What's the Big Deal about VSOE?

How Software Accounting Rules Could Trip You Up - Even if You're Not in the Software Business

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What's the Big Deal about VSOE?

It's the leading cause of revenue restatements, a destroyer of stock market listings, accounting's equivalent of quantum mechanics and string theory: it's Vendor Specific Objective Evidence. What??? We can demystify it a little. And we will tell you why you should pay close attention to it from now on – especially if you <u>don't think</u> you are in the software business.

VSOE, or Vendor Specific Objective Evidence, is Fair Value for Software. If you're tempted to stop reading now because your company isn't in the software business – don't. More and more companies find themselves dealing with VSOE as embedded software becomes an increasingly essential element in the products of companies outside the traditional software sectors. Consider cell phones, medical devices, computer networks, cars and perhaps even your company's products as examples, and read on. And even without any embedded software whatsoever, you may be surprised to see how many industries and companies are drawn into the complexities of determining and applying fair value for their products and services.

The concept of VSOE, the term, and the methodologies for establishing it, were introduced in 1997 by the AICPA in their Statement of Position (SOP) 97-2: Software Revenue Recognition. SOP 97-2 governs how any company that licenses, sells, leases or otherwise markets software (unless it's incidental to the product or service as a whole) must recognize the revenue. In particular, it governs how companies must recognize revenue from so-called "multiple-element arrangements" – bundles of software products and related services sold as a unit, at a single price. In establishing these special rules for software and VSOE, the AICPA has essentially set software uniquely apart from other products, and established a more difficult set of standards for companies to meet in order to put software revenue on their financial statements.

Revenue Recognition Rules – Leveling the Playing Field

Because top-line revenue is such a critical factor in assessing the financial condition of companies, US GAAP revenue recognition accounting rules have evolved to level the playing field for public-company reporting – protecting shareholders and investors by preventing earnings from being stated before they are, in fact, earned. The definition of "earned" is key to revenue recognition in general. Before the revenue for any product or service can be recognized –regardless of whether the company has been paid or not – four tests must be met: there is evidence of an agreement, the price is fixed and determinable, collectability is probable, and delivery has occurred.

Separate Rules for Software – SOP 97-2 and VSOE of Fair Value

Most software revenue comes from license fees, and historically that revenue was recognized as soon as the product was delivered to the customer – assuming the other three tests were also met. But by the time software was widely entrenched for commercial use, it was common for license fees, installation and maintenance services, training, upgrade rights, and other software-related elements all to be sold together. These packages complicated revenue recognition decisions considerably: when there's just one price or fee covering elements that will be delivered at varying times – some now and some later – how do you decide how much to allocate to each?

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The answer is provided by SOP 97-2: you allocate relatively, splitting the fee amongst the products and related elements based upon VSOE – which is the price established by the vendor for the separate sale of each element. Each VSOE price is usually established through accumulation of a quantity of discrete sales "sufficient" to prove that the market, in it's willingness to pay that price, thinks the price is fair. And here's the big catch: you can not recognize revenue for any element in a software arrangement either until VSOE exists for each and every element, or until all of the elements have been delivered.

So the availability of demonstrable VSOE for the software-related items that a company may offer in an arrangement controls the revenue recognition schedule for the whole arrangement. A company that has trouble establishing VSOE could have to defer revenue for products and services delivered and otherwise earned until completion of the entire contract. In that interim period, their financial statements – with no recognized revenue – could make it appear that the company is underperforming. That perception wouldn't be corrected until the arrangement was finished and all the revenue recognized at once, inserting a spike in the financial picture.

Allocating the Fee in a Multiple-Element Software Arrangement

$$\text{Total Package Price} \times \frac{\text{VSOE of Element}}{\text{Total VSOE of All Elements Combined}} = \text{Relative Allocation for Individual Element}$$

Note that in this formula the absence of a total VSOE for all elements combined makes it impossible to solve for the value of any element. SOP 98-9 amends this difficulty slightly, offering a Residual rate method that allows some delivered elements to be recognized if VSOE exists for those that are undelivered.

The Expanding Vortex of VSOE – Many Industries are Drawn In

VSOE may be coming to your world soon, even if you don't think you are in the software business. An article recently published in the Journal of Accountancy, Software Revenue Recognition on the Rise: Technology Boom Expands Relevance of SOP 97-2, is well worth reading if there is ANY software at all in your company's products. Embedded software in products outside of the traditional software sector– such as computer networks, medical devices, or cellular phones – is often now a key market differentiator, making it much more than just "incidental" to the product and subjecting it to software revenue recognition accounting.

Under these rules, the hardware too is drawn into the vortex of VSOE and SOP 97-2. The authors note Apple's decision to recognize iPhone revenue, as well as that from MacIntosh computers, under software revenue recognition accounting, deferring the software and the hardware according to those rules. Just imagine the implications if Apple had not made that critical decision, but several years down the road was judged in error for not having done so.

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No Software? Not so fast!

Now, FASB didn't stop with software. FASB's "Emerging Issues Task Force" looked at business arrangements with multiple components in general, no matter what product, service or industry is involved. By introducing the guidance "EITF 00-21 - Revenue Arrangements with Multiple Deliverables," FASB essentially expanded revenue recognition and Fair Value rules across all industries. EITF 00-21 too requires the difficult task of identifying all the elements of an agreement and at the same time establishing fair value for each individual component.

