

# New and Emerging Revenue Recognition Issues for Software and High Technology Companies

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## Agenda

- ◆ EITF 00-21 - Accounting for Revenue Arrangements with Multiple Deliverables
- ◆ SOP 97-2 Issues - Contractual Customer Acceptance Provisions, Specified Upgrades and Product Replacement
- ◆ Warranties: Comparison to Cancellations, Short-Term Rights of Return and PCS
- ◆ Selected Technical Practice Aids
- ◆ EITF 01-3 - Accounting in a Purchase Business Combination for Deferred Revenue of an Acquiree

## EITF 00-21 – Scope and Exceptions

EITF 00-21 applies to all deliverables within contractually binding arrangements in all industries except:

- a) Arrangements involving multiple deliverables or a deliverable(s) within multiple-deliverable arrangements for which guidance (whether and/or how to allocate consideration) is provided by other higher-level existing accounting literature (for example, SFAS No. 13, No. 45, and 66, FIN 45, TB 90-1, SOP 81-1, 97-2, and 00-2),

## EITF 00-21 – Other Scope Exceptions

- b) Arrangements including vendor offers to a customer of either (1) free or discounted products or services to be delivered at a future date or (2) a rebate or refund of a determinable cash amount if the customer completes a specified number of transactions or remains a customer for a specified period of time, and
- c) Arrangements involving the sale of award credits by broad-based loyalty program operators.

## Interaction of EITF 00-21 and Higher-level Literature (HLL)

### Notes:

1. Higher-level literature means categories (a) and (b) of the GAAP hierarchy defined in AICPA Statement on Auditing Standards No. 69, *The Meaning of “Present Fairly in Conformity With Generally Accepted Accounting Principles” in the Independent Auditor’s Report*. EITF Consensuses are category (c) literature.
2. Whether higher-level literature applies to a deliverable depends on the scope provisions of that literature and this assessment **ignores** the order of delivery of that item.
3. *EITF 00-21 applies to the deliverable(s) outside the scope of HLL.*

## Interaction of EITF 00-21 and HLL – Category 1

The application of EITF 00-21 or higher-level literature (HLL) for the separation of deliverables and the allocation of arrangement consideration to these deliverables is a function of the segregation provisions in relevant higher-level literature:

### Category 1:

The segregation provisions of HLL must be used when it provides guidance on the separation of deliverables **and** the allocation of arrangement consideration to those separate units of accounting.

## Interaction of EITF 00-21 and HLL – Category 2

Category 2: The arrangement consideration must be allocated on a relative fair value basis if HLL provides guidance on the separation of deliverables within its scope from deliverables not within its scope but does not specify how the arrangement consideration must be allocated to these separate units of accounting.

*Segmentation provisions of EITF 00-21 apply to deliverable(s) outside the scope of HLL.*

Note: For the purpose of this allocation, an entity's best estimate of fair value is not limited to vendor-specific objective evidence (VSOE) of fair value or third-party evidence of fair value as defined by paragraph 16 of EITF 00-21.

## Interaction of EITF 00-21 and HLL – Category 3

### Category 3:

EITF 00-21 applies to deliverables for which HLL provides no guidance regarding the separation or the allocation of the arrangement consideration.

Note: A deliverable(s) subject to HLL may not meet EITF 00-21 (paragraph 9) criteria for separation; such deliverables may have to be combined with other undelivered items to determine appropriate revenue recognition methods for the combined deliverables.

## Interaction of EITF 00-21 and HLL – Category 3

Example: Consider an arrangement that includes the design and manufacture of complex electronic equipment (SOP 81-1 deliverables) and the operation of the equipment (a non-SOP 81-1 deliverable).

Although SOP 81-1 provides separation and allocation guidance (segmentation provisions) for deliverables within its scope, it does not contain similar separation and allocation guidance for SOP 81-1 and non-SOP 81-1 deliverables.

***The segmentation provisions of EITF 00-21 must be applied to this arrangement.***

## Interaction of EITF 00-21 and HLL – Category 3

- ◆ SOP 81-1 segmentation guidance must be applied if EITF 00-21 separates design and manufacture deliverables from the operation of the final product.
- ◆ If EITF 00-21 does not call for the separation of the design and manufacture components, they must be combined with the operation deliverable and revenue recognition criteria must be established for the combined deliverables.

## Interaction of EITF 00-21 and SOP 81-1

EITF 00-21 – SOP 81-1 is not applicable unless all of the deliverables fall within the scope of SOP 81-1.

Implementation question: How does this interpretation affect the accounting for arrangements that include significant production, modification, or customization of software?

