FASB Emerging Issues Task Force

Issue No. 08-1

Title: Revenue Arrangements with Multiple Deliverables

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Previously distributed EITF materials: Issue Summary No. 1, dated February 29, 2008; Issue Summary No. 2, dated October 20, 2008; Working Group Report No. 1, dated June 9, 2008; Working Group Report No. 2, dated August 13, 2008; Issue Summary No. 2, Supplement No. 1, dated February 12, 2009

References:

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

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

FASB Statement No. 48, *Revenue Recognition When Right of Return Exists* (Statement 48)

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

FASB Statement No. 68, *Research and Development Arrangements* (Statement 68)

FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (Statement 91)

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

FASB Statement No. 157, *Fair Value Measurements (Statement 157)*

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* **The alternative views presented in this Issue Summary Supplement 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.**

FASB Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles* (Statement 162)

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

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

AICPA Accounting Research Bulletin No. 45, *Long-Term Construction-Type Contracts* (ARB 45)

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

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

AICPA Statement of Position 98-9, *Modification of SOP 97-2,* Software Revenue Recognition, *With Respect to Certain Transactions* (SOP 98-9)

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 104, Topic 13)

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

EITF Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)" (Issue 01-9)

EITF Issue No. 09-3, "Applicability of AICPA Statement of Position 97-2 to Certain Arrangements That Include Software Elements" (Issue 09-3)

Background

1. Entities often enter into revenue arrangements that provide for multiple payment streams. For example, a service provider may receive an up-front payment upon signing a service contract with a customer and then receive 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. If delivery of a single unit of accounting spans multiple accounting periods or includes multiple deliverables, an entity needs to determine how to allocate the multiple payment streams (arrangement consideration) to the unit(s) of accounting and when the arrangement consideration should be recognized as revenue.

2. The determination of when to recognize revenue can be further complicated when multiple deliverables are required by Issue 00-21 to be accounted for as a single unit of accounting. Current guidance does not explicitly address many of the issues encountered by entities in practice as a result of having to account for multiple deliverables as one unit of accounting. Some constituents contend that having to account for multiple deliverables as one unit of accounting often results in accounting that they believe does not reflect the underlying economics of a transaction. One common reason entities are unable to separate deliverables in an arrangement under Issue 00-21 is because of the absence of objective and reliable evidence of fair value for the undelivered item in an arrangement.

3. This Issue considers whether to modify the objective and reliable evidence of fair value threshold of Issue 00-21.

Prior EITF Discussion

4. At the November 13, 2008 EITF meeting, the Task Force reached a consensus-for-exposure on this Issue and directed the staff to issue a draft abstract for public comment. The draft abstract contained the following key amendments to Issue 00-21:

a. A vendor may estimate the selling price of an undelivered element in a revenue arrangement if the vendor would otherwise not be able to account for the deliverable as a separate unit of accounting as a result of not having VSOE or TPE for that deliverable.

b. A vendor's estimate of selling price shall be consistent with the objective of determining VSOE for the unit of accounting; that is, the price at which the entity would transact if the undelivered item(s) were sold regularly on a standalone basis. The entity must consider market conditions as well as entity-specific factors when estimating the selling price.

c. An entity is required to use the residual method of allocating arrangement consideration when the selling price of the undelivered unit(s) of accounting is based on the vendor's best estimate. However, the amount allocated to the delivered unit(s) of accounting as a result of applying this methodology shall not exceed the selling price of the delivered unit(s) of accounting based on VSOE or TPE, if known.

d. References to "fair value" should be replaced with references to "selling price" to avoid confusion with Statement 157.

e. The Task Force reached a consensus-for-exposure that the draft abstract be modified to include guidance on disclosure, transition, and effective date.

5. The Task Force also recommended to the FASB Chairman that a separate Issue be added to the EITF agenda to consider changes to the accounting for multiple element arrangements under SOP 97-2. The FASB Chairman was present at the meeting and after considering the input from Task Force and Board members, decided to add the Issue to the EITF agenda (refer to Issue 09-3).

6. A draft abstract was posted to the FASB website on December 1, 2008, with a comment period that ended January 30, 2009. At the March 19, 2009 EITF meeting, the Task Force considered the following issues raised by respondents to the draft abstract:

Issue 1— Whether the Task Force should continue discussion of this Issue, and, if so, whether the Task Force should amend the draft abstract to provide an exception to the requirement that a vendor's best estimate of selling price be used in some circumstances in which VSOE or TPE of selling price do not exist

Issue 2— Whether the Task Force should provide additional guidance regarding the definition of standalone value in paragraph 9(a) of the draft abstract

Issue 3— Whether the Task Force should amend the draft abstract to require the use of the relative-selling-price method of allocation and allow for the use of a vendor's best estimate of selling price for the delivered unit(s) of accounting when VSOE or TPE of selling price do not exist. If not, whether the Task Force should retain the limitation of the amount of arrangement consideration that can be allocated to the delivered unit(s) of accounting when using the residual method and whether the Task Force should amend the draft abstract according to changes proposed by the staff to clarify the application of the residual method.

7. On Issue 1, the Task Force agreed to continue discussion of this Issue and not to provide an exception to the requirement to use a vendor's best estimate of selling price when VSOE or TPE of selling price do not exist. In making its decisions, the Task Force discussed the progress of the FASB and IASB joint project on revenue recognition. The Task Force observed that addressing this Issue would provide a short-term improvement for the uneconomic reporting that can sometimes result when applying the current revenue recognition model under Issue 00-21. One Task Force member expressed concern about the reliability of using management estimates in place of VSOE or TPE of selling price and whether entities may default to using an estimated selling price without applying a reasonable amount of effort to obtain VSOE or TPE. That Task Force member also questioned whether the Task Force had provided enough guidance regarding the level of effort that vendors should expend before concluding that VSOE or TPE of selling price could not be determined.

8. The Task Force acknowledged that there may be instances in which estimating the selling price of deliverables may be difficult either because of limited information available from the vendor's own transactions or because of the lack of similar transactions in the marketplace. However, the Task Force observed that separating deliverables into multiple units of accounting to recognize revenue upon delivery of a product or performance of a service better reflects the

economics of most transactions than not separating because the deliverables are required to be accounted for as one unit of accounting. The Task Force discussed an approach to mitigate concerns regarding the reliability of management estimates of selling price through disclosures.

9. On Issue 2, the Task Force observed that there is limited guidance provided on standalone value as that assessment requires judgment. Accordingly, the Task Force agreed not to provide any further clarification to the draft abstract on the issue of standalone value.

10. On Issue 3, the Task Force discussed the staff's recommendation to eliminate the residual method and require the use of the relative-selling-price method when an entity is unable to determine VSOE or TPE of selling price. Task Force members generally agreed that the relative-selling-price method may be a conceptually preferable approach to allocate arrangement consideration, and that the use of the relative-selling-price method would simplify the application of Issue 08-1. However, some Task Force members expressed a concern that requiring entities that were previously using the residual method to adopt the use of the relative-selling-price method may result in a significant change in practice for those companies that were previously able to separate deliverables under Issue 00-21.

11. Some Task Force members questioned why the use of a vendor's best estimate of selling price is a valid method for determining selling price only for undelivered products and services when applying the residual method. Those Task Force members indicated that if the use of the vendor's best estimate is a valid method for determining selling price, its use should not be restricted to the residual method.

12. After discussing Issue 3, the Task Force reached a tentative conclusion to eliminate the residual method and require vendors to allocate arrangement consideration using the relative-selling-price method. The Task Force also reiterated its commitment to address the need for enhanced disclosures of management estimates of selling price. Considering the decisions reached at that meeting, the Task Force agreed that if a new consensus-for-exposure is reached on the application of the relative-selling-price method and enhanced disclosures, a revised draft

abstract should be exposed to provide constituents with the opportunity to comment on the elimination of the residual method and the proposed disclosures.

13. The Task Force discussed several possible disclosure proposals intended to provide users with sufficient information to understand the extent to which revenue was being recognized using a vendor's best estimate of selling price and the degree to which those estimates may change over time, but did not reach any conclusions. Accordingly, the Task Force requested that the FASB staff develop a proposal for disclosures with the assistance of both users and preparers. The staff agreed to meet with users and preparers to explore possible disclosures and to present the alternatives to the Task Force at a future meeting. As a result, the Issue 08-1 Disclosure Group (Disclosure Group) was formed to explore the issue in detail.

14. The Task Force did not discuss the effective date and transition for this Issue at the March 19, 2009 EITF meeting.

Current EITF Discussion

15. The Disclosure Group met on May 1, 2009 and included representatives from various entities, public accounting firms, financial statement users, and an observer from the SEC. Presented below are some of the more significant matters discussed at the meeting. A more complete summary of the meeting is included in Issue 08-1 Disclosure Group Report.

16. The Disclosure Group discussed the fact that the use of an estimated selling price (ESP) and elimination of the residual method of allocation may result in a change in a vendor's revenue recognition patterns. As a result, the Disclosure Group considered it important that the disclosure requirements include information regarding any significant change in the timing or amount of revenue recognition.

17. The Disclosure Group also discussed the fact that some constituents may be concerned that the determination of ESP may be more subjective than selling price determined using VSOE or TPE, and therefore ESP may be more susceptible to bias or error. That view was further supported by comments on the draft abstract submitted by analysts. Overall, analysts suggested

that the objective of Issue 08-1 disclosures should be to help analysts understand the extent to which management judgments affect revenue recognition.

18. While bias or error in ESP can affect revenue recognition, the Disclosure Group discussed several matters that may reduce the ultimate effect of bias or error on revenue recognition, including:

a. The allocation of arrangement consideration is affected by the relative interaction of the various units of accounting in an arrangement
b. Performance or delivery for all units of accounting in an arrangement may occur in the same period
c. Limitation on the allocation of revenue to the amount that is not contingent
d. Existence of certain checks and balances, including scrutiny by various external parties.

19. The Disclosure Group also discussed the fact that the concern of constituents appears to stem from the degree to which management judgment is required in the determination of selling price. However, there was general agreement by the Disclosure Group that VSOE and TPE of selling price also require the use of management judgment. For example, management must make certain judgments in determining whether VSOE of selling price exists. Additionally, in many cases, if VSOE of selling price cannot be established, revenue may end up being deferred. As a result, management judgments have a significant impact on the timing and amount of revenue recognition regardless of whether selling price is established based on VSOE, TPE, or ESP. As a result, the Disclosure Group considered it important that the disclosure requirements include information regarding the significant judgments made in the application of Issue 08-1 for all three of those selling price methods.

20. Based on the above, the Disclosure Group generally agreed with the following disclosure objective:

To disclose information regarding the significant judgments made about application of Issue 08-1 and significant changes in those judgments or the application of Issue 08-1 that may affect the timing or amount of revenue recognition.

21. To simplify the discussion of disclosures, the Disclosure Group discussed qualitative ongoing disclosure requirements, quantitative ongoing disclosure requirements and transition disclosure requirements separately. The accounting issues and alternatives presented below are consistent with the Disclosure Group discussions.

Accounting Issues and Alternatives

Issue 1: Whether the Task Force should require the qualitative disclosure requirement as proposed.

22. The following alternatives were presented to the Disclosure Group for its consideration. These alternatives were not intended to limit the Disclosure Group's consideration of other alternatives but were provided to inform the Disclosure Group of possible disclosures previously discussed by the Task Force. View A is the proposed disclosure requirements that were included in the draft abstract. View B is the staff's recommendation that was presented at the March 19, 2009 EITF meeting as a result of respondents' comments on the draft abstract. View C and View D are two of the alternative views discussed at the March 19, 2009 EITF meeting.

View A: A vendor shall disclose (a) its accounting policy for recognition of revenue from multiple-deliverable arrangements (for example, whether deliverables are separable into units of accounting) and (b) the description and nature of such arrangements, including performance-, cancellation-, termination-, or refund-type provisions.

A vendor shall also disclose both qualitative and quantitative information on an aggregated basis that enables users of its financial statements to understand the inputs and methodologies used to develop estimated selling price when neither VSOE nor TPE of selling price exists. Information related to individually significant arrangements should be separately disclosed.

View B: A vendor shall disclose (a) its accounting policy for recognition of revenue from multiple-deliverable arrangements (for example, whether deliverables are separable into units of accounting) and (b) the description and nature of such arrangements, including performance-, cancellation-, termination-, and refund-type provisions.

A vendor shall also disclose information on an aggregated basis and in sufficient detail by major product type to enable users of its financial statements to understand the inputs and methodologies used to develop estimated selling price.

View C: A vendor shall disclose (a) its accounting policy for recognition of revenue from multiple-deliverable arrangements (for example, whether deliverables are separable into units of accounting) and (b) the description and nature of such arrangements, including performance-, cancellation-, termination-, and refund-type provisions.

