

**FASB Emerging Issues Task Force**

**Issue No.** 08-9

**Title:** Milestone Method of Revenue Recognition

**Document:** Issue Summary No. 1, Supplement No. 4, with Working Group Report No. 1\*

**Date prepared:** February 16, 2010

**FASB Staff:** Cadambi (ext. 358)/Bonn (ext. 226)/Bement (ext. 233)

**EITF Liaison:** Bob Uhl

**Dates previously discussed:** March 12, 2008; June 12, 2008; September 10, 2008; November 13, 2008; March 19, 2009; June 18, 2009; September 9–10, 2009

**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; Issue Summary No. 1, Supplement No. 3, dated August 27, 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

**Background**

1. The objective of allocating arrangement consideration to separate elements of the arrangement is to determine how much revenue to recognize for each element. As set forth in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 83, revenue recognition “involves consideration of two factors, (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the

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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. When and if a vendor will receive additional arrangement consideration that is not considered fixed at the inception of the arrangement (for example, arrangement consideration contingent upon achievement of a specified event), depends on whether the arrangement consideration is fixed or determinable and whether collectibility is reasonably assured. This Issue does not address the issue 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 in which a vendor satisfies its obligations to a customer over a period of time, the determination of 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 related to the achievement of a milestone may be deemed to be related solely to past performance.

#### **Prior EITF Discussion**

4. Prior to the November 13, 2008 EITF meeting, this Issue was discussed by the Task Force as part of EITF Issue No. 08-1, "Revenue Recognition for a Single Unit of Accounting." 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 EITF 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 paragraph 7 of the draft abstract. 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. The Task Force discussed whether the application of the milestone method should be an accounting policy election or whether a vendor should be required to apply that method for all arrangements that include substantive milestones. 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. Task Force members questioned whether other methods are also available that may achieve the same accounting result.

16. 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 view 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, one that results in recognition of consideration from a milestone in its entirety in the period 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 FASB 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.

17. At the September 9–10, 2009 EITF meeting, the Task Force discussed the analysis provided by the FASB staff on the types of transactions that may be within the scope of this Issue. Some Task Force members expressed concerns that this Issue may now affect arrangements more broadly than the Task Force had originally intended. Some of those Task Force members questioned whether the scope of this Issue should be limited to arrangements that gave rise to the Issue originally, such as research and development arrangements. Other Task Force members observed that limiting the scope of this Issue to certain types of arrangements would not be preferable as it may be viewed as providing industry-specific guidance rather than broad guidance for contingent payments.

18. Other Task Force members questioned whether to modify the definition of a milestone such that substantive uncertainty would be a factor to consider as opposed to a requirement, based on facts and circumstances.

19. A Working Group was formed to assist the staff in advising the Task Force on this Issue. The Working Group met on November 10, 2009, and its members included some Task Force members and an observer from the SEC. The objective of the meeting was to assist the FASB staff in developing a recommendation as to what the scope of the project should be and to explore the alternatives that may be available to finalize the Issue. The Working Group's report from this meeting is attached in Appendix 08-9A.

20. At the March 18, 2010 EITF meeting, the staff will present various items to the Task Force for it to consider in proceeding with this Issue. The Task Force will be asked to finalize the scope of the Issue and consider transition alternatives.

### **Accounting Issues and Alternatives**

#### **Issue 1: Whether the scope of this Issue should be limited to transactions involving research or development.**

21. The Working Group members were unanimous in their support for limiting the scope of this Issue to transactions involving research or development. This is a slight modification from the Task Force's previous consideration of limiting the scope to research *and* development transactions. The Working Group believes that revising this issue by specifying the two kinds of transactions it is limited to will reduce confusion about whether the service transaction needs to involve both the research and the development phases of a project or rather involve at least one of those phases. The Working Group members believe that limiting the scope to transactions involving research or development would address the practice issue that was raised to the Task Force without inadvertently scoping-in other transactions. Additionally, they were influenced by concerns about the ability of the Task Force to address contingent consideration for all service transactions when there is no specific guidance for service transactions, other than revenue recognition principles, and given the possibility that the pending joint revenue recognition project may change the contingent consideration model in its entirety.<sup>1</sup> The Working Group

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<sup>1</sup> Tentative decision reached at the joint FASB-IASB meetings, May 21, 2009 and December 16, 2009. The exposure draft is expected to be issued by June 2010.