Response: SOP 81-1 applies to transactions involving significant production, modification, or customization of software because HLL SOP 97-2 contains guidance for these transactions (See paragraphs 7 and 74 of SOP 97-2). Such arrangements are treated as Category 1 transactions.



## Interaction of EITF 00-21 and SOP 81-1



Alternative response:

This EITF 00-21 interpretation of the scope of SOP 81-1 also applies to software arrangements. These arrangements would be treated as Category 3 transactions and EITF 00-21 must be used to determine whether SOP 81-1 deliverables must be separated from non-SOP 81-1 deliverables.

## Contingent Revenue

- ◆ The amount of revenue allocable to a delivered item(s) is limited to the amount that is not contingent upon delivery or performance on undelivered items (paragraph 14).
- ◆ Allocated amounts are not adjusted for general rights of return.
- ◆ The contingent revenue guidance of EITF 00-21 does not apply to deliverables subject to HLL.



## General Right of Return and Contingent Revenue



Difference between revenue subject to a general right of return and contingent revenue:

- ◆ General right of return – Customers may return delivered items for any reason.
- ◆ Contingent revenue – Customers may have a right to return delivered items or withhold payment, or both under limited conditions, for example, incomplete performance by the seller.



## General Right of Return and Contingent Revenue



Criterion 9 (c) is based on the ability of the seller to complete its performance obligation for undelivered items. It is not concerned with the seller's ability to estimate returns or otherwise satisfy SFAS 48 requirements. The evaluation of contingent revenue excludes consideration of the probability of performance.

Implications for contractual terms: Because of contingent revenue provisions, it may be prudent to clarify contracts and limit a customer's general right of return as defined in EITF 00-21. See discussion of contingent revenue.



## General Right of Return and Contingent Revenue



Conditions under which criterion 9 (c) may not be met:

- Deliverables are highly customized;
- Seller has a history of not completing performance in similar arrangements;
- Significant reliance on sub-contractors;
- Completion is expected over a long time period; or
- There is uncertainty regarding the financial condition of the seller.

## Revenue Recognition – Combined Deliverables

- ◆ Regulation S-X, Section 5-03(b) requires separate display of product sales, rental income, service revenue, and other revenues. Revenues may be reported on a combined basis if one or more items are less than 10% of total revenues.
- ◆ When product sales and service revenues are combined, additional disclosures may be required. The display should clearly indicate that reported revenues are from product sales and services.

# Measurement and Allocation: Implementation Issue

Determination of total arrangement consideration when it is probable that performance bonuses will be earned and collected,

- ◆ Customers will purchase additional products or services, or
- ◆ Cancellation penalties will be assessed and collected.

Response: The total arrangement consideration is based on performance in accordance with the arrangement terms and it does *not* include:

- ◆ Additional purchases or cancellation penalties, or
- ◆ Performance bonuses.

Entity-specific evidence of the probability of bonuses cannot be used to overcome this presumption.

## Measurement and Allocation: Implementation Issue

Evaluation of the pricing of deliverables in arrangements involving commitments to supply an indeterminate number of units at a fixed price per unit.

- ◆ Determine whether the per-unit price is at fair value.
- ◆ Although the measurement guidance requires the assumption that no optional units will be purchased, the vendor must determine whether the price of optional units is at or above fair value.
- ◆ If the price of the optional units is below fair value (that is, they are discounted), a portion of the arrangement fee must be allocated to the discounted optional items.

## Measurement and Allocation – Fair Value

- ◆ Vendor Specific Objective Evidence (VSOE), as defined in SOP 97-2, *Software Revenue Recognition*, is the best evidence of fair value;
- ◆ The price at which the deliverable is regularly sold on a standalone basis;
- ◆ Contractually stated or list prices are not necessarily representative of fair value;
- ◆ Cost plus a “normal” profit margin cannot be used to allocate the arrangement consideration.

## Measurement and Allocation – Fair Value

- ◆ Fair value evidence is either entity-specific or VSOE as defined in paragraph 10 of SOP 97-2 – the price charged when the deliverable is sold separately, or
- ◆ For an item not being sold separately, the price established by management having the relevant authority and it must be probable that the price once established, will not change before the separate sale of the item.
- ◆ Where available, VSOE should be used. Where VSOE is not available, entities may use third-party evidence of fair value. Generally, it will be difficult to obtain third-party evidence of VSOE of the fair value of deliverables.

## Contingent Revenue (Paragraphs 14 and 15)

Some arrangements allow customers to delay payments or receive refunds for specified types of nonperformance.

EITF Consensus: Contingent revenue is the portion of the total arrangement consideration that is a function of delivery or other specified performance requirements.

- ◆ Although contingent revenue must be allocated to deliverables, *it cannot be recognized as revenue on delivery.*
- ◆ The amount of revenue allocated to a deliverable is not affected by a general right of return; SFAS 48 may affect the amount of revenue recognized.

