Automating Vendor-Specific Objective Evidence (VSOE) & Fair Market Value (FMV) to Optimize Revenue Recognition

Challenges & Opportunities with Multi-Element Scenarios

Over the past few years, the financial reporting requirements for multi-element sales scenarios have changed dramatically, creating both challenges and opportunities for companies providing products and services that include delivery of diverse elements over extended timeframes.

Such a multiple-element arrangement occurs whenever a vendor agrees to provide more than one product or a combination of products and services to a customer under an ongoing agreement. For example, multiple element arrangements may include additional software products, rights to purchase additional software products at a discount, specified upgrades or enhancements, combinations of software & hardware, post-contract customer support (commonly referred to as PCS) or other ongoing relationships such as Software as a Service (SaaS) offerings.

Under Financial Accounting Standards Board (FASB) rules ETIF 08-01 and ETIF 09-03, which became effective in 2010, companies that provide multi-element offerings and/or SaaS services must collect, analyze and manage financial information at a significantly more detailed level in order to support revenue recognition of the various elements in a timely fashion.

The Opportunity. . .

From a business strategy perspective, the new rules offer the opportunity to recognize major elements such as installation and services early on in the contract when they are actually delivered, rather than having to recognize all the elements over the contract term, or worse yet at the end of the contract.

The Challenge . . .

From an accounting perspective, achieving FASB compliance for multi-element revenue recognition depends on the ability to accurately track and document evidence for supporting all of the financial reporting actions. This documentation is typically achieved through massive spreadsheets and staffing investments that drive up costs, inhibit scalability and increase the risk of errors.

The Key to Success . . .

From an IT systems perspective, the key to success lies in comprehensive automated processes for “carving out” specific delivered and undelivered elements to capture detailed *Vendor Specific Objective Evidence (VSOE)* and *Fair Market Value (FMV)* information for supporting revenue recognition actions.

Revenue Recognition Process Overview

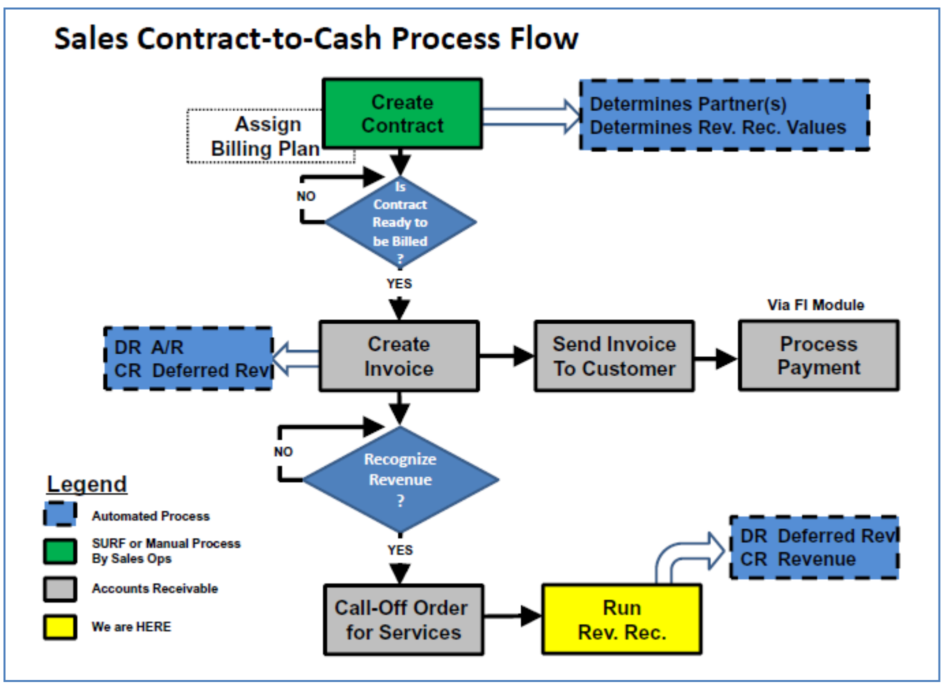
Should be Integrated . . . but also Independent

The Revenue Recognition Process needs to be tightly integrated within the overall sales contract-to-cash system flow in order to efficiently capture relevant information and to drive timely decision making. But at the same time, it is important for the revenue recognition mechanisms to operate independently from the billing process in order to mesh with overall accounting and compliance objectives.

Based on the revenue recognition rules, the independent process uses the sales, delivery, and billing information to propose the amounts and associated G/L accounts of the revenue to be recognized so that the correct financial postings can be made upon its execution.

Process Flow

During the sales and contract creation process, multi-element items in the contract should be identified as relevant for revenue recognition. These items populate the revenue recognition tables and upon billing are made available for subsequent revenue recognition when appropriate.



