

Planning for New Revenue Recognition Standards— Governance, Communications and Disclosure Implications

FASB's ratification of new revenue recognition standards on September 23, 2009 means that companies will soon be adopting policies that in many instances will result in significantly accelerated revenue recognition on bundled sales of goods and services. The change will affect companies in industries as diverse as automobile, biotechnology, industrial equipment, information technology, manufacturing, medical device and telecommunications. Companies that sell bundled hardware, software and services may experience the largest impact.

Internal finance and accounting staff at affected companies are already working with external auditors to assimilate the new standards, reformulate revenue recognition policies, quantify the impacts and assess internal control implications. It's not too soon to be thinking through the governance, communications and disclosure implications of these changes.

Background

The accounting profession has for decades been struggling with how to recognize revenue in "multiple deliverable" transactions like the following:

- the sale of computer hardware, together with a software license and future rights to software maintenance and customer support;
- the sale of a mobile phone with a subscription contract;
- the sale of industrial equipment or consumer appliances, together with installation and maintenance services;
- the sale of medical equipment with consumables and installation; and
- a biotech license and research and development services arrangement.

Under current standards, companies that enter into multiple deliverable arrangements like these may not recognize revenue separately on *any* deliverable without objective and reliable evidence of fair value for *each* deliverable. Without such evidence, revenue must be recognized on *all* deliverables together, which can result in the aggregate revenue being either deferred entirely until all items in the arrangement are delivered or being recognized ratably over the life of the product or contract for services. (For the technically inclined, the current broadly applicable standard is set forth in [EITF Issue 00-21 \(contained in ASC 605-25\)](#), but note that there are also specialized standards, such as the standard for certain types of software transactions set forth in [SOP 97-2 \(contained in ASC 985-605\)](#).¹)

When accountants struggle, the rest of us share the pain. The conceptual complexity of these standards has created a minefield for companies, since modest changes in contractual terms or in delivery modalities can carry huge revenue and profitability implications. The result has been a virtual revenue recognition industry, in which internal finance teams and external auditors conduct painstaking analyses as to whether vendor specific objective evidence (VSOE) or other applicable standards have been met. Technological advances are further complicating the analytical framework; in the smartphone sector, for example, the emergence in recent years of devices from companies like Apple and Palm that sell with the

¹ Basic access to the Accounting Standards Codification (ASC), which contains these standards and is now the single source of authoritative U.S. GAAP, is available for free upon registration with www.fasb.org.

prospect of free software upgrades has required these companies to spread revenue ratably over a two year period rather than recognize the revenue up front.

But critics have complained that all of this effort has not improved transparency and comparability, and that in some cases the deferral of revenue effectively understates true economic value in the early periods and overstates it in the out periods. As a result many companies have resorted to reporting supplemental non-GAAP revenue measures that effectively recognize up front the entire selling price of a multiple deliverable arrangement. This approach, of course, has its own distortions.

The consequences of improper revenue recognition to companies and their executives are huge. Revenue recognition is the largest single issue involved in financial restatements, and improper recognition of multiple deliverable transactions has often been the source of restatements. Restatements can lead to forced disgorgement by executives and legal and financial personnel of compensation paid on the basis of financial results that are restated. (See our previous memo "[Beneath the Hype: Notes on Key Executive Compensation Issues](#)" discussing the growing use of "clawback" policies.) Restatements also give enforcers and plaintiffs a head start, since a restatement can be viewed as an admission of a prior material misstatement. With the SEC stepping up and streamlining its enforcement activity (224 formal orders of investigation issued in the first six months of 2009, compared to 93 over the same period in 2008²), the stakes for ensuring proper revenue recognition have never been higher.

The New Standards

The new revenue recognition standards are contained in [EITF Issue 08-1, "Revenue Arrangements with Multiple Deliverables"](#) (now contained in ASU 2009-13), and [EITF Issue 09-3, "Applicability of AICPA Statement of Position 97-2 to Certain Arrangements That Include Software Elements"](#) (now contained in ASU 2009-14). Companies will be required to adopt these standards for transactions entered into in fiscal years beginning after June 15, 2010 (the first quarter of 2011 for calendar-year companies), but early adoption is permitted.

