FASB Emerging Issues Task Force

Issue No. 08-1

Title: Revenue Recognition for a Single Unit of Accounting

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Previously distributed EITF materials: Issue Summary No. 1, dated February 29, 2008; Working Group Report No. 1, dated June 9, 2008

References:

FASB Statement No. 13, *Accounting for Leases* (FAS 13)

FASB Statement No. 45, *Accounting for Franchise Fee Revenue* (FAS 45)

FASB Statement No. 66, *Accounting for Sales of Real Estate* (FAS 66)

FASB Statement No. 154, *Accounting Changes and Error Corrections* (FAS 154)

FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees* (FIN 45)

FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts* (FTB 90-1)

FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (CON 5)

AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* (SOP 81-1)

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* **The alternative views presented in this Working Group Report are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

AICPA Statement of Position 97-2, *Software Revenue Recognition* (SOP 97-2)

AICPA Statement of Position 00-2, *Accounting by Producers or Distributors of Films* (SOP 00-2)

SEC Staff Accounting Bulletin 104, Topic 13, *Revenue Recognition* (SAB Topic 13)

EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables" (Issue 00-21)

Background

1. At the March 12, 2008 EITF meeting, the Task Force considered how an entity should attribute multiple customer payment streams to a single unit of accounting in a revenue arrangement.[1] An example of an arrangement with multiple payment streams is the situation in which a service provider receives an up-front payment upon signing a service contract with a customer and then receives additional payments as services are provided to that customer. Other examples can be more complex, such as in biotechnology and pharmaceutical research and development arrangements, because they may involve multiple deliverables, up-front payments, payments for specific services, and payments upon achievement of certain clinical milestones. Determination of the appropriate attribution model is further complicated if delivery of a single unit of accounting spans multiple accounting periods.

2. The ultimate objective of attributing arrangement consideration to a single unit of accounting is to determine when the arrangement consideration should be recognized as revenue. The fundamental criteria of revenue recognition are set forth in CON 5, paragraph 83, which states that "recognition involves consideration of two factors, (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration." Generally, revenue is considered both realizable and earned when each one of the following four conditions[2] is met:

a. Persuasive evidence of an arrangement exists
b. The arrangement fee is fixed or determinable
c. Delivery or performance has occurred
d. Collectibility is reasonably assured.

3. Initially, this Issue was based on the premise that all of the conditions for revenue recognition have been met except for delivery or performance. In other words, the sole intent of this Issue was to address when delivery or performance has occurred.

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[1] For simplicity and unless otherwise specified in this Issue, references to a single unit of accounting refer to arrangements that include a single revenue generating activity (single deliverable) or multiple revenue generating activities (multiple deliverables) that are accounted for under Issue 00-21 as a single unit of accounting (that is, multiple deliverables that cannot be separated for revenue recognition purposes).

[2] References to the four conditions can be found in SAB Topic 13A1; SOP 97-2, paragraph 8; SOP 00-2, paragraph 7, and other revenue recognition accounting literature.

4. Constituents have adopted various accounting methods to attribute revenue in arrangements that have multiple payment streams that are accounted for as a single unit of accounting. In both Issue Summary No. 1 and Working Group Report No. 1, the staff classified those various methods as either a Single Attribution Model or a Multiple Attribution Model. Under a Single Attribution Model, all arrangement consideration is recognized using a single method, such as straight-line over the arrangement term or on a per unit basis, but not both. Under a Multiple Attribution Model, arrangement consideration is recognized using multiple methods for the single unit of accounting; for example, an up-front payment may be recognized on a straight-line basis over the term of the arrangement while a price per unit may be recognized as units are delivered.

5. At the March 12, 2008 EITF meeting, some Task Force members questioned whether this Issue was appropriately addressing the practice issues that initially gave rise to the Issue being added to the EITF agenda and asked the staff to perform additional research. In response, Task Force members were solicited for examples of fact patterns that they believed required their consideration. In addition, Task Force members were requested to articulate the underlying issue or issues creating the practice concerns and to provide input on how to resolve those issues. Respondents indicated that the issues included in Issue Summary No. 1 were the proper questions to be addressed and provided examples to illustrate the practice issues.

6. Based on Task Force members' responses, the Issue 08-1 Working Group (Working Group) was formed to explore the practice issues in detail. The objectives of the Working Group were to:

a. More thoroughly identify and evaluate the practice issues
b. Determine the questions to be asked to address those practice issues
c. Develop a recommendation for the Task Force.

7. The Working Group met on June 6, 2008. There was general agreement among Working Group members that applying a Multiple Attribution Model to a single unit of accounting would be acceptable in certain facts and circumstances. In addition, Working Group members discussed various scenarios in which a Multiple Attribution Model might be acceptable and considered whether existing accounting literature would prevent the use of such a model. However, there

was diversity among Working Group members as to what would constitute a Multiple Attribution Model. The following topics were discussed in the context of a Multiple Attribution Model:

a. Whether "standing ready to perform" is a deliverable
b. How contingently deliverable products or services impact revenue attribution
c. How substantive delivery or performance bonuses impact revenue attribution
d. The impact of the "objective and reliable evidence of fair value" threshold of Issue 00-21 on revenue attribution
e. The use of the straight-line attribution method for convenience when a more precise measure of performance or delivery is impracticable to determine.

8. No majority decision was reached by the Working Group. The Working Group was split as to whether to recommend to the Task Force that it continue or cease discussion of the Issue. Furthermore, the Working Group was split (assuming the Issue continued to be considered) on what the scope of the Issue should be and how the Issue should be addressed. Hence, no recommendation on that topic was established by the Working Group.

