

FASB Emerging Issues Task Force

Issue No. 08-9

Title: Milestone Method of Revenue Recognition

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Previously distributed EITF materials: Issue Summary No. 1, dated October 20, 2008; Issue Summary No. 1, Supplement No. 1, dated March 2, 2009; Issue Summary No. 1, Supplement No. 2, dated May 12, 2009; and the following discussion materials related to Issue No. 08-1, "Revenue Arrangements with Multiple Deliverables:" Issue Summary No. 1, dated February 29, 2008; Working Group Report No. 1, dated June 9, 2008; Working Group Report No. 2, dated August 13, 2008; Issue Summary No. 2, dated October 20, 2008

References:

FASB Accounting Standards Codification Topic 250, *Accounting Changes and Error Corrections* (Topic 250)

FASB Accounting Standards Codification Topic 450, *Contingencies* (Topic 450)

FASB Accounting Standards Codification Topic 605, *Revenue Recognition* (Topic 605)

FASB Accounting Standards Codification Topic 840, *Leases* (Topic 840)

FASB Accounting Standards Codification Topic 92X, *Entertainment* (Topic 92X)

FASB Accounting Standards Codification Topic 985, *Software* (Topic 985)

FASB Statement No. 5, *Accounting for Contingencies* (currently under Topic 450) (Statement 5)

*** 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. 13, *Accounting for Leases* (currently under Topic 840) (Statement 13)

FASB Statement No. 154, *Accounting Changes and Error Corrections* (currently under Topic 250) (Statement 154)

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

FASB Invitation to Comment, *Accounting for Certain Service Transactions* (Invitation to Comment on Service Transactions)

AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* (currently under Topic 605) (SOP 81-1)

AICPA Statement of Position 97-2, *Software Revenue Recognition* (currently under Topic 985) (SOP 97-2)

AICPA Statement of Position 00-2, *Accounting by Producers or Distributors of Films* (currently under Topic 926) (SOP 00-2)

SEC Staff Accounting Bulletin No. 104, Topic 13, *Revenue Recognition* (SAB Topic 13A1)

EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables" (currently under Topic 605) (Issue 00-21)

EITF Issue No. 08-1, "Revenue Arrangements with Multiple Deliverables" (Issue 08-1)

EITF Abstracts, Topic No. D-96, "Accounting for Management Fees Based on a Formula" (currently under Topic 605) (*EITF Abstracts* Topic D-96)

Background

1. The ultimate objective of attributing arrangement consideration is to determine when the arrangement consideration should be recognized as revenue. As set forth in Concepts Statement 5, paragraph 83, "recognition involves consideration of two factors, (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration." Generally, revenue is considered both realizable and earned when each one of the following four conditions is met:

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

2. The issue of when and if a vendor will receive additional arrangement consideration that is not considered initially fixed upon consummation of the arrangement (for example, arrangement consideration contingent upon achievement of a specified event), relates to whether the arrangement consideration is fixed or determinable and whether collectibility is reasonably assured. This Issue does not address the topic of whether collectibility is reasonably assured.

3. Typically, contingent arrangement consideration becomes fixed or determinable only after the contingency is resolved. At the time the contingency is resolved or the event is achieved, a vendor must determine how to allocate the additional consideration. For arrangements comprising a single deliverable or unit of accounting under which a vendor satisfies its performance obligations to a customer over a period of time, the determination as to whether the additional arrangement consideration relates to past performance, future performance, or both can be very difficult. The purpose of this Issue is to examine the use of the milestone method as one possible method for determining how to allocate the contingent arrangement consideration once it becomes fixed or determinable. Under the milestone method, arrangement consideration earned from the achievement of a milestone may be deemed to be related to the portion of the performance period dedicated to achieving that specific milestone.

Prior EITF Discussion

4. Prior to the November 13, 2008 EITF meeting, this Issue was discussed by the Task Force as part of Issue 08-1. Beginning with the November meeting, this Issue was separated from Issue 08-1 for further discussion. The Task Force reached a tentative consensus on various issues at the November 13, 2008 meeting that it later finalized as a consensus-for-exposure at the March 19, 2009 EITF meeting as discussed below.

5. At the March 19, 2009 EITF meeting, the Task Force considered the following Issues:

Issue 1—Whether a license has standalone value in a research and development arrangement

Issue 2—How an entity should account for arrangements with contingent consideration in an arrangement consisting of a single deliverable or unit of accounting.

