

October 20, 2010

Financial Accounting Standards Board Attention: Technical Director 401 Merritt 7 PO Box 5116 Norwalk, CT 06856-5116

Re: File Reference No. 1820-100: Proposed Accounting Standards Update – Revenue Recognition (Topic 605), Revenue from Contracts with Customers

#### Ladies and Gentlemen:

BMC Software, Inc. ("BMC") appreciates the opportunity to respond to the Exposure Draft entitled "Revenue Recognition (Topic 605), Revenue from Contracts with Customers." BMC is a global enterprise software and solutions company that is publicly traded on the NASDAQ Global Select Market exchange and is a member of the Standard & Poor's 500 and the NASDAQ 100 market indexes.

In general, BMC supports many of the provisions in the proposed standard. However, as addressed herein, there are certain provisions within the proposed standard that raise significant concern to us, most relating to the appropriateness and/or practicality of their application within the enterprise software industry because of the significance of intangible intellectual property ("IP") software deliverables as core bargained-for elements in customer agreements. Additionally, we advocate that companies should be provided with the election to adopt this standard on a prospective application basis with disclosure of supplemental quantitative and qualitative information to aid in comparability due to the enormity of effort and cost that it will take companies such as BMC to adopt this standard on a retrospective basis, which we believe will significantly outweigh related benefits. Our detailed comments are as follows:

## <u>Identifying Separate Performance Obligations – Distinct Good or Service</u> (Corresponds with Respondent Question 2)

We agree with the criteria that an entity should identify performance obligations to be accounted for separately on the basis of whether the promised good or service is *distinct* and that the criteria prescribed by paragraph 23(a) and paragraph 23(b)(i) of the proposed standard are reasonable indicators to determine whether a promised good or service is distinct. However, we do not agree with the *distinct profit margin* requirement prescribed by paragraph 23(b)(ii) as we believe that such criteria may preclude typical enterprise software companies from being able to reasonably and consistently segregate license and PCS (as that term is currently defined in ASC 985-605, *Software-Revenue Recognition*) performance obligations, which could in turn require such companies to combine license and PCS elements into a single performance obligation that is recognized over the PCS term. We believe that this would be an unintended consequence of the proposed standard as the licensing of software IP has immediate and distinct function to customers and is clearly a bargained-for element in typical enterprise software vendor arrangements.

Since satisfying the distinct good or service requirement for a license element will require an enterprise software vendor to meet either the criteria of 23(a) or 23(b) of the proposed standard, rationale for our concern is as follows:

- i) Typical enterprise software companies (including BMC) will be unable to meet the distinct criteria prescribed by paragraph 23(a) because such companies rarely, if ever, sell license elements separately; and
- ii) It will be difficult for a typical enterprise software company to meet the explicit *distinct profit margin* criteria of paragraph 23(b)(ii) because of the normal manner in which software IP is developed and sold to customers. Specifically, within the industry, common research and development resources are used to develop software IP irrespective of how it is licensed to customers, yet a typical software vendor will distribute such software IP to customers in two forms as a new product license and as an unspecified when-and-if-available product upgrade or enhancement right under PCS. In other words, a software vendor will routinely convey the same exact software IP to some customers under new license agreements and to other customers (e.g., existing licensees of a prior version of the software IP) as rights under PCS. Accordingly, it will be a challenge for a typical software company to separately identify resources used to satisfy these performance obligations, if that separation can be made at all, and thus difficult to identify distinct profit margins for these otherwise distinct obligations (this has related ramifications on the allocation of the transaction price to separate performance obligations as discussed below).

While we respect the intent of paragraph 23(b)(ii) and its practical application in certain industries (e.g., construction), we believe that this requirement would be inappropriately rigid for the enterprise software industry and that it should be removed, appended or clarified in a manner that will allow a typical enterprise software vendor to consistently conclude, without subjectivity, that a bargained-for software license is a distinct performance obligation. Moreover, as this section is presently written, we believe that different interpretations and/or application of the *distinct profit margin* requirement could lead to materially different accounting conclusions and inconsistencies among reporting entities. This would reduce the comparability of similarly-situated transaction types among reporting entities and be detrimental to investors and other users of financial statements.

