Debrief on ASU 2009-14 (EITF 09-3): Seismic Shift in SOP 97-2

RevenueRecognition.com Staff

Tangible products with essential software excluded from SOP 97-2. Change of scope impacts revenue pictures and economics for many technology companies

The EITF agreed to a seismic change, by eliminating from the scope of SOP 97-2 all "tangible products containing software components and non-software components that function together to deliver the product's essential functionality." While the debate may rage on over the definition of what, exactly, that includes, there is no question that this will have a major impact not just on accounting practices, but on the economics of the many companies and business models affected.

When SOP 97-2 was evolving, it is doubtful that its architects contemplated a world in which software was embedded in cars, phones, picture frames, kitchen stoves, light fixtures, etc. Today every electric device can potentially use software to enhance its functionality. The result over time has been that the hardware products of more and more companies, containing even just a bit of software, have been drawn into the SOP 97-2 net. Accounting under SOP 97-2 is not just highly complex: it has had a tendency to cause revenue to be deferred frequently, especially where evidence of Fair Value/VSOE for software not sold separately is a real issue. With these hardware/software combinations now excluded from the scope of SOP 97-2, and now controlled by ASU 2009-13 (formerly known as EITF 08-1) – read on as that changes too – not only should the accounting get simpler, but companies should be able to follow more economically advantageous pricing policies and to recognize revenue sooner.

This potentially disadvantages pure software company, still subject to SOP 97-2 and VSOE, with no estimating of prices allowed.

Key Issues at a Glance

ASU 2009-14 (formerly known as EITF 09-3) tackles a hotly debated item: Should the existence of a software component in a tangible product trigger the application of software revenue recognition accounting rules. Manufactures of cell phones, computer hardware, medical devices, even cars have had to determine if included software was merely incidental or really essential to the whole product. Now ASU 2009-14 specifically excludes such types of products from the use of software revenue recognition rules. This removes the VSOE requirement and allows vendors to use the estimated selling price and multiple-deliverable arrangements guidance for revenue recognition. ASU 2009-14 will be effective for fiscal years beginning June 15th 2010 and early adoption is possible.

EITF 08-1 & EITF 09-3: The Essential Back Story on Issues that Go Hand-In-Hand

The impacts of ASU 2009-14 (EITF 09-3) need to be understood within the context of ASU 2009-13 (EITF 08-1): Revenue Arrangements with Multiple Deliverables. Both issues were released simultaneously and go hand-in-hand. EITF 08-1 is based on and supersedes EITF 00-21. It includes narrow but significant changes in the existing accounting guidance for all multiple-deliverable arrangements. Notably, it eliminates the requirement for objective and reliable evidence of fair value in order to separate accounting units, permitting instead the use of estimated "selling prices" for undelivered item if Fair Value evidence was unavailable. Since the lack of such evidence for undelivered items often prevents companies from recognizing revenue from undelivered elements, the use of estimated prices instead may permit many more elements to be recognized and potentially accelerating revenue recognition for delivered items.

EITF Chooses Change of Scope and Defines the Key Principle

In its consideration of this issue, the Task Force also discussed whether to expand the scope of EITF 08-1 to include transactions managed under SOP 97-2: Software Revenue Recognition. SOP 97-2 focuses on arrangements that include software and software-related items. It also pulls in hardware wherein software is "essential to the functionality

After much deliberation, the Task Force reached the conclusion that the "tangible products containing software components and non-software components that function together to deliver the product's essential functionality" would be considered non-software deliverables and therefore excluded from SOP 97-2.

To further clarify, the EITF laid out a set of factors intended to provide guidance in interpreting what the Task Force intended and what type of circumstances make ASU 2009-14 apply. Software is considered essential and part of a tangible product based on the following five factors:

- Sales of the product without the software is infrequent
- Similar products are only differentiated by the software
- Software can also be sold stand-alone
- Software elements are not necessarily required to be embedded in the tangible product
- Non-software elements substantially contribute to the product's functionality

Proposed Disclosures, Transition and Effective Dates

Since the new ASU will simply "move" certain arrangements from the SOP 97-2 into the ASU 2009-13 (EITF 08-1) accounting camp, there are no additional disclosures required beyond those already required for ASU 2009-13. For companies whose multiple element arrangements will still be accounted for entirely within the scope of SOP 97-2, there will be no change at all. ASU 2009-14 will be effective for fiscal years beginning June 15th 2010 and early adoption is possible. The transition and effective dates for ASU 2009-14 (EITF 09-3) coincide with ASU 2009-13 (EITF 08-1).

A Potentially Seismic Shift in Practices and Market Economics

The impacts of this change are potentially momentous. Any hardware/software arrangement excluded from SOP 97-2 by this accounting standard can now be accounted for under the new ASU 2009-13 (EITF 08-1). That means that the more flexible standard of estimated selling price, rather than TPE or VSOE, can potentially be applied to undelivered elements in an arrangement, permitting separation and accelerating the recognition of revenue for items delivered.

Perhaps even more importantly, it means that pricing and discounting policies can be more flexible, and more competitive than under the rigid requirements of VSOE under SOP 97-2. The establishment of VSOE pricing – which is essential in order to separate accounting elements –requires setting strict pricing policies and maintaining prices within a very narrow range. Offering a customer a big discount outside of this band in order to win the business jeopardizes VSOE: the company in question may win the battle for that customer, but in so doing they will risk losing the larger war of what revenue they can recognize when. Removing companies from this battle entirely should enable them to sell their products at prices in line with the realities of the marketplace.

How this will affect pure software companies remains unclear. Actually, the guidance doesn't affect them at all. But the advantage may now go to companies whose product lines and business models enable them to bundle hardware and competitive software.

Sources:

FASB ASU 2009-14:
Software (Topic 985)
Certain Revenue Arrangements That Include Software Elements
a consensus of the FASB Emerging Issues Task Force

Related Articles on RevenueRecognition.com:

Debrief on ASU 2009-13 (EITF 08-1):
Revenue Arrangements with Multiple Deliverables

About RevenueRecognition.com

RevenueRecognition.com is dedicated to educating finance professionals on revenue management and related issues. The site focuses on revenue accounting; revenue recognition; revenue reporting and forecasting; internal controls; Sarbanes-Oxley compliance; SEC, FASB, and international accounting guidelines; contract management; and industry specific revenue challenges. Contact us at: info@revenuerecognition.com. RevenueRecognition.com is sponsored by Softrax Corporation.

About Softrax

Softrax Corporation is a leading provider of enterprise revenue management and billing software solutions that fundamentally change the way companies manage, analyze, report and forecast their revenue. Softrax solutions automate the entire revenue cycle, from revenue recognition, reporting and forecasting, through complex billing and contract renewals. Hundreds of corporations benefit from using Softrax to optimize their revenue, reduce operating expenses, comply with revenue recognition regulations and Sarbanes-Oxley requirements, and gain unprecedented visibility into their business performance. Softrax Corporation, headquartered in Canton, MA is privately held. More information can be found at www.softrax.com and by calling 1.888.4.SOFTRAX.

RevenueRecognition.com

Revenue Management Resources for Today's Financial Executive