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January 30, 2009

Mr. Robert Herz, Chair
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116

*EITF0801DA*

**VIA EMAIL: director@fasb.org**

LETTER OF COMMENT NO. 13

Re: File Reference No. EITF 0801

Dear Mr. Herz:

Cisco Systems, Inc. ("Cisco", "Company") appreciates the opportunity to comment on the proposed EITF Issue 08-1 *Revenue Arrangements with Multiple Deliverables* ("Issue 08-1"). We view this issue as highly critical to a large number of companies and believe that it is a significant step in the convergence effort with International Financial Reporting Standards.

**Overview and Summary**

We believe that the scope of Issue 08-1 should be expanded to include hardware products in which software is embedded and more than incidental, but for which software is not the primary deliverable ("software-embedded devices"), as we believe this will result in financial reporting that is better aligned with the underlying economic substance of transactions that include software-embedded devices.

For instance, Cisco's revenue transactions generally involve physical delivery of tangible hardware products over time. The delivery time frame usually results from the customer's need to receive our products over a period of time rather than being due to the delivery of services to significantly customize or modify the software embedded in the hardware. The software on these products is more than incidental, as presently defined by SOP 97-2, but it is not the primary deliverable from the customer's perspective. This is evidenced by generally lower relative prices for post-contract customer support ("PCS") as well as lower attach rates between PCS and the related products compared to the levels generally experienced by companies in the software industry. Attach rates represent the proportion of revenue transactions where PCS is sold in conjunction with hardware products. We believe the lower relative prices on PCS is an indication that our customers place lower value on the software element and has lower expectations and need for software updates and/or upgrades. In the Appendix to this letter, we have included an example of a transaction involving software-embedded devices where application of Issue 08-1 would result in improved financial reporting compared to application of SOP 97-2.

We support the Task Force's views that any guidance issued pursuant to the separate EITF project for AICPA Statement of Position 97-2 *Software Revenue Recognition* ("SOP 97-2") should have the same effective date as that for Issue 08-1, and we believe that this goal will be best achieved by expanding the scope of this Issue to include certain SOP 97-2 transactions relating to software-embedded devices. The current scope of SOP 97-2 has had the effect of encompassing transactions that involve software-embedded devices as the software is more than incidental and as a result, such transactions would be excluded from Issue 08-1. However, we do believe accounting for such transactions under Issue 08-1 would result in financial reporting that is more reflective of the underlying economics.

We agree with the proposed inclusion of Best Estimate of Selling Price ("ESP") as a method to measure selling prices in addition to Vendor Specific Objective Evidence ("VSOE") and Third Party Evidence ("TPE"). We would like to further understand the Task Force's views on acceptable methods of ESP determination and whether ESP can always be determined.

We believe Issue 08-1 should clarify the parameters for establishing VSOE. We would support broadening the definition of VSOE, as it is the best evidence of selling price. A narrow definition of what constitutes VSOE forces more reliance on the lesser methods of TPE and ESP which may not be as accurate and reliable as a broadened definition of VSOE. We have provided a suggestion in our detailed response on improving the way in which VSOE may be established.

We believe that the use of ESP should be allowed in the relative price method of revenue allocation rather than being restricted only to the residual method. In addition, we disagree with the limit on the amount of the arrangement consideration that can be allocated to the delivered unit of accounting as this would result in inconsistency with revenue allocation principles of residual method under Statement of Position 98-9 *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions* ("SOP 98-9").

Under the residual method, we suggest that the Task Force provide further guidance on the allocation of discount and how to account for multiple units of a deliverable.

In general, we agree with the disclosure and transition requirements proposed in Issue 08-1.

**EITF Issue 08-1 Question a:**

**Do you agree with the consensus-for-exposure to allow vendors to estimate the selling price of undelivered unit(s) of accounting when VSOE or TPE do not exist?**

**Response to EITF Issue 08-1 Question a:**

*The discussion in the consensus-for-exposure implies a prioritization of inputs used to measure selling price into three broad levels, with the highest priority to VSOE followed by TPE and the lowest priority to ESP. We believe that applying a selling price hierarchy increases consistency and comparability in revenue recognition. Therefore, we agree with the consensus-for-exposure to allow vendors to estimate the selling price of the undelivered element when VSOE or TPE do not exist.*