6. The Task Force agreed not to address Issues 1 and 2. Task Force members expressed a concern that both Issue 1 and Issue 2 encompass broader practice concerns than were originally intended to be addressed by this Issue. Rather, the Task Force reached a consensus-for-exposure to affirm the tentative conclusions reached at the November 13, 2008 EITF meeting. In addition, the Task Force reached a consensus-for-exposure that the scope of this Issue should be based on the following:

This Issue may be applied to a single deliverable or unit of accounting arising from arrangements under which a vendor satisfies its performance obligations to a customer over a period of time, and when a portion or all of the arrangement consideration is contingent upon uncertain future events or circumstances, except when the guidance in this Issue conflicts with other authoritative literature that provides guidance with respect to the revenue recognition convention for the single deliverable or unit of accounting.

7. The Task Force reached a consensus-for-exposure that when applying the guidance in this Issue a vendor may make an accounting policy election to recognize the arrangement consideration that is contingent upon the achievement of a substantive milestone in its entirety in the period in which the milestone is achieved.

8. The Task Force reached a consensus-for-exposure that, for purposes of this Issue, a milestone is defined as an event for which there is substantial uncertainty at the date the arrangement is entered into that the event will be achieved when that event can only be achieved based in whole or in part on the vendor's performance or a specific outcome resulting from the vendor's performance and, if achieved, would result in additional payments being due to the vendor.

9. The Task Force reached a consensus-for-exposure that the determination of whether a milestone is substantive is a matter of judgment. However, the following principle shall be used in making a determination as to whether a milestone is substantive:

The consideration earned from the achievement of a milestone is commensurate with either the vendor's performance to achieve the milestone or the enhancement of the value of the delivered item(s) as a result of a specific outcome resulting from the vendor's performance to achieve the milestone. The consideration earned from the achievement of a milestone relates solely to past performance and is reasonable relative to all of the deliverables and payment terms (including other potential milestone consideration) within the arrangement.

10. The Task Force reached a consensus-for-exposure that a milestone shall not be considered substantive if any portion of the associated milestone consideration relates to the remaining deliverables in the unit of accounting (that is, it does not relate solely to past performance). In order to recognize the milestone consideration in its entirety as revenue in the period in which the milestone is achieved, the milestone must be substantive in its entirety. It is not appropriate to bifurcate milestone consideration into substantive and nonsubstantive components. In addition, if a portion of the consideration earned from achieving a milestone may be refunded or adjusted based on future performance (for example, through a penalty or clawback), the contingent consideration is not considered to relate solely to past performance and thus the related milestone cannot be considered substantive. If the arrangement consideration from an individual milestone is not considered to relate solely to past performance, the vendor would not be precluded from using the milestone method for other milestones in the arrangement.

11. The Task Force reached a consensus-for-exposure that to be considered a milestone, an event must be achieved based in whole or in part on the vendor's performance or a specific

outcome resulting from the vendor's performance; therefore, a milestone does not include events for which the occurrence is contingent solely upon the passage of time or events that are the result of a counterparty's performance.

12. The Task Force reached a consensus-for-exposure that the guidance in this Issue is not the only acceptable revenue attribution model for arrangement consideration contingent upon achievement of a milestone (whether or not the milestone is substantive). A vendor's policy for recognizing arrangement consideration contingent upon achievement of a milestone shall be applied consistently to similar arrangements.

13. At the June 18, 2009 EITF meeting, the Task Force discussed the comment letters received on the draft abstract as well as transition guidance. The Task Force considered whether to modify the term *substantial uncertainty* as used in the definition of a milestone. Some Task Force members commented that the term *substantial uncertainty* suggested that there needed to be a considerable amount of uncertainty around whether the event will be achieved before the event could be considered a milestone. Those Task Force members observed that the language was only intended to convey a notion of more than the mere presence of uncertainty. After that discussion, the Task Force reached a tentative conclusion to change the terminology to indicate that the uncertainty must be substantive.

14. Task Force members affirmed their prior consensus-for-exposure that the application of the milestone method is a policy election. Task Force members noted that there are many factors an entity must consider in establishing its revenue recognition policies and that an entity should be afforded the opportunity to evaluate its facts and circumstances in determining whether to apply the milestone method or another proportional performance method.