For those products to which revenue was allocated based on estimated selling price, a vendor shall disclose the amount of revenue recognized based on estimated selling price by product type in the period. In addition, to the extent the estimated selling price for any product type materially changes, a vendor shall also disclose the expected effect of the change, if practicable.

A vendor shall also disclose information on an aggregated basis and in sufficient detail by major product type to enable users of its financial statements to understand the inputs and methodologies used to develop estimated selling price.

View D: A vendor shall disclose (a) its accounting policy for recognition of revenue from multiple-deliverable arrangements (for example, whether deliverables are separable into units of accounting) and (b) the description and nature of such arrangements, including performance-, cancellation-, termination-, and refund-type provisions.

At each balance sheet date, a vendor shall disclose, on an aggregated basis, the total amount of recognized and unrecognized revenue for multiple-element revenue arrangements with undelivered items at the reporting date. This disclosure shall further disaggregate both the *recognized and unrecognized revenue amounts to show whether the associated allocation of arrangement consideration was determined using verifiable objective evidence (VSOE of selling price and TPE of selling price) or a vendor's best estimate of selling price.*

A vendor shall also disclose information on an aggregated basis and in sufficient detail by major product type to enable users of its financial statements to understand the inputs and methodologies used to develop estimated selling price.

23. The Disclosure Group generally agreed that the use of management judgment was not limited to the determination of ESP but was embedded throughout the application of Issue 08-1. Therefore, the Disclosure Group did not believe that qualitative disclosures should be limited solely to judgments around the use of estimated selling price but should include all significant judgments.

24. The Disclosure Group also discussed the level of operation at which the disclosure information should be provided. Several Disclosure Group members who were preparers commented that requiring disclosure at a level below a vendor's major product type could result in disclosure of proprietary information, particularly as it relates to the company's go-to-market and pricing strategies that were used in determining estimated selling price. The Disclosure Group also expressed concern over a potential requirement to disclose information by *major product type* because that term is not defined within GAAP. Disclosure by segment was also discussed by the Disclosure Group but it was dismissed because an arrangement can have elements that cut across segments. However, the Disclosure Group agreed that a more useful requirement would be to disclose information regarding similar types of multiple-deliverable arrangements. It was generally believed that disclosures at this level would provide more useful information to users of the financial statements regarding the vendor's operations and how management evaluates its multiple-deliverable arrangements.

25. The Disclosure Group also agreed that the existing requirement to disclose a vendor's accounting policy for recognition of revenue from multiple-deliverable arrangements should be revised. Disclosure Group members noted that the disclosure requirement generally results in a

vendor simply reciting certain language from Issue 00-21. The Disclosure Group agreed that what should be disclosed instead, is the nature of the vendor's multiple-deliverable arrangements, including a description of the arrangements, how the vendor identifies deliverables within the arrangements, the timing of delivery of those deliverables and performance, cancellation, termination, and refund-type provisions.

26. While the Disclosure Group recognized that users may benefit from an understanding of unrecognized revenue, there was agreement among Disclosure Group members that broad disclosures about unrecognized revenue appeared to be outside of the scope of this Issue. As it relates to deferred revenue, the Disclosure Group members, most of whom were preparers and auditors, agreed that deferred revenue balances often provide limited predictive value in assessing the timing and amount of future revenues of the vendor for two reasons. First, the deferred revenue balance is a product of several factors including timing of cash receipts, performance, applicable revenue recognition guidance, and contractual terms. Second, the deferred revenue balance does not reflect the amount of off-balance sheet unrecognized revenue. Therefore, the Disclosure Group agreed that broad disclosures about deferred revenue and unrecognized revenue should not be included in the recommendations. The Disclosure Group agreed that any consideration of disclosure related to these items should be addressed through the broader revenue recognition project.

27. Based on the above, the Disclosure Group provided a framework for qualitative disclosures that the staff drafted into the proposed disclosure guidance presented below. The staff received the Disclosure Group's general agreement with the qualitative disclosures included in the proposed guidance through the Disclosure Group's review of the Disclosure Group Report. In addition, while the following proposed guidance was drafted from a discussion of qualitative disclosures and while quantitative disclosures are not explicitly required by this guidance, the staff believes that vendors will often need to disclose specific facts and circumstances, which may at times include quantitative information to fully comply with certain requirements of the proposed disclosure guidance.

The objective of this disclosure guidance is to provide information regarding the significant judgments made about the application of this Issue and changes in those judgments or in the application of this Issue that may significantly affect the timing or amount of revenue recognition. Therefore, in addition to the required disclosures, a vendor shall also disclose other information as necessary to comply with this objective.

A vendor shall disclose the nature of its multiple-deliverable arrangements, including a description of the arrangements by similar type, how it identifies deliverables within the arrangements, the general timing of delivery or performance of service for those deliverables, and performance-, cancellation-, termination-, and refund-type provisions. A vendor shall also disclose information aggregated by similar types of arrangements regarding the significant judgments, inputs, and methodologies used in its evaluation of the arrangements. This information shall include a discussion of whether the major deliverables within the arrangement qualify as separate units of accounting and, for the significant units of accounting, the significant factors and estimates used to determine selling price (whether VSOE, TPE, or ESP) and the general timing of revenue recognition.

Significant changes in the vendor's judgment necessary to apply this Issue, including significant changes to the selling price or in the method used to determine selling price for a specific unit of accounting, shall be disclosed in sufficient detail to communicate the expected effect on the timing and amount of revenue recognition.

Issue 2: Whether the Task Force should require quantitative disclosure related to the allocation of revenue based on ESP. If so, the disclosures that should be required.

28. The Disclosure Group did not reach an agreement regarding a recommendation for quantitative disclosure requirements. However, included below are some of the more significant comments discussed at its meeting.

29. Certain Disclosure Group members raised the issue about whether estimates are an integral part of financial statements, including the recognition of revenue, and indicated that it appeared

unusual that disclosures would be requested under this Issue when similar disclosures are not required under other literature, specifically other revenue recognition literature (for example, SOP 81-1). In addition, some Disclosure Group members also noted that public companies are already required to make certain disclosures under the SEC's rules and regulations and questioned whether additional quantitative disclosures within this Issue are warranted.

30. A Disclosure Group member who is an analyst from a large institutional money manager indicated that an important disclosure that would be beneficial to his analysis is information that provides visibility into a vendor's timing of revenue recognition, including sufficient information to analyze the consistency and comparability of revenue from period to period and between different entities. He further indicated that the FASB runs the risk of requiring disclosure of information that is not fully understood by users of the financial statements because many analysts outside the software industry do not understand what VSOE of selling price represents or how VSOE differs from TPE or ESP. As a result, it was his opinion that disclosing revenue by these categories would not be helpful. When questioned whether qualitative disclosures could be sufficient to allow him to analyze a vendor's operations, he indicated that such disclosures might be sufficient if robust.

31. Several members of the Disclosure Group commented that they believe that the quantitative disclosures being proposed would not provide users with meaningful information. Other Disclosure Group members commented that requiring a vendor to disclose quantitative information may help to ensure that vendors maximize the use of VSOE and TPE.

32. In addition to a general question as to whether quantitative disclosures provide users with useful information, preparers on the Disclosure Group indicated that there would be a high cost to comply with any quantitative disclosure requirement. They indicated that current systems are not configured to track and collect this information and that for the larger multi-national organizations, that process may involve disparate revenue systems around the world. In order to track whether allocation of revenue was based on VSOE, TPE or ESP, a significant revision would be required to many organizations' revenue systems. The preparers questioned whether the

incremental benefit received from the additional disclosure justified the additional compliance cost to vendors.

33. Some constituents believe that quantitative disclosures may be more easily achieved for smaller organizations than larger multi-national organizations. However, there are currently no proposed exceptions to the disclosure requirements of this Issue based on the size of the organization or the number of revenue arrangements.

34. As noted earlier under the discussion of qualitative disclosures, the Disclosure Group believed that broad disclosures about deferred revenue and unrecognized revenue should not be included in this Issue but should be addressed through the broader revenue recognition project.

35. Although the Disclosure Group generally believed that this Issue should not contain any specific quantitative disclosure, the staff believes that the Task Force may still wish to consider some specified quantitative disclosures. Therefore, the following alternative views are being presented for Task Force consideration.

View A: A vendor shall disclose the total amount of revenue recognized in the period from multiple-deliverable revenue arrangements. The amount of revenue recognized in the period from multiple-deliverable revenue arrangements that included the use of estimated selling price in the allocation of arrangement consideration shall be disclosed separately.

36. Proponents of View A believe that the objective of quantitative disclosure requirements should be to provide users with information to evaluate the relevance of ESP to the allocation of arrangement consideration. Proponents believe that View A disclosure requirements allow users to evaluate the significance of ESP to a vendor's multiple-deliverable arrangements, proportionate changes in the vendor's use of ESP over time, how the vendor's use of ESP compares with the use of ESP by the vendor's competitors, and, to a lesser extent, the significance of ESP on future earnings.

37. Proponents of View A believe that there is subjectivity and judgment applied in the determination of VSOE and TPE; however, by definition, there is *more* subjectivity in the determination of best estimate. Therefore, because this Issue is providing additional flexibility in the determination of selling price, proponents of View A believe that it is reasonable for a vendor to provide information about how that flexibility is affecting the timing and amount of revenue recognition.

38. Proponents of View A believe that vendors will be more likely to provide more complete and robust qualitative disclosures to supplement the quantitative information as a result of the requirements of View A. Proponents of View A acknowledge that the majority of the benefit received from View A is in the form of directional information regarding the vendor's use of ESP and that it does not provide information regarding the reliability or quality of the estimates used. However, proponents of View A believe that it is necessary to supplement the qualitative disclosures with information that conveys to revenue as a whole the significance of the estimates used. They believe that the disclosures provided under View A will accomplish that objective and, therefore, be useful in a user's evaluation of a vendor's operations.

39. Proponents of View A note that View A does not require disclosure of revenue recognized from units of accounting for which the selling price was determined using ESP but rather the total revenue from arrangements that included the use of ESP. Proponents of View A believe that this should greatly reduce the amount of time and cost a vendor must incur to track and identify the required disclosure information while still providing users with information necessary to evaluate the relative uses of ESP, VSOE, and TPE.

40. Proponents of View A believe that more quantitative disclosures than proposed under View A would likely provide little incremental benefit over those achieved under this view unless the additional disclosure could effectively communicate the subjective nature of ESP. Proponents of View A believe that the only way to effectively communicate the subjective nature of ESP would be through a sensitivity analysis. However, proponents of View A believe that while a sensitivity analysis may accomplish the goal of providing some insight into the subjective nature of ESP, the analysis is impractical to perform and would often result in the calculation of amounts that

provide little or no benefit to users. Unlike a sensitivity analysis for a financial instrument measured at fair value, which involves consideration of only the instrument being measured, a sensitivity analysis of ESP involves multiple considerations. To properly perform a sensitivity analysis, a vendor must consider the possible variance in each unit of accounting and how a potential change in the ESP for one unit of accounting interacts with changes in the ESP for other units of accounting within the arrangement. To illustrate, consider the following example:

> Vendor A enters into a multiple deliverable arrangement that includes five units of accounting. The selling price is determined for two of the units of accounting using VSOE, while the selling price for the remaining three units of accounting is determined using ESP. Now also consider that the vendor must determine the amount by which revenue recognition could be affected by a 10 percent change in ESP. Should the analysis assume that ESP for the three units of accounting fluctuates in the same direction, an assumption that may not be realistic, or that the prices may fluctuate in various directions, including the fact that ESP may not change for one unit of accounting while it does change for the other unit of accounting? If the vendor concludes that ESP could fluctuate in various directions, a seemingly endless number of scenarios would need to be considered.

41. Therefore, proponents of View A do not believe any reasonable consideration of quantitative disclosure can effectively communicate the subjective nature of ESP.

42. Proponents of View A also note that a Disclosure Group member who is an analyst indicated that many analysts outside the software industry do not understand what VSOE of selling price represents or how VSOE differs from TPE and ESP. As a result, it was his opinion that disclosing revenue by these categories would not be helpful. Proponents of View A believe that the proposed disclosure will provide useful information without the need to disclose information by VSOE, TPE, or ESP.

43. Opponents of View A believe the proposed disclosures lack sufficient specificity to be useful. They indicate that because View A provides only general information without any context to the underlying arrangement, users will be unable to determine the relative quality of

the ESP used in allocating revenues. Users will only know that the vendor allocated arrangement consideration based on ESP.

