number of newly developed products in a subsequent arrangement may not change the overall risk of concession and economic substance of the subsequent transaction.
   3. Elements included in the arrangement. No significant differences in the nature of the elements included in the arrangements indicate that the history is relevant. Significant rights to services or discounts on future products included in some arrangements, but not others, may indicate that there is a significant difference between the arrangements. For example, a history developed for arrangements that included bundled postcontract customer support and rights to additional software products would not be comparable to an arrangement that does not include these rights.

c. Similarity of license economics, for example:
   1. Length of payment terms. For the history to be considered relevant, the overall payment terms should be similar. Although a nominal increase in the length of payment terms may be acceptable, a significant increase in the length of the payment terms may indicate that the terms are not comparable.
   2. Economics of license arrangement. The overall economics and term of the license arrangement should be reviewed to ensure that the vendor can conclude that the history developed under a previous arrangement is relevant, particularly if the primary products licensed are near the end of their lives and the customer would not be entitled to the updated version under a postcontract customer support arrangement.

**Subsequent Cash Receipt when Vendor Does Not Have a Practice of Providing Extended Terms**

**55-26** Paragraph 985-605-25-34 states that the presumption that an extended payment term license fee due more than 12 months after delivery of the software is not fixed or determinable may be overcome by evidence that the software vendor has a standard business practice of using long-term or installment contracts and has a history of successfully collecting under the original payment terms without making concessions.

**55-27** For example, on December 1, a calendar-year-end software vendor enters into a licensing arrangement with payments due in installments over two years, beginning in May of the following year. After December 31 but before the vendor issues its year-end financial statements (or before the financial statements are available to be issued, as discussed in Section 855-10-25), the customer pays the full amount due. As of December 1, the software vendor has met all other conditions of revenue recognition except that it does not have a standard business practice of using long-term or installment contracts.

**55-28** Paragraph 985-605-25-35 requires that the software vendor determine whether the fee is fixed or determinable at the outset of the arrangement, which in this situation is December 1. The subsequent cash receipt does not provide sufficient evidence to render the licensing fee as fixed or determinable and does not allow the software vendor to recognize revenue in the December 31 financial statements.

**55-29** The only circumstances sufficient to overcome the presumption that the license fee is not fixed or determinable are that the software vendor has both of the following:

a. A standard business practice of using long-term or installment contracts

b. A history of successfully collecting under the original payment terms without making concessions.

**55-30** Because the software vendor met all other conditions of revenue recognition, it would recognize revenue in the period it receives payment in full directly from the customer (see paragraph 985-605-55-15).

**Transfer by Vendor of Extended Payment Rights to Independent Third Party Without Recourse**

**55-31** Paragraph 985-605-25-34 states that any extended payment terms in a software licensing arrangement may indicate that the fee is not fixed or determinable. The licensing fee is presumed not to be fixed or determinable if payment of a significant portion of the fee is not due until after expiration of the license or more than 12 months after delivery.
## ASC 985-605 — Implementation Guidance (continued)

### 55-32
The presumption that the licensing fee is not fixed or determinable is not overcome if, at the outset of the arrangement or subsequently, the vendor receives cash on the transfer of the extended payment term arrangement. That is true even if the extended payment term arrangement is irrevocably transferred or otherwise converted to cash without recourse to the vendor. The difference in this situation, as compared to the situation in paragraph 985-605-55-15, which addresses prepayments received directly from customers, is that the transfer of the extended payment term arrangement does not change the nature or structure of the transaction between the vendor and customer. Therefore, the presumption in paragraph 985-605-25-34 has not been overcome.

### Effect of Customer Financing of Extended Payments

#### 55-33
For illustrative purposes, the following implementation guidance on customer financing of extended payments assumes that the software arrangement is a single product or single element arrangement. However, the guidance also applies to multiple element arrangements. The guidance is organized as follows:

- a. Customer financing with no vendor participation
- b. Vendor participation in customer financing
- c. Indicators of incremental risk when vendor participates in customer financing
- d. Overcoming the presumption of incremental risk when vendor participates in customer financing
- e. Vendor actions that may not indicate incremental risk
- f. Effect of interest rate buy down in connection with customer financing
- g. Additional considerations when a reseller obtains financing.

### Customer Financing With No Vendor Participation

#### 55-34
Paragraph 985-605-55-15 addresses a situation in which a customer obtains financing, without the software vendor’s participation, and pre pays amounts due the software vendor under previously negotiated extended payment terms. That guidance indicates that a software vendor should recognize revenue in advance of scheduled payments if amounts related to extended payment terms are received directly from customers without the software vendor’s participation in its customers’ financing arrangements, provided all other requirements of revenue recognition in this Subtopic are met. Paragraphs 985-605-55-31 through 55-32 indicate that a software vendor should not recognize revenue in advance of scheduled payments if amounts related to extended payment terms are received as a result of the software vendor’s transfer of a customer’s extended payment term obligation to a third party, without recourse to the software vendor.

#### 55-35
The guidance referred to in the preceding paragraph relates to arrangements with extended payment terms. However, a software vendor may enter into an arrangement with an end user customer that contains customary (that is, not extended) payment terms and the end user customer may obtain, without the software vendor’s participation, financing from a party unrelated to the software vendor. In such an arrangement, the software vendor would recognize revenue upon delivery of the software product, provided all other requirements of revenue recognition in this Subtopic are met.

### Effect of Prepayments on Software Revenue Recognition When the Vendor Participates in Customer Financing

#### 55-36
Paragraph 985-605-55-15 addresses a situation in which amounts related to extended payment terms are received directly from customers without the software vendor’s participation in its customers’ financing arrangements. However, a vendor may participate in the customer’s financing. For example, a software vendor may enter into an arrangement with an end-user customer that contains extended payment terms and receive payments in advance of the scheduled due dates after the vendor participated in the customer’s financing with a party unrelated to the software vendor.

#### 55-37
If the software vendor’s participation in the customer’s financing results in incremental risk that the software vendor will provide a refund or concession to either the end user customer or the financing party, the presumption is that the fee is not fixed or determinable. If the software vendor cannot overcome that presumption, the vendor would recognize revenue as payments from the customer become due and payable to the financing party, provided all other requirements of revenue recognition in this Subtopic are met. The software vendor would account for any proceeds received from the customer or the financing party prior to revenue recognition as a liability for deferred revenue. Indicators of incremental risk are discussed in paragraphs 985-605-55-38 through 55-40. Paragraphs 985-605-55-42 through 55-45 address the evidence the vendor would consider to overcome the presumption.

### Indicators of Incremental Risk When Vendor Participates in Customer Financing

#### 55-38
As indicated in the preceding two paragraphs, vendor participation in the customer’s financing is important to how revenue is recognized in a software arrangement that contains extended payment terms. However, a vendor may also participate in customer financing in arrangements with an end-user customer that contain customary (that is, not extended) payment terms for which the arrangement fee ordinarily would be considered fixed or determinable. For example, simultaneously with entering into a software arrangement, or before the scheduled payment due date(s), the software vendor participates in the end user customer’s financing with a party unrelated to the software vendor.
A software arrangement fee is not fixed or determinable (see paragraph 985-605-25-3) if a software vendor meets either of the following conditions:

a. The vendor lacks the intent or ability to enforce the original payment terms of the software arrangement if the financing is not successfully completed.

b. In past software arrangements, the vendor altered the terms of original software arrangements or entered into another arrangement with customers, to provide extended payment terms consistent with the terms of the financing.

If a software vendor’s participation in an end user customer’s financing results in incremental risk that the software vendor will provide a refund or concession to either the end user customer or the financing party, there is a presumption that the arrangement fee is not fixed or determinable. Any one of the following conditions or software vendor actions would result in incremental risk and a presumption that the fee is not fixed or determinable:

a. The vendor is required to indemnify the financing party above and beyond the standard indemnification provisions that are explicitly included in the software arrangement between the software vendor and the end user customer.

b. The vendor is required to make representations to the financing party related to customer acceptance of the software that are above and beyond the written acceptance documentation, if any, that the software vendor has already received from the end user customer.

c. The vendor is obligated to take action against the customer on behalf of the financing party (such as to terminate the license agreement or any related services) if the end user customer defaults under the financing, and the action results in more than insignificant direct incremental costs. This would not apply if, as part of the original arrangement, the customer explicitly authorizes the vendor upon request by the financing party to take those specific actions against the customer and does not provide for concessions from the vendor as a result of such action.

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

e. The vendor is required to guarantee, certify, or otherwise attest in any manner to the financing party that the customer meets the financing party’s qualification criteria.

f. The vendor has previously provided concessions to financing parties or to customers to facilitate or induce payment to financing parties.

g. Provisions exist that lead to the vendor’s guarantee of the customer’s indebtedness to the financing party.

If the presumption is not overcome, the software vendor would recognize revenue as payments from the customer become due and payable to the financing party, provided all other requirements of revenue recognition in this Subtopic are met.

### Overcoming the Presumption of Incremental Risk When Vendor Participates in Customer Financing

Paragraphs 985-605-55-38 through 55-40 provide indicators of incremental risk that result in a presumption that a fee is not fixed or determinable in an arrangement in which a software vendor participates in an end user customer’s financing with a party unrelated to the software vendor. However, the presumption may be overcome in certain circumstances. The software vendor should use the guidance in paragraphs 985-605-25-34 and 985-605-55-22 through 55-25.

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 the incremental risk indicator in paragraphs 985-605-55-38 through 55-40, the software vendor would consider whether it has relevant history with arrangements in which it granted extended payment terms to its customers. A history of the software vendor’s having granted concessions to either its customers in similar arrangements in which it provided extended payment terms or unrelated financing parties in similar arrangements in which the software vendor participated would prevent the software vendor from overcoming the presumption that the fee is not fixed or determinable.

In circumstances in which there is sufficient evidence to overcome the presumption that the fee is not fixed or determinable, the software vendor would still evaluate the nature of the incremental risk to determine if there are other accounting ramifications, such as the accounting for the software vendor’s continuing involvement that results from a guarantee of the customer’s indebtedness (recourse).
Vendor Actions That May Not Indicate Incremental Risk

55-46 In connection with a software vendor’s participation in an end user customer’s financing of a software arrangement, the following are examples of vendor actions that generally would not cause the vendor to assume incremental risk that the vendor will provide a refund or concession to either the end user customer or the financing party:

a. The vendor introduces the customer and financing party and facilitates their discussions.

b. The vendor assists the customer in prequalifying for financing, so long as the software vendor does not guarantee, certify, or otherwise attest in any manner to the financing party that the customer meets the financing party’s qualification criteria.

c. The vendor represents to the financing party that the software vendor has free and clear title to the licensed software or the right to sublicense if the vendor makes the same written representations in the software arrangement with the end user customer.

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

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

f. The vendor makes customary recourse provisions to its customer related to warranties for defective software.

Effect of Interest Rate Buydown in Connection With Customer Financing

55-47 A software vendor may assist a customer in obtaining financing with an entity unrelated to the software vendor that has a more attractive interest rate than that typically offered by the financing entity. For example, a software vendor may buy down the interest rate a financing entity would otherwise charge to the software vendor’s customer. That interest rate buydown may occur simultaneously with the original software arrangement, or it may occur later. Further, that interest rate buydown may occur with or without the customer’s awareness.

55-48 Revenue recognition is affected by the timing of the interest rate buydown. However, whether the customer is aware of the buydown does not affect revenue recognition.

55-49 An interest rate buydown that is evidenced contemporaneously and occurs simultaneously with the original arrangement between the software vendor and customer is considered an integral part of the arrangement because of its timing. Because the interest rate buydown is an integral part of the original arrangement, customer awareness is not relevant. The amount of the interest rate buydown would be treated as a reduction of the total arrangement fee to be recognized in accordance with this Subtopic, and not as a financing or other expense.

55-50 A software vendor’s buydown of an interest rate that is not evidenced contemporaneously or occurs other than simultaneously with the original arrangement is not considered an integral part of the original arrangement. Rather, it constitutes a concession because it represents a reduction in the arrangement fee not contemplated in the original arrangement (see paragraphs 985-605-55-18 through 55-21). Because the interest rate buy down is a concession, it is irrelevant whether the customer is or is not aware of it.

Additionl Considerations When a Reseller Obtains Financing

55-51 Paragraphs 985-605-55-34 through 55-51 are phrased in the context of end user customers and do not address the complexities that exist for resellers. However, the underlying concepts in those paragraphs are applicable to customers that are resellers, as well as all of the additional factors in paragraph 985-605-25-36 to consider in evaluating whether an arrangement fee with a reseller is fixed or determinable. Further, the existence of financing by a reseller customer may increase the risk of any of the following:

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

b. The reseller may not have the ability to honor a commitment to pay, which could increase the risk of software vendor concessions regardless of the source of the financing.

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

Postcontract Customer Support

55-52 The following provides implementation guidance related to postcontract customer support (see paragraphs 985-605-25-66 through 25-75):

a. Postcontract customer support during deployment phase

b. Fair value of postcontract customer support

c. Postcontract customer support in an arrangement accounted for using contract accounting

d. Bug fixes provided to customers that choose not to obtain postcontract customer support.
Postcontract Customer Support During Deployment Phase

55-53 A software vendor enters into an arrangement with a customer to deliver its software product and to provide postcontract customer support. The product will be deployed in stages. The stipulated term of the postcontract customer support period begins six months after delivery of the product. However, the vendor has a history of regularly making available to all customers the services or unspecified upgrades or enhancements normally associated with postcontract customer support as soon as its products are delivered. That is, the customer receives any upgrades or enhancements released by the vendor during the six-month period after product delivery.

55-54 The postcontract customer support rate inherent in the licensing fee increases over time based on the customer’s deployment of the product. After three years, the predetermined renewal rate for postcontract customer support for a fully deployed license is set at a stipulated rate multiplied by the aggregate list price (as established at the inception of the arrangement) of the licensed product, regardless of the status of the deployment efforts. The vendor does not have vendor-specific objective evidence of fair value of the postcontract customer support if the product is less than fully deployed because the only postcontract customer support sold separately is the renewal of postcontract customer support (that is, the predetermined renewal rate).

55-55 In this situation, the postcontract customer support arrangement commences upon product delivery because the customer receives any upgrades or enhancements released by the vendor during the six-month period after product delivery. In addition, the predetermined renewal rate is the only indicator of fair value because it is the only arrangement under which postcontract customer support is sold separately, and therefore, it should be used to establish vendor-specific objective evidence of fair value of the postcontract customer support. In this situation, the vendor would defer initially the portion of the arrangement fee related to the three and one-half years of postcontract customer support provided under the arrangement based on the predetermined renewal rate.

Fair Value of Postcontract Customer Support

55-56 Implementation guidance on the fair value of postcontract customer support is organized as follows:

a. Perpetual license
b. Short-term license
c. Multiyear time-based license
d. Perpetual and multiyear time-based licenses
e. Consistent renewal percentage (but varying renewal dollar amounts)
f. Based on users deployed.

Fair Value of Postcontract Customer Support in a Perpetual License

55-57 Perpetual software licenses may include postcontract customer support. For example, assume that the fee for a perpetual software license includes postcontract customer support services for a term of two years. However, only one-year postcontract customer support renewal rates are offered to those holding the perpetual license rights.

55-58 If the postcontract customer support renewal rate and term are substantial, they provide vendor-specific objective evidence of the fair value of the postcontract customer support element included (bundled) in the software arrangement pursuant to paragraphs 985-605-25-6 through 25-7 and 985-605-25-67 through 25-69. The dollar amount of the one-year renewal rate multiplied by two (which reflects the postcontract customer support term included in the arrangement) constitutes vendor-specific objective evidence of the fair value of postcontract customer support pursuant to the provisions in those paragraphs.

Fair Value of Postcontract Customer Support in a Short-Term License

55-59 In arrangements that include time-based software licenses and postcontract customer support services, the duration of the time-based software license may be so short that a renewal rate or fee for the postcontract customer support services does not represent vendor-specific objective evidence of the fair value of the bundled postcontract customer support. For example, a software arrangement might provide a 12-month license that includes (bundles) 6 months of postcontract customer support services for a total fee of $100,000 and specifies a 6-month renewal fee for postcontract customer support services of $5,000.

55-60 For time-based software licenses with a duration of one year or less, the fair value of the bundled postcontract customer support services is not reliably measured by reference to a postcontract customer support renewal rate. The short period during which any unspecified upgrade provided under the postcontract customer support agreement can be used by the licensee prevents objectively demonstrating the vendor-specific objective evidence of fair value of the licensee’s right to unspecified upgrades.

55-61 Although a postcontract customer support service element may not be of significant value when it is provided in a short duration time-based license, this Subtopic does not provide for an exception from its provision that vendor-specific objective evidence of fair value is required for each element of a multiple-element arrangement. Consequently, when there is no vendor-specific objective evidence of the fair value of postcontract customer support services included (bundled) in a multiple-element arrangement, even if the arrangement provides a short duration time-based software license, the total arrangement fee would be recognized under paragraphs 985-605-25-9 through 25-11 (or paragraphs 985-605-25-71 through 25-72, if applicable). Paragraphs 985-605-55-62 through 55-63 address circumstances in which a renewal rate for postcontract customer support in connection with a multiyear time-based license may not constitute vendor-specific objective evidence of the fair value of postcontract customer support.
### ASC 985-605 — Implementation Guidance (continued)

**Fair Value of Postcontract Customer Support in a Multiyear Time-Based License**

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<th>Paragraph</th>
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<tr>
<td>55-62</td>
<td>Arrangements for multiyear time-based software licenses may include initial (bundled) postcontract customer support services for only a portion of the software license’s term (for example, a five-year time-based software license that includes initial postcontract customer support services for one year), and a renewal rate for postcontract customer support for an additional year or years within the time-based license period. If the postcontract customer support renewal rate and term are substantive, that renewal rate constitutes vendor-specific objective evidence of the fair value of the postcontract customer support under paragraphs 985-605-25-6 through 25-7 and 985-605-25-67 through 25-69.</td>
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<tr>
<td>55-63</td>
<td>Circumstances that indicate that the postcontract customer support renewal rate or term is not substantive include the following:</td>
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<td>a. The period of initial (bundled) postcontract customer support services is relatively long compared to the term of the software license (for example, four years of initial postcontract customer support services in connection with a five-year time-based software license, with a specified postcontract customer support renewal rate for the remaining year).</td>
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<td>b. The aggregate postcontract customer support renewal term is less than the initial (bundled) postcontract customer support period (for example, a five-year time-based software license with three-year bundled postcontract customer support and two annual postcontract customer support renewals).</td>
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<td>c. A postcontract customer support renewal rate that is significantly below the vendor’s normal pricing practices in combination with a time-based software license that is for a relatively short period (for example, a two-year time-based software license that includes initial [bundled] postcontract customer support for one year for a total arrangement fee of $1,000,000 and that stipulates a postcontract customer support renewal rate for the second year of $25,000 when the vendor’s normal pricing practices suggest higher renewal rates).</td>
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**Fair Value of Postcontract Customer Support in Perpetual and Multiyear Time-Based Licenses**

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<tr>
<td>55-64</td>
<td>A software vendor may offer licenses for the same product currently as a perpetual license and a multiyear time-based license (for example, two or more years). The pricing of the licenses reflects the duration of the license rights. Renewal rates may provide vendor-specific objective evidence of fair value for postcontract customer support services in the perpetual licenses. However, for multiyear time-based licenses, postcontract customer support services for the entire license term are included (bundled) in the license fee and there is no renewal rate because the time-based license rights are coterminous with the postcontract customer support service period. In this situation, the postcontract customer support renewal terms in the perpetual license do not provide vendor-specific objective evidence of the fair value of the postcontract customer support services element included (bundled) in the multiyear time-based software arrangement pursuant to the provisions of this Subtopic.</td>
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<tr>
<td>55-65</td>
<td>Paragraphs 985-605-25-6 through 25-7 state that vendor-specific objective evidence of fair value is provided by the price charged when the same element is sold separately. Postcontract customer support services for a perpetual license and for a multiyear time-based license are two different elements. Although the same unspecified product upgrades or enhancements may be provided under each postcontract customer support arrangement, the time period during which the software vendor’s customer has the right to use such upgrades or enhancements differs based on the terms of the underlying licenses. Because postcontract customer support services are bundled for the entire term of the multiyear time-based license, those postcontract customer support services are not sold separately.</td>
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<tr>
<td>55-66</td>
<td>However, in the rare situations in which both of the following circumstances exist, the postcontract customer support renewal terms in a perpetual license provide vendor-specific objective evidence of the fair value of the postcontract customer support services element included (bundled) in the multiyear time-based software arrangement:</td>
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<td>a. The term of the multiyear time-based software arrangement is substantially the same as the estimated economic life of the software product and related enhancements that occur during that term.</td>
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<td>b. The fees charged for the perpetual (including fees from the assumed renewal of postcontract customer support for the estimated economic life of the software) and multiyear time-based licenses are substantially the same.</td>
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<td>55-67</td>
<td>If the software vendor also offers multiyear time-based licenses for the same product that include bundled postcontract customer support services for a portion of the license period (instead of only including bundled postcontract customer support services for the entire license term), the renewal terms of those transactions may provide vendor-specific objective evidence of the fair value of the postcontract customer support services elements that are bundled for the entire license term. See paragraphs 985-605-55-62 through 55-63 for additional guidance on vendor-specific objective evidence of postcontract customer support renewals.</td>
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**Fair Value of Postcontract Customer Support With a Consistent Renewal Percentage (but Varying Renewal Dollar Amounts)**

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<td>55-68</td>
<td>A software vendor may charge a customer $100,000 for a software license while charging another customer $150,000 for the same software license. Under each arrangement, the postcontract customer support renewal rate is 15% of the license fee.</td>
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55-69  Assuming that the postcontract customer support renewal rate expressed as a consistent percentage of the stipulated license fee for customers is substantive, that renewal rate would be the vendor-specific objective evidence of the fair value of postcontract customer support. In this situation, the existence of varying dollar amounts of postcontract customer support renewal fees for the same software product does not indicate an absence of vendor-specific objective evidence of the fair value of postcontract customer support or the possible presence of discounts on postcontract customer support that should be accounted for under paragraph 985-605-25-8.

