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Software Revenue Recognition on the Rise

Technology boom expands relevance of SOP 97-2.

by Greg Regan and Tim Regan

When Statement of Position 97-2, *Software Revenue Recognition*, was issued in October 1997, it was clear that all software companies would transition to this new standard. What was not clear was how bright lines would blur for companies outside of the traditional software sector as technology evolved over the next decade.

As technology becomes further woven into consumer and enterprise products ranging from cell phones to copiers, companies in unlikely and sometimes unsuspecting industries are beginning to realize that the true economic value of their offerings is not in their machinery or hardware, but rather in the product's underlying technology—its software.

As a result, software revenue recognition is becoming a reality for many professionals, a fact that can be unnerving in light of the complexities inherent in software accounting rules. This article will help CPAs address the presence of software in a transaction and decide what revenue recognition rules apply. It also highlights the most important provisions of GAAP related to software revenue recognition.

SOP 97-2, *Software Revenue Recognition*, provides guidance on when revenue should be recognized and in what amounts for licensing, selling, leasing or otherwise marketing computer software. It should be applied by all entities that earn such revenue. It does not apply to revenue earned on products or services containing software that is incidental to the products or services as a whole.

So what are the consequences of falling within the software revenue requirements? The same basic revenue recognition rules, such as SEC Staff Accounting Bulletin no. 104, *Revenue Recognition*, apply. Evidence of the arrangement or transaction must exist; the fee must be fixed or determinable; delivery must be complete; and collection of the fee must be probable. However, the terms for satisfying each requirement are different from basic revenue recognition requirements.

The consequences of not complying with the rules loom large. If companies are taken by surprise and are unable to develop the requisite analysis, they may be unable to prepare financial statements in accordance with GAAP.

Such was the case with Tokyo-based NEC Corp. The information technology, mobile and electronic device company announced in September that it was unable to complete the analysis necessary under SOP 97-2 to provide vendor specific objective evidence (VSOE) to support recognition of revenue from certain types of software and maintenance and support services provided as part of multiple-element contracts.

Without the analysis, NEC's outside auditor couldn't complete the audit of the company's consolidated financial statements for the fiscal year ended March 31, 2006. As a result, NEC was unable to file its Form 20-F annual report with the SEC. The problem affected NEC's consolidated financial statements dating back to early 2000.

"Because of the complexities involved in determining the adjustments required to restate its U.S. GAAP results, NEC has concluded that a restatement is not practicable," NEC said in a press release. Nasdaq delisted NEC as of Sept. 27, halting trading on the exchange of the company's American Depositary Receipts.

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HAVE I SOLD SOFTWARE?

The application of software revenue recognition rules begins with determining whether the sale of any product or service contains software that is more than incidental to the products or services as a whole. The answer to this question would seem, on its face, rather obvious. After all, Ford Motor Co. is not Oracle.

However, this determination is not as simple as it might seem. While historically many companies may have trusted that SOP 97-2, as amended, only applied to pure software companies, today periodic and thorough reviews of the software indicators spelled out in paragraph 2 of SOP 97-2 are necessary.

Specifically, accountants should review marketing materials for existing and prospective products to gauge how heavily software is promoted as a key part of a company's competitive advantage. Accountants must also consider the nature and extent of support services a company provides for its products, and software-specific development efforts that led to a final product.

Companies that want to avoid SOP 97-2 should limit their software support practices and obligations. Post-contract support, such as updates or upgrades, and ongoing services provided to customers is often the separating factor in determining whether SOP 97-2 is applicable, given that they introduce multiple-element accounting and, thus, may have a direct impact on a company's recorded revenue.

Even a retailer selling boxed software has to be mindful of the requirements of SOP 97-2 if that retailer also sells related software services along with the product.

EXECUTIVE SUMMARY

- **Statement of Position (SOP) 97-2 provides** guidance on applying GAAP in recognizing revenue from software and software-related transactions. The SOP provides instruction on recognition for licensing, selling, leasing or otherwise marketing software.
- **As technology becomes further entrenched** in consumer and enterprise products, companies outside of the traditional software sector are beginning to realize that the economic value of their offerings resides in the underlying technology—software—subjecting those products to software revenue recognition rules.
- **One of the critical concepts established** by SOP 97-2 is vendor specific objective evidence (VSOE). The term is generally compatible with fair value. If a company is unable to assert that it possesses VSOE for each element in a multiple-element arrangement, the likely result is deferral of some, if not all, of the arrangement's associated revenue.
- **Companies that want to avoid SOP 97-2** should limit their software support practices and obligations. Post-contract support, such as updates or upgrades, and ongoing services provided to customers are often separating factors in determining whether SOP 97-2 is applicable, given that they introduce multiple-element accounting and thus may have a direct impact on a company's recorded revenue.

