

■ Public Company Financial Executive Briefing ■ **MODIFICATIONS TO REVENUE RECOGNITION GUIDANCE**

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EXECUTIVE SUMMARY

Emerging Issues Task Force (“EITF”) 08-1 (Accounting Standards Update No. 2009-13) and EITF 09-3 (Accounting Standards Update No. 2009-14) are effective for arrangements entered into or materially modified beginning on or after June 15, 2010 with early adoption permitted. If EITF 09-3 is adopted, it must be adopted in the same period as EITF 08-1. If the election is taken to adopt early, this change must be made prospectively from the beginning of the vendor’s fiscal year of adoption. These modifications provide guidance regarding the allocation of the arrangement consideration in multiple deliverable arrangements to achieve financial reporting that better reflects the economics.

Under EITF 08-1, the residual method of the allocation of arrangement consideration is no longer permitted. Expanded qualitative and quantitative disclosures are also required. This EITF applies to all vendors that provide multiple products or services (“deliverables”) to customers as part of a single arrangement and were previously following guidance on separating the deliverables and allocating the arrangement consideration to separate units of accounting. Current guidance modifies fair value requirements by providing “best estimate selling price” when the vendor specific objective evidence (“VSOE”) or third-party evidence (“TPE”) can not be determined. With this change, consideration was

given to whether similar changes should be made to software revenue recognition. Software revenue recognition currently does not allow for the use of TPE for fair value. It also requires the use of residual method when the VSOE of fair value is known for all of the undelivered items, but not for all the delivered items.

SUMMARY OF ACCOUNTING

Background:

Previously, guidance was provided on how the arrangement consideration should be measured and allocated to separate units of accounting. Once the units were determined, the arrangement consideration is allocated among the separate units based on the relative fair value. In the absence of fair value evidence for any of the delivered items if the fair value is known for the undelivered item, vendors were required to use the residual method to allocate the arrangement consideration. This method resulted in the amount of consideration allocated to the delivered items equaling the total consideration net the fair value of the undelivered items.

If the fair value was not known for the undelivered items, the delivered items were combined with the undelivered items as a single unit of accounting. This usually resulted in a deferral of some or all of the revenue because of the inability to separate the deliverables. Previous guidance stated that contractually stated prices for

individual products or services did not reflect fair value, but were best represented by the price of a deliverable when the vendor regularly sold it on a standalone basis. This is referred to as VSOE or in the absence of VSOE, a vendor could rely on TPE of fair value, referred to as vendor objective evidence (“VOE”).

Changes:

EITF 08-1 (amended ASC section 605-25-55) introduced the concept of “best estimate of selling price” in addition to VSOE or TPE (also referred to as VOE). If TPE or VSOE is not available, vendors are required to use the best estimate. This means that all deliverables are separate units provided:

- A delivered item has value to the customer on a standalone basis
- If there is a right of return relative to the delivered item, delivery or performance of the undelivered items is considered probable and substantially in the control of the vendor

The best estimate of selling price must be determined in a way that is consistent with a price that the vendor would sell the deliverable on a standalone basis. With the introduction of the best estimate of selling price resulting in separate units of accounting for all deliverables, the residual method is no longer applicable.

As it relates to software guidance, it was concluded that the software industry should still

be held accountable to a higher threshold of VSOE for separating deliverables and reinforcing the use of residual method, where appropriate.

EITF 09-3 (amended ASC section 985-605-15) does modify the scope of SOP 97-2 (ASC section 985-605-15) to achieve financial reporting that better reflects the economics by providing a scope exception for SOP 97-2. It excludes (i) non software components of tangible products and (ii) software components of tangible products that are sold, licensed or leased with tangible products when the software components and non-software components of the tangible product function together to deliver the tangible product's essential functionality. As a result, many vendors that sell software-enabled products will be able to apply EITF 08-1 instead of SOP 97-2.

The following are factors that a vendor should consider in determining whether a tangible product is delivered with software components and non-software components that function together to deliver the tangible product's essential functionality:

- Sales of the tangible product without the software elements are infrequent, a rebuttable presumption exists that software elements are essential to the functionality of the tangible product.
- In cases where a vendor sells products that provide similar functionality (for example, different models of similar products) and the only significant difference between the products is that one includes software and the other does not, the products are considered the same product for purposes of performing the evaluation in the first bullet above.
- In cases where a vendor sells a tangible product containing software that it also sells on a standalone basis separate from the tangible

product, the separate sale of the software should not cause a presumption that the software is not essential to the functionality of the tangible product.

- Software elements do not need to be embedded within the tangible product to be considered essential to the tangible product's functionality.
- The non-software elements of the tangible product must substantively contribute to the tangible product's essential functionality. For example, the tangible product should not simply provide a mechanism to deliver the software to the customer.

Examples are also provided and included in EITF 09-3. Additionally, if a vendor elects to apply EITF 09-3 prospectively, the vendor should provide the transition disclosures required by EITF 08-1 as noted below.

ONGOING DISCLOSURE REQUIREMENTS

The requirements of the disclosure are to provide both qualitative and quantitative information necessary for a user of the financial statements to understand the nature of the judgments made in applying EITF 08-1 (amended ASC section 605-25-25), changes in judgment or application of EITF 08-1 that would impact the timing or amount of revenue recognition. Companies should disclose qualitative and quantitative information that would meet this objective in addition to the following information presented by similar type of arrangement:

- Nature of such arrangement,
- Significant deliverables within the arrangements,
- General timing of delivery or performance of service for the deliverables,
- Performance, cancellation, termination and refund-type provisions
- Discussion of significant factors, inputs, assumptions, and methods used to determine

selling prices for the significant deliverables,

- General timing of revenue recognition for significant units of accounting, and
- The effect of changes on either the selling price or method or assumptions used to determine the selling price for a specific unit of accounting if either one of the changes has a significant effect on the allocation of arrangement consideration

TRANSITION DISCLOSURE REQUIREMENTS

EITF 08-1 (amended ASC section 605-25-25) also requires specific transition disclosure requirements. If EITF 08-1 is applied prospectively, in the first year of adoption, vendors are required to disclose information that enables user to understand the impact of the change in accounting principle. At a minimum, the following is required:

- Description of any change in the units of accounting,
- Description of the change in the vendor allocation of specific units of accounting,
- Description of the changes in the pattern and timing of revenue recognition, and
- Whether the adoption of EITF 08-1 (amended ASC section 605-25-25) is expected to have a material effect on financials after the initial adoption

If the effect of adopting EITF 08-1 (amended ASC section 605-25-25) is material, the above information must be supported by quantitative information in the period of adoption such as the amount of revenue that would have been recognized under EITF 00-21 (ASC section 605-25-25) compared to EITF 08-1 (amended ASC section 605-25-25) in the year of adoption.

FOR FURTHER INFORMATION, PLEASE CONTACT ONE OF THE FOLLOWING:

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