Fundamentals in Software Revenue Recognition

Grant Thornton

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About the Authors

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Lynne serves in the Accounting Principles Group of Grant Thornton, and has more than 20 years of experience assisting public and private companies with complex accounting, auditing and SEC matters, including revenue recognition. She is also one of the national directors of Grant Thornton's U.S. Technology Industry Practice.

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Overview

- **Recurring revenue recognition issues** in software companies
- Determining **the right accounting literature** to apply is not always as easy as it seems
- Understanding the **terms of each arrangement** is an important first step

Determining the right accounting literature to apply is not always as easy as it may seem. Software revenue recognition is a more complex contract term. It often differs from customer to customer and sometimes even for the same deliverable. As a result, it is critical that there is an understanding of the terms for each arrangement.

Common Pitfalls

Lynne and I will talk about some of the pitfalls and warning signs that we've run into with our clients in the area of revenue recognition. As I indicated on the previous slide, understanding the term is imperative. If your sale force has the ability to customize the contract, you can't assume similarity from contract to contract. I've certainly seen clients wide-eyed with surprise when we've brought some unusual provision buried in a contract to their attention during the audit process, and chances are that unusual provision will affect revenue recognition. Globalization adds to the complexity. If you're entering into an agreement in Japan or Germany, the customer may insist on terms that you would not ordinarily see in a US based transaction. One of my clients entered into a contract with a Japanese company. The customer on the Japanese side insisted on establishing a technology pool and this was in addition to the usual remix pools that my client was accustomed to. This provision in the contract generated a great deal of discussion between us and the client around the impact that it would have on revenue recognition.

TRIPLETT: It's not just the global nature of the business environment, but also here in the US sometimes the customer size impacts the contract terms. If the customer is quite large in comparison to the size of the vendor, they sometimes have the ability to influence what is or isn't included in the contract terms which can in fact impact revenue recognition.

AKERBLOM: Absolutely. Then it comes down to a business decision. If you're out there and you're a small or mid-size enterprise and you're doing business with the largest of customers, you're probably familiar with the fact that they very often insist on utilizing their own contract formatting terms rather than what you have adopted as your standard. You want to be sure you understand all the provisions included in their format and make an informed business decision.

Also, it is so important for senior management of your company to also set the tone at the top when it comes to undocumented agreements. There should be frequent and reoccurring discussion within your sales force emphasizing the penalties for these types of arrangements. Even in situations where there are no un-documented side agreements, the lack of communication can result in a revenue recognition result which is less than optimal. And it might have been optimized had both parties communicated before the contract was signed. I've often seen my clients bemoaning the fact that contract terms were negotiated without consultation with the finance department of the revenue recognition impact that it might have.

TRIPLETT: I think though just as a reminder, sometimes there are business decisions that get made and it is not always wrong for a contract term to impact revenue recognition. It is just a matter of being aware of what those terms are and what the impact is going to be. It's important to enter agreements with your eyes open to revenue recognition implications if contract terms are changed.

Applicability of 97-2

TRIPLETT: Another challenge that software companies face results from the volume and complexity of the revenue recognition guidance that exists. In this quick session we can't possibly address all of the literature, but I am going to begin with a brief discussion of the applicability of SOP 97-2. One of the difficulties lies in determining whether or not 97-2 applies. Many people believe that the 97-2 model is more restrictive because of the need for Vendor Specific Objective Evidence of fair value and they don't always apply it when they should. But we've also seen recent instances of companies using 97-2 when it does not apply. Particularly in software hosting arrangements, which Jacqueline will talk about.

So when does 97-2 apply? Simply put, it applies when software is licensed, sold, leased or otherwise marketed. However it does not apply when the software is incidental to the product or services as a whole. Because so many products and services contain embedded software, it can be challenging to determine when the software is more than incidental. A company that hasn't historically thought of itself as a software company may find that it needs to apply 97-2 because its product has evolved and the software is no longer incidental to the product as a whole. Examples include companies in the medical device, and telecommunications industries. It is important for companies to regularly assess whether or not 97-2 applies, especially when their products are evolving.

