Revenue Recognition

A guide to navigating through the maze
Revenue Recognition:
A guide to navigating through the maze
Revenue is one of the most important line items in the financial statements, but finding the appropriate model to apply in recognizing revenue can be a challenge for even the most seasoned accounting professional.

The complexity in the authoritative guidance on revenue recognition makes it difficult to know when and how to appropriately record revenue. This implementation guide is intended to provide a road map to assist users in navigating through the maze of certain accounting literature related to revenue recognition. It includes guidance on:

- applying the basic criteria for revenue recognition,
- evaluating multiple-element arrangements,
- using industry-specific guidance relating to software revenue transactions, and
- determining presentation and disclosure requirements for revenue arrangements in the financial statements.

This guide also incorporates numerous examples to illustrate the application of the interpretive guidance. It does not address specific industry guidance, except for software, and is not a substitute for reading and applying the specific guidance in the FASB Accounting Standards Codification™ (ASC or Codification) when applicable.
This document reflects the following Codification amendments:

- **ASC 605-25, Revenue Recognition: Multiple-Element Arrangements**, as amended by Accounting Standards Update (ASU) 2009-13, *Multiple-Deliverable Revenue Arrangements – a consensus of the FASB Emerging Issues Task Force*

- **ASC 985-605, Software: Revenue Recognition**, as amended by ASU 2009-14, *Certain Revenue Arrangements That Include Software Elements – a consensus of the FASB Emerging Issues Task Force*

- **ASC 605-28, Revenue Recognition: Milestone Method**, as amended by ASU 2010-17, *Milestone Method of Revenue Recognition – a consensus of the FASB Emerging Issues Task Force*

The amended guidance in ASC 605-25 and ASC 985-605 is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The amendments in ASC 605-28 are effective prospectively for milestones achieved in fiscal years and in interim periods within those years beginning on or after June 15, 2010.
### Table of contents

1. **Introduction** .......................................................... 1

2. **What is the starting point in evaluating revenue transactions?** ............... 3

3. **What are the general principles of revenue recognition?** ....................... 7
   - Persuasive evidence of an arrangement .................................................. 8
   - Side agreements .................................................................................. 9
   - Determining if delivery has occurred or services have been performed ....... 9
     - Consignment sales and financing arrangements ................................... 9
   - Fixed or determinable fees ................................................................... 10
     - Cancellation provisions .................................................................... 10
     - Contingent income .......................................................................... 11
     - Right of return .................................................................................. 11
     - Breakage ........................................................................................... 11
     - Sales incentives ................................................................................ 12
     - Cooperative advertising ..................................................................... 13
     - Slotting fees and buydowns ............................................................... 13
     - Price-protection features .................................................................. 14
   - Collectibility is reasonably assured ....................................................... 14
4. When is revenue recognized for product sales? ............................ 15
   Persuasive evidence of an arrangement ................................................. 16
   Side agreements .................................................................................. 17
   Delivery terms .................................................................................... 17
   Bill and hold transactions .................................................................... 18
   Layaway sales ...................................................................................... 20
   Consignment sales ............................................................................... 20
   Customer acceptance ........................................................................... 22
   Inconsequential or perfunctory activities ............................................. 25
Fixed or determinable fees ....................................................................... 27
   Sales incentives ................................................................................... 27
   Cooperative advertising ....................................................................... 32
   Slotting fees and buydowns ................................................................ 33
   Price-protection features ..................................................................... 34
   Right of return .................................................................................... 35
   Contingent income .............................................................................. 37
   Breakage ............................................................................................... 38
Collectibility is reasonably assured ............................................................ 40
   Payment terms ..................................................................................... 40
   Subsequent change in collectibility ...................................................... 40

5. What is the accounting for service transactions? ............................... 41
   Persuasive evidence of an arrangement ............................................... 42
   Fixed or determinable fees and collectibility ....................................... 42
   Cancellation provisions ....................................................................... 43
   Contingent income ............................................................................. 44
   Extended payment terms .................................................................... 45
Services rendered (delivery) ..................................................................... 45
   Nonrefundable up-front fees ............................................................... 46
   Inconsequential or perfunctory obligations ......................................... 49
Specific performance method .................................................................. 50
Completed performance method .............................................................. 50
Proportional performance method .......................................................... 51
Warranties ............................................................................................... 53
   Standard warranties ................................................................. 54
   Separately priced warranties .......................................................... 54
6. How is a multiple-element arrangement evaluated? ........................................... 55
General.................................................................................................................. 55
Scope of ASC 605-25 .......................................................................................... 56
Determining the arrangement ............................................................................. 56
Identifying elements in an arrangement............................................................. 58
Accounting literature interaction in multiple-element arrangements .................. 60
Criteria for determining whether the elements in an arrangement can be separated .................................................................................................................. 62
Stand-alone value................................................................................................. 63
Is performance of the undelivered item(s) considered probable and in the vendor’s control? ............................................................................................................ 65
Measurement and allocation of arrangement consideration .................................. 65
General.................................................................................................................. 65
Allocating consideration to the various elements in an arrangement............... 65
Determining the selling price ............................................................................. 68
Considerations for developing a best estimate of selling price .......................... 69
Use of contract prices ......................................................................................... 73
Utilizing a range of estimated selling prices ...................................................... 73
Documentation considerations for developing a best estimate of selling price ... 75
Allocating significant and incremental future discounts ..................................... 75
Accounting for costs of a delivered item when revenue cannot be separately recognized ...................................................................................................... 76