# <u>Measurement of Revenue: Determination of the Transaction Price – Variable Consideration</u> (Corresponds with Respondent Question 4)

We do not agree that an entity should include estimates of certain types of variable consideration, particularly contingent consideration, in its determination of the transaction price and recognition of revenue. Rather, we believe that measurement and recognition of contingent consideration should not occur until it is fixed or determinable, as that term is generally used in existing US GAAP, principally on the basis that revenue should not be recognized until it is realizable.

Within the enterprise software industry, the magnitude of judgment and estimates required to determine whether contingent fees can be reasonably estimated is concerning to us, particularly with respect to the following fee types that are prevalent and material within the industry: i) royalty fees calculated based on the level of customer redistribution of software license rights in distributor (e.g., original equipment manufacturer) and similar arrangements, and ii) usage-based fees contingent upon a customer's future software license capacity/usage levels. Each of these fee types is typically reported and paid by customers quarterly or annually in arrears. Under the proposed standard, an entity would need to assess the degree to which such fees are estimable at contract inception (and in subsequent reporting periods) and recognize such estimable fees as revenue when the related performance obligation is satisfied. Because the performance obligation of delivering an intangible software license to a customer (for redistribution or incremental usage by that customer) will typically be satisfied upon license delivery at contract inception, software entities may be required to estimate and recognize material contingent fees well in advance of when they ultimately become fixed or determinable and realizable (if at all). The complexity of such estimates would be further compounded by the requirement to estimate the timing of

the usage change and discount the initial recognition to the estimated present value of such payments in accordance with the proposed standard.

We believe that this high magnitude of judgment and estimates could contribute to increased revenue and earnings volatility and lead to materially different accounting conclusions and inconsistencies among reporting entities for similar transaction types, all of which will be detrimental to investors and other users of financial statements. Additionally, we believe that the inclusion of contingent fee revenue in the determination of the transaction price would require us and similarly-situated companies to provide an otherwise unnecessarily high level of supplemental information outside of the core financial statements solely to provide users with information necessary to comply with the financial statement objectives outlined in paragraph 5 of the proposed standard.

We also note that the accounting described above would be inconsistent with the accounting for similar transaction structures in tangible product industries where a reporting entity may typically be responsible for the distribution of additional product capacity to a customer simply by virtue of selling a tangible good versus an intangible solution. In this case, a tangible product company would typically not meet the performance obligation criteria of the proposed standard until control of additional product is transferred to the customer through physical delivery at a point in the future and thus would not likely be impacted by the inclusion of variable fees in the transaction price.

Based on the foregoing, we reiterate our belief that contingent fees should not be included in the determination of the transaction price. Rather, measurement and recognition of contingent consideration should not occur until it is fixed or determinable.

## <u>Measurement of Revenue: Determination of the Transaction Price – Collectibility</u> (Corresponds with Respondent Question 5)

We do not agree that a customer's credit risk should affect *how much* revenue an entity should recognize when it satisfies a performance obligation. Rather, we believe that existing US GAAP guidance, under which probable or reasonably assured collectibility is a criterion of recognition rather than measurement, is preferable on the basis that revenue should not be recognized until realizable, and in this regard we believe that customer credit risk should be accounted for as a bad debt expense. We believe that the proposed model would unnecessarily introduce: i) significant incremental levels of subjectivity, estimation and judgment that would be applied inconsistently among reporting entities, and ii) increased revenue and earnings volatility, particularly related to the amount of revenue recognized since subsequent adjustments to the transaction price would become a component of other income (expense) rather than revenue under the proposed standard, all of which we believe will be detrimental to investors and other users of financial statements.

If the Boards ultimately conclude that credit risk should affect *how much* revenue should be recognized in a customer transaction rather than *whether* revenue should be recognized in a transaction, we further disagree with the requirement to use a *probability-weighted* approach to estimate the amount of consideration an entity expects to receive and the requirement to reflect adjustments to such estimates as a component of other income (expense). On the former, we believe that a preferable approach would be to use "*management's best estimate*" of amounts to be collected, particularly in situations where there are a limited number of possible collection outcomes. On the latter, we believe that it would be preferable to record adjustments to collectibility estimates as components of the transaction price (and associated revenue or deferred revenue) rather than of other income (expense) in order to ensure that the amount of revenue recognized over the course of a customer arrangement is more consistent with the amount of the contract fee realized and collected by the reporting entity (subject to other transaction price adjustments prescribed by the proposed standard).