15. Task Force members also discussed whether the milestone method is the only method available to an entity that chooses to recognize arrangement consideration that is contingent upon the achievement of a milestone in its entirety in the period in which the milestone is achieved. Some Task Force members indicated that they believe that the milestone method is the only method available that would provide an entity with the opportunity to recognize arrangement

consideration that is contingent upon the achievement of a milestone in its entirety in the period in which the milestone is achieved. Those Task Force members clarified their belief that the policy election option provided by this Issue is not an option that provides an entity with the opportunity to apply a method other than the method described in this Issue that results in recognition of consideration from a milestone in its entirety in the period in which the milestone is achieved. Those Task Force members also observed that the optionality of this Issue relates to recognizing all of the contingent consideration in the period of achievement, instead of an alternative accounting method that would defer a portion of the contingent consideration. Other Task Force members noted that the Task Force had not previously discussed whether other proportional performance methods exist that could result in the same accounting result. The Task Force requested that the staff perform additional analysis to determine the types of transactions that may be within the scope of this Issue and how this Issue may affect those transactions.

16. At the June 18, 2009 EITF meeting, Task Force members discussed whether the adoption of the milestone method by an entity that has previously made an alternate accounting policy election should be considered a change in accounting principle subject to the preferability requirement of Section 250-10-45 (*Accounting Changes and Error Corrections > Overall > Other Presentation Matters*). Some Task Force members observed that an entity may not have elected to apply the milestone method previously because the entity was unsure whether it was an allowable method under existing accounting literature. Other Task Force members commented that if the facts and circumstances supported the use of the milestone method, then an entity should be able to prove preferability. As a result, Task Force members did not support providing an exception to the preferability guidance in Section 250-10-45.

17. Task Force members also discussed whether the guidance in this Issue is clear that an entity that previously applied a milestone method that did not comply with the guidance of this Issue would be required to comply with the preferability requirements of Section 250-10-45, including the need for retrospective application of the milestone method as provided for by this Issue. Task Force members discussed whether it was necessary to clarify the transition guidance to clarify that retrospective application would be required in the above instance. Other Task Force

members questioned whether an entity that had previously applied a milestone method that was considered to be an appropriate application of U.S. GAAP should be required to apply the guidance in this Issue through retrospective application. The Task Force requested that the staff perform additional analysis to determine the types of transactions that may be within the scope of this Issue, to determine how this Issue may affect those transactions, and to further develop the transition alternatives.

Accounting Issues and Alternatives

18. The staff performed research and outreach to identify other types of arrangements that may be affected by this Issue that the Task Force may not have previously considered in this Issue. This Issue has previously been focused upon arrangements in the biotechnology and pharmaceutical industries. The staff believes that there are various types of service arrangements that include performance bonus provisions that could also be within the scope of this Issue if the decision is made to make the milestone method the only acceptable method for recognizing a milestone in its entirety. The staff believes that the following transaction is illustrative of such arrangements:

Vendor operates outsourced customer service call centers. Under the typical terms of its arrangements, vendor is responsible for the outsourced services for a period of three years. Vendor's agreements generally include (a) a one-time non-refundable upfront payment, (b) fixed constant monthly payments, and (c) a quarterly bonus payment if it achieves at least a 75 percent customer satisfaction rate for its customers each quarter. The quarterly bonus payment is for the same amount throughout the contract term and there is no clawback nor any refund rights associated with the payment. Vendor's historical experience with similar arrangements indicates that Vendor has maintained satisfaction levels in the 70 percent to 80 percent range. Vendor has historically recognized the quarterly bonus payment each quarter if it achieves the performance level.

19. The staff outreach indicated that there may be concern as to whether or not substantive uncertainty exists for the customer satisfaction milestone in the above arrangement. Some have interpreted the current milestone definition to mean that if a vendor expects to achieve a

milestone, then substantive uncertainty does not exist. If substantive uncertainty does not exist, then the milestone payment would not be eligible for recognition in its entirety in the period in which the milestone is achieved.

20. The staff believes that the criteria for a substantive milestone would largely have been considered in practice when assessing whether to recognize revenue for the milestones or performance bonuses in these arrangements except with respect to the substantive uncertainty provision. The staff believes that in assessing whether revenue recognition was appropriate for the bonus, the focus would have primarily been on whether the bonus was related to the entity's past performance and whether it was reasonable in relation to the other payments and terms in the arrangement (in addition to the general revenue recognition requirements). Therefore, it is possible that companies were recognizing the bonuses in their entirety without fully complying with the requirements of this Issue.