## Contingent Revenue and General Right of Return

Example: A Company sells two products in a bundled arrangement for \$90. Separately, Product A sells for \$60 and its Product B sells for \$40. The customer must pay \$50 on receipt of Product A and the remaining \$40 when Product B is delivered.

### Assumptions:

- ◆ Historically, customers have returned 2% of Product A due to a general right of return;
- ◆ All separation criteria of EITF 00-21 are satisfied; and
- ◆ All of the SFAS 48 criteria are satisfied.

## Contingent Revenue and General Right of Return

### Example:

- ◆ The arrangement consideration, \$90, is allocated under the relative fair value method - \$54 to Product A and \$36 to Product B.
- ◆ However, on delivery of Product A only \$50 can be recognized as revenue because the remaining \$4 is contingent on delivery of Product B.
- ◆ SFAS 48 must be applied to recognize the effect of the general right of return. Based on its experience with a sufficient number of similar transactions, the company would recognize \$49 as revenue on delivery of Product A.

## Contingent Revenue and General Right of Return

### Comments:

- ◆ The amount allocated to the deliverables in the bundled arrangement is not affected by the application of SFAS 48 – the effect of the general right of return.
- ◆ It is not clear whether the amount of the contingent revenue should be allocated to the undelivered items or recognized as part of the delivered items. Despite the impact on the timing of revenue recognition, the latter method preserves the gross margins in terms of the fair value of the deliverables.

## Contingent Revenue and Cancellation Clauses

- ◆ Although early termination penalties are not components of the total arrangement consideration, they are included in the determination of the existence of contingent revenue if
  - (1) the vendor normally enforces cancellation provisions, and
  - (2) cancellation penalties are applicable regardless of whether the customer or the vendor cancels or terminates the contracts.
- ◆ Generally, contingent revenue will have to be recognized unless the delivered item has standalone value and the vendor is unable to repossess the delivered item.
- ◆ In this type of arrangement, a cancellation penalty may trump the contingent revenue provision.

# Allocation and Deferral of Costs

- ◆ Contingent revenue may significantly affect the timing of revenue and profit.
- ◆ Where contingent revenue results in the recognition of a loss and the entity has an enforceable contract expected to generate positive margins, the entity should consider deferring direct and incremental costs related to that deliverable.
- ◆ Direct and incremental costs should not be deferred when the existence of contingent revenue results in a breakeven or a minor profit margin.

# Allocation and Deferral of Costs

- ◆ The total deferred direct and incremental costs should not exceed the fair value of the delivered item.
- ◆ Impairment considerations: In tests of recoverability, cash flows are limited to those expected from the delivered items. Cash flows from other deliverables cannot be considered.
- ◆ Generally, losses are limited to actual costs incurred. However, SOP 81-1, *Accounting for the Performance of Construction-Type and Certain Production-Type Contracts*, mandates loss recognition when it is evident – earlier than actual occurrence.

## SEC Staff Comments on Allocation and Deferral of Costs 2003 AICPA National Conference

Example: The SEC Staff did not object to the recognition of an asset (investment in an existing contract) in the amount of the loss incurred on delivery of the first item. The revenue attributable to undelivered elements exceeds the fair value of the those deliverables because of contingent revenue related to the first item delivered.

Other issues:

- ◆ Nature of costs included in the computation of the loss on delivered items, appropriate amortization period, evaluation of impairment, timing of loss recognition (at inception), and basis for loss measurement – unit of accounting level or the overall contract.

## Example – Accenture

Effective September 1, 2003, Accenture adopted EITF 00-21 on a prospective basis. The company noted that the adoption will *“potentially change the timing of revenue recognition and affect margins in some situations, depending on our ability to structure contracts to accommodate the requirements of Issue 00-21.”*

Had EITF 00-21 been adopted earlier, revenues would have been \$114 million lower and Accenture would have reported a \$54 million reduction in operating income over the 2001 -2003 period. Diluted EPS would have been \$0.02 and \$0.01 lower or \$1.03 and \$ 0.55 in 2003 and 2002, respectively.

## Example – Accenture

### Prior Year Impact of EITF 00-21

Pro forma impact of EITF 00-21	2001	2002	2003
Revenue before reimbursements	\$ (14)	\$ (35)	\$ (65)
Operating income	\$ (6)	\$ (15)	\$ (33)
Diluted earnings per share	NA	\$(0.01)	\$(0.02)

## SOP 97-2 and Contractual Customer Acceptance Provisions

- ◆ General principle: When customer acceptance is uncertain, revenue should not be recognized prior to customer acceptance.

