

FASB Emerging Issues Task Force

Issue No. 09-3

Title: Applicability of SOP 97-2 to Certain Arrangements That Include Software Elements

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References:

FASB Statement No. 13, *Accounting for Leases* (Statement 13)

AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* (SOP 81-1)

AICPA Statement of Position 91-1, *Software Revenue Recognition* (SOP 91-1)

AICPA Statement of Position 97-2, *Software Revenue Recognition* (SOP 97-2)

SEC Staff Accounting Bulletin No. 104, Topic 13, *Revenue Recognition* (SAB Topic 13)

International Accounting Standard 18, *Revenue* (IAS 18)

EITF Issue No. 00-3, "Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware" (Issue 00-3)

EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables" (Issue 00-21)

EITF Issue No. 03-5, "Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software" (Issue 03-5)

EITF Issue No. 08-1, "Revenue Arrangements with Multiple Deliverables" (Issue 08-1)

*** The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

Background

1. At the November 13, 2008 EITF meeting, the Task Force reached a consensus-for-exposure on Issue 08-1 that would modify Issue 00-21 to require an entity to use its best estimate of selling price for the undelivered item(s) in an arrangement in situations in which vendor-specific objective evidence (VSOE) or third-party evidence (TPE) is not available. The Task Force reached a consensus-for-exposure that the scope of Issue 08-1 should be the same as the scope of Issue 00-21 and that the scope should not be expanded to include deliverables within the scope of SOP 97-2. The Task Force also recommended to the FASB Chairman that a separate Issue be added to the EITF agenda to consider changes to the accounting for multiple element arrangements under SOP 97-2. The FASB Chairman, who was present at the meeting, considered the Task Force recommendation and input from other Board members also in attendance, and decided to add the project to the EITF agenda. The Task Force noted that it would be preferable if any amendments arising from future Task Force deliberations on SOP 97-2 were to have an effective date that is consistent with Issue 08-1.

Prior EITF Discussion

2. At the March 19, 2009 meeting, the Task Force reached a tentative consensus that this Issue should focus on amending the scope of SOP 97-2. The Task Force reached a tentative conclusion that SOP 97-2 and Issue 03-5 should be modified such that the following products would be considered non-software deliverables and therefore excluded from the scope of SOP 97-2:

Tangible products containing software components and non-software components that function together to deliver the product's essential functionality.

This tentative conclusion results in the increased separability of deliverables into separate units of accounting. The Task Force discussed the application of the scope modification to various arrangements, such as when the software could be sold separately from the hardware and when alternative software was available that would provide similar functionality. The Task Force also discussed whether and how to require that software be separated into those components that were essential to the product's functionality and those that were not. The Task Force requested that the FASB staff prepare illustrative examples of how the proposed scope amendment would be

applied to transactions currently accounted for in accordance with SOP 97-2 for discussion at a future meeting.

Scope

3. This Issue applies to arrangements that include the sale of tangible products that are within the scope of SOP 97-2.

Current EITF Discussion

Assumptions Used in Examples

4. Appendix 09-0A to this Issue Summary Supplement provides the staff's analysis of how it believes the tentative consensus would be applied to various transaction scenarios. The staff made the following assumptions in applying the tentative consensus to the examples by interpreting what the Task Force intended by "the product's essential functionality."

Assumption 1 - Software that is always included on a tangible product would be considered essential to the product's functionality.

5. This assumption is illustrated in Examples 1 – 1d. The staff believes that applying the scope exception means that the hardware element of a software enabled product along with the software that is necessary to deliver the product's essential functionality would together be considered non-software deliverables and excluded from the scope of SOP 97-2. The staff believes that it would be rare that the hardware on a tangible product would not be considered essential in delivering the product's functionality. Therefore, the focus in the examples is on determining which software on the device is essential to the product's functionality. The conclusions in the examples are based on the premise that the software would be considered essential in delivering the product's functionality if the software is always included on the product, that is, the vendor does not sell the product without the software. Some products serve only one primary function, in which case it may not be difficult to determine what software is essential to the product's functionality. However, many products frequently provide various functions and determining what software is necessary to provide the product's essential

functionality can be quite subjective and require knowledge of customer intention, which many times will be unknown.