Fair Value of Postcontract Customer Support Renewals Based on Users Deployed

55-70  A software vendor may offer a perpetual license to an end-user customer with postcontract customer support bundled for the initial year. The initial fee is $1,150,000, with $1,000,000 stated as the software license fee and $150,000 stated as the postcontract customer support fee. The end-user customer is entitled to deploy an unlimited number of copies of the software product for a three-year period. During the three-year unlimited deployment period, the end-user customer has the option to renew postcontract customer support annually for Years 2 and 3 for a stipulated fee of 15% of the stated license fee, which is $150,000 per year. After the expiration of the three-year unlimited deployment period, the end-user customer is required to pay additional license and postcontract customer support fees if it deploys additional copies of the software product. The optional postcontract customer support fee for Year 4 and annually thereafter is based on the ultimate number of copies of the software product deployed by the end-user customer at the end of the three-year unlimited deployment period.

55-71  The annual postcontract customer support renewal rates stipulated for Years 2 and 3 do not constitute vendor-specific objective evidence of fair value for the first year’s postcontract customer support in accordance with this Subtopic. In this arrangement there are two different pricing methodologies for postcontract customer support and no basis for determining which pricing methodology produces the appropriate vendor-specific objective evidence of fair value of the postcontract customer support bundled in Year 1 and offered in Years 2 and 3. Accordingly, the vendor would recognize the entire arrangement fee ($1,450,000) ratably over the 3-year deployment period. (The aggregate fee recognized should not exceed the amount that is not subject to forfeiture, refund, or other concession, as required in paragraph 985-605-25-13.) This presumes that postcontract customer support will be renewed in Years 2 and 3; however, if the customer does not renew in Year 2 or 3, the vendor should recognize the remaining deferred revenue at the time postcontract customer support is no longer being provided.

55-72  If sufficient objective evidence demonstrated that the renewal rate in Year 4 and thereafter is more likely than not (that is, a likelihood of more than 50%, as that term is used in paragraph 740-10-30-5(e)) to approximate or be less than the amount charged in Years 2 and 3, the annual postcontract customer support renewal rates stipulated for Years 2 and 3 would constitute vendor-specific objective evidence of fair value of postcontract customer support.

55-73  One example of such evidence would be a vendor’s past history of deployment with other comparable arrangements that result in postdeployment postcontract customer support fees that approximate postcontract customer support fees charged during the unlimited deployment period. Another example would be a stated cap or maximum on the price to be charged for postcontract customer support in Year 4 and thereafter that would result in a price that approximates or is less than the amount charged in Years 2 and 3. In such a circumstance, the amount allocated to the perpetual license ($1,000,000) would be recognized immediately, provided all other requirements for revenue recognition in this Subtopic are met, and the fair value of postcontract customer support in Year 1 would be recognized ratably over the postcontract customer support period. Likewise, the fees related to postcontract customer support renewals after Year 1 ($150,000 each for Years 2 and 3) would be recognized ratably over the respective postcontract customer support periods.


55-74  Paragraph 985-605-15-3(e) states that if a software arrangement includes services that meet the criteria discussed in paragraph 985-605-25-78, those services shall be accounted for separately. The types of services addressed by that paragraph are described in paragraph 985-605-25-76 and specifically exclude postcontract customer support-related services. A software arrangement may be subject to contract accounting and include postcontract customer support-related services (other than those meeting the cost accrual criteria in paragraphs 985-605-25-71 through 25-72).

55-75  If the vendor has vendor-specific objective evidence of the fair value of such postcontract customer support-related services determined pursuant to paragraphs 985-605-25-67 through 25-69, those related services shall be accounted for separately from the balance of the arrangement that is being accounted for in conformity with Subtopic 605-35.

Bug Fixes Provided to Customers that Choose Not to Obtain Postcontract Customer Support

55-76  In some software arrangements, customers may elect whether to obtain postcontract customer support from the vendor as an element of the software arrangement. To satisfy its warranty obligations, the software vendor provides bug fixes (free of charge) that are necessary to maintain compliance with published specifications to those customers that do not obtain postcontract customer support from the software vendor.

55-77  Paragraph 985-605-25-37 states that obligations related to warranties for defective software, including warranties that are routine, short-term, and relatively minor, shall be accounted for in conformity with Topic 450. However, postcontract customer support may include services such as the correction of errors (for example, bug fixing).

55-78  If a software vendor provides bug fixes (under warranty obligations) without charge that are necessary to maintain compliance with published specifications, the vendor would account for the estimated costs to provide bug fixes (that are necessary to maintain compliance with published specifications) in accordance with Topic 450.

55-79 The following provides implementation guidance as to the effect of customer acceptance provisions on determining whether a software arrangement meets the delivery criterion for revenue recognition (see paragraphs 985-605-25-18 through 25-21).

55-80 Customer acceptance provisions in a software arrangement may affect whether a software vendor may recognize revenue (provided all of the other revenue recognition criteria of this Subtopic have been met) before formal customer acceptance occurs.

55-81 Paragraph 985-605-25-21 is not intended to suggest that the mere existence of a customer acceptance provision precludes revenue recognition until formal acceptance has occurred. Items to consider in evaluating the effect of customer acceptance on revenue recognition include the following:

a. Historical experience with similar types of arrangements or products
b. Whether the acceptance provisions are specific to the customer or are included in all arrangements
c. The length of the acceptance term
d. Historical experience with the specific customer.

Accounting for Significant Incremental Discounts

55-82 Consistent with paragraph 985-605-25-8, if a software arrangement includes a right to a significant incremental discount on a customer’s future purchase of a products or services, a proportionate amount of that significant incremental discount shall be applied to each element covered by the arrangement based on each element’s fair value without regard to the significant incremental discount. See Example 10 (paragraph 985-605-55-185) for illustrations of this guidance.

55-83 If the maximum amount of the incremental discount on the future purchases is quantifiable, that quantifiable amount should be allocated to the elements of the arrangement and the future purchases assuming that the customer will purchase the minimum amount necessary to utilize the maximum discount, if either of the following conditions exists:

a. The future products or services to which the discount is to be applied is not specified in the arrangement (for example, a customer is allowed a discount on any future purchases).
b. The fair value of the future purchases cannot be determined under paragraphs 985-605-25-6 through 25-7.

See Example 10, Cases B1 and B2 (see paragraphs 985-605-55-191 through 55-194) for illustrations of this guidance.

55-84 The maximum amount of the significant incremental discount on future purchases may not be quantifiable. For example, the future purchases that can be purchased under the significant incremental discount arrangement are not limited by quantity of products or services. Revenue otherwise allocated to each element covered by the arrangement without regard to the significant incremental discount shall be reduced by the rate of the significant incremental discount. See Example 10, Case C (paragraph 985-605-55-197) for an illustration of this guidance.

55-85 The portion of the fee deferred as a result of the significant incremental discount shall be recognized as revenue proportionately as the future purchases are delivered, assuming all other revenue recognition criteria are met, such that a consistent discount rate is applied to all purchases under the arrangement. If the future purchases are not limited by quantity of products or services, the portion of the fee that is deferred as a result of the presence of a significant incremental discount shall be recognized as revenue as a subscription in accordance with paragraphs 985-605-25-58 through 25-59.

Applicability of Discount Accounting to Option to Buy Additional Copies of Software

55-86 Paragraph 985-605-15-3(d) states that if a discount or other concessions in an arrangement are more than insignificant, a presumption is created that an additional element or elements (as defined in paragraph 985-605-25-5) are being offered in the arrangement.

55-87 However, the provisions of paragraph 985-605-15-3(d) should not be applied to an option within a software arrangement that allows the customer to purchase additional copies of products licensed by and delivered to the customer under the same arrangement. In that case, revenue should be recognized as the rights to additional copies are purchased, based on the price per copy as stated in the arrangement. Additional copies of delivered software are not considered an undelivered element. In accordance with paragraphs 985-605-25-22 through 25-24, duplication of software is considered incidental to an arrangement, and the delivery criterion is met upon the delivery of the first copy or product master.

Effect of Discounts on the Residual Method

55-88 The following provides implementation guidance as to the effect of discounts on the application of the residual method of recognizing software revenue (see paragraphs 985-605-25-10 through 25-11).
### ASC 985-605 — Implementation Guidance (continued)

#### 55-89 Paragraph 985-605-15-3(d) defines a more-than-insignificant discount with respect to future purchases, and Example 10 (see paragraph 985-605-55-185) provides examples of accounting for significant incremental discounts that are within the scope of this Subtopic. The term discount, as used in this Subtopic, is the difference between the arrangement fee and vendor-specific objective evidence of fair value when vendor-specific objective evidence of fair value exists for all elements in the arrangement. However, a question arises as to how to compute the amount of a discount if the software vendor is applying the residual method as described in paragraphs 985-605-25-9 through 25-11, because vendor-specific objective evidence of fair value does not exist for all of the elements in the arrangement.

#### 55-90 For example, a software vendor enters into an arrangement with a customer that licenses currently available software products and services (referred to as the initial arrangement) and offers a discount off of its published list price on future purchases of products not previously licensed by the customer. The software vendor does not have vendor-specific objective evidence of fair value of its software products. However, the software vendor is able to apply the residual method pursuant to paragraphs 985-605-25-9 through 25-11, when the only undelivered elements are services.

#### 55-91 In this situation, the software vendor would compute the discount provided in the initial arrangement by comparing the published list price of the delivered elements in the initial arrangement to the residual value attributable to those delivered elements. If the discount on future purchases of future products is significant and incremental to the discount provided on the delivered elements in the initial arrangement, the software vendor should apply the significant and incremental discount to purchases to the initial arrangement using the guidance in paragraphs 985-605-55-82 through 55-85.

#### 55-92 See Example 11 (paragraph 985-605-55-201) for an illustration of this guidance.

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

#### 55-93 The following provides implementation guidance as to the effect of subsequent events on the timing of the establishment of vendor-specific objective evidence of fair value (see paragraphs 985-605-25-6 through 25-7).

#### 55-94 Vendor-specific objective evidence of fair value may be established by management after the balance sheet date but before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25), either by separate sales or by establishment of a price by a pricing committee. However, an entity may not use such evidence to recognize revenue at the balance sheet date in accordance with this Subtopic.

#### 55-95 Establishment of vendor-specific objective evidence after the balance sheet date is a nonrecognized subsequent event, as discussed in Topic 855—Subsequent Events. As a result, revenue should be deferred at the balance sheet date in accordance with paragraphs 985-605-25-9 through 25-11. However, if, after the balance sheet date, management merely compiles evidence that existed at the balance sheet date, that evidence should be used to assess whether there is sufficient vendor-specific objective evidence (in accordance with paragraphs 985-605-25-6 through 25-7) to recognize revenue at the balance sheet date.

### Delivery and Fixed and Determinable Fee

#### 55-96 The following provides implementation guidance on determining whether the criteria of delivery and fixed or determinable fees have been met (see paragraphs 985-605-25-18 through 25-40):

- **a.** Delivery terms if arrangement requires physical delivery of software
- **b.** Effect of change in license mix
- **c.** Effect of commencement of initial license term
- **d.** Effect of commencement of extension or renewal of license term
- **e.** Effect of additional products in an extension or renewal of license term

### Delivery Terms If Arrangement Requires Physical Delivery of Software

#### 55-97 Delivery is one of the basic criteria for revenue recognition in this Subtopic. In an arrangement that requires physical delivery of software, delivery terms that indicate when the customer assumes the risks and rewards of its licensing rights (for example, free on board [FOB] destination and FOB shipping point terms) are relevant in the assessment of whether software has been delivered.

#### 55-98 This guidance also applies to arrangements in which a software vendor licenses a software product and retains title to the product. For example, software arrangements that include FOB destination terms do not meet the delivery criterion until the customer receives the software.

### Effect of Change in License Mix

#### 55-99 Software arrangements may allow a user to change or alternate its use of multiple products or licenses (license mix) included in a license arrangement after those products have been delivered by the software vendor. The user has the right under the arrangement to deploy and use at least one copy of each licensed product (that is, the user has a license to use each delivered product). The products may or may not be similar in functionality. These arrangements may limit the customer’s use at any time to any mix or combination of the products as long as the cumulative value of all products in use does not exceed the total license fee. Certain of these arrangements may not limit use of a product or products, but may limit the number of users that simultaneously can use the products (referred to as concurrent user pricing).
Effect of Commencement of Initial License Term

Paragraphs 985-605-55-1 through 55-104 address the effect of commencement of an initial license term on software revenue recognition, and indicate that revenue should not be recognized before the license term commences even if all other criteria for revenue recognition have been met. However, if the license is an extension or renewal of a preexisting, currently active license for the same product(s), commencement of the extension or renewal term should not also be a prerequisite for revenue recognition.

Effect of Commencement of Extension or Renewal of License Term

If all other revenue recognition criteria are met, the software vendor should recognize the portion of the extension or renewal arrangement fee allocated to the license of Product A as revenue on September 20, 20X0. In the case of an extension or renewal of a preexisting, currently active license for the same product(s), the customer already has possession of and the right to use the software to which the extension or renewal applies.

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

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

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

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

For example, consider the arrangement described in paragraphs 985-605-55-105 through 55-109, including that vendor-specific objective evidence of fair value exists for postcontract customer support. The license term of Product A commenced on January 3, 20X1, and ends on January 2, 20X4. In September 20X3, the customer decides it wants to continue to use Product A beyond January 2, 20X4, and also to include in the arrangement a license to Product B, which will commence upon the delivery of Product B. The software vendor and customer execute an arrangement on September 20, 20X0, to extend or renew the terms of the existing license through December 31, 20X5. The extension or renewal arrangement includes only product or products already included in the existing, currently active arrangement.

The software vendor would allocate the extension or renewal arrangement fee using vendor-specific objective evidence of fair value consistent with paragraphs 985-605-25-6 through 25-7.
55-113 Consistent with paragraphs 985-605-55-105 through 55-109, the software vendor would recognize the portion of the extension or renewal arrangement fee allocated to Product A as revenue on September 20, 20X3 (if all other revenue recognition criteria are met), because the customer already has possession of and the right to use the software to which the extension or renewal applies. The portion of the extension or renewal arrangement fee allocated to Product B would be recognized when the criteria of paragraph 985-605-25-3 are met and the license period for Product B has commenced.

55-114 In considering the guidance in paragraphs 985-605-25-34 through 25-35 on determining whether the extension or renewal fee is fixed or determinable, the date that the extension or renewal arrangement is executed as it relates to the portion of the arrangement fee allocated to Product A and the date Product B is delivered as it relates to the portion of the arrangement fee allocated to Product B would be used to determine whether the extension or renewal arrangement payment terms are extended.

Effect of Option to Extend a Time-Based License Indefinitely

55-115 The following illustrates the guidance in paragraphs 985-605-25-6 through 25-7.

55-116 A software vendor may sell a product with postcontract customer support under a three-year term license with postcontract customer support renewable after one year. Vendor-specific objective evidence of fair value exists for postcontract customer support. The arrangement specifies that at any time during its term the customer can extend the license for the product indefinitely for an additional fee. Effectively, the arrangement contains an option to convert the three-year term license into a perpetual license for the product.

55-117 The option itself is not an element as contemplated in paragraphs 985-605-25-6 through 25-7 because there is no new deliverable. The exercise of the option merely affords the customer a longer time period to use the same product that it already has as part of the original arrangement. The additional fee to exercise the option is essentially the same as the fee for an extension or renewal of a license, as discussed in paragraphs 985-605-55-105 through 55-109.

55-118 If the perpetual license for the product necessitated another delivery of software media because the term license software media contained a self-destruct or similar mechanism to allow the vendor to control the usage of its intellectual property, that would not create an element or deliverable to be accounted for in the original arrangement. However, such media would need to be delivered before the option exercise fee could be recognized as revenue.

Hosting Arrangement

55-119 This implementation guidance addresses the scope application of this Subtopic to a hosting arrangement.

55-120 [Paragraph Not Used Not Used]

55-121 A software element subject to this Subtopic is only present in a hosting arrangement if both of the following criteria are met:

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

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

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

55-122 For purposes of item (a) in the preceding paragraph, the term significant penalty contains two distinct concepts:

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

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

55-123 Therefore, arrangements that do not give the customer such an option are service contracts and are outside the scope of this Subtopic. Hosting arrangements that are service arrangements may include multiple elements that affect how revenue should be attributed.

55-124 For those hosting arrangements in which the customer has the option, as described in paragraph 985-605-55-122 to take possession of the software, delivery of the software occurs when the customer has the ability to take immediate possession of the software. If the software element is within the scope of this Subtopic, all of this Subtopic’s requirements for recognizing revenue, including vendor-specific objective evidence of fair value and the requirement that the fee allocated to the software element not be subject to forfeiture, refund, or other concession, must be met to recognize revenue upon delivery for the portion of the fee allocated to the software element. The portion of the fee allocated to the hosting element should be recognized as the service is provided. Hosting arrangements that are within the scope of this Subtopic may also include other elements, such as specified or unspecified upgrade rights, in addition to the software product and the hosting service.