21. Other types of transactions that may be accounted for in a manner similar to that of the milestone method include incentive fee arrangements for investment management and real estate management businesses, which are accounted for in accordance with Section 605-20-S99 (*Revenue Recognition > Services > SEC Materials*). This guidance provides an accounting policy choice for entities to record (a) incentive fee income at the end of the contract year (Method 1) or (b) incentive fee income that would be due under the formula at any point in time as if the contract was terminated at that date (Method 2). The SEC staff considers Method 1 to be the preferable accounting policy since it is consistent with the analysis presented in SAB Topic 13A1, which states, "the staff does not believe that it is appropriate to recognize revenue based upon the probability of a factor being achieved." Each of these methods could result in the recognition of a milestone in its entirety upon achievement of the milestone (or earlier in the case of Method 2) without considering all of the guidance in the milestone method. Method 1 would be inconsistent only if the arrangement was for longer than one year. However, the staff notes that transactions that are accounted for in accordance with this SEC guidance would be outside the scope of this Issue, since the guidance in this Issue does not apply if it conflicts with other authoritative literature that provides revenue recognition guidance.

Staff Recommendation

22. The staff does not believe that it was the Task Force's intent to imply that substantive uncertainty could not exist if a vendor expected to achieve a milestone at the inception of the arrangement. As discussed at the June 18, 2009 EITF meeting, the staff believes that the Task Force's intent was to imply that the uncertainty was "real" and not a form of disguised upfront payment or unsubstantive provision. As already included in the consensus-for-exposure, an entity would need to apply judgment in determining whether substantive uncertainty exists at the inception of the arrangement. The staff proposes the following clarification to the definition of a milestone so that the principle is not misinterpreted:

An event for which there is substantive uncertainty at the date the arrangement is entered into that the event will be achieved when that event can only be achieved based in whole or in part on the vendor's performance or a specific outcome resulting from the vendor's performance and, if achieved, would result in additional payments being due to the vendor. A vendor's assessment that it expects to achieve a milestone does not necessarily mean that there is not substantive uncertainty associated with achieving the milestone. A milestone does not include events for which the occurrence is contingent solely upon the passage of time or the result of a counterparty's performance.

23. If this modification is made to the milestone definition, the staff believes that the principle in the substantive milestone method should be operable for various types of service arrangements that include "bonus-type" provisions. The staff also recommends that examples be included in any amendments to the Codification to assist in illustrating the intent of this guidance. The staff has included two examples in Appendix 08-9A for the Task Force's consideration.

Question 1 – Does the Task Force agree with the staff recommendation to revise the milestone definition and include examples in the Amendments to the Codification?

24. The staff recommends that the Task Force require that the guidance in this Issue be applied consistently for all similar arrangements with performance-based payments associated with a milestone payment if that payment is to be recognized in its entirety in the period the milestone

is achieved. Other methods that would result in the recognition of a milestone payment in its entirety in the period the milestone is achieved would be precluded. However, an entity would not be precluded from making an accounting policy election to apply a different policy that results in the deferral of some portion of the milestone payment even if the criteria in this Issue are met.

25. Because the focus of this Issue has previously been on arrangements in the biotechnology and pharmaceutical industries, entities outside of those industries may not have realized that the Issue might affect them. Accordingly, the staff believes that this Issue should be re-exposed if the Task Force decides to require the application of this Issue whenever a milestone payment is to be recognized in its entirety in the period achieved.

Question 2 - Does the Task Force agree with the staff recommendation that entities are required to meet the guidance in this Issue in order to record the milestone payment in its entirety in the period in which the milestone is achieved?

Transition

26. The staff believes that the Task Force needs to consider the following two scenarios when concluding on transition guidance:

Scenario #1 – An entity has previously applied a proportional performance model other than the milestone method that did not result in recognition of a milestone in its entirety in the period achieved but the milestone would have been considered a substantive milestone had the entity applied the guidance in this Issue. The entity is considering an accounting principle change to the milestone method.

Scenario #2 – An entity has previously applied the milestone method to arrangements that do not comply with the guidance in this Issue.

27. Consistent with the Task Force's discussions relating to Scenario #1 at the June 2009 meeting, the staff recommends that the adoption of the milestone method by an entity that has previously made an alternate accounting policy election should be considered a change in

accounting principle subject to the preferability requirement of Section 250-10-45 (*Accounting Changes and Error Corrections > Overall > Other Presentation Matters*), which requires reporting a change in accounting principle retrospectively for all prior periods, unless it is impracticable. The staff notes that Task Force members observed at the June 2009 meeting that they believed entities would generally be able to support preferability in such a situation.

Question 3 – For Scenario#1, does the Task Force agree with the staff’s recommendation that entities considering a change to the milestone method from another proportional performance method for arrangements that meet the criteria of this Issue would be subject to the requirements of Section 250-10-45?