44. As discussed earlier in this Issue Summary Supplement, an analyst on the Disclosure Group indicated that disclosures that provide visibility into a vendor's timing of revenue recognition, including sufficient information to analyze the consistency and comparability of revenue from period to period and between different entities would be beneficial. Opponents of View A do not believe that quantitative information under this Issue is necessary to comply with the analyst's request because the information requested relates more broadly to the recognition of revenue and not the allocation of arrangement consideration. And while changes in ESP, or for that matter VSOE or TPE, could result in a change in the timing and amount of revenue recognition because of the change in allocation of arrangement consideration, this change, if significant, would be required under the proposed qualitative disclosure requirements discussed earlier in this Issue Summary Supplement.

View B: A vendor shall disclose the total amount of revenue recognized in the period from multiple-deliverable revenue arrangements. This information shall be further disaggregated to indicate whether the selling price for the product or service used in the allocation of arrangement consideration was determined using VSOE, TPE, or ESP. A vendor shall also disclose the amount of deferred revenue under multiple-deliverable revenue arrangements at the reporting date.

45. Proponents of View B agree with many of the proponents' views under View A regarding the objective of quantitative disclosure requirements and the benefits achieved from such disclosures, including that vendors will be more likely to provide more complete and robust qualitative disclosures if they are required to make quantitative disclosures. However, proponents of View B do not believe sufficient information is required by View A to communicate the relevance of ESP to the allocation of arrangement consideration. Proponents of View B believe that this view provides for disclosure of necessary information missing from View A and that it is this additional information that will provide benefit to users. For example, proponents of View B believe that this view will allow users to evaluate the significance of ESP

to a vendor's multiple-deliverable arrangements, proportionate changes in the vendor's use of ESP over time, how the vendor's use of ESP compares with the use of ESP by the vendor's competitors, and to a lesser extent, the significance of ESP on future earnings.

46. Opponents of View B agree with many of the opponents' views presented under View A, including: (a) that analysts outside of the software industry do not understand what VSOE of selling price represents or how VSOE differs from TPE and ESP, (b) that the proposed quantitative disclosures lack sufficient specificity to be useful, and (c) that quantitative disclosures are not necessary to provide visibility into a vendor's timing of revenue recognition.

47. Because many analysts may not understand the differences between VSOE, TPE, and ESP, opponents of View B question the benefit achieved by the disclosure of that information. Furthermore, while View B requires other disclosures in addition to those required by View A, opponents of View B believe that the additional disclosures provide no insight into the underlying arrangements. Thus View B proponents believe that users will be unable to determine the relative quality of the ESP used in allocating revenues; users will only know that the vendor allocated arrangement consideration based on ESP.

48. In addition, while View B would be provided as a supplement to the proposed qualitative disclosures, a vendor will normally be unable to communicate whether its ESP varies from the selling price used by its competitor. That is, just because a vendor uses a different method for determining selling price from its competition does not mean that the ESP is incorrect or that it differs from the selling price used by the vendor's competitors. Furthermore, while View B provides users of the financial statements with an understanding of the gross amount of revenue recorded and that it was allocated based on the vendor's use of ESP, it does not convey whether a change in ESP would affect the allocation of arrangement consideration (and thus the timing and amount of revenue recognition). For example, if the product/service for which ESP is used is either a very significant or insignificant portion of an arrangement, a change in ESP would most likely not have a very significant effect on the allocation of arrangement consideration. That is because even if the estimate of selling price was changed, the effect of the change on the allocation of revenue would not be significant.

49. Opponents of View B believe that for a quantitative disclosure to be effective, it must communicate the subjective nature of ESP. They also believe that the best way to provide that information would be through a sensitivity analysis. However, as discussed under proponents to View A, a sensitivity analysis is impractical to perform and may result in the calculation of amounts that provide little or no benefit to users. Therefore, if the purpose of the quantitative disclosure requirement on this Issue is to provide users with an understanding of the subjective effect ESP can have on the operations of a vendor, opponents do not believe that View B or any reasonable consideration of quantitative disclosure will accomplish that goal.

50. Opponents of View B also believe that the cost of compliance exceeds any incremental benefit received from the proposed quantitative disclosure. They believe that in order to track whether allocation of revenue was based on VSOE, TPE, or ESP, a significant and potentially costly revision to many organizations' revenue systems would be required. Proponents of View B believe that the cost of compliance exceeds the directional benefit obtained by View B.

51. Regarding a requirement to disclose deferred revenue related to multiple-element arrangements, opponents of View B believe that deferred revenue balances often provide limited predictive value in assessing the future results of the vendor, for two reasons. First, the deferred revenue balance is a product of several factors including timing of cash receipts, performance, applicable revenue recognition guidance, and contractual terms. Second, the deferred revenue balance does not reflect off-balance sheet amounts related to unrecognized revenue (the total amount of contractual arrangement consideration minus amounts previously recognized as revenue). Unrecognized revenue differs from deferred revenue in that unrecognized revenue also includes amounts that are not reflected in the balance sheet, for example, when the vendor has not been paid in advance of performance. While the adoption of Issue 08-1 may result in a decrease in deferred revenue balances because of a greater separation of deliverables, proponents of View B believe that without a detailed analysis as to whether the change is due solely to the adoption of Issue 08-1 versus timing of cash receipts or other factors, disclosure of the deferred revenue balances provides limited incremental benefit to users of the financial statements.

View C: No specific quantitative disclosures.

52. It appears that from prior discussions of this Issue, some constituents believe that users are best served by the inclusion of quantitative information. However, proponents of View C believe that specific quantitative disclosures, when considered in the context of the qualitative disclosures under Issue 1, are not cost-beneficial and should not be required. Proponents of View C believe that before any quantitative disclosures are considered, it is important to understand the benefit that is expected to be achieved from the proposed disclosure and whether the benefit achieved justifies the cost of compliance. Therefore, proponents of View C ask whether the objective of quantitative disclosures should be to disclose (a) that ESP is used, or (b) the amount by which ESP could vary and the potential impact on revenue recognition, or (c) both. Similar to opponents to View A, proponents of View C do not believe a sufficient benefit is obtained from disclosure of the amount of revenue allocated based on ESP to warrant its disclosure. In addition, the amount by which ESP could vary (sensitivity analysis) is not easily determined and will often result in an amount that may provide little benefit to users.

53. Some of the proponents of View C believe that the only reason the method of determining selling price matters is if there is an issue with the accuracy of its determination. For example, under Issue 00-21, the staff is unaware of any criticism over the use of VSOE versus TPE because both are considered to be based on objectively determined evidence. However, there appears to be a push for disclosure of ESP because of a perception that the evidence supporting ESP is less objective than VSOE or TPE and introduces a greater level of subjectivity into the allocation of revenue. Therefore, proponents of View C believe that the request for increased disclosure must be the result of ESP not being objectively determined or not being subject to constraints in its determination. Otherwise, proponents of View C question whether it is necessary to disclose quantitative information related to how a vendor determines selling price if the three methods available all require a degree of judgment and result in the determination of a reasonably accurate selling price.

54. As discussed under View A, it was the opinion of an analyst on the Disclosure Group that disclosing revenue by the methods for determining selling price would not be helpful. In

addition, the Disclosure Group also believed that deferred revenue and unrecognized revenue should not be included in the recommended disclosure but addressed through the broader revenue recognition project because it appears to have a scope and an objective that is broader than just multiple-element arrangements.

55. Proponents of View C believe that the cost of providing quantitative information under this Issue could exceed the incremental benefit received from the disclosures. They indicated that in order to track whether allocation of revenue was based on VSOE, TPE or ESP, a significant and potentially costly revision would be required to many organizations' revenue systems. For example, several matters must be considered to properly track whether ESP is used in the allocation of arrangement consideration and its impact on revenue recognition. Preparers noted that for many of their standard multiple-element arrangements, billing terms are set to correspond to the allocation of revenue recognition under Issue 00-21 so that the arrangements can be handled through normal automated billing and accounting processes. Only non-standard arrangements are accounted for individually. Accordingly, for many preparers, most of their multiple-element revenue arrangements currently are indistinguishable from single element arrangements in their accounting systems.

56. A vendor will often be unable, currently, to tag a particular product or service within its system when it does not have VSOE or TPE of the selling price for that item. This is because the vendor may sell the product or service separately and accordingly such transactions would be outside of the scope of this Issue. Furthermore, because a unit of accounting can be comprised of numerous deliverables (which may vary from arrangement to arrangement), a vendor would need to tag each unique unit of accounting for tracking purposes. Therefore, a substantial amount of effort will be required for many vendors to track quantitative information.

57. Proponents of View C believe that comparisons of quantitative disclosures about VSOE, TPE, and ESP to disclosures about fair value measurements under Statement 157 are not appropriate. Instruments that are subject to the Statement 157 disclosures are valued on a stand-alone basis at a point in time. On the other hand, the allocation of revenue under this Issue involves price interactions with other elements in the arrangement and involves the flow of

numerous transactions through the revenue system. They also observe that Statement 157 requires a rollforward for those items whose measurements are based on Level 3 inputs. In order to disclose the amount of revenue recognized in the period for which ESP was used in the allocation of arrangement consideration, not only would the tracking discussed above be required, but also a complete review of each arrangement to ascertain what has and what has not been delivered under the arrangement.

58. Proponents of View C also note that disclosures may change again (potentially significantly) when the Board's broad revenue recognition project is completed. They question whether it is necessary for a vendor to make a significant investment to comply with quantitative disclosure requirements under this Issue and then have to make another significant investment in systems to comply with any requirements resulting from the revenue recognition project. Proponents of View C recommend that the revenue recognition project team do a follow up on the quality and informational value of disclosures under this Issue in considering disclosures under the revenue project.

59. Opponents of View C believe that qualitative disclosures on their own are not sufficient for financial statement users to understand the significance of the allocation of revenue under this Issue to an entity's financial statements. Opponents believe that users will not be able to assess the quality of an entity's earnings and the risks associated with the subjective judgments required to determine ESP without specific quantitative disclosure requirements.

Issue 3: Whether the Task Force should require specific transition disclosures. If so, the disclosures that should be required.

60. The Disclosure Group did not reach agreement on a transition disclosure recommendation. The Disclosure Group did not believe that a final recommendation could be reached for transition disclosures until the ongoing disclosure requirements were resolved. The Disclosure Group indicated that the more robust the ongoing disclosures, the less transition information they thought would be needed.

61. Certain Disclosure Group members commented that a requirement to disclose the amount of revenue recognized subject to Issue 00-21 in comparison to Issue 08-1 would affect all vendors and not just those vendors for whom the adoption of Issue 08-1 has a significant effect on the timing of revenue recognition. So, while the adoption of Issue 08-1 may not affect the operations of a vendor (for example, because selling price is always determined using VSOE), the vendor would still be required to incur the time and cost to track revenue subject to Issue 00-21 in comparison to Issue 08-1. The preparers believed that the cost of complying with this type of disclosure requirement was not justified based on the limited benefit that they believed would be provided.

62. In addition, subsequent to the Disclosure Group meeting, the staff received comments from certain users that disclosure of the amount of revenue recognized subject to Issue 00-21 versus Issue 08-1 will result in extremely disjointed information regarding revenue recognition policies, assumptions, and so forth. The users indicated that analysts would most likely not separate contracts subject to Issue 00-21 from those subject to Issue 08-1 in their evaluation of vendors and that separation for disclosure may not make much sense.

63. The Disclosure Group also discussed whether there is a benefit from knowing the amount of revenue recognized subject to Issue 00-21 versus Issue 08-1 without also understanding how the vendor's timing of revenue recognition is affected by the adoption of Issue 08-1. For example, the disclosure of revenue recognized in the period that was subject to Issue 08-1 provides no information to users without an understanding of the amount of revenue that would have been recognized if the related transactions had been subject to Issue 00-21. Preparers on the Disclosure Group were split as to the degree of difficulty and time and expense that would be necessary to maintain two sets of accounting records.

64. Consistent with the Disclosure Group discussion of qualitative disclosures, the Disclosure Group believed that deferred revenue and unrecognized revenue should not be included in the recommended disclosure but addressed through the broader revenue recognition project.

65. Based on the above, the following alternative views are presented for Task Force consideration.

View A: Require the following disclosure: For each reporting period in the initial year of adoption, a vendor shall disclose the amount of its revenue recognized subject to the measurement requirements of Issue 08-1 and the amount of revenue that would have been recognized if the related transactions were subject to the measurement requirements of Issue 00-21.

View B: No specific transition disclosures should be required; however, the scope of qualitative disclosure requirements described in Issue 1 should be expanded to apply to transactions accounted for under both Issue 08-1 and 00-21 after the effective date.

66. As discussed by the Disclosure Group, disclosure of the amount of revenue recognized subject to Issue 00-21 versus Issue 08-1 provides little information to users without information regarding how the vendor's timing of revenue recognition is affected by the adoption of Issue 08-1. View A attempts to bridge that information gap by requiring a vendor to disclose the amount of revenue that would have been recognized if the related transactions were subject to the measurement requirements of Issue 00-21. The staff has received several informal inquiries regarding whether the transition disclosure under View A should be required for a period greater than one year. If the Task Force chooses to include View A transition disclosures in this Issue, it may wish to discuss whether a one year requirement is sufficient or whether the term should be extended to a longer period.