55-125 If the vendor never sells, leases, or licenses the software in an arrangement within the scope of this Subtopic, then the software is utilized in providing services and the development costs of the software should be accounted for in accordance with Subtopic 350-40.
ASC 985-605 — Implementation Guidance: Illustrations

Example 1: Scope — An Automobile Manufacturer

55-126 This Example illustrates the guidance in paragraphs 985-605-15-3 through 15-4 regarding the determination of whether software is incidental to the products or services as a whole.

55-127 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 Subtopic 985-20 and the production costs of such software are insignificant relative to the other development and production costs of the automobile.

55-128 This Subtopic is not applicable to such software because the software is deemed incidental to the product as a whole.

55-129 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.

Example 2: Scope — A Developer of Interactive Training Courses

55-130 This Example illustrates the guidance in paragraphs 985-605-15-3 through 15-4 regarding the determination of whether software is incidental to the products or services as a whole.

55-131 An entity develops interactive training courses for sale or licensing to customers. These courses are delivered on a compact disc, which is loaded onto a customer’s computer. The courses are developed such that, based on the responses received to a particular question, different questions are generated and content of the course material that is displayed is determined in a manner that directs the user’s learning experience in a more focused way. The course developer’s costs for the development of the software content are within the scope of Subtopic 985-20 and are significant. The interactive nature of the courses is mentioned prominently in the marketing efforts.

55-132 This Subtopic is applicable because the software is not incidental to the product.

55-133 Although some might say that the product is educational services, the marketing of the product focuses on the software-reliant interactive features. In addition, the course developer incurs significant costs that are within the scope of Subtopic 985-20. The nature of the relationship between the vendor and the customer is not one in which the customer would have a need for postcontract services. Consequently, the absence of postcontract customer support is not presumptive that software is incidental to the product. Accordingly, a conclusion is reached that the software is not incidental to the product as a whole. Therefore, the provisions of this Subtopic apply.

Example 3: Additional Software Products — Price per Copy

55-134 The following Cases illustrate the guidance in paragraphs 985-605-25-43 through 25-65:

a. One product not available at arrangement date (Case A)

b. No limit on number of copies of undelivered product (Case B).

55-135 Cases A and B share the following assumptions.

55-136 A vendor enters into an arrangement under which a customer has the right to make copies of Product A at $100 per copy, copies of Product B at $200 per copy, or copies of Product C at $50 per copy until such time as the customer has made copies aggregating $100,000 based on the per-copy prices. The customer is obligated to pay the $100,000 whether or not the customer makes all the copies to which it is entitled under the arrangement. In all other respects, the $100,000 is considered to meet the criteria of a fixed fee, as described in this Subtopic.

55-137 Master copies of Products A and B are available currently and have been delivered. Product C is not available yet; therefore, no master copy has been delivered. The contract is clear that no portion of the fee allocable to copies made of Products A and B is refundable if Product C is not delivered, nor is there any further obligation to deliver Product C if copies of Products A and B aggregating $100,000 have been made. The per-copy prices included in the arrangement for Products A and B are the per-copy prices included in the vendor’s price list, and the vendor has already approved the per-copy price list for Product C to be $50 per copy. Product C is not essential to the functionality of Products A or B.

Case A: Maximum Number of Copies of Undelivered Product

55-138 Assume that the maximum number of copies of Product C that can be made is 500.

55-139 The vendor would allocate $25,000 of the arrangement fee to Product C. The remaining $75,000 of revenue would be recognized when the master copies of Products A and B are delivered to the customer. The $25,000 allocated to Product C would be recognized when the master copy of Product C is delivered to the customer. If the customer duplicates enough copies of Products A and B so that the revenue allocable to those products exceeds $75,000, the additional revenue would be recognized as the additional copies are made.
<table>
<thead>
<tr>
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</thead>
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**ASC 985-605 — Implementation Guidance: Illustrations (continued)**

<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-140</td>
<td>As discussed in paragraph 985-605-25-52, in an arrangement in which a number of products are not deliverable or specified at the inception of the arrangement, an allocation of the arrangement fee generally cannot be made, because the total revenue allocable to each software product is unknown and depends on choices to be made by the customer and, sometimes, future development activity. As discussed in paragraph 985-605-25-56, however, if such an arrangement specifies a maximum number of copies of the undeliverable or unspecified product or products, a portion of the arrangement fee shall be allocated to the undeliverable product or products. This allocation shall be made assuming the customer elects to receive the maximum number of copies of the undeliverable product or products.</td>
</tr>
<tr>
<td>55-141</td>
<td>Because the arrangement states a maximum number of copies of Product C that can be made, a basis for allocating the fair value to each product of the arrangement exists. The amount allocated to the undelivered product is the maximum amount that can be allocable to that product, based on the maximum number of copies of Product C that can be made (500) and the fee per copy ($50). Accordingly, $25,000 would be allocated to Product C and deferred until delivery of the product master. Because all other conditions for revenue recognition in this Subtopic have been met, revenue related to Products A and B may be recognized upon delivery of the masters of those products as discussed in paragraphs 985-605-25-53 through 25-54.</td>
</tr>
</tbody>
</table>

**Case B: No Limit on Number of Copies of Undelivered Product**

<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-142</td>
<td>Assume that the arrangement does not state a maximum number of copies of Product C that can be made.</td>
</tr>
<tr>
<td>55-143</td>
<td>Revenue would be recognized as copies of Products A ($100 of revenue per copy) and B ($200 of revenue per copy) are made, until the master of Product C is delivered to the customer. Any remaining revenue would be recognized upon delivery of the master of Product C.</td>
</tr>
<tr>
<td>55-144</td>
<td>As discussed in paragraph 985-605-25-52, although the fee per copy is fixed at the inception of the arrangement and the cost of duplication is incidental, the total fee allocated to the undelivered software (Product C) is unknown and will depend on the choices made by the customers as to how many copies of each product will be used.</td>
</tr>
</tbody>
</table>

**Example 4: Authorization Codes — Optional Functions**

<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-145</td>
<td>This Example illustrates the guidance in paragraphs 985-605-25-27 through 25-28.</td>
</tr>
<tr>
<td>55-146</td>
<td>A vendor includes 10 optional functions on a compact disc read-only memory (CD-ROM) on which its software product is licensed. Access to those optional functions is not available without a permanent key. Users can order the optional functions and receive permanent keys to enable the full use of those functions.</td>
</tr>
<tr>
<td>55-147</td>
<td>The vendor would recognize revenue for each individual optional function when the user purchases it by placing an order, evidence of such order exists, and the key is delivered to the user.</td>
</tr>
<tr>
<td>55-148</td>
<td>Although the user has received a fully functional version (except for the keys) of the optional functions on the CD-ROM, the user has not agreed to license them. Because no evidence of an arrangement exists (as discussed in paragraphs 985-605-25-15 through 25-17), revenue for the optional functions may not be recognized when the CD-ROM is delivered.</td>
</tr>
</tbody>
</table>

**Example 5: Authorization Codes — Access to Additional CPU**

<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-149</td>
<td>This Example illustrates the guidance in paragraphs 985-605-25-27 through 25-29.</td>
</tr>
<tr>
<td>55-150</td>
<td>A software vendor’s products run on two different levels of central processing units (CPUs) of the same manufacturer—Model X and Model Y (both of which are on the same platform). The vendor enters into a license arrangement with a user whereby the user licenses the vendor’s products to run on Model X but allows the user to move to Model Y at no additional charge. The vendor delivers the product in the form of a disc pack along with a CPU authorization code. At the time the user chooses to move to Model Y, the user does not receive a new disc pack; rather the vendor gives the user a new CPU authorization code.</td>
</tr>
<tr>
<td>55-151</td>
<td>The vendor would recognize revenue on the delivery of the disc pack. Delivery of the authorization code to move to another CPU is not considered to be an additional software deliverable.</td>
</tr>
</tbody>
</table>

**Example 6: Multiple-Element Arrangements — Products**

<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-152</td>
<td>The following Cases illustrate the guidance in paragraph 985-605-25-12:</td>
</tr>
<tr>
<td>55-153</td>
<td>Cases A and B share the following assumptions.</td>
</tr>
<tr>
<td>55-154</td>
<td>A vendor licenses to a user one license covering a single copy of Products A, B, C, and D for a nonrefundable fixed fee of $80, with no stated price per product. Products A, B, and C are deliverable. Product D is not deliverable. The vendor has a history of sales prices for Products A, B, and C of $25 each. The vendor’s pricing committee has established a price for Product D of $25. It is probable that the price established by the pricing committee for Product D will not change before introduction. Therefore, the vendor is able to derive its specific price for the undelivered software.</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Description</th>
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</thead>
<tbody>
<tr>
<td>55-155</td>
<td>Product D is not essential to the functionality of Products A, B, or C. Persuasive evidence exists that indicates that the revenue related to Products A, B, or C is not subject to refund, forfeiture, other concessions if Product D is not delivered.</td>
</tr>
</tbody>
</table>
### Example 8: Multiple-Element Arrangements — Products and Services

#### Case A: Undelivered Product Essential to Functionality of Delivered Products

In this Case, Product D is delivered, in accordance with paragraph 985-605-25-12.

Accordingly, the $10,000 revenue allocated to the upgrade right is deferred until delivery of Product D, and therefore the entire amount would be recognized on delivery of version 2.0.

#### Case B: Undelivered Product Essential to Functionality of Delivered Products

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

Therefore, the vendor would defer all revenue until delivery of Product D. Because revenue allocable to the delivered software is expected not to exercise the upgrade right until delivery of the upgrade or enhancement, and recognize the remaining $24,000 on delivery of version 1.0.

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

In this Case, the pricing committee determines that version 2.0 will be offered to users of version 1.0 as a specified upgrade at a price of $100.

Accordingly, the $10,000 revenue allocated to the upgrade right would be deferred until delivery of the upgrade or enhancement, and recognize the remaining $10,000 on delivery of version 1.0.

#### Example 8: Multiple-Element Arrangements — Products and Services

The following Cases illustrate the guidance in paragraphs 985-605-25-76 through 25-85:  

- a. Implementation services (Case A)
- b. More than minor modifications (Case B)
- c. Implementation services not customarily sold separately (Case C).

In Cases A, B, and C, a vendor has entered into an arrangement to provide a customer with its off-the-shelf software product and related implementation services.
ASC 985-605 — Implementation Guidance: Illustrations (continued)

Case A: Implementation Services

55-171 The software and service elements of the contract are stated separately and the vendor has a history of selling these services separately such that the revenue allocation criteria of paragraphs 985-605-25-3 through 25-14 can be satisfied. The software license fees are due under the vendor’s normal trade terms, which are net 30 days. The services are expected to be provided over the next 90 days and are of the type performed routinely by the vendor. The features and functionality of the software are not altered to more than a minor degree as a result of these services.

55-172 In this Case, the vendor would recognize the license revenue allocated to the software element upon its delivery and the revenue allocated to the service element as such services are performed.

55-173 When license arrangements have multiple elements, revenue shall be allocated to each of the elements and recognized when the related element is delivered and all of the following conditions exist:
   a. The undelivered elements are not essential to the functionality of the delivered elements.
   b. The revenue allocated to the delivered elements is not subject to forfeiture, refund, or other concession if the undelivered elements are not delivered.
   c. Sufficient vendor-specific objective evidence exists to allocate separate prices to each of the elements.

55-174 The service element in this arrangement is not deemed to be essential to the functionality of the software element because the features and functionality of the software are not altered to more than a minor degree as a result of the services.

Case B: More than Minor Modifications

55-175 In this Case, the vendor agrees to make more than minor modifications to the functionality of the product to meet needs as defined by the user. The software and service elements of the contract are stated separately and the vendor has a history of selling these services separately such that the revenue allocation criteria of paragraphs 985-605-25-3 through 25-14 can be satisfied. Payment terms are 10% upon installation of the software, with the remainder according to a time line, and the final 25% withheld until acceptance. The desired modifications are not unusual; the vendor has made similar modifications to the product many times and is certain that the planned modifications will meet the user’s needs.

55-176 The vendor would follow the guidance on contract accounting (using either the percentage-of-completion or completed-contract method, depending on the facts and circumstances) included in paragraphs 985-605-25-88 through 25-107. The new conditions would preclude service transaction accounting because the functionality of the software product is being altered in more than a minor way, the payment of the fees is coincident with the services being performed, and the software is subject to the user’s unique acceptance criteria.

Case C: Implementation Services Not Customarily Sold Separately

55-177 Assume the same transaction as described in Case A, except that the vendor never sells implementation services separately. The implementation services do not involve significant customization of the software.

55-178 The vendor would recognize all revenue from the arrangement over the 90 day period during which the services are expected to be performed, commencing with delivery of the software product.

55-179 The criteria for vendor-specific objective evidence of the fair value require that the element be sold separately or be planned to be sold separately. Because implementation services are neither sold separately nor planned to be sold separately, and upon delivery of the software product such services are the only undelivered elements, paragraph 985-605-25-80 requires that all revenue be recognized over the period during which the implementation services are expected to be provided.

Example 9: Multiple-Element Arrangements — Products and Services — Application of the Residual Method

55-180 This Example illustrates the guidance in paragraphs 985-605-25-9 through 25-11.

55-181 A vendor sells software Product A for $950. The license arrangement for Product A always includes one year of free postcontract customer support. The annual renewal price of postcontract customer support is $150.

55-182 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 Subtopic are met, revenue in the amount of $150 would be deferred and recognized in income over the one-year postcontract customer support service period. Revenue of $800 would be allocated to the software element and recognized upon delivery of the software.

55-183 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 985-605-25-10 states, however, that the residual method shall 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 Subtopic are met, and the fair value of all of the undelivered elements is less than the total arrangement fee.

55-184 If there had been vendor-specific objective evidence of the fair value of the delivered software but not of the undelivered postcontract customer support, the vendor would defer the entire arrangement fee and recognize it ratably over the contractual postcontract customer support period in accordance with paragraphs 985-605-25-10 through 25-11 and 985-605-25-70.
Example 10: Accounting for Significant Incremental Discounts

55-185 The following Cases illustrate the guidance in paragraphs 985-605-15-3 through 15-4 and 985-605-55-82 through 55-85:

- Application of discount to each element covered by the arrangement (Case A)
- Future products or services unknown, but maximum future discounts quantifiable (Case B)
- No maximum future discount (Case C)
- Discount significant but not incremental (Case D).

55-186 In each Case, vendor-specific objective evidence of fair value equals list price.

Case A: Application of Discount to Each Element Covered by the Arrangement

55-187 A software vendor sells Product A for $40 with a right to a discount (the coupon) of $30 on another of its software products, Product B. Vendor-specific objective evidence of fair value is $40 for Product A and $60 for Product B. The $30 discount on Product B is a significant incremental discount that normally would not be given in comparable transactions.

55-188 The vendor would allocate the $30 discount across Product A and Product B. The overall discount is 30% ($30/$100). Therefore, upon the delivery of Product A, the vendor would recognize $28 of revenue and defer $12. If the customer uses the discount and purchases Product B, the vendor would recognize $42 in revenue upon delivery of Product B ($30 in cash received plus the $12 previously deferred). If the discount expires unused, the $12 in deferred revenue then would be recognized.

Case B: Future Products or Services Unknown, but Maximum Future Discounts Quantifiable

55-189 The following Cases illustrate the guidance in paragraph 985-605-55-83:

- Dollar discount on any one additional product purchased (Case B1)
- Half-price discount on any future purchases with cumulative maximum (Case B2)
- Discount on future purchases significant and incremental to discount on original purchase (Case B3).

55-190 In each Case, the maximum future discounts can be quantified, although the future products or services that the customer will purchase and apply the discounts to are not known.

Case B1: Dollar Discount on Any One Additional Product Purchased

55-191 A software vendor sells Product A for $40 with a right to a discount (the coupon) of $20 on any one of its other software products, Products B through Z. Vendor-specific objective evidence of fair value for Product A is $40 and for Products B through Z ranges from $30 to $100. The $20 discount is a significant incremental discount that normally would not be given in comparable transactions.

55-192 The vendor would allocate the $20 discount across Product A and the assumed purchase of whichever of Product B through Z has the lowest fair value ($30). The overall discount is 28.57% ($20/$70). Therefore, upon delivery of Product A, the vendor would recognize $28.57 in revenue, and defer $11.43. If the customer uses the discount and purchases the additional Product B with a fair value of $30, the vendor would recognize $11.43 in revenue upon its delivery (the $11.43 previously deferred and the additional cash license fee due of $10). If the discount expires unused, the $11.43 in deferred revenue then would be recognized.

Case B2: Half-Price Discount on Any Future Purchases With Cumulative Maximum

55-193 A software vendor sells Product A for $40 with a right to a discount (the coupon) of 50% off list price on any future purchases of its other software products, Products B through Z, with a maximum cumulative discount of $100. Vendor-specific objective evidence of fair value for Product A is $40 and for Products B through Z ranges from $20 to $100. The 50% discount is a significant incremental discount that normally would not be given in comparable transactions.

55-194 The vendor would assume that the maximum discount will be used. Therefore, the vendor would allocate the $100 discount across Product A and the assumed additional products to be purchased. The overall discount is 41.67% ($100/$240). Therefore, upon delivery of Product A, the vendor would recognize $23.33 of revenue and defer $16.67. If the customer uses the discount by purchasing additional products with fair value totaling $200, the vendor would recognize $116.67 in revenue upon delivery of those products ($100 in cash received plus the $16.67 previously deferred). If the discount expires unused, the $16.67 in deferred revenue then would be recognized.

Case B3: Discount Future Purchases Significant and Incremental to Discount on Original Purchase

55-195 A software vendor sells Product A for $60, which represents a 40% discount off list price (vendor-specific objective evidence) of $100. In the same transaction, it also provides the right to a discount of 60% off of the list price (vendor-specific objective evidence) on any future purchases of units of software Product B for the next 6 months with a maximum discount of $200. The discount of 60% on future purchases of units of Product B is a discount normally not given in comparable transactions.
ASC 985-605 — Implementation Guidance: Illustrations (continued)

55-196 Because the discount offered on future purchases of Product B normally is not given in comparable transactions and is both significant and incremental in relation to the 40% discount, it would be accounted for as part of the original sale consistent with Case B2. The vendor would assume that the maximum discount will be used. Therefore, the vendor would allocate the $240 discount ($40 on Product A and $200 maximum on future purchases) across Product A and the assumed additional products to be purchased. The overall discount is 55.38% ($240/$433.33; $433.33 is the sum of the $100 list price of Product A and the $333.33 accumulated list price of Product B that results in a maximum discount of $200). Therefore, upon the delivery of Product A, the vendor would recognize $44.62 of revenue and defer $15.38. If the customer uses the discount by purchasing additional products with fair value totaling $333.33, the vendor would recognize $148.71 in revenue upon delivery of those products ($133.33 in cash received plus the $15.38 previously deferred). If the discount expires unused, the $15.38 in deferred revenue then would be recognized.

Case C: No Maximum Future Discount

55-197 A software vendor sells Product A for $40 with a right to a discount (the coupon) of 50% off list price on any future purchases of its other software products, Products B through Z, with no maximum cumulative discount. Vendor-specific objective evidence of fair value for Product A is $40. Vendor-specific objective evidence of fair value (which equals list price) of Products B through Z ranges from $20 to $100. The 50% discount is a significant incremental discount that normally would not be given in comparable transactions.