7. What is the accounting for a right of return? .................................................. 77
General rights of return....................................................................................... 77
Specific rights of return ...................................................................................... 79

8. What is the revenue recognition model applied to a software arrangement? ................................................................................................................. 83
General.................................................................................................................. 83
Scope ..................................................................................................................... 83
Determining whether an arrangement is in the software revenue recognition guidance ............................................................................................................. 84
Software revenue recognition guidance scope exceptions ................................. 86
Recognizing software revenue .......................................................................... 88
Multiple-element arrangements .......................................................................... 88
General .................................................................................................................. 88
<table>
<thead>
<tr>
<th>Topic</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Combining contracts</td>
<td>89</td>
</tr>
<tr>
<td>Allocating consideration</td>
<td>90</td>
</tr>
<tr>
<td>Interaction with other accounting literature</td>
<td>94</td>
</tr>
<tr>
<td>Evidence of an arrangement</td>
<td>98</td>
</tr>
<tr>
<td>Delivery</td>
<td>100</td>
</tr>
<tr>
<td>Physical delivery</td>
<td>100</td>
</tr>
<tr>
<td>Electronic delivery</td>
<td>101</td>
</tr>
<tr>
<td>Customer acceptance uncertainties</td>
<td>101</td>
</tr>
<tr>
<td>Multiple copies of software products versus multiple licenses</td>
<td>103</td>
</tr>
<tr>
<td>Authorization codes</td>
<td>105</td>
</tr>
<tr>
<td>Use of fulfillment houses</td>
<td>106</td>
</tr>
<tr>
<td>Impact of license term in initial and renewal arrangements</td>
<td>106</td>
</tr>
<tr>
<td>Inconsequential or perfunctory activities</td>
<td>107</td>
</tr>
<tr>
<td>Fixed or determinable fees and collectibility</td>
<td>108</td>
</tr>
<tr>
<td>Extended payment terms</td>
<td>108</td>
</tr>
<tr>
<td>Concessions</td>
<td>110</td>
</tr>
<tr>
<td>Financing arrangements</td>
<td>113</td>
</tr>
<tr>
<td>Resellers</td>
<td>117</td>
</tr>
<tr>
<td>Collectibility</td>
<td>118</td>
</tr>
<tr>
<td>Additional software elements</td>
<td>119</td>
</tr>
<tr>
<td>Specified additional software products</td>
<td>119</td>
</tr>
<tr>
<td>Unspecified additional software products</td>
<td>120</td>
</tr>
<tr>
<td>Upgrades or enhancements</td>
<td>120</td>
</tr>
<tr>
<td>Discounts on future software elements</td>
<td>122</td>
</tr>
<tr>
<td>Hosting arrangements</td>
<td>124</td>
</tr>
<tr>
<td>Multiple-element hosting arrangements with software element</td>
<td>126</td>
</tr>
<tr>
<td>Multiple-element hosting arrangements with no software element</td>
<td>126</td>
</tr>
<tr>
<td>Software with significant production, modification, or customization</td>
<td>130</td>
</tr>
<tr>
<td>Percentage-of-completion method</td>
<td>132</td>
</tr>
<tr>
<td>Postcontract customer support, including unspecified upgrades</td>
<td>133</td>
</tr>
<tr>
<td>Establishing VSOE of fair value of PCS</td>
<td>134</td>
</tr>
<tr>
<td>VSOE of fair value does not exist for PCS</td>
<td>138</td>
</tr>
<tr>
<td>VSOE of fair value of PCS in short-term time-based licenses</td>
<td>140</td>
</tr>
<tr>
<td>VSOE of fair value of PCS in multiple-year time-based licenses</td>
<td>141</td>
</tr>
<tr>
<td>PCS during deployment stage</td>
<td>142</td>
</tr>
<tr>
<td>Various other PCS issues</td>
<td>144</td>
</tr>
<tr>
<td>Section</td>
<td>Page</td>
</tr>
<tr>
<td>------------------------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>Exchange or return rights</td>