## <u>Measurement of Revenue: Determination of the Transaction Price – Time Value of Money</u> (Corresponds with Respondent Question 6)

While we are in general agreement with paragraphs 44 and 45 of the proposed standard on a conceptual level, we do not believe that recording a transaction price inclusive of an interest "gross-up or gross-down" (effectively in the form of a premium or discount) would faithfully depict the underlying economics as intended by vendors and customers in typical industry-standard transactions, including in particular: i) prepaid PCS and similar transactions when the related vendor performance obligations are delivered continuously over a period of one year or less, and ii) transactions containing trade payment terms of one year or less that are associated with licenses delivered at the outset of a customer contract. In this view, we are analogizing primarily to existing US GAAP guidance contained in ASC 835-30 "Imputation of Interest," wherein interest should not be recorded on receivables and payables arising from transactions with customers or suppliers in the normal course of business which are due in customary trade terms not exceeding approximately one year.

We are also concerned about the practical application of these proposed requirements, principally due to the incremental system capabilities and associated effort and cost that would be necessary to account for differences between contract fee invoicing and transaction price determinations, and to a lesser degree the incremental effort and cost associated with the determination of specific customer discount rates in connection with individual transactions. Overall, we do not feel that the conceptual benefits of these requirements would outweigh the associated costs and efforts to reporting entities.

Additionally, notwithstanding our views above, we believe that the proposed standard should explicitly clarify how an entity should analyze materiality at the individual customer contract level. As a US public company registrant, we and other similarly-situated companies typically apply materiality considerations at the financial statement level in accordance with various quantitative and qualitative considerations including those prescribed by the US Securities and Exchange Commission ("SEC") in Staff Accounting Bulletin No. 99. However, we are not clear as to how an entity should analyze materiality at the individual contract level in the context of paragraphs 44 and 45.

# Allocation of the Transaction Price to Separate Performance Obligations (Corresponds with Respondent Question 7)

We generally believe that allocating the transaction price to separate performance obligations based on the stand-alone selling price (estimated if necessary) will help financial statement users to better understand the underlying economic substance of a transaction, particularly for multiple-element transactions containing licensed software IP. However, we believe that the proposed allocation methodology creates multiple issues and unintended consequences that will impact the enterprise software industry in the absence of allowing the residual method (as that term is currently defined in existing US GAAP guidance including ASC 985-605, *Software-Revenue Recognition*) to assign the transaction price to intangible license elements. Our core concerns are as follows:

#### Stand-Alone Selling Price Issues

Software licenses are rarely, if ever, sold on a stand-alone basis by enterprise software vendors, including BMC. In the absence of an observable stand-alone selling price, an entity would be required to estimate one based on the criteria in either paragraph 52(a) or 52(b) of the proposed standard. Application of paragraph 52(a), which prescribes a cost plus margin approach, would be inherently difficult and subjective, primarily because of the difficulty in identifying underlying costs when core development resources are used to both create software IP as well as unspecified when-and-if-available upgrades and enhancements to software IP under PCS (as addressed previously in our comments related to Respondent Question 2 re: *distinct profit margin*). Application of paragraph 52(b), which prescribes an adjusted market assessment approach, would not be practicable if an enterprise software vendor and its competitors do not typically sell software licenses separately, which will virtually always be the case as indicated above. Furthermore, when allocating the transaction price to separate performance obligations,

we do not believe it is appropriate to apply a uniform discount to all elements of a transaction, especially when the profit margins amongst the elements in a single arrangement are significantly different.

Based on the foregoing, a significant level of judgment will be required to estimate the selling price of the software license performance obligations, and neither we nor peer companies nor professional accounting firms with whom we have consulted have identified a reasonable or practicable approach to dealing with this issue. Accordingly, in the absence of allowing a residual method or similar approach, we believe that this requirement will lead to significant transaction price and revenue recognition inconsistencies among reporting entities, allocations of transaction prices that do not appropriately reflect the underlying economics of the transaction, reduced comparability of similarly-situated multiple element license transactions, and increased revenue and earnings volatility overall, all of which will be detrimental to investors and other users of financial statements.