9. At the June 12, 2008 EITF meeting, the Task Force was given a status report on the discussions of the Working Group. There was general agreement among Task Force members that the Working Group should continue to explore the Issue.

10. The Working Group next met on July 15, 2008. At that meeting, the Working Group deliberated each of the following topics separately: (a) scope, (b) alternative project plans, and (c) the practice issues to be addressed in this Issue.

Scope

11. The staff recommended that the Working Group initially limit its consideration of practice issues to those arrangements within the scope of paragraph 4 of Issue 00-21. Certain Working Group members presented arguments for expanding the scope of Issue 08-1 to include arrangements within the scope of SOP 97-2 and possibly other revenue recognition literature. However, the Working Group ultimately agreed to proceed with a more limited initial scope with the understanding that it would be provided an opportunity at a later date to consider whether its

recommendations should be expanded to include other revenue recognition literature. Therefore, the Working Group proceeded with a discussion of the alternative project plans and practice issues based on an initial scope that was limited only to those arrangements within the scope of paragraph 4 of Issue 00-21.

Alternative Project Plans

12. Working Group members discussed the following alternative project plans:

Plan A: Stand-Alone Interpretive Guidance
Plan B: Adopt Portions of the Revenue Recognition Project
Plan C: Reconsider Existing Literature
Plan D: Stand-Alone Disclosure Guidance.

13. Under Plan A, this Issue would be directed towards the issuance of interpretive guidance and not a complete reconsideration of existing literature. Plan A would address the specific issues encountered in practice and may result in some minor modifications to existing literature but not wholesale changes. For example, this plan would not provide for reconsideration of whether revenue recognition should be based on a customer perspective or a provider perspective.

14. Under Plan B, the Issue would focus on early adoption of selected portions of the ongoing joint revenue recognition project. The significance of the guidance adopted from the revenue recognition project would likely dictate whether the Working Group's recommendation is issued in the form of interpretive guidance or a revision of existing literature.

15. Under Plan C, the Issue would focus on a reconsideration of existing literature. While this plan may provide interpretive guidance, the real focus of this plan would be a reconsideration of whether existing revenue recognition literature should be revised. For example, whether the customer focus in existing literature should be replaced with a provider focus. Unlike Plan A, this plan may result in more substantive changes to existing revenue recognition guidance, such as Issue 00-21.

16. Under Plan D, the Issue would be directed towards the issuance of additional revenue recognition disclosure guidance. While Plans A-C may also include disclosure requirements, Plan D would be limited to providing disclosure guidance and would not provide any interpretive guidance on how to recognize revenue.

17. Working Group members agreed to proceed with a discussion of the practice issues based on Plan A with an understanding that existing literature, particularly Issue 00-21, may require amendment. The Working Group agreed that the need to amend existing literature was dependent on what issues the Working Group recommends the Task Force address and what conclusion it reaches on those issues.

Practice Issues

18. At the March 12, 2008 EITF meeting, discussion initially focused on whether, under certain facts and circumstances, it was acceptable to use a Multiple Attribution Model to account for a single unit of accounting consisting of a single deliverable or multiple deliverables. However, at the June 6, 2008 Working Group meeting, there was diversity among Working Group members as to what would constitute a Multiple Attribution Model. Throughout discussion of this Issue by both Working Group and Task Force members, the conversation generally moved away from the acceptability of applying a Multiple Attribution Model to a single unit of accounting toward a discussion of specific facts and circumstances giving rise to the practice issues. Accordingly, for the July 15, 2008 and August 7, 2008 Working Group meetings, Working Group members focused their discussion on the facts and circumstances that give rise to the practice issues and not on whether the practice issue was caused by the use of a Single or Multiple Attribution Model.

19. Revenue recognition for a single unit of accounting depends on the nature of the deliverable(s) composing that unit of accounting, the corresponding revenue recognition criteria, and whether those criteria have been met. Current guidance does not explicitly address many of the issues encountered by entities in practice. As a result, entities have adopted various methods for addressing the issues encountered in practice. Those practice issues can generally be arranged into the following two categories: those impacting the determination of the unit of accounting under Issue 00-21 and those related to revenue recognition attribution methods. Any Working

Group recommendations impacting the determination of the unit of accounting would require an amendment to Issue 00-21, while recommendations providing guidance on revenue recognition methods would most likely result in the issuance of a new abstract. The following are the six practice issues identified by the staff and presented to the Working Group for discussion:

Unit of Accounting:

a. Whether "access or standing ready to perform" can be a deliverable
b. Whether and how contingent deliverables should impact revenue recognition
c. Whether the fair value threshold requirement of Issue 00-21 needs to be revised

Revenue Recognition Attribution Methods:

d. Whether the Milestone Method is an acceptable attribution method of revenue recognition
e. How the proportional performance model should be applied to a single unit of accounting composed of multiple deliverables
f. Whether straight-line for convenience is acceptable.

20. Before proceeding with a discussion of the practice issues as identified above, Working Group members were requested to provide input as to whether there were other practice issues that might warrant consideration. Working Group members generally agreed that the only additional item that might warrant consideration was the issue of defining a deliverable. The staff acknowledged that the term deliverable is currently not clearly defined in the accounting literature and that a considerable amount of judgment is required to identify a deliverable. However, the staff also noted that the Issue 00-21 Working Group concluded, after considerable time and effort, that the development of a conceptual definition of a deliverable would prove impractical. The staff recommended that the Working Group limit its discussion of deliverables to a determination of whether certain items are deliverables and not address the broader issue of defining a deliverable. Working Group members generally agreed that the issue of what is a deliverable may be more appropriately addressed in a separate project, apart from Issue 08-1, and agreed to proceed with a discussion of the practice issues identified by the staff. Working Group

members also noted that the scope of the FASB's revenue recognition project encompasses creation of a definition of a deliverable (performance obligation).