28. Presented below are three transition alternatives for Task Force consideration relating to Scenario #2:

Alternative A: Entities cannot apply the milestone method to these arrangements after the effective date of this Issue and must elect an alternative accounting policy that shall be applied on a retrospective basis to all periods. That policy cannot result in the milestone being recognized in its entirety in the period achieved.

Alternative B: The guidance in this Issue must be applied to all outstanding arrangements as of the beginning of the fiscal year in which this Issue is initially applied. The entity must elect an alternative accounting policy that shall be applied on a retrospective basis to all periods in which those arrangements were outstanding. That policy cannot result in the milestone being recognized in its entirety in the period achieved. The cumulative effect of the change in accounting principle should be recognized as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for the earliest period presented.

Alternative C: Entities should apply this Issue on a prospective basis to milestones achieved after the effective date of this Issue. Prior periods would not be adjusted even if

milestones that did not meet the criteria in this Issue had been recognized in their entirety in the period achieved.

29. Alternative A is the transition guidance included in the draft amendments to the codification updates. Proponents of Alternative A observe that the FASB's conceptual framework describes comparability (including consistency) as one of the qualitative characteristics of accounting information. Those proponents refer to paragraph B7 of the Basis for Conclusions in Statement 154, which states that “the Board concluded that retrospective application improves financial reporting because it enhances the consistency of financial information between periods. That improved consistency enhances the usefulness of the financial statements, especially by facilitating analysis and understanding of comparative accounting data.” Opponents of Alternative A believe that retrospective application to all prior periods would be onerous and may require entities to go back many years in order to comply with this approach including for arrangements that are no longer outstanding.

30. Proponents of Alternative B believe that retrospective application to all prior periods would be too onerous and costly and outweighs the benefits of consistency and comparability. Proponents of Alternative B believe that applying the consensus only to outstanding arrangements provides some consistency and comparability in a more cost-efficient manner. Opponents of Alternative B are proponents of Alternative A or Alternative C and are concerned with the opportunity to record revenue twice for the same arrangement.

31. Proponents of Alternative C believe that the information needed to retrospectively apply a consensus under this Issue (including evaluation of substantive uncertainty that existed at the inception of an arrangement) may not be readily available or determinable in all circumstances. Additionally, those proponents believe that, even if such information were available, it may be difficult to objectively perform this assessment as of the inception of the arrangement.

32. Alternative C would eliminate the need to reassess prior arrangements with milestones achieved prior to the effective date of this Issue and be a practical approach to align practice in this area without undue burden on entities that had applied accounting policies in good faith.

Opponents of Alternative C believe that this approach results in the least consistency and comparability in financial reporting. Opponents of Alternative C also note that constituents could continue to be subject to challenge for periods prior to adoption if they had applied a milestone method but had not complied with all the guidance in this Issue. However, some believe that this would equally apply to Alternative A and Alternative B.

Transition Disclosures

33. Section 250-10-45 (*Accounting Changes and Error Corrections > Overall > Other Presentation Matters*) is applicable for any change in accounting principle, including a change in the method of applying an accounting principle. As such, companies will be required to follow the disclosure requirements in Section 250-10-45. The staff recommends that the Task Force not require any additional disclosures other than the requirements in Section 250-10-45.

Effective date

34. If the Task Force selects transition Alternative C, the staff recommends that this Issue be effective for fiscal years, and interim periods within those years, beginning on or after December 15, 2009.

The guidance in this Subtopic is effective immediately for entities adopting an initial accounting policy for substantive milestones. For all other entities, the guidance in this Subtopic will be effective as of the beginning of fiscal years, and interim periods within those years, beginning on or after December 15, 2009.

35. If the Task Force selects transition Alternative A or Alternative B, the staff recommends that this Issue be effective for fiscal years, and interim periods within those years, beginning on or after June 15, 2010, so that it provides adequate time for preparers to adopt this Issue on a retrospective method. Early adoption would be permitted.

The guidance in this Subtopic is effective for fiscal years, and interim periods within those years, beginning on or after June 15, 2010. Earlier adoption is permitted as of the

beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including interim financial statements, for any period of that fiscal year.

Appendix 08-9A

DRAFT AMENDMENTS TO THE FASB ACCOUNTING STANDARDS CODIFICATION™

The highlighted sections of this draft represent changes to the draft included with Issue Summary No. 1, Supplement No. 2, which was discussed at the June 18, 2009 EITF meeting. These changes are in response to several of the staff recommendations included in this Issue Summary Supplement. The transition paragraphs of this draft will be updated further based on Task Force decisions at the September 9-10, 2009 EITF meeting .

