

Hey! What's New? 2024-95

Beware Of This Subscription Software Accounting Error

Here is something a little different. A blog by Peter Madara on the *CFO* webpage points out that CFOs and chief accounting officers (CAOs) need to pay attention to accounting for software costs, particularly accounting for the purchase of subscription-based software licenses. "CFOs and CAOs are often surprised to learn that their companies have been getting the accounting wrong all along," he says, "Worse still, they are even more surprised that even their external auditors failed to detect the wrong accounting."

For the longest time, software was sold through perpetual licenses, meaning you paid once and could use the software forever. Madara says that accounting for these licenses is simple: The perpetual license fee is recorded as capital expenditure and the associated software maintenance fee is recorded as a prepaid cost and amortized into operating expenses (OpEx).

Over the past decade, however, the industry has shifted to subscription-based licenses, where you pay for the software use over a specified term. "Today, almost every company uses subscription-based software licenses. The subscription contracts typically bundle software that was previously sold via perpetual licenses, software maintenance and other cloud-based services into a single subscription fee."

But, Madara points out that "many companies often wrongly assume that all software-related subscription fees should be recorded as prepaid costs and amortized into OpEx. In some cases, however, GAAP requires subscription payments to be handled as settlement of vendor-provided financing for acquiring a software asset. In such cases:

- A financed 'software asset' must be recorded based on the portion of the single subscription fee attributable to software licenses.
- A liability must be recorded for the obligation to make future payments related to the financed software asset."

A good example, he adds, is a Microsoft 365 subscription which includes various software elements, software support and cloud-based services. Depending on the specific Microsoft 365 product, anywhere from 30% to 60% of the subscription fees are required to be recorded as vendor-provided financing for software assets previously sold via perpetual licenses.

Several impacts on financial statements need to be considered, therefore. Madara notes the following are the primary ones.

- **Balance sheet:** Wrong accounting results in understatement of software assets (typically included in property, plant and equipment or intangible assets) and understatement of liabilities.
- **Income statement:** Understatement of depreciation and amortization expenses and interest expense, and overstatement of OpEx.
- **Non-GAAP EBITDA:** For companies that look to non-GAAP EBITDA as a comparable measure relative to peers, EBITDA is understated due to overstatement of OpEx.
- **Cash flow statement:** "Vendor financing payments" wrongly included in cash flow from operating activities instead of cash flow from financing activities.

“If a company records 100% of its software-related subscriptions as prepaid costs amortized into OpEx,” says Madara, “then it is almost a certainty that the accounting for vendor-financed software assets is not being handled correctly. In addition, a potential accounting error is also detectable from public company financial statements.” Here are a few indicators that a company may not be handling the accounting correctly:

- **MD&A commentary** where increases or decreases in OpEx (that is, not considering depreciation and amortization expenses) are attributed in part to software license fees.
- **Purchase commitments disclosures** which indicate that material cash commitments include those for software licensing.
- **Cash flow statement** where the financing activities section has no line item that could possibly include vendor-financed software payments.

The steps outlined here apply to any situation where the CFO and CAO become aware that their financial statements might contain an accounting error. Madara has expanded them here to provide additional insights specific to subscription-based software licenses.

For more, see [Beware of this subscription software accounting error | CFO](#).