### Onerous Performance Obligation Issues

Because of the discount allocation methods in the proposed standard, there will be instances where the allocation methodology will result in onerous performance obligations at a specific performance obligation level even when the overall arrangement is profitable as a whole. In such instances, the requirement to recognize an onerous performance obligation loss at the outset of an arrangement (or at a later point even if the overall arrangement remains profitable), rather than potentially allocating more of the arrangement consideration to those elements where the profit margins are inherently lower, could result in a gross-up of the income statement on day one (higher revenue recognized related to certain delivered performance obligations along with a corresponding onerous contract loss related to the undelivered performance obligations). Accordingly, we believe that the proposed standard should be amended so that reporting entities are not required to recognize onerous performance losses (but rather defer additional revenue) until such time that an entity determines the overall remaining performance obligations in the arrangement will be in a loss position. If this is an intended consequence of the proposed standard, we strongly disagree with this requirement as we do not believe that accelerated expense recognition in these instances would faithfully depict the underlying economics of a customer transaction or provide users of the financial statements with appropriate information to assess corporate performance.

#### Maintenance Fee Volatility Issues

Fees for on-going PCS comprise a key and material part of the business and revenue model for enterprise software companies. Typically, customers will initially purchase software licenses together with an initial period of PCS and will subsequently renew PCS on a stand-alone basis for incremental periods (generally on an annual basis). Application of the proposed standard's stand-alone selling price and allocation requirements to a typical enterprise software business model, without allowing use of the residual method, will require most software companies to allocate a higher portion of a multiple element transaction fee to the software license obligation. This in turn will typically reduce the amount of the transaction fee allocated to the PCS performance obligation in the initial license and PCS transaction (for discussion purposes we are excluding the potential impact to other undelivered elements such as professional services). However, upon renewal of PCS in stand-alone agreements, software companies will typically record an increase in PCS fees and revenue as compared to the initial transaction allocation. We believe that this inconsistency will create unnecessary volatility that will negatively impact financial statement users. Namely, one of the key metrics that users of our financial statements analyze is the recurring PCS revenue stream. By discounting the initial PCS term based on the allocation of an arrangement's discount, there will be a significant upward trend in PCS revenue upon renewal that does not reflect an increase in the overall volume of the PCS delivered. Furthermore, analysts and users of our financial statements will be unable to assess the current PCS revenue stream when making projections of future cash flows arising from PCS renewal transactions, which will significantly impede their ability to understand the nature and timing of current and future PCS revenue streams that are typically material to enterprise software companies.

#### Recommendation to Allow a Residual or Similar Method

Based on the foregoing, we believe that companies in the enterprise software and similar intangible industries should be provided the ability to apply judgment when allocating the transaction price in an arrangement based on the overall economics of the transaction and the anticipated prices of renewals of current performance obligations (or similar independent sales to other customers), and that use of a residual or similar method should be allowed when it is determined by company management to represent the best method of allocating the transaction price to performance obligations <sup>1</sup>.

### **Effective Date and Transition**

### (Corresponds with Respondent Question 13)

We do not believe that an entity should be required to apply the proposed guidance retrospectively. Rather, we believe that entities should be allowed to adopt the revised guidance on a *prospective application* basis consistent with recent FASB guidance issued under ASC 605-25/ASU 2009-13, under which an entity would prospectively apply the guidance to all customer arrangements entered into or materially modified after the date of adoption of the proposed standard, with supplemental quantitative and qualitative disclosures provided to satisfy the objective of enabling users of the financial statements to understand the effect of the change in accounting principle.

