

Query No. 14

Subject: Accounting for software income.¹

A. Facts of the Case

1. A company is into information technology (IT) business. The company focuses into two major product verticals, viz., network monitoring tools and cloud computing applications (called as SAAS). Network monitoring tools are downloadable software products that will be used by network administrators and IT managers to manage their internal networks. Cloud computing applications (SAAS) comprise of varied business and office applications which reside in centralised servers that are accessed by customers across the globe. The querist has stated that the query is on recognition of revenue for the network monitoring tool product vertical. In this segment, the customer has two types of licensing options:

- (i) Perpetual
- (ii) Subscription

2. Perpetual model: In this model, the customer will be able to use the product perpetually. For perpetual model, the license fee and maintenance charges are clearly defined in the invoice. The license fee portion is accounted for as revenue immediately and the maintenance part is deferred over the period of maintenance. On an average, the license component works out to 5/6 and the maintenance component is 1/6 of the total.

3. Subscription model: In this model, the customer has the option to choose the usage period. Generally, the period is for 1 year; however the customer has the option of subscribing for multiple years. In this case, the customer is entitled to upgrades to the product, done during the period, free of cost. The invoice amount would be mentioned as a single line item named 'subscription license fee'. (The querist has supplied a copy of the invoice raised under the subscription model for the perusal of the Committee.) Under this model, the price of the product is divided into license fee and maintenance charges. Based on the perpetual model, 5/6th of the amount is treated as license fee and 1/6th as maintenance charges. The maintenance charges are recognised as revenue over the months/years over which the product is subscribed for. (The querist has supplied a copy of the extracts from the significant accounting policies of the company forming part of the Notes to the financial statements for the year ended 31st March, 2015 for the perusal of the Committee.)

4. With respect to license fee, the company wants to get an opinion as to whether the license revenue needs to be deferred over the period of the contract or be recognised upfront.

5. General terms of contract

The customer who is interested in purchasing the product will have to agree to the terms of the contract. On purchase of the product, a license key is sent to the customer. The company has a standard refund policy captured in the contract. Any customer who does not like the product can claim refund for the entire amount within 30 days from date of purchase. 100% of the amount is refunded by the company and no questions are asked.

6. Further, with regard to the nature of licence fee charged to the customers under the subscription model, the querist has clarified that upon payment of the applicable license fees, the company grants licensee a non-exclusive, non-transferable, world-wide license to

¹ Opinion finalised by the Committee on 9.6.2017.

use the licensed software, including user documentation that licensee has downloaded or received on media provided by the company, including all updates, where applicable, provided that such access and use of the license software is in accordance with the single installation license granted by the company. "Use" means storing, locating, installing, executing or displaying the licensed software. "Single Installation License" means that the license keys provided shall not be used for more than one concurrent 'Use'. Under the subscription license, the licensed software is licensed only for the period of subscription ('subscription period'). If licensee does not renew the subscription beyond the subscription period, licensee agrees to stop using the software and remove the software from licensee's systems. To continue using the licensed software beyond the subscription period, licensee must renew the license at least 10 days before the expiry of the subscription period. As a part of the subscription license, all updates, upgrades, email support for problem reporting and online access to product documentation to the licensed software will be provided to licensee at no additional cost during the subscription period. According to the querist, the broad terms of the contract will be as follows:

- (a) The seller's price to the buyer is substantially fixed or determinable at the date of sale.
- (b) The buyer has paid to the seller, or the buyer is obligated to pay to the seller and the obligation is not contingent on resale of the product.
- (c) The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product.
- (d) The buyer acquiring the product for resale has economic substance apart from that provided by the seller.
- (e) The seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer.
- (f) The amount of future returns can be reasonably estimated.

B. Query

7. On the basis of the above, the querist has sought opinion with respect to license fees, as to whether the license revenue needs to be deferred over the period of the contract or be recognised upfront.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised by the querist relates to timing of recognition of license fees under the subscription model of network monitoring tools, viz., whether the same needs to be deferred over the period of the contract or be recognised upfront. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting treatment of maintenance charges, accounting treatment of the fee received under perpetual model, accounting treatment of cloud computing applications, etc. At the outset, the Committee wishes to point out that since the querist has supplied the copy of the invoice and the extracts from the financial statements pertaining to the period before 31st March, 2016, the Committee has not examined the applicability of Indian Accounting Standards (Ind ASs) notified under the Companies (Indian Accounting Standards) Rules, 2015.

9. In the context of the arrangement of subscription license, the Committee notes the following from the Software License Agreement:

“Upon payment of the applicable license fees, the company grants Licensee a non-exclusive, non-transferrable, world-wide *License to Use* the Licensed Software, including user documentation that Licensee has downloaded or received on media provided by the company, including all updates ...”