6. A customer generally has choices on which product it wishes to purchase. Some of the factors that affect a customer's purchasing decision include price, functionality, aesthetics, and branding amongst others. Each customer is different and certain aspects of the product are more important to some customers than they are to others. The staff believes that a vendor cannot be expected to determine essential to the functionality for each individual customer and that the determination of essential to the functionality is better assessed from the standpoint of the vendor (which is consistent with the guidance of SOP 97-2 and Issue 08-1 for the determination of VSOE and selling price, respectively). If inclusion of the software on the product is optional, then that would imply that the vendor does not consider it to be essential in delivering its product's functionality. However, if the vendor always includes the software on the product, the vendor must have determined that the software was essential to delivering the functionality it intended the product to provide. The vendor may have various reasons for including the software such as product differentiation or competitive advantage.

Assumption 2 – Whether the vendor sells the software separately is not relevant in determining whether the software is essential to delivering the product's functionality.

7. This assumption is illustrated in Example 2. The tentative conclusion was based on the premise that a tangible product contains hardware and software that work together in delivering the product's essential functionality. The fact that the vendor may also sell the software on a stand-alone basis in separate transactions is not relevant in determining whether the software is necessary to deliver the combined products' essential functionality. For example, assume that a vendor sells devices that require an operating system to function and the vendor always includes the operating system on the device. The vendor may also sell the operating system separately as a customer upgrade to operating systems on prior devices. The vendor may have also configured the operating system so that it will also function on its competitors' products. The vendor's business decision to sell the software product separately does not determine whether or not the operating system is necessary for the device to function, which is the focus of this Issue.

Assumption 3 – Undelivered software elements (that is, post customer support (PCS) and specified software upgrades) that relate to essential software on a device that is a non-software deliverable would also be considered to be a non-software deliverable and outside of the scope of SOP 97-2.

8. This assumption is illustrated in Example 3. This assumption is consistent with existing accounting when software is considered incidental to the arrangement and the combined product is not within the scope of SOP 97-2. An alternative view is that undelivered software elements, such as specified upgrades and PCS, should be viewed as software elements to which SOP 97-2 should apply. Because the specified software upgrades and PCS are not being delivered at the same time as the related hardware, they should not be considered essential to the functionality of the original product. This alternative view would result in the vendor allocating the transaction price to the tangible product (including essential software) and any undelivered software elements. This allocation is necessary in order to determine how much consideration is subject to other literature, such as SAB 104 or Issue 00-21, and how much is subject to SOP 97-2. The allocation would be based on VSOE of each of the elements if it existed. If VSOE was not present, the vendor would be required to use either TPE or its best estimate to allocate the transaction price to the elements.

9. Assuming VSOE exists for each of the SOP 97-2 elements, revenue recognition should be substantially the same regardless of whether the specified upgrade rights or PCS is within the scope of SOP 97-2. Assume that a specified software upgrade and PCS are present. Revenue for the combined product would be recognized upon delivery (assuming other revenue recognition criteria are met). Revenue would be recognized for the specified upgrade when that upgrade was delivered (assuming all other revenue recognition criteria are met) and revenue would be recognized for PCS over the PCS period. If the only element scoped into SOP 97-2 was PCS (that is, specified software upgrade rights did not exist), then the same answer would result even if VSOE did not exist for the PCS. Assume, however, that VSOE does not exist for the specified upgrade right or PCS. In that situation, the vendor would not be able to begin recognizing revenue for the amount allocated to the specified software upgrade right and PCS until the

specified upgrade was delivered (that is because the specified upgrade right cannot be separated from PCS in this situation under SOP 97-2).

10. The staff believes that requiring two accounting models to be applied in those situations would lead to unnecessary complexity, particularly when the same accounting answer may result many times. If two models were required, an entity would be required to estimate the prices of the undelivered elements in order to allocate revenue to the delivered device, which would then be recognized in accordance with other revenue recognition guidance, presumably upon delivery, if all other requirements have been met. The staff notes that one of the primary reasons in SOP 97-2 for requiring deferral of revenue associated with delivered elements when VSOE is not present for the undelivered elements is that there was concern that a reasonable estimate of selling price could not be determined for the undelivered elements. Given that this conclusion would result in revenue being recognized for the delivered product, the staff sees little benefit in still requiring those undelivered elements to be subject to a different model than the delivered product to which they relate.

Assumption 4 – The sale of software separate from a transaction including a tangible product would be subject to SOP 97-2 even if that software would have been considered essential to the functionality of a tangible product if sold with that product.

11. This assumption is illustrated in Example 4. The rationale behind this assumption is that the scope of this Issue is focused on whether the sale of a tangible product that includes essential software should be outside the scope of SOP 97-2, while a stand-alone transaction of software is within the scope of SOP 97-2. The staff recognizes that this could potentially lead to inconsistencies in revenue recognition if a vendor does not have VSOE of selling price for all elements within a software transaction; however, the staff believes that this conclusion is inevitable given the Task Force's decision not to broadly modify the measurement criteria within SOP 97-2.