55-198 The vendor would apply the 50% discount to Product A and all future products purchased using the discount. Therefore, upon the delivery of Product A, the vendor would recognize $20 of revenue and defer $20. If the customer purchases additional products using the discount, the vendor would recognize revenue equal to the cash received upon the delivery of those products. The previously deferred $20 should be accounted for as a subscription in accordance with paragraphs 985-605-25-10 through 25-59 and recognized pro rata over the discount period or, if no period is specified in the arrangement, over the estimated period during which additional purchases will be made.

Case D: Discount Significant but Not Incremental

55-199 A software vendor sells Product A for $30 with the right to a discount (vendor-specific objective evidence) on any future purchases of its other software products, Products B through P, for the next 6 months with no maximum cumulative discount. Product A is also given at a 70% discount and the vendor-specific objective evidence of fair value of Product A is $100.

55-200 Because the discount offered on future purchases over the next 6 months is equal to the discount offered on the current purchase (70%), there is no accounting necessary in the original sale for the discount offered on future purchases.

Example 11: Effect of Discounts on Future Products on the Residual Method

55-201 On December 31, 20X1, a software vendor licenses Product A (with a published list price of $100) on a perpetual basis, bundled with postcontract customer support for the first year, to a customer for $80. The customer may elect to renew postcontract customer support following the initial year at a stipulated rate of $15, which requires the software vendor to apply the residual method pursuant to paragraphs 985-605-25-10 through 25-11. In conjunction with the licensing of Product A, the software vendor offers the customer a 55% discount off of its published list price on the purchase of all new products released by the vendor during the three years subsequent to December 31, 20X1, with no maximum cumulative discount. Based on the guidance in paragraph 985-605-55-91, the vendor would perform the following calculation to assist in determining whether the discount offered on future purchases of future products is significant and incremental (as discussed in paragraph 985-605-15-3(d)).

<table>
<thead>
<tr>
<th>Product A</th>
<th>Published List Price</th>
<th>Residual Value</th>
<th>Discount From Published list</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product A</td>
<td>$100</td>
<td>$65</td>
<td>35.00%</td>
</tr>
<tr>
<td>Future Products</td>
<td>Unknown</td>
<td>Unknown</td>
<td>55.00%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>(a)</th>
<th>(b)</th>
<th>(a)*(b)=(c)</th>
<th>(d)</th>
<th>(c)+(d)=(e)</th>
<th>(f)</th>
<th>(f)–(e)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100</td>
<td>20%</td>
<td>$20</td>
<td>$15</td>
<td>$35</td>
<td>$80</td>
<td>$45</td>
</tr>
</tbody>
</table>

55-202 Assuming that the software vendor concludes that the additional discount (that is, 20% in this Example) on future purchases is significant and incremental, the vendor would allocate such discount to Product A and defer revenue related to the postcontract customer support in the initial arrangement as follows.
ASC 985-605 — Implementation Guidance: Illustrations (continued)

55-203 Consistent with Example 10, Case C (see paragraph 985-605-55-197), on delivery of Product A the vendor would recognize $45 of revenue and defer $35, provided all other requirements of revenue recognition in this Subtopic are met. The $15 revenue related to postcontract customer support deferred pursuant to the residual method would be recognized over the initial year of the license in accordance with paragraphs 985-605-25-67 through 25-69. The $20 deferred revenue related to the discount would be accounted for as a subscription in accordance with paragraphs 985-605-25-58 through 25-59 and recognized pro rata over the 3-year discount period. If the customer purchases additional products using the discount, the vendor would recognize revenue equal to the fee attributable to those additional products, provided all other requirements of revenue recognition in this Subtopic are met.

Example 12: Multiple-Element Arrangements — Products and Discounted Postcontract Customer Support

55-204 This Example illustrates the guidance in paragraphs 985-605-25-6 through 25-7.

55-205 A software vendor enters into an arrangement under which it licenses 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 postcontract customer support, priced for the first year at 15% of the discounted license fee, or $90,000 (rather than 15% 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% of the list price of the software (or $150,000).

55-206 There are no other undelivered elements. All revenue recognition conditions of this Subtopic have been satisfied.

55-207 The vendor does not have sufficient vendor-specific historical evidence that costs of providing postcontract customer support are incurred on other than a straight-line basis.

55-208 In Year 1, the total arrangement fee is $690,000. Of this amount, $552,000 would be allocated to the software element and recognized on delivery of the software element. The remaining $138,000 would be allocated to the postcontract customer support element and recognized ratably over the period during which the postcontract customer support services are expected to be performed. The allocation of the $690,000 arrangement fee is determined as shown in the following tables.

Fair values when sold separately are as follows.

<table>
<thead>
<tr>
<th>Element</th>
<th>Fair Value</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Software element</td>
<td>$600,000</td>
<td>80%</td>
</tr>
<tr>
<td>Postcontract consumer support</td>
<td>$150,000</td>
<td>20%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$750,000</td>
<td>100%</td>
</tr>
</tbody>
</table>

Allocation is as follows.

<table>
<thead>
<tr>
<th>Element</th>
<th>Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Postcontract consumer support</td>
<td>$ 690,000 × .20 = $ 138,000</td>
</tr>
<tr>
<td>Software element</td>
<td>$ 690,000 × .80 = $ 552,000</td>
</tr>
</tbody>
</table>

55-209 In allocating the arrangement fee to postcontract customer support, the vendor would look first to the price the customer will pay for the postcontract customer support 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 postcontract customer support, as discussed in paragraphs 985-605-25-6 through 25-7.

55-210 If the customer were entitled to postcontract customer support 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 postcontract customer support were based on the discounted value of license fees, no additional fees would have been allocated from the software element to postcontract customer support. Therefore, the vendor would have allocated $600,000 to the software element and $90,000 to postcontract customer support.

Example 13: Arrangements That Include Tangible Products and Software Elements

55-211 The following cases illustrate the guidance in paragraphs 985-605-15-3 through 15-4 and paragraph 985-605-25-10. The cases provide guidance for purposes of allocating arrangement consideration in a multiple-element revenue arrangement that includes a tangible product and software. The cases illustrate whether a product contains software elements and nonsoftware elements that function together to deliver the tangible product’s essential functionality as discussed in paragraph 985-605-15-4. The cases are:

a. Computer with operating system included (Case A)

b. Computer with operating system excluded more than infrequently (Case B)

c. Computer and multiple operating systems (Case C)

d. Computer with additional software products included (Case D)

e. Personal digital assistant (Case E)

f. Computer with operating system sold separately (Case F)

g. Computer and undelivered software elements (Case G)

h. Standalone sale of an operating system (Case H)
### ASC 985-605 — Implementation Guidance: Illustrations (continued)

1. Computer with nonessential software and postcontract customer support included (Case I)
2. Networking equipment (Case J)
3. Similar products (Case K)
4. Change in business practice (Case L)

**Case A: Computer with Operating System Included**

55-212 Vendor sells a personal computer that includes an operating system that, along with the hardware, provides the basic functionality of a personal computer including the ability to manage the computer and its hardware functions, the ability to manage and interact with a range of hardware peripherals, and the ability to communicate through a variety of types of computer networks. This arrangement has no undelivered elements. Vendor infrequently sells the personal computer without the operating system. Because both the hardware and operating system are necessary to deliver the computer’s essential functionality, the arrangement would be excluded from the scope of this Subtopic.

**Case B: Computer with Operating System Excluded More Than Infrequently**

55-214 Consider the same fact pattern as in Case A, except that Vendor sells the personal computer both with and without the operating system more than infrequently.

55-215 Because Vendor sells the personal computer without an operating system more than infrequently, the operating system is not considered essential to the functionality of the personal computer. Therefore, the computer would be excluded from the scope of this Subtopic, and the operating system would be considered a separate deliverable that is within the scope of this Subtopic.

**Case C: Computer and Multiple Operating Systems**

55-216 Consider the same fact pattern as in Case A, except that Vendor also sells the personal computer with a different operating system that provides essentially the same functionality as the operating system in Case A.

55-217 Vendor infrequently sells the personal computer without an operating system, which indicates that an operating system is essential to the functionality of Vendor’s personal computer. All deliverables would be excluded from the scope of this Subtopic.

**Case D: Computer with Additional Software Products Included**

55-218 Consider the same fact pattern as in Case A, except that Vendor also includes a productivity software bundle with the personal computer that allows users to create, edit, and use documents, spreadsheets, and presentations. Vendor frequently sells the same computer both with and without the productivity software. When the productivity software is included with the software, the functionality of the productivity software is prominently displayed in the marketing materials and specifications of the computer. The productivity software is also sold separately.

55-219 The productivity software would not be considered necessary for the computer to provide its essential functionality. While the operating system is essential to deliver the personal computer’s basic functionality, the productivity software is not. This is demonstrated by the fact that the computer is frequently sold both with and without the productivity software. The computer and operating system would be considered one deliverable that is excluded from the scope of this Subtopic. The productivity software would remain within the scope of this Subtopic.

**Case E: Personal Digital Assistant**

55-220 Vendor sells a personal digital assistant. The personal digital assistant provides several functions, such as phone, camera, and computing functionality, that allow the user to access and use various software programs, such as a music player and games. The personal digital assistant contains an operating system that allows the customer to access the functionality of the device, including the ability to utilize software that is necessary to provide the phone, camera, and other functionality. The phone and camera software are frequently included on the personal digital assistant, but the music player and game software are excluded more than infrequently. The phone, camera, and music player software are not sold separately, but the game software is sold separately.

55-221 The personal digital assistant hardware, operating system, phone, and camera software are essential to the functionality of the personal digital assistant and would be considered one deliverable that is outside the scope of this Subtopic. The music player and game software would be considered software deliverables within the scope of this Subtopic because the product also is sold more than infrequently without this software. Whether the software is sold separately does not affect the conclusion in this example.

**Case F: Computer with Operating System Sold Separately**

55-222 Vendor sells a personal computer that includes an operating system that, along with the hardware, provides the basic functionality of a personal computer, including the ability to manage the computer and its hardware functions, the ability to manage and interact with a range of hardware peripherals, and the ability to communicate through a variety of types of computer networks. The arrangement has no undelivered elements. Vendor never sells the personal computer without the operating system, but does sell the operating system for the personal computer separately. The personal computer hardware cannot function without an operating system, and the operating system does not function without the computer hardware.
### ASC 985-605 — Implementation Guidance: Illustrations (continued)

<table>
<thead>
<tr>
<th>Section</th>
<th>Illustration</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-223</td>
<td>Vendor determines that the operating system is necessary to deliver the computer’s essential functionality as evidenced by the fact that the vendor does not sell the computer without the operating system. Accordingly, the computer and operating system would be considered one deliverable that is excluded from the scope of this Subtopic. Whether the software is sold separately or in a different transaction does not affect the conclusion in this example. The critical assessment is whether the computer and the operating system in one transaction are both necessary to provide the computer’s essential functionality. See paragraph 985-605-55-227 for an illustration of how Vendor would account for the separate sale of the operating system without the computer.</td>
</tr>
<tr>
<td>55-224</td>
<td>Consider the same fact pattern as in Case A, except that Vendor also provides a specified upgrade right for the next version of its operating system along with postcontract customer support, including information about available upgrades of the operating system.</td>
</tr>
<tr>
<td>55-225</td>
<td>Because the computer and operating system are determined to be a single nonsoftware deliverable that is excluded from the scope of this Subtopic, all deliverables related to that nonsoftware deliverable are also considered nonsoftware deliverables and excluded from the scope of this Subtopic. Accordingly, the postcontract customer support and specified upgrade right for the operating system would be nonsoftware deliverables excluded from the scope of this Subtopic.</td>
</tr>
<tr>
<td>55-226</td>
<td>Vendor releases a new upgraded version of its computer operating system. Vendor sells the upgraded operating system in a standalone transaction to a customer that had previously purchased a computer that contained a prior version of Vendor’s operating system. Vendor now includes the upgraded operating system on all of its computers. When sold with the personal computer, the operating system is combined with the personal computer as a single nonsoftware deliverable that is excluded from the scope of this Subtopic.</td>
</tr>
<tr>
<td>55-227</td>
<td>The separate sale of the operating system would be within the scope of this Subtopic. Even though this software would be considered a nonsoftware deliverable if it were sold with the computer, this Subtopic only provides a scope exception for the operating system when it is part of an arrangement that includes the sale of a tangible product.</td>
</tr>
<tr>
<td>55-228</td>
<td>Consider the same fact pattern as in Case D, except that Vendor also provides postcontract customer support for both the computer (including the operating system) and productivity software.</td>
</tr>
<tr>
<td>55-229</td>
<td>The combined computer and operating system product is considered to be a single nonsoftware deliverable, and the productivity software is considered to be a software deliverable consistent with Case D. Because the postcontract customer support relates to deliverables within the scope of this Subtopic and deliverables outside the scope of this Subtopic, it must be bifurcated into software and nonsoftware related components. Postcontract customer support relating to the productivity software would be a deliverable within the scope of this Subtopic. Postcontract customer support relating to the computer (including the operating system) would be a nonsoftware deliverable that is outside the scope of this Subtopic.</td>
</tr>
<tr>
<td>55-230</td>
<td>Vendor sells networking equipment that provides its energy company customers with the ability to remotely monitor and manage their customers’ energy use. Vendor sells an integrated package of equipment and software that consists of a monitoring device that is placed at the energy company’s customer location to collect data that it then relays back to the energy company’s remote location and software that allows the energy company to analyze the data and interface with its billing system. The software is installed on the energy company’s computer system, which is not purchased from Vendor. The equipment does not have functionality without the software, and the software does not have functionality without the equipment. Vendor’s customers will initially purchase all of these components together; however, they also can separately purchase replacement or expansion equipment or updated versions of the software at a subsequent time.</td>
</tr>
<tr>
<td>55-231</td>
<td>The equipment and software would all be considered nonsoftware elements outside the scope of this Subtopic. The monitoring and relay equipment work together with the software (though not as a physically combined unit) to deliver the product’s essential functionality and allow the energy company to access and analyze its customers’ usage data. Vendor cannot access the functionality of the equipment without the software. Although Vendor does sell the equipment separately without the software, it only does so in replacement situations or as the customer base of the energy company expands. The customer would have needed to previously acquire the software for the replacement equipment to function.</td>
</tr>
<tr>
<td>55-232</td>
<td>Vendor sells two models of personal digital assistant devices — Model 100 and Model 200. Model 100 (including the software delivered on Model 100) is considered to be a nonsoftware deliverable excluded from the scope of this Subtopic when applying this Subtopic. The difference between the two models is that Vendor infrequently sells the Model 200 without music player software. The music player software is not included on Model 100, but customers can separately purchase the software for use on Model 100. There is no substantive difference in the other hardware or software components of the two models.</td>
</tr>
</tbody>
</table>
Nonmonetary Exchange

**ASC 985-845 — Implementation Guidance**

**55-1** The following table summarizes the guidance in this Subtopic.

<table>
<thead>
<tr>
<th>Software Vendor’s Technology Exchanged</th>
<th>Software Vendor’s Use of Technology Received</th>
<th>Same Line of Business</th>
<th>Accounting Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Software product held for sale in the ordinary course of business (that is, inventory)</td>
<td>Technology to be held for sale in the ordinary course of business (that is, inventory)</td>
<td>1. Yes</td>
<td>1. Record at historical cost</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2. No</td>
<td>2. Record at fair value</td>
</tr>
<tr>
<td>Software product held for sale in the ordinary course of business (that is, inventory)</td>
<td>Internal-use software</td>
<td>N/A</td>
<td>Record at fair value</td>
</tr>
</tbody>
</table>

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

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

(c) Assumes that vendor-specific objective evidence of fair value exists and the transaction has a business purpose.

(d) 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.

**Example 1: Exchange of Software Products**

**55-2** This Example illustrates the guidance in this Subtopic for both the software vendor (see Section 985-845-25) and the other party to the nonmonetary exchange.

**55-3** Software Vendor A licenses Software Product 1 (a suite of financial accounting applications) to customers in the normal course of business. Software Vendor A has vendor-specific objective evidence of fair value of Product 1 resulting from prior cash transactions with its customers. Product 1 includes technology (Product 2) sublicensed by Software Vendor A from Entity B.

**55-4** Software Vendor A agrees to exchange Product 1 with Entity B for licenses to Product 2. Software Vendor A intends to relicense Product 2 (as a separate product or embedded in Product 1) to its customers. Entity B intends to use Product 1 for internal use.
Software Vendor A would account for the transaction as follows.

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

Entity B would account for the transaction as follows.

Entity B exchanged property held for sale (Product 2) for a productive asset (Product 1, which will be used by Entity B as an amortizable asset). The exchange would be measured based on fair value by Entity B, and revenue would be recognized on the exchange. Such accounting treatment is based on the fact that the fair value of the technology exchanged or received is reasonably determinable and that the exchange has commercial substance.
# Appendix A — Glossary of Terms in ASC 985-605

<table>
<thead>
<tr>
<th>985-605-20 Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Authorization Code</strong></td>
</tr>
<tr>
<td>A vehicle used by vendors to permit customers access to, use of, or duplication of software that would otherwise be restricted. Also called a key.</td>
</tr>
</tbody>
</table>

| **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 any of 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.

| **Enhancement** |
| See Upgrade. |

| **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. |

| **Hosting Arrangement** |
| In connection with the licensing of software products, an arrangement in which an end user of the software does not take possession of the software; rather, the software application resides on the vendor’s or a third party’s hardware, and the customer accesses and uses the software on an as-needed basis over the Internet or via a dedicated line. |

| **Licensing** |
| Granting the right to use but not to own software through leases or licenses. |

| **Maintenance** |
| 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. |

| **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. |
### 985-605-20 Glossary (continued)

<table>
<thead>
<tr>
<th><strong>Platform-Transfer Right</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Postcontract Customer Support</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>The right to receive services (other than those separately accounted for as described in paragraph 985-605-25-79) or unspecified product upgrades or enhancements, or both, offered to users or resellers, after the software license period begins, or after another time as provided for by the postcontract customer support arrangement. Unspecified upgrades or enhancements are postcontract customer support only if they are offered on a when-and-if-available basis. Postcontract customer support does not include any of the following:</td>
</tr>
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<td></td>
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<td></td>
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<tr>
<td>Postcontract customer support may be included in the license fee or offered separately. Postcontract customer support generally is referred to in the software industry as maintenance. However, the term maintenance is not used in referring to postcontract customer support for the following reasons:</td>
</tr>
<tr>
<td></td>
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<tr>
<td></td>
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<tr>
<td></td>
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<tr>
<td>The right to receive services and unspecified upgrades or enhancements provided under postcontract customer support generally is described by the postcontract customer support arrangement. Typical arrangements include services, such as telephone support and correction of errors (bug fixing or debugging), and unspecified product upgrades or enhancements developed by the vendor during the period in which the postcontract customer support is provided. Postcontract customer support arrangements include patterns of providing services or unspecified upgrades or enhancements to users or resellers, although the arrangements may not be evidenced by a written contract signed by the vendor and the customer.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Product Master</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>A completed version, ready for copying, of the computer software product, the documentation, and the training materials that are to be sold, leased, or otherwise marketed.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Reseller</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>An 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.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Site License</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>A license that permits a customer to use either specified or unlimited numbers of copies of a software product either throughout an entity or at a specified location.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Upgrade</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Upgrade Right</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>The right to receive one or more specific upgrades or enhancements that are to be sold separately. The upgrade right may be evidenced by a specific agreement, commitment, or the vendor’s established practice.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>User</strong></th>
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</thead>
<tbody>
<tr>
<td>The party that ultimately uses the software in an application.</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>When-and-If-Available</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>
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. 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. Concepts Statement 5, Recognition and Measurement in Financial Statements of Business Enterprises, paragraph B3(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 B4(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 B4(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,\(^1\)
- Delivery has occurred or services have been rendered,\(^4\)
- The seller’s price to the buyer is fixed or determinable,\(^5\) and
- Collectibility is reasonably assured.\(^6\)

\(^1\) 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 B3-B4; FASB ASC paragraph 605-10-25-1 (Revenue Recognition Topic); FASB ASC paragraph 605-10-25-3; FASB ASC paragraph 605-10-25-5. 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 FASB ASC paragraph 985-605-25-3 (Software Topic). 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, paragraphs B4(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.

