Issue No. 08-1

Title: Revenue Arrangements with Multiple Deliverables

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References:

FASB Statement No. 13, Accounting for Leases (Statement 13)
FASB Statement No. 45, Accounting for Franchise Fee Revenue (Statement 45)
FASB Statement No. 48, Revenue Recognition When Right of Return Exists (Statement 48)
FASB Statement No. 66, Accounting for Sales of Real Estate (Statement 66)
FASB Statement No. 68, Research and Development Arrangements (Statement 68)
FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases (Statement 91)
FASB Statement No. 154, Accounting Changes and Error Corrections (Statement 154)
FASB Statement No. 157, Fair Value Measurements (Statement 157)
FASB Statement No. 162, The Hierarchy of Generally Accepted Accounting Principles (Statement 162)

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

* The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.
AICPA Accounting Research Bulletin No. 45, *Long-Term Construction-Type Contracts* (ARB 45)
AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* (SOP 81-1)
AICPA Statement of Position 97-2, *Software Revenue Recognition* (SOP 97-2)
AICPA Statement of Position 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions* (SOP 98-9)
AICPA Statement of Position 00-2, *Accounting by Producers or Distributors of Films* (SOP 00-2)
EITF Issue No. 00-21 "Revenue Arrangements with Multiple Deliverables" (Issue 00-21)
EITF Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)" (Issue 01-9)
EITF Issue No. 08-9, "Milestone Method of Revenue Recognition" (Issue 08-9)
Background

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

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

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

3. At the March 12, 2008 EITF meeting, the Task Force discussed this Issue but was not asked to reach a conclusion. The issues presented at that meeting were:

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

\(^2\) References to the four conditions can be found in SAB Topic 13A1; SOP 97-2, paragraph 8; SOP 00-2, paragraph 7, and other revenue recognition accounting literature.
Issue 1— Whether, under certain facts and circumstances, it may be acceptable to use a multiple attribution model to account for a single unit of accounting consisting of a single deliverable

Issue 2— Whether, under certain facts and circumstances, it may be acceptable to use a multiple attribution model to account for a single unit of accounting consisting of multiple deliverables.

4. The Task Force requested that the FASB staff perform additional research on the transactions that give rise to the practice concern addressed by this Issue, including the formation of a Working Group, if necessary.

5. At the June 12, 2008 EITF meeting, the Task Force was informed that a Working Group had been formed to provide recommendations to the Task Force on this Issue. The Task Force discussed the initial findings of the Working Group but was not asked to reach a conclusion. The Task Force instructed the staff to continue to develop this Issue with the assistance of the Working Group for discussion at a future Task Force meeting.

6. At the September 10, 2008 EITF meeting, the Task Force discussed the results of the Working Group meetings held on July 15, 2008 and August 7, 2008, including the Working Group's recommendations and the specific practice issues that had been identified and discussed during those Working Group meetings.

7. The Working Group agreed that revenue recognition for a single unit of accounting depends on the nature of the deliverable(s) composing that unit of accounting, the corresponding revenue recognition criteria, and whether those criteria have been met. The Working Group also agreed that current guidance does not explicitly address many of the issues encountered by entities in practice. As a result, entities have adopted various accounting methods to attribute revenue in arrangements that have multiple payment streams that are accounted for as a single unit of accounting. Those practice issues can generally be arranged into the following two categories: those impacting the determination of the unit of accounting under Issue 00-21 and those related to revenue recognition attribution methods. The Working Group identified the following as areas
in which issues have been encountered in practice when entities consider the appropriate attribution model for revenue with multiple payment streams:

**Unit of Accounting:**

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

**Revenue Recognition Attribution Methods:**

4. Whether the milestone method is an acceptable attribution method of revenue recognition
5. How the proportional performance model should be applied to a single unit of accounting composed of multiple deliverables
6. Whether recognition of revenue on a straight-line basis is acceptable when the goods or services may not be delivered ratably over the period.

8. The Working Group discussed the six practice issue and recommended that the Task Force not provide guidance on Issues 1, 2, 5, and 6. However, the Working Group did recommend that the Task Force provide guidance on Issues 3 and 4.

9. The Task Force discussed Issues 1, 2, 5, and 6 and tentatively agreed with the Working Group's recommendation not to provide guidance on them. Some members of the Task Force noted that in order to address those issues the Task Force may need to create a definition of a deliverable, which they believed would take longer than one year. The definition of a deliverable is currently being addressed in the Board's revenue recognition project. Task Force members also noted that changing the objective-and-reliable-evidence-of-fair-value threshold in Issue 00-21 (Issue 3) might reduce or resolve some of those issues without requiring additional standards setting. Therefore, the Task Force tentatively agreed not to provide guidance on Issues 1, 2, 5, and 6.

10. The Task Force agreed to proceed with the Working Group's recommendation to provide guidance on Issues 3 and 4. In addition, the Task Force also agreed with the FASB staff recommendation that Issues 3 and 4 be split into two separate EITF Issues for discussion at a future EITF meeting because each of those issues has a separate scope. Further discussion of Issue 4 is now included in Issue 08-9. The remainder of this Issue Summary focuses on Issue 3, that is, whether the fair value threshold requirement of Issue 00-21 needs to be revised.
11. The Task Force discussed the Working Group's recommendation to modify the objective-and-reliable-evidence-of-fair-value threshold in Issue 00-21 to allow the use of an estimated selling price for the undelivered unit(s) of accounting in transactions in which vendor-specific objective evidence (VSOE) or acceptable third-party evidence of the selling price for an undelivered unit of accounting are unavailable. Task Force members noted that the absence of objective and reliable evidence of fair value of the undelivered item in an arrangement is one of the most common reasons entities are unable to separate deliverables in an arrangement under Issue 00-21 and that this often results in accounting that constituents believe does not reflect the underlying economics of a transaction.

12. The Task Force discussed a model that would amend Issue 00-21 to require an entity to estimate the selling price of the undelivered unit(s) of accounting and allocate the arrangement consideration using the residual method when the entity does not have VSOE or acceptable third-party evidence of the selling price for the undelivered unit(s) of accounting. When estimating the selling price for the undelivered unit of accounting(s), the Task Force discussed whether the following principle should be applied: the vendor's estimate of selling price shall be consistent with the objective of determining VSOE for the unit of accounting; that is, the price at which the entity would transact if the undelivered item(s) were sold regularly on a standalone basis. The entity must consider market conditions as well as entity-specific factors when estimating the selling price.

13. The Task Force also discussed whether Issue 00-21 should be amended to provide a principle for determining the estimated selling price of the undelivered unit of accounting and to include examples to demonstrate the application of that principle. The Task Force requested that the FASB staff update the existing examples in Issue 00-21 for discussion at a future Task Force meeting and include additional examples illustrating how an entity might develop the estimated selling price for the undelivered unit of accounting.

14. The Task Force also discussed whether the current fair value terminology in Issue 00-21 is intended to be representative of a fair value measurement consistent with the requirements of Statement 157. The Task Force agreed that the objective of that measurement is not a Statement 157 fair value measurement. The FASB staff notes that Statement 157, paragraph 3(a), excludes
from its scope accounting pronouncements that permit measurements that are based on, or otherwise use, VSOE of fair value. Such pronouncements include Issue 00-21 and SOP 97-2, as noted in footnote 3 of Statement 157. The Task Force tentatively concluded that if a consensus on this Issue were to revise Issue 00-21, references to "fair value" should be replaced with references to "selling price" to avoid confusion with Statement 157. The Task Force noted that amendments that refer to selling price are not intended to result in a change in practice.

15. The Task Force discussed the Working Group recommendation that the scope of this Issue be limited to the proposed amendments to the fair value threshold of Issue 00-21 and not expanded to include other revenue recognition guidance that contains similar concepts (for example, SOP 97-2). The Task Force tentatively agreed with the Working Group recommendation but requested that the FASB staff seek user input on whether the scope of the proposed amendments to the fair value threshold of Issue 00-21 should be expanded to other revenue recognition guidance. In addition, the Task Force requested that the staff also seek user input on what, if any, additional disclosures should be required as a result of the proposed change in the fair value threshold.