Assumption 5 – If an undelivered element relates to both a software element and a non-software element, that undelivered element needs to be bifurcated into both a software element and a non-software element.

12. Example 5 illustrates this assumption. The staff believes that the only other manner in which to address these situations is to associate the undelivered element with either the delivered software element or the non-software element. Such an approach would likely require development of factors to assist in determining whether the undelivered element is more closely associated with the software element or the non-software element, which the staff believes may still be arbitrary and difficult to apply.

Assumption 6 – Software need not be embedded on a device to be considered essential to delivering the product's functionality.

13. Example 6 illustrates this example. The rationale for this conclusion is that the focus of this Issue is on products that require both hardware and software in order to deliver the products' essential functionality. The staff does not believe the manner in which the vendor delivers the product should impact this assessment. If both the hardware and software are sold as an integrated package and are both necessary in delivering the product's essential functionality, then both the hardware and software elements would be considered non-software elements outside of the scope of SOP 97-2.

Questions for the Task Force

14. At the June 19, 2009 EITF meeting, the Task Force will be asked whether it agrees with the staff's application of the tentative conclusion to the examples provided. The staff believes that if Task Force members do not agree with the recommendations, it is likely because they have a different view of what is considered essential to a product's functionality and disagree with one or more of the assumptions made by the staff in responding to the examples. The Task Force will therefore be asked the following questions relating to the staff's interpretation of the scope exception and each of the examples in order to further explore the Task Force's intention of how this Issue should be applied.

Question 1 – Does the Task Force agree with the staff's interpretation that software always included on a product would be considered essential to a product's functionality? If the answer to this question is no, Task Force members will be asked to provide examples of situations in which software is always included with a product sale and the Task Force does not believe the software should be considered essential to its functionality.

Question 2 – Does the Task Force agree that the fact that the software is sold separately is not relevant in determining whether the software is essential to a tangible product's functionality?

Question 3 – Does the Task Force agree that undelivered software elements that relate to essential software on a device that is a non-software deliverable would also be considered to be a non-software deliverable and outside of the scope of SOP 97-2?

Question 4 – Does the Task Force agree that the sale of software separate from a transaction including a tangible product would be subject to SOP 97-2 even if that software would have been considered essential to the functionality of the tangible product if sold with that product?

Question 5 – Does the Task Force agree that if an undelivered element relates to both a software element and a non-software element, the undelivered element needs to be bifurcated into both a software element and a non-software element?

Question 6 – Does the Task Force agree that software need not be embedded on a device to be considered essential to delivering the product's functionality?

Question 7 – After consideration of the Task Force's answers to Questions 1 through 6, does the Task Force wish to modify the draft abstract to provide additional clarification to the meaning of "essential to the functionality"?

Question 8 – Should the examples in Appendix 09-03A be included in a draft abstract? Are there additional examples that should be included in order to provide clarity to the scope modification?

Disclosures

15. The staff does not believe that any additional disclosures other than those required under Issue 08-1 would be required for this Issue. The qualitative or quantitative disclosures required for multiple element arrangements would be similarly applicable to arrangements affected by this Issue. If a multiple element arrangement is still accounted for entirely within the scope of SOP 97-2, then no additional disclosures would be required since there is no change in accounting for those arrangements.

Transition and Effective Date

16. The staff believes that the transition method for this Issue should be consistent with that of Issue 08-1. That is, it would be effective on a prospective basis for all arrangements entered into or materially modified subsequent to the effective date. The staff also recommends that the effective date be consistent with those in a final consensus for Issue 08-1.

Appendix 09-03A

APPLICATION OF THE TENTATIVE CONCLUSION

This appendix includes the staff's analysis of how the tentative conclusion reached by the Task Force at the March 19, 2009 meeting would be applied in various situations.

Example 1 – Computer

The purpose of this example is to illustrate how the tentative consensus would be applied to software that is always included on a tangible product (Staff Assumption 1) and when that software is not sold separately. Because all elements in the arrangement are delivered at the same time and there are no undelivered elements in the arrangement, revenue recognition would most likely be the same for the elements whether or not the software is scoped out of SOP 97-2. However, the purpose of this example is to illustrate the basic concept of essential to the functionality.