EITF 08-1. Under EITF 08-1 (which does not apply to sales that are primarily software sales), lack of VSOE or third party evidence for each deliverable in a multiple deliverable arrangement will no longer necessarily result in deferral of the entire arrangement or ratably revenue recognition over the life of the product or services contract. Instead, revenue will be allocated among the deliverables based upon relative selling prices. Selling prices will be determined in accordance with a hierarchy that consists of VSOE (when available), third party evidence (if VSOE is not available) or management's best estimate of the standalone selling price of the deliverable (if neither VSOE nor third party evidence is available). *The key change is the ability to recognize revenue based on management's best estimates.* This means that management will have a greater ability to determine the timing of revenue recognition than under the current rules, and fewer arrangements will be significantly deferred or recognized ratably. ([Here](#) is a good summary of the new standard and how it differs from the current standard.)

EITF 09-3. Transactions that are primarily software sales are subject to a special accounting standard contained in SOP 97-2, "Software Revenue Recognition" (now contained in ASC 985-605). Under the current rules, sales of many hardware products that contain software are also subject to SOP 97-2. SOP 97-2 is even more restrictive than the current multiple deliverable revenue recognition standard because each element in a software arrangement requires VSOE. This often results, as in the smartphone case, in large portions of revenue being deferred and recognized ratably over a period of months or years.

EITF 09-3 narrows SOP 97-2 by excluding tangible products containing both software and non-software components that "function together to deliver the product's essential functionality". Examples listed in EITF 09-3 include smartphones, PDAs and computers that are sold with pre-installed software necessary

² Mary L. Schapiro, Chairman of the U.S. Securities and Exchange Commission, *Testimony Concerning SEC Oversight: Current State and Agenda*, Hearing before the H. Comm. on Financial Services (July 14, 2009).

to run the device. In the future, these kinds of sales will be excluded from SOP 97-2 and instead be subject to the more flexible EITF 08-1 standard. ([Here](#) is a good summary of the new standard.)

Investor Communications Implications

What to do now. Analysts, investors and the press are already speculating about the timing and impact of the new revenue recognition standards. Companies will want to avoid communicating quantitative information prematurely, even on an estimated basis. Until the impact of the new standards has been sufficiently vetted, the standard IR response can simply be “We’re still working through the impact and timing of the change”.

Guidance should be handled with care, especially for companies that provide guidance on both a GAAP and non-GAAP basis.

- *GAAP Guidance.* When giving GAAP guidance, companies will want to be clear that the guidance reflects *current* GAAP standards, and that the guidance would be different if determined under *new* GAAP standards.
- *Non-GAAP Guidance.* Many companies currently disclose non-GAAP revenue, billings or other measures that, in essence, treat some portion of deferred revenue as current revenue. The new standards will likely result in accelerated upfront revenue and less deferred revenue. So GAAP revenue and non-GAAP revenue measures for these companies will be closer but probably not identical. It will be prudent in these circumstances to point out that guidance being provided under a company’s existing non-GAAP practices could or would be different if determined under new GAAP standards.
- *Dispensing with Guidance.* For companies considering dispensing with the practice of issuing guidance, now might be a graceful time to do so. See our previous memo “[To Guide or Not to Guide: Communicating with Investors in Uncertain Times](#)” for further considerations on this topic.

Implementation and Transition Stages. During the transition period, companies will need to show the effect of the new standards as clearly as possible, both to enable period-over-period comparisons and to highlight short-term anomalies that could occur because the new standards will apply only to *new* transactions. This means that companies will continue to recognize deferred revenue from historical transactions while at the same time recognizing accelerated revenue on new transactions. This overlap will continue until revenue from historical transactions is fully recognized. Unless this point is highlighted, investors and analysts could misinterpret the data and make incorrect trend assumptions.