We prefer this approach due to a multitude of substantive accounting and business reasons, principally related to the enormity of cost and effort vis-à-vis the perceived benefits. The retrospective adoption requirement in the proposed standard will cause significant organizational effort and cost to us and similarly-situated enterprise software companies, which we believe would significantly outweigh the benefits of retrospective application. For companies such as BMC with long-term customer arrangements reaching as long as five years in duration (inclusive of deferred license and/or PCS revenues), retrospective adoption preparation will effectively require up to eight years of restatement effort<sup>2</sup> including parallel system and accounting effort for most, if not all, periods between the final standard issuance and adoption deadline. Among other things, this effort would require us to:

- i) Re-review and account for thousands of historical contracts to determine: a) the proper transaction price, b) the separate performance obligations (as re-defined), c) the proper allocation of the transaction price to separate performance obligations, and d) the proper revenue recognition timing for each separate performance obligation. Notwithstanding dual system constraints which are a concern to us and similarly-situated corporations (off-the-shelf ERP systems cannot currently handle these mechanics), the technical accounting effort to train personnel and re-review, document and account for these contracts would be massive and would encompass an indeterminably large number of incremental employee and consultant labor hours over the course of multiple years via resources that are already limited and that may be difficult to employ;
- ii) Determine revised accounting conclusions based on facts and circumstances existing at the time the customer transactions were originally executed (e.g., the determination of stand-

<sup>&</sup>lt;sup>1</sup> We note in paragraph BC125 (*Background Information and Basis for Conclusions*) the Boards' confirmation that the residual method should <u>not</u> be used to allocate the transaction price to separate performance obligations but that a residual or reverse residual technique may be an appropriate method for estimating a stand-alone selling price if there is a directly observable price for one performance obligation but not the other. Notwithstanding our view that the residual method should be allowed to allocate the transaction price when deemed appropriate by management, as indicated above, we believe that this paragraph is unclear and potentially contradictory as to intent and thus should be clarified as applicable.

<sup>&</sup>lt;sup>2</sup> Potentially up to ten years of effort if restatement of all periods presented within the *Selected Financial Data* tables of the Annual Report on Form 10-K is required by the SEC.

alone selling prices based on management's best estimates using contemporaneous information at the transaction dates). Notwithstanding the increased significance of management judgment under the proposed standard, it will be incredibly difficult, and in some cases impossible, for accounting and organizational management to form these conclusions on a retrospective basis without the use of hindsight;

- iii) In connection with i) and ii) above, establish, maintain and test the sufficiency of key financial reporting controls, process documentation, accounting policies and our overall control environment in a manner sufficient to allow management to conclude that our internal control over financial reporting is effective as of the end of the fiscal year in which we adopt this new pronouncement;
- iv) Engage our independent public accounting firm to re-audit transactions, and test the sufficiency of underlying internal controls, during this approximate eight year time period to a level that will allow them to opine on the revised annual financial statements for the three years presented in our first annual financial statement filing upon adoption as well as our internal controls over financial reporting as of the end of the fiscal year in which we adopt this new pronouncement. This will require significant internal and external resources and will result in very significant incremental audit fees; and
- v) Potentially delay critical ERP upgrades because of the additional effort, resource limitations and system constraints that would be imposed by a requirement to develop and run parallel revenue and order processing systems for a period of three years. This is in addition to the restatement of multiple prior years' accounting, all in an effort to prepare for adoption of this proposed standard. This concern is further heightened for companies that run on versions of major ERP systems that go off support (by the ERP vendor) absent significant upgrade in the next several years.

Based on the foregoing, we firmly believe that the costs and risks associated with a retrospective adoption requirement will greatly outweigh the benefits. Accordingly, it is in our view critical that the joint Boards agree to provide companies with the option of adopting this standard through prospective application, allowing company management to carefully consider the approach that is most appropriate for its particular facts and circumstances. While we respect that the comparability and usefulness of restated financial statements may be perceived to be preferable from an academic and user perspective, we believe that companies can and should be able to include sufficient quantitative and qualitative disclosures that will provide financial statement users sufficient and appropriate information to aid in the comparability of financial statement information in the most relevant periods, and in this regard we believe that the final standard should include optional *prospective application* guidance in a form substantially similar to that prescribed by ASC 605-25/ASU 2009-13.

We would be pleased to further discuss our comments with you. Should you have any questions in relation to this letter, please contact me at 713.918.2740, or Paul Vigil, Senior Director-Revenue Recognition, at 713.918.1197.

Sincerely,

/s/ T. Cory Bleuer

T. Cory Bleuer Vice President, Controller & Chief Accounting Officer