\(^5\) Concepts Statement 5, paragraph B3(a); FASB ASC subparagraph 605-15-25-1(a); FASB ASC paragraph 985-605-25-3. The FASB ASC Master Glossary 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.” FASB ASC paragraphs 985-605-25-30 through 985-605-25-40 discuss how to apply the fixed or determinable fee criterion in software transactions. The staff believes that the guidance in FASB ASC paragraphs 985-605-25-30 through 985-605-25-31 and 985-605-25-36 through 985-605-25-40 is appropriate for other sales transactions where authoritative guidance does not otherwise exist. The staff notes that FASB ASC paragraphs 985-605-25-33 through 985-605-25-35 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.

\(^6\) FASB ASC paragraph 605-10-25-3 through 605-10-25-5. See also Concepts Statement 5, paragraph 84(g) and FASB ASC paragraph 985-605-25-3.
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.\textsuperscript{7}

2. Persuasive Evidence of an Arrangement

\textbf{Question 1}

\textbf{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.

\textbf{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?

\textbf{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.\textsuperscript{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.

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 (\textit{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.

\textbf{Question 2}

\textbf{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.

\textbf{Question:} May Company Z recognize revenue upon delivery of its product to Customer A?

\textsuperscript{7} See FASB ASC paragraph 605-25-15-2 through 605-25-15-3 for additional discussion.

\textsuperscript{8} AU Section 560.05.
**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
   - (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 FASB ASC paragraphs 840-10-55-12 through 840-10-55-21 (Leases Topic) and does not qualify for sales-type lease accounting.

4. The product is delivered for demonstration purposes.16

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9 FASB ASC subparagraph 605-15-25-1(b).
10 FASB ASC subparagraph 605-15-25-1(b). 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 FASB ASC subparagraph 605-15-25-1(c).
12 FASB ASC subparagraph 605-15-25-1(d).
13 FASB ASC subparagraph 605-15-25-1(e).
14 FASB ASC subparagraph 470-40-15-2(a) (Debt Topic). This paragraph 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.
This list is not meant to be a checklist of all characteristics of a consignment or 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 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.\(^\text{17}\) 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.\(^\text{18}\) The buyer must have substantial business purpose for ordering the goods on a bill and hold basis;


\(^\text{18}\) Such requests typically should be set forth in writing by the buyer.
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.

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:

1. The date by which the seller expects payment, and whether the seller has modified its normal billing and credit terms for this buyer;

2. The seller’s past experiences with and pattern of bill and hold transactions;

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.

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. 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 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.

19 See Note 17, supra.

20 Such individuals should consider whether FASB ASC Subtopic 835-30, Interest — Imputation of Interest, pertaining to the need for discounting the related receivable, is applicable. FASB ASC subparagraph B35-30-15-3(a) indicates that the requirements of that Subtopic 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 FASB ASC paragraph 985-605-25-25.

22 FASB ASC paragraph 985-605-25-21. 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.
of the customer’s order. In those cases, revenue should not be recognized because a sale has not occurred. In applying this concept, the staff observes that customer acceptance provisions normally take one of four general forms. Those forms, and how the staff generally assesses whether customer acceptance provisions should result in revenue deferral, are described below:

(a) **Acceptance provisions in arrangements that purport to be for trial or evaluation purposes.** In these arrangements, the seller delivers a product to a customer, and the customer agrees to receive the product, solely to give the customer the ability to evaluate the delivered product prior to acceptance. The customer does not agree to purchase the delivered product until it accepts the product. In some cases, the acceptance provisions lapse by the passage of time without the customer rejecting the delivered product, and in other cases affirmative acceptance from the customer is necessary to trigger a sales transaction. Frequently, the title to the product does not transfer and payment terms are not established prior to customer acceptance. These arrangements are, in substance, consignment arrangements until the customer accepts the product as set forth in the contract with the seller. Accordingly, in arrangements where products are delivered for trial or evaluation purposes, revenue should not be recognized until the earlier of when acceptance occurs or the acceptance provisions lapse.

In contrast, other arrangements do not purport to be for trial or evaluation purposes. In these instances, the seller delivers a specified product pursuant to a customer’s order, establishes payment terms, and transfers title to the delivered product to the customer. However, customer acceptance provisions may be included in the arrangement to give the purchaser the ability to ensure the delivered product meets the criteria set forth in its order. The staff evaluates these provisions as follows:

(b) **Acceptance provisions that grant a right of return or exchange on the basis of subjective matters.** An example of such a provision is one that allows the customer to return a product if the customer is dissatisfied with the product. The staff believes these provisions are not different from general rights of return and should be accounted for in accordance with FASB ASC Subtopic 605-15, Revenue Recognition — Products. This Subtopic requires that the amount of future returns must be reasonably estimable in order for revenue to be recognized prior to the expiration of return rights. That estimate may not be made in the absence of a large volume of homogeneous transactions or if customer acceptance is likely to depend on conditions for which sufficient historical experience is absent. Satisfaction of these requirements may vary from product-to-product, location-to-location, customer-to-customer, and vendor-to-vendor.

(c) **Acceptance provisions based on seller-specified objective criteria.** An example of such a provision is one that gives the customer a right of return or replacement if the delivered product is defective or fails to meet the vendor’s published specifications for the product. Such rights are generally identical to those granted to all others within the same class of customer and for which satisfaction can be generally assured without consideration of conditions specific to the customer. Provided the seller has previously demonstrated that the product meets the specified criteria, the staff believes that these provisions are not different from general or specific warranties and should be accounted for as warranties in accordance with FASB ASC Subtopic 450-20, Contingencies — Loss Contingencies. In this case, the cost of potentially defective goods must be reliably estimable based on a demonstrated history of substantially similar transactions. However, if the seller has not previously demonstrated that the delivered product meets the seller’s specifications, the staff believes that revenue should be deferred until the specifications have been objectively achieved.

(d) **Acceptance provisions based on customer-specified objective criteria.** These provisions are referred to in this document as “customer-specific acceptance provisions” against which substantial completion and contract fulfillment must be evaluated. While formal customer sign-off provides the best evidence that these acceptance criteria have been met, revenue recognition also would be appropriate, presuming all other revenue recognition criteria have been met, if the seller reliably demonstrates that the delivered products or services meet all of the specified criteria prior to customer acceptance. For example, if a seller reliably demonstrates that a delivered product meets the customer-specified objective criteria set forth in

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23 See, for example, FASB ASC paragraphs 985-605-25-28 through 985-605-25-29.
26 FASB ASC subparagraphs 605-15-25-3(c) and 605-15-25-3(d).
27 FASB ASC paragraph 460-10-25-5 (Guarantees Topic) and FASB ASC subparagraph 605-15-15-3(c).
28 FASB ASC paragraph 460-10-25-6.
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 FASB ASC Subtopic 605-25, Revenue Recognition — Multiple-Element Arrangements.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 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

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29 This fact is provided as an assumption to facilitate an analysis of revenue recognition in this fact pattern. No interpretation of FASB ASC Subtopic 605-25 is intended.
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 FASB ASC Subtopic 450-20. 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 FASB ASC Subtopic 450-20. 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. 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?

**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.

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16 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.”
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 FASB ASC Subtopic 605-25. 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. 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.

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.

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.

**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. 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.

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31 FASB ASC paragraph 985-605-25-12.
33 Ibid.
34 Concepts Statement 5, paragraph 83(a) and FASB ASC subparagraph 605-15-25-1(b).
35 FASB ASC paragraph 926-605-25-1 (Entertainment — Films Topic).
**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.”

**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 FASB ASC Subtopic 605-25,\(^\text{36}\) when should the revenue relating to nonrefundable, up-front fees in these types of arrangements be recognized?

\(^{36}\)The staff believes that the vendor activities associated with the up-front fee, even if considered a deliverable to be evaluated under FASB ASC Subtopic 605-25, will rarely provide value to the customer on a standalone basis.
**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 products delivered or services performed that represent the culmination of a separate earnings process, 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. 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., FASB ASC Subtopic 922-605, **Entertainment — Cable Television — Revenue Recognition**).

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 and generally should be deferred and recognized systematically over the periods that the fees are earned.

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.

**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 FASB ASC Subtopic 310-20, *Receivables — Nonrefundable Fees and Other Costs*, and that this arrangement qualifies as a single unit of accounting under FASB ASC Subtopic 605-25.42

**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 FASB ASC Subtopic 720-15, *Other Expenses — Start-Up Costs*?

**Interpretive Response:** FASB ASC paragraph 720-15-15-4 states that the guidance does not address the financial reporting of costs incurred related to “ongoing customer acquisition costs, such as policy acquisition costs” addressed in FASB ASC Subtopic 944-30, *Financial Services — Insurance — Acquisition Costs*, and “loan origination costs” addressed in FASB ASC Subtopic 310-20. This guidance 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 FASB ASC Subtopic 720-15.

The staff believes that the incremental direct costs (the FASB ASC Master Glossary provides a 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 FASB ASC paragraph 605-20-25-4 or FASB ASC paragraph 310-20-25-2. The staff believes the accounting policy chosen for these costs should be disclosed and applied consistently.

**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, the FASB ASC Master Glossary includes a definition of incremental direct costs. FASB ASC Subtopic 310-10, *Receivables — Overall*, 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. Further, FASB ASC Subtopic 605-20, *Revenue Recognition — Services*, also requires capitalization of incremental direct customer acquisition costs. 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 FASB ASC Subtopic 310-20, *Receivables — Nonrefundable Fees and Other Costs*, or FASB ASC Subtopic 605-20. Registrants should disclose their policies for determining which costs to capitalize as contract acquisition and origination costs.

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42 See Note 36, supra.
43 See Note 39, supra.
**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 FASB ASC Subtopic 605-25?

**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., FASB ASC Subtopic 985-605, Software — Revenue Recognition, FASB ASC Subtopic 926-605, Entertainment — Films — Revenue Recognition, and FASB ASC Subtopic 928-605, Entertainment — Music — Revenue Recognition) 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 licensor 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

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 FASB ASC Subtopic 605-15, Revenue Recognition — Products.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.

44 FASB ASC paragraph 605-20-25-4.
45 Note, however, the staff believes that this obligation qualifies as a guarantee within the scope of FASB ASC Topic 460, subject to a scope exception from the initial recognition and measurement provisions.
46 FASB ASC paragraph 985-605-25-37.
47 Ibid.
48 Ibid.
**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 FASB ASC Subtopic 605-15) 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.”

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, FASB ASC Topic 860, Transfers and Servicing, 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. 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 FASB ASC Subtopic 605-15 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, 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 FASB ASC Subtopic 605-15. 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 FASB ASC Subtopic 605-15 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 FASB ASC Subtopic 605-15, the most direct authoritative literature to be applied to the extinguishment of obligations under such contracts is FASB ASC Topic 860. As noted above, because the refund privilege extends to the end of the contract term irrespective of the amount of the service performed, FASB ASC Topic 860 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 FASB ASC Subtopic 605-15 and that practice did not change when FASB ASC Topic 860 became effective. Reasonable people held, and continue to hold, different views about the application of the accounting literature.

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49 FASB ASC paragraph 405-20-40-1 (Liabilities Topic).
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 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.\(^{56}\)

\(^{51}\) The staff will question further analogies to the guidance in FASB ASC Subtopic 605-15 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.

\(^{54}\) The term “remote” is used here with the same definition as used in the FASB ASC Master Glossary.

\(^{55}\) FASB ASC paragraph 605-15-25-3 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 FASB ASC paragraph 310-20-35-26.
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 FASB ASC Subtopic 720-35, Other Expenses — Advertising Costs. 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 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 FASB ASC Subtopic 605-15 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 FASB ASC Subtopic 605-15, or may it choose to defer all revenue until the refund period lapses as suggested by FASB ASC Topic 860 even if the criteria above for analogy to FASB ASC Subtopic 605-15 are met?

**Interpretive Response:** The analogy to FASB ASC Subtopic 605-15 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.

\(^{57}\) FASB ASC paragraphs 310-20-25-2 and 605-20-25-4 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 FASB ASC Subtopic 605-15 method to the FASB ASC Topic 860 method of accounting for these refundable fees? May a registrant change from the FASB ASC Topic 860 method to the FASB ASC Subtopic 605-15 method?

Interpretive Response: The staff believes that FASB ASC Topic 860 provides a preferable accounting model for service transactions subject to potential refunds. Therefore, the staff would not object to a change from the FASB ASC Subtopic 605-15 method to the FASB ASC Topic 860 method. However, if a registrant had previously chosen the FASB ASC Topic 860 method, the staff would object to a change to the FASB ASC Subtopic 605-15 method.

Question 5

Question: Is there a minimum level of customers that must be projected not to cancel before use of FASB ASC Subtopic 605-15 type accounting is appropriate?

Interpretive Response: FASB ASC Subtopic 605-15 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 FASB ASC paragraph 605-15-25-1, 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: FASB ASC paragraph 605-15-25-3 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. The paragraph concludes by stating “other factors may preclude a reasonable estimate.”

Question: What “other factors,” in addition to those listed in FASB ASC paragraph 605-15-25-3, 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) 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.

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.”
Appendix B — SEC Staff Accounting Bulletin Topic 13, “Revenue Recognition”
Software Revenue Recognition: A Roadmap to Applying ASC 985-605

The staff reminds registrants that if a transaction fails to meet all of the conditions of FASB ASC paragraphs 605-15-25-1 and 605-15-25-3, 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 FASB ASC Subtopic 605-15?

Interpretive Response: No. “Reliability” of financial information is one of the qualities of accounting information discussed in Concepts Statement 2, Qualitative Characteristics of Accounting Information. The staff’s expectation that estimates be reliable does not change the existing requirement of FASB ASC Subtopic 605-15. 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 FASB ASC Subtopic 605-15?

Interpretive Response: The specific guidance above does not apply to transactions within the scope of FASB ASC Subtopic 605-15. 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 FASB ASC Subtopic 605-15.

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 FASB ASC Subtopic 605-15?

Interpretive Response: The staff does not believe there is any specific length of time necessary in a product transaction. However, FASB ASC Subtopic 605-15 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?

Interpretive Response: No. If a reasonable estimate of future returns cannot be made, FASB ASC Subtopic 605-15 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 FASB ASC Subtopic 605-15.

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.

59 FASB ASC paragraph 605-15-25-1.
60 FASB ASC subparagraph 605-15-25-1(f).
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

FASB ASC paragraph 840-20-25-1 states that “[r]ent shall be charged to expense by lessees (reported as income by lessors) over the lease term as it becomes payable (receivable). If rental payments are not made on a straight-line basis, rental expense nevertheless 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 is derived from the leased property, in which case that basis shall be used.”

FASB ASC paragraph 840-10-25-4 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.” FASB ASC paragraph 840-10-55-38 provides the following example of determining contingent rentals:

Assume that a lease agreement for retail store space stipulates 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.

FASB ASC Section 840-20-25 addresses whether it is appropriate for lessors in operating leases to recognize scheduled rent increases on a basis other than as required in FASB ASC paragraph 840-20-25-1. FASB ASC subparagraph 840-20-25-2(a) 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.” 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. FASB ASC subparagraph 840-20-25-2(b) states “[i]f the lessee and lessor eliminate the risk of variable payments inherent in contingent rentals by agreeing to scheduled rent increases, the accounting shall reflect those different circumstances.”

The example provided in FASB ASC paragraph 840-10-55-39 implies that contingent rental income in leases classified as sales-type or direct-financing leases becomes “accrual” when the changes in the factors on which the contingent lease payments are based actually occur. FASB ASC paragraph 840-20-25-2 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 FASB ASC Section 840-20-25 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.

61 Lessees should follow the guidance established in FASB ASC Subtopic 840-10.
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 M’s customers collect on the billings.

B. Disclosures

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 FASB ASC Topic 235, Notes to Financial Statements. FASB ASC paragraph 235-10-50-3 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 FASB ASC Subtopic 605-15 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.

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62 Concepts Statement 5, paragraph 83(a).
63 Concepts Statement 5, paragraph 83(b).
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, See also In the Matter of Caterpillar Inc., AAER 363 (March 31, 1992).
• 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.

• Seasonal trends or variations in sales.

• A gain or loss from the sale of an asset(s).68

67 FASB ASC Subtopic 825-10, Financial Instruments — Overall.
68 Gains or losses from the sale of assets should be reported as “other general expenses” pursuant to Regulation S-X, Article 5-03(6). Any material item should be stated separately.
Appendix C — Basis for Conclusions of SOP 97-2 and Response to Comments Received (Appendix B of SOP 97-2)

SOP 97-2 — Basis for Conclusions

Background

.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.

Basic Principles

.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 10330]. 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

[the 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]
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.

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.

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.

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.

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.

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.

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.
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.

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

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.

Delivery

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.

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.

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.

Fixed or Determinable Fees and Collectibility

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.

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 84(g) 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.

Multiple-Element Arrangements

Additional Software Deliverables and Right to Exchange or Return Software

.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.
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.

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.

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.

Post-Contract Customer Support

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.

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.

Services

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.
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.

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

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 . . . .

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.

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.

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 . . . .

Contract Accounting

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.

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.”

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

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].
Distinguishing Transactions Accounted for Using Contract Accounting From Product Sales

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.

Application of ARB No. 45 and SOP 81-1

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

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:

In 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].

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:

The 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]

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].

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.

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.
Response to Comments Received: Appendix B of 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.
Appendix D — Key Differences Between ASC 985-605 and the FASB’s and IASB’s Revised ED

The table below summarizes key differences between ASC 985-605 and the FASB’s and IASB’s revised ED. It does not address all possible fact patterns and should be read in conjunction with ASC 985-605, with the revised ED, and with other relevant guidance. ASC 985-605 states that if an arrangement contains software as well as services that involve significant production, modification, or customization of the software, the services cannot be recognized separately from the software and the arrangement is therefore within the scope of ASC 605-35. The revised ED would completely supersede ASC 985-605 and ASC 605-35, among most other current revenue recognition guidance in U.S. GAAP. The table focuses solely on the potential impacts to contracts currently within the scope of ASC 985-605 and does not address the potential changes to contracts within the scope of ASC 605-35. Although the revised ED also addresses other topics that are not in ASC 985-605, such as onerous contracts, costs to obtain or fulfill a contract, financial statement presentation, and disclosures, the table does not assess the potential impact of those topics.

The links below can be used to jump to groups of topics in the table, which consists of the five primary steps for revenue recognition under the revised ED (as well as its scope):

- Scope.
- Step 1: Identify the Contract With a Customer.
- Step 2: Identify the Separate Performance Obligations in the Contract.
- Step 3: Determine the Transaction Price.
- Step 4: Allocating the Transaction Price to the Separate Performance Obligations in the Contract.
- Step 5: Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation.
### ASC 985-605

This guidance generally applies to the following transactions and activities:

- “Licensing, selling, leasing, or otherwise marketing computer software.”
- “The software and software-related elements of arrangements that include software that is more-than-incidental to the products or services in the arrangement as a whole.”
- “More-than-insignificant discounts on future purchases that are offered by a vendor in a software arrangement.”
- “Arrangements to deliver software or a software system, either alone or together with other products or services that require significant production, modification, or customization of software.” (ASC 985-605-15-3)

ASC 985-605 includes various scope exceptions, which are described in further detail in the sections below.