*We reiterate our view that the scope of Issue 08-1 should be expanded to include hardware products in which software is embedded and more than incidental but for which software is not the primary deliverable ("software-embedded devices"), as we believe this will result in financial reporting that is better aligned with the underlying economic substance of the transactions. Based on conversations that we have had with peer companies, we believe that the situation where SOP 97-2 is applied because software is more than incidental, but the economic transaction's primary deliverable is the hardware product, is common across many software-embedded device companies. Changing the scope of SOP 97-2 to exclude more software-embedded device companies would improve the financial reporting for these companies by making it more reflective of the underlying economics of the transaction. This would also improve comparability of financial results between software-embedded device companies currently following SOP 97-2 and other companies that will be following the guidance proposed in Issue 08-1 as well as those applying International Financial Reporting Standards ("IFRS"). In addition, as SOP 97-2 was initially intended for pure software companies, there are various business practices that SOP 97-2 anticipated that are not consistent with the development, sales and marketing activities of typical software-embedded device companies.*

*We support the Task Force's views that any guidance issued pursuant to the separate EITF project for SOP 97-2 should have the same effective date as that for Issue 08-1, and we believe that this goal will be best achieved by expanding the scope of this Issue to include certain SOP 97-2 transactions relating to software-embedded devices.*

*However, we believe that it may be challenging for vendors to always be able to estimate the selling price of the undelivered element. We would ask the Task Force to clarify the standards or requirements to be met in order for the vendor's ESP to be considered valid for use as stated in this Issue. For example, does the Task Force believe that a vendor who is selling a new offering in a new unfamiliar market is able to make an ESP that can be used for purposes of this Issue? In addition, how should these estimates be able to be substantiated?*

**EITF Issue 08-1 Question b:**

**Is the guidance in paragraph 17 regarding a vendor's best estimate operational and does it provide a principle that could be applied consistently?**

**Response to EITF Issue 08-1 Question b:**

*Examples 6 and 11 in Exhibit 08-1B illustrate how vendors could determine their ESP for undelivered elements, using a cost plus gross profit margin model that takes into consideration the competitive landscape and customer acceptance of pricing in the relevant markets in which they transact. The costs that are considered in determining ESP appear to be direct costs but the examples should be further clarified to address this point. Additionally, further clarity on how these costs should be determined would be beneficial to preparers.*

*We would suggest that additional guidance be provided as to what methods can be used to determine ESP for undelivered elements. Does the Task Force consider the cost plus gross profit margin model to be the only method that can be used for determining ESP? For hosting arrangements that fall within the scope of Issue 00-21 presently, our experience has been that a cost plus gross profit margin model is usually inconsistent with the go-to-market pricing models used because of low marginal cost infrastructures resulting in a revenue maximization approach to pricing rather than one that is affected by costs and margins.*

*We would suggest that further guidance be provided under Issue 08-1 as to how VSOE can be established. In practice, VSOE has been generally characterized as a narrow band or range of values (e.g. median value where 80% of the valid population of data fall within a range of +/- 15% of that median) based on the selling price of an element on a stand-alone basis. We believe that the absence of consistent selling prices is not necessarily indicative of a lack of fair value. We assert that if stand-alone transactions exist between willing buyers and willing sellers, then fair value exists. The inability to price consistently is often driven by competition which is a fundamental construct of a market system which defines fair value. We understand that inconsistency in pricing makes determining fair value more difficult. This leads to the risk that a company will not assign sufficient value to undelivered elements, thus inappropriately accelerating their revenue. We would suggest that where pricing is inconsistent, companies could be allowed to take the median value of the upper quartile of transactions, or some other reasonable measure of a minimum value, as fair value. We believe that this would more closely align the accounting for the revenue* *with the economic substance delivered. At the same time, it would not allow companies to assign an inappropriately low value to undelivered elements.*

*We also suggest that the Issue clearly state that the methodology used by vendors to estimate the selling price of undelivered elements under this Issue should be consistent with management's regular methodology and basis for determining selling prices for its offerings.*

**EITF Issue 08-1 Question c:**

**Do you agree with the consensus-for-exposure to require the use of the residual method and agree with the limit on the amount of the arrangement consideration that can be allocated to the delivered unit(s) of accounting?**