Introduction

A1. The following are amendments to the Accounting Standards Codification as a result of this proposed Update. Terms from the Master Glossary are in **bold** type. Added text is underlined and deleted text is ~~struck out~~. This appendix outlines how this proposed Issue would affect the *FASB Accounting Standards Codification™*.

A2. This proposed Issue would amend Topic 605, Revenue Recognition, and create a new Subtopic 605-26, Milestone Method.

Amendments to **the Codification Topic 605**

[Added text is underlined.]

[Changes from the prior version are underlined and highlighted.]

A3. Amend paragraph **605-10-05-1**, with a link to transition paragraph **605-26-55-1**, as follows:

605-10-05-1 The Revenue Recognition Topic provides guidance for transaction-specific revenue recognition and certain matters related to revenue-generating activities that are not addressed specifically in other Topics. Other Topics may contain transaction-specific revenue recognition guidance related to transactions in those Topics. This Topic includes the following Subtopics:

- a. Overall. The Overall Subtopic provides guidance on the following:
 1. Revenue and gains
 2. Installment and cost recovery methods of revenue recognition.

- b. Products. The Products Subtopic provides guidance on the following:
 - 1. Sales with a right of return
 - 2. Repurchases of product sold subject to an operating lease.
- c. Services. The Services Subtopic provides guidance on the following:
 - 1. Separately priced extended warranty and product maintenance contracts
 - 2. Commissions from certain experience-rated or retrospective insurance arrangements
 - 3. Certain loan guarantee fees
 - 4. In-transit freight service
 - 5. Advertising barter transactions.
- d. Multiple-Element Arrangements. The Multiple-Element Arrangements Subtopic provides guidance on arrangements under which a vendor will perform multiple revenue-generating activities (that is, provide multiple deliverables).
- e. Rights to Use.
- f. Construction-Type and Production-Type Contracts. The Construction-Type and Production-Type Contracts Subtopic provides guidance on contracts for which specifications are provided by the customer for the performance of contracts for the construction of facilities or the production of goods.
- g. Gains and Losses. The Gains and Losses Subtopic provides guidance on miscellaneous gains and losses not addressed in other Topics in the Codification.
- h. Principal-Agent Considerations. The Principal-Agent Considerations Subtopic provides guidance on reporting revenue gross or net of certain amounts paid to others.
- i. Customer Payments and Incentives. The Customer Payments and Incentives Subtopic provides guidance on accounting by vendors and customers for consideration given by a vendor to a customer.
- j. Milestone Method. The Milestone Method Subtopic provides guidance on the application of the milestone method of revenue recognition.

A4. **AddInsert** paragraph **605-10-25-2A**, with a link to transition paragraph 605-26-55-1, as follows:

605-10-25-2A See Subtopic 605-26 for guidance on the application of the milestone method of revenue recognition.

A5. ~~Insert~~ Add Subtopic **605-26**, with a link to transition paragraph 605-26-55-1, as follows:

605 Revenue Recognition

26 Milestone Method

605-26-05 Overview and Background

05-1 This Subtopic specifies the accounting for arrangement consideration accounted for under the milestone method of revenue recognition.

605-26-15 Scope and Scope Exceptions

> Entities

15-1 The guidance in this Subtopic applies to all entities.

> Transactions

15-2 The guidance in this Subtopic applies to transactions involving a single deliverable or unit of accounting arising from an arrangement under which a vendor satisfies its performance obligations to a customer over a period of time, and when a portion or all of the arrangement consideration is contingent upon uncertain future events or circumstances, except when the guidance in this Subtopic conflicts with the guidance provided elsewhere in Topic 605 for the single deliverable or unit of accounting.

15-3 The guidance in this Subtopic is not the only acceptable revenue attribution model for arrangement consideration contingent upon achievement of a milestone (whether or not the milestone is substantive). A vendor's policy for recognizing arrangement consideration contingent upon achievement of a milestone shall be applied consistently to similar arrangements.

15-4 This Subtopic does not address whether an arrangement comprises one or more deliverables or whether multiple deliverables within an arrangement meet the separation requirements of Subtopic 605-25.

605-26-25 Recognition

25-1 A vendor may make an accounting policy election to recognize arrangement consideration that is contingent upon the achievement of a substantive milestone in its entirety in the period in which the milestone is achieved.

