# REVENUE RECOGNITION ISSUES IN THE SOFTWARE SERVICES INDUSTRY

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## ABSTRACT

Revenue recognition is an area in accounting which continues to receive significant attention from preparers of financial statements, auditors and regulators. The large and diverse volume of rules dealing with this area has made application of the rules complex and highly judgmental. Revenue recognition issues top the list of financial reporting restatements and improper revenue recognition accounted for more than half of all SEC initiated enforcement cases in the last 5 years. A significant portion of such revenue recognition related cases involved the timing of revenue recognition.

AICPA SOP 97-2, *Software Revenue Recognition* provides guidance on software revenue recognition. Revenue from arrangements for software development and related services that involves significant production, modification or customization of the software, is accounted in conformity with ARB No. 45, using the guidance in SOP 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. This is stated in the Accounting Standards Executive Committee's conclusion in paragraph 95 of SOP 97-2. Hence almost all revenue related arrangements entered into by companies in the software services industry are generally governed by SOP 81-1. SOP 81-1 states that the pervasive principle of realization and its exceptions and modifications are central factors underlying accounting for contracts and draws guidance from APB Statement 4 which states revenue is generally recognized when both of the following conditions are met: (1) the earnings process is complete or virtually complete, and (2) an exchange has taken place. FASB Statement of Financial Accounting Concepts (SFAC) No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* states that revenue should not be recognized until it is realized or realizable and earned.

In SAB 104, the SEC Staff has stated that they believe that revenue generally is realized or realizable and earned when all of the following criteria are met: (1) Persuasive evidence of an arrangement exists, (2) Delivery has occurred or services have been rendered, (2) The seller's price to the buyer is fixed or determinable, and (3) Collectibility is reasonably assured. Even though SOP 81-1 provides an exception to contracts covered by it from meeting the realization criteria, all the other essential criteria laid out by the Staff in SAB 104 have to be met for revenue recognition as the Staff has merely provided guidance on SFAC 5 through the criteria. SFAC 5 applies to all contracts including those covered by SOP 81-1. This critical interplay between SOP 81-1 and SAB 104 is often missed out by many who choose a narrow interpretation of the scope SAB 104 and conclude that SAB 104 does not apply to transactions that are within the scope of specific authoritative literature that provides revenue recognition guidance.

This paper will examine several instances where such conflicts amongst the guidance in different sources of literature allows choices and empirical evidence of public companies accounting for the revenue by concluding that SAB 104 does not apply to these transactions and choosing the guidance in SOP 81-1.