Report included in Appendix 08-9A provides the arguments considered by Working Group members in reaching their Task Force recommendation.

*Staff Analysis and Recommendation*

22. Consistent with the Working Group recommendation, the staff recommends that the Task Force limit the scope of this Issue to transactions involving research or development with a milestone payment if that payment is to be recognized in its entirety in the period the milestone is achieved. The staff believes that the terms "research" and "development" are well understood and are already defined in the accounting guidance. Research and development activities would be based on the existing definitions within the Financial Accounting Standards Codification<sup>TM</sup>, which are as follows:

- **Research:** Research is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (referred to as product) or a new process or technique (referred to as process) or in bringing about a significant improvement to an existing product or process.
- **Development:** Development is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives, construction of prototypes, and operation of pilot plants.

23. The staff agrees with the Working Group that expanding the scope of this Issue to apply to all transactions with contingent payments could result in unintended consequences by requiring entities to change the accounting for those transactions upon adoption of this Issue and again when the Boards issue their final standard on revenue recognition. That is because the Boards' decision on contingent consideration under the joint revenue recognition project may ultimately differ from any consensus the Task Force may reach in this Issue.

24. The staff also does not believe that this Issue would need to be re-exposed if it is limited to research or development transactions. The rationale for this view is that the Issue was previously exposed with a broader applicability (that is, not limited to transactions involving research or development). Additionally, the transition approach was restrictive because it required that an entity that had previously made an alternative accounting policy, consider the change to the milestone method as a change in accounting policy in accordance with the other presentation matters guidance in Subtopic 250-10 (Accounting Changes and Error Corrections). Additionally, the staff does not believe the following clarifications from the exposed document warrant re-exposure:

- a. Change the term *substantial* uncertainty to *substantive* uncertainty to clarify the intent that there need not be a considerable amount of uncertainty around whether the event will be achieved before the event could be considered a milestone. Additionally, add the phrase “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” to clarify that substantive uncertainty was to imply that the uncertainty was "real" and not a form of disguised upfront payment or an unsubstantive provision.
- b. Clarify the Task Force intent that the accounting 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 the milestone is achieved. Rather, the policy election was to apply an alternative accounting method that results in the deferral of some portion of the contingent consideration even if the criteria in this Issue are met.

**Question 1—Does the Task Force agree with the staff recommendation to limit the scope of this Issue to research or development transactions?**

**Question 2—If the Task Force answers yes to Question 1, does the Task Force agree with the staff recommendation that re-exposure of the consensus is not necessary?**

**Issue 2: If the Task Force decides in Issue 1 not to limit the scope of this Issue to transactions involving research or development, whether this Issue should apply to any milestone payment when the milestone is recognized in its entirety in the period the milestone is achieved.**

25. If the scope of this Issue is not limited to transactions involving research or development, then other alternatives will need to be identified. However, the staff has not been able to identify other viable scoping alternatives other than that the consensus must be applied to any milestone payment if the payment is to be recognized in its entirety upon achievement. Such an approach would be broader than many believe this Issue was originally intended to address and would not be limited to transactions in any particular industry or service activity. The Working Group also did not provide any additional scoping options for consideration.

26. If the scope of this Issue is not limited to transactions involving research or development, the staff recommends that the consensus be re-exposed. This is because the focus of this Issue has previously been on arrangements in the technology industries, particularly biotechnology and pharmaceutical industries, where research and development activities and milestones are fairly prevalent. If the scope is not limited, then the consensus would apply to any service arrangement that includes a contingent milestone provision where that milestone payment is to be recognized in its entirety in the period achieved. This conclusion would encompass many more types of service activities and industries than many entities may have envisioned based on the previous exposure of this Issue. Accordingly, the staff recommends re-exposure to seek feedback on whether there are types of transactions that may be affected by this consensus and for which constituents believe application of this consensus would not result in representative financial reporting of those transactions.