25-2 The determination of whether a milestone is substantive is a matter of judgment; the assessment of which shall be performed only at the inception of the arrangement. However, the following principle shall be used in making a determination as to whether a milestone is substantive:

a. The consideration earned from the achievement of a milestone is commensurate with either the vendor's performance to achieve the milestone or the enhancement of the value of the delivered item(s) as a result of a specific outcome resulting from the vendor's performance to achieve the milestone. In addition, the consideration earned from the achievement of a milestone relates solely to past performance and is reasonable relative to all of the deliverables and payment terms (including other potential milestone consideration) within the arrangement.

25-3 A milestone shall not be considered substantive if any portion of the associated milestone consideration relates to the remaining deliverables in the unit of accounting (that is, it does not relate solely to past performance). In order to recognize the milestone consideration in its entirety as revenue in the period in which the milestone is achieved, the milestone must be substantive in its entirety. It is not appropriate to bifurcate milestone consideration into substantive and non-substantive components. In addition, if a portion of the consideration earned from achieving a milestone may be refunded or adjusted based on future performance (for example, through a penalty or clawback), the contingent consideration is not considered to relate solely to past performance and thus the related milestone cannot be considered substantive. If the arrangement consideration from an individual milestone is not considered to relate solely to past

performance, the vendor would not be precluded from using the milestone method for other milestones in the arrangement.

605-26-20 Glossary

Milestone

An event for which there is **substantial substantive** uncertainty at the date the arrangement is entered into that the event will be achieved when that event can only be achieved based in whole or in part on the vendor's performance or a specific outcome resulting from the vendor's performance and, if achieved, would result in additional payments being due to the vendor. **A vendor's assessment that it expects to achieve a milestone does not necessarily mean that there is not substantive uncertainty associated with achieving the milestone.** A milestone does not include events for which the occurrence is contingent solely upon the passage of time or the result of a counterparty's performance.

605-26-50 Disclosure

50-1 An entity shall disclose its accounting policy for the recognition of milestone payments as revenue in accordance with Subtopic 235-10. For those entities electing to apply the milestone method pursuant to the guidance of this Subtopic, the following information shall be disclosed in the notes to the financial statements for each arrangement that includes a material milestone payment: (a) a description of the overall arrangement, (b) a description of the individual milestones and related contingent consideration, (c) a determination as to whether the milestones are considered substantive, (d) a list of the factors considered by the entity in making its assessment of whether the milestones are substantive, and (e) the amount of milestone consideration recognized during the period.

605-26-55 Implementation Guidance and Illustrations

55-1 This Section presents generalized Examples intended to illustrate how to apply certain provisions of this Subtopic. The Examples do not address all possible situations or applications of this Subtopic, nor do they establish additional requirements.

55-2 This Example illustrates the guidance in paragraphs [605-26-15-1 through 15-4](#) and [paragraph 605-26-25-1 through 25-3](#).

55-3 This Example is based on the following assumptions:

- a. Biotech Company (Biotech) enters into an agreement with Pharmaceutical Company (Pharma) on January 1, 20X1.
- b. The agreement includes Biotech (i) licensing certain rights to Pharma to use Technology A, and (ii) providing research and development services to Pharma. Additional details on each of those aspects of the agreement follow.
 - (1) 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 any drug developed using Technology A during the licensing period. Biotech retains all ownership rights to Technology A. Biotech has not licensed Technology A to any other party and is the only vendor with the know-how and expertise related to Technology A.
 - (2) Research and development: Biotech agrees to provide research and development services on a best-efforts basis to Pharma. Biotech agrees to devote 8 to 10 full-time equivalents to the research and development activities, and Pharma expects to devote several full-time equivalents to the research and development activities as well. The objective of the research and development services is to develop a viable drug candidate using Technology A and to receive U.S. Food and Drug Administration approval of the drug candidate.
- c. Arrangement consideration is as follows:
 - Biotech receives \$5 million in licensing fees up-front upon signing the agreement
 - Biotech receives \$250,000 per year for each full-time equivalent that performs research and development activities
 - Milestones:
 1. Biotech receives \$2 million for the first drug candidate identified from the

results of the research and development conducted under the arrangement. Biotech expect to achieve this milestone within one month of the arrangement inception date.

2. Biotech receives \$2 million upon successful Phase II clinical trial completion. Biotech believes it will be several years before the clinical trial will be completed.
3. Biotech receives \$3 million upon Food and Drug Administration approval.

None of these payments, once received, is refundable, even if U.S. Food and Drug Administration approval is never received. In addition, Biotech must perform research and development services on a best-efforts basis.

