Bundled Products and Revenue Recognition

New FASB Ruling Overview

by Kelley Wall, CPA, RoseRyan

In September 2009, the Financial Accounting Standards Board (FASB) approved changes to the way many high tech companies, including Cisco, Apple and Tivo, will recognize revenue.

The change in accounting rules will shift how companies recognize revenue, and the new rules will impact companies that sell a bundle of products and services that are not delivered all at once.

The new rules will not apply to a “pure” software company—ones that only sell software and software-related products. These kinds of software companies will still have to follow prior guidance, which often requires revenue recognition to be deferred and recognized over a longer period of time.

What’s the impact to a company’s financial results?

- The rule changes won’t increase a company’s overall revenue. Total revenue associated with a transaction will not change, only the fiscal quarters in which a company recognizes this revenue will change. However, under the new rules, it is likely that more revenue will be recognized up front, in the quarter the sales transaction occurred.

- Revenues will increase upon adoption, because more revenue will likely be realized up front in the quarter of the sales transaction; upon adoption of these new rules, you’ll see a spike in the company’s revenue. The required effective date is not until 2011 for a calendar-year company, but most companies are eager to early adopt.

- Revenues will be more volatile. The existing revenue recognition rules can require companies to defer more revenue or recognize it evenly over say a 12-month period. This can “smooth” top-line results. With more revenue recognized in the quarter of the sales transaction, we’re likely to see more volatility in the revenue line and overall operating results, and quarters with high or low sales volume will be more evident.

Why are companies excited about these changes?

- Revenue recognition will better match the substance of a transaction. Companies will be able to estimate the value of the various elements in their “bundled” arrangement and recognize them as they’re delivered. Previously, companies had rigorous guidelines to follow in determining the fair value of the elements or revenue was deferred or recognized ratably, which often didn’t follow the substance of what/when the company delivered.

- The rule changes may mean a change in business practice, which could drive up revenue. Under previous guidance, in order to avoid deferring large amounts of revenue, companies needed to be
extra careful in how they structured deals with their customers. Under the new guidance, they can focus more on what the customer wants and potentially bundle more products and services in a single sales transaction, without the same risks of deferral. Sales people everywhere should breathe a sigh of relief!

• They can be more competitive on a global basis. International Financial Reporting Standards (IFRS), which has been (or is in process of being) adopted by every major capital market except the U.S. currently, provides less stringent revenue recognition guidance than what was previously allowed under U.S. GAAP. This meant that international competitors could more freely negotiate contracts with customers without the same risk of deferred revenue issues we encounter under U.S. accounting standards. The new rule changes help level the playing field.

What’s the catch?
There is no catch, but there will certainly be some challenges, both from a company standpoint and a market standpoint.

• Internally, companies have a lot of work ahead. Just to name a few examples, the change in methodology will mean updating accounting policies, accounting systems and internal controls; preparing for extensive footnote disclosures in the financial statements; and possibly a review of sales compensation structures and debt covenants; significant consideration will be needed concerning investor information/education.

• Revenue trends will be disrupted. Most companies will adopt the new rules on a “prospective basis” meaning that the current year results will be under the new guidance, but the previous 2 years reported will be under the old guidance.

• Industry data will lack comparison. Companies can early adopt the new FASB ruling or wait until it’s mandatory. Then, there’s the various fiscal years that will drive different adoption dates. In addition, companies can adopt prospectively or, if they choose, retrospectively by restating prior year financial statements. So, given these variables, one company in a market sector might look like it’s doing better than another, but only because they early adopted the new guidance.

About Kelley Wall:
Kelley Wall is a senior consultant for RoseRyan with more than 15 years of experience in finance and accounting. She provides technical accounting and SEC expertise to her clients, both public and private companies, and acts as a technical resource for RoseRyan.

Kelley has significant experience in mergers and acquisitions (key player in Symantec’s acquisition of Veritas) and has provided hands-on leadership in assisting clients with IPOs. She has extensive SEC reporting experience and regularly advises clients on the interpretation and implementation of new accounting pronouncements as well as existing GAAP.

Kelley joined RoseRyan’s finance dream team in 2005. Prior to her consulting career, she held a number of management roles at Adaptec and Symantec involving SEC reporting, technical accounting and stock administration. Kelley began her career at Price Waterhouse, now PricewaterhouseCoopers, later returning to PwC as a senior manager in their national office.

She is a CPA and holds a BS degree in accounting from Santa Clara University. Kelley also has a certification in International Financial Reporting Standards (IFRS) from the Institute of Chartered Accountants in England and Wales. You can e-mail Kelley at kwall@roseryan.com.