16. The FASB staff indicated that it would provide a draft abstract with the discussion materials for the November 13, 2008 EITF meeting for Task Force consideration.

**Current EITF Discussion**

17. As discussed above, the lack of objective and reliable evidence of fair value of the undelivered item in an arrangement is one of the most common reasons entities are unable to separate deliverables in an arrangement under Issue 00-21. This often results in accounting models that many believe do not reflect the underlying economics of a transaction. As a result, at the September 10, 2008 EITF meeting, the Task Force directed the FASB staff to prepare a draft abstract that would include the necessary modifications to Issue 00-21 to allow an entity to use its best estimate of selling price for the undelivered item(s) in an arrangement in those situations in which the entity does did not have VSOE or third-party evidence of selling price for the undelivered item(s) in the arrangement. The Task Force also directed the FASB staff to modify Issue 00-21 to replace references to "fair value" with "selling price" to avoid confusion with Statement 157.
18. Attached as Appendix 08-1A is a draft abstract for Issue 00-21 modified as directed by the Task Force. At the November 13, 2008 EITF meeting, the Task Force will be asked to discuss the questions presented below. Ultimately, the Task Force will be asked to consider the draft abstract, with or without refinements, and then to decide whether to proceed with this Issue. If the Task Force agrees to proceed with this Issue, the Task Force will be provided with an opportunity to address this Issue's scope, disclosure, transition, and effective date.

19. In addition to the one significant modification to Issue 00-21 discussed below, the FASB staff has made additional modifications to maintain consistency with that significant modification throughout Issue 00-21 and to eliminate inconsistencies between the application guidance of Issue 00-21 and the examples included in Exhibit 00-21B of the draft abstract. For instance, Example 6 was removed from Exhibit 00-21B. Example 6 included a requirement for Biotech to provide manufacturing to Pharma if Biotech was able to successfully develop Drug B. During its discussion of Example 6, the Working Group identified several inconsistencies with the evaluation discussed in the example and the application guidance of Issue 00-21. For example, the evaluation of Example 6 concluded that the contingent manufacturing was a deliverable in the arrangement. However, the application guidance of Issue 00-21 provides no guidance as to whether a contingent deliverable should be treated as a deliverable at the inception of an arrangement or at the time the contingent deliverable becomes deliverable. As discussed at the September 10, 2008 EITF meeting, the accounting for contingent deliverables was one of the practice issues that the Working Group considered and on which it recommended the Task force not provide guidance (Issue 2 in Working Group Report No. 2). Because the Task Force decided not to provide guidance on whether and how a contingent deliverable should impact revenue recognition, the FASB staff proposes removing the example.

20. To ensure that the proposed modifications to Issue 00-21 are consistent with the recommendation of the Working Group, a draft of the revisions to Issue 00-21 was provided to the Working Group for its consideration. Comments raised by the Working Group have been incorporated into the accounting issues for Task Force consideration.
Accounting Issues and Alternatives

Issue 1: Whether an entity should be allowed to use its best estimate of selling price for the undelivered item(s) in an arrangement when the deliverable(s) in that arrangement is within the scope of SOP 97-2.

21. At the September 10, 2008 EITF meeting, the Task Force requested that the FASB staff seek user input on whether the scope of the proposed amendments to the fair value threshold of Issue 00-21 should be expanded to other revenue recognition guidance (for example, SOP 97-2). In response, the FASB staff received input from seven users of financial statements (five buy side analysts and two sell side analysts) on whether the scope of this Issue should be expanded to include deliverables within the scope of SOP 97-2. None of those users were in favor of allowing for increased management discretion in determining selling price (referred to as fair value in SOP 97-2). Some users noted that there have been multiple examples observed in the past of abusive and misleading revenue recognition practices applied by some entities within the software industry that, in part, resulted in the form of the current revenue recognition requirements. The users also indicated that software companies may have greater incentive and ability to accelerate revenue compared to other industries, as a result of the lack of tangible deliverables. The users indicated that they understand the frustrations of some companies when they are required to defer revenue recognition because of a lack of VSOE, especially for new products that are part of a larger contract. They also indicated that sometimes the requirement to use VSOE may seem too onerous.

22. The users noted that software, by its very nature, will always have imperfections that require vendor patches, more so than other consumer goods, like a toaster or a television. There will always be intellectual property and security issues in the software industry that result in ongoing work. Because of the diversity in products and services and the combination in which the products and services are sold, the users believed that there is an inherent difficulty in estimating an entity's remaining effort to be performed or the value of its remaining obligations. For these reasons, the users unanimously agreed that the proposed change to Issue 00-21 to require the estimation of selling price for the undelivered units of accounting if third-party evidence does not exist should not be expanded to items within the scope of SOP 97-2.
23. The concept of allocating value to all elements, including those elements described as being provided only on a when-and-if-available basis, is one of the fundamental principles of the software revenue recognition rules. Determining what that value is, as well as providing the necessary evidence to justify that amount, has become one of the most controversial issues surrounding the application of the rules. SOP 97-2 introduced very narrow criteria for what constitutes the evidence that would be required if an arrangement were to be unbundled. If the prescribed level of evidence (VSOE of fair value) is not available to the vendor, all revenue from the arrangement must be deferred, unless one of the exceptions exists or the residual method can be applied. That is, the use of third-party evidence, as allowed by Issue 00-21, is not allowed to be used under the guidance of SOP 97-2.

24. The idea behind VSOE is that there are inherent differences between similar products that are offered by different vendors. Consequently, although products may be similar, their fair values may be different. AcSEC concluded that the use of industry averages or competitor prices did not properly account for these differences and that, therefore, only VSOE of fair value is acceptable.

25. In the software industry, the fair value of products may differ based on the type or size of a customer, the size of the purchase, or even the channel of distribution to that customer. Fair values may also be different for the same basic product sold in different territories around the world, due to environmental or marketing variables. In other words, there conceivably could be more than one fair value for a given product because of the variety of considerations that impact the pricing in an arrangement for that element. To the extent that a significant percentage of actual transaction pricing falls outside of a reasonable range, it may be difficult to determine VSOE.

26. The authors of SOP 97-2 spent a significant amount of time determining what criteria should be used to establish the fair value of an element, and AcSEC debated the issue extensively. In the end, the strict definition noted above was adopted, and all others were rejected. Furthermore, a "with and without" approach was rejected by the authors of SOP 97-2, as was an approach to establish VSOE of fair value based on a defined penalty or fixed damages that would result if the additional element was not delivered. Neither of these potential situations
was considered sufficient evidence to establish VSOE of the fair value of an element or sufficient evidence of fair value to be permitted under the guidance of SOP 97-2.

27. In contrast to the responses received from users, the FASB staff received a comment letter from a preparer (CL #2) that favored expanding the use of best estimates of selling price to the undelivered item(s) in an arrangement when the deliverables in that arrangement are within the scope of SOP 97-2. This comment letter referenced several recommendations in the August 1, 2008 final report of the SEC's Advisory Committee on Improvements to Financial Reporting (CIFR) and noted that limiting the proposed changes to Issue 00-21 would run contradictory to such recommendations. More specifically, the respondent referenced Recommendations 1.6, 1.8, and 1.9 of the CIFR report, which indicate that similar activities should be accounted for in a similar manner, that any exception to that model should be based on the business activities rather than the industry, and that the use of scope exceptions should be kept to a minimum. In addition, the respondent indicated that they "are concerned that the limited scope of Issue 08-1 will create further divergence within U.S. GAAP by requiring the use of such different models for determining fair value in multi-element transactions for what are economically similar transactions."