*Issue* – Do contractual acceptance provisions preclude revenue recognition until

- (1) formal acceptance, or
- (2) the end of the acceptance period?

*Response:* If customer acceptance depends on a service element that is not essential to the functionality of the software, acceptance should be treated as a right of return and SFAS 48 would apply.

## SOP 97-2 and Contractual Customer Acceptance Provisions

### *Response (Continued):*

- ◆ However, services are considered essential to the functionality of the software, if payment of a significant portion of the fee coincides with customer acceptance of the software (including the service element),
- ◆ If the contractual acceptance period extends beyond a short period after the service element has been performed, a sale has not occurred and revenue may not be recognized until formal acceptance or the end of the acceptance period, whichever occurs first,
- ◆ *Recommendation: When acceptance is affected by the service element, separate acceptance of the software (independent of service) should be obtained to establish that service is not essential to the functionality of the software.*

## SOP 97-2 and Contractual Customer Acceptance Provisions

### *Response (Continued):*

- ◆ Revenues adjusted for the right of return can be recognized when all the paragraph 6 criteria of SFAS 48 are met and all SOP 97-2 recognition criteria are satisfied, and
- ◆ Substantial returns indicate pervasive acceptance problems and revenue recognition may not be appropriate even if all SFAS 48 criteria are met.

## Specified Upgrades and Product Replacement

- ◆ Specified upgrades must be accounted for as separate elements even if the customer is otherwise entitled to the upgrade (e.g., as a component of a PCS subscription),
- ◆ The right to receive unspecified upgrades must be accounted for as a subscription,
- ◆ Exchange rights granted to resellers (including stock balancing arrangements) are returns and SFAS 48 applies,

## Specified Upgrades and Product Replacement

Whether replacements for end users are exchanges or returns depends on the nature of the arrangement:

- ◆ Exchanges for products with minimal differences in price, functionality and features are not returns and are considered like-kind exchanges, and
- ◆ Exchanges for products with more than minimal differences in price, functionality and features are considered returns and SFAS 48 applies.

# Warranties: Comparison to Cancellations, Short-Term Rights of Return and PCS

## Paragraph 31 of SOP 97-2:

- ◆ Warranties generally relate to a vendor's obligation to conform a product to published specifications. SOP 97-2 specifies that warranties should be accounted for in accordance with SFAS 5.
  - Warranties require an accrual of related (that must be estimated) costs.
- ◆ Cancellation privileges and short-term rights of return relate to products that conform to published specifications, but do not meet the specific needs of a customer. Short-term rights of return must be accounted for in conformity with SFAS 48.
  - Short-term rights of return and cancellations focus on revenue recognition for a product sold.

# Warranties

- ◆ In accordance with SFAS 5, vendors should accrue the estimated costs of satisfying the warranty obligations (including routine and minor warranties) when the revenue from the arrangement is recognized.
- ◆ If, however, there are significant uncertainties about possible warranty claims and the range of possible loss is wide, consideration should be given to whether any revenue should be recorded until sufficient experience exists or the warranty period expires.
- ◆ A warranty accrual cannot be used to address a known defect in a software product for purposes of recognizing revenue upon delivery.

# Cancellation Privileges

- ◆ When a customer retains the unilateral right to cancel a contract, (or other evidence of the arrangement if contracts are not customarily used), or to cancel it if certain provisions are not met, the vendor must defer revenue recognition until the cancellation provisions are no longer effective.
- ◆ Fees under contracts with cancellation provisions that expire ratably over the contract period become determinable as the cancellation provisions lapse.
- ◆ A contractual termination provision triggered by a breach of contract by either party is not considered a cancellation privilege under SOP 97-2.

## Short-Term (ST) Rights of Return

- ◆ ST rights of return are not cancellation privileges; SFAS 48 applies to all ST rights of return (e.g., 30-day money-back guarantees).
- ◆ When all SFAS 48 criteria are met, the revenue recognized upon delivery of software would be reduced by the estimated returns. The estimate should be based on historical experience and other relevant information.
- ◆ If all the criteria of SFAS 48 are not met, (including the ability to reasonably estimate future returns), revenue should be deferred until rights of return lapse.

## Non-Contractual Rights of Return and New Products

SFAS 48 also applies to the following types of return rights:

- ◆ Customers may be granted occasional (non-contractual) rights of return on existing products,
- ◆ A newly released product may require bug fixes, or
- ◆ The vendor may occasionally accept returns on new products.

## Rights of Return and New Products

Indicators of the inability to reasonably estimate returns for new products:

- ◆ No past experience with similar products,
- ◆ Different customer base,
- ◆ Different distribution channel, and
- ◆ Unproven internal control system relative to the vendor's quality control and beta testing function.

