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Revised Software Revenue Recognition Guidance to Scope in Fewer Arrangements

FASB issues new guidance

Software revenue recognition guidance that was originally issued as AICPA Statement of Position 97-2, *Software Revenue Recognition*, is now included in FASB Accounting Standards Codification (ASC)¹ 985-605, *Software Revenue Recognition*. The scope of this guidance originally included an arrangement to sell a tangible product along with software that is more than incidental to the product as a whole. Given the advances in technology over the last decade, however, more arrangements to sell tangible products were being captured in the scope of this guidance than what may have been intended when it was originally written in 1997. This caused concern because the existing software guidance in ASC 985-605 is considered more restrictive than that for sales of a tangible product that excludes software that is more than incidental to the product.

This concern was heightened upon the issuance of Accounting Standards Update (ASU) No. 2009-13, *Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements (a consensus of the FASB Emerging Issues Task Force)*^{2 3}. ASU 2009-13 modified the separation and allocation guidance for non-software arrangements, which was originally issued as Emerging Issues Task Force (EITF) Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*, to further differentiate this guidance from that for software arrangements. As a result, many felt the accounting treatment under ASC 985-605, which often resulted in deferral of all revenue on the delivery of a product in a multiple-deliverable revenue arrangement even though some value had been transferred to a customer, did not reflect the true economics of arrangements. Accordingly, a revision to this guidance was recently issued in the form of ASU No. 2009-14, *Software (Topic 985): Certain Revenue Arrangements That Include Software Elements (a consensus of the FASB Emerging Issues Task Force)*,

which amended ASC 985-605 to remove from its scope certain revenue arrangements with tangible products that include software elements.

The final ASU document is available at www.fasb.org.

Revised scope of ASC 985-605 as a result of ASU 2009-14

ASU 2009-14 modifies the guidance in ASC 985-605 for tangible products containing software and non-software components such that the following items are no longer within its scope:

- The non-software component of the tangible product;
- The software component of the tangible product if the software and non-software components function together to deliver the tangible product's essential functionality; and
- Undelivered elements (*e.g.*, postcontract customer support services) that relate to software components that are excluded from the scope of ASC 985-605.

The ASU includes the following factors to consider when determining whether a tangible product has software and non-software components that function together to deliver the tangible product's essential functionality (and are thus outside the scope of ASC 985-605):

1. Sales of the tangible product without the software elements are infrequent;
2. If the only significant difference between similar products is that one product includes software that the other product does not, they are considered the same product for the purpose of evaluating factor (1);
3. The separate sale of the software without the tangible product does not lead to a presumption that the software is not essential to the functionality of the tangible product;

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4. Software elements do not need to be embedded within the tangible product to be considered essential to its functionality; and
5. The non-software elements of the tangible product must substantively contribute to the tangible product's essential functionality.

To illustrate the overall principle and the above factors, numerous examples are included in the ASU. These examples focus primarily on scenarios involving the sales of: (a) computers with operating systems and other software products and services, (b) personal digital assistants, and (c) networking equipment.

The ASU also provides that consideration for arrangements with deliverables both within (software deliverables) and outside (non-software deliverables) the scope of ASC 985-605 should be allocated based on the guidance in ASC 605-25, *Revenue Recognition - Multiple-Element Arrangements*, as amended by ASU 2009-13. Note that when differentiating between a software and non-software deliverable, software would be considered a non-software deliverable if it is part of a tangible product and functions together with non-software components to deliver the tangible product's essential functionality. Furthermore, if there are undelivered elements (such as postcontract customer support) that relate to both software and non-software deliverables, these elements will have to be bifurcated into software and non-software deliverables for allocation purposes.

Overall, we believe the adoption of this ASU is expected to have a significant impact on the accounting for multiple-deliverable revenue arrangements that include: (a) products with embedded software and (b) non-embedded software that is more than incidental to a product sold in the same arrangement. This is due to the fact that these arrangements will now be subject to the guidance in ASC 605-25 as amended by ASU 2009-13, which does not require vendor-specific objective evidence of selling price to separate multiple deliverables into individual units of accounting. As a result, more multiple-deliverable revenue arrangements are expected to be separated into more than one unit of accounting, which usually will result in the recognition of a portion of the overall arrangement fee as each item in an arrangement is delivered.