The actual definition of what is "fair value" however is somewhat different and less onerous than VSOE. Instead of requiring evidence by vendor and within the vendor's own products and services ("vendor specific objective evidence"), EITF 00-21 allows the stand-alone value of every element to be determined using widely-available external data – namely, the prices of other vendors' products. This is a more conventional and easier way to derive fair value than VSOE. Furthermore and critically, by this definition it is less likely that fair value would NOT be available for any particular element in an arrangement. The situation that arises under SOP 97-2, wherein the absence of VSOE for one particular element means that revenue for all elements must be deferred – is less likely to happen under EITF 00-21, because market data is market data, and easier to establish. However, once established, the pricing must be distributed across the various elements of the arrangement just as in VSOE, so the accounting procedure may be equally complex even if the pricing exercise is not.

VSOE Pricing – Rocket Science for Accounting Experts

VSOE pricing itself is hard to establish and easy to lose. Both official and informal guidance on establishing VSOE often goes on for pages about methods such as the Bell-Shaped Curve, the Substantive Renewal Rate and the Residual rate. All such descriptions confirm the quantity and quality of sales evidence necessary – and the detailed, ongoing attention to the processes that all of the methods require. Experts also warn of how easily VSOE is lost: it may be lost if pricing consistency slips outside of a narrow range; if the company changes its pricing strategy or business model; in the event they stop selling an element separately or even if the sales force offers higher or lower discounts than usual. And of course, the introduction of brand new products and services means VSOE does not exist for those elements yet, period. And lest we forget, remember that VSOE missing for just one element in an arrangement means that revenue for the entire arrangement must be deferred.

The Case of NEC – A Cautionary Tale

Even with auditors assisting, it's easy to make a mistake. Witness the cautionary tale of NEC, which recently accepted NASDAQ delisting because they couldn't get their VSOE right and the alternative was restating six years of revenue. Revenue recognition mistreatments and mistakes in general are acknowledged to be a leading cause of financial restatements, and VSOE issues are the most likely culprits: VSOE is probably the most difficult of all revenue accounting rules to apply correctly – one blogger recently called it "trickier than string theory" – and often times auditors themselves disagree. The good news about VSOE restatements is that they usually change only the timing of revenue rather than the amount. The bad news, obviously, is that a restatement is a restatement is a restatement…

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A Moral for Everyone

Other companies would also do well to consider carefully the accounting implications of virtually every packaging and pricing decision they make – even the seemingly trivial ones – lest they trip themselves into 97-2 and/or destroy their VSOE by accident. Companies "outside" of the software business cannot look the other way. They need to understand the implications of EITF 00-21 right now and also grit their collective teeth and fortify themselves for tougher revenue recognition regulations in general. While SOP 97-2 was one of the first comprehensive revenue recognition accounting guidelines defined for a specific industry, undoubtedly it will not be the last. FASB has a long-standing taskforce working on a revenue recognition project whose outcomes will likely continue to broaden the types of business models and range of industries affected.

Reading List

Contract Management that Boosts Revenue, O'Connor, Robert; Contract Management; November 2002

EITF 00-21: Revenue Arrangements with Multiple Deliverables; Sondhi, Ashwinpaul C; 2006 Softrax Corporation. A Softrax whitepaper

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Software Revenue Recognition on the Rise: Technology Boom Expands Relevance of SOP 97-2, Regan, Greg and Regan, Tim; Journal of Accountancy; December 1, 2007

SOP 97-2: Current Issues in VSOE Accounting, Sondhi, Ashwinpaul C.; 2007 Softrax Corporation; a Softrax whitepaper

About Softrax

Softrax Corporation is a leading provider of enterprise revenue management and billing software solutions that fundamentally change the way companies manage, analyze, report, and forecast their revenue. Softrax solutions automate the entire revenue cycle, from revenue recognition, reporting and forecasting, through complex billing and contract renewals. Hundreds of corporations benefit from using Softrax to optimize their revenue, reduce operating expenses, comply with revenue recognition regulations and Sarbanes-Oxley requirements, and gain unprecedented visibility into their business performance. Softrax Corporation, headquartered in Canton, MA, is privately held. More information can be found at www.softrax.com, www.RevenueRecognition.com, or by calling 1.888.4SOFTRAX.

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A Footnote from Softrax: Taking Control of VSOE and FMV Accounting

Revenue recognition accounting rules can unexpectedly trip up even savvy accounting and finance personnel. It is not enough simply to get it right, you have to be able to show how and why. That requires internal controls, audit histories, and supporting documentation that's readily available when the auditors show up. Large enterprises are especially prone to "gotchas" because the judgment calls on revenue treatments may be made by dozens of individuals in multiple locations. Issuing a clear revenue recognition policy is a first step. But making the revenue policy an operational reality requires a systematic approach.

Softrax enterprise software solutions manage all revenue recognition processes in one centralized system and can apply multiple criteria for revenue recognition on a line item basis. As a result, complex revenue transactions can be automated – from creating revenue amortization schedules, to reallocating revenue based on FMV or VSOE, to making proper revenue accounting and General Ledger entries as revenue recognition occurs.

With Softrax, revenue line item amounts of a multi-element arrangement can be reallocated according to SOP 97-2, SOP 98-9 or EITF 00-21. Softrax maintains key information such fair value (FMV, VSOE) price books to apportion revenue proportionately, automatically applies residual values or calculates the appropriate reallocation based on specified business rules.

The revenue reallocation process can be controlled either manually or automatically and can be set up for calculation against none, some, or all of the line items in a transaction. Regardless of how the revenue rules are applied, the process can be managed independently from invoicing and the billing amounts remain unchanged. After an allocation process is executed, revenue amortization schedules will be automatically adjusted to reflect the new amounts for each line item and the ensuing Journal Entries to update the General Ledger will be created.

Maintaining all FMV/VSOE related processes and decisions in one integrated application establishes not only a complete control environment for critical audit information, but also the basis for detailed reporting and analysis.

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