67. However, while View A bridges the information gap, Disclosure Group members were split as to the degree of difficulty, time and expense that would be necessary to comply with View A because of the need to maintain two sets of accounting records.

68. To address concerns that some constituents have regarding the lack of sufficient disclosure guidance under Issue 00-21, View B proponents believe that the qualitative disclosure requirements of this Issue should be effective for all revenue arrangements in fiscal years beginning on the effective date. Proponents of View B believe that the proposed qualitative

disclosures should be sufficient to communicate the effect of transition on a vendor's timing of revenue recognition. Proponents of View B also believe that this approach may require less time and expense to comply with than View A.

69. However, to ensure the proposed qualitative disclosures guidance is appropriately applied to the transition from Issue 00-21, the proponents of View B believe that the following revisions to the proposed qualitative disclosure requirement are necessary under Issue 1 (additions are underscored):

> Significant changes in the vendor's judgment necessary to apply this Issue, <u>or resulting from the vendor's adoption of Issue 08-1</u>, including significant changes to the selling price or in the method used to determine selling price for a specific unit of accounting, shall be disclosed in sufficient detail to communicate the expected effect on the timing and amount of revenue recognition.

Issue 4: Whether the Task Force agrees with the staff's recommended changes to the transition guidance.

Transition and Effective Date

70. At the March 19, 2009 EITF meeting, the Task Force did not discuss transition. Therefore, presented below for Task Force consideration are respondents' comments to the exposure document and additional considerations resulting from the delayed issuance of this Issue.

71. Respondents provided feedback indicating that they agreed with the prospective approach included in the draft abstract. Respondents also generally supported early adoption but were mixed on whether the early adoption guidance should allow adoption as of the beginning of an interim period (without retrospective application to the beginning of the vendor's fiscal year) or whether the guidance should be adopted through retrospective application to the beginning of the vendor's fiscal year.

72. One respondent requested additional guidance regarding the intentions of the Task Force as it relates to the meaning of "materially modified." The respondent asked whether materially modified means only financial impacts or could it also apply to other important terms and conditions not, *per se*, affecting the amount of revenue embodied in the arrangement. This respondent questioned whether a simple extension of an arrangement could be considered a material modification. For example, what if an additional year is added to an existing 4 year service arrangement (thereby increasing the arrangement consideration by 25 percent). Would this amendment to the existing arrangement meet the criteria for materially modified?

Staff Recommendation

73. The staff does not believe that it is necessary to clarify the meaning of "materially modified." The staff believes that it would be difficult to address all situations in which an arrangement may be materially modified or when a modification did not result in a material modification. In addition, the staff believes that it is best to allow practice an opportunity to apply the guidance and see if any practice issues arise. If any issues do arise, the staff believes that those issues can be addressed at a later date.

74. Respondents were generally in favor of allowing for early application of this Issue as of an interim date but were mixed as to the method of early adoption that should be applied. The staff believes that if early adoption is allowed, retrospective application to the beginning of the vendor's fiscal year is the most beneficial application. If a vendor is allowed to adopt the provisions of Issue 08-1 during an interim period without retrospective application to the beginning of the period, consideration would need to be given as to whether the proposed disclosure requirements should be revised, particularly if the Task Force reaches a consensus-for-exposure on Issue 3 to require dual disclosure in periods after transition (View A).

75. The draft exposure included an effective date of fiscal years beginning on or after December 15, 2009. However, at the March EITF meeting, the Task Force decided to continue the discussion of this Issue's disclosure requirements and to consider whether this Issue should be re-exposed at a later date. Because this Issue most likely will not be ratified until the fourth quarter of 2009, the staff recommends that the effective date be postponed to allow vendors sufficient

time to prepare for adoption of this Issue. In addition, as discussed in the following paragraph, the staff believes that constituents would benefit from separate effective dates for measurement and disclosure guidance. Therefore, the staff recommends that the effective date for measurement be extended to revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010.

76. In summary, the staff recommends the following transition and effective date guidance:

> The requirements of this Issue shall be applied on a prospective basis for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Earlier application is permitted. If a vendor elects earlier application and the first reporting period after adoption is not the first reporting period in the vendor's fiscal year, the guidance in this Issue must be applied through retrospective application from the beginning of the vendor's fiscal year.

Revisions to Draft Abstract

77. Changes to the draft abstract that would result from the elimination of the residual method of allocation are reflected in Appendix 08-1A (additions are underscored and deletions are ~~struck through~~). Other changes made based on staff recommendations included in this Issue Summary Supplement and drafting suggestions received from respondents are also included in the draft abstract.

Appendix 08-1A

***EITF ABSTRACTS* (DRAFT[*])**

Issue No. 08-1

Title: Revenue Arrangements with Multiple Deliverables

Dates Discussed: March 12, 2008; June 12, 2008; September 10, 2008, November 13, 2008; March 19, 2009

References: FASB Statement No. 13, *Accounting for Leases*

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

FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*

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

FASB Statement No. 68, *Research and Development Arrangements*

FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*

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

FASB Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles*

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

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

AICPA Accounting Research Bulletin No. 45, *Long-Term Construction-Type Contracts*

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

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

AICPA Statement of Position 98-9, *Modification of SOP 97-2,* Software Revenue Recognition, *With Respect to Certain Transactions*

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

SEC Staff Accounting Bulletin 104, Topic 13, *Revenue Recognition*

[*] **This draft abstract is being exposed for a public comment period that will end on XXXX XX, 2009.**

ISSUE

1. To meet their customers' needs, vendors often provide multiple products, services, rights to use assets, or any combination thereof (hereinafter referred to as "deliverables"). These vendors transfer the deliverables to the customer and performance may occur at different ~~points in~~ times or over different periods of time and the customer's payments for these deliverables may be fixed, variable, or a combination of fixed and variable.

2. This Issue addresses some aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. Specifically, this Issue addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting. In applying this Issue, separate contracts with the same entity or related parties that are entered into at or near the same time are presumed to have been negotiated as a package and shall~~should~~, therefore, be evaluated as a single arrangement in considering whether there are one or more units of accounting. That presumption may be overcome if there is sufficient evidence to the contrary. This Issue also addresses how arrangement consideration ~~should~~shall be measured and allocated to the separate units of accounting in the arrangement.

3. This Issue does not address when the criteria for revenue recognition are met or provide revenue recognition guidance for a given unit of accounting. For example, this Issue does not address when revenue attributable to a unit of accounting shall be recognized based on proportional performance. The timing of revenue recognition for a given unit of accounting depends on the nature of the deliverable(s) composing that unit of accounting and on whether the applicable criteria for revenue recognition have been met.

4. This Issue applies to all deliverables within contractually binding arrangements (whether written, oral, or implied, and hereinafter referred to as "arrangements") in all industries under which a vendor will perform multiple revenue-generating activities, except as follows:

a. A multiple-deliverable arrangement or a deliverable(s) in a multiple-deliverable arrangement may be within the scope of higher-level authoritative literature.[1] That higher-level authoritative literature (including, but not limited to, Statements 13, 45, and 66; Interpretation 45; Technical Bulletin 90-1; and SOPs 81-1, 97-2, and 00-2) (referred to hereinafter as "higher-level literature") may provide guidance with respect to whether and/or how to allocate consideration of a multiple-deliverable arrangement. The following describes the three categories into which that higher-level literature falls and the application of this Issue or the higher-level literature in determining separate units of accounting and allocating arrangement consideration:

   i. If higher-level literature provides guidance regarding the determination of separate units of accounting and how to allocate arrangement consideration to those separate units of accounting, the arrangement or the deliverable(s) in the arrangement that is within the scope of that higher-level literature ~~should~~<u>shall</u> be accounted for in accordance with the relevant provisions of that literature rather than the guidance in this Issue.

   ii. If higher-level literature provides guidance requiring separation of deliverables within the scope of higher-level literature from deliverables not within the scope of higher-level literature, but does not specify how to allocate arrangement consideration to each separate unit of accounting, such allocation ~~should~~<u>shall</u> be based on the relative selling price of the deliverable(s) within the scope of higher-level literature and the deliverable(s) not

[1] Whether a deliverable(s) is within the scope of higher-level authoritative literature is determined by the scope provisions of that literature, without regard to the order of delivery of that item in the arrangement. The term *higher-level literature* refers to categories (a) and (b) of the generally accepted accounting principles (GAAP) hierarchy as defined in Statement 162.

within the scope of higher-level literature.[2,3] Subsequent identification of separate units of accounting and allocation of arrangement consideration to the deliverable(s) not subject to higher-level literature would be governed by the provisions of this Issue.

iii. If higher-level literature provides no guidance regarding the separation of the deliverables within the scope of higher-level literature from those deliverables that are not or the allocation of arrangement consideration to deliverables within the scope of the higher-level literature and to those that are not, then the guidance in this Issue ~~should~~shall be followed for purposes of such separation and allocation.[4] In such circumstances, it is possible that a deliverable subject to the guidance of higher-level literature does not meet the criteria in paragraph 9 of this Issue to be considered a separate unit of accounting. In that event, the arrangement consideration allocable to such deliverable ~~should~~shall be combined with the amount allocable to the other applicable undelivered item(s) within the arrangement. The appropriate recognition of

[2] For purposes of the allocation between deliverables within the scope of higher-level literature and deliverables not within the scope of higher-level literature, selling price shall be determined using the guidance as discussed in paragraphs 16 and 17 of this Issue. ~~The use of a vendor's best estimate of selling price shall not be limited to the undelivered item(s) for purposes of applying this paragraph.~~

[3] For example, leased assets are required to be accounted for separately under the guidance of Statement 13. Consider an arrangement that includes the lease of equipment under an operating lease, the maintenance of the leased equipment throughout the lease term (executory cost), and the sale of additional equipment unrelated to the leased equipment. The arrangement consideration should be allocated between the Statement 13 deliverables and the non-Statement 13 deliverables using the relative selling price method (Although Statement 13 does not provide guidance regarding the accounting for executory costs, it does provide guidance regarding the allocation of arrangement consideration between the lease and the executory cost elements of an arrangement. Therefore, this example refers to the leased equipment and the related maintenance as Statement 13 deliverables.) The guidance in Statement 13 would then be applied to separate the maintenance from the leased equipment and to allocate the related arrangement consideration to those two deliverables. This Issue would be applied to further separate any non-Statement 13 deliverables and to allocate the related arrangement consideration.

[4] For example, SOP 81-1 provides separation and allocation guidance (segmentation provisions) for deliverables within its scope. However, SOP 81-1 does not provide separation and allocation guidance between SOP 81-1 deliverables and non-SOP 81-1 deliverables. Consider an arrangement that includes designing complex electronic equipment, manufacturing complex electronic equipment (both SOP 81-1 deliverables), and providing the service of running the equipment for a fixed period of time once the equipment is designed, manufactured, and placed in service (a non-SOP 81-1 deliverable). This Issue would be applied to identify separate units of accounting and to allocate arrangement consideration to those separate units of accounting. If applying the guidance in this Issue results in the separation of the design and manufacture of the equipment from the service of running the equipment, the segmentation provisions of SOP 81-1 would be used to determine if it is appropriate to further segment the design deliverables from the manufacture deliverables in accordance with its segmentation provisions. If this Issue prohibits separation of the SOP 81-1 deliverables from the non-SOP 81-1 deliverables, then the amounts otherwise allocable to the design and manufacture deliverables and to the service of running the equipment should be combined. The appropriate recognition of revenue should then be determined for those combined deliverables as a single unit of accounting.

revenue ~~should~~shall then be determined for those combined deliverables as a single unit of accounting.

b. Arrangements that include vendor offers to a customer for either (1) free or discounted products or services that will be delivered (either by the vendor or by another unrelated entity) at a future date if the customer completes a specified cumulative level of revenue transactions with the vendor or remains a customer of the vendor for a specified time period or (2) a rebate or refund of a determinable cash amount if the customer completes a specified cumulative level of revenue transactions with the vendor or remains a customer of the vendor for a specified time period, are excluded from the scope of this Issue. For a further discussion on these types of arrangements, see Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)." Additionally, arrangements involving the sale of award credits by broad-based loyalty program operators are excluded from the scope of this Issue.

