International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

October 27, 2010

Dear Sir or Madam,

We are writing to express our comments on the Exposure Draft "Revenue from Contracts with Customers" issued jointly by the IASB and FASB. The European Software Accounting Group (ESAG) is composed of leading companies in the European Software industry (Alcatel-Lucent, Dassault Systèmes, Mysis, Nokia, Sage, SAP, Software AG). The ESAG was formed to facilitate sharing of IFRS accounting principles and best practices, particularly on software revenue recognition. Our group meets quarterly to work hand-in-hand to identify issues with applying IFRS, to compare rules and practices between IFRS and US GAAP, to share points of view and policies and to discuss practical implications of these accounting rules. In addition, we discuss the implications of IASB Board projects on our industry.

Difficulties in estimating stand alone selling prices for certain performance obligations – Allowing the use of the residual method

ESAG generally agrees that allocating the transaction price to the performance obligations based on stand alone selling prices is a proper, objective way of allocating the transaction price; however we are concerned that in certain instances estimating stand-alone prices could prove difficult, impracticable and/or unverifiable. This could lead to various approaches by companies and reduce comparability.

We believe that specifically in our industry, there are occasions in which we may be unable to reliably estimate stand-alone selling prices. The main problems with estimating a stand-alone selling price for software vendors are due to the following:

- The same software or solution may be sold at very different prices,

  In the software industry, each vendor may sell software license rights along with related standard services (e.g. maintenance or consulting). While stand alone selling prices for these services are usually easier to identify, this is far more difficult for some intangible software license rights. Discounts can vary widely from customer to customer. On some lines of software license rights, customers

even expect very large discounts based on competitive offerings from various vendors and paying list price or close to it would be unthinkable.

- The incremental costs for delivering software is often incidental,

  Indeed, since most of the costs are part of the company's overall R&D budget, they do not constitute a typical cost of sales that is triggered by or could be associated with a specific transaction. Estimating a stand-alone selling price on a cost-plus basis could therefore be difficult or inappropriate.

- In many cases, software solutions are so specific that there may be many instances where competitors' prices or market prices are not relevant.

Accordingly we would suggest that the Boards consider a model whereby a hierarchy could be used in allocating the revenue to the different performance obligations associated with an arrangement:

- First the allocation would be based on observable stand alone selling prices in similar past transactions,
- If no such standalone selling prices are observable the allocation should be based on estimated stand alone selling prices if such estimates can be made in a reliable manner,
- If stand alone selling prices can be observed for most but not all elements of an arrangement, then the residual method should be permitted, i.e. contract fees are allocated to the elements with determinable/estimable standalone sales prices based on these sales prices with the residual contract fee being allocated to the element for which no standalone sales price can be determined/estimated.

More specifically, ESAG believes that when reliably estimate of stand-alone selling prices of all performance obligations is not possible, the residual method should continue to be an option available for use. If the option to use the residual method would not be an available option and the transaction price would need to be allocated based on relative "list prices", this could lead to a loss for some performance obligations (e.g. consulting services) and too much upfront revenue recognition (e.g. license). If list prices would be substituted with "estimations" of the standalone selling prices for each individual deal, there would be too much subjectivity in judgements being made, which is contrary to the goals of this ED of providing objectively comparable results between companies.

In conclusion, the ESAG Group firmly believes that the residual method should be an acceptable alternative to allocate the transaction price of an arrangement when estimating stand alone selling price is not sufficiently reliable.

Considering software maintenance arrangements as one performance obligation

In the software industry companies generally sell a perpetual licence along with maintenance and support (often called PCS arrangements or PCS). PCS is a key revenue stream of the business. PCS can be defined as an explicit or implicit right to receive certain services, unspecified product upgrades/enhancements, or a combination of both, after the software product has been delivered or the licence period has begun. PCS typically includes post-sale services, such as telephone support and correction of errors (bug fixing or debugging not under warranty obligations), and unspecified future upgrades or enhancements to be delivered on a when-and-if-available basis. In many cases the timing of the future upgrades/enhancements are unknown and could occur a number of times over the term of the PCS arrangement.

Consider the following example. A payroll PCS arrangement may include the right to receive upgrades for tax table updates following fiscal tax rate changes. This may happen on an annual basis (of which the date from a customer and business perspective would generally be known and anticipated). However, it could be feasible that there could be more than one tax rate change over the course of the year or that the business releases additional upgrades with feature changes in the period. As such, the predictability and number and timing of such events would be uncertain at the start of the PCS arrangement and hence it would be more appropriate to recognise revenue over the life of the PCS arrangement.

