SOP 97-2: CURRENT ISSUES IN VSOE ACCOUNTING

A Technical Brief

Presented by:

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About Ashwinpaul (Tony) C. Sondhi, Ph.D

Ashwinpaul "Tony" C. Sondhi is currently a member of the Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board (FASB). He has been a member of the Global Financial Reporting Advocacy Committee of the CFA Institute; the Accounting Standards Executive Committee (AcSEC) of the AICPA and the Planning Subcommittee of the AcSEC; the Financial Accounting Policy Committee of the CFA Institute; the FASB Task Force on Accounting for Impairments of Long-lived Assets; and the Statement of Cash Flows Steering Committee of the International Accounting Standards Committee. Dr. Sondhi was also an advisor to the FASB on its' project comparing U.S. and International Financial Reporting Standards.

Dr. Sondhi is a co-author of the 2006 and the (forthcoming) 2007 Miller Revenue Recognition Guide, and The Analysis and Use of Financial Statements, Third Edition, which is a recommended text for the Chartered Financial Analysts (CFA) program. Dr. Sondhi is also a professor and a consultant to leading companies and executives worldwide.

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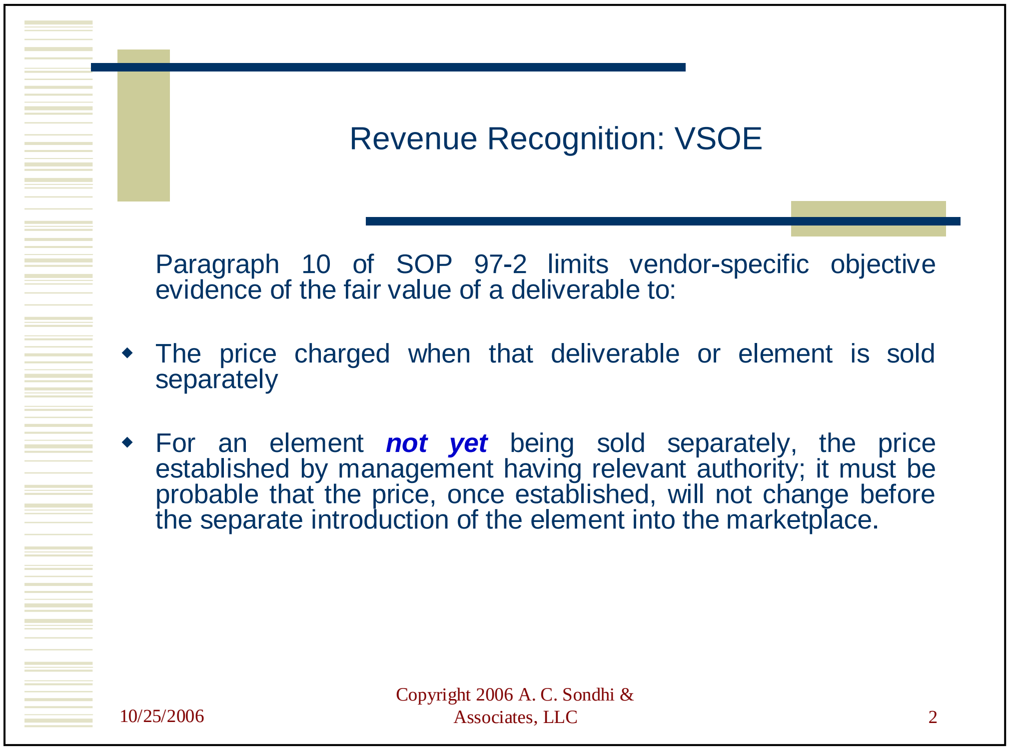
Definitions



SOP 97-2, paragraph 10 tells us that VSOE stands for Vendor Specific Objective Evidence of the fair value of a deliverable or an element in an arrangement. The SOP further tells us that the best evidence of fair value is obtained from the price at which a specific deliverable or element is sold on a stand-alone or separate basis. But as we all know, a significant number of our transactions these days are bundled. Some of the elements within these bundles are sold separately, while some are not.

So how do we handle those deliverables or elements that have not yet been sold separately and that may be new? Again, paragraph 10 of the SOP tells us that the VSOE is the price established by management having relevant authority. Once you've established that price as VSOE and officially acknowledged it as such, that price must not be expected to change prior to the separate introduction of that element into the marketplace. Also keep in mind that the introduction of that deliverable into the marketplace on a separate basis ought to be within a very short period of time after the VSOE price is set. Accounting firms have differing opinions on how long is too long, so make certain you are aware of your accounting firm's guidelines on this issue.