28. The above comments contain one overarching theme, that multi-element transactions in the software industry are sufficiently similar to multi-deliverable transactions in other industries to justify the same fundamental accounting principles in all circumstances. However, as noted above, AcSEC concluded that such differences existed within the software industry from transaction to transaction that competitor transactions were not sufficient evidence of fair value for products sold by a vendor. The FASB staff agrees with the CIFR recommendations noted above, however, the FASB staff believes that there are sufficient differences between multi-element transactions in the software industry and multi-deliverable transactions in other industries to justify the variance in principles. For example, both SOP 97-2 and Issue 00-21 require the use of VSOE, when available. However, Issue 00-21 allows for the use of third-party evidence to establish selling price because transactions for largely interchangeable products or services in non-software industries are considered sufficiently similar to each other. However, the use of third-party evidence is not allowed in SOP 97-2 because AcSEC concluded that there are no largely interchangeable software products offered by third-parties. In addition, given the
user comments and the pre-eminently focus of users as highlighted in the CIFR report, the staff
believes amending SOP 97-02 would not result in more useful information for investors.

29. Finally, the respondent commented that "Many products are becoming more dependent on
software to function and, absent a change to SOP 97-2, companies not considered traditional
software companies will be required to follow the revenue recognition guidance currently
contained in SOP 97-2." The FASB staff understands that it is becoming increasingly difficult to
determine whether a deliverable is within the scope of SOP 97-2 or Issue 00-21; however, the
FASB staff believes that this is a separate issue from whether to expand the use of best estimates
of selling price to the undelivered item(s) in an arrangement when the deliverables in that
arrangement are within the scope of SOP 97-2.

30. For the following reasons, the FASB staff recommends that the use of a vendor's best
estimate of selling price for the undelivered item(s) in an arrangement not be expanded to
include SOP 97-2:

- Users do not believe that the change is warranted or that such a change will result in
  better financial reporting. The FASB staff notes that investor perspectives should be
given pre-eminence by all parties involved in standards-setting, based on
Recommendation 2.1 of the CIFR report.

- AcSEC considered models other than VSOE when deliberating SOP 97-2 but rejected
  those less strict models. Any decision to move to a less stringent model should only be
  contemplated after a thorough consideration of the factors considered by AcSEC at the
time SOP 97-2 was deliberated.

- A move to allowing estimates in the software industry would be a major change in
  practice considering even third-party evidence is not currently allowed to be used
  under the guidance of SOP 97-2.

- Because of the inherent differences between similar products that are offered by
different vendors and the fact that the fair value of products may differ based on the
type or size of a customer, the size of the purchase, the channel of distribution to that
customer, or even the territory in which the products are sold, any estimate of selling price would be subject to a high degree of inaccuracy.

**Issue 2:** Whether an entity should be allowed to use a method other than the residual method of allocating arrangement consideration when the selling price of the undelivered unit(s) of accounting is based on the vendor's best estimate.

31. At the September 10, 2008 EITF meeting, the Task Force discussed a Working Group recommendation for changing the model for allocating arrangement consideration under Issue 00-21. Under that model, an entity would be required to estimate the selling price of the undelivered unit(s) of accounting and allocate the arrangement consideration using the residual method when the entity does not have objective and reliable evidence of selling price for the undelivered unit(s) of accounting. However, after reviewing the draft abstract, some Working Group members raised a question as to whether the use of the residual method was appropriate when its use would result in allocating arrangement consideration to the delivered unit of accounting(s) that is greater than the objective and reliable evidence of selling price for that delivered unit of accounting(s). In order to fully address this issue, the various methods of allocation considered by the Working Group and FASB staff are presented below.

*View A: An entity is required to allocate the arrangement consideration using the residual method.*

32. In reaching a recommendation on the allocation method under Issue 00-21, the Working Group tried to keep its recommendation consistent with the design of Issue 00-21 to ensure that entities do not overstate revenue. For example, Issue 00-21 requires the use of the residual method when objective and reliable evidence of selling price is not available for all of the delivered units of accounting but is available for the undelivered unit of accounting. In those situations, the use of the residual method allows arrangement consideration to be allocated to the delivered units of accounting but because of the subjective nature of the model (VSOE and third-party evidence of selling price is not available for the delivered units of accounting), the entire arrangement discount is not required to be allocated to the delivered unit(s) of accounting.
33. For similar reasons, the Working Group recommended the use of the residual method in those situations in which the selling price of the undelivered unit(s) of accounting is based on the vendor's best estimate. The Working Group believed that by requiring the use of the residual method in those situations in which the selling price of the undelivered units of accounting is based on the vendor's best estimate greatly reduces the risk that the arrangement discount would be allocated to the undelivered unit of accounting.

34. For example, if a vendor were to overestimate the selling price of the undelivered unit of accounting (estimating a selling price that is greater than the selling price if it were to be determined using VSOE), a greater portion of the arrangement discount would be allocated to the delivered unit of accounting than if the relative selling price model were used. Conversely, if a vendor were to underestimate the selling price of the undelivered unit of accounting (estimating a selling price that is lower than the selling price if it were to be determined using VSOE), a portion of the arrangement discount would be allocated to the undelivered unit of accounting. However, in that scenario, it is unlikely that the full amount of the discount would be allocated to the undelivered unit of accounting because as more discount is included in the estimated selling price of the undelivered unit of accounting, the more unlikely it becomes that the vendor will be able to support such a low estimate of selling price.

35. In addition, the FASB staff believes that the risk that arrangement consideration may be allocated to the delivered unit of accounting in an amount that is greater than the objective and reliable evidence of selling price for that delivered unit of accounting is mitigated for several reasons. First, the FASB staff believes that most transactions in which multiple deliverable are involved are priced at a discount to the price the customer would pay to purchase the individual deliverables. Therefore, if the arrangement consideration allocated to the delivered unit of accounting exceeds the delivered unit of accounting objective and reliable evidence of selling price, it may suggest that the estimated selling price of the undelivered unit of accounting does not reflect the amount that it would sell for on a stand alone basis and, in fact, may be too low.

36. Second, paragraph 14 of Issue 00-21 limits the amount allocable to a delivered item(s) to the amount that is not contingent upon the delivery of additional items or to meeting other specified performance conditions. As a result, the FASB staff believes that in many cases the amount of
arrangement consideration to be allocated to the delivered item(s) would be limited because of this requirement.

37. The FASB staff does acknowledge that despite the mitigating factors, the proposed modifications to Issue 00-21 could result in the arrangement consideration allocated to the delivered unit of accounting exceeding the selling price for that unit of accounting as determined using objective and reliable evidence. The FASB staff does not believe it is very likely under the current requirements of Issue 00-21 that arrangement consideration would be allocated to the delivered unit of accounting in an amount that exceeds the delivered unit of accounting selling price due to the stricter requirement for determining selling price (VSOE or third-party evidence).

38. View A’ is the same as View A except that the amount of arrangement consideration to be allocated to the delivered unit(s) of accounting would be limited to the objective and reliable evidence of selling price for the delivered unit(s) of accounting. This model would have the same benefits as View A except that it would address the concerns that some have regarding an allocation model that could result in the arrangement consideration allocated to the delivered unit of accounting exceeding the selling price for that unit of accounting as determined using objective and reliable evidence.

39. However, some observe that this approach would require an entity to determine whether or not objective and reliable evidence of selling price was available for the delivered unit(s) of accounting whereas View A would not. Because the benefit to be received by allowing an entity to estimate the selling price for the undelivered unit of accounting is limited to being able to separate deliverables that previously could not be separated, entities may not have needed to determine whether objective and reliable evidence of selling price exists for the delivered unit(s) of accounting. This method would require an entity to perform an analysis of whether objective and reliable evidence of selling price existed for the delivered unit(s) of accounting. Some
believe that this model introduces a level of complexity and cost not justified based on the limited chance that arrangement consideration may be allocated to the delivered unit(s) of accounting in an amount in excess of the objective and reliable selling price for that unit(s) of accounting.

**View B:** An entity is be required to allocate the arrangement consideration using the relative selling price method if the vendor has objective and reliable evidence of selling price for the delivered unit(s) of accounting. In the absence of objective and reliable evidence of selling price for the delivered unit(s) of accounting, an entity is required to allocate the arrangement consideration using the residual method.

40. The residual method would ensure that the arrangement discount is split between the delivered and undelivered unit(s) of accounting. However, the Working Group rejected it based on the arguments set forth under View A above.

