NDH	Topics in Accounting: Accounting for Computer Software Revenue The NDH Group, Ltd. *Authoritative text related to the concepts presented here include:* *ARB 45 – Accounting for LT Construction Contracts / SOP 97-2*
The NDH Group, Ltd.	**October 2004**

Overview & Objective – The purpose of this TIA is to review current standards as they apply to revenue recognition from the sale of computer software and related services.

General Application – In order to apply the correct standard, a determination of whether the software fits a "modifiable" or "non-modifiable" class must be made. In addition, revenue from services and post-consumer support related to a sale of computer software often requires separate treatment.

Modifiable Software – Modifiable software includes software that will *require* significant production, modification, or customization. This is typically considered "core software code" that will need to be tailored to meet specific and varied business processes, and/or integration requirements. In such instances, revenue should be recognized in accordance with *ARB 45, Accounting for Long-Term Construction-Type Contracts*. Revenue recognition of modifiable software follows either the *completed-contract method* or the *percentage-of-completion method*:

- **Percentage-of-Completion Method** – The percentage-of-completion method applies when contract revenue, costs, and completion can be reasonably determined. In addition, certainty of customer payments must be reasonably assured. In these instances, revenue is recognized in proportion to the percentage of total modifications or customization required for the software to "go live."

- **Completed-Contract Method** – The completed-contact method of revenue recognition is appropriate in circumstances where estimates for contract revenue, costs, and completion dates are uncertain or indeterminable. In such instances, all revenue recognition is deferred until the software is delivered and installed. Receivables are booked against an unearned revenue account until completion of the contract, even if cash is collected.

Non-Modifiable Software – Non-modifiable software includes programs that *do not require* significant production, modification, or customization for ordinary use. Changes to the base code or underlying architecture for so-called "canned software" is impossible or highly unlikely. Revenue recognition guidelines from the sale of this class of software follow *Statement of Position 97-2*, which states, "Revenue from licensing, selling, or leasing computer software should be recognized when the following criteria are met:"

- **Pervasive Evidence of a Sale** – A sale has occurred when a signed contract, purchase order, or on-line authorization (sale made via Internet) exist.

- **Delivery** – Delivery has occurred when the software is physically transferred to the site of the end user or reseller, downloaded completely if delivery is by electronic means.

- **Revenue is Fixed or Determinable** – Revenue is deemed fixed if the software price is agreed to and not dependent on sales of additional licenses or copies, and the possibility of future concessions or refunds, or default by the customer is remote.

- **Collectibility is Probable** – Collectibility is considered probable if no portion of the software charge is subject to refund or forfeiture, or if payment for partial delivery has been made, and the customer is using the software.

Service Revenue – Services to train employees or to implement, configure, or integrate the software with other existing applications often accompany a sale of software. The services considered here are only those which allow the customer to access specific features of the software *within defined system limitations*, and are not essential for use of the software. If the services are essential for the basic functionality of the software, revenue must be recognized in accordance with *ARB 45, Accounting for Long-Term Construction-Type Contracts* (see above). In instances where the services are optional and not necessary to use of the software, revenue should be recognized independently of the sale as the services are performed.

Postcontract Customer Support (PCS) – Ongoing service or support contracts are also typical with software sales. Known as support and release contracts or PCS, they often include upgrades, patches, fixes, or releases. Revenue from these plans should be recognized on a straight-line basis over the PCS term *or,* if a more accurate determination may be made, revenue may be recognized as costs are incurred. Finally, PCS revenue may be recognized at the time of the sale if *all* of the following conditions are met: 1) The PCS is included in the initial license fee; 2) The PCS is for one year or less; 3) Costs to provide for PCS are insignificant; and 4) Upgrades or releases are infrequent and of minimal cost.

Typical Journal Entries – *Modifiable Software*

Year 1	**% of Completion Method**	**Completed-Contract Method**
Cost		
Software-in-Progress	**DR**	**DR**
Cash	**<CR>**	**<CR>**
Billings		
Accounts Receivable	**DR**	**DR**
Unearned Revenue	**<CR>**	**<CR>**
Cash Collected		
Cash	**DR**	**DR**
Accounts Receivable	**<CR>**	**<CR>**
Revenue Recognition		
Software Expenses	**DR**	**None**
Software-in-Progress	**DR**	
Software Revenue	**<CR>**	

Final Year	**% of Completion Method**	**Completed-Contract Method**
Cost, Billings, Cash Collected – As above		
Revenue Recognition		
Software Expenses	**DR**	**None**
Software-in-Progress	**DR**	
Software Revenue	**<CR>**	
Unearned Revenue	**DR**	**None**
Software-in-Progress	**<CR>**	
Software Expenses		**DR**
Software-in-Progress		**<CR>**
Unearned Revenue		**DR**
Software Revenue		**<CR>**

Typical Journal Entries – *Non-Modifiable Software*

Journal entries follow typical accrual basis where revenue is recognized at the point of sale *if* all criteria for *non-modifiable software* cited above are met.

Software Use – *Modifiable Software*

Year 1	**% of Completion Method**	**Completed-Contract Method**
Cost Software-in-Progress Cash	Normal use of A/P Module; estimating payroll may be difficult.	Normal use of A/P Module; estimating payroll may be difficult.
Billings Accounts Receivable Unearned Revenue	Use of “Unearned Revenue” account label in A/R Module.	Use of “Unearned Revenue” account label in A/R Module.
Cash Collected Cash Accounts Receivable	Normal application of cash to outstanding invoice in A/R Module.	Normal application of cash to outstanding invoice in A/R Module.
Revenue Recognition Software Expenses Software-in-Progress Software Revenue	Record revenue as a transaction in Sales Journal of G/L Module; use of a recurring transaction is helpful.	**None**

Final Year	**% of Completion Method**	**Completed-Contract Method**
Cost, Billings, Cash Collected – As above		
Revenue Recognition Software Expenses Software-in-Progress Software Revenue	Record revenue as a transaction in Sales Journal of G/L Module; use of a recurring transaction is helpful.	**None**
Unearned Revenue Software-in-Progress	Record reversal as transaction in General Journal of G/L Module.	**None**
Software Expenses Software-in-Progress	**None**	Record reversal as transaction in General Journal of G/L Module.
Unearned Revenue Software Revenue	**None**	Record revenue as transaction in Sales Journal of G/L Module; use of a recurring transaction is helpful.

Software Use – *Non-Modifiable Software*

Software use follows typical accrual basis accounting procedures.

Further Instruction & Use – For further information regarding Accounting for Computer Software Revenue contact The NDH Group, Ltd. at 312.461.0876