Indicators that Software is More than Incidental

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Indicators that software is more than incidental

- The software is a **significant focus** of the marketing or the software is sold separately
- The vendor provides **post-contract support**
- The vendor incurs significant software **development costs**

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Even though 97-2 provides indicators to assist companies in making the determination about the significance of embedded software, it is still a difficult area to apply and significant professional judgment may be needed to determine whether the software is more than incidental.

None of the indicators given in 97-2 is presumptive. Rather they should all be considered together to determine if the software is more than incidental.

In looking at the first indicator of whether the software is the significant focus of the marketing, a company should evaluate whether the software is used to differentiate its products from those of its competitors. Is the customer buying because of the product? Or are the features and functionality of the software such a focus that it is likely that the software is influencing the customer's buying decision? In evaluating this factor, all of the marketing materials that are available to a customer should be considered and those include the company's website, customer proposals and other product write-ups and even the content of conversations between sales personnel and the customer.

Selling the software separate from the product may also indicate that the software is more than incidental. In addition, if a company provides support services for the software in the form of upgrades, enhancements or other maintenance, including when and if available deliverables, this may indicate that the software is more than incidental. And if the company provides support for both the hardware and the software elements, it is sometimes difficult to determine the significance of the support provided for each. If the software support is limited to bug fixes and doesn't

provide additional functionality, it may mean that the software is only incidental to the product or service and 97-2 might not apply.

Finally, a company should evaluate the level of software development costs in relation to the total development cost of the product. And if those software costs go up it does become an indicator that 97-2 might apply.

O'CONNOR: If I could interrupt for just one minute, given these guidelines, how do companies work with their auditors to make a case for or against applying 97-2?

TRIPLETT: I would recommend that they actually go through each of these indicators to see where their company falls. Look at your marketing materials, look at what your website says, look at how your sales personnel talk with the customers and portray the product. Is it really the software or is it the product? So to go through each one of these, is there support provided? Based on this review, they should prepare a position paper and then talk with their auditors about it. They should approach their auditors saying, "We've come to the conclusion that 97-2 does or does not apply and here's the reasons why from looking at each of these indicators. Can you agree with our conclusion?"

AKERBLOM: It is really important that companies actually think about this especially if they aren't a traditional software enterprise. One of my recent clients considered themselves to be a telecom equipment manufacturer. And up until the point when they introduced a particular new product, that was basically what they were. However, as we were looking at this new product in the audit process, we also looked at these indicators. We looked at the very significant R and D costs that went into the software component. We looked on the client's website and saw significant marketing material emphasizing the advantage over their competitors because of the software component of this piece of equipment. And they also provided PCS in the arrangement. When we raised this with the client, they were so predisposed to think of themselves as an equipment manufacturer, they never really considered that 97-2 might apply to them. But once we went through the process, we arrived at the conclusion that with this new piece of equipment they did in fact fall into 97-2.

TRIPLETT: We know that many people view 97-2 as the less advantageous accounting to have to apply and so it is really important to sit back and consider each of these indicators and carefully evaluate arrangements. This is especially important for those companies with embedded software and in companies that haven't hereto for considered themselves to be software companies. Careful consideration is critical in determining the appropriate accounting treatment.

Multiple Element Software Arrangements

Multiple-element software arrangements

- May include software and non-software related elements
- EITF Issue 03-5, "Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software"
- Is the software essential to the functionality of the other elements?
  - If yes, then apply SOP 97-2
  - If no, then apply other guidance, including EITF Issue 00-21, "Revenue Arrangements with Multiple Deliverables," and Staff Accounting Bulletin *104, Revenue Recognition*

A software license arrangement conveys the rights to more than one deliverable. The application of the basic revenue recognition criteria of 97-2 is made more complicated because each element must be evaluated to determine if the fees can be allocated between the deliverables. And this includes post-contract customer support {PCS}. Because so many software arrangements include multiple deliverables, companies often must apply more than one piece of accounting literature to an arrangement. The interaction of the literature can be quite challenging and increases the complexity of the accounting. We'll talk more about that.

The first step in evaluating a multiple-element arrangement is to determine what the various deliverables are. That sounds quite simple but quite often people haven't read all of the contract terms to determine what exactly is being delivered. Often arrangements include both software and non-software related elements. If a multiple element arrangement includes software that is more than incidental -- you've tripped yourself into 97-2, but you also need to look at EITF issue 03-5 to determine which elements are in fact within the scope of 97-2 and if there are elements outside of the scope of 97-2. In doing so, issue 03-5 requires an evaluation of whether the software is essential to the functionality of the other element. And if the answer is yes, than the entire arrangement is within the scope of 97-2 and so the separation guidance of 97-2 is applied to determine if the elements can be treated as separate units of accounting.

