// The Issue

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BEWARE THE PITFALLS OF REVENUE ACCOUNTING

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Revenue, or the top line, is the major driver of business and is one of the factors used as a basis for sizing an enterprise. The concept of revenue is simple. It is the amount received when a product or service is delivered. However, complications arise when the product and / or payment is delivered piecemeal, or over time. For example, subscriptions or service agreements are paid in advance, with the revenue is recognized over the appropriate time period. In instances where there is a right of return, a portion of the revenue may have to be deferred.

Revenue is generally realized or realizable and earned when the following criteria are met:

- There is persuasive evidence that an arrangement exists
- Delivery has occurred, or services have been rendered
- The price is fixed, or determinable, and
- Collectability is reasonable assured.

The accounting literature[i] contains detailed discussions and examples for each of the above requirements. Additionally, there are industry specific criteria for the financial services, entertainment, and other industries, such as airlines, contractors, real estate, franchises and software.
Contracts which provide for a bundling of products and services, which may be delivered at different times or over different periods, are known as multiple element arrangements. Examples of multiple element arrangements include:

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- Equipment sold with installation and servicing
- Product sales sold with consulting services
- Audit and tax services sold for a packaged price
- Automobiles sold with service contracts
- Sale of equipment with supplies
- License of IP along with the sale of associated manufacturing devices

Recent guidance[ii] has been issued relating to the recognition of revenue where there are multiple deliverables. A deliverable can be a product, a service, the right to use assets, or even a significant discount on future purchases. This is particularly pertinent to those of us in the technology and software industries. These transactions occur when products are bundled, or sold as systems, many times at a discount. The methodology allocates a portion of the sales price, and any discount to each element, with revenue for each element recognized when earned. This is accomplished by assigning fair value[iii] (best estimate for non software, and specific company / industry history for software), and allocating the bundled price to each element. An example where some elements are accounted for by using the general rules and some by using the software rules follows:

> Your company sells a computer related product that includes an operating system, a software application (email, contact manager) and a one year support package for $10,000. Estimated sales prices and the sources for each component are:

Element	Estimated Selling Price	Source
Computer and operating system	$ 6,500	Best estimated selling price (“BSP”)
Application software and one year support	4,000	Vendor specific objective evidence (“VSOE”) support at 15% of selling price
Support for operating system	500	BSP, since considered part of computer
TOTAL	$11,000	

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In order to determine the accounting treatment for each element, we first have to separate the software products from the non-software products by allocating according to their relative selling prices as follows:

Element	Calculation to Allocate Revenue Among Elements	Relative Selling Price	Revenue Recognized
Non-Software:			
Computer and OS	($6,500 / $11,000) x $10,000	$5,909	Upon Shipment
OS Support	($500 / $11,000) x $10,000	455	Deferred with $37.88 per month recognized over 12 months
Non-Software revenue		$6,464	
Software Revenue	($4,000 / $11,000) x $10,000	3,636	
Revenue to be allocated		$10,000	

We finally have to allocate revenue among its software elements by splitting the software related revenue into the price for the product, and the post contract support by using VSOE for the software support contract, as required by software accounting rules:

Element	Calculation to Allocate Revenue Among Elements	Allocated Revenue	Revenue Recognized
Software:			
Application Software	$3,636 x (1 – 15%)	$3,091	Recognized upon shipment or acceptance
Software Support	$3,091 x 15%	545	Deferred with $45.45 per month recognized over 12 months
Total Software revenue recognized		$3,636	

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As seen in the above simple example, revenue accounting can be complex, with $9,000 able to be recognized upon shipment, with the remaining $1,000 recognized ratably over the 12 month period as earned.

Improper revenue accounting has reduced valuations for many M&A and IPO transactions causing them to be delayed or cancelled. For example, Groupon had to reduce the revenue included in its registration statement filed with the SEC by more than 50% (greater than $400 million for 2010) for the three years reported. As a result of this restatement and several other well-publicized issues, Groupon's IPO has been deferred, and the estimated valuation reduced from up to $30 billion, to $11+ billion.

As part of the convergence of US and International accounting standards, the respective boards are in the process of replacing the labyrinth of existing revenue guidance with a new global accounting standard that will apply to all revenue transactions, regardless of industry.

The above discussion relates to accounting for revenue for under Generally Accepted Accounting Principles (GAAP) for US companies only, and does not apply to tax, international, governmental or not-for profit accounting.

There are many software products that claim to account for revenue. Some also claim to consider accounting for software revenue. A major software company recently announced completely compliant engine for software revenue recognition that would interface with the major Enterprise Reporting and Planning (ERP) systems, such as Oracle and SAP.

Endnotes

[i] The single source of authoritative nongovernmental U.S. generally accepted accounting principles (US GAAP) is the Accounting Standards Codification, published by the Financial Accounting Standards Board. The Codification was effective for interim and annual periods ending after September 15, 2009.

[ii] ASU 2009-13 Topic (605) applies to arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted (must be adopted retrospectively to at least the beginning of the fiscal year of adoption)

[iii] Fair value is determined by one of three methods in descending hierarchal order:

- Vendor specific objective evidence ("VSOE")
- Third party evidence ("TPE")
- Best estimated Sales Price ("BSP")

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Summary

As we have demonstrated above, Revenue Recognition is a complex accounting area, with implications that impact earnings, valuations, and the timing of M&A and IPO transactions. It is essential to employ the services of an expert, if your company engages in multiple element arrangements.

Please contact Chuck or one of the CFOs2GO partners listed in this Newsletter for assistance with your revenue recognition issues, as well as other accounting matters.✍

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