Speech by SEC Staff: Remarks before the 2007 AICPA National Conference on Current SEC and PCAOB Developments

by

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Introduction

Good afternoon. It is a pleasure to be here. Today, I would like to talk about a few issues related to software revenue recognition and fair value.

Revenue Recognition for Hardware Deliverables in Software Arrangements

While SOP 97-2[1] is fairly comprehensive, it obviously does not provide specific guidance for every software arrangement. Additionally, while some argue that SOP 97-2 is too rules based, I believe that there are certain principles that can be applied and that the standard does, in fact, require significant judgment. I would like to discuss one type of arrangement in which the staff has accepted a significant amount of judgment.

With exponential advances in technology, it is not unusual to see more and more hardware deliverables within the scope of SOP 97-2, whether it is because there is software embedded in the hardware that is more than incidental to the arrangement or because there is separate software that is more than incidental to the arrangement[2] and essential to the functionality of hardware.[3] There may be significant difficulty in applying the provisions of SOP 97-2 when the remaining deliverables are multiple units of hardware that will be delivered over a long period of time and vendor-specific objective evidence (VSOE) of fair value does not exist for such hardware. In applying the provisions of SOP 97-2, one may conclude that all revenue from the arrangement should be deferred until either sufficient VSOE of fair value exists for the remaining hardware deliverables or all hardware elements have been delivered.[4]

We have, however, heard arguments that another approach may be acceptable when the remaining deliverables are multiple units of the same hardware product. SOP 97-2 does contain exceptions to the general rule on revenue deferral, including situations in which the only undelivered element is post-contract customer support (PCS) and situations in which the only undelivered element is services that do not involve significant production, modification or customization of software.[5] When the only undelivered element is PCS, the entire fee is recognized ratably, and when the only undelivered element is services, the entire fee is recognized over the period during which the services are expected to be performed. We also understand that in practice, when the only undelivered elements are both PCS and services and VSOE of fair value does not exist for PCS or services or both, one methodology may be to recognize the entire fee over the longer of the PCS or service period. This methodology is based on the view that there is no inappropriate front-loading of revenue since revenue, including any significant discount that may be included in the arrangement, is recognized over the longest period of performance.

Can the aforementioned methodology be applied by analogy when the remaining deliverables are multiple units of the same hardware product based on the principles and models underlying the literature? We believe that reasonable application of the provisions of SOP 97-2 can result in proportionate recognition of revenue for hardware without VSOE of fair value if the remaining deliverables are multiple units of the same product. For example, a company has an arrangement in which the remaining deliverables are 100 units of Hardware Product A and 200 units of Hardware Product B. VSOE of fair value does not exist for either hardware product and both hardware products are in the scope of SOP 97-2. In this fact pattern, the staff would not object if revenue were recognized based on a consistent ratio of both products (that is, one unit of Product A for every two units of Product B).[6] This methodology ensures that revenue is not prematurely recognized and that any discount in the arrangement is recognized proportionately.

Fair Value

With the issuance of Statement 157,[7] there has been an increased focus on what measuring an item at fair value entails. While some of the concepts in Statement 157 are new, there are other concepts related to fair value that are not, including the use of market participant assumptions. I would like to share a couple of issues the staff dealt with related to pre-existing fair value concepts, as well as an emerging issue that has been brought to our attention. I would also like to briefly share our thoughts on using a "simplified method" of calculating expected term for share options.

Intangible Assets and the Use of a Replacement Cost Approach

One area we continue to see a lot of practice issues on is the valuation of intangible assets in a business combination under Statement 141.[8] For certain intangible assets, it may be appropriate to use a replacement cost approach. In order to determine the replacement cost of an intangible asset, do not forget to ask the following question: "Would a market participant pay a premium for the benefit of having the intangible asset available for use today, rather than waiting until the asset is obtained or created?" If the answer is yes, and the premium for immediate use would be material, we believe that an "opportunity cost" should be considered in the fair value of the intangible asset under a replacement cost approach. That opportunity cost represents the foregone cash flows during the period it takes to obtain or create the asset, as compared to the cash flows that would be earned if the intangible asset was on hand today. Some of the questions to keep in mind include, but are not limited to, the following:

- Is the asset difficult to obtain or create?
- Is there a long period of time required to obtain or create the asset?
- Is the asset scarce?
- Is the asset critical to the business operations?

