

**Statutory Issue Paper No. 111**

**Software Revenue Recognition**

- b. Paragraph 33 is amended to remove the reference to Technical Bulletin (TB) No. 79-10: Fiscal Funding Clauses in Lease Agreements
- c. Paragraph 57 is amended to remove the reference to FAS No. 86, Accounting for the Costs of Computer Software to Sold, Leased, or Otherwise Marketed
- d. Paragraph 73 is rejected as not applicable to statutory accounting.

### Effective Date and Transition

6. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years beginning on or after January 1, 2002.

### DISCUSSION:

- 7. The modifications to SOP 97-2 were made in order to maintain consistency with current statutory accounting principles and the Statement of Concepts.
  - a. Paragraph 10 is amended because it includes a reference to FAS No. 5, Accounting for Contingencies—Liabilities, Contingencies and Impairments of Assets. SSAP No. 5 contains the authoritative statutory accounting for loss contingencies;
  - b. Paragraph 33 is amended because it includes a reference to TB No. 79-10. The removal of the reference does not change the accounting prescribed in SOP 97-2 and it eliminates any possible conflict with the fact that TB No. 79-10 is rejected by SSAP No. 22 — Leases;
  - c. Paragraph 57 was amended because it includes a reference to FAS No. 86. Paragraph 57 is not impacted by the removal of FAS No. 86 because it is used in the context of a piece of historical evidence. SSAP No. 17, Preoperating and Research and Development Costs requires all such costs to be expensed, therefore there is no capitalization experience to analyze;
  - d. Paragraph 73 was deemed to be not applicable because of the requirement to follow FAS No. 86 in the case of capitalizing funded software-development costs. This approach is inconsistent with the provisions of SSAP No. 17 and the requirement to expense such costs. The directive to expense such costs eliminates the need for this paragraph.
- 8. SOP 98-4 as well as the effective date paragraph of SOP 97-2 and SOP 98 were not adopted in this issue paper as it is expected that the effective date for the SSAP will be January 1, 2002.
- 9. EITF 00-3 was adopted because it supports the principles adopted in SOP 97-2.
- 10. SOP 97-2 includes several references to GAAP pronouncements that were deemed not applicable in the initial SSAPs. This includes Accounting Research Bulletin No. 45, Long-Term Construction-Type Contracts; SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts; FAS No. 48, Revenue Recognition When Right of Return Exists; and FAS 68, Research and

Development Arrangements These GAAP pronouncements are deemed to be applicable to statutory accounting only to the extent that SOP 97-2 references them.

## RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE:

### Statutory Accounting

11. In general, the initial SSAPs deemed the relevant GAAP guidance to be not applicable to statutory accounting. As discussed above, technology and the environment have changed significantly since the original SSAPs were adopted and therefore guidance is now needed.

### Generally Accepted Accounting Principles

12. AICPA Statement of Position 97-2 Software Revenue Recognition provides the following:

#### Conclusions

.06 The following conclusions should be read in conjunction with the Basis for Conclusions section, beginning with paragraph .93 of this SOP, and the examples in appendix A, Examples of the Application of Certain Provisions of this SOP.

#### Basic Principles

.07 Software arrangements range from those that provide a license for a single software product to those that, in addition to the delivery of software or a software system, require significant production, modification, or customization of software. If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the entire arrangement should be accounted for in conformity with Accounting Research Bulletin (ARB) No. 45, Long-Term Construction-Type Contracts, using the relevant guidance herein, and in SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts.

.08 If the arrangement does not require significant production, modification, or customization of software, revenue should be recognized when all of the following criteria are met.

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

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

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

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

The amount allocated to undelivered elements is not subject to later adjustment. However, if it becomes probable that the amount allocated to an undelivered element will result in a loss on



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

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

#### Evidence of an Arrangement

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

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

.17 Even if all other requirements set forth in this SOP for the recognition of revenue are met (including delivery), revenue should not be recognized on any element of the arrangement unless persuasive evidence of an arrangement exists.