The overall objective of the Revenue Recognition system is not necessarily to automate the entire process removing all human actions but rather to comprehensively capture the relevant information, to perform objective analysis using structured rules and to propose appropriate revenue recognition actions based upon objective criteria.

Drill-down capabilities also provide visibility into the billing and revenue recognition documents. The revenue recognition due list allows selection of all the items that are available to be recognized for a certain period. When the due list is run, the system automatically makes the correct revenue postings, from deferred revenue to revenue or from revenue to unbilled receivables. Generally revenue recognition is run as an automatic batch process, and as part of the month end closing.

The Critical Role of VSOE and FMV

Sales agreements that bundle software, hardware, maintenance, and professional services or that deliver ongoing SaaS offerings have increasingly become the norm in the high-tech industry. Accurate revenue recognition in these complex multi-element situations requires complete understanding and application of all terms and conditions for each element of a contract.

Under these arrangements, revenue is allocated to each element based on Vendor-Specific Objective Evidence (VSOE), when available, and can be recognized only when specific revenue recognition criteria for each element are met. Even elements such as cancellation rights, upgrades, and maintenance contracts – whether offered free or at a discount – must be allocated as revenue based on VSOE. If VSOE is not available for an element, the timing for recognizing the entire sales bundle is impacted.

If VSOE has <u>not</u> been established for each element in a multiple-element arrangement, <u>all of the revenue must be deferred</u> until VSOE has been established or until all of the elements have been delivered.

Fair Market Value (FMV) is defined as the price at which an item is regularly sold on a standalone basis. Since VSOE and FMV do not always equate to the stated list price, a company must have historical evidence to substantiate the Fair Market Value of each deliverable. To maintain accurate ongoing revenue recognition, VSOE and FMV values also must be reassessed and regularly updated over time.

For most of today's complex multi-element situations, it is unrealistic to depend solely on manual analysis and calculations to establish and maintain VSOE and FMV values. Therefore automated calculation and monitoring methodologies also need to be an intrinsic part of the overall process.

Automating VSOE & FMV Calculations and Monitoring Methodologies

VSOE calculations essentially define the center-point for a range for each element that is used to drive the revenue recognition process. During revenue recognition analysis, the system then performs a "yes or no" checklist against the VSOE range in order to guide companies toward the appropriate accounting treatment. In this manner, VSOE allows vendors to recognize revenue on a partial (or allocated) basis and helps them to determine the value of these revenue allocations, based on historical transactions.

An example VSOE calculation is shown below:

Sales | Contract data | Shipping | Billing Document | Billing plan | Accounting | Conditions | Account

Net 162,540.00 USD

Tax 6,474.35

Pricing Elements

N..	CnTy	Name	Amount	Crcy	per	U...	Condition value	Curr.	Status	Conditi
	ZVSV	VSOE - Undelivered					40,880.00	USD		
	ZVSW	VSOE - Delivered					121,659.95	USD		
	ZVLS	VSOE List					47,880.00	USD		
	ZFM+	High End of VSOE					7,182.00	USD		
	ZFM-	Low End of VSOE					7,182.00-	USD		
	PR00	Price					187,790.00	USD		
	ZA00	Sales Discount					25,250.00-	USD		
		Net Selling Price					162,540.00	USD		
		Maintenance Price					0.00	USD		
		VSOE of Fair Value					162,539.95	USD		

However, if too many situations fall outside of the VSOE “acceptable range” for any element (generally defined as ± 15% of the median price), the company can potentially lose the validity of the VSOE for that element, which would void the ability to use VSOE for any contracts containing the invalidated element.

Similarly, Fair Market Value calculations such as those needed for SaaS service offerings, are derived from a Best Estimate Selling Price (BESP) combined with high and low limits to determine the acceptable values for accurate revenue recognition.

An example FMV calculation is shown below:

Qty 233.0 HR

Net 69,900.00 USD

Tax 2,796.00

Pricing Elements

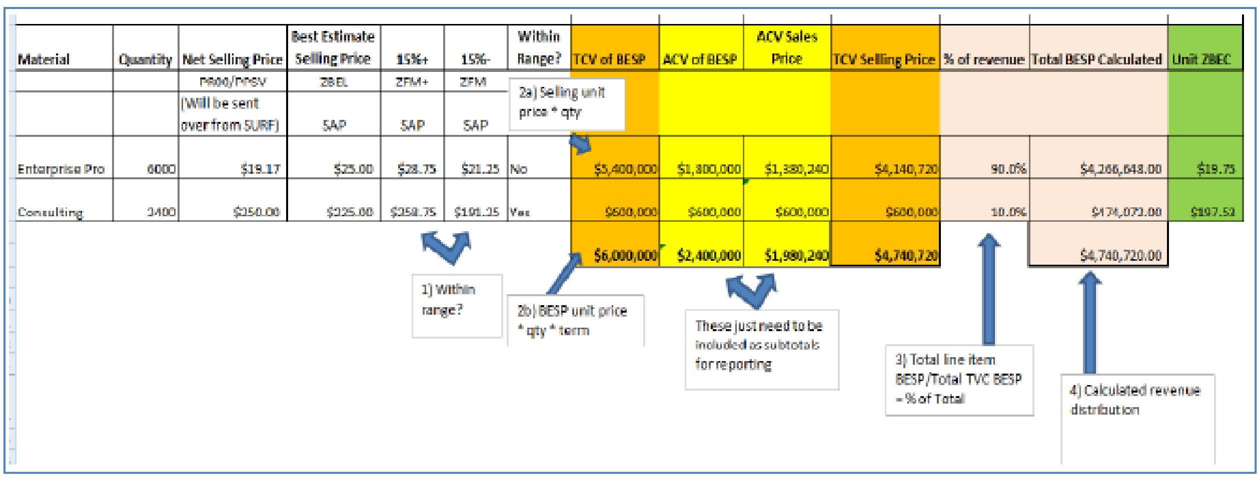
N..	CnTy	Name	Amount	Crcy	per	U...	Condition value	Curr.
	ZBEL	BESP List Price	225.00	USD	1	HR	52,425.00	USD
	ZFM+	High End Of BESP	20.000	%			10,485.00	USD
	ZFM-	Low End Of BESP	20.000-	%			10,485.00-	USD
	ZBEC	BESP Calculated	246.76	USD	1	HR	57,495.58	USD
	PR00	Selling Price - PS	300.00	USD	1	HR	69,900.00	USD
		Annual Subscription	300.00	USD	1	HR	69,900.00	USD
		Total Service Value	300.00	USD	1	HR	69,900.00	USD
		Total Subscription V	300.00	USD	1	HR	69,900.00	USD
		Net Value List + Dis	300.00	USD	1	HR	69,900.00	USD

Integrating VSOE & FMV within the Revenue Recognition Process Flow

Although FASB and GAAP requirements define the overall rules and mandates for use of VSOE, in actual practice, every company has specialized needs that must be considered for a successful implementation. Even with seemingly similar scenarios, such as selling bundled software and support services, the actual calculations and allocations to support VSOE & FMV carve-outs are specific to each situation.

To achieve an optimal balance of compliance, operating efficiency and time-to-implementation, it is important to start with an underlying process that provides both the disciplined structure needed to meet VSOE & FMV mandates <u>and</u> the flexibility for adapting to each company's specific set of requirements.

The key to success is driving the automation of calculations and monitoring down into the detail of the company's specific product and services mix, thereby eliminating the need for cumbersome and error prone spreadsheet-based manual calculations. For example, the screenshot below shows an example of automating the detailed processes used in determining FMV for specific service offerings.



Material	Quantity	Net Selling Price	Best Estimate Selling Price	15%+	15%-	Within Range?	TCV of BESP	ACV of BESP	ACV Sales Price	TCV Selling Price	% of revenue	Total BESP Calculated	Unit ZBEC
		PR00/PPSV	ZBEL	ZFM+	ZFM								
		(Will be sent over from SURF)	SAP	SAP	SAP								
Enterprise Pro	6000	$19.17	$25.00	$28.75	$21.25	No	$5,400,000	$1,800,000	$1,380,240	$4,140,720	90.0%	$4,266,648.00	$19.75
Consulting	3400	$250.00	$225.00	$258.75	$191.25	Yes	$600,000	$600,000	$600,000	$600,000	10.0%	$474,072.00	$197.53
							$6,000,000	$2,400,000	$1,980,240	$4,740,720		$4,740,720.00	

Over the course of multiple VSOE implementations, Idhasoft Inc's experience has shown that the underlying power and flexibility of the SAP software infrastructure can be extended with specific enhancements to readily address a wide range of company-specific VSOE requirements.

By combining the VSOE and FMV calculations, allocations and monitoring functions into a unified process that is both tightly integrated with all other SAP-enabled functions and can be tailored to each company's business-specific requirements, this automated approach provides accurate and timely information to drive revenue recognition decisions.

The Bottom Line: FASB Compliance and Revenue Optimization

The bottom line is that, by using the right software and implementation approach, you can automate all of the more-objective portions of the VSOE, FMV and revenue recognition processes, thereby increasing data accuracy and visibility, helping to ensure compliance, and comparing actual and forecast revenue against budget targets.

An analytics-led approach can also support what-if scenarios and root-cause analysis, identify and address unrecognized revenue, reduce the cost of revenue recognition, and improve the efficiency of your revenue-recognition process.

The intelligent integration of VSOE and FMV processes within the overall business management and analytics infrastructure not only improves FASB and GAAP compliance capabilities. It also enhances a company's ability to monitor pricing and profitability while maximizing cash flow and operating efficiency.