**Question 3—Does the Task Force agree that entities are required to meet the guidance in this Issue in order to recognize the milestone payment in its entirety in the period in which the milestone is achieved?**

**Question 4—If the answer to Question 3 is yes, does the Task Force agree with the staff recommendation that this consensus should be re-exposed?**

## **Transition**

27. 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.

28. Consistent with the Task Force's discussions relating to Scenario #1 at the June 18, 2009 EITF 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 the other presentation matters guidance in Subtopic 250-10, 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 believe that entities would generally be able to support preferability in such a situation.

**Question 5—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?**

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

*Alternative A: Entities cannot apply 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 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.*

30. 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 FASB Statement No. 154, *Accounting Changes and Error Corrections*, 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.” Proponents of Alternative A also note that retrospective application would be consistent with the adoption method that would need to be applied in Scenario 1 by any entity that voluntarily changes its accounting policy in order to apply this consensus. 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.

31. 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.

32. 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 at the inception of the arrangement.

33. Alternative C would eliminate the need to reassess prior arrangements with milestones achieved prior to the effective date of this Issue and would be a practical approach to align practice in this area without unduly burdening 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 Section 250-10-45 includes an impracticability exception provision for those situations in which it is impracticable to restate prior periods upon adopting a new accounting standard. As such, proponents of Alternative A believe that an entity must restate prior periods to the earliest practicable date. 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.

**Question 6—For Scenario#2, which alternative does the Task Force support?**

***Transition Disclosures***

34. The other presentation matters guidance in Subtopic 250-10 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***

35. 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 June 15, 2010. The transition language would be:

*The guidance in this Subtopic shall be applied on a prospective basis to milestones achieved in fiscal years, and interim periods within those years, beginning on or after June 15, 2010.*

36. 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 December 15, 2010, so that it provides adequate time for preparers to adopt this Issue using a retrospective method. The transition language would be:

*The guidance in this Subtopic is effective for fiscal years, and interim periods within those years, beginning on or after December 15, 2010.*

37. Additionally, the staff recommends that the Task Force allow entities to elect earlier application of this Issue, including at anytime during the entity's fiscal year, because this Issue addresses the lack of guidance in U.S. GAAP by incorporating the milestone method into the

Codification. Additionally, this would be consistent with the Task Force decision on Issue 08-1. The staff believes that users who state that they do not support mid-year adoptions of accounting standards because they do not receive restated information for the quarters preceding adoption until the Form 10-K is filed (in summarized quarterly data) or the following year in the Form 10-Q, can be overcome with the following disclosures:

*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 shall be applied through retrospective application from the beginning of the vendor's fiscal year. Vendors shall disclose the following information at a minimum for all previously reported interim periods in the year of adoption: revenue, income before income taxes, net income, earnings per share, and the effect of change for the appropriate captions presented.*

**Question 7—Does the Task Force support early adoption?**

## Appendix 08-9A

### EITF Issue 08-9 Working Group Report

**Issue No.** 08-9

**Title:** Milestone Method of Revenue Recognition

**Document:** Working Group Report No. 1\*

**Date prepared:** January 11, 2010

**FASB Staff:** Cadambi (ext. 358)/Bonn (ext. 226)/Bement (ext. 233)

**EITF Liaison:** Bob Uhl

**Dates previously discussed:** March 12, 2008; June 12, 2008; September 10, 2008; November 13, 2008; March 19, 2009; June 18, 2009; September 9–10, 2009

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#### Background

1. At the September 9–10, 2009 EITF meeting, the Task Force discussed the analysis provided by the FASB staff on the types of transactions that may be within the scope of this Issue. Some Task Force members expressed concerns that this Issue may now affect arrangements more broadly than the Task Force had originally intended. Some of those Task Force members

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questioned whether the scope of this Issue should be limited to arrangements that gave rise to the Issue originally, such as research and development arrangements. Other Task Force members observed that limiting the scope of this Issue to certain types of arrangements would not be preferable as it may be viewed as providing industry-specific guidance rather than broad guidance for contingent payments.

2. Other Task Force members questioned whether to modify the definition of a milestone such that substantive uncertainty would be a factor to consider as opposed to a requirement, based on facts and circumstances.