21. Note that the following summary of the Working Group's discussion of practice issues includes information from both the July 15, 2008 and August 7, 2008 meetings, as applicable.

Practice Issues - Access or Standing Ready to Perform

22. As discussed earlier, certain revenue arrangements have multiple payment streams for deliverables accounted for as a single unit of accounting. As an entity evaluates how to recognize revenue in its specific facts and circumstances, it must first identify all of the deliverables in the arrangement. That step is necessary because each deliverable must be evaluated to determine whether it should be accounted for separately or in combination with other deliverables for purposes of revenue recognition in accordance with the guidance in Issue 00-21 or other applicable guidance.

23. Throughout each of the EITF and Working Group discussions on this matter, the question arose as to whether access or standing ready to perform (generally referred to as "Access" throughout the remainder of this Working Group Report) should be considered a deliverable.

24. The objective of this practice issue was to determine whether there were circumstances under which Access could be a deliverable.

25. The Working Group provided arguments for and against Access being considered a deliverable and indicated that there appears to be diversity in practice regarding under what circumstances entities consider Access to be a deliverable. However, there was general agreement of the Working Group that for various reasons, this diversity was not resulting in inappropriate revenue recognition models but that the diversity was most likely caused by the individual facts and circumstances in the arrangement.

26. The Working Group decided to recommend that the Task Force not provide guidance on when "access or standing ready to perform" should be a deliverable.

Practice Issues - Contingent Deliverables

27. The Working Group discussed whether and how contingent deliverables should impact an entity's revenue recognition attribution model. That is, whether a contingent deliverable should be evaluated at the inception of the arrangement as a deliverable, evaluated at the time of delivery as a deliverable (requiring re-evaluation of the arrangement under 00-21), or treated as a separate arrangement.

28. At the July 15, 2008 Working Group meeting, the majority of the discussion on contingent deliverables centered on defining a contingent deliverable and various scenarios involving contingencies in a revenue arrangement. Working Group members sorted those scenarios into the following three categories:

a. Contingent Payments—The terms of the arrangement provide the vendor with additional consideration based upon the outcome of possible future events
b. Optional Purchases—The terms of the arrangement provide the customer with an option to purchase products or services in the future
c. Contingent Deliverables—The terms of the arrangement call for a revenue generating activity whose delivery is contingent upon the occurrence of a future event that is not exclusively within the control of the customer. If that future event occurs, the explicit terms of the arrangement require the vendor to deliver specified products or services.

29. The Working Group agreed that the treatment of Contingent Payments depends on whether the arrangement consideration is fixed or determinable. The Working Group also agreed to limit its consideration of whether an arrangement fee is fixed or determinable to those issues addressed under the heading "Practice Issues - Milestone Method." As it relates to Optional Purchases, there was general agreement among Working Group members that the issue of Optional Purchases is not causing practice concerns.

30. At the August 7, 2008 Working Group meeting, the Working Group continued its discussion of Contingent Deliverables. More specifically, the Working Group discussed whether Issue 00-21 currently requires Contingent Deliverables to be considered deliverables at the inception of an arrangement. Views on that question were mixed. However, Working Group

members generally agreed that the proposed change to the fair value threshold of Issue 00-21 would solve the majority of the practice issues in this area. See Example 1, R&D Arrangement – Contingent Deliverable, included at Exhibit 08-1A, for an illustration of fact patterns frequently discussed in the context of this practice issue.

31. The Working Group decided to recommend that the Task Force not provide guidance on Optional Purchases or Contingent Deliverables. However, the Working Group also indicated that this recommendation should be reconsidered if the Task Force chooses not to accept the Working Group's recommendation related to the fair value threshold of Issue 00-21.

Practice Issues - Fair Value Threshold

32. Once an entity has identified the deliverables in an arrangement, it must then determine whether a particular deliverable may be accounted for separately from the other deliverables in an arrangement. The guidance for making such a determination is included in paragraph 9 of Issue 00-21. Among the requirements of paragraph 9 is the stipulation that in order to account for the *delivered* items as a separate unit of accounting, there must be objective and reliable evidence of fair value of the *undelivered* item(s) in the arrangement. The arrangement consideration allocable to a delivered item(s) that does not qualify as a separate unit of accounting within the arrangement should be combined with the amount allocable to the other applicable undelivered item(s) within the arrangement. The appropriate recognition of revenue should then be determined for those combined deliverables as a single unit of accounting.

33. The lack of objective and reliable evidence of fair value of the undelivered item(s) in the arrangement is one of the most common reasons entities are unable to separate deliverables in an arrangement under Issue 00-21. At the July 15, 2008 Working Group meeting, members agreed that the objective and reliable evidence of fair value threshold of Issue 00-21 should be amended. More specifically, the Working Group recommendation would require an entity to apply the residual method described in paragraph 12 of Issue 00-21 by estimating a standalone fair value for the undelivered item(s) in an arrangement in those situations in which the entity did not have vendor-specific objective evidence (VSOE as defined in paragraph 10 of SOP 97-2) or objective and reliable evidence (VOE) of selling price for the undelivered item(s) in the arrangement. In those situations in which an entity did not have VSOE or VOE of fair value for the undelivered

items in an arrangement, the entity would be required to follow the residual method of allocation currently provided for in Issue 00-21.

