

**Equipment Leasing Association
Lease Accountants Conference
September 13, 1999-San Antonio, Texas**

SOFTWARE ACCOUNTING & TAX ISSUES

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SOP 97-2: AN EXAMPLE

If sufficient **vendor-specific objective evidence** of **fair value** does not exist for all **elements** of the **arrangement**, the **entire revenues generally will be deferred** until such evidence exists or until all elements have been delivered, with certain exceptions.

SOFTWARE LEASING AND FINANCING - WHAT IS IT?

- **Financing of software and related costs on 1 to 5 years terms**
- **Loans or leases (capital)**
- **Secured or unsecured**
- **Watch Uniform Computer Information Technology Act & Federal Intellectual Property Security Act**
- **?? - What residual value do you put on computer hardware?**

SOFTWARE LEASING TRENDS

- **Small ticket - just like rest of small ticket**
- **Large ticket investment grade - Similar to investment grade leasing market**
- **Middle market - Few lessors in this market**
- **Venture leasing - Little**
- **Will continue to grow - More publicity; more lessors; software becomes even more important; hardware less costly**

LESSOR UNDERSTAND SOFTWARE COMPANY ACCOUNTING ?

- **SOP 97-2, supplemented by SOP 98-4 and 98-9, is the bible for software company**
- **Assist lessor sales and marketing**
- **Understand why lessors can't get support used to seeing from vendor**
- **Revenue recognition errors account for more than 70% of accounting misstatements in securities litigation**

LESSOR UNDERSTAND SOFTWARE COMPANY ACCOUNTING ?

- **Lessors still look at FASB 13 or loan accounting**
- **Much more difficult problem for software company than lessor**
- **Because FASB 13 is so easy, you need some intellectual stimulation**

REASONS FOR SOP 97-2

- **SOP 91-1- Lots of implementation problems and inconsistent practices**
- **CPA's dissatisfied with vendor program obligations In FASB 13**
- **Overly aggressive revenue recognition by many software companies**

SOP 97-2 OVERVIEW

- Accountants have outlawyered the lawyers in complexity
- Split contract into separate **elements** based on **fair value** of each element
- Fair value determined by "**vendor specific objective evidence**" (VSOE)
- If substantial services (customization, etc.), use percentage of completion accounting on entire contract unless meet certain conditions

SOP 97-2 OVERVIEW

- Definition of VSOE delayed or widened by SOP 98-4
- Very strict rules result in more deferral of income and less receivables
- Complex business results in lot of confusion
- Still lots of implementation problems
- Mixed hardware/software leases accounted by vendor for under FASB 13 and SOP 97-2

4 REVENUE RECOGNITION TESTS

- 1. Persuasive evidence of agreement
- 2. Delivery has occurred
 - Delivery to fulfillment house - not delivery
 - The channel stuffing problem - not delivery
 - No delivery of an element until delivery of all elements necessary for functionality of the delivered element

4 REVENUE RECOGNITION TESTS

- **3. Revenues fixed and determinable**
 - If more than 12 months payment terms, rebuttable presumption no current income
 - Need a history of collection without concessions
 - Revenue when become due, not on a rolling 12-month basis
- **4. Collection is probable**
 - Not collectable if subject to refund if other elements not delivered

MULTIPLE ELEMENTS

- Determine the elements involved
- Split contract into separate elements based on fair value of each element
- VSOE - actual price or price which will be charged for the element
- VSOE horrible implementation issue for software company
- VSOE somewhat relaxed until 3/31/99 (see SOP 98-4)

MULTIPLE ELEMENTS

- Apply SOP 97-2 to each element separately
- If not have VSOE for all elements, all revenues deferred until all elements delivered
- If there are any vendor obligations, even insignificant, serious problem created for revenue recognition!

SOME OTHER ISSUES

- **When-and-if available deliveries**
- **Right to exchange products**
- **Post contract support (maintenance) arrangements**
- **Services - percentage of completion**
- **Upgrade rights – generally complete deferral of revenue unless VSOE**
- **Obtaining VSOE**

MANY BUSINESS IMPLICATIONS

- **Formal pricing mechanisms crucial to revenue recognition**
- **Customization services means deferral of revenue on license itself**
- **Should software company provide customization?**
- **Need to review contract language**
- **Is deferral all that bad?**

SALES TAX ISSUES - #1

- **Most confusing sales tax situation ever seen**
- **Sales tax laws designed to tax tangible property**
- **Software and other intangibles growing portion of commerce**
- **Many states not up to speed on software**

SALES TAX ISSUES - #2

- **States tax different software elements differently**
- **States define software elements differently**
- **Internet sales in hopeless disarray; comparison to catalog sales**

SALES TAX ISSUES - #3

- **Financiers rarely get title to license**
- **Accountants often think in terms of title, as do sales tax administrators**
- **When is tax due - upfront or over lease term**

CONCLUSIONS

- Revenue recognition a difficult implementation problem for software companies
- Lessors need to be aware of software company issues if they finance software
- Sales tax problems will require policy and processing decisions upfront

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