One practice I recommend strongly is that when you introduce an item into the market; begin to keep very good, comprehensive records of the price at which that item has sold. It should become part of your database of transactions, which you will need to develop and sustain evidence of VSOE. This database can also reduce or even eliminate hassles with respect to the timing and the amount of revenue you can recognize.

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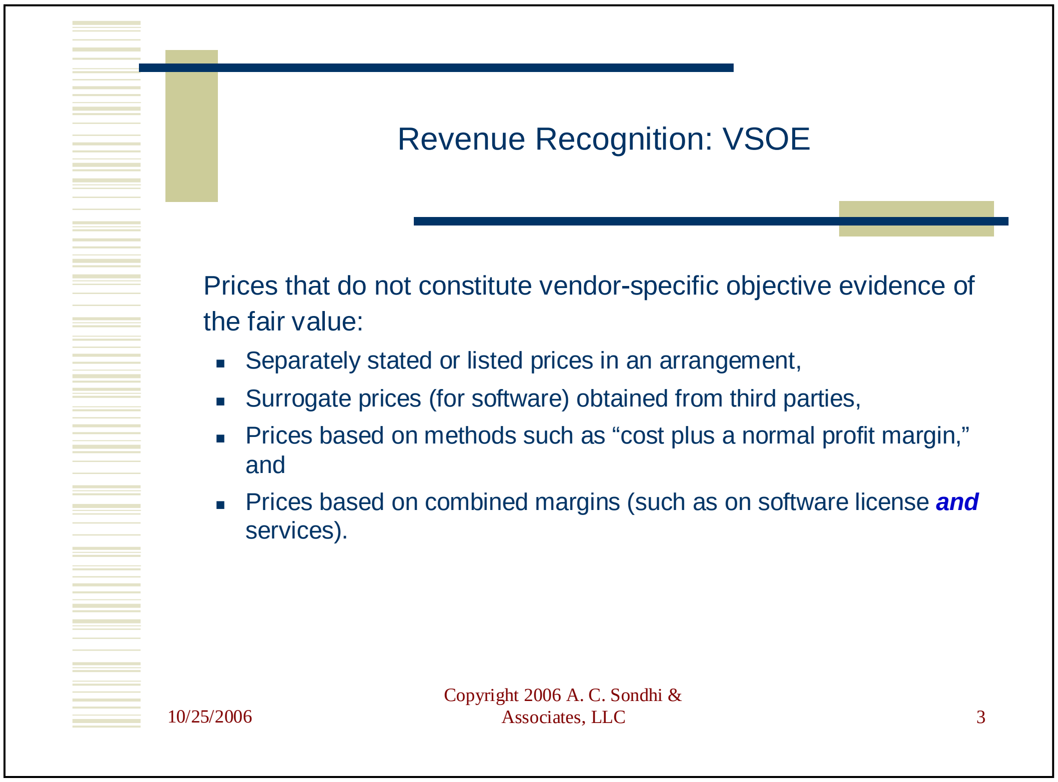