<td>146</td>
</tr>
<tr>
<td>Platform-transfer rights</td>
<td>147</td>
</tr>
<tr>
<td>Arrangements with both software and services</td>
<td>148</td>
</tr>
<tr>
<td>Separating services from the software</td>
<td>148</td>
</tr>
<tr>
<td>Service element essential to functionality of software</td>
<td>149</td>
</tr>
<tr>
<td>Funded software-development arrangements</td>
<td>150</td>
</tr>
<tr>
<td>9. When and how should contract accounting be applied?</td>
<td>153</td>
</tr>
<tr>
<td>Completed-contract method</td>
<td>156</td>
</tr>
<tr>
<td>Percentage-of-completion method</td>
<td>156</td>
</tr>
<tr>
<td>Measuring the extent of progress toward completion</td>
<td>156</td>
</tr>
<tr>
<td>Combining or segmenting contracts</td>
<td>158</td>
</tr>
<tr>
<td>Combining contracts</td>
<td>159</td>
</tr>
<tr>
<td>Segmenting contracts</td>
<td>159</td>
</tr>
<tr>
<td>Change orders</td>
<td>160</td>
</tr>
<tr>
<td>Claims</td>
<td>161</td>
</tr>
<tr>
<td>Loss contracts</td>
<td>162</td>
</tr>
<tr>
<td>10. Can contract costs be deferred?</td>
<td>163</td>
</tr>
<tr>
<td>Customer acquisition and set-up costs</td>
<td>163</td>
</tr>
<tr>
<td>Fulfillment costs</td>
<td>165</td>
</tr>
<tr>
<td>Recoverability of capitalized costs</td>
<td>166</td>
</tr>
<tr>
<td>11. What is the proper accounting for research and development</td>
<td>169</td>
</tr>
<tr>
<td>arrangements?</td>
<td></td>
</tr>
<tr>
<td>Service arrangements</td>
<td>172</td>
</tr>
<tr>
<td>Milestone-based model</td>
<td>172</td>
</tr>
<tr>
<td>Scope</td>
<td>173</td>
</tr>
<tr>
<td>Milestone definition</td>
<td>173</td>
</tr>
<tr>
<td>Substantive milestones</td>
<td>173</td>
</tr>
<tr>
<td>Performance-based models</td>
<td>177</td>
</tr>
<tr>
<td>Other considerations</td>
<td>179</td>
</tr>
<tr>
<td>Collaborative arrangements</td>
<td>180</td>
</tr>
<tr>
<td>Active participation</td>
<td>181</td>
</tr>
<tr>
<td>Significant risks and rewards</td>
<td>181</td>
</tr>
<tr>
<td>Income statement classification</td>
<td>181</td>
</tr>
<tr>
<td>Section</td>
<td>Page</td>
</tr>
<tr>
<td>------------------------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>12. How should revenue be presented and disclosed?</td>
<td>183</td>
</tr>
<tr>
<td>Presentation</td>
<td></td>
</tr>
<tr>
<td>Gross versus net presentation</td>
<td>184</td>
</tr>
<tr>
<td>Revenue or gain classification</td>
<td>188</td>
</tr>
<tr>
<td>Shipping and handling fees and related costs</td>
<td>189</td>
</tr>
<tr>
<td>Sales incentives</td>
<td>189</td>
</tr>
<tr>
<td>SEC presentation requirements</td>
<td>189</td>
</tr>
<tr>
<td>Taxes collected from customers</td>
<td>191</td>
</tr>
<tr>
<td>Disclosures</td>
<td>191</td>
</tr>
<tr>
<td>Accounting policies</td>
<td>191</td>
</tr>
<tr>
<td>Multiple-element arrangements</td>
<td>192</td>
</tr>
<tr>
<td>Milestone method</td>
<td>193</td>
</tr>
<tr>
<td>Collaborative arrangement disclosures</td>
<td>193</td>
</tr>
<tr>
<td>SEC disclosure requirements</td>
<td>194</td>
</tr>
</tbody>
</table>
Revenue is one of the key items reported in an entity’s financial statements, but finding the appropriate model to apply in recognizing revenue can be a challenge even for the most seasoned professional. That is not surprising, given the complexity of the accounting guidance related to revenue recognition. While the establishment of the FASB Accounting Standards Codification™ (ASC or Codification) has reorganized various pieces of revenue recognition literature in U.S. GAAP into one broad revenue recognition topic and various industry specific topics, the content, amount and complexity of the guidance has not changed as a result of the Codification. Even within the Codification, an entity often must refer to more than one section to determine the appropriate revenue recognition model to apply to a transaction. Specific revenue recognition guidance exists for certain industries, such as real estate and financial services, but many entities operate in industries that lack specific guidance.

