

Financial Reporting Center – Revenue Recognition

Working Draft: Software Revenue Recognition Implementation Issue



Issue #14-1: Determining Whether Software Intellectual Property is Distinct in Cloud Computing Arrangements (i.e., Hosting, Software-as-a-Service and Hybrid Software/SAAS)

Expected Overall Level of Impact to Industry Accounting:
Significant

Wording to be Included in the Revenue Recognition Guide:

1. An entity must first consider whether a software license exists within the scope of FASB ASC 606-10-55-54(a), which specifically excludes software subject to a hosting arrangement that does not meet the criteria of FASB ASC 985-20-15-5. If the customer cannot take possession of the software at any time during the hosting period without significant penalty and cannot feasibly run it on its own hardware or contract with another party unrelated to the vendor to host the software, a software intellectual property “IP” license does not exist and therefore does not represent a separate promise of a license. The software IP would be considered utilized by the entity only in providing other services to the customer.
2. As software is provided as an example of IP with standalone functionality in BC 56 of ASU 2016-10, FinREC believes that when the software IP subject to a hosting arrangement meets the criteria of ASC 985-20-15-5, such software would be viewed as capable of being distinct. This is consistent with the guidance provided in the illustrative examples of FASB ASC 606, specifically FASB ASC 606-10-55-140(e) which states: “The entity concludes that the software and the updates are each promised goods or services in the contract and are each capable of being distinct in accordance with paragraph 606-10-25-19(a). The software and the updates are capable of being distinct because the customer can derive economic benefit from the software on its own throughout the license period (that is, without the updates the software would still provide its original functionality to the customer)...”
3. When a software license is capable of being distinct, an entity must then consider whether it is separately identifiable (distinct within the context of the contract) per FASB ASC 606-10-25-21. That paragraph includes several factors that indicate two or more goods or services in a contract may not be separately identifiable, though there may be other factors an entity could consider, as acknowledged in BC29 of ASU 2016-10. When evaluating whether a software license is separately identifiable from other goods or services in a contract, an entity

should first evaluate the factors in FASB ASC 606-10-25-21 and the following sections of the Basis for Conclusions paragraphs in FASB ASU 2016-10 to understand the Boards' intent:

BC29 of FASB ASU 2016-10:

...The inputs to a combined item (or items) concept might be further explained, in many cases, as those in which an entity's promise to transfer the promised goods or services results in a combined item (or items) that is greater than (or substantively different from) the sum of those promised (component) goods and services.

BC32 of FASB ASU 2016-10:

...Therefore, the entity should evaluate whether two or more promised goods or services (for example, a delivered item and an undelivered item) each significantly affect the other (and, therefore, are highly interrelated or highly interdependent) in the contract. The entity should not merely evaluate whether one item, by its nature, depends on the other (for example, an undelivered item that would never be obtained by a customer absent the presence of the delivered item in the contract or the customer having obtained that item in a different contract).

BC33(b) of FASB ASU 2016-10:

...Therefore, utility also is relevant in evaluating whether two or more promises in a contract are separately identifiable because even if two or more goods or services are capable of being distinct because the customer can derive some measure of economic benefit from each one, the customer's ability to derive its intended benefit from the contract may depend on the entity transferring each of those goods or services.

4. As indicated from the guidance above, the consideration of "utility" is an important aspect of this determination. Utility is defined in FASB ASC 606-10-55-59(a) as software IP's "ability to provide benefit or value" to the customer. When software IP and other goods or services in a contract significantly affect each other in a manner that results in a combined item (or items) that is greater than (or substantively different from) the sum of those promised goods or service, they may be viewed as a single performance obligation to deliver the intended benefit of the contract, as acknowledged in BC29 of ASU 2016-10.
5. To illustrate this framework, the following examples of software IP delivery models are provided: Hosted software, Software as a service ("SaaS") and Hybrid software/SaaS.
6. The examples provide numerous indicators for entities to consider when evaluating whether a software license is capable of being distinct from other goods or services, and whether it is distinct within the context of the contract. These indicators are not expected to be an all-inclusive list, and entities should consider the specific facts and circumstances of their offering arrangements. Furthermore, an entity should not consider any one indicator determinative, and should evaluate all appropriate indicators together in reaching a conclusion.

Example 1 - Hosted Software

7. A "hosting arrangement" is defined under the Master Glossary as: "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". FASB ASC 606 did not amend this definition within the Master Glossary.
8. Hosting arrangements generally provide the customer with a license to the underlying software IP. As discussed in paragraph 1, an entity must first consider whether the software license subject to a hosting arrangement meets the criteria of FASB ASC 985-20-15-5 and customers have the right and ability to run the software on their own hardware without significant penalty. If not, the arrangement does not include a promise of a license in accordance with FASB ASC 606-10-55-54(a).
9. If the software subject to a hosting arrangement meets the criteria of FASB ASC 985-20-15-5, the promise of a separate license exists in the arrangement and FinREC believes it is capable of being distinct from the hosting service. The entity would then assess whether the

software is distinct within the context of the contract in accordance with paragraph 3. FinREC believes that in most situations, the software likely would be distinct within the context of the contract from the hosting service as the indicators in FASB ASC 606-10-25-21 would likely not be met (i.e., the entity is not providing a significant service of integrating the software and the hosting service, neither the software nor the hosting service significantly modifies or customizes the other, and the software and hosting are not highly dependent, or highly interrelated with, each other).