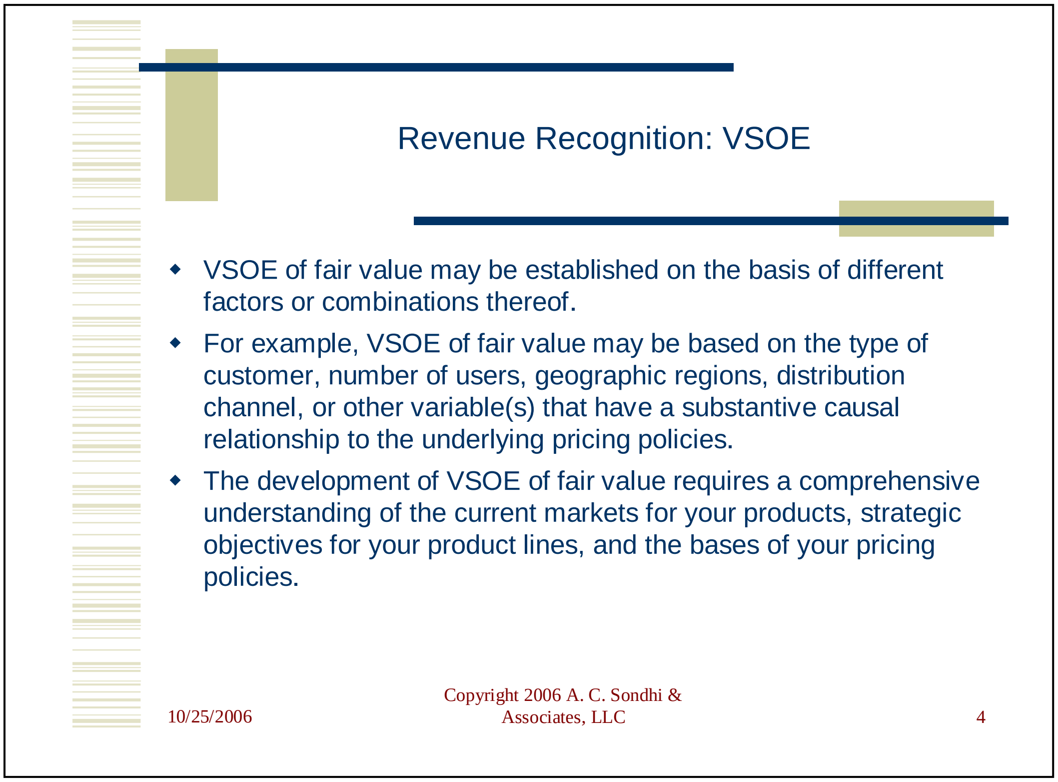
List prices don’t work. Of course, the exception just discussed is the price at which management has decided that you are going to sell an item in the very near future. Once again, for an item that hasn’t been sold separately before, you may use the list price but then that price should be the price at which you will sell that item separately.

`You can’t use surrogate prices obtained from 3rd party software. Software is quite different across different vendors. It’s unlikely that the functionality and features are going to be similar; therefore one wouldn’t expect the price to be similar.

You also can’t use methods such as cost plus a profit margin. There again, because software costs don’t follow the normal sorts of costing models we see in entities such as manufacturing, you aren’t allowed to use this method.

Finally, when you have multiple element arrangements, you may have software licenses plus services and be tempted to use a combined gross margin. That also is not acceptable.