But if the software is not essential to the functionality of any or all of the other elements, than 97-2 is applied to the software element, or if there is more than one software element, to all of those elements, and other literature is applied to the non-software element. The other literature should include the separation guidance, the EITF issue 00-21, if there is more than one non-software element in the arrangement. And then also the revenue recognition guidance of SAB 104 would be applied.

This is just one example of how the interaction of the accounting literature increases the complexity of accounting for a multiple-element arrangement and it is critical that there is an understanding of all the terms of the arrangement in order to come to the right conclusion regarding the accounting literature to apply.

Software and Services

**Multiple-element software arrangements
Software and services**

- If significant customization or modification of the software, contract accounting should be used
- Services not involving significant customization or modification, can be separated if
    - VSOE exists for the services
    - Services are not essential to the functionality of software
    - Arrangement consideration would change if services were not included

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Many software arrangements include both software and services. The services could include installation, training, software design, or customization and modification of the software. If the services involve significant customization or modification of the software, then contract accounting under SOP 81-1 should be used for the arrangement. In these situations, the software cannot be separated from the services. So it is treated as one unit of accounting. So even if there is a non-refundable up-front payment for the software license, there *isn't* up-front revenue recognition in these types of arrangements.

If the services don't involve significant customization or modification of the software, if you just have implementation or training or some other type of consulting services, the company should evaluate whether the services can be separated from the software for accounting purposes. And in order to separate the services, there must be VSOE of fair value for the services. The services must not be essential to the functionality of the software or other elements in the arrangement, and the contract must describe the services in such a way that the total price of the contract would be expected to vary if those services were not included in the arrangement.

Revenue recognition can be challenging in software arrangements that include service elements. If VSOE does not exist for all of the elements, then the order of delivery of those elements can impact revenue recognition. We have also seen numerous companies inappropriately using percentage of completion accounting. Percentage of completion accounting should only be applied to arrangements that are specifically within the scope of SOP 81-1 or involve significant production modification or customization of software as SOP 97-2 directs you back to SOP 81-1.

O'CONNOR: Just a quick question on 81-1 coming from the audience. What is the most common metric used? Is it milestone based, is it hours, weeks, months?

TRIPLETT: I will say that the most common is generally some kind of hour-based metric. A preferable method is to look at the outputs that are given but I think most people actually look at some type of time metric.

O"CONNOR: Measured up against the project?

TRIPLETT: Right. So measuring the time that has been incurred to the total time expected.

But revenue for services that are not within the scope of 81-1 should be recognized *as* the services are performed, using the proportional-performance method. Or on a straight-line basis, if no other pattern of performance is discernible. In some situations I think what trips people up is that the proportional-performance method looks alot like a percentage-completion method, but there are differences. One of them is that in applying the proportional-performance method, costs are expensed as incurred: they're not captured on a balance sheet and taken in some future period. They're expensed in the period incurred.

There are many other multiple-element software arrangements that we could go review but a bit later in the presentation we're going to focus on Software as a Service (SaaS) because this is a sector in the software industry that has recently experienced increased activity and it is an area that has generated many questions to us.

Establishing and Maintaining VSOE

Establishing VSOE

- Price charged when sold separately
- If not yet sold separately, price established by management
- Must be probable that the price established by management will not change when item is separately introduced to the market

One of the hurdles in separating software elements within the scope of SOP 97-2 is establishing Vendor Specific Objective Evidence of fair value for the elements. VSOE is a complex subject and could be a long discussion. For that reason, I am going to focus on how it relates to PCS since this is an area in which we are frequently consulted.

In deliberating on 97-2, AcSEC spent time thinking about whether they should allow an entity to look to the sales of another entity in determining fair value for an element. But they decided that because each software product is unique, vendor specific objective evidence of fair value would be required to separate the elements in a multiple element arrangement. So this means that a vendor must have its own separate sales of the element to look to as evidence. And VSOE applies to all elements in a software arrangement. I have had people say that because there are other vendors that could provide a professional services or some other element of the arrangement, that they should be able to use the price charged by others as evidence of fair value. But if the entire arrangement falls within 97-2 then the criteria of 97-2 including the concept of VSOE should be applied to all of the elements.