41. Furthermore, as discussed under View A', this model would also require an entity to perform an analysis of whether objective and reliable evidence of selling price existed for the delivered unit(s) of accounting when such an analysis was not previously required. Some believe that this model introduces a level of complexity and cost not justified based on the remote chance that arrangement consideration may be allocated to the delivered unit(s) of accounting in an amount in excess of the objective and reliable selling price for that unit(s) of accounting.

**View C:** An entity is required to allocate the arrangement consideration using the relative selling price method. In the absence of objective and reliable evidence of selling price for any deliverable in the arrangement, the entity shall be required to estimate the selling price for the deliverable based on the vendor's best estimate.

42. The Working Group considered and rejected this method, predominately due to the fact that they believed that this model introduced a level of subjectivity that could be avoided by the use of View A. As the Working Group discussed this Issue, they had an objective of introducing a change to the allocation method of Issue 00-21 that would allow a greater number of deliverables in multi-element arrangements to be separated. It was the Working Group's view that this
objective could be achieved without the need to introduce a level of subjectivity introduced by allowing a vendor to estimate the selling price of the delivered unit(s) of accounting. The Working Group also believed that a requirement to estimate the selling price for all deliverables in an arrangement could significantly increase the cost and complexity of accounting for revenue arrangements under Issue 00-21.

43. At the November 13, 2008 EITF meeting, the Task Force will be asked whether it would like to change the allocation rule as proposed in the draft abstract.

**Disclosure**

44. At the September 10, 2008 EITF meeting, the Task Force discussed the Working Group recommendation to modify the disclosure requirements of Issue 00-21. In addition, the Task Force requested that the FASB staff seek user input on what, if any, additional disclosures should be required as a result of the proposed change in the fair value threshold. The following is a summary of the additional disclosure information that users thought might be beneficial:

- Potential variability of estimates
- The percentage of deferred revenue calculated based on the use of an estimated selling price.

45. The FASB staff considered the user request for information regarding the variability of estimates but was unsure whether a specific disclosure requirement would provide significant benefit to the users beyond the requirement to disclose both the qualitative and quantitative information that enables users of its financial statements to understand the inputs and methodologies used to develop estimates of selling price. In addition, the FASB staff is unsure whether any useful information is obtained by knowing the percentage of deferred revenue related to the use of an estimated selling price, particularly because revenue allocated to undelivered item(s) may or may not be recorded as deferred revenue on the balance sheet, depending on the timing of payments.

46. Based on the above and the Working Group input, the FASB staff has included the following disclosure requirement in the draft abstract:

20. A vendor shall also disclose both qualitative and quantitative information on an aggregated basis that enables users of its financial statements to understand the inputs and
methodologies used to develop estimates of selling price when objective and reliable evidence of selling price does not exist. Information related to individually significant arrangements should be disclosed separately.

Transition

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

**Alternative A: Retrospective Application.**

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

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

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

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

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

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

The consensus should be applied only to those revenue arrangements entered into or modified after the effective date.

48. The Working Group acknowledged that retrospective application is generally the preferred method of transition. However, some Working Group members expressed a concern that retrospective application would require a significant undertaking given the number of revenue arrangements an entity may have entered into and the age of some of those arrangements.

49. The Working Group's view on this topic is supported by Honeywell International Inc. (CL#1), that commented:

> However, in regards to the transition guidance associated with proposed EITF 08-1, Honeywell is concerned with the significant implementation costs associated with any type of retrospective application. Honeywell has approximately 160,000 customers worldwide, with whom numerous contracts are executed including a significant number of multiple element agreements, as such any retrospective analysis of individual customer contracts would prove to be extremely challenging and costly. Therefore, Honeywell fully supports a prospective application of EITF 08-1.

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

51. Working Group members agreed that requiring transition on a prospective basis would eliminate the need to reassess all revenue arrangements and the need to perform activities that may not be considered cost beneficial. However, they also acknowledged that this alternative could create inconsistency in reporting for similar revenue transactions completed within the same period simply based on the time frame in which the related arrangements were consummated.

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

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

54. The staff considers Alternative A to be consistent with paragraph 7 of Statement 154, which requires retrospective application to changes in accounting principles. In addition, retrospective application is the transition method that best achieves consistency of financial information between periods and facilitates comparability of accounting data. If it is impracticable to apply retrospective application, paragraph 9 of Statement 154 allows for the new accounting principle to be applied on a prospective basis. Given the significant number of transactions that may need to be reassessed under this proposed new guidance, Alternative A would be the most costly to implement from the preparers perspective but the comparability that would result provides the most benefit to the financial statement user. If the Task Force opted for Alternative A, it may need to reconsider the FASB staff's suggested effective date of fiscal years beginning after December 15, 2008.
55. Alternative B carries the benefit of consistency and comparability for the current year and future years without the burden of recasting prior years' amounts. Alternative B requires entities to evaluate only the arrangements in effect at the effective date of this Issue. The staff acknowledges that with the reduced costs and burdens of Alternative B comes less consistency and comparability for years prior to the year of adoption when compared to years after adoption.

56. Alternative C would eliminate the need to reassess a significant number of arrangements, an activity that may not be considered cost beneficial from the preparers' perspective. Opponents of Alternative C are concerned with the inconsistency of allowing revenue transactions entered into prior to the effective date of this Issue to be accounted for in a manner inconsistent with the consensus reached. Alternative C would allow an entity to have multiple policies for revenue recognition for some period of time after this Issue is finalized, as arrangements entered into before its effective date would follow the entity's historic policy and arrangements entered into after the effective date would follow the guidance in this Issue.

**Effective date**

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

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

59. Attached as Appendix 08-1A is a draft abstract of Issue 00-21. At the November 10, 2008 EITF meeting, the Task Force will be asked to discuss the questions presented below. Ultimately, the Task Force will be asked to consider the draft abstract, with or without refinements, and then to decide whether to proceed with this Issue.

60. The draft abstract may require additional edits based on the Task Force's conclusions on Issues 1 and 2.

**Issue 3: Does the Task Force agree with the FASB staff's modifications to the Application Guidance of Issue 00-21?**

**Issue 4: Does the Task Force agree with the FASB staff's modifications to the examples included in Exhibit 00-21B of the draft abstract?**

**Board Project**

61. The FASB and IASB are currently working on a revenue recognition project that is expected to nullify this Issue when effective.

**International Convergence**

Title: Revenue Arrangements with Multiple Deliverables


References: FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements
FASB Statement No. 13, Accounting for Leases
FASB Statement No. 45, Accounting for Franchise Fee Revenue
FASB Statement No. 48, Revenue Recognition When Right of Return Exists
FASB Statement No. 66, Accounting for Sales of Real Estate
FASB Statement No. 68, Research and Development Arrangements
FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases
FASB Statement No. 162, The Hierarchy of Generally Accepted Accounting Principles
FASB Technical Bulletin No. 90-1, Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts
FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises
APB Opinion No. 20, Accounting Changes
AICPA Accounting Research Bulletin No. 45, Long-Term Construction-Type Contracts
AICPA Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts
AICPA Statement of Position 97-2, Software Revenue Recognition
AICPA Statement of Position 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions
AICPA Statement of Position 00-2, Accounting by Producers or Distributors of Films
SEC Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements
SEC Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements—Frequently Asked Questions and Answers
SEC Staff Accounting Bulletin 104, Topic 13, Revenue Recognition (SAB Topic 13)
ISSUE

1. Many companies offer multiple solutions to meet their customers' needs, entities often provide. Those solutions may involve the delivery or performance of multiple products, services, or rights to use assets, or any combination thereof (hereinafter referred to as “deliverables”). These deliverables transfer to the customer and performance may occur at different points in time or over different periods of time, and the customer’s. In some cases, the arrangements include initial installation, initiation, or activation services and involve consideration in the form of a fixed fee or a fixed fee coupled with a continuing payment stream. The continuing payment stream generally corresponds to the continuing performance, and the amount of the payments for these deliverables may be fixed, variable based on future performance, or a combination of fixed and variable payment amounts.