Bases of Pricing Policies

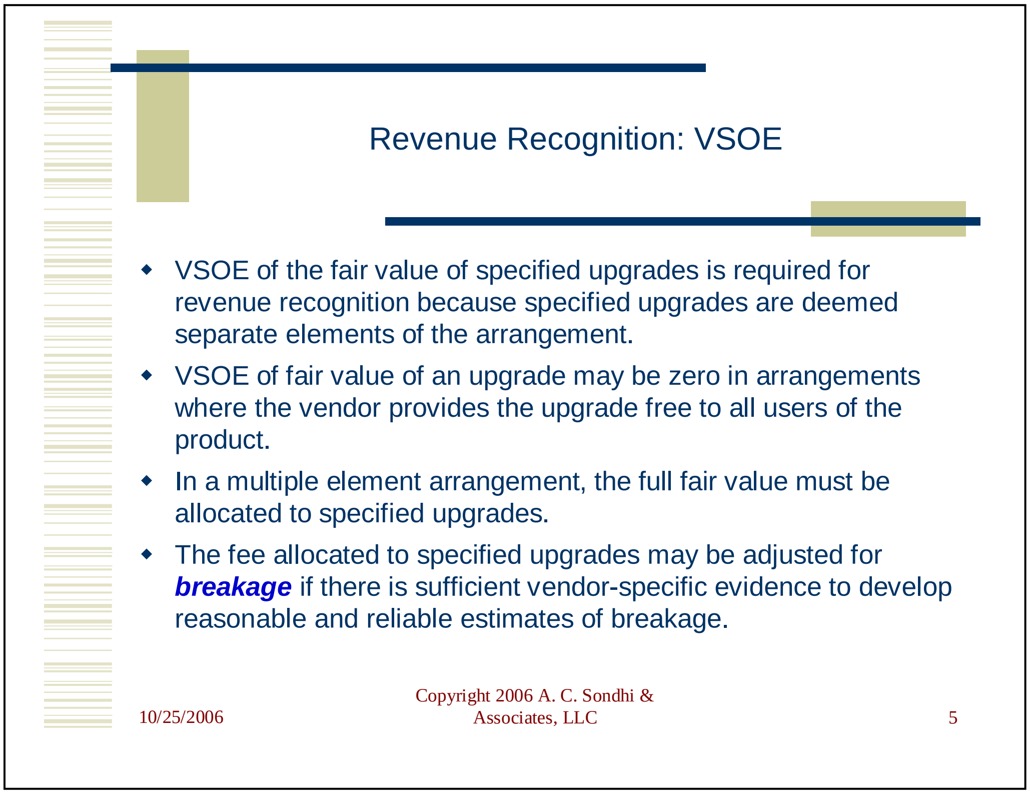


Establishing VSOE is not, however, all limitations and constraints. The VSOE of fair value can be established using many different factors, only some of which are listed in the second bullet point on this slide. You may use the type of customers, the number of users, and the geographic region where you sell it. For example, there are times when the price at which you sell an item in North America and Canada is not sustainable elsewhere due to a range of market differences. You may have to price that same item quite differently to sell it in Australia and New Zealand.

Distribution channels may be another factor. Are you selling to the government? Are you selling through resellers and distributors as well as end users? There are companies that sell to all three and they could certainly have three different prices. What all these variables need to have in common is a very substantive causal relationship to the underlying pricing policy.

This brings me to what I think if as an important principle in the development of VSOE: you need to have a very comprehensive understanding of the current markets for your products, the strategic objectives you have for the products you are currently selling; what will be included in new versions, what will happen with the platform, and how you are going to sell. All of this information helps form the bases of your pricing. You need a very good understanding of why you have established a particular price and of your ability to sustain that price. Again, this suggests the need for very high-level management involvement. The CFO must be involved in deciding and ensuring that the underlying principles are being applied correctly. You need to collect the requisite amounts of data to develop your VSOE database, and that database must be kept up to date and accurate.

Specified Upgrades

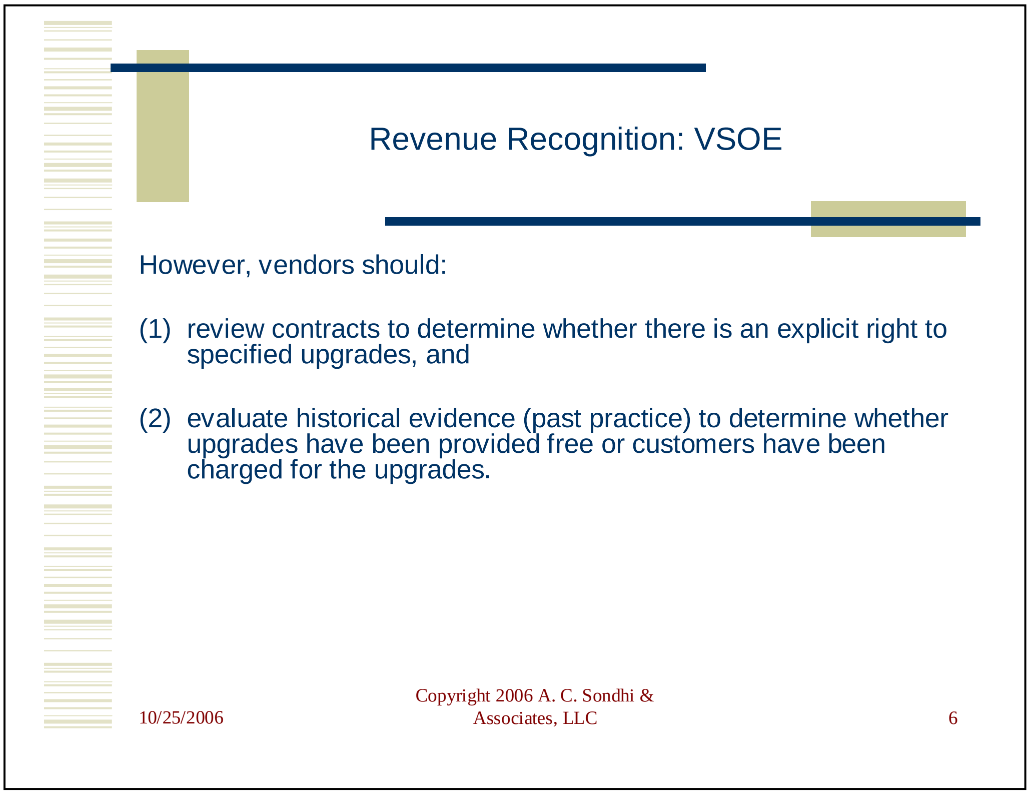


Another area in which VSOE is critical is specified upgrades. Specified upgrades create a special class of concerns and issues for software companies. In general, a specified upgrade is considered a separate element, which means that you will need VSOE for it. Under 97-2 you need the fair value of all elements. 98-9 did permit companies to use the residual method but there you absolutely need the VSOE of undelivered elements. Certainly you are aware at the inception of a contract that specified upgrades will be initially undelivered.