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NOTE: *The views expressed by the authors do not necessarily reflect those of their employers.*

Application to Non-Software Products and Services

If the software is more than incidental to a product, the next determination required by EITF 03-05, *Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software,* is whether the software is essential to the workings of the non-software products or services. If it is, then those non-software elements also fall within the jurisdiction of software accounting.

"The guidance outlined in EITF 03-05 continues to be consistent with the objectives of standard setters, one of which is to reduce diversity in practice," says Stuart Harden, a member of FASB's Emerging Issues Task Force and the managing director of the litigation and forensic consulting services group of Hemming Morse Inc. (Note: Author Greg Regan is also employed by Hemming Morse.) "I anticipate that the FASB's ongoing revenue recognition project will further reduce diversity in practice and will likely bring consistency to revenue recognition principles among different industries. As a result, an understanding of the principles of SOP 97-2, including the fair value concepts of [vendor specific objective evidence] may provide practitioners with a solid foundation for the future."

Professional judgment, as well as consultations with knowledgeable internal parties and external auditors, is often required in performing this evaluation. For instance, would a radio alarm clock, a high-definition television or a photocopier operate as expected without its embedded software? Even more difficult, would a customer buy a network router, an iPhone or a digital camera if the product did not come with its related software? Increasingly, companies are considering these types of questions carefully, and as a result, some non-traditional software manufacturers are now determining that they are, in fact, software providers.

Apple has disclosed in quarterly filings that it recognizes revenue from its new iPhone as well as the iPod and Macintosh computers under software revenue recognition rules. Apple will record all revenue and related costs of sales from the iPhone on a straight-line basis over the two-year estimated life of this product. Historically, many hardware companies might have recognized revenue upfront, at the time of the sale, from a product similar to an iPhone. However, Apple intends to provide iPhone users with free software upgrades, necessitating the deferral of revenue under SOP 97-2.

Juniper Networks, a player in the high-performance networking space, believes its products are integrated with software that is essential to the equipment. "Our customers continue to make it clear that our JUNOS single-source network operating system provides competitive differentiation that is integral to the functionality and performance of our current generation of products, and is likely to become even more strategic in the future," says Ken Miller, Juniper's senior director of corporate planning. "Based upon that, and other factors, we concluded that SOP 97-2 was the right guidance for us to employ."

The SEC staff has addressed the question of pinpointing the bright line in cases in which products or services within a transaction are software-based (see comments made in 2004 by then-SEC Associate Chief Accountant G. Anthony Lopez at **www.sec.gov/news/speech/spch120604gal.htm**), and reiterated the evaluation indicators provided by SOP 97-2.

The SEC also included additional examples for consideration and recommended periodic reviews of a company's underlying facts and circumstances to encourage practitioners to make these assessments on a timely basis. As a result, it is important that companies consider some of the following factors when reviewing for the presence of software.

A company should determine whether software-like features are advertised as important to its product's functionality. This evaluation includes reviewing:

- Marketing materials distributed to customers
- The contents of recent press releases
- Information published on the company's Web site
- Internal and/or external training documentation
- Disclosures made within financial statements
- The underlying customer agreements pertinent to the products in question

"It is important to know if customers are receiving post-contract support, such as updates or upgrades that provide new functionality to previously sold products," adds Jeff Pickett, a senior manager at the Connor Group, a Silicon Valley consulting firm.

Over the past year, Pickett has helped several hardware companies implement SOP 97-2. "This post-contract support can be mistakenly accounted for under warranty, but in fact it is a separate deliverable that requires different accounting," he says. "Companies should have conversations with internal legal and customer service departments to develop an understanding of all ongoing services given to customers and over what period of time they are given."

Another important source of information lies in understanding the composition of the company's research and development team. While this may seem a daunting task, CPAs can gather information through a review of a company's existing job titles and its job postings, including those listed on the Web site, in search of indicators such as whether the company employs or is hiring software engineers.