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

3. This Issue does not address when the criteria for revenue recognition are met or provide revenue recognition guidance on the appropriate revenue recognition convention for a given unit of accounting. For example, this Issue does not address when revenue attributable to a unit of accounting should be recognized based on proportional performance. The timing of revenue recognition for a given unit of accounting will depend on the nature of the deliverable(s) composing that unit of accounting (and the corresponding revenue recognition convention) and on whether the applicable general conditions for revenue recognition have been met.
4. This Issue applies to all deliverables (that is, products, services, or rights to use assets) within contractually binding arrangements (whether written, oral, or implied, and hereinafter referred to as "arrangements") in all industries under which a vendor will perform multiple revenue-generating activities, except as follows:

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

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

ii. If higher-level literature provides guidance requiring separation of deliverables within the scope of higher-level literature from deliverables not within the scope of higher-level literature, but does not specify how to allocate arrangement consideration to each separate unit of accounting, such allocation should be performed on the relative selling price of the deliverable(s) in fair value basis using the entity's best estimate of the selling price of the deliverable(s) within the scope of higher-level literature.

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1Whether a deliverable(s) is within the scope of higher-level authoritative literature is determined by the scope provisions of that literature, without regard to the order of delivery of that item in the arrangement. The term higher-level literature refers to categories (a) and (b) of the generally accepted accounting principles (GAAP) hierarchy as defined in Statement 162AICPA Statement on Auditing Standards No. 69, The Meaning of "Present Eitely in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report. EITF consensuses represent category (c) of the hierarchy.
and the deliverable(s) not within the scope of higher-level literature. Subsequent accounting (identification of separate units of accounting and allocation of arrangement consideration value thereto) for the value allocated to the deliverable(s) not subject to higher-level literature would be governed by the provisions of this Issue.

iii. If higher-level literature provides no guidance regarding the separation of the deliverables within the scope of higher-level literature from those deliverables that are not or the allocation of arrangement consideration to deliverables within the scope of the higher-level literature and to those that are not, then the guidance in this Issue should be followed for purposes of such separation and allocation. In such circumstances, it is possible that a deliverable subject to the guidance of higher-level literature does not meet the criteria in paragraph 9 of this Issue to be considered a separate unit of accounting. In that event, the arrangement consideration allocable to

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2Solely For purposes of the allocation between deliverables within the scope of higher-level literature and deliverables not within the scope of higher-level literature, an entity's best estimate of fair value selling price is not limited to vendor-specific objective evidence of fair value or third-party evidence of fair value, as those concepts are to be determined using the guidance as discussed in paragraphs 16 and 17 of this Issue. The use of a vendor’s best estimate of selling price shall not be limited to the undelivered item(s).

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

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

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

5. The issues are:

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

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

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

Issue 4—How to account for direct costs incurred related to an arrangement that (a) are not associated with a specific deliverable or (b) are associated with a specific deliverable but that deliverable is required to be combined with another deliverable (or other deliverables)
Issue 5(a) —The impact, if any, of a customer's ability to cancel a contract and incur a cancellation penalty on the measurement of arrangement consideration

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

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

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

EITF DISCUSSION

6. In an arrangement with multiple deliverables, the Task Force reached a consensus that the principles in paragraph 7 and application guidance in paragraphs 8–17 should be used to determine (a) how the arrangement consideration should be measured, (b) whether the arrangement should be divided into separate units of accounting, and (c) how the arrangement consideration should be allocated among the separate units of accounting. Examples illustrating the application of the principles and application guidance in this Issue are included in Exhibit 00-21B.

Principles

7. The principles applicable to this Issue are:

   • Revenue arrangements with multiple deliverables should be divided into separate units of accounting if the deliverables in the arrangement meet the criteria in paragraph 9.

   • Arrangement consideration should be allocated among the separate units of accounting based on their relative selling prices fair values (or as otherwise provided
in paragraphs 12 and 13). The amount allocated to the delivered item(s) of accounting is limited as discussed in paragraph 14.

- Applicable revenue recognition criteria should be considered separately for separate units of accounting.

**Application Guidance**

**Units of Accounting (Issue 1)**

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

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

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

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

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

Refer to the flowchart in Exhibit 00-21A for an illustration of the above criteria. The criteria for dividing an arrangement into separate units of accounting should be applied consistently to arrangements with similar characteristics and in similar circumstances.
10. The arrangement consideration allocable to a delivered item(s) that does not qualify as a separate unit of accounting within the arrangement should be combined with the amount allocable to the other applicable undelivered item(s) within the arrangement. The allocation of arrangement consideration and the appropriate recognition of revenue should then be determined for those combined deliverables as a single unit of accounting.

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

11. The amount of total arrangement consideration must be fixed or determinable other than with respect to the impact of (a) any refund rights or other concessions (hereinafter collectively referred to as "refund rights") to which the customer may be entitled or (b) performance bonuses to which the vendor may be entitled.

12. If there is objective and reliable evidence of fair value selling price (as discussed in paragraph 16) for all units of accounting in an arrangement, the arrangement consideration should be allocated to the separate units of accounting based on their relative fair value selling price (the relative fair value selling price method), except as specified in paragraph 13. However, in the absence of objective and reliable evidence of selling price for all units of accounting in the arrangement, there may be cases in which there is objective and reliable evidence of the fair value(s) of the undelivered item(s) in an arrangement but no such evidence for the delivered item(s). In those cases, the residual method should be used to allocate the arrangement consideration. Under the residual method, the amount of consideration allocated to the delivered unit(s) of accounting item(s) equals the total arrangement consideration less the aggregate fair value selling price of the undelivered unit(s) of accounting item(s) (as discussed in paragraph 17). The "reverse" residual method (that is, using a residual method to determine the fair value selling price of an undelivered unit(s) of accounting item) is not an acceptable method of allocating arrangement consideration to the separate units of accounting, except as described in paragraph 13.

13. To the extent that any separate unit of accounting in the arrangement (including a delivered item) is required under GAAP to be recorded at fair value (and marked to market each reporting period thereafter), the amount allocated to that unit of accounting should be its fair value. Under
those circumstances, the remainder of arrangement consideration should be allocated to the other units of accounting in accordance with the requirements in paragraph 12.

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

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

16. Objective and reliable evidence of selling price shall be determined using vendor-specific objective evidence (VSOE), and in the absence of VSOE, third-party evidence (TPE) of selling price. In the absence of both VSOE and TPE, objective and reliable evidence of selling price shall be determined not to exist. Contractually stated prices for individual products and/or services in an arrangement with multiple deliverables should not be presumed to be representative of fair value selling price. The best evidence of fair value is the price of a deliverable when it is regularly sold on a standalone basis. Fair value evidence often consists of vendor-specific objective or VSOE of fair value. As discussed in paragraph 10 of SOP 97-2, VSOE of fair value is limited to (a) the price charged for a deliverable when it is sold separately or (b), for a deliverable not yet being sold separately, the price established by management having the relevant authority (it must be probable that the price, once established, will not
change before the separate introduction of the deliverable into the marketplace)\(^3\). The use of VSOE of fair value is preferable in all circumstances in which it is available. Third party evidence of fair value, TPE, is the (for example, prices of the vendor's or any competitor's largely interchangeable products or services in standalone sales to similarly situated customers) is acceptable if VSOE of fair value is not available.

17. When applying the residual method of allocation, the selling price for the undelivered unit(s) of accounting shall be determined using objective and reliable evidence of selling price (VSOE if available, otherwise TPE). In the absence of objective and reliable evidence of selling price for the undelivered unit(s) of accounting, the vendor must use its best estimate of the selling price for the undelivered unit(s) of accounting. The vendor's best estimate of selling price shall be consistent with the objective of determining VSOE for the unit of accounting; that is, the price at which the entity would transact if the undelivered unit of accounting were sold regularly on a standalone basis. The vendor must consider market conditions as well as entity-specific factors when estimating the selling price.

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

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

Disclosure

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

20. A vendor shall also disclose both qualitative and quantitative information on an aggregated basis that enables users of its financial statements to understand the inputs and methodologies used to develop estimates of selling price when objective and reliable evidence of selling price exists for a unit of accounting.