VSOE is the price charged when the element is sold separately by the vendor. If the element is new and has not yet been sold separately, then VSOE can be established by management having the relevant authority -- but it must be probable that the price will not change when the item is sold separately. In order to support the assertion that the price will not change, separate sales should occur within a relatively short period of time. People often use 30 days as a rule of thumb. That is because the more time that passes from the date the price is established to the date the element is sold separately, the more likely that the price will change.

In my experience, it is rare that a vendor will be able to establish VSOE through reference to a price set by management prior to the introduction of the element to the market. I did have a company that thought they had VSOE for a new element at the end of one accounting period because their pricing committee had set a price: they had sent several proposals out to customers and believed they had good response -- although no one had signed up. Then in the subsequent period, the separate sales did not quickly materialize and the company determined that VSOE never existed and then they needed to consider re-statement of their prior-period financial statements. So the effort to make that VSOE argument early turned out not to be in their favor.

A company should have sufficient separate sales of the element to provide evidence of fair value. We often are asked what constitutes a sufficient number of transactions: it really requires professional judgment and depends on the facts and circumstances of each situation. But certainly one or just a few would not be sufficient. This can be an especially challenging area for newer entities that just haven't established a pattern of sales or separate sales.

Establishing VSOE – PCS

Establishing VSOE - PCS

- Paragraph 57 of SOP 97-2
- Price customer will be required to pay when it is sold separately (renewal rate)
- Two widely-accepted methods (policy election)
  - Bell-shaped curve
  - Substantive renewal rate
- Do not presume that a renewal rate within a contract represents VSOE

PCS is an area on which we are often consulted, and demonstrating that VSOE exists can be especially challenging for companies that have more than minimal variability in their pricing of PCS. One place to look for guidance related to VSOE for PCS include paragraph 57 of SOP 97-2. There are also are numerous AICPA Technical Practice Aides that address PCS.

Paragraph 57 says that the fair value of PCS should be determined by reference to the price the customer will be required to pay when PCS is sold separately. So a renewal rate. But it shouldn't be presumed that a PCS renewal rate stated within a contract represents VSOE. A company should also have evidence of separate sales or renewals that support that stated renewal rate.

There are two widely-accepted methods of establishing VSOE for PCS: they are the bell-shaped- curve method and the substantive-renewal-rate method. The method used by an entity is an accounting policy election that should be made and then applied consistently to all arrangements.

Bell-Shaped Curve Method

Bell-shaped curve method

- Uses the entire population of separate transactions to determine VSOE
- VSOE is a range, not a point within the range
- When pricing is below VSOE – must defer an amount within the range (either midpoint or low-end)
- When pricing is above VSOE – do not adjust
- Periodically update analysis of VSOE

These two methods are somewhat similar but each has a very different focus. The bell-shaped-curve approach looks at the entire population of separate sales for renewals to determine if the substantial majority of the renewals --generally 80 percent -- fall within a relatively narrow range. I think a lot of people use plus or minus 15 percent. When using the bell-shaped-curve method, VSOE of fair value is a range: it is not really a point within the range. So if the stated PCS renewal rate in a bundled arrangement is below the range of VSOE that has been established, the amount to be deferred and recognized over the PCS term is either the midpoint of the range or the low end of the range. And again, whether a company uses the midpoint or the low end is an accounting policy election and it should be consistently applied. So if your company chooses to use the mid point of the range for deferring the amount related to PCS, than you should always use the midpoint.

When the stated PCS renewal rate is above VSOE, then the amount to be deferred should generally be the amount stated in the arrangement terms and this avoids early recognition of amounts that are potentially refundable. One of the stipulations in paragraph 14 of SOP 97-2 is that you can't recognize amounts that are potentially refundable.

And in applying the bell-shaped curve method, a company should perform an analysis at least once a year to confirm that the pricing for separate PCS transactions is still within that relatively narrow range. This analysis should include all separate PCS transactions. So even those transactions that were outliers -- they were either above the range or if they were below the range and you deferred an amount up to VSOE -- all of those get included: you don't get to exclude them because you consider them to be outliers.