# Discounts, the Residual Method, and Revenue Recognition

TPA 5100.74:

SOP 97-2 defines discounts as the difference between the arrangement fee and the VSOE of fair value when VSOE is available for ***all*** the elements in an arrangement.

- ◆ Issue - Computation of the amount of the discount when the residual method applies, i.e., VSOE of fair value is not available for the delivered elements.

# Discounts, the Residual Method, and Revenue Recognition

## Example:

A software vendor enters into an arrangement where the customer licenses currently available software and other services. The vendor also offers a discount off the published list price on future purchases of products not previously licensed by the customer. The vendor does not have VSOE of the fair value of the products.

- ◆ Issue – How should the vendor determine whether the discount on future purchases is significant and incremental since it does not have the VSOE of fair value of its software products?

# Discounts, the Residual Method, and Revenue Recognition

Reply:

- ◆ The software vendor must first compute the discount in the initial arrangement (the difference between the list price of those deliverables and the residual value attributable to those items).
- ◆ If the discount on future purchases is significant and incremental to the discount on the delivered elements in the initial arrangement, the discount on the future purchases must be accounted for under TPA 5100.51.

# Discounts, the Residual Method, and Revenue Recognition

<b><i>Assumptions</i></b> <b><i>FV of PCS is \$15</i></b>	Published List Price	Residual Value	Discount from Published List Price
Product A Perpetual License	\$100	\$65	35.00%
Future Products	Unknown	Unknown	55.00%
Additional Discount			20.00% <b><i>Significant &amp; Incremental</i></b>

# Discounts, the Residual Method, and Revenue Recognition

A	B	$A*B=C$	D	$C+D=E$	F	$F-E$
List Price	Additional Discount	Revenue Deferred For Discount	Revenue Deferred For PCS	Total Revenue Deferred	Fee	Upfront Revenue Product A
\$100	20%	\$20	\$15	\$35	\$80	\$45

# Discounts, the Residual Method, and Revenue Recognition

***Inquiry:*** Vendor offers a perpetual license at \$ 1,000,000 with PCS for \$150,000. The customer is entitled to deploy an unlimited number of copies of the software for 3 years.

- ◆ During that 3-year period, the customer has a renewal option on PCS for years 2 and 3 at 15% of the license fee (\$150,000), and
- ◆ After the 3-year unlimited deployment period, the customer must pay additional fees to deploy additional copies. The optional PCS fee for year 4 and thereafter is based on the number of copies used.
- ◆ Do the annual renewal rates for years 2 and 3 constitute VSOE for year 1 PCS?

# Discounts, the Residual Method, and Revenue Recognition

**Reply:** The annual renewal rates for years 2 and 3 do not constitute VSOE for year 1 PCS because there are two pricing schemes for PCS and there is no way to determine which pricing methodology produces appropriate VSOE of fair value for PCS in year 1.

- ◆ The vendor must recognize the total arrangement fee of \$1,450,000 ratably over the three year period under the assumption that PCS will be renewed for years 2 and 3.
- ◆ If PCS is not renewed for years 2 and 3, remaining deferred revenue must be recognized when PCS is no longer provided.

# Discounts, the Residual Method, and Revenue Recognition

**Reply:** The annual years 2 and 3 PCS renewal rates would constitute VSOE of FV of PCS if there is sufficient objective evidence to demonstrate that the renewal rate in year 4 and thereafter is more likely than not to approximate or be less than the amount charged in years 2 and 3.

- ◆ The vendor's past history with similar transactions is one example of the type of evidence needed.
- ◆ Stated caps or maximum amounts to be charged in years 4 and thereafter resulting in PCS fees that approximate or are less than the amount charged in years 2 and 3.

## Fair Value in Multiple Element Arrangements that Include Contingent Usage-Based Fees

***Inquiry:*** Unlike number of user-based fees, usage-based fees are computed by applying a constant multiplier to the frequency of use of software, e.g., a fee of \$.01 charged for each call to a customer call center.

For the following examples, we assume that the software provides value only through use in the activity on which the usage-based fees are computed:

## Fair Value in Multiple Element Arrangements that Include Contingent Usage-Based Fees

**Scenario 1:** Non-refundable initial fee and contingent usage-based fees determined monthly or quarterly and due shortly thereafter. PCS is provided at no additional charge for the first year and may be renewed thereafter at a substantive rate.

**Scenario 2:** Non-refundable initial fee and contingent usage-based fees determined monthly or quarterly and due shortly thereafter. PCS is provided at no additional stated charge.

**Scenario 3:** Arrangement provides for a perpetual license solely in exchange for contingent usage-based fees determined monthly or quarterly and due shortly thereafter. PCS is provided at no additional stated charge.