Although the new standards will require companies to provide additional qualitative and quantitative disclosure regarding the effects of the new rules in 10-K and 10-Q financial statement footnotes, the degree to which the same disclosures are made at the time of a quarterly earnings release remains to be seen. Options include (1) providing some or all the required additional disclosures in the earnings press release, (2) posting some or all the required additional disclosures on the company website in connection with the earnings call and (3) concurrently with the issuance of the earnings press release, filing the related quarterly or annual report containing the required additional disclosures.

Should you dispense with non-GAAP revenue measures? The new standards will for many companies bring GAAP and non-GAAP revenue significantly closer, which raises the question of whether companies should dispense with the non-GAAP measures altogether. In cases where the new GAAP standards will result in significantly increased up-front revenue and very little deferred revenue, it may be harder to conclude that non-GAAP revenue measures are useful to investors, particularly if management stops using non-GAAP revenue in managing the business. Companies that nonetheless continue to disclose non-GAAP revenue measures may expect renewed pressure on this point from the SEC staff, which often strongly discourages non-GAAP measures.

Supplemental quantitative disclosure. When the effect of the change in accounting standard is material, the new standards require supplemental disclosure of quantitative information to enable users to understand the effect of the change. One method would be to apply the new standards retrospectively to prior periods. Another would be to apply the old standards prospectively to current periods. Both of these methods are listed as examples of ways to satisfy the quantitative disclosure requirement. When used during the transition period, these supplemental disclosures should not be considered non-GAAP measures for purposes of the SEC's non-GAAP regulations.

Disclosure in Annual and Quarterly Reports

What to do now. Affected companies should begin disclosing FASB's recent adoption of the new standards under "Recent Accounting Pronouncements". Initially, however, the disclosure is likely to consist only of a brief summary of the new standards, the required adoption date and a statement that the company is still assessing the impact of the standards. As planning progresses, companies will begin disclosing the materiality of the impact and whether they will choose to adopt the new standards early.

Implementation and transition stages. The following sections of quarterly and annual reports may require updated disclosure.

- Notes to Financial Statements. The notes will need to include all the additional qualitative and quantitative disclosures mandated in the new revenue recognition standards.
- MD&A: "Critical Accounting Estimates": Given the potential for increased use of management estimates in determining the timing of revenue recognition, this section may require a significant overhaul for some companies. We would expect the SEC to focus on this disclosure in future comment letters. Based on [SEC guidance](#) issued in 2003, this section should focus on the degree to which management estimates determine the amount of revenue recognized in any given period, as well as the impact of and potential reasons for future changes in those estimates. The SEC strongly encourages the use of quantitative examples when reasonably available if they would provide material information to investors.
- MD&A: "Results of Operations": Discussions of period-over-period results will need to disclose the impact of the change on a qualitative and, if significant, quantitative basis. The disclosure should also caution readers about any transitional increase in revenue and earnings, the effect of which will dissipate as revenue from sales made in previous periods is fully recognized.
- Risk Factors. Some companies may choose to add risk factors that address the lack of comparability between current and previously-issued financial statements. Any existing risk factors that address revenue recognition should be reviewed for continuing accuracy and relevance.

Involving the Board

Audit Committee. Audit committees should be involved early and continually as management works through the financial reporting and disclosure implications of the new standards. This is especially true in light of the increased role for management judgment. As planning progresses, it will also be appropriate to brief the Audit Committee on any required changes to accounting systems and internal controls.

Compensation Committee. Compensation committees should be thinking about the effect of the new standards on employee and management bonus and other incentive arrangements, since revenue and profitability-based targets may need to be reset. This may be especially complex in the case of multi-year schemes that may straddle the adoption date of the new standards.

Contract Review

Now is also a good time to consider whether the revised revenue recognition standards will affect revenue and profitability-based measures determined “in accordance with GAAP” in contractual provisions like earnouts and financial covenants. The answer will depend upon whether “in accordance with GAAP” is determined on the basis of GAAP in effect at the time of the agreement or as in effect from time to time; in some cases the contract will be silent. Implications of a change in rights and obligations range from outdated contractual obligations disclosure in SEC reports to increased payment obligations or expanded borrowing capacity.

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