Substantive Renewal Rate Method

Substantive renewal rate method

- Evaluate renewal of PCS in each arrangement to determine if term and rate are substantive
- Consistent pricing for similar arrangements
- If determined to be nonsubstantive, then VSOE for that arrangement does not exist

In applying the substantive-renewal-rate method, a vendor should evaluate each arrangement to determine if the renewal term and the renewal rate are substantive. In looking at the renewal rate, the company should compare the stated renewal rate in the arrangement to the total initial consideration in the bundled arrangement to determine if the renewal rate is substantive. So generally a renewal rate of less than 10 percent of the initial consideration is not considered substantive but again, this is a judgment call. There may be reasons why less than 10 percent is OK. If there are significant amounts of hardware cost included in the arrangement, that could be a possibility. But that is why each transaction needs to be looked at separately. In addition, a renewal rate that is significantly below the vendor's normal pricing practices, is not considered substantive. So in using the substantive-renewal-rate method, a company still needs to assess whether its pricing is consistent. I think this is the most common method that is used, but it doesn't avoid the need to determine whether the pricing is consistent.

In looking at the renewal term, it is not substantive if it's either less than one year or less than the initial PCS period bundled with the software sale. And in addition, the aggregate PCS renewal period must be equal to or greater than the initial PCS period. So for example, if you had an arrangement that was for a five year license, with an initial PCS period of three years and two annual renewals, the term would not be considered substantive.

In arrangements where either the renewal rate, the term or both are determined not to be substantive, then VSOE for that arrangement doesn't exist, and the entire consideration for both the software and the PCS should be recognized ratably over the PCS term. That assumes all other revenue recognition criteria are met and PCS is the only undelivered element.

Maintaining VSOE

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Maintaining VSOE

- Periodic assessment
- Change in elements or pricing strategy
- Element no longer sold separately
- Range of prices no longer sufficiently narrow

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So in looking at whether or not a company has maintained VSOE, on at least an annual basis they should assess whether or not the actual separate transactions continue to support the amounts being used. This assessment should be performed more frequently if there is more than minimal variability in pricing.

There are a number of changes that could impact whether VSOE still exists, and those include changes in elements that are being sold or a change in pricing strategy. Or perhaps an element is no longer being sold separately: it is only being sold in bundled arrangements. Or if the range of prices of separate sales is no longer sufficiently narrow, then VSOE of fair value would not exist. Again it is important for companies to make sure that their sales personnel are aware of the importance of pricing in maintaining VSOE if that is an important thing for the company to do. Again, as we said, sometimes companies choose to alter their pricing policy for business reasons, perhaps to gain acceptance of a product in the market or some other similar reason. But in making a decision to change prices they often offer concessions. Make sure that management is aware of the accounting implications.

AKERBLOM: It is incredibly important. I've seen a client who had established VSOE within a pretty tight range move out of VSOE over time so that the following year we were concerned because we saw a loosening of the range. They still met our view of criteria for establishing it. But then the following year, the pricing was all over the board: it was a business decision that they made in order to stay in the market. They lost VSOE, and once it's lost, it's even more of a challenge to re-establish it.

Stratifying Transaction Pool

Establishing and maintaining VSOE
Stratifying transaction pool

- Population may be stratified in evaluating VSOE
  - Customer size
  - Product type
  - Geographical location
  - Level of service provided
- Must have sufficient transactions within a pool to conclude VSOE of fair value exists

TRIPLETT: We frequently get questions about whether the transaction pool must be looked at in total to evaluate VSOE or whether it can be stratified. The population can be stratified when there are significant differences in the pricing for different pools of transactions --whether that is customer size, product type, geographical location or level of service. But bear in mind that there should be sufficient transactions within each pool in order to conclude that VSOE exists. And as I noted earlier, judgment is needed to determine the number of transactions that would be considered sufficient: but one or just a few is not it.

Hosting Arrangements

Hosting arrangements

- Arrangements with software-as-a-service are occurring more frequently
- Two elements are delivered
  - Licensed software
  - Hosting service
- EITF Issue 00-3, "Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware"

AKERBLOM: In the past three to four years we have seen a steady increase in the number of clients offering their software as a service and utilizing the software and service model. Typically, what is a hosting arrangement? Typically the software is not transferred to the customer. It resides on the vendor or third-party server and the arrangement provides the customer access to the software for a defined period of time.