55-4 Before evaluating whether the events are substantive milestones, Biotech must first determine whether the events qualify as milestones and then whether the events are within the scope of other guidance contained in U.S. GAAP or in the scope of this Subtopic. Also, the entity would have to conclude that it has a single unit of accounting or deliverable to be within the scope of this Subtopic. Biotech concludes that milestone one does not contain substantive uncertainty based in part on the short period of time between the contract inception date and when the milestone is expected to be achieved. Biotech also considered its existing research data on the drug compound and the negotiations with Pharma for this transaction both of which indicated that it was virtually certain that a drug candidate had been identified. Because of the numerous variables that may affect Biotech's ability to achieve the events and the high rate of failure inherent in the research and development of new products, Biotech believes substantive uncertainty exists at the inception date of the arrangement as to whether it will achieve milestones two and three. In addition, Biotech concluded that those payments relate solely to past performance because the arrangement does not include a provision for the contingent fees to be refunded and the amounts of the milestone payments were reasonable in relation to the other payments in the arrangement and the effort involved in achieving the milestone. .

55-5 Biotech will put forth a significant portion of the effort and will perform a significant portion of the work related to developing the compound to achieve the milestones. During the arrangement, Biotech staffing will be no fewer than eight full-time equivalents. While Pharma will also contribute staff (approximately three full-time equivalents) to the development effort,

Biotech's efforts and skills are critical to the achievement of the milestones so Biotech will continue to be heavily involved in the clinical trial and development efforts throughout the development lifecycle, including after completion of Phase II trials. Biotech is the only vendor with the know-how and expertise related to Technology A. Accordingly, Biotech has concluded that the consideration earned from the achievement of the milestone is commensurate with the value added to Technology A by Biotech's efforts.

Outsourced Customer Service Call Centers⁵⁵⁻⁶ This Example illustrates the guidance in paragraphs 605-26-15-1 through 15-4 and paragraph 605-26-25-1 through 25-3.

55-7 This Example is based on the following assumptions:

- a. Vendor operates outsourced customer service call centers.
- b. Vendor enters into an arrangement with a customer to outsource this service for a period of three years.
- c. The agreement includes (i) a one-time non-refundable upfront payment, (b) fixed constant monthly payments, and (ii) a quarterly bonus payment if it achieves at least a 75 percent customer satisfaction rate for its customer each quarter.
- d. The quarterly bonus payment is for the same amount throughout the contract term and there is no clawback nor any refund rights associated with the payment.
- e. Vendor's historical experience with similar arrangements indicates that Vendor has maintained satisfaction levels in the 70 percent to 80 percent range and Vendor expects to achieve the milestone payments each quarter at the inception of the arrangement.

55-8 Before Vendor evaluates whether the events resulting in the additional consideration are substantive milestones, it must first determine whether the events meet the definition of a milestone and then whether the events are within the scope of other guidance contained in U.S. GAAP or in the scope of this Subtopic. Also the entity would have to conclude that it has a single unit of account or deliverable to be within the scope of this Subtopic. Vendor determined that there was substantive uncertainty associated with achieving the 75 percent customer satisfaction level threshold. Based on industry norms, that level of satisfaction is considered to be

good. Even though Vendor expects to achieve that level of performance, the actual achievement of that threshold is contingent upon Vendor continuing to perform at a high level. Vendor also considered that the customer's previous service provider had generally not achieved that level of customer satisfaction, which was one of the reasons that the customer decided to change service providers.

55-9 Vendor determines that the milestone is substantive because the bonus payments are reasonable in comparison to the other payments in the arrangement, are consistent with industry norms for similar performance compensation, and relate to the performance during each quarter since there are no clawback nor any refund provisions. Accordingly, Vendor recognizes the bonus payment at the end of each period in which it achieves the milestone.

605-26-565 Transition and Open Effective Date Information

565-1 The application of the milestone method is an accounting policy election. Entities that have previously applied the milestone method to arrangements with non-substantive milestones or to arrangements for which the achievement of the milestone is certain at the inception of the arrangement cannot apply the milestone method after the effective date of this Subtopic and must elect an alternate accounting policy that shall be applied on a retrospective basis to all periods in accordance with Subsections 250-10-45. Adoption of the milestone method by an entity that has previously made an alternate accounting policy election shall be considered a change in accounting principle and be recognized in accordance with Subsections 250-10-45-11 through 45-13, including justifying a change in the method of applying an accounting principle on the basis of preferability.