5. The issues are:

Issue 1—How to determine whether an arrangement with multiple deliverables consists of more than one unit of accounting

Issue 2—If an arrangement consists of more than one unit of accounting, how the arrangement consideration ~~should~~shall be allocated among the separate units of accounting

Issue 3—What effect, if any, certain customer rights due to vendor nonperformance have on the measurement of arrangement consideration and/or the allocation of consideration to the delivered unit(s) of accounting

Issue 4—How to account for direct costs incurred related to an arrangement that (a) are not associated with a specific deliverable or (b) are associated with a specific deliverable but that deliverable is required to be combined with another deliverable (or other deliverables)

Issue 5(a)— The impact, if any, of a customer's ability to cancel a contract and incur a cancellation penalty on the measurement of arrangement consideration

Issue 5(b)—The impact, if any, of consideration that varies as a result of future *customer* actions on the measurement and/or allocation of arrangement consideration

Issue 5(c)—The impact, if any, of consideration that varies as a result of future *vendor* actions on the measurement and/or allocation of arrangement consideration

Issue 6—The impact of a vendor's intent not to enforce its contractual rights in the event of customer cancellation on the measurement and/or allocation of arrangement consideration.

EITF DISCUSSION

6. In an arrangement with multiple deliverables, the Task Force reached a consensus that the principles in paragraph 7 and application guidance in paragraphs 8–18 ~~should~~shall be used to determine (a) how the arrangement consideration ~~should~~shall be measured, (b) whether the arrangement ~~should~~shall be divided into separate units of accounting, and (c) how the arrangement consideration ~~should~~shall be allocated among the separate units of accounting. Examples illustrating the application of the principles and application guidance in this Issue are included in Exhibit 08-1B.

Principles

7. The principles applicable to this Issue are:

- Revenue arrangements with multiple deliverables ~~should~~shall be divided into separate units of accounting if the deliverables in the arrangement meet the criteria in paragraph 9.
- Arrangement consideration ~~should~~shall be allocated among the separate units of accounting based on their relative selling prices (or as otherwise provided in paragraphs 12 and 13). The amount allocated to the delivered unit(s) of accounting is limited as discussed in paragraphs 12 and 14.
- Applicable revenue recognition criteria ~~should~~shall be considered separately for separate units of accounting.

Application Guidance

Units of Accounting (Issue 1)

8. A vendor ~~should~~shall evaluate all deliverables in an arrangement to determine whether they represent separate units of accounting. That evaluation must be performed at the inception of the arrangement and as each item in the arrangement is delivered.

9. In an arrangement with multiple deliverables, the delivered item(s) ~~should~~shall be considered a separate unit of accounting if both 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. 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.

Refer to the flowchart in Exhibit 08-1A for an illustration of the above criteria. The criteria for dividing an arrangement into separate units of accounting ~~should~~shall be applied consistently to arrangements with similar characteristics and in similar circumstances.

10. A delivered item(s) that does not qualify as a separate unit of accounting within the arrangement ~~should~~shall be combined with the other applicable undelivered item(s) within the arrangement. The allocation of arrangement consideration and the recognition of revenue ~~should~~shall then be determined for those combined deliverables as a single unit of accounting.

Measurement and Allocation of Arrangement Consideration (Issues 2, 3, 5(a), 5(b), 5(c), and 6)

11. The amount of total arrangement consideration must be fixed or determinable other than with respect to the impact of (a) any refund rights or other concessions (hereinafter collectively

referred to as "refund rights") to which the customer may be entitled or (b) performance bonuses to which the vendor may be entitled.

12. ~~If there is vendor specific objective evidence (VSOE) or third-party evidence (TPE) of selling price (as discussed in paragraph 16) for all units of accounting in an arrangement, the a~~ Arrangement consideration shall ~~should~~ be allocated at the inception of the arrangement to ~~the separate~~ all deliverables ~~units of accounting~~ based on their relative selling price (the relative selling price method), except as specified in paragraphs 13 and 14. When applying the relative selling price method, the selling price for each deliverable shall be determined using vendor specific objective evidence (VSOE) of selling price, if it exists, otherwise third-party evidence (TPE) of selling price (as discussed in paragraph 16). If neither VSOE nor TPE of selling price exists for a deliverable, the vendor shall use its best estimate of the selling price for that deliverable (as discussed in paragraph 17) when applying the relative selling price method. ~~However, in the absence of VSOE or TPE of selling price for all units of accounting in the arrangement, 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 equals the total arrangement consideration less the aggregate selling price of the undelivered unit(s) of accounting (as discussed in paragraph 17). When allocating the arrangement consideration using the vendor's best estimate of selling price for the undelivered unit(s) of accounting, the amount allocated to the delivered unit(s) of accounting shall not exceed VSOE or TPE of the delivered unit(s) of accounting, if VSOE or TPE exists for the delivered unit(s) of accounting~~. In deciding whether the vendor can ~~establish~~ determine VSOE or TPE of selling price, the vendor shall not ignore information that is reasonably available without undue cost and effort. The "reverse" residual method (that is, the amount of consideration allocated to the undelivered item(s) equals the total arrangement consideration less the aggregate selling price of the delivered item(s) ~~using a residual method to determine the selling price of an undelivered unit(s) of accounting~~) is not an acceptable method of allocating arrangement consideration to the separate units of accounting, except as described in paragraph 13.

13. To the extent that any separate unit of accounting in the arrangement is required under GAAP to be recorded at fair value (and marked to market each reporting period thereafter), the amount allocated to that unit of accounting ~~should~~shall be its fair value. Under those

circumstances, the remainder of arrangement consideration ~~should~~shall be allocated to the other units of accounting in accordance with the requirements in paragraph 12.

14. The amount allocable to the delivered unit(s) of accounting is limited to the amount that is *not* contingent upon the delivery of additional items or meeting other specified performance conditions (the noncontingent amount). That is, the amount allocable to the delivered unit(s) of accounting is the lesser of the amount otherwise allocable in accordance with paragraphs 12 and 13, above, or the noncontingent amount. Additionally, although Statement 48 may ~~impact~~ affect the amount of revenue recognized, the allocated amount is not adjusted for the impact of a general right of return pursuant to that Statement.

15. The ~~Task Force reached a consensus that the~~ measurement of revenue per period ~~should~~shall be limited to the measurement that results from assuming that cancellation of the arrangement will not occur. The ~~Task Force observed that the~~ amount recorded as an asset for the excess of revenue recognized under the arrangement over the amount of cash or other consideration received from the customer since the inception of the arrangement ~~should~~shall not exceed all amounts to which the vendor is legally entitled, including cancellation fees (in the event of customer cancellation). However, ~~the Task Force further observed that~~ whether a vendor intends to enforce its contractual rights in the event of customer cancellation ~~should~~shall be considered in determining the extent to which an asset ~~should~~shall be recorded.

16. ~~When applying the relative selling price method of allocation, the selling price for each unit of accounting shall be determined using VSOE of selling price, if it exists available, otherwise TPE of selling price.~~ VSOE of selling price 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). TPE of selling price is the price of the vendor's or any competitor's largely interchangeable products or services in standalone sales to similarly situated customers. ~~Contractually stated prices for individual products and/or services in an arrangement with multiple deliverables should *not* be presumed to be representative of VSOE or TPE of selling price.~~

17. ~~When applying the residual method of allocation, the selling price for the undelivered unit(s) of accounting shall be determined using VSOE of selling price, if it exists, otherwise TPE of selling price. If neither VSOE nor TPE of selling price exists, the vendor shall use its best estimate of the selling price for the undelivered unit(s) of accounting.~~ The vendor's best estimate of selling price shall be consistent with the objective of determining VSOE of selling price for the deliverable ~~unit of accounting~~; that is, the price at which the vendor would transact if the deliverable ~~undelivered unit of accounting~~ were sold by the vendor regularly on a standalone basis. The vendor shall consider market conditions as well as entity-specific factors when estimating the selling price.

18. Contractually stated prices for individual products or services in an arrangement with multiple deliverables shall *not* be presumed to be representative of VSOE or TPE of selling price or a vendor's best estimate of selling price.

Accounting for Direct Costs in an Arrangement with Multiple Deliverables (Issue 4)

1~~8~~9. The Task Force agreed not to provide guidance on Issue 4 due to the broad, general nature of the question and its applicability beyond arrangements involving multiple deliverables. As such, this Issue does not address the allocation of direct costs in an arrangement.

Disclosure

20~~19~~. To be updated based on decisions reached at the June EITF meeting. ~~A vendor should disclose (a) its accounting policy for recognition of revenue from multiple-deliverable arrangements (for example, whether deliverables are separable into units of accounting) and (b) the description and nature of such arrangements, including performance-, cancellation-, termination-, or refund-type provisions.~~

~~20. A vendor shall also disclose both qualitative and quantitative information on an aggregated basis that enables users of its financial statements to understand the inputs and methodologies used to develop estimated selling price when neither VSOE nor TPE of selling price exists. Information related to individually significant arrangements should be separately disclosed.~~

~~21. A vendor shall separately disclose the amount of its revenue recognized each reporting period under Issue 00-21 and Issue 08-1 until the amount of revenue reported under Issue 00-21 is no longer material to the entity. A vendor shall also separately disclose the amount of deferred revenue as of the end of the period which is recognized in accordance with Issue 00-21 and Issue 08-1.~~

Transition

21~~22.~~ To be updated based on decisions reached at the June EITF meeting. ~~This Issue shall be effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after December 15, 2009. This Issue shall be applied on a prospective basis. Earlier application is permitted as of the beginning of a fiscal year.~~

Amendments to Other Literature

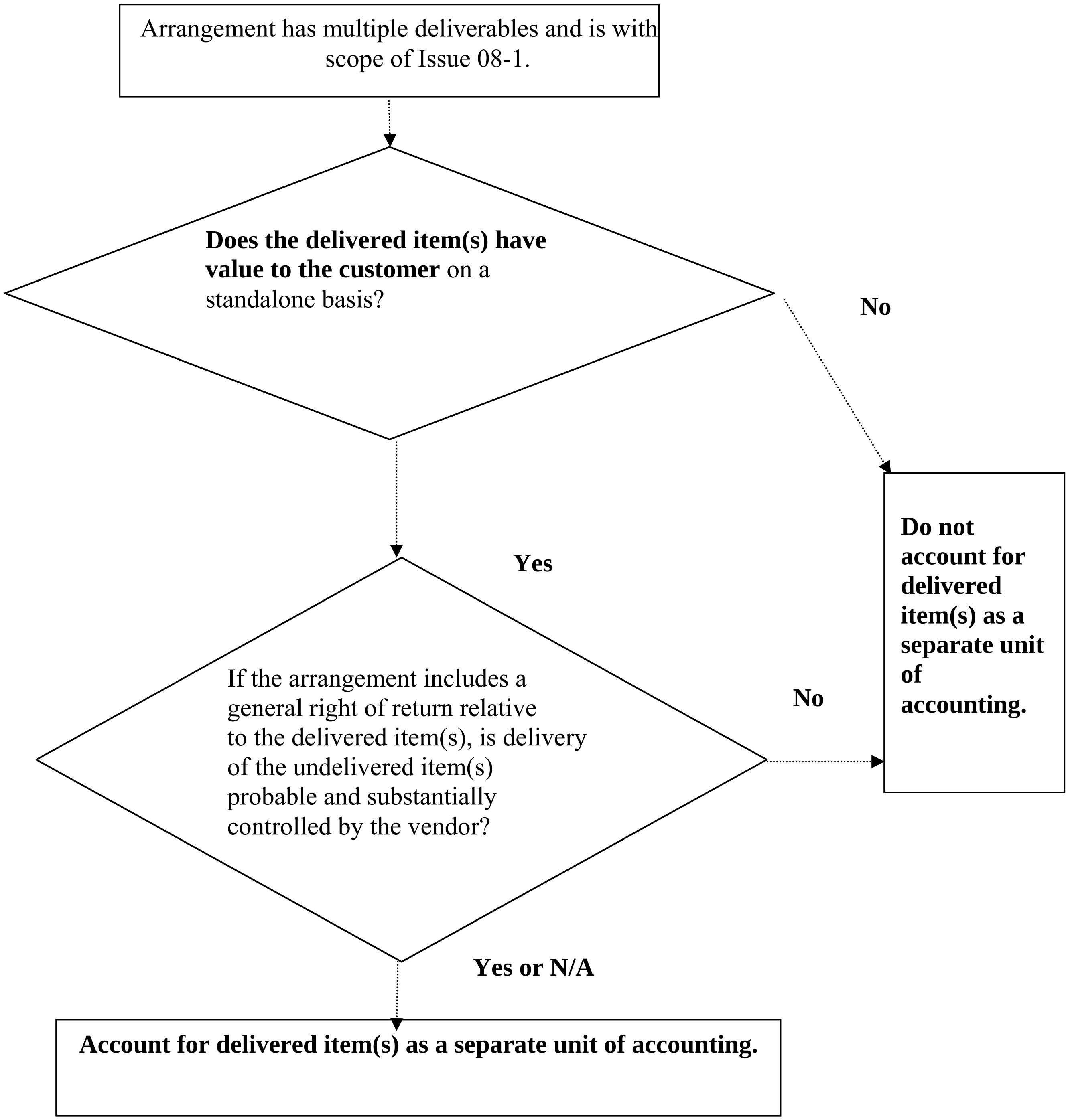
22~~3~~. Issue 00-21 is superseded by this Issue.