It is also possible that the VSOE of the fair value of an upgrade may be zero when the vendor provides the upgrade free to all users of the product. But keep in mind that in a multiple element arrangement, the full fair value has to be allocated to a specified upgrade. While professional opinion is divided on assigning zero as a fair value, my preference is that you always charge for specified upgrades.

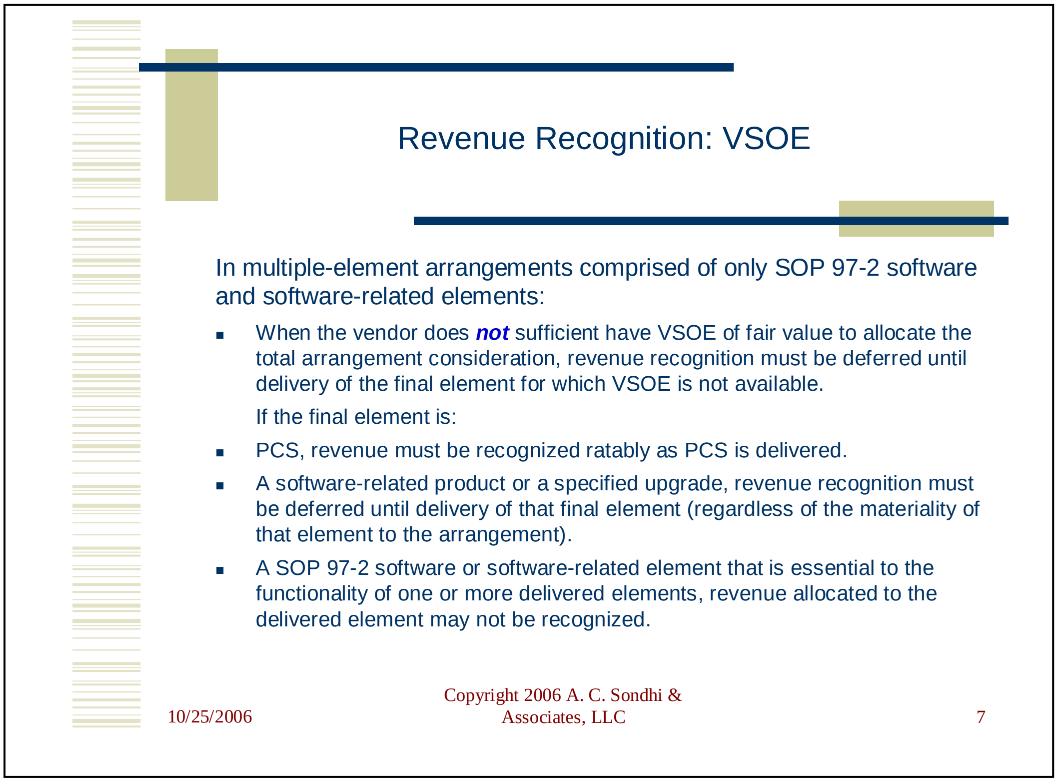
The final point I want to make here is that this is a rare area where the SOP actually permits the use of breakage. If you have sufficient evidence that certain customers will not take a particular upgrade, you could adjust for that. You'll need sufficient historical data to develop reasonable and reliable estimates of breakage. This reinforces again the need for that very comprehensive database.

Historical Evidence



A related issue is whether or not your contracts provide for an explicit right to specified upgrades. I strongly recommend that you take at look at your contracts to see whether you have provided for such an explicit right. Work to ensure that both your accounting department and general counsel understand this issue and then further work with your sales staff to ensure they understand the distinction between PCS or Post Contract Support and specified upgrades. The SOP defines PCS as having three elements; telephone support, bug fixes, and then "when and if available" upgrades and enhancements—which means unspecified upgrades and enhancements. So there is a clear distinction between the two. So go back and look through historical evidence. Do a random search through at least 30 transactions from the past year to find out whether specified upgrades were provided free or customers were charged. Then compare your findings with what each contract actually says. It's critical that you be very careful with your contracts in this matter.

Multiple Element Arrangements Under SOP 97-2



A few final but critical points: When you have multiple element arrangements that fall completely under SOP 97-2 and 98-9, and you ***don't*** have sufficient VSOE of fair value to allocate the total arrangement consideration, then revenue recognition ***must*** be deferred until delivery of the **final element** for which VSOE is not available.