Software Accounting: A Higher Bar

Often, as part of software-based arrangements, multiple products or services are provided to a customer. Therefore, one of the critical concepts established by SOP 97-2 is VSOE. This title is generally compatible with the term fair value. VSOE is critical because if a company cannot assert that it possesses VSOE for each element in a multiple-element arrangement (particularly those products or services still to be delivered), the likely result is deferral of some, if not all, of the arrangement's associated revenue.

VSOE is an even higher standard than subsequently released guidance on multiple-element arrangements such as EITF 00-21. Under EITF 00-21, an entity may use a competitor's selling price as evidence of fair value of its own products. As its name suggests, VSOE bars such a comparison.

SOP 97-2 permits only two methods to establish VSOE. The preferred method involves the use of the company's data related to separate sales. The second method uses the figure, set by appropriate management, for separately sold items as determined within a short time of the ultimate pricing decision, often considered to be 30 days.

VSOE can be determined by demonstrating that separate sales regularly occur either at the same price or within a tight band. For instance, a hardware networking company recently changed its revenue recognition policy to SOP 97-2 in anticipation of an initial public offering. The company used a rule of thumb—a methodology often referred to as the bell-shaped curve approach—stating that VSOE exists when at least 80% of separately sold products are priced within a plus/minus 15% band.

For example, the median discount from list price in all relevant sales was 40%, so the acceptable range was deemed to be between 34% and 46% of list price (that is, +/−15% of 40%). Thus, in this instance, VSOE was obtained if 80% of included transactions occurred within this range.

One challenge is that companies often use distinct pricing practices based on such factors as geography, class of customer, or transaction size. Each disrupts homogeneity in the pricing required for VSOE. However, the unique pricing conditions required in these circumstances should be taken into consideration in developing VSOE.

Other acceptable methods can be used to verify that pricing conformity exists for separate sales to establish VSOE. One such method is the stated renewal rate for customer support.

The use of VSOE is intended to allocate revenue among the transaction's products or services in a way that reflects the true fair value of its elements. For example, a company should not deliver a product along with yearly support services, yet recognize all revenue pertinent to the arrangement at the point of product shipment. The rules are intended to identify the fair value associated with the products, and to drive revenue recognition on a representative and timely basis as those elements are earned. As such, when VSOE of the elements within a transaction is known, revenue is recognized according to their respective values once each item is delivered.

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A Continued Transition

In addition to the notion that SOP 97-2 sets higher standards in multiple-element accounting, it also presents more situational examples than other, more general revenue-recognition literature. As such, accountants often turn to SOP 97-2 for analogous guidance.

"Given the increasing significance of software to products in the networking equipment, medical devices, telecommunications equipment and other industries, many of our clients consider the concepts and guidance of SOP 97-2 in evaluating their multiple-element arrangements" even if they have concluded that these transactions are not within the scope of the guidance, says Andrew Cotton, Ernst & Young's Americas director of software.

In particular, companies should consider not only the explicit obligations that may be relevant to a given transaction, but also the implied commitments that may have been made. This frequently involves considering transactions from the customers' perspectives. Did they expect to receive support for the product, even if the contract did not specifically state they would? Did they expect to receive future products or discounts that may have been mentioned in the course of negotiations? Again this process involves judgment and often highlights the importance of training key salespeople and other employees on the impact of certain commitments to customers. ❖

Exhibit Sources of Guidance

Detailed guidance is provided in the following situations by three key sources of revenue recognition literature:

Situation	SOP 97-2 and its related TPAs	SEC SAB 104	EITF 00-21
Multiple-element arrangements	✔		✔
Customer acceptance rights	✔	✔	
Post-contract support	✔		
Specified upgrades	✔		
Extended payment terms	✔		
Implicit obligations	✔		
Significant discounts	✔		

AICPA RESOURCES

Publications

- *Auditing Revenue in Certain Industries–AICPA Audit Guide* (#012517)
- *AICPA Technical Practice Aids* (#005147)
- *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions–SOP 98-9* (#014920PDF)
- *High Tech Audit Risk Alert* (#022408; scheduled for January 2008 release)

CPE

Revenue Recognition in Today's Business Climate, a CPE self-study course (#732423)

For more information or to make a purchase, go to **www.cpa2biz.com** or call the Institute at 888-777-7077.

OTHER RESOURCES

Publication

KPMG's implementation guide, **www.us.kpmg.com/microsite/attachments/2005/SoftwareRevRecognitionBook2005.pdf**