34. Working Group members emphasized that the requirement for an entity to estimate fair value would be limited to the undelivered item(s) in an arrangement and then only when VSOE or VOE was unavailable for the undelivered items. Part of the Working Group's basis for this recommendation was that it was concerned about attributing more revenue to the delivered items when VSOE or VOE was not available for the undelivered item; that is, attributing more of the arrangement discount to the undelivered item as a result of the use of estimates. In addition, the Working Group discussed a practicability concern of requiring entities to determine an estimated fair value for a delivered item that may require the use of significant judgment. The Working Group noted that most entities are comfortable with the application of the residual method under Issue 00-21 already and believe that requiring an estimate of fair value for delivered items would be a more significant change to practice than is needed to address the practice issues. As a result, Working Group members believe that their recommendation would reduce the number of situations in which deliverables cannot be separated from other deliverables in an arrangement while preventing premature recognition of revenue in those situations in which the fair value of the undelivered item has to be estimated due to the lack of VSOE or VOE.

35. In addition, Working Group members noted that while the proposed change to the fair value threshold of Issue 00-21 would not allow for estimation of fair value for the delivered items, the recommendation to allow estimates is consistent with the current discussions regarding measurement in the FASB's long-term joint revenue project.

36. The Working Group's recommendation would result in an amendment to Issue 00-21. The following excerpts illustrate the amendments the staff believes would be necessary to reflect the Working Group's recommendation. [Added text is <u>underlined</u> and deleted text is ~~struck out~~.] In addition to the revisions presented below, modification of some of the Issue 00-21 examples and other minor changes would also be required to reflect the Working Group's recommendation.

> 9. In an arrangement with multiple deliverables, the delivered item(s) should be considered a separate unit of accounting if <u>both</u> ~~all~~ of the following criteria are met:

a. The delivered item(s) has value to the customer on a standalone basis. That item(s) has value on a standalone basis if it is sold separately by any vendor or the customer could resell the delivered item(s) on a standalone basis. In the context of a customer's ability to resell the delivered item(s), the Task Force observed that this criterion does not require the existence of an observable market for that deliverable(s).

b. ~~There is objective and reliable evidence of the fair value of the undelivered item(s).~~Text deleted.

c. If the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the vendor.

12. If there is objective and reliable evidence of fair value (as discussed in paragraph 16) for all units of accounting in an arrangement, the arrangement consideration should be allocated to the separate units of accounting based on their relative fair values (the relative fair value method), except as specified in paragraph 13. However, in the absence of vendor-specific objective evidence (VSOE) or acceptable third-party evidence of fair value (as discussed in paragraph 16) for all units of accounting in the arrangement, ~~there may be cases in which there is objective and reliable evidence of the fair value(s) of the undelivered item(s) in an arrangement but no such evidence for the delivered item(s). In those cases~~, the residual method should be used to allocate the arrangement consideration. Under the residual method, the amount of consideration allocated to the delivered unit(s) of accounting ~~item(s)~~ equals the total arrangement consideration less the aggregate fair value of the undelivered unit(s) of accounting ~~item(s)~~. The "reverse" residual method (that is, using a residual method to determine the fair value of an undelivered unit(s) of accounting ~~item~~) is not an acceptable method of allocating arrangement consideration to the separate units of accounting, except as described in paragraph 13.

16. Contractually stated prices for individual products and/or services in an arrangement with multiple deliverables should *not* be presumed to be representative of fair value. The best evidence of fair value is the price of a deliverable when it is regularly sold on a standalone basis. Fair value evidence often consists of entity-specific evidence or VSOE of

fair value. As discussed in paragraph 10 of SOP 97-2, VSOE of fair value is limited to (a) the price charged for a deliverable when it is sold separately or (b), for a deliverable not yet being sold separately, the price established by management having the relevant authority (it must be probable that the price, once established, will not change before the separate introduction of the deliverable into the marketplace). The use of VSOE of fair value is preferable in all circumstances in which it is available. Third-party evidence of fair value (for example, prices of the vendor's or any competitor's largely interchangeable products or services in standalone sales to similarly situated customers) is acceptable if VSOE of fair value is not available. In the absence of VSOE or acceptable third-party evidence of fair value for an undelivered unit of accounting, the vendor must use its best estimate of the fair value for the undelivered unit of accounting. The vendor's best estimate of fair value shall be consistent with the objective of determining the entity's selling price for the unit of accounting if it was to be sold separately.

37. Transition and effective date issues are addressed later in this document.

Practice Issues - Milestone Method

38. Another practice issue raised during the Working Group discussions of Issue 08-1 is the topic of milestone payments and whether the use of the Milestone Method of revenue recognition is currently acceptable under U.S. Generally Accepted Accounting Principles (U.S. GAAP). More specifically, the questions raised around milestones and the Milestone Method are:

a. Is "achieving a milestone" a deliverable?

b. If "achieving a milestone" is a deliverable, must the deliverable be evaluated along with other deliverables in an arrangement under Issue 00-21?