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\(^3\) The guidance of paragraph 10 of SOP 97-2 shall be applied by analogy in further assessing whether VSOE of selling price exists for a unit of accounting.
does not exist. Information related to individually significant arrangements should be disclosed separately.

Transition

2149. Pending discussion of the Task Force. The guidance in this Issue is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. Alternatively, entities may elect to report the change in accounting as a cumulative effect adjustment in accordance with Opinion 20 and Statement 3. If so elected, disclosure should be made in periods subsequent to the date of initial application of this consensus of the amount of recognized revenue that was previously included in the cumulative effect adjustment. Early application of this consensus is permitted.

20. The Task Force reached its consensus on this Issue subject to certain clarifications to be made with respect to the scope provisions in paragraph 4(a). At the May 15, 2003 meeting, the Task Force finalized the scope of those provisions. For an enterprise that adopted the consensuses in this Issue prior to the May 15, 2003 meeting, the final guidance in paragraph 4(a) should be treated as a new consensus subject to the transition and effective-date provisions in Topic No. D-1, "Implications and Implementation of an EITF Consensus."

21. The SEC Observer commented that the SEC staff would review and revise SAB 101 and the SAB 101 FAQ, as necessary, to be consistent with the consensus in this Issue. In the interim, however, to the extent that the guidance in SAB 101 (and the SAB 101 FAQ) and Issue 00-21 conflict, the guidance in this Issue should be followed.

STATUS

22. No further EITF discussion is planned.
Exhibit 00-21A

This Exhibit will be deleted and replaced with the new Exhibit following. DETERMINING SEPARATE UNITS OF ACCOUNTING

- Arrangement has multiple deliverables and is within scope of Issue 00-21.

  - Does the delivered item(s) have standalone value to the customer?
    - Yes
    - No

    - Is there objective and reliable evidence of the fair value of the undelivered item?
      - Yes
      - No

    - If the arrangement includes a general return relative to the delivered item and delivery of the undelivered item is probable and substantially controlled by the vendor?
      - Yes
      - No

    - Yes or N/A

  - Account for delivered item(s) as a separate unit of accounting.

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5This diagram represents an overview of the provisions of this Issue with respect to determining the separate units of accounting in an arrangement and should, therefore, be reviewed in conjunction with the entire consensus.
Exhibit 00-21A

DETERMINING SEPARATE UNITS OF ACCOUNTING

Arrangement has multiple deliverables and is within scope of Issue 00-21.

Does the delivered item(s) have standalone value to the customer on a standalone basis?

Yes

If the arrangement includes a right of return relative to the delivered item(s), is delivery of the undelivered item(s) probable and substantially controlled by the vendor?

Yes or N/A

Do not account for delivered item(s) as a separate unit of accounting.

No

Account for delivered item(s) as a separate unit of accounting.

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This diagram represents an overview of the provisions of this Issue with respect to determining the separate units of accounting in an arrangement and should, therefore, be reviewed in conjunction with the entire consensus.
EXAMPLES OF THE APPLICATION OF THE EITF CONSENSUS ON ISSUE 00-21

Note: The examples below provide guidance only with respect to determining whether a multiple-deliverable revenue arrangement contains more than one unit of accounting and, if so, how to measure and allocate the arrangement consideration to the separate units of accounting. As discussed in paragraph 3, above, this Issue (including the examples below) does not address (for any unit of accounting) when the criteria for revenue recognition are met or provide guidance on the appropriate revenue recognition convention.

Example 1—Cellular Telephone Contract

CellularCo runs a promotion in which new customers who sign a two-year contract receive a "free" phone. The contract requires the customer to pay a cancellation fee of $300 if the customer cancels the contract. There is a one-time "activation fee" of $50 and a monthly fee of $40 for the ongoing service. The same monthly fee is charged by CellularCo regardless of whether a "free" phone is provided. The phone costs CellularCo $100. Further, assume that CellularCo frequently sells the phone separately for $120. CellularCo is not required to refund any portion of the fees paid for any reason. CellularCo is a sufficiently capitalized, experienced, and profitable business and has no reason to believe that the two-year service requirement will not be met. CellularCo is considering whether (a) the phone and (b) the phone service (that is, the airtime) are separable deliverables in the arrangement. The activation fee is simply considered additional arrangement consideration to be allocated. The phone and activation are delivered first, followed by the phone service (which is provided over the two-year period of the arrangement).

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

The total arrangement consideration is $1,010. The fair value selling price of the phone service is $960 ($40 × 24 months), the price charged by CellularCo when sold separately. The fair value selling price of the phone is $120, the price of the phone when sold separately by CellularCo. Without considering whether any portion of the amount allocable to the phone is contingent upon CellularCo's providing the phone service, CellularCo would allocate the arrangement consideration on a relative fair value selling price basis because CellularCo has objective and reliable evidence of selling price for all deliverables in the arrangement. That allocation would be as follows: $112.22 [($1,010 × ($120 ÷ [$120 + $960]))] to the phone and $897.78 [($1,010 × ($960 ÷ [$120 + $960]))] to the phone service. However, because a "free" phone is provided in the arrangement and the customer has no obligation to CellularCo if phone service is not provided, the amount of arrangement consideration allocated to the phone is limited to the noncontingent fee of $50, $62.22 (assuming the customer has paid the nonrefundable activation fee) is contingent upon CellularCo's providing the phone service. Therefore, the amount allocable to the phone service is increased to $960 ($897.78 + ($112.22 – $50)) is limited to $50 ($112.22 – $62.22), and the amount allocable to the phone service is increased to $960 and only $50 is allocated to the phone.

Example 2—Can Manufacturing Equipment

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

Company C is evaluating whether Equipment X, Y, and Z can be accounted for separately revenue recognition under the following scenario:

Company C delivered Equipment X and Z on March 27, but did not deliver Equipment Y until April 6. Without Equipment Y, the customer does not have use of Equipment X and Z.
However, there is an active market for new Equipment X, Y, and Z on a separate basis, as the equipment is often bought separately from other vendors as replacements become necessary. The contract provides that if all pieces of equipment are not delivered, the customer may return Equipment X and Z and have no liability to Company C. The contract requires delivery of all equipment prior to June 1, and Company C has sufficient production capacity and inventory to deliver all of the equipment prior to that contractual deadline.

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

**Example 3—Standard Equipment and Installation**

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

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

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

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

**Evaluation:** The first condition for separation is met for the equipment. The equipment has standalone value as it is sometimes sold separately by Company E. The second condition for separation is also met—Objective and reliable evidence of the fair value for the installation exists. There is sufficient evidence of the fair value of the installation on a separate component basis (as evidenced by the amount charged by independent third parties). Finally, there are no general refund rights. Therefore, the equipment and the installation service are separable units of accounting in the arrangement.

Regardless of whether the installation is performed, the total arrangement consideration is $200,000. Because Company E has objective and reliable evidence of selling price for all units of accounting in the arrangement, consideration in the arrangement should be allocated on a relative fair value basis. In this case, the arrangement consideration of $200,000 should be allocated to the separate units of accounting using the relative fair value selling price method. Thus, allocation of the arrangement consideration would be $192,308 [$200,000 × ($200,000 ÷ [$200,000 + $8,000])] to the equipment and $7,692
[$200,000 \times ($8,000 \div [200,000 + 8,000])$] to the installation service. Additionally, none of the amount allocable to the equipment is contingent upon performing the installation.

**Example 4—Automobiles Sold with Lifetime Maintenance Services**

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

**Evaluation:** The first condition for separation is met for the automobile because, even though the automobile is not sold separately by any vendor, it is considered to have standalone value because the customer could resell the automobile on a standalone basis. The second condition for separation also is met as there is sufficient evidence of the fair value of the maintenance services on a separate component basis (as evidenced by the amount charged on a standalone basis by Company A for maintenance services and data available from which to estimate the volume and types of maintenance services provided during a typical customer's ownership of the vehicle). Finally, there are no refund rights (general or otherwise) in the arrangement. Therefore, the automobile and the maintenance services should be considered separate units of accounting in the arrangement.