Under the Subscription License, the Licensed Software is licensed only for the period of subscription (“Subscription Period”). If Licensee does not renew the subscription beyond the Subscription Period, Licensee agrees to stop using the software and remove the software from Licensee’s systems.”

“The company provides support that includes email support for problem reporting, product upgrades, updates, and online access to product documentation during the Subscription Period.”

“The *company owns all right*, title and interest in and to the Licensed Software.

The Licensed Software is *only licensed and not sold to Licensee* by the Company.”

“The company may terminate this Agreement in the event that Licensee is in breach of any of the terms of this Agreement and does not cure such breach... Upon termination, Licensee shall destroy or return to the company all copies of the Licensed Software and certify in writing that all known copies have been destroyed. ...”

“Technical Support:

Perpetual License:

Subscription License: The company provides support that includes email support for problem reporting, product upgrades, updates, and online access to product documentation during the /subscription period.

From the above, the Committee notes that under the subscription arrangement in the extant case, the right to use of a particular software has been transferred to the customer for a specified period, which as per the facts of the case, for 1 year. In this context, the Committee notes the following paragraphs of Technical Guide on Revenue Recognition for Software (hereinafter referred to as the ‘Technical Guide’), issued by the Research Committee of the Institute of Chartered Accountants of India as follows:

“2.1 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 customisation of software. The principles of AS 9, Revenue Recognition, are applicable to all types of software arrangements. ...”

“2.8 Generally, revenue is recognised when all the following conditions are met:

- (a) Significant risks and rewards of ownership have been transferred to the buyer, which in software industry are generally considered to be transferred when the delivery has occurred,
- (b) The seller’s price to the buyer is fixed or determinable, and
- (c) Collection is reasonably assured.”

“2.15 Delivery may be considered to be complete for revenue recognition purposes upon the commencement of the license term even if the license is delivered earlier and payment is also received. ...”

“5.1 Many entities offer multiple solutions to their customers’ needs. Those solutions may involve the delivery or performance of multiple products, services, or rights to use assets, and performance may occur at different points in time or over different periods of time. ...

5.2 A multiple-element software arrangement is any arrangement that provides the customer with the right to software along with any combination of additional software deliverables, services, postcontract customer support (PCS), and non-software deliverables. ...

5.3 A vendor should evaluate all deliverables in an arrangement to determine whether they represent separate units of accounting. That evaluation must be performed at the inception of the arrangement and as each item in the arrangement is delivered.

5.4 In an arrangement with multiple-deliverables, the delivered item(s) may be considered as a separate unit of accounting if the following criteria are met:

- The delivered item(s) has value to the customer on a standalone basis. That item(s) has value on a standalone basis if it is sold separately by the vendor or the customer could resell the delivered item(s) on a standalone basis.
- Reliable fair values of the undelivered item(s) can be determined.
- If the arrangement includes a general right of return relative to the delivered item(s), and delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the vendor.”

General Guidelines for revenue recognition for multiple-element arrangements

“5.7 General guidelines for revenue recognition for multiple element arrangements are as follows:

- Revenue arrangements with multiple deliverables should be divided into separate units of accounting if the deliverables in the arrangement meet the separate identification criteria specified in paragraph 5.4.
- Revenue recognition criteria should be applied to each separately identifiable component of a single transaction to reflect the transaction’s substance. However, in applying those criteria, the delivery of an element is considered not to have occurred if there are undelivered elements that are essential to the functionality of the delivered element, because the customer would not have the full use of the delivered element. In software industry reliable determination of fair values for each of the separately identifiable elements is usually essential to reasonably determine the price for such elements, which is one of the conditions for revenue recognition.
- Arrangement consideration should be allocated among the separate units of accounting based on their relative fair values or by application of the residual method.”

“5.10 ... For revenue to be recorded for the delivered elements, the amount allocated to delivered elements may not be subject to a future adjustment. The portion of the fee that is allocated to an element should generally be recognised as

revenue when all of the criteria for revenue recognition have been met with respect to that element. If reliable fair value of each of the element does not exist, all revenue from the arrangement should be deferred until the earlier of when:

- (i) Such evidence does exist for each element, or
- (ii) All elements have been delivered, or
- (iii) The reliable fair values of the undelivered elements can be determined.

...”

“5.32 Upgrade right is the right to receive one or more specified upgrades or enhancements, even if it is offered on a when-and-if available basis. If an upgrade right is offered on a when-and-if available basis then it is considered as Postcontract Customer Support (PCS).”