Discounts and Share-Based Payment Arrangements

Statement 123(R)[9] establishes fair value as the measurement objective in accounting for share-based payment arrangements.[10] While the actual measurement of share-based payment arrangements is not necessarily at fair value and Statement 157 does not apply to such arrangements, Statement 123(R) nonetheless states that the valuation and assumptions used should be consistent with the fair value measurement objective.[11]

One analysis that may sometimes be difficult in valuing any security, not just those issued in share-based payment arrangements, is determining which assumptions should be incorporated in the valuation because they are attributes a market participant would consider (it is an attribute of the security), versus an attribute a specific holder of the security would consider. For example, one common term we see in share-based payment arrangements is a restriction that prohibits the transfer or sale of securities. If the security contains such a restriction that continues after the requisite service period, that post-vesting restriction may be factored as a reduction in the value of the security. As a reminder, the staff has previously communicated that the discount calculated should be specific to the security, and not derived based on general rules of thumb.

On the other hand, we have also seen instances in which assumptions related to a specific holder attribute were incorporated in the valuation of share-based payments. While the determination of which assumptions to incorporate is judgmental, we believe that it would be difficult to substantiate that assumptions that reflect an attribute of a specific holder versus a market participant would be appropriate. Statement 123(R) specifies that the assumptions should reflect information available to form the basis for an amount at which the instrument being valued would be exchanged, and that the assumptions used should not represent the biases of a particular party.[12] For example, we have heard arguments that a significant discount should be taken on certain share-based payment awards because the securities were issued to a group of executives that were subject to higher taxes than other employees. The staff does not believe this assumption is consistent with a fair value measurement objective. As an additional observation, Statement 157 also refers to assumptions that are incorporated in the fair value of a security because they are specific to the security (that is, attributes of the security) and would, therefore, transfer to market participants.[13]

Interaction of the Fair Value Option with Non-Financial Performance Obligations

Statement 159[14] allows an entity to make an irrevocable election to measure certain eligible items at fair value, including many recognized financial assets and liabilities. If that election is made, all gains and losses related to changes in fair value on those items are currently recognized in earnings.

Before a company considers applying the fair value option to a particular item, we believe that the company should carefully analyze whether a substantive non-financial performance obligation is embedded in that item. The existence of such an embedded feature highlights the need to consider the interplay of applying a fair value measurement attribute and other areas of GAAP, such as revenue recognition. The intersection of Statement 159 and revenue recognition is put under stress when the appropriate revenue recognition criteria are not met under other applicable GAAP but revenue is otherwise accelerated when an item is measured at fair value.

For example, an investor may have an equity interest in another entity that is accounted for under the equity method of accounting. That equity interest may also have an embedded feature that provides the investor with a disproportionate allocation of returns. This scenario often occurs in certain partnership agreements, in which the general partner's interest includes an embedded feature commonly known as a "carried interest." If the general partner measured its investment at fair value, the carried interest might be included in that measurement. However, if the general partner's investment includes a substantive performance obligation to the equity method investee, such as management services, the carried interest may represent compensation for services to be performed. If so, measuring the investment at fair value may result in a gain recognized for profits associated with future performance obligations.