#### Delivery

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

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

#### Customer Acceptance

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

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

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

- In the former kind of arrangement, duplication is incidental to the arrangement and the delivery criterion is met upon the delivery of the first copy or product

master. The vendor may be obligated to furnish up to a specified number of copies of the software, but only if the copies are requested by the user. The licensing fee is payable even if no additional copies are requested by the user or reseller. If the other criteria in



future price changes in light of competitive conditions, or if significant uncertainties exist about the vendor's ability to maintain its price, the arrangement fee is not fixed or determinable. In such circumstances, revenue from the arrangement should be deferred until the vendor is able to reasonably estimate the effects of future price changes and the other conditions of this SOP have been satisfied.

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allocated to the products that are undeliverable or not specified at the inception of the arrangement.

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

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

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

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

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

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

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

.50 Rights to Exchange or Return Software. As part of an arrangement, a software vendor may provide the customer with the right to return software or to exchange software for products with no more than minimal differences in price, functionality, or features. The accounting for





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

.61 Postdelivery Telephone Support at No Additional Charge. Postdelivery telephone support provided to users by the vendor at no additional charge should be accounted for as PCS, in conformity with this SOP, regardless of whether the support is provided explicitly under the licensing arrangement. Although such telephone support may be offered or available for periods exceeding one year, if the vendor has established a history of providing substantially all the telephone support within one year of the licensing



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

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

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

#### Contract Accounting

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

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

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

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

.78 **Measuring Progress-to-Completion Under the Percentage-of-Completion Method.** Paragraph 46 of SOP 81-1 describes the approaches to measuring progress on contracts (or

segments thereof) under the percentage-of-completion method. Those approaches are grouped into input and output measures, as follows.

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

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

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

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

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

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

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

.83 Labor hours often are chosen as the basis for measuring progress-to-completion,



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need not be applied to transactions entered into before fiscal years beginning after March 15, 1999.

.06 All other provisions of SOP 97-2, including the remainder of paragraph 10, should be applied as stated in SOP 97-2. Accordingly, this SOP does not alter the requirements that (a) any allocation of the fee in a multiple-element arrangement to the various elements should be based on the fair values of each element, (b) those fair values must be supported by VSOE, and (c) in instances where there is insufficient VSOE of the fair values of each element to allow for an allocation of revenue to each element, all revenue from the arrangement should be deferred pursuant to paragraph 12 of that SOP.

#### Effective Date and Transition

.07 This SOP is effective as of March 31, 1998. If an enterprise had applied SOP 97-2 in an earlier period for financial statements or information already issued prior to the promulgation of this SOP, amounts reported in those financial statements or as part of that information may be restated to reflect the deferral of the effective date of the second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 and the related examples noted in paragraph .03 of this SOP.

#### 14. AICPA Statement of Position 98-19, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions provides the following:

##### Conclusions

.06 The following changes are made to SOP 97-2.

- a. The following sentence is added to the end of paragraph 11 of SOP 97-2.

Moreover, to the extent that a discount exists, the residual method described in paragraph 12 [of SOP 97-2] attributes that discount entirely to the delivered elements.

- b. The following is added to the end of paragraph 12 of SOP 97-2.

There may be instances in which there is vendor-specific objective evidence of the fair values of all undelivered elements in an arrangement but vendor-specific objective evidence of fair value does not exist for one or more of the delivered elements in the arrangement. In such instances, the fee should be recognized using the residual method, provided that (a) all other applicable revenue recognition criteria in this SOP [SOP 97-2] are met and (b) the fair value of all of the undelivered elements is less than the arrangement fee. Under the residual method, the arrangement fee is recognized as follows: (a) the total fair value of the undelivered elements, as

income over the one-year PCS service period. Revenue of \$800 should be allocated to the software element and recognized upon delivery of the software.