### Revised ED

This guidance applies to all contracts with customers for the transfer of goods or services. Certain contracts, such as lease contracts, insurance contracts, guarantees, nonmonetary exchanges, and certain other contractual rights and obligations (i.e., most ASC financial instruments topics) are outside the scope of the revised ED. (9)

“A contract with a customer may be partially within the scope of [the revised ED] and partially within the scope of other [ASC topics].” If other topics specify how to separate or initially measure any parts of the contract, an entity first applies those separation or measurement requirements. If the other topics do not specify how to separate or initially measure any parts of the contract, the entity applies the revised ED to separate or initially measure those parts of the contract. (11)

### Likely Impact

Contracts previously accounted for under ASC 985-605 are within the scope of the revised ED. Entities will no longer have to evaluate whether an arrangement is within the scope of multiple revenue standards (e.g., ASC 985-605, ASC 605-35, and ASC 605-25). They will use a single, comprehensive model to account for all arrangements within the scope of the revised ED, and the prior guidance will be superseded.

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<p>| <strong>Nonsoftware Deliverables in a Software Arrangement</strong> | <strong>ASC 985-605 does not provide guidance on separating nonsoftware-related deliverables that are within the scope of other literature from software and software-related deliverables. Therefore, entities generally first apply the separation and allocation guidance in ASC 605-25 to an arrangement that contains both software and nonsoftware deliverables.</strong> |
| <strong>The separation of a contract into separate performance obligations and the allocation of the transaction price are addressed by the revised ED. See Steps 2 and 4 of the five-step model, below.</strong> |
| <strong>Contracts previously accounted for under ASC 985-605 are within the scope of the revised ED. Entities will no longer have to evaluate whether an arrangement is within the scope of multiple revenue standards (e.g., ASC 985-605, ASC 605-35, and ASC 605-25). They will use a single, comprehensive model to account for all arrangements within the scope of the revised ED, and the prior guidance will be superseded.</strong> |</p>
<table>
<thead>
<tr>
<th><strong>ASC 985-605</strong></th>
<th><strong>Revised ED</strong></th>
<th><strong>Likely Impact</strong></th>
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<tr>
<td><strong>Software Components Excluded From the Scope of ASC 985-605</strong></td>
<td>When an arrangement contains both nonsoftware components of tangible products and software components, the nonsoftware components are excluded from the scope of ASC 985-605. If it is determined that the software components and tangible products function together to deliver the tangible products’ essential functionality, the essential software and any undelivered elements related to that essential software are excluded from the scope of ASC 985-605. (ASC 985-605-15-4)</td>
<td>All promised goods or services in a contract with a customer (e.g., software components, nonsoftware components, and tangible products) that do not meet any of the scope exceptions, are within the scope of the revised ED.</td>
</tr>
<tr>
<td><strong>Arrangements Including Leased Software and Tangible Products</strong></td>
<td>Under ASC 985-605, in arrangements involving a lease of software and hardware (e.g., property, plant, or equipment), revenue attributable to the hardware is accounted for in accordance with ASC 840, while revenue attributable to the software, including PCS, is accounted for in accordance with ASC 985-605 (provided that the software is more than incidental to the arrangement but not essential to the functionality of the combined product). If the software functions together with the leased equipment to deliver the product’s essential functionality, the hardware, software, and software-related elements are outside the scope of ASC 985-605 and subject to other applicable accounting guidance (e.g., ASC 840, ASC 605-25, or SAB Topic 13).</td>
<td>A contract with a customer may be partially within the scope of the revised ED and partially within the scope of other ASC topics. If other topics specify how to separate or initially measure any parts of the contract, an entity first applies those separation or measurement requirements. If the other topics do not specify how to separate or initially measure any parts of the contract, the entity applies the revised ED to separate or initially measure those parts of the contract. (11)</td>
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The FASB and IASB are also in the process of a complete overhaul of lease accounting. As currently proposed, the tentative lease guidance provides indicators for entities to use in determining whether an asset used by a supplier in the delivery of a service is separable from the arrangement as a whole (e.g., whether the asset is sold or leased separately by the supplier and whether the customer can use the asset on its own or together with other resources available to the customer). In situations in which a supplier directs how an asset is used to perform services for a customer, the customer and supplier must assess whether the use of the asset is separable from the services provided to the customer (e.g., computer and server equipment with outsourced information technology services or a cargo ship with time charter services). If the asset is separable, the arrangement could contain a lease if the asset is within the scope of the tentative lease accounting guidance (and thus is outside the scope of the proposed revenue guidance). However, if the use of an asset is an inseparable part of the services requested by the customer, the entire arrangement would be within the scope of the proposed revenue guidance.
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<th>Hosting Arrangements</th>
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<td>A software element in a hosting arrangement is only within the scope of ASC 985-605 if the &quot;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 . . . to host the software.&quot; If the arrangement does not meet these two criteria, it would be accounted for as a service contract and would be outside the scope of ASC 985-605. (ASC 985-605-55-121)</td>
<td>Depending on the substance of a hosting arrangement, a customer may obtain control of the software itself, simply have the right to use it over time, or a combination of both. (See Step 4 below for a discussion of the factors that indicate whether control transfers over a period of time or at a point in time.) In other instances, the tangible products used to provide the hosting might be within the scope of the tentative lease accounting guidance (see Arrangements Including Leased Software and Tangible Products above).</td>
<td>Hosting arrangements, whether historically accounted for under ASC 985-605 or as a service contract, will be within the scope of the revised ED. Entities will have to closely evaluate the substance of the contract to determine whether the entity is (1) performing a service for which control is transferring over time or (2) in substance, licensing software for which control is transferred at a point in time and providing a separate hosting service (which may be the case when the criteria in ASC 985-605-55-121 are met). While an entity will most likely consider factors similar to the scoping rules in ASC 985-605 to determine the substance of the arrangement and appropriate accounting in accordance with the revised ED, these criteria are not specifically included in the revised ED and thus not necessarily determinative of the accounting conclusion. Further, entities should closely evaluate the contractual terms of the hardware as it may meet the definition of a lease. If it does, the contract would need to be separated and initially measured as described in Arrangements Including Leased Software and Tangible Products above.</td>
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| Software Requiring Significant Production, Modification, or Customization | Contracts currently accounted for under ASC 605-35 are within the scope of the revised ED. | Contracts previously accounted for under ASC 985-605 or ASC 605-35 are within the scope of the revised ED. Entities will no longer have to evaluate whether an arrangement is in the scope of multiple revenue standards (e.g., ASC 985-605, ASC 605-35, and ASC 605-25). They will use a single, comprehensive model to account for all arrangements within the scope of the revised ED, and the prior guidance will be superseded. |

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**Notes:**
- **Step 4** includes a discussion of the factors that indicate whether control transfers over a period of time or at a point in time.
- The scoping rules in ASC 985-605 provide guidance for determining the substance of an arrangement and appropriate accounting in accordance with the revised ED.
- Entities must closely evaluate the contractual terms of the hardware to determine if it meets the definition of a lease.
- The revised ED introduces a single, comprehensive model to account for all arrangements within its scope.
### ASC 985-605

**STEP 1: IDENTIFY THE CONTRACT WITH A CUSTOMER**

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<th>Persuasive Evidence of an Arrangement Exists</th>
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| 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. 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 (e.g., a purchase order from a third party or online authorization). If the vendor’s customary business practice is to use written contracts, evidence of the arrangement is provided only with a contract signed by both parties. | The revised ED defines a contract as an agreement between two or more parties that creates enforceable rights and obligations. Contracts can be written, oral, or implied by the entity’s customary business practices. (13) Under the proposed revenue requirements, a contract exists only if:  
- “The contract has commercial substance.”  
- “The parties to the contract have approved the contract” and are committed to satisfying “their respective obligations.”  
- “The entity can identify each party’s rights regarding the goods or services to be transferred.”  
- “The entity can identify the payment terms for the goods or services to be transferred.” (14) In addition, a contract does not exist if each party “has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (parties).” (15) | The definition of a contract under the proposed guidance differs from the definition of persuasive evidence of an arrangement under ASC 985-605. Depending on an entity’s historical practice, these differences may result in accounting changes. In addition, the requirement in ASC 985-605 that “collectibility is probable” for revenue to be recognized is not an explicit criterion in the revised ED. However, in the Basis for Conclusions of the revised ED, the boards indicated that a reasonable expectation of collectibility would be necessary for a contract to have commercial substance. Therefore, when an entity does not have a reasonable expectation of collectibility, a contract may not exist under the revised ED (and thus, revenue cannot be recognized). Some may interpret the current requirement (i.e., that collectibility is probable) as a different threshold than that in the revised ED (i.e., that the contract has commercial substance and therefore an entity has a reasonable expectation of collectibility). |
<table>
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<th>Combination of Contracts</th>
<th>ASC 985-605</th>
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|                          | “Software vendors may execute more than one contract or agreement with a single customer. However, a group of contracts or agreements may be so closely related that they are, in effect, parts of a single arrangement and should be viewed as one multiple-element arrangement [in the determination of] the appropriate amount of revenue to be recognized in accordance with [ASC 985-605]. The form of an arrangement is not necessarily the only indicator of the substance of an arrangement. The existence of any of the following factors (which are not all-inclusive) may indicate that a group of contracts should be accounted for as a single multiple-element arrangement.” | An entity combines two or more contracts and accounts for them as a single contract if they are entered into at or near the same time with the same customer (or related parties) if one or more of the following criteria are met:  
* “The contracts are negotiated as a package with a single commercial objective.”  
* “The amount of consideration . . . in one contract depends on the price or performance of the other contract.”  
* The goods and services (or some goods or services) promised in the contracts meet the criteria to be accounted for as a single performance obligation. | Other than the concept in the revised ED of potentially being required to combine contracts not only with the customer but also with parties related to the customer, the overall principles on combining contracts appear to be similar and are not likely to result in a significant change to current practice. |
|                          | • “[N]egotiated or executed within a short timeframe of each other.”       |                                                                                                                                                                                                           |               |
|                          | • Elements in contracts “are closely interrelated or interdependent in terms of design, technology, or function.”                                      |                                                                                                                                                                                                           |               |
|                          | • The fee for one “is subject to refund, forfeiture, or other concession if another contract is not [satisfied].”                                    |                                                                                                                                                                                                           |               |
|                          | • One or more elements in one contract “are essential to the functionality” of another contract.                                           |                                                                                                                                                                                                           |               |
|                          | • Payment terms in one contract “coincide with performance criteria of another contract.”                                               |                                                                                                                                                                                                           |               |
|                          | • Negotiated “jointly with two or more parties” to do a single project. (ASC 985-605-55-4)                                            |                                                                                                                                                                                                           |               |
### Modifications to a Software License and Side Agreements

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<td>Other than requiring the vendor to consider the implications of concessions, ASC 985-605 does not specifically discuss modifications to software arrangements. If a modification to a software arrangement is considered a concession, the vendor may need to evaluate whether the original fee was fixed or determinable and consider the impact on the accounting for future arrangements. Generally, previously recognized revenue is not affected and the vendor determines the impact of a modification prospectively on the basis of the facts and circumstances of the modification. Side agreements should be evaluated on a case-by-case basis to determine whether and how they affect the terms of the arrangement and when, in fact, an arrangement has been consummated.</td>
<td>“A contract modification exists when the parties to a contract approve a change in the scope or price of a contract (or both).” (18) If the modification meets the contract criteria under the revised ED (discussed in Persuasive Evidence of an Arrangement Exists above), the accounting treatment depends on the nature of the modification. However, if the parties have approved a change in the scope but not the price, an entity would only account for the modification when the entity has an expectation that the price of the modification will be approved. A contract modification would be accounted for as a separate contract only if the modification results in (1) a separate performance obligation and (2) additional consideration that reflects the entity’s stand-alone selling price of that separate performance obligation (when appropriate adjustments for the contract’s particular circumstances are taken into account). Otherwise, an entity would evaluate the modified contract and allocate the remaining transaction price to the remaining performance obligations (prospectively) and update its measure of progress toward completion for performance obligations that are satisfied over time (which could result in a cumulative catch-up). However, if the modification to the contract is only a change in the transaction price, the modified transaction price would be reallocated to all performance obligations in the contract (see Step 4 below). (19–22, 78)</td>
<td>Although there is no explicit guidance, entities within the scope of ASC 985-605 generally account for contract modifications and side agreements prospectively. Since the revised ED specifically addresses accounting for contract modifications, it should improve discipline and consistency in accounting for contract modifications. The revised ED may result in a cumulative-effect adjustment when the modification is only to the transaction price (because the modified transaction price is reallocated to the separate performance obligations as if it existed at contract inception, potentially affecting the amount of revenue previously recognized for satisfied performance obligations). The revised ED does not specifically address side agreements, and entities will need to evaluate them on a case-by-case basis to determine whether they (1) represent terms in the original contract (and meet the contract criteria under the proposed guidance, discussed above) or (2) represent a contract modification (and should be accounted for under the contract modification guidance described above). If a side agreement represents terms that existed in the original contract and were not included in the original accounting for that contract, the entity should determine whether the adjustments for the impact of the side agreement result in an error under ASC 250.</td>
</tr>
</tbody>
</table>
### Table: Key Differences Between ASC 985-605 and the FASB’s and IASB’s Revised ED

<table>
<thead>
<tr>
<th>ASC 985-605</th>
<th>Revised ED</th>
<th>Likely Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Multiple-Element Arrangements</strong></td>
<td>Software arrangements commonly comprise multiple elements or deliverables (i.e., software and any combination of PCS, specified or unspecified software products or upgrades, additional licenses, services, or other nonsoftware deliverables). A vendor should separate a multiple-element arrangement to account for each component individually (in accordance with the specific guidance provided in ASC 985-605).</td>
<td>An entity identifies “which goods or services (or which bundles of goods or services) are distinct” and therefore accounted for as separate performance obligations. (23) The revised ED defines a performance obligation as “a promise in a contract with a customer to transfer a good or service to the customer.” This obligation may be explicit in the contract or implied. (24) The revised ED lists what may be considered a good or service in a contract. (26). Entities evaluate the goods or services to determine the appropriate accounting units (i.e., separate performance obligations). See Separating the Arrangement below for additional discussion of how to determine the accounting units in a contract.</td>
</tr>
</tbody>
</table>

### Separating the Arrangement

| “If an arrangement includes multiple elements, the fee is allocated to the various elements [VSOE] of fair value, regardless of any separate prices stated in the contract for each element. [VSOE] of fair value is limited to the following:” | An entity accounts for a promise to transfer more than one good or service as a separate performance obligation if it is distinct. A good or service is “distinct” if the entity regularly sells it separately or the “customer can benefit from the good or service either on its own or together with other resources that are readily available.” (27) Further, the boards decided that an entity would account for a bundle of goods or services as a single performance obligation if the goods or services are (1) “highly interrelated” and the entity provides “a significant service of integrating” them into a combined item or items and (2) significantly modified or customized to fulfill the contract. (28) “As a practical expedient, [when] two or more distinct goods or services . . . have the same pattern of transfer to the customer,” an entity may combine them into one separate performance obligation. (30) | The revised ED replaces the specific rules under ASC 985-605 with a principle that is likely to increase the number of accounting units because of the less restrictive requirements in the revised ED to separate performance obligations. For example, the fact that VSOE of fair value does not exist for an undelivered element will not dictate whether goods or services in a contract can be separated. The “distinct” criteria provided in the revised ED are generally viewed as being consistent with the stand-alone value concept in ASC 605-25. Under the revised ED, an entity may need to use significant judgment when determining whether the goods or services are “highly interrelated” and “significantly modified or customized.” The proposed ASU includes examples to illustrate this guidance; however, further clarification may be needed to ensure consistent application. |

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(23) An entity identifies “which goods or services (or which bundles of goods or services) are distinct” and therefore accounted for as separate performance obligations.

(24) The revised ED defines a performance obligation as “a promise in a contract with a customer to transfer a good or service to the customer.” This obligation may be explicit in the contract or implied.

(26) The revised ED lists what may be considered a good or service in a contract. Entities evaluate the goods or services to determine the appropriate accounting units (i.e., separate performance obligations).

(27) An entity identifies “which goods or services (or which bundles of goods or services) are distinct” and therefore accounted for as separate performance obligations.

(28) Further, the boards decided that an entity would account for a bundle of goods or services as a single performance obligation if the goods or services are “highly interrelated” and the entity provides “a significant service of integrating” them into a combined item or items and (2) significantly modified or customized to fulfill the contract.

(30) “As a practical expedient, [when] two or more distinct goods or services … have the same pattern of transfer to the customer,” an entity may combine them into one separate performance obligation.
<table>
<thead>
<tr>
<th>ASC 985-605</th>
<th>Revised ED</th>
<th>Likely Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional Products</td>
<td>As part of a bundled arrangement, a vendor may agree to “deliver specified additional software products in the future.” Sometimes, a vendor offers the rights to these additional products as part of PCS. Generally, even when the additional products are included in PCS, the additional software product is a separate element in the contract. ASC 985-605 requires vendors to distinguish between specified and unspecified additional products. This determination is important because rights to specified products, including those offered on a when-and-if-available basis, must be treated as separate elements of the software arrangement. Conversely, the right to unspecified additional products is accounted for as a subscription. (ASC 985-605-25-47 through 25-59)</td>
<td>Specified and unspecified additional products may meet the criteria for treatment as separate performance obligations (see Separating the Arrangement above). In addition, if these extra products are provided as an option to the customer free of charge or at a discount, the option represents a separate performance obligation if it gives the customer a material right that it would not have received without entering into that contract. ([IG20–IG24])</td>
</tr>
<tr>
<td>ASC 985-605</td>
<td>Revised ED</td>
<td>Likely Impact</td>
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</tr>
<tr>
<td>Upgrade Rights</td>
<td>ASC 985-605 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. ASC 985-605 does not define “specified.” However, an upgrade or product is generally considered to be “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 (such as a product “roadmap”) to a mere statement of its name or version number. Finally, no discount in a bundled arrangement is allocable to specified upgrade rights. (ASC 985-605-25-44 through 25-46)</td>
<td>Specified and unspecified upgrade rights represent goods or services in the contract that would be analyzed to determine whether they meet the criteria to be treated as separate performance obligations (see Separating the Arrangement above). In addition, if these upgrade rights are provided as an option to the customer free of charge or at a discount, the option represents a separate performance obligation if it provides the customer a material right that it would not have received without entering into that contract. (IG20–IG24)</td>
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### Postcontract Customer Support

PCS revenue is generally recognized in the same pattern (i.e., ratably over the PCS period) regardless of whether it is sold separately or as part of an overall arrangement. If historical evidence suggests that costs to provide PCS are incurred on other than a straight-line basis, then revenue should be recognized in proportion to the amounts expected to be charged to expense for the PCS services.

Because PCS is generally not considered essential to the functionality of other deliverables in an arrangement, it is usually viewed as a separate element. As with other software elements, a portion of the arrangement fee must be allocated to PCS on the basis of VSOE of fair value (and recognized over the PCS period in accordance with ASC 985-605). If VSOE of fair value cannot be established and the PCS is the only remaining undelivered element, the entire arrangement fee must be recognized ratably over the stated PCS period (if explicitly stated in the contract) or the period over which PCS services are expected to be provided (if implicit rights to PCS exist).

VSOE of fair value for PCS is generally evidenced by the price the customer will be required to pay when it is sold separately (i.e., the renewal rate).