A few "ifs":

If that final element is Post Contract Support, then revenue recognition must occur ratably as that support is delivered.

If the final element is software-product related or a specified upgrade, then you have to defer revenue recognition until that element is delivered – regardless of the materiality of that element in the arrangement.

Lastly, if the final element is either a SOP 97-2 software product or license and/or a software-related element essential to the functionality, then you can't recognize revenue even with respect to the delivered elements. That's because the delivered elements aren't functional without the final element.

Frequently Asked Questions

Question: What happens if you introduce a new product into the market at a lower introductory price than the higher price management intends to charge once the product is established? How long, what kind of track record, how many transactions to establish VSOE for a new product?

Answer: Unfortunately there are no real guidelines with respect to how long a period of time it takes or how many transactions establish a track record or how much data you need to have. That's why I think that VSOE should be established using a bell-curve approach. Or to simplify that, you need to establish the median price at which you are selling an item, if you ensure that 85% of your sales prices are within plus or minus 15% of that median, then the median can serve as the VSOE. You'll need to examine at least 30 transactions, randomly selected, to provide enough information for a normal distribution. I understand that with a brand new product you may have to sell it initially at a lower price, and it may take quite a while to establish VSOE. You won't have much of a problem if you are selling it by itself. But it you are bundling it with other products you'll have to have VSOE and that will be a problem.

Question: Can you help people distinguish between specified and unspecified – two terms you have used frequently in your discussion?

Answer: With "specified" you spell out what you are going to be offering. The specified upgrade says, "Here's a new or here's an existing version of our software, and we are going to add this particular functionality within some period of time." When you say something like that, you are on your way to specifying that particular upgrade.

An unspecified upgrade is characterized by language such as "when and if available, upgrades and enhancements." That language is vague enough that you aren't really saying what you are going to do, or even if you are going to do it.

You must be careful about what your salespeople are promising customers, about what's in your literature, what's on your website, what's in your contracts. The more you use language like, "This is what it does now and this is what it will do soon", or "soon we are going to add this feature or that functionality" the more you have specified.

Question: Many customers demand product roadmaps because they want to know where the product is going. Can you offer any guidance to keep roadmaps from becoming specified upgrades?

Answer: I get a lot of questions about roadmaps, and I know that general roadmaps aren't practical because customers want detail. The fact remains that the more specific you are, the closer a roadmap gets to being a specified upgrade. That is where a very good contract with your customers is useful. You must also have a crystal clear policy about how you charge existing versus new customers when new elements or features are added.

Question: How does a global company establish VSOE for professional services given different rates and markets in different geographies?

Answer: There are no simple answers to that though the approach is really the same whether establishing VSOE for services or for products. You must develop very good data for the countries where you sell. The CFO and controller need to set very clear guidelines on how you are going to price different services. You must keep a complete and accurate database of all of your transactions everywhere that you sell. You should look frequently at your database to see where you have bands of similar prices. The people in your company who do the bidding and decide what to charge for a particular transaction are your critical first line in defense of your VSOE. They need to be very familiar with the price bands and the pricing policies.

Question: What are the most significant differences between GAAP and the International Accounting Standards now and where is that headed?

Answer: A general comment that can be made about the differences between the two, certainly with regard to revenue recognition in IAS 18, is that the IAS depends on a principles-based standard which is open to interpretation and can actually be quite permissive. GAAP, on the other hand, is rules-based with highly-detailed strictures. For example, the IAS standards have only very brief discussions about multiple-element arrangements, where EITF 00-21 is a huge issue in the US. We have contingent revenue issues in the US that can be very difficult. I think it would be positive if GAAP moved a little closer to IAS 18 and if IAS 18 moved a bit closer to the GAAP standard. The middle ground is probably a preferable place.

About A. C. Sondhi and Associates

A. C. Sondhi and Associates, LLC, is a financial advisory firm that develops analytical tools and databases for investment and financial reporting purposes. These tools are marketed to institutional and individual clients around the world. In conjunction with this activity, the firms' principal, Ashwinpaul (Tony) Sondhi, conducts on-site programs and off-site executive seminars that focus on financial reporting, disclosure and analysis issues for companies and their top executives. We have a dynamic consulting practice in the areas of financial reporting, valuation, earnings quality, securitization and credit analysis. Go to www.acsondhi.com.

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