Facts

Vendor sells a personal computer that includes an operating system that, along with the hardware, provides the basic functionality of a personal computer including the ability to manage the computer and its hardware functions, the ability to manage and interact with a range of hardware peripherals, and the ability to communicate through a variety of types of computer networks. There are no undelivered elements in this arrangement. The vendor never sells the personal computer without the operating system and never sells the operating system for the personal computer separately.

Response

Because both the hardware and operating system are necessary to deliver the computer's essential functionality, all deliverables would be excluded from the scope of SOP 97-2.

Example 1a – Computer – Operating System Not Always Included

The purpose of this example is to illustrate how this tentative conclusion would be applied when the vendor sells the same product with and without software.

Facts

Consider the same fact pattern as in Example 1, except that the vendor also sells the personal computer without an operating system.

Response

Because the vendor sells the personal computer without an operating system, the operating system does not meet the criteria of always being included on the tangible product. Therefore, the computer would be outside the scope of SOP 97-2 and the operating system would be within the scope of SOP 97-2. This conclusion may result in the same arrangement being accounted for differently by various vendors depending on whether or not the personal computer is ever sold on a stand-alone basis.

Example 1b – Computer – Multiple Operating Systems

The purpose of this example is to illustrate how the tentative consensus would be applied when a tangible product always includes software that performs a particular function but the vendor sells multiple versions of the software such that the product does not always include the same software package.

Facts

Consider the same fact pattern as in Example 1 except that the vendor also sells the personal computer with a different operating system. The different operating system provides essentially the same functionality as the operating system included in Example 1.

Response

The hardware and an operating system are necessary to deliver the computer's essential functionality. All deliverables would be excluded from the scope of SOP 97-2. The fact that the

vendor sometimes sells the product with different operating systems does not affect the conclusion that both the computer and an operating system are necessary to provide the computer's essential functionality

Example 1c – Computer with Additional Software Products

The purpose of this example is to illustrate how the tentative consensus would be applied to software that is always included on a tangible product (Staff Assumption 1) and when additional software products are present.

Facts

Assume the same fact pattern as in Example 1 except that the vendor includes a productivity software bundle with the personal computer that allows users to create, edit, and use documents, spreadsheets, and presentations. The vendor sells the same computer with and without the productivity software. When the productivity software is included with the software, the functionality of the productivity software is prominently displayed in the marketing materials and specifications of the computer. The productivity software is also sold separately.

Response

The productivity software would not be considered necessary for the computer to provide its essential functionality. The personal computer's purpose is to allow a user to access and use various software programs and hardware peripherals. The productivity software is one type of software that is able to be used on the computer but is not always included on the computer. While the operating system is essential to deliver the personal computer's basic functionality, the productivity software is not. This is further demonstrated by the fact that the computer is sold with and without the productivity software.

Example 1d – Personal Data Assistant

The purpose of this example is to illustrate how the tentative consensus would be applied when software is always included on a tangible product (Staff Assumption 1) and when certain of the software components are sold separately. Because all elements in the arrangement are delivered at the same time and there are no undelivered elements in the arrangement, revenue recognition

would most likely be the same for the elements whether or not the software is scoped out of SOP 97-2. However, the purpose of this example is to illustrate the basic concept of essential to the functionality.

Facts

Vendor sells a personal data assistant (PDA). The PDA provides several functions, such as phone, camera, and computer functionality, that allow the user to access and use various software programs, such as e-mail and games. The PDA contains an operating system that allows the customer to access the functionality of the device including the ability to utilize software that is necessary to provide the phone, camera, and other functionality. The phone and camera software is always included on the PDA but the e-mail and game software are not always included. The phone, camera, and e-mail software are not sold separately but the game software is sold separately.

Response

The PDA device, operating system, phone, and camera software are considered non-software deliverables since they are always included on the PDA. The e-mail and game software are considered software deliverables within the scope of SOP 97-2 since they are not always included on the device. Whether the software is sold separately is not a consideration in the conclusion.

Example 2 – Computer, Operating System Sold Separately

The purpose of this example is to illustrate how the tentative conclusion would be applied to software that is always included on a tangible product and when that software is sold separately (Staff Assumption 2). Because all elements in the arrangement are delivered at the same time and there are no undelivered elements in the arrangement, revenue recognition would most likely be the same for the elements whether or not the software is scoped out of SOP 97-2. However, the purpose of this example is to illustrate the basic concept of essential to the functionality.

Facts

Vendor sells a personal computer that includes an operating system that, along with the hardware, provides the basic functionality of a personal computer including the ability to manage the computer and its hardware functions, the ability to manage and interact with a range of hardware peripherals, and the ability to communicate through a variety of types of computer networks. There are no undelivered elements in this arrangement. The vendor never sells the personal computer without the operating system but *does* sell the operating system for the personal computer separately. The personal computer hardware cannot function without an operating system and the operating system does not function without the computer hardware.