## Fair Value in Multiple Element Arrangements that Include Contingent Usage-Based Fees

### ***Reply:***

Usage based fees are not specifically addressed in SOP 97-2. However, Paragraph 10 of SOP 97-2 which provides guidance for assessment of VSOE, requires the consideration of all factors of the pricing structure. Usage fees should, therefore, be considered in determining whether there is sufficient VSOE of FV of all elements in the arrangement.

## Fair Value in Multiple Element Arrangements that Include Contingent Usage-Based Fees

**Scenario 1:** Because there is a substantive PCS rate, the residual method can be used. The amount of revenue allocated to the software license is recognized at delivery and that allocated to PCS is recognized ratably over the term of the contract. Usage-based fees are recognized when a reliable estimate is available and collectibility is probable.

**Scenario 2:** Because there is no substantive PCS rate, there is no VSOE and there is no way to demonstrate that the initial fee does not include a component for PCS. The initial fee must be recognized ratably over the term of the contract. Usage-based fees are recognized when a reliable estimate is available and collectibility is probable.

**Scenario 3:** The usage-based fees pay for both the license and the PCS, therefore, revenue is recognized when a reliable estimate of actual usage is available and collectibility is probable.



## Red Hat: Subscription Revenue

- ◆ In July 2004, Red Hat announced that it would restate its results to correct the way the Company accounts for subscription revenue.
- ◆ Historically, the Company had recognized subscription revenue on a monthly basis, meaning that for a one-year agreement, 1/12 of the revenue was recognized in the calendar month of commencement of the subscription and the balance over the next 11 calendar months.

## Red Hat: Subscription Revenue

- ◆ In the first quarter of fiscal 2005, the Company began to recognize revenue ratably over the period of each particular subscription agreement, beginning not before the initiation date of the contractual period.
- ◆ The effect of this change was to defer a portion of the revenue that had been previously recognized in the month of commencement of a subscription to the final month of the subscription term.

## Red Hat: Subscription Revenue

### Impact:

- ◆ The Company decreased enterprise and retail subscription revenues \$.4 M and \$.6 M, respectively, for the period ending 5/31/03.
- ◆ The related cost of enterprise technologies and retail revenues was also decreased by \$.4 M to in order to match the incremental direct costs to the revenues being deferred.
- ◆ Sales and marketing expense was also reduced by \$.2 M to adjust for the sales commissions associated with the revenues now being deferred.

## Source Corp.: Contractual Output and Services Revenue

Range of adjustments	Year ended	12/31/2003 (A)	6 months ended	6/30/2004 (A) (B)
In \$ 000's	Low	High	Low	High
Increase (decrease) in revenues	\$(5,400)	\$(5,400)	\$(2,800)	\$2,500
% Increase (decrease)	(1%)	(1%)	(1%)	1%
Increase (decrease) in Diluted EPS	\$(0.19)	\$(0.17)	\$(0.10)	\$0.06
% Increase (decrease)	(11%)	(10%)	(14%)	9%

## Source Corp.: Contractual Output and Services Revenue

### Footnotes:

- A. The adjustments for 2003 and a portion of the adjustments for 2004 reflect revenue and associated expenses recognized prior to delivery of contracted output. The revenue adjustments resulted in deferral of revenue that may not be recognized in the event contractually required output is not delivered or accepted by the customer.
- B. A portion of the 2004 adjustments involve performance and delivery of services in excess of contractual volume and/or revenue limits. There is no assurance when, if ever, such revenue will be recognized.

## Qualcomm: Accounting for Royalties

- ◆ On September 17, 2004, Qualcomm announced that it had placed the company's method of accounting for royalties under review.
- ◆ Since 1998, royalties from licensees for which estimates could be reasonably made have been accrued in the quarter when earned and adjusted in the subsequent quarter for the actual royalties reported to the company.
- ◆ Qualcomm has noted in its' financial reports that as the global CDMA market develops and diversifies, the company's ability to forecast and reliably estimate for many or all of its licensees could decrease.

## QUALCOMM: Accounting for Royalties

- ◆ As a result, the company may cease accruing royalty amounts for these licensees and instead record royalty revenues as **they are reported** to the company.
- ◆ If the accounting change is deemed necessary for the 4<sup>th</sup> fiscal quarter of 2004 and applied to all licensees for whom estimated royalties are accrued, the change will result in a one-time pre-tax charge of \$298 million.

## QUALCOMM: Accounting for Royalties

- ◆ On October 28, 2004, the company announced the completion of its review and changed its method of estimating royalty revenues. Effective the 4<sup>th</sup> fiscal quarter of 2004, royalties will be recognized solely on the basis of **reports received** from licensees (prospective adoption).
- ◆ The company intends to provide two reports:
  1. “*Pro Forma*” 4<sup>th</sup> quarter and fiscal 2004 royalty revenues using its prior method of estimating revenues, and
  2. On the new method for fiscal years 2001 and 2002 and quarterly reports for fiscal years 2003 and 2004.