Because no entity sells the automobile separately, objective and reliable evidence of selling price does not exist. However, there is objective and reliable evidence of selling price of the maintenance services (as evidenced by the amount charged on a standalone basis by Company A
for maintenance services and data available from which to estimate the volume and types of maintenance services provided during a typical customer's ownership of the vehicle. As a result, the consideration in the arrangement should be allocated to the units of accounting using the residual method. The selling price of the maintenance services should be determined as described in the above paragraph. The remaining arrangement consideration should be allocated to the automobile. Additionally, none of the amount allocable to the automobile is contingent upon providing the maintenance services.

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

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

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

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

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

Assume that a customer purchases Appliance W with both installation and maintenance services for $1,000. Based on its experience, Company S believes that it is probable that installation of
the equipment will be performed satisfactorily to the customer. The maintenance services are priced separately and should be accounted for based on the guidance in Technical Bulletin 90-1. Company S is evaluating whether Appliance W and the installation service represent separate units of accounting. (The maintenance services are separately priced at $175 and should be accounted for based on the guidance in Technical Bulletin 90-1.)

**Evaluation:** The first condition for separation is met for Appliance W because it is sometimes sold separately by Company S. The second condition for separation is also met. There is objective and reliable evidence of the fair value of the installation on a separate component basis (as evidenced by the amount charged by independent third parties). The third condition for separation is met because, even though a general right of return exists, performance of the appliance installation is probable and within the control of Company S. Therefore, Appliance W and installation should be accounted for as separate units of accounting.

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

**Example 6—Human Resources Outsourcing Services**

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

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

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

**Evaluation:** In accordance with paragraph 8 of this Issue, HR is required to assess whether the delivered items in the arrangement are considered separate units of accounting at the inception of the arrangement and as each item in the arrangement is delivered. For purposes of this example, the assessment at January 1, 20X1 is not shown. Rather, for purposes of this example, the assessment of whether the deliverables in the arrangement qualify as separate units of accounting is performed as of December 31, 20X1, HR’s annual reporting date. As of that date, HR has delivered payroll processing services, one training event, and the executive compensation handbook. At that date, the first condition for separation is met for each of the three delivered items as each service is sold separately by other vendors. The second condition for separation is also met as there are no general refund rights. Therefore, the three delivered items are considered separate units of accounting in the arrangement.
Because HR does not have objective and reliable evidence of selling price for all of the units of accounting in the arrangement, HR must estimate the selling price for the undelivered units of accounting and allocate the arrangement consideration using the residual method.

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

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

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

<table>
<thead>
<tr>
<th>Costs to be incurred</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payroll costs</td>
<td>519,330</td>
</tr>
<tr>
<td>1 - Payroll gross profit margin</td>
<td>.74</td>
</tr>
<tr>
<td>Employee handbook costs</td>
<td>56,113</td>
</tr>
<tr>
<td>1 - Employee handbook gross profit margin</td>
<td>.85</td>
</tr>
<tr>
<td>Training costs</td>
<td>40,706</td>
</tr>
<tr>
<td>1 - Training gross profit margin</td>
<td>.78</td>
</tr>
</tbody>
</table>

Estimated selling price of the undelivered units of accounting $820,000

HR would allocate the arrangement consideration ($1,275,000) using the residual method as HR does not have objective and reliable evidence for all units of accounting in the arrangement. Therefore, at December 31, 20X1, HR allocates $455,000 ($1,275,000 - $820,000) to the delivered units of accounting.

**Example 6—Biotech License, Research and Development, and Contract Manufacturing Agreement**

Biotech Company (Biotech) enters into an agreement with Pharmaceutical Company (Pharma). The agreement includes (a) Biotech licensing certain rights to Pharma, (b) Biotech providing research and development services to Pharma, and (c) Biotech contract manufacturing product for Pharma. Additional details on each of those aspects of the agreement follow.

**License:** Biotech licenses certain rights on an exclusive basis to Pharma for a period of 10 years. The license gives Pharma the exclusive right to market, distribute, and manufacture Drug B as developed using Technology A. Biotech retains all ownership rights to Technology A and Drug B. There are no when-and-if-available clauses or other performance obligations associated with the license, except as described below.

**Research and development:** Biotech agrees to provide research and development services on a best-efforts basis to Pharma. Biotech agrees to devote four full-time equivalents (FTEs) 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 Drug B using Technology A. The ultimate objective is to receive Food and Drug Administration (FDA) approval on Drug B.

Contract manufacturing: If successfully developed, Biotech agrees to manufacture Drug B for Pharma for a period of five years.

Compensation under the arrangement is as follows:

- Biotech receives $5 million up-front upon signing the agreement.
- Biotech receives $2 million upon meeting each of 4 defined milestones ($8 million in total if all 4 defined milestones are met).
- Biotech receives $250,000 per year for each FTE that performs research and development activities.
- Biotech receives "cost plus 30 percent" for manufacturing Drug B (that is, Biotech will receive compensation for its direct costs plus a 30 percent margin for manufacturing Drug B).

None of these payments, once received, are refundable, even if FDA approval is never received. In addition, while Biotech must perform on a best-efforts basis, it is not obligated to achieve the milestones.

While Biotech has licensed certain rights related to Technology A to other parties, Biotech has not licensed Technology A to others for use in the development of Drug B. Likewise, Biotech has not licensed the marketing, distribution, or manufacturing rights of Drug B to any other party.

Pharma must use Biotech to perform the research and development activities necessary to develop Drug B using Technology A because the know-how and expertise related to Technology A is proprietary to Biotech. In other words, Biotech is the only party capable of performing the level and type of research and development services required by Pharma under the agreement. Biotech has determined that the fees charged for the research and development services (that is, the $250,000 per year for each FTE that performs research and development activities) are competitive with what other third-party vendors charge for similar research and development services (that is, they represent the fair value of those services). In addition, Biotech regularly
provides similar research and development services to other customers for comparable fees. The fees earned by Biotech if it reaches the milestones represent performance bonuses that are contingent only on performance of the research and development services (that is, they are unrelated to the contract manufacturing deliverable and are not part of the fair value of the research and development services).

Assuming that the contract manufacturing provided by Biotech could be provided by other contract manufacturers (who would not be dependent on Biotech for critical ingredients), the license agreement gives Pharma the right to manufacture the drug; no proprietary information related to the manufacturing process would preclude other parties from being able to manufacture Drug B. Biotech has determined that cost plus 30 percent is competitive with what other third-party contract manufacturers charge for manufacturing drugs similar to Drug B (that is, it represents the fair value of those services). In addition, Biotech regularly provides similar contract manufacturing services for other customers for comparable fees.

**Evaluation:** There are three deliverables in this arrangement that should be considered for separation: (1) license, (2) research and development activities, and (3) contract manufacturing. The efforts expended by Biotech to reach each of the four defined milestones are considered part of the research and development activities and are not evaluated on a standalone basis. The fees earned by Biotech if it reaches the milestones represent performance bonuses that are contingent only on performance of the research and development services (that is, they are unrelated to the contract manufacturing deliverable).

The license deliverable does not meet the first criterion for separation. The license deliverable does not have standalone value to Pharma. Because Drug B has not yet been developed, the license is of no value to Pharma without the ensuing research and development activities using Technology A, which is proprietary to Biotech. Likewise, Pharma could not sell the license on a standalone basis to another party (that is, without Biotech agreeing to provide the research and development activities for that other party).

On a combined basis, however, the license and research and development activities have value on a standalone basis. That is, Biotech, in similar arrangements, has sold the license and
research and development separately from the manufacturing process. Additionally, Pharma could sell that combined unit of accounting to another party.

The combined unit of accounting (license and research and development activities) also meets the second criterion for separation from the contract manufacturing because Biotech has objective and reliable evidence of the fair value of the contract manufacturing (based on what it and other third parties charge for that type of service). Finally, there are no general rights of return in the arrangement. Therefore, the combined unit of accounting should be considered a separate unit of accounting in the arrangement.