New recurring disclosure requirements

The ASU does not expand the disclosure requirements for arrangements that are still within the scope of ASC 985-605. However, arrangements that are now outside the scope of ASC 985-605 as a result of the adoption of this ASU will be within the scope of ASC 605-25 (as amended by ASU 2009-13). Vendors that enter into these types of arrangements will be required to include many new disclosures related to these multiple-deliverable revenue arrangements. On an ongoing basis, vendors must disclose information by similar types of arrangement, including a description of the arrangements, significant deliverables, and timing of delivery or performance, as well as revenue recognition timing for separate units of accounting. Furthermore, the significant factors and estimates that a vendor uses to determine vendor-specific objective evidence (VSOE), third-party evidence (TPE) or best estimates of selling price must be disclosed along with any significant changes in selling price or the underlying methodologies used to determine selling price.

Effective date of the ASU and required transitional disclosures

The guidance in ASU 2009-14 is effective for fiscal years beginning on or after June 15, 2010 and may be adopted either prospectively or retrospectively. If adopted prospectively, a vendor would apply the guidance to all revenue arrangements entered into or materially modified after the date of adoption, with early adoption permitted if ASU 2009-13 is also adopted early.

If a vendor adopts ASU 2009-14 on a prospective basis, it must disclose information regarding the effect of applying this ASU by similar types of arrangements in the initial year of adoption. These disclosures must include qualitative information such as any changes in the unit of accounting, allocation of arrangement consideration or pattern and timing of revenue recognition, as well as whether the adoption of this ASU will have a material effect on financial statements in future periods. Furthermore, quantitative information must also be disclosed describing the effect of the adoption if it is material to the financial statements. The ASU does not prescribe a specific form or specific content for this quantitative information or the number of periods for which quantitative information must be disclosed. However, the following are examples of information listed in the ASU that may satisfy the disclosure objective:

- Amount of revenue that would have been recognized in the year of adoption if the related arrangements entered into or materially modified after the effective date were subject to the measurement requirements of EITF 00-21
- Amount of revenue that would have been recognized in the year preceding adoption if the arrangements accounted for under EITF 00-21 were subject to the measurement requirements of ASU 2009-13
- Amount of revenue recognized in the reporting period and the amount of deferred revenue as of the end of the reporting period from applying the guidance in:
 - EITF 00-21 for arrangements entered into prior to adoption of ASU 2009-13 and not materially modified; and
 - ASU 2009-13 for arrangements entered into or materially modified after its adoption

Note that these disclosure requirements may necessitate tracking the amount of revenue recognized both under this ASU and the previous guidance for at least one annual reporting period.

If the ASU is adopted early during a period other than a vendor's first interim reporting period (if applicable), it must be applied on a retrospective basis from the beginning of the vendor's fiscal year and disclosure is required regarding the effect of retrospective application on revenue, income before income taxes, net income, and earnings per share.

If a vendor adopts this ASU on a retrospective basis, all years presented in the financial statements must be "recast" as if the new guidance had been in effect when the revenue arrangements were entered into as required by ASC 250-10, *Accounting Changes and Error Corrections*, paragraphs 45-5 through 45-8 (formerly Statement 154, paragraphs 7 through 10). In addition, the disclosures noted in ASC 250-10-50-1 through 50-3 (formerly Statement 154 paragraphs 17 and 18) must be provided in the initial year of adoption, including the effect of retrospective adoption on certain financial statement line items for prior reporting periods.

What should we do now?

Vendors with revenue arrangements that may be affected by this ASU should evaluate its provisions and understand the implications on their revenue transactions, financial reporting processes, and internal systems. This evaluation should focus on revenue arrangements that are currently included in the scope of ASC 985-605 as a result of a tangible product that includes more-than-incidental software. Furthermore, vendors should consider in this evaluation whether they believe early adoption of the ASU is feasible and will be beneficial. In considering the feasibility of early adoption, vendors should pay close attention to the substantial disclosure requirements and the amount of effort they believe will be required to comply with these disclosures.

To help you further understand the implications of ASU 2009-14, please contact McGladrey & Pullen to arrange a review of your specific situation with one of our audit specialists.

¹ The FASB launched the ASC as the single source of authoritative nongovernmental U.S. generally accepted accounting principles (GAAP) on July 1, 2009. The ASC reorganizes the thousands of U.S. GAAP pronouncements into roughly 90 accounting topics and displays all topics using a consistent structure. It also includes relevant SEC guidance that follows the same topical structure in separate sections in the ASC.

² Since the ASC went into effect, all changes to authoritative U.S. GAAP are communicated through an ASU. ASUs are published for all authoritative U.S. GAAP promulgated by the FASB, regardless of the form in which such guidance may have been issued prior to the release of the ASC (*e.g.*, FASB Statements, EITF Abstracts, FASB Staff Positions, *etc.*).

³ See our fact sheet, *New Model for Multiple-Deliverable Revenue Arrangements Better Reflects Economics*, for additional information on ASU 2009-13.