39. The following definition of the Milestone Method was provided to Working Group members to facilitate their discussion of this Issue:

> Milestone Method[3]
>
> The milestone-based method separates, rather than combines, the up-front and milestone payments. Because the up-front fee does not relate to a discrete earnings process, it should be recognized over the performance period on a systematic and rational basis…. The milestone payments, however, are deemed to relate to the portion of the performance period that is dedicated to achieving that specific milestone. As a result, each milestone is, in substance, treated as if it were a separate contract to be evaluated under a Completed Performance model.
>
> The milestone-based method assumes that each milestone is substantive. If they are not, the milestone-based method cannot be used. In these situations, the basis of the method falls apart because customers would not separately pay for achieving a nonsubstantive milestone. Determination of whether a milestone is substantive and meaningful is a matter of judgment. Questions that should be considered in this assessment include:
>
> - Is substantive effort required to reach the milestone?
> - What labor and other costs must be incurred to achieve the milestone?
> - What type of skill is required to achieve the milestone?
> - How certain is achievement of the milestone?
> - Does the amount of the milestone payment seem reasonable in light of the effort required to achieve the milestone?
> - How does the elapsed time between the payments compare to the effort required to reach the milestone?

40. Working Group members observed that some constituents view a milestone to be a deliverable. They also noted that those same constituents believe it is inconsistent with Issue 00-21 to exclude such deliverables from a determination of the revenue attribution for an arrangement. Those constituents believe that based on paragraph 8 of Issue 00-21, a vendor should evaluate all deliverables in an arrangement to determine whether the deliverables represent separate units of accounting at the inception of the arrangement **and** again as each item in the arrangement is delivered.

41. However, the Working Group generally did not consider a milestone to be a deliverable. Rather, Working Group members generally agreed that achieving a milestone represented the

[3] Source: *2008 Revenue Recognition Guide*, by Ashwinpaul C. Sondhi and Scott A. Taub.

resolution of whether the contingent portion of the fee associated with a deliverable that includes a milestone payment is fixed or determinable. For example, in a Biotech arrangement in which Biotech is providing R&D services but receives a milestone payment upon achievement of Food and Drug Administration (FDA) approval, the Working Group did not consider FDA approval to be a deliverable. The Working Group agreed that since Biotech does not have the proper authority to issue FDA approval, FDA approval cannot be considered a deliverable in the arrangement. Rather, the Working Group believed that the additional payment represented a contingent fee that became fixed upon achievement of the milestone (a direct result of the R&D services provided by Biotech in the above example). As a result, Working Group members reached agreement on the following definition of a milestone:

> Milestone - An event that, under the terms of the arrangement, if achieved, may entitle the vendor to additional compensation based on either the vendor's performance or a specific outcome resulting from the vendor's performance.

42. Because Working Group members view the milestone payment as additional compensation that is earned based on either the level of the vendor's performance or a specific outcome resulting from the vendor's performance (for example, performance of R&D services by a Biotech that leads to FDA approval), Working Group members also agreed that the milestone payment may relate to past performance and may be a good indicator of the value provided to the customer by way of the vendor's performance for that aspect of that arrangement. Accordingly, Working Group members believed that a revenue recognition model that captures the value transferred to the customer would be consistent with U.S. GAAP; specifically, the proportional performance model of revenue recognition.

43. Working Group members noted that while the proportional performance model is not fully defined within U.S. GAAP, the model has generally been accepted as a way of recognizing revenue in a pattern that reflects a vendor's performance under the contractual arrangement. In other words, under the proportional performance model, revenue is recognized as performance occurs based on the relative value of the performance that has occurred up to that point in time.

44. Working Group members agreed that because the objective of the Milestone Method is to determine whether a milestone payment is indicative of value transferred to a customer, the

Milestone Method may be a valid application of the proportional performance model. However, for the Milestone Method to be a valid application of the proportional performance method, the Working Group agreed that the milestone in an arrangement must be substantive. Working Group members also agreed that if the milestone in an arrangement was not substantive; the Milestone Method should not be used for that milestone. Determining whether a milestone is substantive and meaningful is a matter of judgment. Working Group members indicated that the following principle should be applied to each milestone in making a determination as to whether the milestone payment is substantive:

> The amount of the payment associated with the milestone is commensurate with the effort required to achieve the milestone, relates solely to past performance and is not unreasonable when considering the deliverables and payment terms (including other potential milestone payments) within the arrangement.

45. The following are factors an entity shall consider in its assessment of the above principle. However, not withstanding the following factors, a milestone shall not be considered substantive if any portion of the milestone payment relates to the remaining deliverables in the unit of accounting. Furthermore, in order to recognize revenue immediately for a milestone payment, that milestone payment must be substantive in its entirety. It is not appropriate to bifurcate a milestone payment into substantive and non-substantive components. If the milestone is not substantive, the Milestone Method shall not be used.

46. No one factor is indicative as to whether a milestone is substantive but, rather, these factors (along with other facts and circumstances, as appropriate) should be evaluated in their totality at the inception of the arrangement in the context of the entire arrangement. The following are factors that shall be considered in determining whether the milestone is substantive:

- There is a substantive uncertainty that the vendor will achieve the milestone
- Highly specialized skills are required to achieve the milestone
- The amount of labor and other costs that are expected to be incurred to achieve the milestone and the value transferred are reasonable in relation to the payment amount
- Resources necessary to achieve the milestone are scarce.

47. Working Group members also agreed that while the Milestone Method is an acceptable revenue attribution model, it is not necessarily the only acceptable revenue attribution model available under U.S. GAAP, even if the milestone is substantive.