#### Discussion

Vendor-specific objective evidence of the fair value of the software does not exist because the software is never sold separately. Consequently, sufficient vendor-specific objective evidence of fair value does not exist for the allocation of revenue to the various elements based on their relative fair values. Paragraph 12 of this SOP [SOP 97-2] states, however, that the residual method should be used when there is vendor-specific objective evidence of the fair values of all undelivered elements; all other applicable revenue recognition criteria in this SOP [SOP 97-2] are met; and the fair value of all of the undelivered elements is less than the total arrangement fee.

If there had been vendor-specific objective evidence of the fair value of the delivered software but not of the undelivered PCS, the entire arrangement fee would be deferred and recognized ratably over the contractual PCS period in accordance with paragraphs 12 and 58 [of SOP 97-2].

.07 Paragraph 5 of SOP 98-4, Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition, is replaced with the following.

The second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 which limit what is considered VSOE [vendor-specific objective evidence] of the fair value of the various elements in a multiple-element arrangement, and the related examples noted in paragraph 3 of this SOP [SOP 98-4] need not be applied to transactions entered into before fiscal years beginning after March 15, 1999.

.08 All provisions of SOP 97-2 for software transactions outside the scope of this SOP and all other provisions of SOP 97-2 for transactions within the scope of this SOP should be applied as stated in SOP 97-2.

#### Effective Date and Transition

.09 The provisions of this SOP that extend the deferral of the application of certain passages of SOP 97-2 are effective December 15, 1998. All other provisions of this SOP are effective for transactions entered into in fiscal years beginning after March 15, 1999. Earlier adoption is permitted as of the beginning of fiscal years or interim periods for which financial statements or information has not been issued. Retroactive application of the provisions of this SOP is prohibited.

15. EITF 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 provides the following:

#### EITF 00-3 ISSUE

1. In connection with the licensing of software products, some vendors are offering arrangements in which end users of the software do 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 ("hosting").
2. Structurally, the form of those arrangements may be split into two elements-(a) the right to use software and (b) the hosting service. The arrangements 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.
3. SOP 97-2 establishes standards for recognition of revenue for licensing, selling, leasing, or otherwise marketing computer software. The scope of SOP 97-2 includes arrangements that provide for multiple deliverables (for example, software products and services), which are termed

multiple elements. Under SOP 97-2, if an arrangement includes multiple elements, the fee should be allocated to the various elements based on vendor-specific objective evidence (VSOE) of fair value and recognized when certain criteria are met. One of the criteria for revenue recognition is that delivery has occurred. In addition, if a multiple-element arrangement includes both software and services, the portion of the fee allocable to the services is recognized separately as the services are performed, provided certain criteria are met.

4. The issues are:

Issue 1—Whether SOP 97-2 applies to arrangements that require the vendor to host the software.

Issue 2—Whether SOP 97-2 applies to arrangements in which the customer has an option to take delivery of the software. If so, when does delivery of the software occur and how does the vendor's hosting obligation impact revenue recognition?

#### EITF 00-3 DISCUSSION

5. The Task Force reached a consensus that a software element covered by SOP 97-2 is only present in a hosting arrangement if the customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty and it is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software. Therefore, SOP 97-2 only applies to hosting arrangements in which the customer has such an option. Arrangements that do not give the customer such an option are service contracts and are outside the scope of SOP 97-2. The Task Force observed that hosting arrangements that are service arrangements may include multiple elements that affect how revenue should be attributed.

6. The Task Force also reached a consensus that for those hosting arrangements in which the customer has the option, as described above, to take possession of the software, delivery of the software occurs when the customer has the ability to take immediate possession of the software. The Task Force observed that if the software element is within the scope of SOP 97-2, all of the SOP's requirements for recognizing revenue, including VSOE 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 in order 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. The Task Force noted that hosting arrangements that are, pursuant to this Issue, within the scope of SOP 97-2 may also include other elements, such as specified or unspecified upgrade rights, in addition to the software product and the hosting service.

7. The Task Force observed that if the vendor sells, leases,

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