In another example, a company may have a recognized receivable related to a customer arrangement that also includes a variable fee component related to future performance obligations. In that example, the company may have recognized a receivable related to services already performed. However, the variable fees may not have been recognized because the appropriate revenue recognition criteria were not met. Additionally, even if there were no future performance obligations, there may be features in the arrangement that would also preclude revenue recognition. In this example, the variable fees may also not have been recognized because the consideration may not be fixed or determinable. If the receivable is measured at fair value, such fair value might incorporate the variable fees related to the future performance obligations or otherwise accelerate the recognition of revenue that would have been prohibited under other applicable GAAP.

In these scenarios and others, until the FASB addresses the fair value option for items that are not currently eligible under Statement 159, the staff believes careful consideration is required to determine whether the fair value option under Statement 159 is even available.

Simplified Method of Calculating Expected Term for Share Options

Finally, I would like to mention one last topic on share-based payments. When the staff issued SAB 107 in 2005[15], we provided certain of our views regarding the valuation of share-based payment arrangements, including the determination of expected term as a significant input in a closed-form option pricing model used to value share option grants in accordance with Statement 123(R). The staff indicated in SAB 107 that we will accept a "simplified method" of calculating expected term for "plain vanilla" options.[16] The expected term under this method is simply the average of the vesting term and the original contractual term.

Based upon information available at the time SAB 107 was issued, the staff believed that more detailed external information about exercise behavior (such as actuarial studies on expected term for various categories of similar entities) would, over time, become readily available to companies. Accordingly, the staff indicated that it did not expect that the simplified method would be used for share option grants after December 31, 2007. However, we understand that such detailed information about exercise behavior anticipated with the issuance of SAB 107 is not expected to be widely available by the end of the year. We also understand that many companies will encounter difficulties in estimating expected term because of the lack of sufficient historical share option exercise experience.

Consequently, the staff is considering the need for additional guidance on the continued acceptance of the simplified method for "plain vanilla" options. Any continued acceptance could depend, for example, on whether a company concludes that its historical share option exercise experience does not provide a reasonable basis to estimate expected term. We appreciate that the current guidance expressly sunsets on December 31, 2007, so stay tuned.

Conclusion

That concludes my prepared remarks. Thank you for your attention.

Endnotes

[1] AICPA Statement of Position 97-2, *Software Revenue Recognition* (SOP 97-2).

[2] SOP 97-2, paragraph 2, provides that the SOP does not apply to revenue earned on products or services containing software that is incidental to the products or services as a whole.

[3] EITF Issue No. 03-5, *Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software*, provides that software-related elements include any non-software deliverable(s) for which a software deliverable is essential to its functionality.

[4] SOP 97-2, paragraph 12.

[5] Ibid.

[6] Continuing on with the example, if four units of Product A were delivered at $10 per unit and four units of Product B were delivered at $15 per unit in a particular period, revenue would be limited to two units of Product A ($20) and four units of Product B ($60). If instead, two units of Product A were delivered and six units of Product B were delivered, revenue would likewise be limited to two units of Product A ($20) and four units of Product B ($60).

[7] Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (Statement 157).

[8] Statement of Financial Accounting Standards No. 141, *Business Combinations* (Statement 141), paragraph 37, requires that recognized intangible assets be measured at estimated fair values.

[9] Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (Statement 123(R)).

[10] Statement 123(R), paragraph 1.

[11] Statement 123(R), paragraphs A8 and A10.

[12] Statement 123(R), paragraph A10.

[13] Statement 157, paragraph A29.

[14] Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (Statement 159).

[15] Staff Accounting Bulletin Topic 14, *Share-Based Payment* (SAB 107).

[16] Pursuant to SAB 107, "plain vanilla" options have the following characteristics: (1) the share options are granted at-the-money; (2) exercisability is conditional only on performing service through the vesting date; (3) if an employee terminates service prior to vesting, the employee would forfeit the share options; (4) if an employee terminates service after vesting, the employee would have a limited time to exercise the share options (typically 30-90 days); and (5) the share options are nontransferable and nonhedgeable.

http://www.sec.gov/news/speech/2007/spch121007sek.htm