48. The FASB staff asked the Working Group to discuss possible objections to the Milestone Method. One objection considered was whether the application of the Milestone Method allows entities to ignore their method of calculating proportional performance because it allows the entity to recognize the full milestone payment without attributing it proportionally to the entire deliverable or components of the unit of accounting. For example, in an R&D arrangement, it would not be uncommon for Biotech to attribute revenue based on the number of hours of R&D service performed. When recognizing all of the milestone payment, Biotech does not attribute that milestone payment to all of the R&D hours that will be performed within the arrangement, but instead attributes it only to those R&D hours that have been completed. As R&D hours are not distinguishable from one another, a question exists as to whether the milestone payment should be attributed proportionally to each R&D hour performed within the arrangement. Working Group members discussed this potential objection but concluded that they consider the Milestone Method to be an application of the proportional performance model with the objective of measuring the value of the performance that has occurred up to a specific point in time.

49. One of the arguments in support of the Milestone Method is that a substantive milestone is indicative of additional value transferred to the customer. For example, successful completion of a particular stage of clinical studies may be viewed by the customer as a reduction of the risk that a drug will never reach commercial viability, which increases the value of the R&D services performed to date. Another potential objection to the Milestone Method as described within this Working Group Report that was discussed by the Working Group was whether it provides sufficient guidance on how to measure the additional value received by the customer (for example, whether some portion of the payment should be attributed to undelivered elements of the arrangement). The Working Group discussed that potential objection but concluded that the Milestone Method provides a principle within which entities are allowed to use judgment in determining whether the milestone payment is substantive and, accordingly, whether the milestone payment is indicative of the additional value transferred to the customer.

50. It is the Working Group's recommendation that the Task Force issue guidance that provides for the use of the Milestone Method as outlined above.

51. See Example 2, R&D Arrangement – Milestone Method included at Exhibit 08-1A for an illustration of fact patterns frequently discussed in the context of this practice issue.

Practice Issues - Proportional Performance Model

52. Throughout the discussion of Issue 08-1, there was a lack of agreement among Working Group members as to what constituted a Single Attribution Model versus a Multiple Attribution Model. One of the issues giving rise to that confusion is that some constituents believe the use of the proportional performance model for a single unit of accounting composed of multiple deliverables is a Single Attribution Model while others believe the resulting model is more appropriately considered a Multiple Attribution Model.

53. The Working Group discussed various scenarios under which an entity may use the proportional performance model and whether there was any diversity in how the proportional performance was being applied in practice. In addition, the Working Group discussed whether an entity should be allowed to use a proportional performance model based on delivery of the underlying deliverables when having to account for the multiple deliverables as a single unit of accounting.

54. Working Group members did not observe sufficient diversity in the application of the proportional performance model to warrant the issuance of guidance on its application. Additionally, Working Group members believe that many of the practice issues that may exist in this area would be resolved if the Task Force accepts the Working Group's recommendation related to the fair value threshold of Issue 00-21.

Practice Issues - Straight-line for Convenience

55. Working Group members discussed the issue of straight-line for convenience. An example of a straight-line attribution model is where an entity recognizes up-front nonrefundable fees as revenue evenly over the arrangement term while using a different method to recognize the remaining arrangement consideration. For example, an entity may decide to amortize an upfront

nonrefundable fee over the arrangement term and recognize any fees received from product purchases as received (earned).

56. Working Group members discussed whether this issue was frequently encountered in practice or whether the result of a different attribution model may appear to result in a straight-line for convenience attribution. For various reasons, the Working Group recommends not providing any guidance related to straight-line for convenience.

Accounting Issues and Working Group Recommendations

57. After consideration of the input received from the Working Group members, the Task Force will be asked to discuss the questions presented below. Alternative views to the questions are not presented in this Working Group Report. Ultimately, the Task Force will be asked to consider the recommendations of the Working Group, with or without refinements, and then to decide whether to return the issues to the Working Group for further consideration or provide an alternative plan for the resolution of those issues. If the Task Force agrees to accept the Working Group's recommendations, the Task Force will be provided with an opportunity to address scope, transition, effective date, and disclosure for each of the issues. In addition, the recommendations set forth below are not considered interdependent. That is, if the Task Force decides not to accept one of the Working Group's recommendations, that decision does not impact the Task Force's consideration of the remaining Working Group recommendations.

58. In addition, the Task Force will also be provided with an opportunity to discuss those practice issues for which the Working Group chose not to make a recommendation.

Question 1 – No Recommendation Provided

59. As discussed earlier in this Working Group Report, the Working Group discussed six specific practice issues and the facts and circumstances that give rise to them. Because of a lack of diversity in how entities are addressing the practice issues or because the diversity that did exist was not resulting in inappropriate revenue recognition models, the Working Group chose

not to provide recommendations on the following four practice issues:

a. Whether "access or standing ready to perform" can be a deliverable
b. Whether and how contingent deliverables should impact revenue recognition
c. How the proportional performance model should be applied to a single unit of accounting composed of multiple deliverables
d. Whether straight-line for convenience is acceptable.

Question 1—Does the Task Force agree with the Working Group's recommendation not to provide guidance on the above four practice issues?

Questions 2 through 6 – Proposed Amendment to Issue 00-21 Fair Value Threshold

60. As discussed earlier in this Working Group Report, the lack of objective and reliable evidence of fair value of the undelivered item in an arrangement is one of the more common reasons entities are unable to separate deliverables in an arrangement under Issue 00-21. This often resulted in accounting models that many felt did not reflect the underlying economics of a transaction. As a result, the Working Group agreed that the objective-and-reliable-evidence-of-fair-value threshold of Issue 00-21 should be modified. More specifically, the Working Group recommended allowing an entity to use a best estimate of selling price for the undelivered item(s) in an arrangement in those situations in which the entity does did not have VSOE or VOE of selling price for the undelivered item(s) in the arrangement.