STATUS

23~~4~~. No further EITF discussion is planned.

Exhibit 08-1A

DETERMINING SEPARATE UNITS OF ACCOUNTING[5]



[5] This diagram represents an overview of the provisions of this Issue with respect to determining the separate units of accounting in an arrangement and should, therefore, be reviewed in conjunction with the entire consensus.

Exhibit 08-1B

EXAMPLES OF THE APPLICATION OF THE EITF CONSENSUS ON ISSUE 08-1

Note: The following examples ~~below~~ provide guidance *only* with respect to determining whether a multiple-deliverable revenue arrangement contains more than one unit of accounting and, if so, how to measure and allocate the arrangement consideration to the separate units of accounting. As discussed in paragraph 3, above, this Issue (including the examples below) does *not* address (for any unit of accounting) when the criteria for revenue recognition are met or provide revenue recognition guidance. The examples illustrate potential application of this Issue based on the limited facts presented. The evaluations following each of the example fact patterns are not intended to represent the only manner in which the guidance in this Issue could be applied. Additional facts would most likely be required in order to fully evaluate the deliverables, units of accounting and presentation issues related to these arrangements.

Example 1—Cellular Telephone Contract

CellularCo runs a promotion in which new customers who sign a two-year contract receive a "free" phone. There is a one-time "activation fee" of $50 and a monthly fee of $40 for the ongoing service. The same monthly fee is charged by CellularCo regardless of whether a "free" phone is provided. The phone costs CellularCo $100. Further, assume that CellularCo frequently sells the phone separately for $120. CellularCo is not required to refund any portion of the fees paid for any reason. CellularCo is a sufficiently capitalized, experienced, and profitable business and has no reason to believe that the two-year service requirement will not be met. CellularCo is considering whether (a) the phone and (b) the phone service (that is, the airtime) are separable deliverables in the arrangement. The activation fee is simply considered additional arrangement consideration to be allocated. The phone is delivered first, followed by the phone service (which is provided over the two-year period of the arrangement).

Evaluation: The first condition for separation is met for the phone. That is, the phone has value on a standalone basis because it is sold separately by CellularCo. The second condition is also met because there are no general rights of return in this arrangement. Therefore, the phone and the phone service should be accounted for as separate units of accounting.

The total arrangement consideration is $1,010. The selling price of the phone service is $960 ($40 × 24 months), the price charged by CellularCo when sold separately. The selling price of the phone is $120, the price of the phone when sold separately by CellularCo. Without considering whether any portion of the amount allocable to the phone is contingent upon CellularCo's providing the phone service, CellularCo would allocate the arrangement consideration on a relative selling price basis because CellularCo has either VSOE or TPE of selling price for all deliverables in the arrangement. That allocation would be as follows: $112.22 [$1,010 × ($120 ÷ [$120 + $960])] to the phone and $897.78 [$1,010 × ($960 ÷ [$120 + $960])] to the phone service. However, because a "free" phone is provided in the arrangement and the customer has no obligation to CellularCo if phone service is not provided, the amount of arrangement consideration allocated to the phone is limited to the noncontingent fee of $50. Therefore, the amount allocable to the phone service is increased to $960 ($897.78 + ($112.22 – $50)) and only $50 is allocated to the phone.

Example 2—Can Manufacturing Equipment

~~Company~~Entity C sells high-speed aerosol can manufacturing equipment. Entity~~Company~~ C sells a complete manufacturing process, which consists of Equipment X, Y, and Z. Entity~~Company~~ C does not sell Equipment X, Y, and Z separately; however, other companies do sell the same equipment separately and there is a market for used equipment. Installation is not considered in this example.

Entity~~Company~~ C is evaluating whether Equipment X, Y, and Z are separate units of accounting under the following scenario:

> Entity~~Company~~ C delivered Equipment X and Z on March 27, but did not deliver Equipment Y until April 6. Without Equipment Y, the customer does not have use of Equipment X and Z. However, there is an active market for Equipment X, Y, and Z on a separate basis, as the

equipment is often bought separately from other vendors as replacements become necessary. The contract provides that if all pieces of equipment are not delivered, the customer may return Equipment X and Z and have no liability to Entity~~Company~~ C. The contract requires delivery of all equipment prior to June 1, and Entity~~Company~~ C has sufficient production capacity and inventory to deliver all of the equipment prior to that contractual deadline.

Evaluation: The first condition for separation is met for Equipment X and Z. Equipment X and Z have value on a standalone basis because they are sold separately by other vendors. The second condition is also met because there is no general right of return in the arrangement. Therefore, Equipment X, Y, and Z should be accounted for as separate units of accounting. However, even though accounted for as separate units of accounting, the arrangement consideration allocable to both Equipment X and Z is $0 because the full amount otherwise allocable to those separate deliverables is contingent upon the delivery of Equipment Y.

Example 3—Standard Equipment and Installation

Entity~~Company~~ E is an experienced manufacturer of equipment used in the construction industry. Entity~~Company~~ E's products range from small to large individual pieces of automated machinery to complex systems containing numerous components. Unit selling prices range from $200,000 to $2.5 million. Unit selling prices are quoted inclusive of installation.

Each equipment model has standard performance specifications and is not otherwise customized for the specific needs of a buyer. Entity~~Company~~ E extensively tests the equipment against those specifications prior to shipment. The installation process does not involve changes to the features or capabilities of the equipment and does not require proprietary information about the equipment in order for the installed equipment to perform to specifications.

While there are others in the industry with sufficient knowledge about the installation process for the equipment, as a practical matter, most purchasers engage Entity~~Company~~ E to perform the installation services. However, some customers choose not to have the equipment installation performed by Entity~~Company~~ E for various reasons (for example, their proprietary use of the equipment, their preference that installation be performed by their own employees or other vendors with whom the customers have established relationships, or for their own convenience). If a potential customer wishes to purchase equipment without installation, Entity~~Company~~ E will not reduce the quoted selling price for the commensurate value of the installation. If a customer chooses to purchase equipment without installation, there is only one deliverable.

Assume that a customer enters into an arrangement to purchase equipment with a price of $200,000 (the price at which Entity~~Company~~ E regularly sells the equipment without installation) from Entity~~Company~~ E and chooses to have Entity~~Company~~ E perform the installation for that equipment. The customer is obligated to pay Entity~~Company~~ E the arrangement consideration upon delivery of the equipment. The price of the installation service when it is performed by vendors other than Entity~~Company~~ E is $8,000 (TPE of selling price). There are no refund rights (general or otherwise) in the arrangement. Entity~~Company~~ E is considering whether (a) the equipment and (b) the installation service are separate units of accounting in the arrangement.

Evaluation: The first condition for separation is met for the equipment. The equipment has standalone value as it is sometimes sold separately. The second condition for separation is also met as there are no general refund rights. Therefore, the equipment and the installation are considered separate units of accounting in the arrangement.

Regardless of whether the installation is performed, the total arrangement consideration is $200,000. ~~Because~~ Entity~~Company~~ E has either VSOE or TPE of selling price for all units of accounting in the arrangement.~~,~~ The~~the~~ arrangement consideration of $200,000 should be allocated to the separate units of accounting using the relative selling price method. Thus, allocation of the arrangement consideration would be $192,308 [$200,000 × ($200,000 ÷ [$200,000 + $8,000])] to the equipment and $7,692 [$200,000 × ($8,000 ÷ [$200,000 + $8,000])] to the installation service. Additionally, none of the amount allocable to the equipment is contingent upon performing the installation.

Example 4—Automobiles Sold with Lifetime Maintenance Services

Entity~~Company~~ A is an established auto dealer. Entity~~Company~~ A's service center provides all scheduled maintenance services (including oil changes) at no additional charge (other than for parts) for any customer who purchases an automobile from Entity~~Company~~ A for the period that the customer owns the automobile. The customer may also choose to have the maintenance services performed by others without affecting the vehicle warranty, but most customers utilize Entity~~Company~~ A's maintenance services unless they move to a distant location. Neither Entity~~Company~~ A nor any other dealer sells the automobile without the lifetime maintenance services. However, Entity~~Company~~ A sells maintenance services separately to customers who did not purchase their vehicles from Entity~~Company~~ A. The automobiles are sold subject to a limited warranty and there are no refund rights in the arrangement. Customers are obligated to Entity~~Company~~ A for all arrangement consideration upon taking delivery of the automobile. Since lifetime maintenance services are not separately priced when a customer purchases an automobile from Entity~~Company~~ A, they are not within the scope of Technical Bulletin 90-1.

Evaluation: The first condition for separation is met for the automobile because, even though the automobile is not sold separately by any vendor, it is considered to have standalone value because the customer could resell the automobile on a standalone basis. The second condition for separation also is met as there are no refund rights (general or otherwise) in the arrangement. Therefore, the automobile and the maintenance services should be considered separate units of accounting in the arrangement.

Because no entity sells the automobile separately, neither VSOE nor TPE of selling price exists for the automobile. However, there is VSOE of selling price of the maintenance services (as evidenced by the amount charged on a standalone basis by Entity~~Company~~ A for maintenance services and data available from which to estimate the volume and types of maintenance services provided during a typical customer's ownership of the vehicle). As a result, when applying the relative selling price method, Entity A shall use its best estimate of selling price for the automobile and VSOE of selling price for the maintenance. ~~the consideration in the arrangement should be allocated to the units of accounting using the residual method. The selling price of the maintenance services should be determined as described above. The remaining arrangement consideration should be allocated to the automobile.~~ Additionally, none of the amount allocable to the automobile is contingent upon providing the maintenance services.

Example 5—Sale of Home Appliances with Installation and Maintenance Services

Entity~~Company~~ S is an experienced home appliance dealer. Entity~~Company~~ S also offers a number of services together with the home appliances that it sells. Assume that Entity~~Company~~ S regularly sells Appliance W on a standalone basis. Entity~~Company~~ S also sells installation services and maintenance services for Appliance W. However, Entity~~Company~~ S does not offer installation or maintenance services to customers who buy Appliance W from other vendors.

Pricing for Appliance W is as follows:

- Appliance W only $800
- Appliance W with installation service $850
- Appliance W with maintenance services $975
- Appliance W with installation and maintenance services $1,000

In each instance in which maintenance services are provided, the maintenance service is separately priced within the arrangement at $175. Additionally, the incremental amount charged by Entity~~Company~~ S for installation of $50 approximates the amount charged by independent third parties.

Appliance W is sold subject to a general right of return. If a customer purchases Appliance W with installation and/or maintenance services, in the event that Entity~~Company~~ S does not complete the services satisfactorily, the customer is only entitled to a refund of the portion of the fee that exceeds $800.

Assume that a customer purchases Appliance W with both installation and maintenance services for $1,000. Based on its experience, Entity~~Company~~ S believes that it is probable that installation of the equipment will be performed satisfactorily to the customer. The maintenance services are priced separately and should be accounted for based on the guidance in Technical Bulletin 90-1. Entity~~Company~~ S is evaluating whether Appliance W and the installation service represent separate units of accounting.

Evaluation: The first condition for separation is met for Appliance W because it is sometimes sold separately by Entity~~Company~~ S. The second condition for separation is also met because, even though a general right of return exists, performance of the appliance installation is probable and within the control of Entity~~Company~~ S. Therefore, Appliance W and installation should be accounted for as separate units of accounting.

Entity~~Company~~ S would allocate $175 of the arrangement consideration to the maintenance services based on the guidance in Technical Bulletin 90-1. Without considering whether any of the amount otherwise allocable to Appliance W is contingent upon the performance of the installation, Entity~~Company~~ S would allocate the remainder of the arrangement consideration ($825) to Appliance W and the installation service using the relative selling price method. VSOE of selling price of Appliance W is its price when sold separately ($800), and the TPE of selling price of the installation service is the amount charged by independent third parties, which approximates $50. Therefore, the amounts allocable to Appliance W and to the installation services are $776 [$825 × ($800 ÷ [$800 + $50])] and $49 [$825 × ($50 ÷ [$800 + $50])], respectively. Since the customer is entitled only to a refund of the portion of the fee that exceeds $800 if the installation is not performed, no portion of the amount allocable to Appliance W is contingent upon that installation.

