

Deal Flash!*

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Software revenue recognition rules could affect deals in other sectors

Whether installed on a PC, embedded on a semiconductor chip that runs the latest electronic gadget, or preinstalled as part of a network router, software is becoming a more critical component of many products and services. As this occurs, companies may have to change their revenue recognition policies, moving from principles outlined in SAB 101 to those required for software companies in SOP 97-2. This could have a significant impact on a company's financial statements, as well as on certain acquisitions because:

- *A target may have accounted for revenue incorrectly, distorting historical operating results and requiring a potential restatement; or*
- *A target's products or services may be evolving in a way that will make software more critical in the future, triggering a required change in accounting treatment that could have a material impact on its financial projections.*

Technology companies outside the software sector—especially manufacturers of medical devices and networking equipment—will be particularly affected by such a change in revenue recognition accounting principles.

How hard can it be to recognize revenue? As accounting rules struggle to keep pace with evolving technologies and advanced business models, companies remain under pressure to ensure compliance and transparency. Since Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements* (SAB 101), was issued in 1999, the SEC has increasingly scrutinized the revenue recognition practices of public companies.

In recent remarks, the SEC staff has reminded companies that “changes in circumstances or contractual provisions must be constantly considered in determining whether revenue recognition policies are still appropriate.”¹ As software embedded in products or used to deliver services evolves, a company may no longer be able to assume the software is incidental to those products or services.

Why should dealmakers be concerned about this? There are two main reasons. First, an acquisition candidate who has accounted for revenue incorrectly may have distorted historical operating results and could potentially have to restate earnings. Second, as software becomes more critical to the functionality or marketability of more and more products or services, some companies outside the software industry will have to adopt the revenue recognition policies of the software industry, which could have a material impact on their financial projections.

In recent years, several large technology companies that are generally considered software companies have had to migrate

from SAB 101 and apply the revenue recognition policies of software companies as specified in AICPA Statement of Position 97-2, *Software Revenue Recognition* (SOP 97-2). This may be required when embedded software gives a high-end network router or medical device its cutting-edge features, or functionality becomes the key factor that distinguishes it from the competition and keeps customers coming back.

While there is some similarity between SAB 101 and SOP 97-2, there are also some significant differences, such as the treatment of sales arrangements that contain multiple elements. Changing revenue recognition accounting policies could affect a company's historical and projected earnings, with a potentially significant and adverse impact on enterprise value and future exit multiples.

SOP 97-2 could have dramatic consequences for future revenue and earnings, with an adverse impact on enterprise value and potential exit multiples.

For example, network equipment companies—particularly those selling to communications carriers—frequently find that their products must be customized to function on a carrier's networks, and typically include future functionality requirements in their master purchase agreements. Under software accounting rules, all revenue derived from deliverables that enable future functionality may require deferral until that functionality is delivered.

¹ Remarks before the 2004 AICPA National Conference on Current SEC and PCAOB Developments (Tony Lopez)

Although this is a developing area with varying industry practices, it is vital that deal principals determine whether an acquisition candidate is applying the appropriate accounting guidance for recognizing revenue, especially when the target makes leading-edge, technology-enabled products. Since SOP 97-2 does not apply to products and services whose software is incidental to their overall functionality,² deal professionals should ask the following questions to determine whether software could be considered more-than-incidental to the target's product or service:

- Is the target's software or its specific features or functionality prominently featured in marketing and advertising for the product or service?
- Is the software sold separately from the product or service?
- Does the target incur significant software development or related costs?
- Are customers required to provide dedicated IT support to maintain and troubleshoot the underlying software as part of the sales agreement?
- Does the target provide customers with post-contract software support?

Although the SEC staff has advised companies not to regard the 'more-than-incidental' criteria too proscriptively, answers to these questions may indicate whether software is vital to the target's products or services, or is becoming more important.

A recent survey confirms just how complex the application of software revenue recognition rules can be. Of financial restatements by software companies in the last five years, 47 percent were due to revenue recognition irregularities.³ But migrating to the software accounting model can be very painful. Extended warranty services sold by hardware companies are typically one to five percent of the product price, while software maintenance contracts are typically 15 to 20 percent. Switching

to an accounting model that might delay the recognition of these revenues could thus have a dramatic effect on a company's EBITDA run rates. Not surprisingly, some companies have resisted the transition.

Two examples illustrate the impact a change in accounting policies could have on a potential transaction. In the first, a private equity firm was looking to acquire the server manufacturing unit of a network equipment company. During diligence, questions arose as to whether software was more than incidental to the overall product offering. When this was confirmed, the rules required the target to substantiate and segregate the fair value of the product's software and maintenance elements (which is more difficult under SOP 97-2). Because the target could not provide sufficient evidence, it was required to recognize all product revenue ratably over the maintenance period. This had a significant adverse impact on the target's profit projections.

The second example involves the proposed merger of two publicly held network equipment companies. During due diligence, it became evident that the features differentiating one of the company's products were increasingly attributable to software. After a thorough investigation of the underlying facts and circumstances, it became clear that the company should have been accounting for these products under SOP 97-2. Making this change would defer approximately 20 percent of that company's annual revenue. These findings caused merger talks to fall apart, and shortly thereafter the company issued a press release announcing the restatement of its historical financial statements.

These examples illustrate the challenges involved in assessing whether a business is recognizing revenue under the appropriate accounting principles, particularly when software is a component of its underlying products or services. By asking basic questions on whether software could potentially be considered as more-than-incidental, potential acquirers can minimize unwelcome surprises affecting the historical or future profitability of an acquisition or target. As this is a developing and complex area, we recommend that acquirers consult with software revenue recognition specialists whenever they are considering targets whose products or services appear to have critical software components.

² SOP 97-2, paragraph 2, footnote 2

³ Huron Consulting Group, *2004 Annual Review of Financial Reporting Matters* dated March 25, 2005.

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