**Response to EITF Issue 08-1 Question c:**

*Although the best estimate method is the least preferable method in the selling price hierarchy, we believe that it is still a valid method for determining selling price. If it were not the case, then the selling price hierarchy should only be restricted to VSOE and TPE as is currently the case under Issue 00-21. Therefore, if the best estimate method is a proper and valid method for determining selling price, we do not believe that its use should be restricted to the residual method. The residual method, as noted in paragraph 25 of Statement of Position 98-9 Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions ("SOP 98-9"), is not an acceptable alternative to allocation based on relative fair values when VSOE of fair value exists for each element in a transaction. If the ESP method is a valid method of determining selling price, then we continue to believe that the relative fair value method of revenue allocation should be preferred. In addition, the use of ESP for all elements whether delivered or undelivered, in a relative fair value model is consistent with the approach generally practiced in accordance with International Accounting Standard 18 ("IAS 18") as well as the approach proposed by the International Accounting Standards Board ("IASB") / Financial Accounting Standards Board's ("FASB") Preliminary Views on Revenue Recognition in Contracts with Customers. Therefore, the residual method should be applied only when the relative fair value method cannot be used, i.e. when VSOE, TPE and ESP cannot be determined for all elements of the transaction. Adequate and proper disclosure, as proposed under the disclosure requirements of this consensus-for-exposure, should be* *sufficient to address financial statements users' requirements in this respect to revenue allocation methods employed by the financial statement preparer.*

*SOP 98-9 is the initial accounting standard that provided guidance on the residual method. SOP 98-9 does not contain any limit on the amount that can be allocated to the delivered element. If we applied the guidance in the consensus-for-exposure, we would have inconsistency in terms of limits on the amount we can allocate revenue to the delivered elements under SOP 98-9 compared to the consensus-for-exposure. This inconsistency does not arise from a difference in accounting principle but because of application of different standards. This inconsistency will also create process and systems impacts for vendors if there were to be different requirements arising from the transactions of the same economic substance. Therefore, we do not agree with the limit on the amount of the allocation to the delivered element.*

**EITF Issue 08-1 Question d:**

**Is the application of the residual method, including the limit, understandable and operational?**

**Response to EITF Issue 08-1 Question d:**

*There are two areas where there is ambiguity in the consensus-for-exposure and related examples:*

*i)* *The consensus-for-exposure is silent on the treatment of discount and whether it should be attributed entirely to the delivered elements or allocated between the delivered and undelivered elements. In contrast, SOP 98-9 states that to the extent that a discount exists, the residual method attributes that discount entirely to the delivered elements.*

ii) *We request more clarity on the application of the best estimate basis in the residual method when there are multiple units of the same deliverable involved.*

*For example, a vendor enters into an agreement with a customer to deliver the following for a total consideration of $1,000:*

- *Two units of hardware H, and*
- *Services S to maintain the hardware for a period of 1 year.*

*Both units of hardware H are expected to be delivered before commencement of services S. The vendor does not have VSOE nor TPE for hardware H nor services S. The vendor's ESP for each unit of hardware H is $500, and the ESP for services S is $200.*

*Should the revenue allocated to the first unit of hardware H be equal to that allocated to the second unit of hardware H? In other words, should the revenue allocated to hardware H be calculated at each point in time as each unit of the hardware is delivered, i.e. $300 for the first unit of hardware H and $500 for the second unit of hardware H. Or should the revenue allocated to hardware H be calculated such that multiple units of the same deliverable are allocated the same revenue per unit, i.e. $400 each for the 2 units of hardware H?*

**EITF Issue 08-1 Question e:**

**Is the required disclosure operational?**

**Response to EITF Issue 08-1 Question e:**

*We believe that where there is a significant amount of judgment involved that affect financial reporting, it is appropriate to provide the necessary disclosures to users of the financial statements in order to understand the information reported. However, we believe that more detailed guidance is required in this area such as examples of qualitative and quantitative information to be disclosed.*

**EITF Issue 08-1 Question f:**

**If you agree that the disclosure is operational, will it provide sufficient information for users of the financial statements to evaluate the use of estimates when an entity allocates arrangement consideration to revenue transactions?**

**Response to EITF Issue 08-1 Question f:**

*Please see our response to e. above.*

**EITF Issue 08-1 Question g:**

**If not, please describe what disclosures you believe should be required. Should the required disclosures include additional quantitative disclosures? If so, please describe the specific quantitative disclosures you believe should be provided and how those disclosures will improve a user's ability to evaluate reported revenues.**

**Response to EITF Issue 08-1 Question g:**

*Not applicable.*

**EITF Issue 08-1 Question h:**

**Do you agree that prospective adoption should be required?**

**Response to EITF Issue 08-1 Question h:**

*We believe that clarification of the effective date is required since the dates stated in the notice to the Draft Abstract and the consensus-for-exposure are different. We agree with the proposal for prospective adoption. We would like clarification as to the disposition of historical transactions that had been accounted for under previous guidance and for which revenue deferrals exist as at the adoption date of Issue 08-1.*

