

MHM Messenger

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FASB Enacts Significant Changes in Revenue Recognition Guidance

At its September 23, 2009 meeting, the Financial Accounting Standards Board (FASB) ratified Emerging Issues Task Force (EITF) Issue No. 08-1, *Revenue Arrangements with Multiple Deliverables* (EITF 08-1). EITF 08-1 updates the existing multiple-element revenue arrangements guidance under EITF Issue 00-21, *Revenue Arrangements with Multiple Deliverables* (EITF 00-21). The FASB also ratified EITF Issue 09-3, *Certain Revenue Arrangements that Include Software Elements* (EITF 09-3). EITF 09-3 modifies the scope of Statement of Position No. 97-2, *Software Revenue Recognition* (SOP 97-2), to exclude certain tangible products and software components of tangible products that meet the criteria specified in EITF 09-3.

EITF Issue 08-1, Revenue Recognition with Multiple Deliverables

EITF 00-21 is the predominant guidance in determining whether an arrangement, involving multiple deliverables, contains more than one unit (deliverable) of accounting, and how the arrangement consideration should be measured and allocated among the separate units of accounting. For a delivered item to be considered a separate unit of accounting, EITF 00-21 requires that all of the following criteria be met:

1. A delivered item has value to the customer on a standalone basis;
2. There is objective and reliable evidence of the fair value of the undelivered item(s); and

3. If the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the vendor.

Vendors that were unable to separate the deliverables using the above guidance were required to defer the revenue recognition of some or all of the consideration received for these arrangements. The revised guidance provided by EITF 08-01 eliminates the second requirement that objective and reliable evidence of the fair value exists for the undelivered items in order for a delivered item to be treated as a separate unit of accounting. In addition to this change, EITF 08-01 also modifies the fair value requirements to a less onerous hierarchy that retains the old concepts of vendor specific objective evidence of fair value (VSOE) and third-party evidence (TPE) from EITF 00-21, but adds the ability to use the “best estimate of selling price” when VSOE or TPE cannot be determined. These changes eliminate the use of the residual method commonly used under EITF 00-21.

EITF Issue 09-3, Certain Revenue Arrangements that Include Software Elements

SOP 97-2 is the primary revenue recognition guidance for software arrangements. SOP 97-2 also applies to those products which contain an element of software and the software elements are more than incidental to the product, as a whole, or are essential to the functionality of any non-software elements. Given the increase of products in the marketplace containing elements of software embedded in tangible products that are essential to the functionality of the tangible product (thereby subjecting these arrangements to the accounting under SOP 97-2), and in conjunction with the FASB’s adoption of EITF 08-1 (discussed above), the FASB determined that a change was also needed to the software revenue recognition model.



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EITF 09-3 changes the scope of SOP 97-2 for non-software components of tangible products and software components of tangible products that are sold, licensed, or leased with tangible products when the software components and non-software components of the tangible product function together to deliver the tangible product's "essential functionality." This change will result in more products containing software and hardware being scoped out of the software revenue recognition rules thereby resulting in an accounting model for revenue recognition that more closely mirrors the economics of the transaction. The example below illustrates the change in revenue recognition with the new guidance.

XYZ Company manufactures telephone systems, the software component of the telephone systems is determined to be more than incidental due to the additional features the software provides. Due to the significance of the software component, the accounting for this arrangement previously was in accordance with SOP 97-2, as software. Upon adoption of the new revenue guidance XYZ Company would account for the telephone systems upon shipment provided all other revenue recognition requirements are met.

What This Means

The modification of the guidance related to multiple element arrangements and the recognition by the FASB of the impact that software is having on the accounting for many tangible products is anticipated to result in a better matching of the accounting and economics related to many transactions. We anticipate that in many situations revenue recognition will occur at an earlier point in time compared to the historical accounting practices of many companies. Both EITFs 08-1 and 09-3 are effective for fiscal years beginning June 15, 2010. Earlier adoption is permitted; however, if a Company has revenue subject to both EITFs 08-1 and 09-3, both standards must be adopted. In the coming weeks, MHM plans to publish additional in-depth guidance related to the recent changes to the revenue recognition standards.

The information in this MHM Messenger is a brief summary and may not include all the details relevant to your situation. Please contact your MHM service provider to further discuss the impact on your financial statements.