## QUALCOMM: Accounting for Royalties

1. “*Pro Forma*” fiscal 2004 royalty revenues using its prior method of estimating revenues would have been \$251 million higher, and
2. Under the new method net income for fiscal 2004 was \$153 million lower than under the prior method.

Note: During the 4<sup>th</sup> quarter and fiscal 2004, the mix of domestic and foreign revenues and the effective tax rate changed.

# Google - Advertising Revenue Recognition

- ◆ In the 1<sup>st</sup> quarter of 2000, Google offered advertisers the ability to place text-based ads on Google's web sites targeted to users' search queries. Google recognized revenues when the ads appeared on the customers' search results pages. The amount of the revenue recognized was based on the number of times the ads appeared.
- ◆ In the 4<sup>th</sup> quarter of 2000, Google launched ADWords, an online self-service program permitting customers to place ads on Google sites. The revenue recognition method did not change.
- ◆ In the 1<sup>st</sup> quarter of 2002, Google switched to offering ADWords exclusively on a cost-per-click basis. As of January 1, 2004, all advertisers are subject to a single price structure based on the ADWords cost-per-click model. The company recognizes revenues when users click on the ads.

# Google - Advertising Revenue Recognition

- ◆ Google regularly refunds advertisers for click-through fraud – clicks by persons whose objective is to increase the revenue share payment to the Google network member (or more recently, to increase the cost to a competitor without a corresponding increase in revenues) rather than the ad content.
- ◆ However, there is no disclosure of the amount of refunds or a reserve, if any, for such refunds.



## EITF Issue No. 01-3 Accounting in a Purchase Business Combination for Deferred Revenue of an Acquiree



- ◆ SFAS 141: The fair value of acquiree liabilities assumed in a business combination are a cost of the acquisition.
- ◆ The acquiree's deferred revenue may not represent an assumed liability under SFAS 141. Alternatively, the deferred revenue may represent a liability, but its fair value may not be equal to the deferred revenue recognized under purchase accounting.



## EITF Issue No. 01-3

# Accounting in a Purchase Business Combination for Deferred Revenue of an Acquiree



### Issues:

- ◆ Whether an acquirer has assumed a liability for the deferred revenue on the balance sheet of the acquiree when the combination is initially recorded, and
- ◆ How to measure the amount of the liability and present it in the financial statements of the acquirer.

# EITF Issue No. 01-3

## Accounting in a Purchase Business Combination for Deferred Revenue of an Acquiree

### EITF Discussion

Whether a liability is assumed depends on the reason for deferral:

- ◆ Solely because collectibility was not reasonably assured: no obligation has been assumed although the acquired receivable must be recorded at fair value,
- ◆ Significant continuing involvement (e.g., sale-operating leasebacks): Acquirer has not assumed an obligation for the deferred revenue (gain) but may have acquired an asset or assumed a liability for the continuing involvement.



# EITF Issue No. 01-3

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### EITF Discussion and Observations

Whether a liability is assumed depends on the reason for deferral:

- ◆ Acquiree is obligated to grant future concessions (e.g. inability to reasonably estimate returns under SFAS 48, price protection provisions, and extended payment terms in software sales) or due to a lack of arrangement evidence: Acquirer assumes a performance obligation only when there is a legal obligation to grant concessions or provide goods or services to a customer,

# EITF Issue No. 01-3

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### EITF Discussion and Observations


- ◆ Application of SFAS 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises,*” was deemed beyond the scope of this Issue.
- ◆ View of most members of the EITF: The fair value of the liability would be reduced by the fair value of the assets expected to be received by the acquirer on settlement of the obligation.

Example: When the acquiree is a lessor on a lease with below-market rentals. The Task Force generally agreed that the fair value of the concession obligation is measured only as the amount by which the rentals fall below market rates. Note that servicing rights (SFAS 140) are also measured as the fair value of all expected cash inflows less the fair value of the expected cash outflows from the servicing right.



# EITF Issue No. 01-3

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### EITF Discussion and Observations

- ◆ The EITF has decided to discontinue discussion on this issue as it is within the scope of the FASB agenda project, Business Combinations: Purchase Method Procedures.
- ◆ The Task Force affirmed the tentative conclusions presented in the preceding slides.




## EITF Issue No. 01-3

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Example: Kronos, Inc.