Question 2—Does the Task Force agree with the Working Group's recommendation to modify the objective-and-reliable-evidence-of-fair-value threshold of Issue 00-21 for undelivered?

<u>Scope</u>

61. Question 2 relates to a Working Group recommendation to amend the fair value threshold of Issue 00-21. While the Working Group provided no recommendation to revise the existing scope of Issue 00-21,the Working Group did recommend that the Task Force consider adding a project to consider whether any change to the fair value threshold of Issue 00-21 should be expanded to other revenue recognition guidance, specifically SOP 97-2. In addition, some members of the Working Group recommended that the notice to recipients of a draft abstract for Issue 08-1

specifically solicit constituents' views regarding whether the variance in allocation principles between Issue 00-21, as proposed, and other revenue recognition guidance will create practice issues for constituents.

Question 3—Does the Task Force agree with the recommendation to limit the scope of the amendment to items within the scope of paragraph 4 of Issue 00-21?

Transition

62. The Working Group discussed the following transition alternatives but was unable to reach agreement on a recommendation for the Task Force.

Alternative A: Retrospective Application

The consensus should be applied retrospectively to all prior periods presented. The cumulative effect of the change in accounting principle on periods prior to those presented should be recognized as of the beginning of the first period presented. An offsetting adjustment should be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period, presented separately.

Alternative B: Entities should recognize the effect of the change on all outstanding revenue arrangements that have undelivered units of accounting at the effective date through a cumulative-effect adjustment to beginning retained earnings at the effective date

The consensus should be applied to all undelivered units of accounting for all outstanding revenue arrangements as of the beginning of the fiscal year in which the consensus is initially applied as if the revenue arrangement was entered into on the effective date. The cumulative effect of the change in accounting principle should be recognized as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that fiscal year, presented separately.

No cumulative-effect adjustment shall be recorded when the fair value of the undelivered units of accounting exceeds the deferred revenue under the arrangement at the effective date. In those cases in which the fair value of the undelivered units of accounting exceeds the deferred revenue under the arrangement at the effective date, the deferred revenue shall be allocated to the undelivered units of accounting based on the relative fair value of the undelivered units of accounting.

In those cases in which the deferred revenue under the arrangement exceeds the fair value of the undelivered units of accounting at the effective date, the cumulative-effect adjustment shall equal the sum of deferred revenue minus the fair value of the undelivered units of accounting at the effective date (net of the change in deferred costs directly related to the deferred revenue).

Alternative C: Entities should recognize the effect of the change on a prospective basis to revenue arrangements entered into after the effective date.

Alternative C would require entities to apply the consensus only to those revenue arrangements entered into after the effective date.

63. The Working Group acknowledged that retrospective application is generally the preferred method of transition. However, some Working Group members expressed a concern that retrospective application would require a significant undertaking given the number of revenue arrangements an entity may have had and the age of some of those arrangements. In addition, some Working Group members expressed a concern over the use of hindsight and how it might inappropriately affect the determination of fair value. Furthermore, given the significance of revenue to most entities' financial statements, some Working Group members were concerned that entities might incur significant costs that might otherwise be avoided if another transition method were selected. Other Working Group members noted that because of the significance of revenue to an entity's financial statements and operational trends, some entities may prefer the retrospective application. Working Group members considered a transition similar to the transition provided by Issue 00-21 (prospective with an alternative for reporting the change in accounting as a cumulative-effect adjustment).

64. Working Group members agreed that the prospective basis would eliminate the need to reassess all revenue arrangements and the need to perform activities that may not be considered

cost beneficial. However, they also acknowledged that this alternative would create inconsistency in reporting simply because it is based on the time frame for when an arrangement was consummated.

65. Some Working Group members appeared to support Alternative B; however, they were concerned that this alternative would effectively result in the loss of revenue as certain amounts of deferred revenue at the effective date would never be recognized through earnings.

66. As a result of the above, Working Group members were unable to reach a recommendation on transition. Depending on the Task Force's response to this question, there may be a need to specify whether the transition guidance of this Issue applies to uncompleted arrangements as of the effective date or only to arrangements entered into after the effective date.

Question 4—What transition alternative does the Task Force recommend?

Effective Date

67. While the Working Group did not provide a specific recommendation regarding the effective date; Working Group members did support allowing entities the ability to early adopt the guidance included in this Issue. Working Group members also indicated that they understand early adoption is normally precluded because users prefer, for consistency reasons, that all entities adopt a new standard at the same time. However, because of the existing fair value threshold within Issue 00-21, there already exists a lack of consistency for reporting revenue among entities. Working Group members did not believe that the level of consistency would be negatively impacted by allowing the guidance within this Issue to be early adopted.

68. Based on the above, the Task Force is being asked to consider whether the consensus on this Issue should be effective on the last day of the first annual reporting period ending after December 15, 2009. The transition guidance of this Issue shall be applied as of the first day of the annual reporting period that includes the effective date. Interim periods within the annual reporting period that includes the effective date shall be restated to conform to the provisions of this Statement. Earlier application of the consensus on this Issue is permitted.

Question 5—Does the Task Force agree with the effective date?

Disclosures

69. Working Group members recommend that the Task Force modify the disclosure requirements of Issue 00-21 to include a requirement, for material revenue arrangements, that entities disclose the methods used to estimate fair value when fair value is based on the entity's best estimate. Working Group members also recommended that the notice to recipients of a draft abstract specifically solicit constituents' views regarding the sufficiency of Issue 00-21 disclosure requirements.