### Revised ED

PCS would generally be accounted for as a separate performance obligation. It would most likely be distinct from the other goods or services in the contract since it is either sold separately (as evidenced through subsequent renewals) or the customer can benefit from the software without the PCS. (See Recognition of PCS Revenue Upon Delivery of the Related Software in Step 5 below for additional discussion of the revised ED for revenue recognition for PCS.)

Because the revised ED is less restrictive in separating and allocating contract consideration, there are likely to be fewer instances in which all revenue is required to be deferred for a bundle of goods or services to be recognized ratably over the PCS period. (See Recognition of PCS Revenue Upon Delivery of the Related Software in Step 5 below for additional discussion of likely impact to revenue recognition for PCS.)

### Likely Impact

The revised ED for separately priced warranty options or warranties beyond assuring an entity’s past performance may result in the allocation and deferral of contract consideration in certain circumstances rather than accrual of costs (as may be the case under current GAAP). Most likely this will have a limited impact on typical software arrangements since a separately priced warranty under existing guidance is often viewed as PCS.

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<table>
<thead>
<tr>
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<tr>
<td><strong>Postcontract Customer Support</strong></td>
<td>PCS revenue is generally recognized in the same pattern (i.e., ratably over the PCS period) regardless of whether it is sold separately or as part of an overall arrangement. If historical evidence suggests that costs to provide PCS are incurred on other than a straight-line basis, then revenue should be recognized in proportion to the amounts expected to be charged to expense for the PCS services. Because PCS is generally not considered essential to the functionality of other deliverables in an arrangement, it is usually viewed as a separate element. As with other software elements, a portion of the arrangement fee must be allocated to PCS on the basis of VSOE of fair value (and recognized over the PCS period in accordance with ASC 985-605). If VSOE of fair value cannot be established and the PCS is the only remaining undelivered element, the entire arrangement fee must be recognized ratably over the stated PCS period (if explicitly stated in the contract) or the period over which PCS services are expected to be provided (if implicit rights to PCS exist). VSOE of fair value for PCS is generally evidenced by the price the customer will be required to pay when it is sold separately (i.e., the renewal rate).</td>
<td><strong>Revised ED</strong></td>
</tr>
</tbody>
</table>

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<p>| <strong>Warranty-Related Services</strong> | Warranties that protect customers from defective software and that are routine, short-term, and relatively minor, are not considered PCS and should be accounted for in accordance with ASC 450. (ASC 985-605-25-37) However, PCS may include certain warranty-type services such as the correction of errors (e.g., bug fixes). (ASC 985-605-55-77) | “If a customer has the option to purchase a warranty separately” from the entity, the entity should account for the “warranty as a separate performance obligation because the entity [is providing a service] in addition to the product.” Therefore, the entity would allocate revenue to the warranty service. (IG11) “If a customer does not have the option to purchase a warranty separately [from the entity], the entity should account for the warranty in accordance with [ASC 460-10]” (cost accrual model) unless the warranty provides a service to the customer “in addition to the assurance that the product complies with [the contract’s] agreed-upon specifications” (in which case the entity would account for the warranty service as a separate performance obligation). (IG12 and IG14) | <strong>Warranty-Related Services</strong> | Warranties that protect customers from defective software and that are routine, short-term, and relatively minor, are not considered PCS and should be accounted for in accordance with ASC 450. (ASC 985-605-25-37) However, PCS may include certain warranty-type services such as the correction of errors (e.g., bug fixes). (ASC 985-605-55-77) | “If a customer has the option to purchase a warranty separately” from the entity, the entity should account for the “warranty as a separate performance obligation because the entity [is providing a service] in addition to the product.” Therefore, the entity would allocate revenue to the warranty service. (IG11) “If a customer does not have the option to purchase a warranty separately [from the entity], the entity should account for the warranty in accordance with [ASC 460-10]” (cost accrual model) unless the warranty provides a service to the customer “in addition to the assurance that the product complies with [the contract’s] agreed-upon specifications” (in which case the entity would account for the warranty service as a separate performance obligation). (IG12 and IG14) | <strong>Likely Impact</strong> | The revised ED for separately priced warranty options or warranties beyond assuring an entity’s past performance may result in the allocation and deferral of contract consideration in certain circumstances rather than accrual of costs (as may be the case under current GAAP). Most likely this will have a limited impact on typical software arrangements since a separately priced warranty under existing guidance is often viewed as PCS. |</p>
<table>
<thead>
<tr>
<th>Postdelivery Telephone Support</th>
<th>ASC 985-605</th>
<th>Revised ED</th>
<th>Likely Impact</th>
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<tbody>
<tr>
<td>ASC 985-605 requires that postdelivery telephone support that is offered or available to customers at no additional charge be accounted for as PCS. Generally, the arrangement consideration allocated to the telephone support would have to be recognized as revenue over the period during which the telephone support is expected to be provided unless the ASC 985-605-25-71 conditions are met, in which case the revenue allocable to telephone support may be recognized together with the initial licensing fee on delivery of the software (substantially all telephone support services are performed within one year of the date of software delivery).</td>
<td>Postdelivery telephone support is most likely a service in the contract and an entity must evaluate if the service represents a separate performance obligation. If it does not meet the separation criteria, the service should be combined with another good or service until that bundle is distinct.</td>
<td>The revised ED does not explicitly include the exceptions that would allow for postdelivery telephone support to be recognized upon delivery of the software license. Rather, an entity would have to conclude that the services to be provided are not material in accordance with ASC 105 to conclude that these services do not require allocation and deferral of a portion of the consideration in the arrangement. ASC 105 states that the guidance in the ASC does not need to be applied to immaterial items.</td>
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| Indemnification Clauses | The standard software license agreement of a software vendor often 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. 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. | “[A]n entity’s promise to indemnify the customer for liabilities and damages arising from claims of patent, copyright, trademark, or other infringement by the entity’s products does not give rise to a performance obligation.” The entity accounts for such obligations in accordance with the guidance on loss contingencies in ASC 450-20. | It is not likely that this will have a significant impact because the provisions of the revised ED are consistent with current practice. |
## Appendix D — Key Differences Between ASC 985-605 and the FASB’s and IASB’s Revised ED

*Software Revenue Recognition: A Roadmap to Applying ASC 985-605*

### Table: Key Differences Between ASC 985-605 and the FASB’s and IASB’s Revised ED

<table>
<thead>
<tr>
<th>ASC 985-605</th>
<th>Revised ED</th>
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<tbody>
<tr>
<td><strong>STEP 3: DETERMINE THE TRANSACTION PRICE</strong></td>
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</tbody>
</table>
| **Vendor’s Fee Is Fixed or Determinable — Extended Payment Terms** | Under ASC 985-605, an arrangement fee must be fixed or determinable before revenue can be recognized. If a vendor cannot conclude that the fee is fixed or determinable at the outset of an arrangement, revenue would be recognized as payments from the customer become due (provided that all other requirements for revenue recognition are met). | An entity’s objective when determining the transaction price is to estimate the total amount of consideration to which the entity expects to be entitled under the contract. To meet that objective, an entity should use either of the following methods to estimate the transaction price, depending on which method better predicts the amount of consideration to which the entity will be entitled:  
   • The expected value (i.e., probability-weighted amount).  
   • The single most likely amount. |
| | | The revised ED may represent a significant change from current practice for extended payment terms. That is, extended payment terms may (1) be indicators of a significant financing component to the contract, (2) affect the calculation of the expected value or most likely amount, or (3) change the uncertainty regarding collectibility (discussed in the next section). |
| | In arrangements with extended payment terms, it may be less likely that the vendor will collect the full payment stipulated in the payment terms and the arrangement fee may not meet the fixed-or-determinable criterion. ASC 985-605-25-34 specifies that an arrangement fee is presumed not to be fixed or determinable “if payment of a significant portion of the software licensing fee is not due until after expiration of the license or more than 12 months after delivery.” | This step in the proposed model simply calculates the amount of revenue that is expected to be received from the contract. While much of the guidance in the subheadings under this step may affect the transaction price calculation, the topics in these subheadings may also affect the amount that the entity is reasonably assured to be entitled to in the determination of the amount of revenue to be recognized (see Step 5 below). |

**Vendor’s Fee Is Fixed or Determinable and Collectability Is Probable** | Under ASC 985-605, the evaluation of collectibility focuses both on whether the customer has the intent and ability to pay (i.e., creditworthiness) and on whether the fee is deemed fixed or determinable. | The revised ED does not include a specific recognition threshold requiring that collectibility be probable. Rather, implicit in the “commercial substance” criterion for when a contract exists is a notion that requires a reasonable expectation of collectibility. (BC168–BC170)  
Initial and subsequent adjustments for collectibility (i.e., a customer’s credit risk or bad-debt expense) are shown as a reduction of revenue in a separate line item (i.e., contra revenue below gross revenue) and are measured in accordance with ASC 310 (69). |

**Vendor’s Fee Is Fixed or Determinable and Collectability is Uncertain** | | Some could interpret the thresholds of “collectibility is probable” and “reasonable expectation of collectibility” as being different. In certain circumstances, this difference could affect the timing and measurement of revenue recognition. The presentation of collectibility adjustments in a separate line item is a change from the current presentation requirements. See additional discussion in **Persuasive Evidence of an Arrangement Exists** above. |
## ASC 985-605 vs. Revised ED

<table>
<thead>
<tr>
<th>Price-Protection Clauses</th>
<th>ASC 985-605</th>
<th>Revised ED</th>
<th>Likely Impact</th>
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</table>
| If a vendor offers a customer 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 would not be fixed and 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). | An entity’s objective when determining the transaction price is to estimate the total amount of consideration to which the entity expects to be entitled under the contract. To meet that objective, an entity should use either of the following methods to estimate the transaction price, depending on which method better predicts the amount of consideration to which the entity will be entitled:  
  - The expected value (i.e., probability-weighted amount).  
  - The single most likely amount. (55) | Future price changes would be included in the entity’s estimate of the transaction price. This estimate would be updated in each reporting period and would affect the amount of revenue recognized. However, the cumulative amount recognized would be limited to the amount that is reasonably assured (see Step 5 below for additional discussion). Unlike current practice, which could require deferral of the entire amount, the revised ED may only require deferral for a lesser amount (i.e., the amount that is not reasonably assured). |

| Customer Cancellation Privileges and Forfeiture or Refund Clauses | Arrangements with customer cancellation privileges do not meet the fixed or determinable fee recognition criteria until the cancellation privileges lapse. When the cancellation privileges expire ratably over the license period, the fees become determinable and revenue is recognized ratably over the license period as the privileges lapse. (ASC 985-605-25-37)  
No portion of the fee (including amounts otherwise allocated to delivered elements) meets the collectibility criterion 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. | Customer cancellation privileges and forfeiture or refund clauses are accounted for as a right of return. When a right of return exists, an entity recognizes (1) revenue for goods or services that have been transferred to the customer and whose return is not reasonably assured, (2) a refund liability, and (3) (if applicable) an asset (including an adjustment to cost of sales) for the right to recover returned goods. If an entity is not reasonably assured of the amount that will be refunded, revenue should not be recognized until such an amount is reasonably assured (which may not be until the right of return expires). (IG2–IG9) | Under the revised ED, when an entity is reasonably assured to be entitled to consideration before the expiration of the cancellation, forfeiture, or refund period, revenue may be recognized earlier than it is under current practice. That is, revenue from contracts that an entity does not expect to be canceled may be recognized when the performance obligations are satisfied. |
### Fiscal Funding Clauses

<table>
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<tr>
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| 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 have been satisfied. | An entity’s objective when determining the transaction price is to estimate the total amount of consideration to which the entity expects to be entitled under the contract. To meet that objective, an entity should use either of the following methods to estimate the transaction price, depending on which method better predicts the amount of consideration to which the entity will be entitled:  
  - The expected value (i.e., probability-weighted amount).  
  - The single most likely amount. (55)  
  An entity must recognize revenue from satisfying a performance obligation in the amount to which the entity is reasonably assured to be entitled. (81) (See Step 5 below for additional discussion of constraining recognized revenue to the amount that is reasonably assured.) | Under the revised ED, when an entity is reasonably assured to be entitled to consideration before the resolution of the contingency created by the fiscal funding clause, revenue may be recognized earlier than it is under current practice. That is, revenue in the amount that an entity is reasonably assured will not be canceled by the customer as a result of the fiscal funding clause may be recognized when the performance obligations are satisfied. Determining the amount that is reasonably assured in accordance with the revised ED may require significant judgment. |

### Discounts

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>A vendor may offer a customer a right to a pricing discount on a future purchase of a product or service. If this discount is more than insignificant, the right to it is considered an element in the arrangement. (ASC 985-605-15-3(d))</td>
<td>The “option to acquire additional goods or services at a discount [represents a] performance obligation [if it] provides a material right to the customer” that would not otherwise have been received. (IG20 and IG21) “If a customer has the option to acquire an additional good or service at a price” that is within the range of prices typically charged for those goods or services, “that option does not provide the customer with a material right even if the option can be exercised only because [a] previous contract” was entered into. The “entity has merely made a marketing offer.” (IG22)</td>
<td>The guidance in ASC 985-605 and the revised ED appear similar; thus, it is not likely that the proposed provision will have a significant impact.</td>
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</table>
### ASC 985-605 vs. Revised ED: Key Differences

<table>
<thead>
<tr>
<th>Fixed-Fee Arrangements Based on a Price per Copy</th>
<th>Revised ED</th>
<th>Likely Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>When a fixed-fee arrangement does not specify the maximum number of copies allowed, the allocation of the arrangement fee to the products is not possible because it depends on the number of copies ultimately made of each product. Revenue is recognized as copies are delivered. However, all unrecognized revenue in the arrangement is recognized when the vendor is not obligated to deliver additional products and either (1) delivery of all products is complete or (2) total revenue resulting from the copies produced equals the arrangement’s fixed fee.</td>
<td>If an entity grants a customer the option to acquire additional goods or services, that option gives rise to a separate performance obligation in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract. . . . If the option provides a material right, . . . the customer in effect pays the entity in advance for future goods or services and the entity recognizes revenue when those future goods or services are transferred or when the option expires.” (IG20 and IG21) Regardless of whether the arrangement specifies the maximum number of copies allowed, the entity would allocate the fixed consideration among the separate performance obligations (i.e., expected number of copies to be transferred to the customer over the life of the arrangement) and would recognize revenue when each copy is transferred in a manner that best depicts the transfer of control. However, the entity would need to reevaluate its performance in relation to the number of copies expected to be delivered when it is measuring its performance to date in each period.</td>
<td>The right to reproduce or obtain copies of software products at a specified price per copy would be considered a customer option for additional goods or services. If the right/option to reproduce or obtain copies of software products would provide the customer with a material right that the customer would not receive without entering into the arrangement, each additional copy of the software would be considered a separate performance obligation. Regardless of whether the arrangement specifies the maximum number of copies allowed, the entity would allocate the fixed fee or transaction price among the separate performance obligations (i.e., expected number of copies to be transferred to the customer over the life of the contract) and would recognize revenue when control for each performance obligation is transferred.</td>
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| Platform-Transfer Rights | For end users, depending on the terms of the arrangement, platform-transfer rights should be classified as a return, as an exchange (if it is for the same product and does not increase the number of copies or concurrent users under the license agreement), or as an additional software product (if the terms allow the customer to continue using a previously delivered software product in addition to the software related to the new platform). | There are no specific requirements for platform-transfer rights. An entity should closely evaluate the terms of the contract and should determine whether the transfer rights represent a return, an exchange, or an additional software product. See Rights to Exchange or Return Software Products in Step 5 below and Additional Software Product in Step 2 above for guidance on each type of contract. | See discussion in Step 5 on “Rights to Exchange or Return Software Products” and Step 2 on “Additional Software Product” for guidance on each type of contract. |
### Step 4: Allocate the Transaction Price to the Separate Performance Obligations in the Contract

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<tr>
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<tbody>
<tr>
<td>Allocating Consideration</td>
<td>The allocation of the consideration to elements in a multiple-element software arrangement and the subsequent recognition of such consideration depend on whether VSOE of fair value has been established. If VSOE of fair value is established for all undelivered elements, the portion of the fee allocated to an element (on the basis of VSOE of fair value) should be recognized as revenue when the recognition criteria are met for each element (unless an undelivered element in an arrangement is considered essential to the functionality of a delivered element). If VSOE of fair value is not established, all revenue from the arrangement must be deferred until the earlier of (1) the establishment of VSOE of fair value or (2) the delivery of all elements in the arrangement (with certain exceptions, as listed in ASC 985-605-25-10). The exceptions in ASC 985-605-25-10 include the use of a residual method.</td>
<td>An entity may be less constrained by the revised ED’s allocation requirements for revenue recognition than it is under the current requirements. The revised ED allows entities to use estimates, in the absence of observable prices, to determine the stand-alone selling price. Although the revised ED includes three examples of suitable estimation methods, it does not prescribe one. Therefore, an entity would be allowed some judgment in determining a method of estimation as long as it maximizes the use of observable inputs and is applied consistently to goods or services and customers with similar characteristics. As a result, and because of an entity’s ability to use a reverse residual method, revenue may be allocated differently under the revised ED than it is under ASC 985-605 in certain circumstances. Entities that currently find it difficult to obtain VSOE of fair value will be given significantly more judgment to use estimates to demonstrate stand-alone selling prices, increasing the likelihood that revenue will be recognized when each performance obligation is satisfied.</td>
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</table>

The transaction price is allocated on a relative stand-alone selling price basis (stand-alone selling price should be estimated if it is not observable). Suitable estimation methods include expected cost plus margin, adjusted market assessment, and the residual approach (in certain limited circumstances). The residual approach does not specifically preclude the use of a reverse residual allocation (i.e., use of a residual method to estimate the stand-alone selling price for an undelivered item). When specific conditions are met, certain discounts or amounts that are contingent on a future event may be allocated to one or more specific separate performance obligations. After contract inception, changes in the transaction price are generally allocated to all performance obligations (on the basis of initial allocation). However, subsequent changes in the transaction price that are related to a contingent future event may be allocated to one or more specific performance obligations (when certain conditions are met).
### Step 5: Recognize Revenue When (or As) the Entity Satisfies a Performance Obligation