Example 2 - Software as a Service (“SaaS”)

10. Similar to a hosting arrangement, SaaS refers to IP that is run on the entity’s systems (commonly referred to as the “cloud”) and accessed remotely by the customer’s users. Unlike many hosting arrangements, SaaS customers do not have the right to obtain the complete software code and run it on their own systems. That is, contractual terms permit the customer only to access the IP during the term of service.
11. Without the customer having the right or ability to run the software IP on its own computer systems, SaaS arrangements do not meet the criteria of FASB ASC 985-20-15-5 and therefore the arrangement does not include a promise of a license in accordance with FASB ASC 606-10-55-54(a).
12. As indicated in FASB ASC 606-10-55-56(b), SaaS arrangements represent services that FinREC believes generally will meet the criteria in ASC 606-10-25-27 for over time revenue recognition. An entity will then consider the appropriate measure of performance based on the guidance of FASB ASC 606-10-55-16 through 55-21.

Example 3 - Hybrid Software/SaaS

13. Hybrid offerings are a combination of desktop/on-premise software and SaaS. Instead of a thin client application (meaning only a limited amount of the software functionality resides with the customer), the customer is initially delivered a fuller desktop application. Varying portions of functionality may reside on the customer’s system or accessed on the entity’s servers. Hybrid offerings may take additional forms including, but not limited to: (1) software which runs on the customer’s systems, but maintains all data on the entity’s servers, (2) software IP which is primarily hosted on the entity’s servers, but offers an offline mode.
14. Hybrid arrangements may include an explicit license to the on-premise software. The explicit license to use the on-premise software IP will generally be limited to use with the hosted services and terminate when the hosting services end.
15. While the customer may be able to perform some functions with the desktop component, they may not be able to fully use the licensed software for its intended purpose without the hosted functionality. Further, while the customer has possession of the portion of the software that resides on premise, the customer is generally unable to take possession of all of the software IP associated with the entity’s offering. It’s possible that the customer may suffer a significant diminution in utility if the hosting services are not provided. For example, the customer’s data is maintained only on the entity’s servers and the customer can only obtain the utility of the on-premise software when connected to the hosted data. In such cases, the on-premise software would not meet the criteria of FASB ASC 985-20-15-5 and therefore not represent a promise of a separate license within the scope of FASB ASC 606-10-55-54(a).
16. Many hybrid offerings will enable customers to perform some functions with the on-premise software even when they are not connected to the hosting service. An entity may determine that the on-premise software meets the criteria of FASB ASC 985-20-15-5 and is capable of being distinct. However, even when the software license is within the scope of FASB ASC 606-10-55-54(a) and is capable of being distinct, it may be considered highly interdependent or interrelated with the hosting service (i.e., not considered distinct in the context of the contract). In making this determination the entity may consider indicators such as the following:
 - a. Hosted functionality is limited to capabilities which are widely available from other vendors. For example, the entity offers online file storage and sharing with minimal integration to the on-premise software workflow. In such cases, a customer could gain substantially all of the benefits included in the offering by utilizing alternative vendor services. This would indicate that the software license likely is both capable of being distinct from the hosted service and distinct within the context of the contract

- as the entity is not providing unique and additional value from the integration of the software and the file storage.
- b. A portion of the hosted functionality is available from other vendors, but the entity provides significant additional utility from the manner in which it integrates the software with its own hosted functionality. For example, the online storage and sharing is integrated with the on-premise software in such a manner that the customer gains capabilities or workflow efficiencies that would not be available when using another vendor's hosted services. In such circumstances the on-premise software is capable of being distinct, but the customer obtains a significant functional benefit by purchasing the complete hybrid offering from the entity. This may indicate that the software license and hosting service are interrelated to each other, and are not distinct within the context of the contract.
 - c. Hosted functionality is limited to functions which the customer may also perform locally with the on-premise software. For example, the customer has the option to perform computationally-intensive tasks on its own computer or upload them to the entity's servers as part of the hosting service. In such circumstances, the customer can obtain the full benefit of the offering with only the on-premise software. This may indicate that the software is not highly dependent on or interrelated with the hosting service, and is therefore distinct within the context of the contract.
 - d. The hybrid offering workflow involves ongoing interactions between the on-premise software and hosted services. As a result, the utility of the offering would be significantly diminished if the customer is not connected to the service. For example, computationally-intensive tasks that can only be performed when connected to the hosting services such that the customer can only obtain the full utility of the on-premise software when connected to the hosted data or content. In such circumstances, the software and hosted services function may function together as inputs to a combined output as contemplated by FASB ASC 606-10-25-21(a). This would indicate that the software is not distinct within the context of the contract.

Comments should be received by December 5, 2016, and sent by electronic mail to Kim Kushmerick at kkushmerick@aicpa.org, or you can send them by mail to Kim Kushmerick, Accounting Standards, AICPA, 1211 Avenue of the Americas, NY 10036.