It is typical in the software industry to bundle hot line / telephone support with the right to receive unspecified upgrades or enhancement on a when and if available basis into one single commercial offering. From a customer perspective, each of these components of PCS is viewed as one common service allowing them to use updated software corrected for identified bugs. This is the commercial reason why these are sold together since each of them do not have stand alone value to the customer, but do represent standalone value when combined.

We believe that the Exposure Draft should introduce this idea of a performance obligation having stand alone value to the customer to be reflected as distinct from another performance obligation, which would clarify accounting for PCS and prevent an interpretation where software vendors would separate maintenance into two or more performance obligations. Notwithstanding the above, we also believe that providing to a customer a right to receive unspecified upgrade on a when and if available basis is a stand ready obligation that is satisfied every day of the PCS period and should be spread evenly over the period of the contract since the software vendor is uncertain in terms of timing and number of updates at the start of the PCS arrangement. We would appreciate a specific guidance clarifying this topic.

Distinction between exclusive and non exclusive licenses

Firstly, we would like to point out that the current practice in the software industry is to analogize the grant of a license to use software to the sale of an asset. This practice results (assuming all other necessary criteria are met) in upfront recognition of the corresponding revenue. We believe that any departure from this existing practice would have major impacts on software company's financial statements and could potentially cause disruption in their business models.

Accordingly, clear guidance with respect to the distinction of licenses that are in substance the sale of a product from those that are in substance the performance of a service over a period of time is of critical importance to our industry.

We believe that the proposed distinction criteria based on whether a license is exclusive or not is workable and appropriately addresses the concerns and issues of software companies. We are aware of the fact that some constituents are challenging the conceptual merit of this proposed distinction criteria. However we do believe that a distinction based on exclusivity is conceptually sound and consistent with the overall proposed model. Notably, it is our view that in the case of an exclusive license there is an obligation for the vendor to <u>not</u> grant a license for the same intellectual property to another customer. From a practical standpoint, the existence of such an obligation is evidenced by the fact that the vendor has given something up (i.e. his right to license the product to another customer). Accordingly we think that this obligation should be identified as a performance obligation in the contract and, as it is performed continually over the term of the license, should appropriately result in ratable recognition of revenue. Conversely, the same principle would result in non-exclusive licenses being accounted for as the sale of a product, which is consistent with our existing practice for perpetual licenses.

Accounting for services

We believe that the revenue recognition model proposed in the Exposure Draft does not result in decision-useful information for construction contracts and service contracts:

Construction Contracts

We understand the approach presented in the Exposure Draft to foresee the following for revenue recognition for multi-period construction contracts:
If control of the constructed asset is transferred to the customer at the end of the construction, no revenue is recognized before the end of the contract. In contrast, if the contract with the customer provides that during the construction period control over the unfinished good is transferred to the customer, some of the total revenue is recognized upon such transfer of control over the unfinished good.

We do not believe that such accounting results in decision-useful information as the following example from our industry shows (the example describes a common transaction in our industry):

Assume an arrangement under which a software vendor develops a software product to the customer's specifications (customer-specific software product). The intellectual property of the developed product remains with the software vendor and the software vendor grants to the customer, upon contract completion, a non-exclusive license to the developed software. The agreed-upon contract fee clearly exceeds the expected cost, i.e. the project is profitable. The customer pays upon contract completion.

From the criteria in para 30 of the Exposure Draft it appears that the majority of the criteria indicate that control has not been transferred before contract completion:

- Indicators that the customer has <u>not</u> obtained control before contract completion:
  - Para 30(a) of the ED: The customer has no unconditional obligation to pay before contract completion
  - Para 30(b) of the ED: The customer has no legal title to the developed intellectual property and will never have such title.
  - Para 30(c) of the ED: The customer has no physical possession because the delivery of the software (via DVD or download) does not occur until contract completion
- Indicators that the customer has obtained control before contract completion:
  - Para 30(d) of the ED: The developed software is customer-specific

If, however, the vendor decided to deliver to the customer, at the end of every day, the current unfinished software and granted a license to use this unfinished product it appears that the criteria in para 30(b) and para 30(c) are met and thus the majority of the criteria indicate that control has been transferred before contract completion. While we are fully aware that the assessment of control transfer under para 30 of the ED is not a simple 'count the indicators' exercise we are concerned that non-substantive changes in the agreements with the customer, like granting licenses to unfinished software, may affect revenue recognition.