Question 6—Does the Task Force agree with the Working Group's recommendation regarding disclosure?

Questions 7 through 11 – Proposed Separate Milestone Method

70. As discussed earlier in this Working Group Report, the Working Group views the milestone payment as additional compensation that is earned based on either the level of the vendor's performance or the outcome resulting from the vendor's performance and as a payment that may be a good indicator of the value provided to the customer by way of the vendor's performance for that aspect of that arrangement. Accordingly, Working Group members believed that a revenue recognition model that captures the value transferred to the customer would be consistent with U.S. GAAP and recommended that the Task Force issue guidance on the application of the Milestone Method.

Question 7—Does the Task Force agree with the Working Group's recommendation to provide guidance on the application of the Milestone Method?

Scope

71. While the Working Group provided a recommendation to the Task Force to issue guidance regarding the application of the Milestone Method, the Working Group did not fully explore the issue of scope other than to indicate that the application of the Milestone Method should not be applied in situations in which an arrangement is otherwise required to be accounted for in accordance with recognition guidance of another standard, for example SOP 97-2.

72. Consistent with the Working Group's discussion, the following proposed scope is being presented to the Task Force for its consideration:

> This Issue applies to all contractual arrangements (whether written, oral, or implied, and hereinafter referred to as "arrangements") under which a vendor satisfies its performance obligations by providing products, services, or other rights (hereinafter referred to as "deliverables") to a customer over a period of time, when there is only one deliverable in the arrangement or when those deliverables qualify as a single unit of accounting in accordance with Issue 00-21, and the deliverable or unit of accounting is not within the scope of other authoritative literature.

Question 8—Does the Task Force agree with the proposed scope?

Transition

73. The Working Group considered the same transition alternatives for this issue as for the proposed revisions to Issue 00-21. Although the Working Group considered the same transition alternatives for this issue as for the proposed revisions to Issue 00-21, the Working Group did not believe it necessary that the transition be the same for both issues. While the Working Group's recommendation regarding the Milestone Method would not require its application, that is, the Milestone Method would be an option available to an entity based on the facts and circumstances of an arrangement, the Working Group still believed that entities should be provided with the opportunity to apply the Milestone Method to prior transactions (retrospective application). The Working Group believed that retrospective application was the appropriate alternative for several reasons. In addition to the retrospective application generally being the preferred method of transition, the Working Group indicated that retrospective application of the Milestone Method should not be excessively burdensome to apply. Furthermore, they believed that because many entities believe that the Milestone Method results in revenue recognition that is reflective of the underlying arrangement, entities will have a desire to apply the Milestone Method.

Question 9—Does the Task Force agree with the Working Group's recommendation regarding transition?

<u>Effective Date</u>

74. The Task Force is being asked whether the effective date for this issue should be the same as for the proposed revisions to Issue 00-21. That would result in the consensus on this Issue being effective on the last day of the first annual reporting period ending after December 15, 2009. The transition guidance of this Issue shall be applied as of the first day of the annual reporting period that includes the effective date. Interim periods within the annual reporting period that includes the effective date shall be restated to conform to the provisions of this Statement. Earlier application of the consensus on this Issue is permitted.

Question 10—Does the Board agree with the proposed effective date?

<u>Disclosures</u>

75. The Working Group did not fully explore the issue of disclosures but requested the staff to perform research on the issue. Consistent with the Working Group's discussion, the following proposed disclosure requirements are being presented to the Task Force for its consideration.

> An entity shall disclose its accounting policy for the recognition of milestone payments as revenue. For those entities electing to apply the guidance of this Issue, the following information shall be disclosed in the notes to the financial statements for each arrangement that includes a material milestone payment: (a) a description of the overall arrangement, (b) a description of the milestones, (c) whether the milestones are considered substantive, and (d) the factors considered by the entity in making its assessment of whether the milestone is substantive. In addition to the required disclosures, an entity shall also disclosure any information necessary to provide a reader of its financial statements with sufficient information to evaluate whether the achievement of the milestone reflects performance under the arrangement.

Question 11—Does the Board agree with the proposed disclosures?

Exhibit 08-1A

EXAMPLES

Example 1: R&D Arrangement – Contingent Deliverable

1. Biotech enters into an arrangement to provide research and development activities, on a best efforts basis, for a period of three years. In addition, if a commercially viable product is successfully developed as a result of those research and development activities, Biotech agrees to manufacture the resulting product for a period of five years.

2. Compensation under the arrangement is as follows:

   a. Biotech receives $250,000 per year for each full time equivalent (FTE) that performs research and development activities.

   b. Biotech receives "cost plus 30 percent" for manufacturing the resulting product (that is, Biotech will receive compensation for its direct costs plus a 30 percent margin for manufacturing the resulting product).

Example 2: R&D Arrangement – Milestone Method

3. Biotech enters into an arrangement to provide research and development activities for a period of three years. Biotech receives $250,000 per year for each FTE that performs research and development activities. In addition, the arrangement specifies three separate milestones that, if achieved, will result in an additional $1,500,000 in compensation ($500,000 for each of the 3 separate milestones). The milestones are considered to be substantive.

4. Biotech has determined that the fees charged for the research and development services (that is, the $250,000 per year for each FTE that performs research and development activities) are competitive with what other third-party vendors charge for similar research and development services (that is, they represent the fair value of those services). In addition, Biotech regularly provides similar research and development services to other customers for comparable fees.