<table>
<thead>
<tr>
<th>ASC 985-605</th>
<th>Revised ED</th>
<th>Likely Impact</th>
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</thead>
<tbody>
<tr>
<td><strong>Delivery Has Occurred</strong></td>
<td>The second criterion in ASC 985-605-25-3 for revenue recognition is delivery. The principle of not recognizing revenue before delivery applies regardless of whether the customer is a user or reseller. Except for arrangements in which the fee is a function of the number of copies, delivery is considered to have occurred upon the transfer of the product master or, if the product master is not to be delivered, upon the transfer of the first copy. For software that is delivered electronically, the delivery criterion in that paragraph is considered to have been met when either of the following has occurred:</td>
<td>The criteria for when a customer obtains control of a good or service at a point in time are generally consistent with the types of items considered in the assessment of whether and when delivery has occurred. Under the proposed model, services will generally be unbundled and recognized over time as the service obligations are satisfied (assuming that the separation criteria in Step 2 are met). See additional discussion below for guidance on accounting for a good or service satisfied over time.</td>
</tr>
<tr>
<td>• The customer has taken possession of the software via a download (i.e., when the customer takes possession of the electronic data on its hardware).</td>
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<tr>
<td>• The customer has been provided with access codes that allow the customer to take immediate possession of the software on its hardware pursuant to an agreement or purchase order for the software.</td>
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<td>An entity satisfies a performance obligation when control of the good or service underlying the obligation has been transferred to the customer. Control of a good or service can be transferred to a customer, and hence an entity can satisfy a performance obligation, at a point in time or over time. An entity satisfies a performance obligation over time if either of the following occurs:</td>
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<td>• “The entity’s performance creates or enhances an asset . . . that the customer controls as the asset is created or enhanced.”</td>
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<td>• “The entity’s performance does not create an asset with an alternative use to the entity” and at least one of the following is met:</td>
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<td>o “The customer simultaneously receives and consumes the benefits of the entity’s performance as [it] performs.”</td>
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<tr>
<td>o “Another entity would not need to substantially reperform the work [performed] to date if that other entity were to fulfill the remaining obligation to the customer.”</td>
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<tr>
<td>o “The entity has a right to payment for performance completed to date and [is expected] to fulfill the contract.” (35)</td>
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<td>Revenue is recognized for separate performance obligations that are satisfied over time by measuring the entity’s “progress toward complete satisfaction of [the] performance obligation” in a manner that best depicts the transfer of goods or services to the customer. (38–40) The proposed ASU provides specific guidance on the use and application of an output method and an input method for measuring progress toward completion. (41–46) The amount recognized is limited to the amount to which the entity is reasonably assured to be entitled. (81)</td>
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<td>ASC 985-605</td>
<td>Revised ED</td>
<td>Likely Impact</td>
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<tr>
<td>Delivery Has Occurred (continued)</td>
<td>If a performance obligation does not meet the criteria for satisfaction over time, it is satisfied at a point in time. The proposed ASU states that indicators that control of an asset has been transferred to a customer at a point in time include, but are not limited to, the following:</td>
<td>If a performance obligation does not meet the criteria for satisfaction over time, it is satisfied at a point in time. The proposed ASU states that indicators that control of an asset has been transferred to a customer at a point in time include, but are not limited to, the following:</td>
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<td></td>
<td>• “The entity has a present right to payment.”</td>
<td>The proposed ED likely impact section of the FASB’s and IASB’s Revised ED is consistent with ASC 985-605, which indicates that it is not likely that these provisions of the revised ED will have a significant impact since they are consistent with current practice. However, the revised ED does not include a presumption that the customer’s acceptance provisions are substantive if they are tied to payment, which could affect the timing of revenue recognition.</td>
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<tr>
<td></td>
<td>• “The customer has legal title.”</td>
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<td></td>
<td>• “The entity has transferred physical possession.”</td>
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<tr>
<td></td>
<td>• “The customer has the significant risks and rewards of ownership.”</td>
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</tr>
<tr>
<td></td>
<td>• “The customer has accepted the asset.”</td>
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<tr>
<td>Customer Acceptance</td>
<td>Customer acceptance is one of the indicators that an entity must consider in determining the point in time at which control is transferred for a good or service provided to a customer. (37e) The effect of the acceptance clauses on determining whether a customer has obtained control of a promised good or service depends on whether an entity can objectively determine that a good or service has been transferred to the customer in accordance with the agreed-upon specifications in the contract. “If an entity can objectively determine that control of a good or service has been transferred to the customer in accordance with the agreed-upon specifications,” the customer acceptance provisions would not affect the determination of control transfer. If an entity cannot objectively make this determination, it would not be able to conclude that it has obtained control until it receives the customer’s acceptance. (IG55–IG58)</td>
<td>Customer acceptance is one of the indicators that an entity must consider in determining the point in time at which control is transferred for a good or service provided to a customer. (37e) The effect of the acceptance clauses on determining whether a customer has obtained control of a promised good or service depends on whether an entity can objectively determine that a good or service has been transferred to the customer in accordance with the agreed-upon specifications in the contract. “If an entity can objectively determine that control of a good or service has been transferred to the customer in accordance with the agreed-upon specifications,” the customer acceptance provisions would not affect the determination of control transfer. If an entity cannot objectively make this determination, it would not be able to conclude that it has obtained control until it receives the customer’s acceptance. (IG55–IG58)</td>
</tr>
<tr>
<td><strong>ASC 985-605</strong></td>
<td><strong>Revised ED</strong></td>
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| **Keys or Authorization Codes** | In software arrangements involving the use of keys, a vendor is not necessarily required to deliver a key to fulfill its delivery responsibility. The software vendor recognizes revenue on delivery of the software if all of the following conditions are met (provided that all other requirements for revenue recognition in ASC 985-605 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.” (ASC 985-605-25-28) | A customer obtains control of a good or service when the customer has the ability to direct the use of, and receive the benefit from, the good or service. When a performance obligation does not meet the criteria to be satisfied over time, it is satisfied at a point in time. The proposed ASU states that indicators that control of an asset has been transferred to a customer at a point in time include, but are not limited to, the following:  
  - “The entity has a present right to payment.”  
  - “The customer has legal title.”  
  - “The entity has transferred physical possession.”  
  - “The customer has the significant risks and rewards of ownership.”  
  - “The customer has accepted the asset.” (37) | In these circumstances, an entity needs to evaluate whether the customer has the ability to direct the use of, and receive benefit from, the good or service under the proposed standard. If the software does not function without the keys or codes, the treatment would be similar.  
An entity will also need to evaluate the specific facts and circumstances associated with the use of keys and how they affect the evaluation of whether the customer has obtained control of the good or service. For example, if the key is used solely to protect against the customer’s failure to comply with the terms of the contract, control may still have been transferred; however, if the key is used to control the use for a trial period or for demonstration purposes, then control may not have been transferred to the customer. |
<table>
<thead>
<tr>
<th>Reseller Arrangement Terms</th>
<th>Revised ED</th>
<th>Likely Impact</th>
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<tr>
<td>For reseller arrangements, if any of the following factors or conditions exist, they are also considered in the evaluation of whether the revenue recognition criteria for fixed or determinable fee and collectibility are met:</td>
<td>“When an entity delivers a product to another party (such as a dealer or a distributor) for sale to end customers, the entity evaluates whether [the dealer or distributor] has obtained control of the product at that point in time” in accordance with paragraph 37. (IG49) “Inventory on consignment typically is controlled by the entity until a specified event occurs, such as the sale of the product to a customer of the dealer, or until a specified period expires. Until that point, the entity typically is able to require the return of the products or to transfer them to another dealer. Moreover, the dealer typically does not have an unconditional obligation to pay for the products (although it might be required to pay a deposit). Accordingly, in those circumstances, the entity would not recognize revenue upon delivery of the products to the dealer.” (IG50)</td>
<td>The factors in ASC 985-605-25-36 concern specific terms of the contract that would preclude an entity from being able to assert that its fee is fixed or determinable and collectibility is probable and that it thus would prevent revenue recognition. Under the revised ED, many of these factors and conditions would not affect the timing or revenue recognition but would instead affect the determination of the transaction price (e.g., price protection clauses, extended payment terms) or collectibility adjustments (reseller’s ability to pay). As a result of these differences, the timing and measurement of revenue recognition under the revised ED may be different from current practice.</td>
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<td>• Business practices, the reseller’s operating history, competitive pressures, informal communications, or other factors indicate that payment is substantially contingent on the reseller’s success in distributing individual units of the product. Contractual arrangements under which the reseller is obligated to pay only as and if sales are made to users are accounted for as consignments.</td>
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<td>• 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.</td>
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<tr>
<td>• 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.</td>
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<td>• 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 there is significant uncertainty regarding the vendor’s ability to maintain its price, the arrangement fee is not fixed or determinable. In such circumstances, revenue from the arrangement is deferred until the vendor is able to reasonably estimate the effects of future price changes and the other conditions have been satisfied.</td>
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<tr>
<td>ASC 985-605</td>
<td>Revised ED</td>
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</table>
| **Rights to Exchange or Return Software Products** | **Right of exchange** — A customer’s right to exchange is the right to replace a software product for another software product that has no more-than-minimal differences in price, functionality, or features. For the transaction to be accounted for as an exchange, the customer should not have the right to continue using the original product.  
In accounting for a right of exchange, a vendor does not reduce revenue for expected customer exchanges; however, the estimated costs of executing such exchanges should be accrued in accordance with ASC 450-20.  
**Right of return** — A customer’s right to return is the right to return a software product for a refund (or to exchange a software product for another product that has more-than-minimal differences in price, functionality, or features). In accounting for a right of return, a vendor must be able to reasonably estimate expected product returns when recognizing revenue. In a manner consistent with ASC 605-15-25-1 through 25-4, revenue recognized should be reduced to reflect the estimated returns and the estimated costs of executing such returns should be accrued in accordance with ASC 450. If the vendor is unable to reasonably estimate returns, revenue must be deferred until a reasonable estimate can be made or the right of return has lapsed. | **Right of exchange** — “Exchanges by customers of one product for another of the same type, quality, condition, and price (for example, one color or size for another) are not considered returns” under the proposed requirements. (IG8)  
**Right of return** — An entity recognizes the following for transferred products with a right of return:  
• Revenue for products transferred that the entity is reasonably assured will not be returned.  
• A refund liability (amount of consideration expected to be refunded).  
• An asset (and equal adjustment to cost of sales) for the entity’s right to recover the transferred goods upon settling the refund liability. (IG3)  
If an entity is not reasonably assured of the quantity of goods to be returned, the entity must recognize any consideration received as a refund liability (and should not recognize revenue). In such cases, the entity recognizes revenue when it determines that it is reasonably assured of the quantity of goods that will not be returned. (IG7)  
An entity updates the “measurement of the refund liability at the end of each reporting period for changes.” (IG6) | The guidance in ASC 985-605 and the proposed guidance appear to be similar; thus, it is not likely that this provision will have a significant impact. |
<table>
<thead>
<tr>
<th><strong>ASC 985-605</strong></th>
<th><strong>Revised ED</strong></th>
<th><strong>Likely Impact</strong></th>
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</thead>
</table>
| Recognition of PCS Revenue Upon Delivery of the Related Software | PCS revenue may be recognized upon delivery of the related software product if the following criteria are met:  
  • The PCS fee “is included with the initial licensing fee.”  
  • The PCS is included with the initial licensing fee “for one year or less.”  
  • The “estimated cost of providing [PCS] during the arrangement is insignificant.”  
  • “Unspecified upgrades or enhancements offered during [the PCS arrangement] historically have been and are expected to be . . . minimal and infrequent.” (ASC 985-605-25-71) | Revenue should be recognized for each separate performance obligation upon transfer to the customer (which may occur at a point in time or over a period of time). Typically, PCS transfers to the customer over time (i.e., over a stated PCS period). An entity satisfies a performance obligation over time if either of the following occurs:  
  • “The entity’s performance creates or enhances an asset . . . that the customer controls as the asset is created or enhanced.”  
  • “The entity’s performance does not create an asset with an alternative use to the entity” and at least one of the following criteria is met:  
    - “The customer simultaneously receives and consumes the benefits of the entity’s performance as [it] performs.”  
    - “Another entity would not need to substantially reperform the work [performed] to date if that other entity were to fulfill the remaining obligation to the customer.”  
    - “The entity has a right to payment for performance completed to date and [is expected] to fulfill the contract.” (35)  
  Revenue is recognized for separate performance obligations that are satisfied over time by measuring the entity’s “progress toward complete satisfaction of [the] performance obligation” in a manner that best depicts the transfer of goods or services to the customer. (38–40) The proposed ASU provides specific guidance on the use and application of an output method and an input method for measuring progress toward completion. (41–46) The amount recognized is limited to the amount to which the entity is reasonably assured to be entitled. (81)  
  Revenue is allocated to each separate performance obligation on the basis of its relative stand-alone selling price. For PCS, the stand-alone selling price would generally be established by (1) separate sales or (2) substantive renewal rates. | The revised ED does not include an exception that allows PCS revenue recognition upon delivery of the related software. Some entities may reach the same accounting conclusion when they determine that the PCS fee is not material in accordance with ASC 105 (which states that the guidance in the ASC does not need to be applied to immaterial items). However, an entity may determine that a change to current accounting is warranted on the basis of its evaluation of the threshold in ASC 985-605 regarding the terms “insignificant” and “immaterial” in ASC 105. |
### ASC 985-605

**Delayed Start for PCS**
The PCS term of a software arrangement may not begin as of 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) there is an implied PCS arrangement that begins upon delivery of the software.

A portion of the fee should be allocated to the implied PCS arrangement on the basis of VSOE of fair value for 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.

### Revised ED

**Goods or services in a contract do not need to be explicitly stated; they may be implied on the basis of an entity’s customary business practices.**

If a customer is able to receive upgrades or enhancements released by the entity in the period between delivery of the license and the beginning of the contractual PCS term, an implied PCS service obligation most likely exists. An entity should determine whether the PCS meets the criteria for a separate performance obligation and, if so, allocate revenue to it on the basis of its relative stand-alone selling price. Revenue should be recognized by using the method that best depicts the transfer of the PCS to the customer (to the extent that it is reasonably assured).

### Likely Impact

Unlike ASC 985-605, the proposal does not contain prescriptive guidance; however, the principles in the revised ED would most likely result in similar accounting, so it is not likely that the new provisions will have a significant impact.

**Services**

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.

If an arrangement includes such services, an entity determines whether the service element can be accounted for separately as the services are performed. ASC 985-605-25-78 discusses the criteria that an entity must consider 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, the entity applies contract accounting to both the software and service elements of the arrangement. ASC 985-605-25-88 through 25-107 address the application of contract accounting to software arrangements.

**Revenue should be recognized for each separate performance obligation upon transfer to the customer (which may occur at a point in time or over a period of time).**

An entity satisfies a performance obligation over time if either of the following occurs:

- “The entity’s performance creates or enhances an asset . . . that the customer controls as the asset is created or enhanced.”
- “The entity’s performance does not create an asset with an alternative use to the entity” and at least one of the following criteria is met:
  - “The customer simultaneously receives and consumes the benefits of the entity’s performance as [it] performs.”
  - “Another entity would not need to substantially reperform the work [performed] to date if that other entity were to fulfill the remaining obligation to the customer.”
  - “The entity has a right to payment for performance completed to date and [is expected] to fulfill the contract.”

The revised ED is less restrictive than current guidance because it removes the requirement that VSOE of fair value must exist before a good or service in a multiple-element contract may be treated as a separate unit of accounting. Under the revised ED, services that previously were bundled may qualify for separation and be recognized as the service obligations are satisfied. The revised ED will likely increase the number of accounting units.
<table>
<thead>
<tr>
<th>ASC 985-605</th>
<th>Revised ED</th>
<th>Likely Impact</th>
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<tbody>
<tr>
<td>Services (continued)</td>
<td>• The services are not essential to the functionality of any other element of the transaction.</td>
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<tr>
<td>• The services are described in the contract such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services.</td>
<td>Revenue is recognized for separate performance obligations that are satisfied over time by measuring the entity’s “progress toward complete satisfaction of [the] performance obligation” in a manner that best depicts the transfer of goods or services to the customer. (38–40) The proposed ASU provides specific guidance on the use and application of an output method and an input method for measuring progress toward completion. (41–46) The amount recognized is limited to the amount to which the entity is reasonably assured to be entitled. (81)</td>
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<tr>
<td>If an arrangement includes services that meet the criteria of ASC 985-605-25-78 for separate accounting, revenue is allocated among the service and software elements of the contract. This allocation should be based on VSOE 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 is 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.</td>
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## Appendix E — Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>AAER</td>
<td>SEC Accounting and Auditing Enforcement Release</td>
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<tr>
<td>AcSEC</td>
<td>Accounting Standards Executive Committee</td>
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<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
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<tr>
<td>ARB</td>
<td>Accounting Research Bulletin</td>
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<tr>
<td>ASC</td>
<td>FASB Accounting Standards Codification</td>
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<tr>
<td>ASP</td>
<td>application service provider</td>
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<tr>
<td>ASU</td>
<td>FASB Accounting Standards Update</td>
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<tr>
<td>CD-ROM</td>
<td>compact disc read-only memory</td>
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<td>CPI</td>
<td>consumer price index</td>
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<tr>
<td>CPU</td>
<td>central processing unit</td>
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<td>ED</td>
<td>exposure draft</td>
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<td>EITF</td>
<td>Emerging Issues Task Force</td>
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<tr>
<td>FASB</td>
<td>Financial Accounting Standards Board</td>
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<tr>
<td>FAT</td>
<td>factory acceptance test</td>
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<tr>
<td>FOB</td>
<td>free on board</td>
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<tr>
<td>GAAP</td>
<td>generally accepted accounting principles</td>
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<td>IASB</td>
<td>International Accounting Standards Board</td>
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<td>IFRS</td>
<td>International Financial Reporting Standard</td>
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<td>IP</td>
<td>Internet protocol</td>
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<td>IPO</td>
<td>initial public offering</td>
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<td>IT</td>
<td>information technology</td>
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<td>LOC</td>
<td>letter of credit</td>
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<tr>
<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
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<tr>
<td>PCS</td>
<td>postcontract customer support</td>
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<tr>
<td>R&amp;D</td>
<td>research and development</td>
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<tr>
<td>SAB</td>
<td>Staff Accounting Bulletin</td>
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<tr>
<td>Abbreviation</td>
<td>Description</td>
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<tr>
<td>SAS</td>
<td>Statement on Auditing Standards</td>
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<tr>
<td>SAT</td>
<td>site acceptance test</td>
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<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
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<td>SOP</td>
<td>AICPA Statement of Position</td>
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<tr>
<td>TIS</td>
<td>AICPA Technical Information Service</td>
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<tr>
<td>TPA</td>
<td>AICPA Technical Practice Aid</td>
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<tr>
<td>UCC</td>
<td>U.S. uniform commercial code</td>
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<tr>
<td>VSOE</td>
<td>vendor-specific objective evidence</td>
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</tbody>
</table>
Appendix F — Glossary of Standards and Other Literature

The standards and literature below were cited or linked to in this publication.

**AICPA Technical Practice Aids**
TIS Sections 5100.38 – 5100.76, “Revenue Recognition”

**Other AICPA Literature**
See the Pre-Codification AICPA Copyrighted Standards page on the FASB’s Web site for the titles of:
- Accounting Research Bulletins.
- Accounting Principles Board Opinions.
- AICPA Practice Bulletins.
- AICPA Accounting Interpretations.
- AICPA Accounting Statements of Position.

**FASB ASC References**
For titles of FASB Accounting Standards Codification references, see Deloitte’s “Titles of Topics and Subtopics in the FASB Accounting Standards Codification.”

**FASB Accounting Standards Updates and Other FASB Literature**
See the FASB’s Web site for the titles of:
- Accounting Standards Updates.
- Pre-Codification literature (Statements, Staff Positions, EITF Issues, and Topics).
- Concepts Statements.

**SEC Regulation S-K**
Item 303, “Management’s Discussion and Analysis of Financial Condition and Results of Operations”

**SEC Regulation S-X**
Rule 5-03, “Income Statements”

**SEC Staff Accounting Bulletin Topics**
SAB Topic 13, “Revenue Recognition” (SAB 101 and SAB 104)
  - SAB Topic 13.A.1, “Revenue Recognition — General”
SAB Topic 13.A.3(c), “Delivery and Performance: Inconsequential or Perfunctory Performance Obligations”
SAB Topic 13.A.3(d), “Delivery and Performance: License Fee Revenue”
SAB Topic 13.A.4, “Fixed or Determinable Sales Price”

**SEC Accounting and Auditing Enforcement Releases (AAERs)**

AAER No. 971, In the Matter of Laser Photonics Inc., Respondent Release Nos. 33-7463 and 34-39166
AAER No. 817, In the Matter of Cypress Bioscience Inc. and Alex P. Soto, CPA, Securities Act Release No. 7333

**International Accounting Standard**

IAS 18, *Revenue*