As I mentioned the number of companies delivering software this way is increasing, and we think one reason is the changing demands of customers who want to pay only for using the functionality. They're also becoming more resistant to the tradition of the payment of a large, upfront license fee. These Software as a Service (SaaS) models also require lower customer infrastructure and implementation costs and they eliminate large upfront payments in favor of a periodic payment stream. This ratable revenue recognition is appealing to the financial markets as well for the predictability of revenue stream. And we've seen a very high level of interest on the part of investment banks and others in the financial markets for this model. How should the revenue from these types of hosting arrangements be accounted for? First we need to evaluate what is being delivered. At the very basic level, these transactions include two elements: the first one being the right to the licensed software and the second being the hosting service. However, just because they are separate in contract terms, they may not be considered separate units of accounting under the literature.

Once you've established that your software is being offered under a hosting arrangement, the guidance of the EITF issue 00-3 should be applied to evaluate whether the software element is within the scope of SOP 97-2 or if it falls under other literature for service arrangements.

Hosting Arrangements Software Element

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Hosting arrangements
Software element

- Software element within SOP 97-2?
  – Contractual right for customer to take possession of software without significant penalty exists
  – Feasible for customer to run the software on its own hardware or the hardware of another party
- If yes, software delivery when customer has ability to take immediate possession of the software
- If no, arrangement accounted for as a service arrangement (apply EITF Issue 00-21, SAB104)

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When we look at 00-3, it tells us that if the customer has contractual rights to take possession of the software without significant penalty and it is feasible for the customer to run the software on its own hardware or the hardware of a third party, then the arrangement has a software element to it.

But what does significant penalty mean? There are two distinct concepts defined in 00-3 with respect to significant penalty. The first one is the ability to take delivery of the software without incurring significant costs. And the second one is the ability to use the software separately without a significant diminution and utility of value. The software does not have to be delivered in order for a software element to exist under 97-2. When a contractual right to the software exists in an arrangement, a company should consider whether economic barriers exist as well. To be significant, an economic barrier should be a dis-incentive to the customer.

If you determine there is not a software element in your arrangement, the entire arrangement should be accounted for as a service contract using other literature

such as EITF issue 00-21 and SEC SAB 104. The most common model of hosting arrangement that we're encountering in our client base does not include a software component and it is therefore outside the scope of SOP 97-2.

Hosting Arrangements – No Software Element Exists

Hosting arrangements
No software element exists

- Software and hosting services generally one unit of accounting
- Hosting is last element delivered
- Revenue recognized as the hosting service is performed

When the arrangement falls outside the scope of SOP 97-2, the software and hosting services are generally treated as one unit of accounting because stand-alone value for the software or the license does not exist. In fact there really is only one deliverable, the hosting service. Some companies may be waylaid into thinking that there is a software component because the contract language speaks to a separate software license and hosting piece. There may even be separate pricing within the contract. However, if you've not met the provisions of 00-3 discussed on a previous slide, the arrangement is really a subscription to the software product via the hosting arrangement.

Since the hosting is delivered over a period of time, revenue for the arrangement is recognized ratably as the hosting service is performed over the estimated customer relationship period in accordance with SAB 104. Note that the relationship period is often different from the hosting period. The relationship period is an assessment which must be made at the inception of the contract together by the finance or accounting department with the sales or customer-relationship representatives. It is a determination of whether or not there is an expectation that renewals will be entered into and or other products from the company contracted by that customer. The relationship period should also be revisited as new arrangements are entered into with the customer.

So even if the contract provides for an up front cash payment for the software license, that amount would be recognized as revenue ratably over the relationship period. There would be no up front recognition for the software because it is not a separate deliverable. For those of you who are private companies out there, you may ask whether or not you're subject to SAB 104, which was promulgated by the SEC. That position is that SAB 104 is based on GAAP and we believe it is reasonable to apply the SEC guidance to non-public companies as well.