Example 6—Human Resources Outsourcing Services

HR Company (HR) provides its customers with human resource solutions (for example, support and guidance in areas such as employee relations, payroll and taxes, health benefits administration, and 401(k) administration). Customers may choose a prepackaged bundle of services, may customize an existing bundle of services, or may select the individual services they require. Given the many services provided by HR and the varying needs of its customers, no two arrangements are exactly alike. HR prices its arrangements based on the unique bundle of services to be provided. As a result, HR does not have VSOE of selling price for any individual service that it provides. Although each service is sold separately by other vendors, and while HR has some information about its competitors' pricing, it is unable to obtain TPE of selling price for any individual service.

Assume that on January 1, 20X1, HR begins providing human resource solution services to Customer Y under a 3-year arrangement. Under the arrangement, HR agrees to provide Customer Y with payroll processing, three periodic training events, employee handbook development, and an executive compensation assessment. The executive compensation assessment and employee handbook development are expected to be completed by June 30, 20X1 and 20X2, respectively. HR expects to provide one training event annually. Total compensation under the arrangement is $1,275,000. HR receives compensation under the arrangement as follows: an upfront payment of $375,000 and monthly payments of $25,000. There are no general refund rights included in the arrangement.

HR is evaluating whether (a) payroll processing, (b) periodic training, (c) employee handbook development, and (d) executive compensation assessment represent separate units of accounting and how to allocate arrangement consideration to the separate units of accounting.

Evaluation: ~~In accordance with paragraph 8 of this Issue, HR is required to assess whether the delivered items in the arrangement are considered separate units of accounting at the inception of the arrangement and as each item in the arrangement is delivered. For purposes of this example, the initial assessment at January 1, 20X1, and the interim periods during the year ended December 31, 20X1, are not shown. Rather, for purposes of this example, the assessment of whether the deliverables in the arrangement qualify as separate units of accounting is illustrated as of December 31, 20X1, HR's annual reporting date. As of that date, HR has delivered payroll processing services, one training event, and the executive compensation assessment. At that date, the first condition for separation is met for each of the three delivered items as each service is sold separately by other vendors. The second condition for separation is also met as there are no general refund rights. Therefore, the three delivered items are considered separate units of accounting in the arrangement.~~

Because no item in the arrangement has been delivered at the inception of the arrangement, HR concludes that there are no units of accounting in the arrangement at that date. However, HR will reassess whether a delivered item(s) should be considered a separate unit(s) of accounting each time it performs under the arrangement.

Because HR does not have either VSOE or TPE of selling price for ~~all of~~ the deliverables ~~units of accounting~~ in the arrangement, HR must use its best estimate of selling price for each deliverable when allocating arrangement consideration under the relative selling price method ~~(as noted earlier, HR has some information about its competitors' pricing but it is unable to obtain TPE of selling price for any individual service), HR must estimate the selling price for the~~

~~undelivered units of accounting and allocate the arrangement consideration using the residual method~~.

~~At December 31, 20X1, the following items remain undelivered: (1) two years of payroll processing, (2) employee handbook development (for which HR has yet to begin development), and (3) two training events. In order to complete the allocation of arrangement consideration, HR must estimate the selling price for these undelivered units of accounting.~~

In estimating the selling price for the deliverables ~~undelivered units of accounting~~, HR considered its internal costs, profit objectives, pricing practices used to establish the bundled price for its services, and whether any market constraints exist that may limit its selling price (for example, whether competitors could charge a lower price for the service or whether the price for the service exceeds the cost savings to its customers). HR believes that as the price for its service begins to exceed the customer's internal cost, the customer would be less likely to purchase the service.

When determining the price for its bundled services, HR typically applies a gross profit margin to the cost (primarily labor and other time and expenses) it will incur in providing the contracted services. The profit margin varies with the types of services to be provided and generally includes a discount based on the number of services being purchased. For example, HR typically includes a 26 percent gross profit margin on its payroll processing services, a 15 percent gross profit margin on its employee handbook development services and executive compensation assessments, and a 22 percent gross profit margin on its training services before considering any discount on the total arrangement. Those gross profit margins have been developed over time (by a relevant authorized level of management) based on available market data and demand for the services. HR believes that these returns are consistent with the gross margins sought by its competitors. In addition, HR has no information that would indicate that a competitor would charge a price that could affect the price HR could charge for its service, either by limiting the price that HR could charge or by allowing HR to increase its price. In addition, HR's analysis also indicates that the price of the individual services calculated using its internal gross profit margins would be in a range in which the service would still be attractive to its customers (that is, the cost of the service would be less than the internal costs for its customers to provide the service themselves).

Using its internal gross profit margins, and the total estimated costs it will incur to deliver the remaining units of accounting and considering market constraints, HR estimates the selling price for the undelivered units of accounting as follows:

Costs to be incurred for payroll processing for ~~2~~3 years	~~519,330~~ $976,250
(1 − Payroll processing gross profit margin of 26 percent)	÷ .74
Estimated selling price for payroll processing	~~701,797~~ 1,319,257
Cost to be incurred for executive compensation assessment	~~56,113~~ 45,223
(1 − executive compensation assessment gross profit margin of 15 percent)	÷ .85
Estimated selling price for executive compensation assessment	~~66,015~~ 53,204
Costs to be incurred for employee handbook	56,113
(1 − Employee handbook gross profit margin of 15 percent)	÷ .85
Estimated selling price for employee handbook	66,015
Costs to be incurred for 3 training events	40,706
(1 − Training event gross profit margin of 22 percent)	÷ .78
Estimated selling price for training events	52,187
Total estimated selling price of ~~the~~ all deliverables ~~undelivered units of accounting~~	$1,490,663~~820,000~~

~~HR would allocate the arrangement consideration ($1,275,000) using the residual method as HR does not have either VSOE or TPE of selling price for all units of accounting in the arrangement.~~ Therefore, at January 1~~December 31~~, 20X1, HR allocates the arrangement consideration ($1,275,000) as follows (before determining whether any individual deliverable should be considered a separate unit of accounting): ~~$455,000 ($1,275,000 − $820,000) to the delivered units of accounting. The residual amount is not limited to VSOE or TPE of selling price of the delivered units of accounting as HR has determined VSOE and TPE of selling price do not exist for the delivered units of accounting.~~

Payroll processing	[1,275,000 × (1,319,257 ÷ 1,490,663)]	$1,128,392
Executive compensation	[1,275,000 × (53,204 ÷ 1,490,663)]	45,507
Employee handbook	[1,275,000 × (66,015 ÷ 1,490,663)]	56,464
3 training events	[1,275,000 × (52,187 ÷ 1,490,663)]	44,637

Total consideration	$1,275,000

As each item in the arrangement is delivered, HR must perform an evaluation to determine whether the delivered item represents a separate unit of accounting. If the delivered item does not qualify as a separate unit of accounting, the arrangement consideration allocable to the delivered item shall be combined with the amount allocable to the other applicable undelivered item(s) within the arrangement.

Example 7—Sale of Medical Equipment with Cartridges and Installation

Entity~~Company~~ M manufactures and sells complex medical equipment to physicians and hospitals for medical scanning purposes. Prior to shipment, each piece of equipment is extensively tested to meet company and FDA specifications. The equipment is shipped fully assembled, but some installation and setup is required. No other companies sell the same or largely interchangeable equipment.

Installation is a standard process, outlined in the owner's manual, consisting principally of uncrating, calibrating, and testing the equipment. A purchaser of the equipment could complete the process using the information in the owner's manual, although it would probably take significantly longer than it would take Entity~~Company~~ M's technicians to perform the tasks. Although other vendors do not install Entity~~Company~~ M's equipment, other vendors do provide largely interchangeable installation services for $25~~0~~,000. Historically, Entity~~Company~~ M has never sold the equipment without installation. Most installations are performed by Entity~~Company~~ M within 7–24 days of shipment. Installation is included in the overall sales price of the equipment.

In addition, the customer must pay for cartridges that record images. ~~The retail price of each cartridge is $250.~~ Entity~~Company~~ M is the only manufacturer of the cartridges ~~but~~ ~~also~~ and it only sells them on a stand-alone basis to ~~on a~~ wholesalers~~ basis~~ through a wide network of distributors. The distributors' retail price of each cartridge is $250. Each cartridge can handle only a specific number of scans. Once a cartridge is exhausted, a new one must be purchased in order to use the equipment. Entity~~Company~~ M always sells its equipment with a starter supply of 20 cartridges.

The sales price of the arrangement that consists of the equipment, installation, and 20 cartridges is $400,000. The customer is obligated to pay in full upon delivery of the equipment. The customer is entitled to a refund of $25,000 if Entity~~Company~~ M does not perform the installation or if the 20 cartridges are not delivered. On March 15, Entity~~Company~~ M delivers the equipment and on April 5 delivers the 20 cartridges and performs the installation. Entity~~Company~~ M is evaluating whether ~~delivery of~~ the equipment represents a separate unit of accounting.

Evaluation: The first condition for separation is met for the equipment because, even though Entity~~Company~~ M has never sold the equipment without the cartridges, a customer could resell the equipment (in a primary or secondary market). The second condition for separation is also met because there are no general rights of return involved in this arrangement. Therefore, the equipment should be accounted for as a separate unit of accounting.

Entity~~Company~~ M does not have VSOE of selling price for the equipment as it does not sell the equipment separately (without installation services and cartridges). In addition, TPE of selling price does not exist as no vendor separately sells the same or largely interchangeable equipment. Therefore, Entity M must use its best estimate of selling price when allocating arrangement consideration. For the cartridges, Entity ~~Company~~ M uses the price when sold separately by its distributors ($5,000 = 20 × $250). In addition, Entity M has TPE of selling price for the installation ($25,000).

In estimating its selling price for the equipment, Entity M considered its cost to produce the equipment, its profit margin for similar arrangements, customer demand, effect of competitors on Entity M's equipment, and other market constraints. After weighing the relevance of the available data points, Entity M estimates its standalone selling price for the equipment to be $385,000. Total selling price for all deliverables in the arrangement on a standalone basis is $415,000.

When applying the relative selling price method, Entity M shall use its best estimate of selling price for the equipment, TPE of selling price for the cartridges and TPE of selling price for the installation. ~~The residual method should be used to allocate the arrangement consideration because Company M has neither VSOE nor TPE of selling price for the delivered unit of accounting (equipment). However, Company M has TPE of selling price for the cartridges~~

~~($5,000 = 20 × $250) and the installation services ($20,000).~~ Accordingly, without considering whether any portion of the amount allocable to the equipment is contingent upon delivery of the other items, the amount allocable to the equipment, cartridges, and installation is as follows: ~~$375,000 to the equipment ($400,000 – [$250 x 20] - $20,000, $5,000 to the cartridges ($250 × 20), and $20,000 to the installation~~ $371,084 to the equipment [$400,000 × (385,000 ÷ 415,000)], $4,819 to the cartridges [$400,000 × (5,000 ÷ 415,000)], and $24,097 to the installation [$400,000 × (25,000 ÷ 415,000)]. Additionally, no portion of the amount allocable to the equipment is contingent upon the delivery of the cartridges or performance of the installation. That is, if the cartridges are not delivered and the installation is not performed, Entity~~Company~~ M would be entitled to $375,000.

Example 8—Sale of Computer System

Entity~~Company~~ B sells computer systems. On April 20, a customer purchases a computer system from Entity~~Company~~ B for $1,000. The system consists of a CPU, a monitor, and a keyboard. Solely for purposes of simplifying this illustration of the application of the guidance in this Issue, it is assumed that the CPU does not include software that is more-than-incidental to the products in the arrangement; therefore, the provisions of SOP 97-2 do not apply. On April 30, Entity~~Company~~ B delivers the CPU to the customer without the monitor or keyboard. Each of the items is regularly sold separately at a price of $700 for the CPU, $300 for the monitor, and $100 for the keyboard. The CPU could function with monitors or keyboards manufactured by others, who have them readily available. The customer is entitled to a refund equal to the separate price of any item composing the system that is not delivered. The arrangement does not include any general rights of return. Entity~~Company~~ B is evaluating whether delivery of the CPU represents a separate unit of accounting.

Evaluation: The first condition for separation is met for the CPU, as it is sold separately by Entity~~Company~~ B. The second condition for separation is met because there are no general rights of return. Therefore, the CPU should be accounted for as a separate unit of accounting.

Entity~~Company~~ B has VSOE of selling price for all deliverables in the arrangement as each is sold regularly on a standalone basis. Without considering whether any portion of the amount allocable to the CPU is contingent upon delivery of the other items, Entity~~Company~~ B would allocate the arrangement consideration using the relative selling price method because either VSOE or TPE of selling price exists for all deliverables in the arrangement. Therefore, the portion of the arrangement fee otherwise allocable to the CPU is $636.36 ($1,000 × [$700 ÷ $1,100]), of which $36.36 ($636.36 – [$1,000 – $300 − $100]) is subject to refund if the monitor and keyboard are not delivered. Therefore, the amount allocable to the CPU is limited to $600, which is the amount that is not contingent upon delivery of the monitor and keyboard.