“6.1 PCS or maintenance as it is usually called, means right to receive services (other than services separately accounted for) or unspecified product upgrades/enhancements (these unspecified arrangements are PCS only if they are offered on ‘when-and-if available’ basis) or both offered to customers after the software license period begins or other time provided for by PCS arrangement.

6.2 PCS may be a separate element, bundled with other products and services or implicitly included in an arrangement. Regardless of whether PCS is separately stated in a contract, every software arrangement should be evaluated for the potential impact of PCS and, if it proves to be part of an arrangement, it should be considered a separate element in determining revenue recognition.”

“GENERAL GUIDELINES FOR REVENUE RECOGNITION OF PCS FOR PERPETUAL LICENSES

6.5 Fees related to PCS, whether sold separately (e.g., renewal period PCS) or as an element of a multiple-element arrangement, should generally be recognised as revenue ratably (i.e., on straight line basis), over the term of the PCS arrangement. If the use of the straight-line basis does not approximate the timing of when the software vendor actually incurs the costs, then revenue could be recognised on pro rata basis based on when the amounts are expected to be charged to expense.”

“PCS CONSIDERATIONS FOR TERM LICENSES

6.7 The guidance given above contemplates to PCS arrangements involving perpetual licenses. However, term licenses are becoming common practice in the arrangements. Term licenses involve a license to use the software for a specific period, generally one to five years. Generally, PCS for all or part of the license term will be bundled together with the term license. In this regard, the following aspects may be considered:

- (a) Fair value of PCS in a short-term time-based license (ordinarily less than one year) and software revenue recognition.

The duration of the time-based software license is so short that a renewal rate or fee for the PCS services does not generally represent the fair value of the bundled PCS. In arrangements of this kind, the total arrangement fee should be recognised ratably over the PCS period.

...

- (b) Fair value of PCS in a multi-year time-based license and software

revenue recognition.

...

6.8 It may be noted that it would not be appropriate to use the fair value of PCS sold with perpetual licenses as a “surrogate” for the fair value for PCS in a term license. However, in following type of indicative situations such values may be considered:

- (a) The PCS renewal terms in a perpetual license provide the fair value of the PCS services element included (bundled) in the multi-year time-based software arrangement when the term of the multi-year time-based software arrangement is substantially the same as the estimated economic life of the software product and enhancements during that term.
- (b) The fees charged for the perpetual (including fees from the assumed renewal of PCS for the estimated economic life of the software) and multi-year time-based licenses are substantially the same.

6.9 In case PCS is the only undelivered element and the fair value cannot be reliably determined, the entire fee under the arrangement is generally recognised ratably over:

- The contractual PCS period (for those arrangements with explicit rights to PCS); or
- The period during which PCS is expected to be provided (for those arrangements with implicit rights to PCS).

6.10 PCS revenue may be recognised simultaneously with the initial license fee when software is delivered in the following indicative situations provided all of the estimated costs of providing the services, including upgrades and enhancements, must be accrued at the time when the software is delivered.

- The PCS fee is included with the initial licensing fee.
- The PCS included with the initial license is for one year or less.
- The estimated cost of providing PCS during the arrangement is insignificant.
- Unspecified upgrades/enhancements offered during PCS arrangements historically have been and are expected to continue to be minimal and infrequent.”

(Emphasis supplied by the Committee.)

From a holistic reading of the above paragraphs, the Committee notes that the extant case is a multiple-element software arrangement as it provides to the customer with the right to use of the software alongwith postcontract customer support (PCS). The Committee further notes that as per the above requirements, in arrangements with multiple-deliverables, if reliable fair value of each of the element does not exist, all revenue from the arrangement should be deferred (refer paragraph 5.10). Further, as per the requirements of paragraph 6.9, reproduced above, in case of short-term term-based licenses, if the only undelivered element is Postcontract Customer Support (PCS) as is the situation in the extant case, and its fair value cannot be determined, the entire fee under the arrangement is recognised ratably over the contractual PCS period in case of

arrangements with explicit rights to PCS. However, if the requirements of paragraph 6.10 are fulfilled, PCS revenue and initial license fee may be recognised simultaneously when the software is delivered. Accordingly, the Committee is of the view that recognition of initial license fee in the extant case would depend upon whether or not the fair value of rights to PCS provided under the subscription license can be determined as per the requirements of the Technical Guide and whether the requirements of paragraph 6.10 of the Technical Guide, as reproduced above are fulfilled.

D. Opinion

10. On the basis of above, the Committee is of the opinion that recognition of license fees under the subscription model would depend upon whether or not the fair value of rights to PCS provided under the subscription license can be determined as per the requirements of the Technical Guide and whether the requirements of paragraph 6.10 of the Technical Guide, as reproduced above are fulfilled, as discussed in paragraph 9 above.