Multiple-Element Hosting Arrangements

> # Multiple-element hosting arrangements
>
> - Determine if the elements can be separated under EITF Issue 00-21
>   - Does the delivered element have **standalone value**?
>   - Is there objective and reliable **evidence of fair value** for each of the undelivered elements?
>

Hosting arrangements often include professional services or other elements in addition to the software license and the hosting. These additional services may be delivered at various points in the arrangement and they are not always an up-front deliverable. When the hosting arrangement is outside the scope of SOP 97-2, because software is not provided, the guidance of paragraph 9 of EITF issue 00-21 should be used to evaluate the elements for separation and the order of delivery may impact revenue recognition. Use of the residual method to allocate consideration requires that evidence of fair value for all undelivered elements exist. Note that the hosting service remains an undelivered element for the life of the contract.

Sometimes it is difficult to determine stand-alone value in a hosting arrangement. Stand-alone value means that the element is sold separately by another vendor or the customer could resell the element on a stand alone basis. In performing this evaluation, an entity should consider whether the undelivered element, usually the hosting service, is required for the delivered element: for example, implementation services or professional services. In many situations, the vendor maintains proprietary knowledge related to the software and as such, no other vendor could provide the professional services or the implementation. There are other situations where the proprietary knowledge may not be necessary to perform the other services and so long as there is another vendor that can perform the services, the first criterion of EITF 00-21 may be met. 00-21 also tells us that the best evidence of fair value is vendor specific objective evidence, VSOE as defined in SOP 97-2 and as Lynne just took us through in the previous slides.

When VSOE is not available, third party evidence may be acceptable. The best evidence of fair value is the price of the deliverable when it is regularly sold on a stand-

alone basis. The third party evidence should be relevant in that it is for similar product for a similar customer. If the service is highly customized, relevant third party evidence may not exist. This may be a pit-fall in hosting service arrangements. The last element being delivered is generally the hosting services and there is generally not another vendor that can be pointed to as providing sufficient similar hosting.

When fair value for the hosting services does not exist, the arrangement must be treated as a single unit of accounting and revenue would be recognized ratably over the customer relationship period once the hosting is the last undelivered element.

Fair Value

Since hosting is generally the last deliverable in the arrangement, evidence of fair value for the hosting services must exist in order for that element and the other elements in the arrangement to be separated for revenue recognition purposes. Hosting services are generally unique to the vendor and as such the vendor must have separate transactions to evidence fair value. Since the hosting services are rarely sold initially on a stand-alone basis, the best evidence of fair value is the renewal rate. In order for renewal rates to provide sufficient evidence of fair value, there must be a history of separate renewals at the stated prices and the pricing should be consistent for similar arrangements.

TRIPLETT: This is one of the areas that I think some people are a little bit tripped up by -- because since hosting is a new delivery model for so many companies, it takes a while for a company to accumulate sufficient evidence of fair value. I know it is hard for people to understand that initially they might not have that fair value to be able to separate the elements.

Revenue Recognition

AKERBLOM: Let's walk through an example. In this situation we have a 12 month hosting arrangement. The contract calls for professional services to be delivered over the first three months of that arrangement. As there is no fair value for the hosting, the revenue must be deferred until the professional services are delivered after the first three months. Once the only remaining deliverable is the hosting, the company then begins recognizing revenue ratably over the remaining nine months in the relationship period. This could potentially be stretched out to a longer period if the relationship period was deemed to be longer than the initial contract period of 12 months. As previously indicated, the guidance of SAB 104 points us to estimating the length of the relationship period and recognizing all revenue ratably over that period.

Q & A

O'CONNOR: Many people had questions about how to control and motivate a sales force to standardize their support for fair value and abide by revenue recognition rules. Do you have any ideas about best practices you may have seen in your client base in terms of how finance and sales forces have worked together well?

AKERBLOM: I think that the most successful companies have a really strong dialog between finance and accounting and sales. They make a regular practice out of such things as sending finance people out to regional or national sales meetings. At least in my larger clients they have regular sort of quarterly sales updates and meetings and they make it a standard policy to have someone from the finance team at the meeting, networking with the sales reps. and even spending some time at the podium reminding them about the accounting revenue recognition rules as it applies to them in their roles entering into contracts with the customers.