3. The Task Force requested that the FASB staff perform additional analysis on the scope of this Issue. In response to the Task Force request, the EITF Issue 08-9 Working Group (Working Group) was formed to explore this Issue. The FASB staff solicited feedback from Working Group members on the following three approaches for addressing this Issue:

- a. Modify the scope of this Issue such that it would only apply to research and development transactions
- b. Modify the scope of this Issue such that it would apply to all transactions that have contingent payments, except when the guidance in this Issue conflicts with guidance provided elsewhere
- c. Discontinue discussion of this Issue.

### **Working Group Discussion**

4. The Working Group met on November 10, 2009. Its members included some members of the Task Force and an observer from the SEC. The objective of the meeting was to assist the FASB staff in developing a recommendation as to what the scope of the project should be and to explore the alternatives that may be available to finalize the Issue. Feedback from Working Group members concerning the three alternative approaches in paragraph 3 for addressing this Issue was used to facilitate the meeting discussion.

5. The FASB staff updated the Working Group on the progress made to date on the Boards' joint revenue recognition project. The staff pointed out that the Boards' decisions on contingent consideration and contract segmentation in that project could differ from a consensus the Task Force may reach in this Issue:

- a. Contingent consideration: When allocating consideration at contract inception, in contrast to existing guidance on multiple-element arrangements, the proposed revenue recognition model would not limit the amount of allocated consideration to amounts that are fixed. The proposed model requires an entity to allocate a probability-weighted estimate of customer consideration (if that estimate is reliable). An entity would re-allocate that expected amount to all performance obligations as uncertainties are resolved and expectations change. The effects of those changes on satisfied performance obligations would be recognized as revenue in the period of change.
- b. Contract segmentation: In contrast to existing guidance, the proposed model would require a single attribution method for each unit of accounting (that is, contract segment). The proposed revenue model requires an entity to segment a contract (that is, determine units of accounting) based on goods or services that are sold separately or that are distinct in function or margin,

The Working Group acknowledged that the model in the revenue recognition project is still being developed and could differ from the consensus in this Issue when the Boards issue a final standard (expected in 2011). As a result, entities might have to change their revenue recognition policies shortly after this Issue is effective.

6. In light of the Boards' ongoing joint revenue recognition project, the Working Group considered whether to recommend discontinuing discussion of this Issue. The Working Group was not supportive of discontinuance of this Issue. Even though the direction of the proposed model in the joint revenue recognition project is different from what the consensus in this Issue might be, the Working Group was concerned that some constituents may believe that the milestone method is not acceptable under existing U.S. GAAP. Working Group members believe that the issuance of this Issue would be an improvement to current U.S. GAAP because it (a) addresses the lack of guidance in U.S. GAAP by incorporating the milestone method in the

FASB Accounting Standards Codification<sup>TM</sup> and (b) would help reduce diversity in practice by providing guidance on the recognition of milestone payments. Working Group members were also concerned with a lack of clear guidance for these transactions for an extended period of time considering that the new joint revenue recognition standard would likely not be effective until 2013, at the earliest. Without such guidance, Working Group members speculated that entities that use an accounting policy similar to the milestone method as described in this Issue will be subject to comments and questions until the joint revenue recognition project is completed. Accordingly, the Working Group recommends that the Task Force continue to deliberate the Issue.

7. Most Working Group members were supportive of modifying the scope of this Issue such that it would only apply to research and development transactions. A suggestion was also made to modify the scope of this Issue such that it would apply to transactions involving research *or* development. Some of the observations noted in support of that approach are as follows:

- a. The underlying economics of contingent payments in project-related activities (that is, transactions involving research or development) primarily relate to value creation from the effort. This is significantly different from process-related activities in which contingent payments are for efficiency of similar services provided by the vendor. For example, contingent payments for early completion of a standardized process—say, monthly processing of invoices.
- b. This approach does not create industry-specific U.S. GAAP because it is activity based, that is, it would apply to all transactions involving research *or* development in any industry.
- c. There is precedence in U.S. GAAP under Subtopic 985-605, Software—Revenue Recognition, which requires a different method to account for service transactions that involve a development arrangement. That is, if an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the entire arrangement is accounted for in conformity with the relevant guidance in Subtopic 605-35, Revenue Recognition—Construction-Type and Production-Type Contracts (contract accounting).

d. This approach addresses the specific matter that was the focus of this Issue and does not expand such that it may inadvertently scope-in other transactions for which no further guidance is necessary or desired.