Response

The same accounting would result as in Example 1 since the vendor determines that the operating system is necessary to deliver the computer's essential functionality. Accordingly, the computer and operating system would not be within the scope of SOP 97-2. Whether the software is sold separately in a different transaction does not impact the assessment under this Issue. The critical assessment is whether the computer and the operating system in one transaction are both necessary to provide the computer's essential functionality.

Example 3 – Computer – Undelivered Software Elements

The purpose of this example is to illustrate how the tentative conclusion would be applied to software that is always included on a tangible product and when undelivered software elements are present in the transaction (Staff Assumption 3).

Facts

Consider the same fact pattern as in Example 1 except that the vendor also provides a specified upgrade right for the next version of its operating system along with PCS, including when and if available upgrades of the operating system.

Response

Because both the hardware and operating system are necessary to deliver the computer's essential

functionality, all deliverables would be excluded from the scope of SOP 97-2. Since the combined deliverable (computer and software) are determined to be non-software and excluded from the scope of SOP 97-2, all deliverables related to that combined product are also considered non-software and excluded from the scope of SOP 97-2.

Example 4 – Stand-Alone Sale of an Operating System

The purpose of this example is to illustrate how the tentative conclusion would be applied in a stand-alone software sale when the software would be considered essential to the functionality of a personal computer if it were sold with the computer (Staff Assumption 4).

Facts

Vendor releases a new upgraded version of its computer operating system. The vendor sells the upgraded operating system in a stand-alone transaction to a customer that had previously purchased a computer that contained the vendor's prior operating system version. The vendor now includes the upgraded operating system on all of its computers and the combined products are considered non-software deliverables and excluded from the scope of SOP 97-2 when applying this Issue.

Response

The separate sale of the operating system would be within the scope of SOP 97-2. Even though this software would be considered a non-software deliverable if it were sold with the computer, the scope exception only applies to a tangible product and its essential software. The scope exception would not apply in this situation since the customer is not purchasing the computer.

Example 5 – Computer with Non-Essential Software and PCS

The purpose of this example is to illustrate how the tentative conclusion would be applied to software that is always included on a tangible product and when an undelivered element relates to both an element within the scope of SOP 97-2 and an element outside the scope of SOP 97-2 (Staff Assumption 5).

Facts

Assume the same fact pattern as in Example 1 except that the vendor includes a productivity software bundle with the personal computer and the vendor provides PCS for both the computer (including the operating system) and productivity software. The vendor sells the same computer with and without the productivity software. When the productivity software is included with the software, the functionality of the productivity software is prominently displayed in the marketing materials and specifications of the computer. The productivity software is also sold separately.

Response

The combined computer and operating system product are considered non-software deliverables and the productivity software is considered a software deliverable consistent with Example 1c. Because the PCS relates to deliverables within the scope of SOP 97-2 and deliverables outside the scope of SOP 97-2 it must be bifurcated into software and non-software related components. PCS relating to the productivity software would be within the scope of SOP 97-2. PCS relating to the computer (including the operating system) would be outside the scope of SOP 97-2.

Example 6 – Networking Equipment

The purpose of this example is to illustrate how the tentative conclusion would be applied to software that is always included with the sale of a tangible product and when the essential software is not embedded within the tangible product but is provided separately (Staff Assumption 6).

Facts

Vendor sells networking equipment that provides its customers, energy companies, with the ability to remotely monitor and manage their customers' energy usage. The vendor sells an integrated package of equipment and software that consists of a monitoring device that is placed at the energy company's customer location to collect data which it then relays back to the energy company's remote location, and software that allows the energy company to analyze the data and interface with its billing system. The software is installed on the energy company's computer system, which is not purchased from the vendor. The software does not have functionality

without the equipment. The vendor's customers will initially purchase all of these components together; however, they can also separately purchase replacement or expansion equipment or updated versions of the software at a subsequent time.

Response

The equipment and software would all be considered non-software elements outside of the scope of SOP 97-2. The essential functionality of the monitoring and relay equipment is to allow the energy company to access and analyze its customer's usage data. The vendor cannot access the functionality of the equipment without the software. Although the vendor does sell the equipment separately without the software, it only does so in replacement situations or as the customer base of the energy company expands. The customer would have needed to acquire the software previously in order for the replacement equipment to function. This conclusion is unaffected by the fact that the vendor sells update versions of the software separately.