Example 9—Sale of 12 Bolts of Fabric

Entity~~Company~~ D sells fabric for use in manufacturing clothing. Customers may purchase fabric from Entity~~Company~~ D in individual 50-yard bolts or in bulk lots consisting of multiple bolts. One of Entity~~Company~~ D's customers (Customer A) is a manufacturer of band uniforms that prefers to purchase the fabric in bulk because it needs the fabric to have a high level of consistency in color and quality. Customer A enters into an arrangement with Entity~~Company~~ D to purchase a 12-bolt bulk lot of fabric that is to be delivered by Entity~~Company~~ D in 3 4-bolt installments over a period of 3 months. At Customer A's request, Entity~~Company~~ D provides a customer satisfaction guarantee that it will refund double the price (up to a maximum of the total arrangement fee) for each bolt of fabric that is not delivered or not delivered from the same dye lot as the initial installment. That is, the double-money-back guarantee provides that the customer, in addition to having no obligation for bolts of fabric not delivered or not delivered from the appropriate dye lot, will receive a refund for (or will not be obligated to pay for) an equal number of bolts. There are no general rights of return included in the arrangement. The price for an individual 50-yard bolt of fabric is $160, and the price for a 12-bolt bulk lot is $1,824.

In determining the units of accounting under the arrangement, Entity~~Company~~ D considered the following scenario:

> Entity~~Company~~ D sold the 12-bolt bulk lot of fabric to Customer A on November 1, 20X2. Entity~~Company~~ D will deliver the first of three four-bolt installments of fabric on November 15, 20X2 and will deliver the remaining installments on December 15, 20X2, and January 15, 20X3. Customer A is obligated to Entity~~Company~~ D for the full price of the fabric on November 15, 20X2, subject to the money-back guarantee. Entity~~Company~~ D has sufficient

production capacity and inventory to deliver all of the fabric in accordance with the installment provisions of the arrangement and, therefore, believes that it will do so. In addition, Entity~~Company~~ D has entered into similar arrangements with many other customers in the past and has rarely failed to deliver fabric from the appropriate dye lot under its bulk-sale arrangements.

Evaluation: The first condition for separation is met for the delivered fabric because Entity~~Company~~ D also sells bolts of fabric individually. The second condition for separation is also met because there are no general rights of return in the arrangement. Therefore, the delivered fabric should be accounted for as a separate unit of accounting.

Without considering whether any portion of the amount allocable to the individual bolts of fabric is contingent upon delivery of the other bolts of fabric, Entity~~Company~~ D would allocate the arrangement consideration evenly among the 12 bolts of fabric using the relative selling price method because each bolt has an identical selling price. Therefore, the portion of the arrangement fee otherwise allocable to each bolt of fabric is $152 ($1,824 ÷ 12). However, in allocating the arrangement consideration, no amount is allocable to the initial delivered fabric because the arrangement provides the customer with a double-money-back guarantee for each bolt of fabric not delivered from the same dye lot as the initial installment. However, upon delivery of the second four-bolt installment (assuming that installment is delivered from the same dye lot as the initial installment), the amount allocable to that installment would be the amount related to four bolts of fabric, $608 ($152 × 4 bolts of fabric). That is, if the third installment was not delivered or was not delivered from the same dye lot as the initial installment, Entity~~Company~~ D would be entitled only to the price charged for four bolts of fabric.

Example 10—Painting Contract

PainterCo is a contractor that provides painting services for commercial and private residences. PainterCo contracts with a customer to paint the customer's house for $3,000. The price is inclusive of all paint, which is obtained by PainterCo at a cost of $800. The customer is given the right to purchase paint separately if so desired (although the customer did not opt to do so in this example). The paint would have cost the customer $900 if purchased from a hardware store. The painting service would have cost $2,150 if purchased without the paint.

All paint necessary to complete the project is delivered to the customer's house prior to the beginning of the work. The customer has a general right of return with respect to any unopened can of paint. Further, the customer may receive a full refund of the sales price for all of the paint (whether or not the cans were opened) if PainterCo does not paint the house. PainterCo has always completed the painting service in accordance with contract terms and, therefore, believes that performance of the painting service in this arrangement is probable. PainterCo does not sell paint without providing the painting service.

Evaluation: The first condition for separation is met because the paint is sold separately by other vendors. The second condition for separation is also met because, even though a general right of return exists, performance of the painting service is probable and within the control of PainterCo. Therefore, the paint and the painting service are considered separate units of accounting.

However, in allocating the arrangement consideration, no amount would be allocated to the paint because, in the event that PainterCo does not perform the painting service, the customer may return all of the paint for a full refund.

Example 11 — Agricultural Equipment

Entity~~Company~~ A engages in the manufacture and distribution of farm equipment and related service parts, including tractors, harvesters, integrated agricultural management systems technology, and precision agricultural irrigation equipment. Each product has standard performance specifications but can be customized to meet the specific needs of any buyer. Entity~~Company~~ A extensively tests the equipment against standard performance indicators and customer specifications prior to shipment.

On December 29, 20X8, Entity~~Company~~ A enters into an arrangement to deliver a tractor and customized irrigation equipment to Customer M for a fee of $270,000. For purposes of this example, it is assumed that the irrigation equipment is not required to be accounted for in accordance with SOP 81-1. The customer is obligated to pay $100,000 upon delivery of the tractor and the remainder of the arrangement consideration upon delivery of the irrigation equipment. On December 31, 20X8, Entity~~Company~~ A delivers the tractor, and on April 5, 20X9, Entity~~Company~~ A delivers the irrigation equipment. Neither product requires installation.

The tractor in this arrangement is often sold separately by Entity~~Company~~ A for a price of $100,000, which is considered VSOE of selling price. The irrigation equipment is also sold separately; however, because of the customized nature of the product, Entity~~Company~~ A has neither VSOE nor TPE of selling price.

Entity~~Company~~ A is considering whether the tractor is a separate unit of accounting and, if so, how to allocate the arrangement consideration at December 31, 20X8.

Evaluation: The first condition for separation is met for the tractor. The tractor has standalone value as it is sold separately by Entity~~Company~~ A. The second condition for separation is also met as there are no general rights of return. Therefore, the tractor should be accounted for as a separate unit of accounting.

~~Because~~ Entity~~Company~~ A has VSOE of selling price for the tractor but has neither VSOE nor TPE of selling price for the ~~undelivered unit of accounting in the arrangement (~~irrigation equipment~~)~~.~~,~~ Therefore, Entity~~Company~~ A must estimate the selling price for the irrigation equipment ~~undelivered unit of accounting and allocate the arrangement consideration using the residual method~~.

Entity~~Company~~ A considered the following in estimating the stand-alone selling price for the irrigation equipment ~~(undelivered unit of accounting)~~:

- Entity~~Company~~ A's cost to produce the customized irrigation equipment is $110,000.
- The division of Entity~~Company~~ A that produces the irrigation equipment and other similar products, earns an average gross profit margin of approximately 30 percent. The profit margins within the irrigation product line vary from 10 to 45 percent. Entity~~Company~~ A generally receives a higher profit margin on the more specialized or customized products.

- When selling non-customized irrigation equipment, Entity~~Company~~ A averages, on a world-wide basis, a selling price of approximately $140,000, which includes a gross profit margin of 25 percent.
- Customer M is located in Asia where high demand has resulted in Entity~~Company~~ A being able to command 10-15 percent higher prices for its irrigation product line than it commands in other markets it serves. This pricing is also consistent with Entity~~Company~~ A's ongoing marketing strategy in Asia.
- Direct competitors to Entity~~Company~~ A's irrigation product line, Entity~~Company~~ D and Entity ~~Company~~ E, earn average gross profit margins in Asia of 30 percent and 32 percent, respectively, based on a review of those companies' periodic filings.
- The customized irrigation equipment includes enhanced functionality that Entity~~Company~~ A does not believe its competitors can provide. Entity~~Company~~ A believes this enhanced functionality has additional value in the marketplace.
- Entity~~Company~~ A's price list provided to prospective customers lists the price for irrigation equipment prior to customization at $155,000.

After weighing the relevance of the available data points, Entity~~Company~~ A estimates its standalone selling price for the irrigation equipment to be $185,000. The determination of that estimated selling price was based on the cost of the irrigation equipment of $110,000 plus an estimated gross profit margin of 40 percent. The 40 percent gross profit margin is management's best estimate based on the margin they would expect to earn on the irrigation equipment if sold separately in Asia. The estimated margin of 40 percent is higher than the 30 percent average margin of the division based on consideration of the fact that the 30 percent average margin includes lower margin products. Entity~~Company~~ A also notes that it believes that it could command higher margins in Asia than the average margin due to the high demand in that market and based on recent history combined with its ongoing pricing strategy. Entity~~Company~~ A also considered the margins reported by its competitors and believes its estimated 40 percent margin is reasonable in relation to the competitor margins considering the enhanced functionality it believes the irrigation equipment has over its competitors' products.

Entity~~Company~~ A did not rely on the $170,000 price of the irrigation equipment that was stated in the arrangement as the stated prices were negotiated to provide for more cash consideration earlier in the arrangement rather than to reflect the standalone selling price of the products. In addition, the arrangement prices are net of any discount embedded in the bundled arrangement rather than standalone selling prices of the products. Considering the customized nature of the irrigation equipment, Entity~~Company~~ A did not consider the estimated selling price of $185,000 to be inconsistent with the list price of $155,000 for uncustomized irrigation equipment.

Accordingly, at December 31, 20X8, using the relative selling price ~~residual~~ method ~~of allocation~~, Entity~~Company~~ A would allocate $94,736 [$270,000 × ($100,000 ÷ $285,000)] to the tractor and $175,264 [$270,000 × ($185,000 ÷ $285,000)] ~~$185,000 of the arrangement consideration~~ to the irrigation equipment. ~~The residual amount of $85,000 ($270,000 – $185,000) would be attributed to the tractor~~. ~~before considering whether the residual amount exceeds the VSOE or TPE of selling price for the tractor. Because Company A has VSOE of the selling price of the tractor, it must consider whether the amount allocated to the tractor using the residual method exceeds its VSOE. The VSOE of the selling price of the tractor is $100,000, which is greater than the amount allocated to the tractor ($85,000), so the amount allocated is not limited by the VSOE of the selling price. Additionally, because $100,000 was due upon delivery of the tractor none of the amount allocable to the tractor is contingent upon delivery of the irrigation equipment.~~ Additionally, none of the amount allocable to the tractor is limited by the amount of payment contingent upon delivery of the irrigation equipment.

Example 12—Biotech License, Research and Development, and Contract Manufacturing Agreement

Biotech Company (Biotech) enters into an agreement with Pharmaceutical Company (Pharma). The agreement includes (1) Biotech licensing certain rights to Pharma and (2) Biotech providing research and development services to Pharma. Additional details on those aspects of the agreement follow.

License: Biotech licenses certain rights on an exclusive basis to Pharma for a period of 10 years. The license gives Pharma the exclusive right to market, distribute, and manufacture Drug B as developed using Technology A. Biotech retains all ownership rights to Technology A and Drug

B. There are no when-and-if-available clauses or other performance obligations associated with the license, except as described below.

Research and development: Biotech agrees to provide research and development services on a best-efforts basis to Pharma. Biotech agrees to devote four full-time equivalent employees (FTEs) to the research and development activities, and Pharma expects to devote several FTEs to the research and development activities as well. The objective of the research and development services is to develop Drug B using Technology A. The ultimate objective is to receive Food and Drug Administration (FDA) approval on Drug B.

Compensation under the arrangement is as follows:

- Biotech receives $5 million up-front upon signing the agreement
- Biotech receives $250,000 per year for each FTE that performs research and development activities.

None of these payments, once received, is refundable, even if FDA approval is never received. In addition, Biotech must perform on a best-efforts basis.

Pharma must use Biotech to perform the research and development activities necessary to develop Drug B using Technology A because the know-how and expertise related to Technology A is proprietary to Biotech. In other words, Biotech is the only party capable of performing the level and type of research and development services required by Pharma under the agreement. 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 TPE of selling price for those services).

Evaluation: There are two deliverables in this arrangement that should be considered for separation: (1) license and (2) research and development activities. The license deliverable does not meet the first criterion for separation since it does not have standalone value to Pharma. Because Drug B has not yet been developed, the license is of no value to Pharma and could not be sold without the accompanying research and development activities using Technology A, which is proprietary to Biotech. Likewise, Pharma could not sell the license on a standalone basis to another party (that is, because without Biotech agreeing to provide the research and development activities for that other party, the other party would not purchase the license). Therefore, the license and research and development activities should be considered a single unit of accounting in the arrangement.