O'CONNOR: One of the interesting things that we've seen in use of our products is that they're routing quotes through our product to see the revenue impact before the quotes are sent to customers. It is an interesting development for us to see customers who are looking to first get revenue treatment on their contracts and different versions before they get to their customers because they don't want to be surprised later on. In this world of revenue recognition, surprises are not what anyone wants.

TRIPLETT: Adding on to that, another best practice is not only the communication between accounting and the sales force, but often times our clients will bring particular provisions to us as the auditors to sort of review and "sign off on" before they enter into the contract or make sure we're all in agreement.

O'CONNOR: There were some questions about the difference between VSOE and fair value. Could either of you spend a moment on that and when one might apply versus the other.

TRIPLETT: Well actually 97-2 is vendor specific objective evidence of fair value. So there is one way to determine fair value of VSOE and it is the one prescribed by 97-2 for software arrangements. So any software arrangement that has more than one software element, you would need to have VSOE of fair value in order to separate those elements for accounting purposes. Fair value, which is looked at I think under 00-21 is one place where you need to separate elements that are not software related and don't fall under 97-2 then the fair value guidance of 00-21 can be applied rather than the stringent requirements of VSOE. And again, I think as Jacqueline said, VSOE is the best measure of fair value -- you have your own separate sales of something. But if you don't under 00-21, but there is another vendor that sells a similar enough product or service you can look to what they sell it for as evidence of fair value.

AKERBLOM:
I think if I looked at my clients, they would consider VSOE to be the most stringent criteria to meet and if you're a hosting arrangement that is not subject to 97-2 and VSOE then it might be a little bit easier to meet the fair value criteria 00-21.

O'CONNOR: There are many questions about thresholds. What is a good threshold to use when deciding whether software development costs are significant?

AKERBLOM: I'd say that it really is a fact and circumstances situation. However in the example that I gave earlier about my Telecom client, we saw a noticeable difference in terms of the percentage of development cost related to the software component of that piece of equipment, especially when compared to the software components of previous generations of equipment. So again it is facts and circumstances but when it is noticeable, when you see an evolution in your product offering such that you're spending significant dollars in the R and D mode on the software component where you haven't in the past, that is a pretty strong indicator that you've passed the "significance" threshold.

O'CONNOR: OK. Telecom is a booming customer base for us right now because of the developments there and they have now greater complexities in terms of revenue recognition that they are now subject to. So I'm going to talk about separate contracts and I think it might be good to make a comment on that. If hardware is on one contract, software is on another, maybe we should get some advice on whether that really matters.

TRIPLETT: Well if hardware is on one contract and software is on another and they are sold within a relatively short period of time of one another, some people say six months, you certainly should consider whether or not they are not really one arrangement as opposed to two separate arrangements. So just papering something as hardware on one piece of paper and software on another piece of paper doesn't negate the fact that you need to look at them as one arrangement.

O'CONNOR: There are a few questions about order of delivery. Why or how does the order of delivery in a multi-element arrangements affect revenue recognition and is there any kind of reference or guidance on that?

TRIPLETT: In a software arrangement, you have to have vendor specific objective evidence of the undelivered element in order to separate them and account for anything early on. Because in using the residual method where there are just two elements, one is the software license and the second is some type of service that is going to be provided later. Neither the service nor the software is essential for the other one. You would need to have VSOE of the services in order to say then OK I'm going to take that amount, that fair value and defer the consideration related to the services and use the residual method -- so whatever's left you can then record for the software. When you have more than two deliverables, you are always looking to see what is going to be the last delivered.

AKERBLOM: Similarly in a hosting situation, the order of delivery is important because the hosting is delivered as you provide the service. So if you refer back to the example that I walked through on my last slide, the hosting was being delivered during those first three months. However, there were significant special services being delivered in those first three months as well. So you could not start recognizing revenue on any of the cash collected or received until those special services had been delivered.

O'CONNOR: We always have a forward looking question and I think we have time for that. If you look in your crystal ball what does the FASB or any other standard setting body have for projects on the horizon that may change and or simplify, I think they're hoping for that, any of the rules related to software revenue recognition?

TRIPLETT: Many people might be aware that there is a significant project underway by FASB to overhaul revenue recognition in total – though that is a long term project. I don't see anything on the immediate horizon that is going to significantly impact software revenue recognition and I would hope that this overhaul would in fact simplify the accounting but sometimes things don't work out that way.

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