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EITF Releases Proposed Revenue Recognition Rules for Public Comment

If Adopted, These Proposals Will Have a Significant Impact on Revenue Recognition and Pricing Strategies for Many Technology Companies

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Technology companies' sales arrangements are often characterized by having multiple deliverables – for example hardware, software and professional services all sold together as part of the same customer arrangement. In order to recognize revenue for delivered items in partially completed sales, companies often opt for economically sub-optimal sales and pricing policies in lieu of the less desirable alternative – deferring all revenue until the last product or service is delivered. Current proposals to change U.S. Generally Accepted Accounting Principles (GAAP) could eliminate this accounting driven economic inefficiency for some companies.

The goal is to have these new standards in place for early adoption starting in January 2010 for some companies. In the interim, technology companies should consider how the competitive landscape and sales practices and policies could be affected if the proposed rules are finalized.

New EITF Guidance

The Emerging Issues Task Force (EITF) has proposed new accounting guidance that, if issued, would significantly change revenue recognition for many multiple deliverable arrangements typical in the technology industry. The changes are being proposed in two issues that were recently released by the EITF for public comment:

1. EITF Issue 08-1, *Revenue Arrangements with Multiple Deliverables*
2. EITF Issue 09-3, *Applicability of AICPA Statement of Position (SOP) 97-2 to Certain Arrangements That Include Software Elements*

Revenue Arrangements with Multiple Deliverables

EITF Issue 08-1, *Revenue Arrangements with Multiple Deliverables*, would replace and significantly change EITF Issue 00-21. Currently, in order to recognize revenue for delivered products and services, companies are required to obtain sufficient evidence of fair value of the undelivered products and services. This commonly involves establishing vendor specific objective evidence (VSOE) of fair value of the undelivered products or services, a complicated process of establishing and consistently following pricing policies.

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Unfortunately, this process can also result in a company making economically undesirable pricing choices in sales arrangements with customers. For example, many technology companies sell products together with related consulting services and offer price discounts to certain customers to discourage them from buying from a competitor. These discounts could preclude the company from meeting the fair value criteria in EITF Issue 00-21, because of the lack of pricing consistency.

This in turn could result in deferral of recognition of the product revenues until the services are subsequently provided. If a company instead wants to recognize the product revenues when the products are delivered to the customer, it would need to limit its practice of providing discounts, which could also result in losing customers to competitors.

To address this issue, the EITF has proposed eliminating the requirement to establish fair value of undelivered products or services and instead proposes to require separate revenue recognition based on management's estimated selling prices of the separate deliverables when fair value can not be established, and assuming the other criteria of EITF Issue 08-1 are met. These other criteria are largely carried forward from EITF Issue 00-21 intact, and include establishing stand-alone value of the delivered items among other criteria. The elimination of the requirement to establish fair value represents a significant change in practice because many companies would no longer be required to establish VSOE in order to recognize revenue.

EITF Issue 08-1 would apply to technology companies that are not subject to SOP 97-2, *Software Revenue Recognition*. This includes many hardware companies, as well as software companies that follow a software-as-a-service (SaaS) delivery model.

Revenue from Joint Products

With EITF Issue 09-3, the EITF is considering whether to modify the scope of SOP 97-2 such that companies selling a joint hardware and software product would no longer be subject to SOP 97-2 and would instead follow the proposed EITF Issue 08-1 and SAB 104 for revenue recognition guidance. The EITF has proposed that this change would apply to "tangible products containing software components and non-software components that function together to deliver the product's essential functionality."

This change would result in a large class of technology companies no longer needing to establish VSOE of fair value for products and services, since these companies would be subject to EITF Issue 08-1 instead of SOP 97-2. The exposure draft of EITF 09-3 that was recently released for public comment contains a number of examples to help companies determine whether their products would fall under SOP 97-2 or EITF 08-1. Companies offering hardware and software products should carefully consider these examples.

Software companies that license their software and do not sell a joint hardware and software product, however, would still be required to obtain VSOE of fair value of undelivered products or services in order to recognize revenue for delivered items. The EITF has been considering but is not currently proposing changing the accounting standards for software revenue recognition at this time due to the unique issues related to how software companies license and sell software products and services, and due to the nature and timing of efforts required to reconsider and change these rules. However there is still significant debate and uncertainty in this area, and software companies are encouraged to consider and share their views with the EITF.

Competitive Landscape Affected

The two new proposed EITF Issues are likely to affect the technology industry's competitive landscape in the following ways:

1. Many affected companies will likely change their pricing policies and sales practices to employ greater variability in pricing products and services. For example, value-based pricing strategies will become easier to implement in some situations.
2. Technology companies have typically been precluded from including future products in sales agreements due to the difficulty of establishing VSOE of fair value. It is likely that companies will start including future products and specified software upgrade rights in sales agreements to entice customers to buy existing products since this would not adversely affect current revenue under EITF 08-1. This practice could quickly become widespread in certain situations.
3. Technology companies sometimes compete against other technology companies that have a different business model. As a result, competitively-opposed companies would sometimes be treated inconsistently under these proposed GAAP changes. Several examples of this include:
   - SaaS companies often compete against traditional software licensing companies. The SaaS companies would

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benefit from the proposed changes but their software licensing competitors would not.

- Companies selling a joint hardware and software solution often compete against pure-play software companies only selling software. The proposed new EITF Issues could give the companies offering a joint hardware and software solution a GAAP advantage. One example is Intel's recently announced intention to provide operating software to accompany certain chips, which puts it in competition with Microsoft. Another example is Oracle's acquisition of Sun, which will presumably result in bundled hardware and software product offerings.
- Professional service organizations of software companies that are bound by the VSOE rules in SOP 97-2 will often compete against professional service organizations of other technology companies that might no longer be similarly constricted.

4. The proposed implementation rules for EITF's 08-1 and 09-3 only permit adoption in a company's first fiscal quarter. As a result, calendar year companies will likely be able to implement the rules in January, however, companies with other fiscal years will have to wait until their first fiscal quarter. This could be a short-term competitive disadvantage for the companies that have to wait to adopt.

Looking Forward

Given the potential strategic significance of the proposed new revenue recognition rules, technology companies are advised to closely monitor their progress and carefully consider ways the competitive landscape could be affected, since these proposed changes could be adopted by some companies as early as January 2010.

The proposed standards can be located at: http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1175801893139.

The EITF is accepting public comments through August 14, 2009, and companies are encouraged to comment to the EITF on their views on these proposals.

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