**EITF Issue 08-1 Question i:**

**Do you believe that the transition disclosure will be useful to users of the financial statements?**

**Response to EITF Issue 08-1 Question i:**

*We believe that the primary information that is of benefit to users of the financial statements are in relation to revenue arising from the vendor's use of ESP, rather than the broad categories of revenue recognized under Issue 00-21 compared to Issue 08-1. Therefore, the Issue should be clearer in terms of its requirements in this area.*

**EITF Issue 08-1 Question j:**

**If not, what transition disclosures should be required?**

**Response to EITF Issue 08-1 Question j:**

*See response to i. above.*

**EITF Issue 08-1 Question k:**

**Should early application of this Issue be permitted after an entity has issued interim financials for the current fiscal year?**

**Response to EITF Issue 08-1 Question k:**

*We would not be opposed to permitting early adoption together with restatement of the earlier interim periods. In this case, the financial statement preparers should comply with typical disclosures in relation to restatement.*

We thank the Board for the opportunity to provide our comments on this critical issue and appreciate the Board's consideration of the views we have provided. If you have any questions regarding our letter or would like to discuss our views in further detail, please feel free to contact me directly at (408) 527 – 0448.

Sincerely,

J. Chad

Jonathan Chadwick
Senior Vice President, Principal Accounting Officer
and Corporate Controller
Cisco Systems, Inc.

Enc. Appendix: Example of a transaction involving software-embedded devices where application of Issue 08-1 would result in improved financial reporting compared to application of SOP 97-2

**Appendix: Example of a transaction involving software-embedded devices where application of Issue 08-1 would result in improved financial reporting compared to application of SOP 97-2**

*There are transactions involving software-embedded devices where SOP 98-9 is applicable and the residual method is not yet able to be applied because VSOE cannot be determined for all undelivered elements. If the exceptions in paragraph 12 of SOP 97-2 are not applicable and all elements of the arrangement have not been delivered, all revenue is deferred until the point in time when VSOE exists for all undelivered elements, after which the residual method can be applied. Under Issue 08-1, if VSOE does not exist for the undelivered element, its fair value would be determined firstly using TPE, or secondly using the vendor's ESP. There is no longer a need to defer all revenue for the arrangement until all elements without VSOE are delivered. Therefore, revenue for software-embedded devices without VSOE are recognizable upon delivery, assuming all other revenue recognition criteria are met. This is illustrated in the example below.*

*<u>Example: Residual Accounting Model</u>*

*Background:*

*The vendor agrees on January 1, 20X1 to sell various software-embedded devices to the customer. These software-embedded devices comprise multiple units of device A and a unit of device B. The arrangement fee is $30 million. Payment for each device is due as it is delivered. VSOE has been determined for device A but not for device B. Device B has a list price of $15,000.*

*The units of device A are delivered to the customer over a period of 6 months from January 1, 20X1 to June 30, 20X1. Device B is delivered on June 30, 20X1. The functionality of device A is not dependent on device B and vice versa.*

*Economic substance of transaction:*

*A significant portion of the vendor's efforts and earnings process in relation to the sales of device A is completed as the devices were delivered over the period of 6 months because of the following reasons:*

- *Title and risk of ownership for the device A transfer to the customer upon delivery of the devices,*
- *Cashflows relating to the sales of the device A are due from the customer upon delivery of the devices, and*
- *From the customer's perspective, the economic value of the device A lies mainly in their purchase and usage in the customer's revenue generating activities. As device A's functionality is not dependent on device B, the customer has full utilization and benefit of the device from the time of delivery.*

*SOP 97-2/98-9 treatment:*

*Based on paragraph 12 of SOP 97-2, since device B does not have VSOE, all revenue relating to sales of device A that has been delivered over the six month period is deferred until device B is delivered on June 30, 20X1.*

*Issue 08-1 treatment:*

*Fair value for undelivered device B would be determined firstly using TPE or secondly using the vendor's ESP. The total fee could then be allocated based on the residual method to the various deliverables. Revenue allocated to sales of device A would be recognized upon delivery of these devices to the extent it does not exceed its fair value based on VSOE.*

*Improvement from applying Issue 08-1 treatment:*

*This treatment would be more closely aligned with the economic substance of the transaction which is described above as revenue is recognized in proportion to the economic value received by the customer.*