- ◆ In its March 2003, acquisition of certain assets and obligations of Ban-koe Systems, Inc. a former Kronos reseller, the company recognized a liability for deferred revenue related to maintenance contracts and installation services.
- ◆ In its December 2001, acquisition of certain assets, obligations, and the ongoing business operations of the Integrated Software Business SimplexGrinnell, Kronos recognized a liability for deferred revenue related to maintenance contracts (phone service, bug fixes, and unspecified upgrades for the remaining contract term) and installation services.



## EITF Issue No. 01-3

# Accounting in a Purchase Business Combination for Deferred Revenue of an Acquiree



Example: Kronos, Inc.

- ◆ In its May 2003, acquisition of the Abra Enterprise customer base from Best Software the company recognized deferred revenue related to the a maintenance revenue stream because it assumed a legal performance obligation for the maintenance revenue.
- ◆ In May 2003, Kronos also acquired certain assets and obligations of Simplex International, a vendor of integrated workforce management software solutions. Kronos assumed a legal performance obligation for the maintenance and performance revenue streams. These obligations were recorded at fair value.

# EITF Issue No. 01-3

## Accounting in a Purchase Business Combination for Deferred Revenue of an Acquiree

### Issue 3:

- ◆ ACS Imports, Inc. is willing to pay an upfront fee to Jade Mountain Vineyards for the right to be the exclusive supplier of Les Jumeaux. (EITF 01-9 – ACS would have to recognize the fee as a reduction in revenue).
- ◆ ACS Imports acquires AMM, a smaller entity that also markets Les Jumeaux. Shortly before the acquisition, AMM paid a fee to Jade Mountain to become the exclusive supplier of Les Jumeaux. As a result of the acquisition, ACS becomes the sole supplier and would recognize the fair value of the acquired exclusivity arrangement as an intangible asset.

# EITF Issue No. 01-3

## Accounting in a Purchase Business Combination for Deferred Revenue of an Acquiree

### EITF Consensus:

- ◆ The EITF 01-9 treatment applies only if the exclusivity arrangement was *not* negotiated independently of the acquirer. Otherwise, it must be treated as an expense.
- ◆ In this case, the Task Force agreed that the exclusivity arrangement was not negotiated independently of the acquirer.
- ◆ Conclusion: EITF 01-9 applies to the acquirer's consolidated income statement treatment of the amortization of the arrangement, that is, it would be reported as a reduction in revenue.



EITF Issue No. 04-11:  
Accounting in a Business Combination for Deferred  
Postcontract Customer Support Revenue of a Software  
Vendor



Note: The EITF was unable to reach a consensus on this issue. The Task Force agreed to discontinue discussion of this issue and to remove it from its agenda.

The following discussion is provided for your information only. It does not constitute GAAP.



## EITF Issue No. 04-11: Accounting in a Business Combination for Deferred Postcontract Customer Support Revenue of a Software Vendor



### Scope:

- ◆ This Issue addresses the recognition of the a legal performance obligation related to PCS in a business combination but does not address the measurement of the assumed obligation at fair value.
- ◆ This Issue applies to software licensing arrangements for which the PCS element has been deferred because the related PCS services have not been performed rather than arrangements for which revenue has been deferred based on other facts and circumstances.

## EITF Issue No. 04-11: Accounting in a Business Combination for Deferred Postcontract Customer Support Revenue of a Software Vendor

### Issues:

What elements of the PCS arrangement should be considered when recognizing the fair value of PCS revenue in a business combination?

*View A-Each element (e.g. bug fixes, phone support, when-and-if available upgrades) should be evaluated separately for determining whether each element individually represents a legal obligation that should be recognized and measured at fair value.*

- ◆ Although the acquiring entity assumes a legal obligation to deliver upgrades/enhancements if they are subsequently developed, there is no legal obligation to develop the upgrades.

## EITF Issue No. 04-11: Accounting in a Business Combination for Deferred Postcontract Customer Support Revenue of a Software Vendor

- ◆ View A proponents believe that "legal obligation" as defined in the accounting literature supports the notion that an entity should not reflect future development costs and the related fulfillment margin in the fair value assigned to the deferred PCS revenue in a business combination.

*View B-The PCS arrangement in its entirety represents a single unit for purposes of assessing whether a legal obligation has been assumed.*

- ◆ View B proponents believe this view is consistent with the definition of PCS and guidance provided in paragraphs 9 and 124 of SOP 97-2.



## EITF Issue No. 04-11: Accounting in a Business Combination for Deferred Postcontract Customer Support Revenue of a Software Vendor



- ◆ Many View B proponents believe that all costs expected to be incurred (e.g. providing support services, bug fixes and costs of developing upgrades/enhancements) and the fulfillment margin thereon should be included in estimating fair value.
- ◆ Some View B supporters note that fair value of the obligation would include the acquiring entity's assessment of the likelihood of nonperformance occurring.