

Revenue recognition for software companies: Making sense of VSOE, discounts and concessions

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Revenue recognition for software vendors can be complicated, to say the least. One of the key challenges under U.S. GAAP relates to recognizing revenue from software sales, which requires the seller to establish vendor-specific objective evidence (VSOE) of fair value for each separate product or service promised under a single contract.

Software vendors typically bundle products and services — such as the software license, installation, training services, and postcontract customer support (PCS) — under a single contract. A vendor is required to determine VSOE of fair value for each product or service in order to recognize partial revenue before the entire contract is fulfilled. If a vendor cannot establish VSOE of fair value, it may have to defer recognizing all revenue until the last element in the contract is delivered.

Establishing VSOE

A vendor must evaluate whether VSOE of fair value exists for each item in a multiple-element software arrangement to determine if the elements can be separated for accounting purposes. If VSOE of fair value exists for each element in an arrangement, the vendor would use the relative fair value method to allocate consideration to each element.

If VSOE of fair value exists for all of the undelivered elements but not for the delivered element(s), the consideration is allocated using the residual method. When applying the residual method, a vendor allocates VSOE of fair value to each of the undelivered elements, and the remaining consideration to the delivered elements. If the vendor is unable to establish VSOE of fair value for at least the undelivered elements, it cannot recognize any revenue until the earlier of when (1) VSOE of fair value exists, or (2) all the elements in the arrangement have been delivered.

Pricing set by management

The software revenue recognition guidance limits VSOE of fair value to the price charged when the same product or service is sold separately. For an item not currently being sold separately that is expected to be sold separately in the future, the selling price established by management might qualify as VSOE of fair value, if it is probable that the price will not change when the element is introduced into the marketplace.

To establish VSOE of fair value, management cannot simply produce a price list. The credibility of that price list might be questionable, especially if the vendor is establishing VSOE of fair value for the first time. Because software vendors tend to sell new products at discounted prices in order to promote customer acceptance in the marketplace, a price list may represent only a starting point for negotiating with a customer, not the actual selling prices of the products. Moreover, due to the uniqueness of software products and services, a vendor cannot use competitor information when establishing VSOE of fair value.

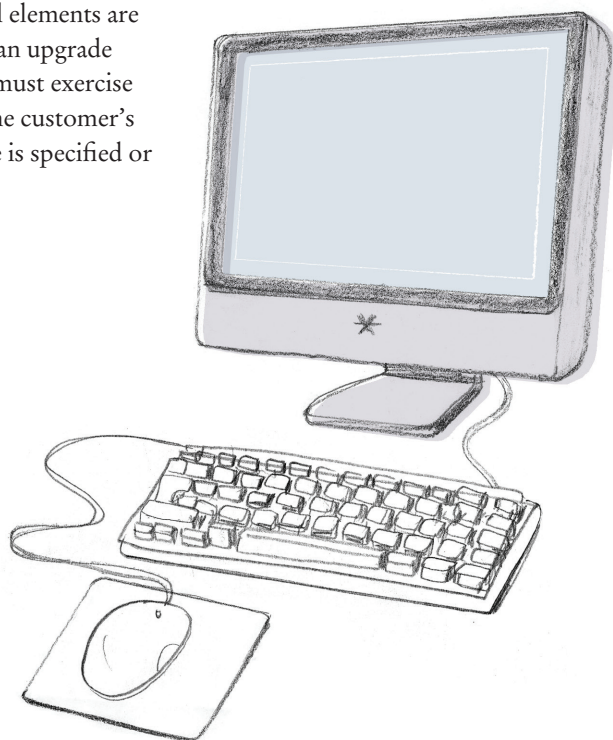


New products versus upgrades

Because technology is constantly changing, many software vendors regularly introduce new software products, as well as upgrades or enhancements to their existing products. It is important for a vendor to distinguish between an upgrade or enhancement and a new software product in order to determine which accounting model to apply. A new software product is one that has more than minimal differences in features and/or functionality from an existing product. An upgrade or enhancement is an improvement to an existing product either by adding functionality, enhancing performance, or both.

For a new software product sold under a multiple-element contract, the vendor must be able to demonstrate that VSOE of fair value exists, for all of the undelivered elements, including the new product, or it must defer all revenue in the arrangement until either (1) VSOE of fair value exists, or (2) all elements are delivered. If the element is an upgrade or enhancement, a vendor must exercise judgment to determine if the customer's right to receive the upgrade is specified or unspecified.

If the vendor has communicated to the customer sufficient detail about the upgrade's features and functionality, it is considered a specified upgrade right. Establishing VSOE of fair value for a specified upgrade right can be difficult because, quite often, the upgrade has not been developed or sold separately at the outset of an arrangement that includes the customer's right to receive the upgrade. On the other hand, if a customer has the right to receive an upgrade only if and when it is available, but the vendor has not provided sufficient details about the upgrade's features and functionality for the customer to form an expectation about the upgrade, it is considered an *unspecified* upgrade right. Unspecified upgrade rights are generally accounted for as PCS, which means the right to receive the upgrade is not considered a separate item from PCS.



Acquisitions and VSOE

When a software vendor acquires another company and begins selling the acquired entity's products, pricing decisions may have an impact on whether VSOE of fair value exists for the acquired products. If the acquiring vendor retains the product pricing and product mix, it can use the acquired vendor's existing VSOE of fair value. However, if the acquirer lowers the price of the acquired entity's products, which is common when the acquired product complements and is bundled with the acquirer's products, the acquirer must carefully evaluate whether it has VSOE of fair value for all elements in the new arrangement. Keep in mind that separate sales of an element are required to support VSOE of fair value. So, if the acquired product is no longer sold on a separate basis, then VSOE of fair value no longer exists.

Impact of concessions and discounts

To either accommodate a customer or to motivate a customer to pay the amount owed, a software vendor may, from time to time, offer a concession, including extended payment terms, price breaks, future discounts, and reduced payments. In contrast, providing additional products or services for a corresponding increase in fees and eliminating a vendor's obligation to deliver products or services without a corresponding refund are not considered concessions.

While concessions seem like a good strategy for motivating customers to pay, they can become problematic when recognizing revenue. If management determines that it has a history of granting concessions, it may be required to delay revenue recognition on all arrangements with extended payment terms until payments become due. As a result, a vendor should consider the reason for granting a concession to a customer and determine whether the concession is an isolated incident or whether it is likely to grant other customers similar concessions.

Discounts on future products also can affect software revenue recognition. If a discount on a future product or service is significant and incremental, the discount is considered another element in the arrangement. A significant and incremental discount on future products or services should be allocated proportionately to each element in the arrangement, including future products or services, based on each element's VSOE of fair value. If future products or services

eligible for the discount are not specified in the arrangement, or if VSOE of fair value for these elements does not exist but the maximum amount of the discount is known, a portion of the consideration should be allocated to both current and future deliverables, assuming the maximum discount will be obtained.

Conclusion

Establishing VSOE of fair value can be extremely challenging for software vendors, especially for new products. Yet compliance with the software revenue recognition guidance and its requirement for VSOE of fair value is critical in evaluating multiple-element software arrangements for revenue recognition. If a vendor improperly reports revenue in its financial statements based on inappropriate VSOE of fair value, it may mislead investors about the company's operating results, which can lead to a host of far more serious problems for the company than delayed revenue recognition. •

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