8. Some Working Group members preferred that the scope of this Issue should be applicable to all transactions, except when the guidance in this Issue conflicts with guidance provided elsewhere. Those members believe that this Issue could equally apply to other service transactions, for example, federal government contracts that are not accounted for under Subtopic 605-35. Additionally, they believe that this Issue is operational across various transactions based on the clarifying language added to the term “substantial uncertainty.” Paragraphs 18–23 in Issue Summary No. 1, Supplement No. 3, clarified the Task Force’s intent that substantive uncertainty was to imply that the uncertainty was “real” and not a form of disguised upfront payment or an unsubstantive provision. If there is no real uncertainty, Working Group members believe that those payments should be treated no differently than upfront nonrefundable payments except that an entity would not be able to recognize revenue for those payments until the contingent threshold was met. Additionally, those members believe that having a narrow scope raises questions as to whether the entity can analogize to this Issue for transactions other than those involving research or development.

9. Some Working Group members questioned whether the current scope of this Issue should be modified such that it would apply to multiple-deliverable arrangements rather than only single deliverable or unit of accounting arrangements. Other Working Group members noted that this scope issue had been considered previously and the Task Force had decided not to broaden the scope to include multiple-deliverable arrangements. That decision was largely due to concerns of addressing broader issues involving contingent consideration in a multiple-deliverable arrangement and the overlap with the joint revenue recognition project. For example, whether contingent consideration should be allocated to the deliverables for which the performance is considered directly related (delivered elements) or reallocated to all deliverables in the arrangement.

10. At the conclusion of the meeting, the Working Group was asked to provide a recommendation to the Task Force. Working Group members were unanimous in their support

for a scope approach limited to transactions involving research or development. Members indicated that this choice was largely influenced by concerns over (a) inadvertently scoping transactions, other than what was originally intended, into the scope of this Issue and (b) observations that certain Working Group members had regarding the lack of guidance currently in U.S. GAAP on the milestone method. Additionally, they were influenced by concerns as to the ability of the Task Force to address contingent consideration for all service transactions when there is no specific guidance for service transactions, other than general revenue recognition principles.

11. Additionally, the Working Group also recommended that the Task Force should not modify the clarifying language added to the term “substantial uncertainty” under either the narrow-scope approach or the broad-scope approach. That is, paragraphs 18–23 in Issue Summary No. 1, Supplement No. 3. However, some Working Group members supported modifying the definition of a milestone such that substantive uncertainty would be a factor to consider as opposed to a requirement, based on facts and circumstances.

## Appendix 08-9B

### *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. 3, which was discussed at the September 9-10, 2009 EITF meeting. These changes are in response to several of the staff recommendations included in this Issue Summary Supplement.

#### Introduction

A1. The Accounting Standards Codification is amended as described in paragraphs A2-A4. In some cases, not only are the amended paragraphs shown but also the preceding and following paragraphs are shown to put the change in context. Terms from the Master Glossary are in **bold** type. Added text is underlined and deleted text is ~~struck out~~.

#### ~~Amendments to the Codification~~ **Topic 605**

~~[Added text is underlined.]~~

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

A2. 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.

A3. Add ~~Insert~~ 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.

A4. ~~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 arrangements involving research or development arrangement consideration that are 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 arrangements involving research or development transactions involving that include 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 The guidance in this Subtopic shall be met in order for a 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. Other methods that would result in the recognition of arrangement consideration in its entirety in the period the milestone is achieved would be precluded. A vendor 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 arrangement consideration even if the criteria in this Subtopic are met.

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 that shall be used in making a determination as to whether a milestone is substantive is that The 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 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 Centers****55-6** 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 guidance in this Subtopic is effective for fiscal years, and interim periods within those years, beginning on or after December 15, 2010. 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 Section 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.

**65-2** Early adoption 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 shall be applied through retrospective application from the beginning of the vendor's

fiscal year. Vendors shall disclose the following information at a minimum for all previously reported interim periods in the year of adoption: revenue, income before income taxes, net income, earnings per share, and the effect of change for the appropriate captions presented.