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Revenue Recognition Considerations for Software Companies

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In August 2017, the FASB issued guidance for software companies in connection with the implementation of ASU 2014-09 and the five-step model.

Step One requires companies to determine whether or not there are multiple contracts. An important consideration specific to software companies is to ensure that all contracts are present, and to determine whether or not there are multiple contracts or if the contracts are interrelated. It is common for software companies to have multiple arrangements that constitute a promise to transfer a good, license, or service in exchange for consideration. A company will need to obtain and consider relationships between Master Service Agreements, purchase orders, side arrangements and more.

Step Two requires companies to identify performance obligations. Most software developers offer post contractual support and maintenance when a license is granted or when a subscription is purchased. Companies will need to identify whether or not the subscription or license, post contractual support and maintenance are bundled together as one performance obligation or whether they are three distinct performance obligations. In addition, when a software license is granted and the Company is hosting the software, a Company must determine whether or not the license is separate and distinct based on criteria including, but not limited to, the right and ability to run the software on their own hardware without significant penalty. SaaS (Software as a Service) arrangements do not include the promise of a license.

Step Three requires companies to identify the transaction price. Oftentimes with software transactions, there are price concessions that include discounts, refunds, credits and more. Arrangements with extended payment terms are analyzed to determine whether or not the terms meets the definition of a significant financing transaction, and to determine, based on historical collections, whether or not payments would be considered variable consideration or a reduction in the transaction price.

Step Four requires companies to allocate the transaction price to the performance obligations. Transaction price is allocated based on the relative standalone selling price for each of the performance obligations. ASC 606 allows for the use of the residual method when the standalone selling price is highly variable or uncertain. If an entity has previously established vendor-specific objective evidence of fair value under ASC 985 for licenses, an observable standalone selling price exists and the residual method should not be applied. The residual method is an allocation method and differs from the residual approach under ASC 985, which is an estimation method.

Step Five is the recognition of revenue. Technical support and software updates will need to be reviewed for overtime or point-in-time recognition. As noted within ASC 606, an entity is not permitted to default directly to a straight-line measure of progress, but a straight-line measure of progress will be reasonable in multiple cases when it applies to technical support and updates.

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