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# Forecast For Cloud Service Providers: More SEC Scrutiny


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*Law360, New York (August 12, 2013, 4:25 PM ET)* -- Cloud computing service providers face significant challenges in determining their proper revenue recognition model. IBM's recent announcement of an ongoing U.S. Securities Exchange Commission investigation into its cloud-related revenue recognition practices is an indication that the accounting for these arrangements has gotten the attention of regulators — and at a time when cloud services are becoming widely embraced across industries. With the proliferation of cloud computing services and complex accounting rules, many technology companies may soon be impacted by increased scrutiny from the SEC.

A recent Gartner study predicts that the cloud computing industry will grow at a compound annual growth rate of 17.7 percent with revenue projected to reach $210 billion globally by 2016.[1] With increased scrutiny on the horizon, it is critical for the growing number of cloud providers to review their service offerings and determine the appropriate accounting model for recognizing revenue.

**What is Cloud Computing**

Cloud computing involves the delivery of hosting services over the Internet. Because cloud computing provides a cost-effective solution that enables flexible access, rapid implementation, easy upgrades and enhanced backup capabilities, companies have been shifting away from traditional in-house IT solutions. There are three primary types of cloud computing services offered in the market, ranging from hardware-only solutions to services that provide a full suite of hardware and software hosting.

- Infrastructure-as-a-Service (IaaS) — users are provided with on-demand hardware resources (i.e., servers, memory and storage) that are held and maintained by cloud providers

- Platform-as-a-Service (PaaS) — in addition to hardware resources, users are provided with a framework (i.e., operating system and software development tools) that enable users to modify and develop their own applications

- Software-as-a-Service (SaaS) — in addition to hardware and platform resources, users are provided with developed applications that can be accessed over the Internet

**Revenue Recognition**

Current accounting literature does not have specific revenue recognition guidelines in place for the cloud computing industry. The following provides a general framework of the key determinations that may impact the timing of revenue recognition for cloud services but is by no means an exhaustive list of considerations that cloud providers should address.

**Is the Arrangement a Sale or Service?**

Cloud providers must first determine whether cloud computing arrangements should be accounted for as software. According to the Financial Accounting Standards Board Accounting Standards Codification (ASC) 985-605-55, a hosting arrangement should be recognized using software revenue recognition guidance if both of the following requirements are met:

1. The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty; and
2. It is feasible for the customer to either run the software on its own hardware or contract with another party, unrelated to the vendor, to host the software.

In most cloud computing arrangements, customers are not given the right to possess provided resources at any time; instead they can only purchase the right to use the resources during the contractual term. For that reason, cloud computing arrangements should typically be treated under the services accounting model rather than as a sale of software.

**Multiple Deliverable Arrangement Model**

Since cloud providers frequently offer other services (e.g., training, implementation, and/or consulting) in addition to their primary hosting service, they will frequently have to apply significant judgment in analyzing deals as multiple deliverable arrangements. The multiple deliverable analysis includes:

1. Identifying the deliverables within an arrangement.
2. Determining whether the deliverables can be separated into units of accounting.
3. Allocating the arrangement consideration among the separate units of accounting.
4. Identifying and applying the revenue recognition methodology for each unit of accounting.

Each step of the multiple deliverable arrangement process requires a careful analysis and application of complex rules. Steps two and three were impacted by changes in accounting guidance issued in 2009 as discussed further below.

***Step 2: Separation of Accounting Units***

In October 2009, FASB Accounting Standard Update (ASU) 2009-13 (pre-codification, Emerging Issues Task Force (EITF) 08-01) was issued and significantly revised the revenue recognition guidance for multiple-deliverable arrangements. Under its guidelines, deliverables should be considered as separate units of accounting if both of the following requirements are met:

1. The delivered item(s) has value to the customer on a standalone basis.
2. If the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the company.

In comparison to prior guidance (EITF 00-21), having objective evidence of "fair value" is no longer required for the separation of accounting units; instead a hierarchy of valuation methods (vendor specific objective evidence (VSOE), third party evidence (TPE), and best estimate of selling price (BESP)) was established under the new standards. The introduction of BESP enables providers who were previously unable to determine VSOE or TPE to separate deliverables.

The emphasis on "selling price" instead of "fair value" clarifies that the allocation of revenue is based on entity-specific assumptions rather than assumptions of a market place participant, which better reflects the economic value of customer arrangements, especially in the cloud space where services are usually highly customized.

The adoption of BESP provides cloud computing providers with greater flexibility in determining the economic value of separate accounting units. At the same time, cloud providers are challenged to establish processes to evaluate BESP. The guidance for establishing BESP is mostly conceptual, meaning that management should exercise significant judgment to determine the inputs for the BESP calculation. As directed by ASU 2009-13, the vendor's BESP shall incorporate considerations of market conditions as well as entity-specific factors. To establish a supportable process of evaluating BESP, providers should consider the following, among other factors:

1. Market demand and competition for current service offerings
2. Industry trends for cloud services
3. Estimated life of the technology and the level of industry advancements
4. Average profit margin for similar offering among competitors
5. Levels of product customization
6. Size and length of the service offerings
7. Cost of the offerings

Evaluating BESP can be complex and usually requires significant financial expertise when considering all relevant factors. Additionally, as a best practice, cloud providers should contemporaneously document all assumptions that support their estimates.

***Step 3: Allocation of Consideration***

Under ASU No. 2009-13, arrangement consideration is allocated proportionately at inception to all accounting units using the relative selling price method. This approach results in discounts ratably applied to all accounting units, rather than "front-ending" discounts to earlier deliverables, as typically occurred under prior guidance.

***Step 4: Application of Revenue Recognition Model***

Once the arrangement consideration is allocated to the accounting units, the revenue recognition methodology for each accounting unit is separately determined and applied. As a practical matter, most of the individual accounting units will typically follow the service revenue model, which allows the revenue to be recognized ratably over the service period unless evidence suggests that revenue should be recognized in a different pattern.

Timing of recognition may be restricted by other factors, such as contingencies tied to yet to be delivered units or delayed payment terms. Therefore a complete understanding of the arrangement is critical in developing the accounting model.

**Other Considerations**

The FASB and International Accounting Standards Board (IASB) continue to work on their ambitious convergence project to develop a single revenue recognition standard applicable for all industries, which is expected to be released later in 2013. Based on the most recent exposure draft issued in January 2012, the proposed standards mostly align with the guidance issued in 2009 and summarized above.

However, there are some key differences that may have a significant impact on cloud providers, including changes to the criteria for assessing the separation of accounting units (referred to as performance obligations in the exposure draft). The new standard is expected to contain a lengthy transition period, which means that existing guidance will likely remain in place for several years.

In addition to revenue recognition challenges that are inherent to cloud computing arrangements, other accounting risk areas include application of the proper accounting model to the costs of development, acquisition, and maintenance / upgrade of software, as well as, determining if cloud computing arrangements contain an embedded lease.

Determining the appropriate revenue recognition model for cloud computing providers can be complex and challenging. With the added pressure of increased scrutiny from regulators, cloud providers must be even more diligent in examining their customer arrangements and properly documenting their processes and accounting judgments.

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[1] "Columbus, Louis. "Gartner Predicts Infrastructure Services Will Accelerate Cloud Computing Growth." Forbes. Forbes Magazine, 19 Feb. 2013. Web. 01 Aug. 2013

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