In the discussions of the Exposure Draft we have experienced so far (including discussions with IASB Board members and staff), a particular emphasis was put on the indicator in para 30(d) (customer-specific design or function of the good or service). Such particular emphasis is, however, not reflected in the Exposure Draft. Rather the opposite: By its wording, indicator 30(d) appears to indicate the expectation that control will transfer rather than that control <u>has already been</u> transferred ("*it is likely that the entity would require the customer to obtain control*").

Service Contracts

We understand the Exposure Draft to assume that there is a transfer of control for services as much as for products. We further understand the Exposure Draft to assume that such transfer may well occur over time rather than upon completion of the entire agreed-upon service.

We believe that the timing of such transfer is difficult to identify and may, again, depend on form rather than substance. In the customer-specific software development example above the question may be raised whether the arrangement is for a service (development of customer-specific software => delivery over time) or a product (license to the developed software => delivery upon contract completion). This may finally depend on the form of the contract rather than its substance. Assume the following example:

A software vendor provides to customer software in a hosted environment. I.e., the software is not delivered to the customer for installation on the customer's hardware but rather remains on the software vendor's hardware and the customer accesses the software over the internet (so called Software-as-a-Service). The arrangement between the software vendor and the customer provides that the fees for the use of the software are due quarterly in arrears but that the fee will only be paid if the software was available for use at each and every day of the respective quarter. Applying the Exposure Draft's guidance is difficult because it is unclear what the customer is actually controlling and when such control transfers to the customer. Does the customer control the use of the software although numerous other customers may use the software concurrently? And does the control over the use of the software transfer continuously or not before the end of the quarter because this is when the vendor has delivered one quarter of access without downtime?

Based on this example we do not believe that transfer of control is an appropriate concept for the timing of revenue recognition for services.

We would like to emphasize that the continuous approach to revenue recognition which we prefer over the Exposure Draft's approach would not result in the difficulties outlined above.

We would like to point out that in the example of customer-specific software developments two views can be taken and each leads to a different conclusion on the pattern of transfer of control.

We understand that the current revenue recognition model which relies on delivery in IAS 18 and on performance in IAS 11 encounters difficulties whenever it is unclear whether a transaction falls under IAS 11 or IAS 18. We do, however, see similar difficulties in the application of the Exposure Draft's model which relies on the concepts of 'control over services' and 'continuous transfer of control' that are very difficult to apply in practice. The new model is therefore not superior to the existing standards. As we believe that percentage of completion accounting for multi-period contracts provides decision-useful information we recommend to continue the current distinction between goods and services that are accounted for under a performance-based approach and goods and services that are accounted for under a delivery-based approach.

In the application guidance section of the future standard, we recommend adding further guidance that clarifies the issues that the software industry faces.

Disclosures

While we understand the need for disclosures, we are concerned that disclosure requirements in the ED are so vast and burdensome, that, not only the reader will be baffled by the information overload but also the preparer of such information will be overwhelmed with the amount of data that needs to be gathered. Moreover, the cost of trying to attain such information through the necessary development of new

systems as well as additional personnel to deal with the additional data entry at the contract level would be much more than the benefit of having this information. Although the ED states that this information should be aggregated or disaggregated so that information shall not be obscured, this information would still need to be prepared at the contract level in the initial step. We believe that a disaggregation of revenue as described in the ED is a realistic disclosure that would provide a reader with key information concerning revenue sources. The reconciliation of contract balances on the other hand, would not only be impractical and extremely costly to prepare but would also not necessarily provide any additional information that would influence a reader of financial statements opinion on the past or future performance of the company. In regards to the disclosures on performance obligations, we believe that it is reasonable to provide general information concerning the accounting policies of the company but not provide information at the contract level. We also believe that for onerous performance obligations, it is reasonable and informative to provide aggregate data for the sum of onerous performance obligations as a whole but reporting such information at the contract level would be tedious and costly and would not provide added value to the readers of the financial statements. All other general disclosures that may provide insight into the company's financial policies and practices seem reasonable from a preparer's standpoint.

Yours sincerely,

ESAG
European Software
Accounting Group