Biotech has not entered into any other agreements in which it has (a) licensed the marketing, distribution, and manufacturing rights to Technology A for use in the development of Drug B and (b) agreed to perform research and development activities to develop Technology A into Drug B. In addition, given the unique nature of Technology A, third-party fair value evidence for the combined unit of accounting also does not exist. As such, Biotech does not have objective and reliable evidence of the fair value of the combined unit of accounting. Based on that analysis, the method of allocating the arrangement consideration would be the residual method because fair value evidence exists for the contract manufacturing, but not the combined unit of accounting. Because the contract manufacturing deliverable is priced at its fair value, none of the other arrangement consideration should be allocated to the contract manufacturing deliverable.

Example 7—Sale of Medical Equipment with Cartridges and Installation

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

Installation is a standard process, outlined in the owner's manual, consisting principally of uncrating, calibrating, and testing the equipment. A purchaser of the equipment could complete the process using the information in the owner's manual, although it would probably take
significantly longer than it would take Company M's technicians to perform the tasks. Although
while the process is not complex and does not involve proprietary information, other vendors do not
install Company M's equipment; provide the service; other vendors do provide largely
interchangeable installation services for $20,000. Historically, Company M has never sold the
equipment without installation. Most installations are performed by Company M and are
completed within 7–24 days of shipment. Installation is included in the overall sales price of the
equipment (that is, Company M does not sell the equipment on a noninstalled basis) and has an
estimated fair value of $20,000 (based on per diem rates for technician time).

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

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

**Evaluation:** The first condition for separation is met for the equipment because, even though
Company M has never sold the equipment without the cartridges, a customer could resell the
equipment (in a primary or secondary market). The second condition for separation is also met
because objective and reliable evidence of fair value exists for the cartridges and the installation
based on third-party evidence and Company M's entity-specific evidence of fair value. The third
condition for separation is met because there are no general rights of return involved in this
arrangement. Therefore, the equipment should be accounted for as a separate unit of accounting.

Company M does not have VSOE of selling price for the equipment as it does not sell the
equipment separately (without installation services and cartridges). In addition, third-party
evidence of selling price does not exist as no vendor separately sells the same or largely interchangeable equipment.

The residual method should be used to allocate the arrangement consideration because Company M does not have objective and reliable evidence of selling price for the delivered unit of accounting (equipment). Company M does have objective and reliable evidence of the undelivered units of accounting, $5,000 for the cartridges (20 × $250) and $20,000 for the installation services. Accordingly, without considering whether any portion of the amount allocable to the equipment is contingent upon delivery of the other items, the amount otherwise allocable to the equipment, cartridges, and installation would be is as follows: $375,000 to the equipment ($400,000 – [250 × 20] - $5,000 – $20,000), $5,000 to the cartridges ($250 × 20), and $20,000 to the installation. Additionally, no portion of the amount allocable to the equipment is contingent upon the delivery of the cartridges or performance of the installation. That is, if the cartridges are not delivered and the installation is not performed, Company M would be entitled to $375,000.

Example 8—Sale of Computer System

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

Evaluation: The first condition for separation is met for the CPU, as it is sold separately by Company B. The second condition for separation is met because the fair values of the
undelivered items (keyboard and monitor) are objectively and reliably determined based on the price of that equipment when sold separately by Company B. The third condition for separation is met because there are no general rights of return. Therefore, the CPU should be accounted for as a separate unit of accounting.

Company B has objective and reliable evidence of selling price for all deliverables in the arrangement as each is sold regularly on a standalone basis. Without considering whether any portion of the amount allocable to the CPU is contingent upon delivery of the other items, Company B would allocate the arrangement consideration on a using the relative selling price method because objective and reliable evidence of selling price exists for all deliverables in the arrangement fair value basis. Therefore, the portion of the arrangement fee otherwise allocable to the CPU is $636.36 ($1,000 × [$700 ÷ $1,100]), of which $36.36 ($636.36 – [$1,000 – $400 – $100]) is subject to refund if the monitor and keyboard are not delivered. Therefore, the amount allocable to the CPU is limited to $600, which is the amount that is not contingent upon delivery of the monitor and keyboard.

Example 9—Sale of 12 Bolts of Fabric

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

Company D sold the 12-bolt bulk lot of fabric to Customer A on November 1, 20X2. Company D will deliver the first of three four-bolt installments of fabric on November 15, 20X2 and will deliver the remaining installments on December 15, 20X2, and January 15, 20X3. Customer A is obligated to Company D for the full price of the fabric on November 15, 20X2, subject to the money-back guarantee. Company D has sufficient production capacity and inventory to deliver all of the fabric in accordance with the installment provisions of the arrangement and, therefore, believes that it will do so. In addition, Company D has entered into similar arrangements with many other customers in the past and has rarely failed to deliver fabric from the appropriate dye lot under its bulk-sale arrangements.

**Evaluation:** The first condition for separation is met for the delivered fabric because Company D also sells bolts of fabric individually. The second condition for separation is also met because objective and reliable evidence of fair value exists based on Company D's vendor-specific evidence of fair value. Arrangement consideration would be allocated evenly among the 12 bolts of fabric because each has an identical fair value (based on Company D's vendor-specific evidence of fair value). The third condition for separation is met because there are no general rights of return in the arrangement. Therefore, the delivered fabric should be accounted for as a separate unit of accounting.

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

**Example 10—Painting Contract**

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

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

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

However, in allocating the arrangement consideration, no amount would be allocated to the paint because, in the event that PainterCo does not perform the painting service, the customer may return all of the paint for a full refund.
Example 11 — Agricultural Equipment

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

On December 29, 20X8, Company A enters into an arrangement to deliver a tractor and customized irrigation equipment to Customer M for a fee of $270,000. For purposes of this example, the irrigation equipment is accounted for in accordance with SAB 104. The customer is obligated to pay $100,000 upon delivery of the tractor and the remainder of the arrangement consideration upon delivery of the irrigation equipment. On December 31, 20X8, Company A delivers the tractor, and on April 5, 20X9, Company A delivers the irrigation equipment. Neither product requires installation.

The tractor in this arrangement is often sold separately by Company A for a price of $100,000, which is considered VSOE of selling price. The irrigation equipment is also sold separately; however, because of the customized nature of the product, Company A does not have objective and reliable evidence of selling price.

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

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

Because Company A does not have objective and reliable evidence of selling price for the undelivered unit of accounting in the arrangement (irrigation equipment), Company A must estimate the selling price for the undelivered unit of accounting and allocate the arrangement consideration using the residual method.
Company A considered the following to determine its best estimate of stand-alone selling price for the irrigation equipment:

- Company A’s cost to produce the customized irrigation equipment is $110,000.
- The division of Company A that produces the irrigation equipment and other similar products, earns an average gross profit margin of approximately 30 percent. The range of profit margins within the irrigation product line varies from 10 to 45 percent. Company A generally receives a higher profit margin on the more specialized or customized products.
- When selling non-customized irrigation equipment, Company A averages, on a worldwide basis, a selling price of approximately $140,000, which includes a gross profit margin of 25 percent.
- Customer M is located in Asia where high demand has resulted in Company A being able to command 10-15 percent higher prices for its irrigation product line than it commands in other markets it serves. This pricing is also consistent with Company A’s ongoing marketing strategy in Asia.
- Direct competitors to Company A’s irrigation product line, Company D and Company E, earn average gross profit margins in Asia of 30 percent and 32 percent, respectively, based on a review of those Companies’ periodic filings.
- The customized irrigation equipment includes enhanced functionality that Company A does not believe its competitors can provide. Company A believes this enhanced functionality has additional value in the marketplace.
- Company A’s price list provided to prospective customers lists the price for irrigation equipment prior to customization at $155,000.

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

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

Accordingly, at December 31, 20X8, using the residual method of allocation Company A would allocate $185,000 of the arrangement consideration to the irrigation equipment. The residual amount of $85,000 ($270,000 − $185,000) would be attributed to the tractor. Additionally, none of the amount allocable to the tractor is contingent upon delivery of the irrigation equipment.