An entity may enter into arrangements that include various components, or elements, that do not fall under the scope of one specific piece of accounting guidance. A single arrangement, for example, may include software, hardware, and service elements. Evaluating the individual elements in such arrangements often requires judgment and is essential in determining the appropriate accounting model to apply. An entity may need to consider the interaction of several sections of the Codification in evaluating multiple elements in a single arrangement. Even arrangements with seemingly similar facts may result in different revenue accounting.
In addition, because of the ever-increasing complexity in contract terms, an entity must identify and evaluate the impact of all contract provisions. This evaluation includes reviewing such provisions as sales incentives, rights of return, contingent revenue, when-and-if-available deliverables, and other terms, each with the potential to affect the timing and/or amount of revenue to be recognized.

This document is intended to provide a road map to assist users in navigating through the maze of certain accounting guidance related to revenue recognition. It includes guidance on:

- applying the basic criteria for revenue recognition,
- evaluating multiple-element arrangements,
- using industry-specific guidance relating to software revenue transactions, and
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- ASC 605-28, Revenue Recognition: Milestone Method, as amended by ASU 2010-17, Milestone Method of Revenue Recognition – a consensus of the FASB Emerging Issues Task Force

The amended guidance in ASC 605-25 and ASC 985-605 is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The amendments in ASC 605-28 are effective prospectively for milestones achieved in fiscal years and in interim periods within those years beginning on or after June 15, 2010.
Even with the launch of the *FASB Accounting Standards Codification™* (ASC), the large volume of revenue recognition guidance in U.S. GAAP makes it a real challenge for entities to determine the appropriate timing and amount of revenue to recognize in the statement of operations. Because of the variety of different types of revenue-generating arrangements, entities need to approach revenue questions in a systematic way to ensure that they select the appropriate guidance for each particular situation. A two-step process can help entities evaluate revenue-generating activities and then select the best-suited guidance.

The first step in evaluating a revenue recognition transaction is to *develop an understanding of the arrangement*. The evaluation starts with identifying the arrangement. In this regard, an entity should determine whether separate contracts should be considered together as one arrangement. The evaluation requires a review of the relevant contract(s) so that all pertinent terms of the arrangement are identified, including, but not limited to, the following:
- Products and/or services to be delivered
- Payment and delivery terms
- Rights of return or refund
- Customer acceptance provisions
- Ongoing obligations
Understanding the economics of a transaction and why the parties entered it will help in determining the appropriate revenue recognition model to apply.

The second step is to determine which revenue recognition guidance is most appropriate in a particular situation. Entities may find this step difficult, even with a complete understanding of all terms in an arrangement, because much of the relevant literature applies only to a narrow set of transactions or to a single industry. SEC Staff Accounting Bulletin (SAB) 104, Revenue Recognition, provides guidance regarding how and when to recognize amounts resulting from general revenue-generating activities, including product or equipment sales, services, and other similar transactions.

The following list identifies certain, but not all, of the existing guidance that entities can apply to revenue derived from specific types of transactions and arrangements.

<table>
<thead>
<tr>
<th>Transaction type</th>
<th>Primary literature</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling, licensing, or marketing software</td>
<td>ASC 985-605, Software: Revenue Recognition</td>
</tr>
<tr>
<td>Long-term construction projects</td>
<td>ASC 605-35, Revenue Recognition: Construction-Type and Production-Type Contracts</td>
</tr>
<tr>
<td>Financial services</td>
<td>ASC 310-20, Receivables: Nonrefundable Fees and Other Costs</td>
</tr>
<tr>
<td>Real estate</td>
<td>ASC 360-20, Property, Plant, and Equipment: Real Estate Sales, and ASC 976-605, Real Estate – Retail Land: Revenue Recognition</td>
</tr>
<tr>
<td>Franchises</td>
<td>ASC 952-605, Franchisors: Revenue Recognition</td>
</tr>
<tr>
<td>Leases</td>
<td>ASC 840, Leases</td>
</tr>
<tr>
<td>Oil and gas</td>
<td>ASC 932-605, Extractive Activities – Oil and Gas: Revenue Recognition</td>
</tr>
</tbody>
</table>

Even if the appropriate literature is identified, it can be challenging to correctly apply that guidance to a particular arrangement. In addition, accounting for transactions that appear to fall under the authority of specific accounting guidance might still be challenging, because the specific guidance often interacts with other guidance, increasing the level of difficulty in determining the appropriate literature to apply. For example, ASC 985-605 requires applying the guidance in ASC 605-35 to an arrangement that includes significant production, modification, or customization of software.
What is the starting point in evaluating revenue transactions?

The concept of “interaction” is discussed further in this document in chapter 6 and chapter 8, but the following example is provided to help clarify the concept.

Interaction of ASC 985-605 and ASC 605-25
A multiple-element arrangement includes a computer hardware product containing embedded software that functions with the hardware component to deliver the tangible product’s essential functionality. Also included in the arrangement is an additional software product that is not essential to the computer hardware’s functionality and postcontract customer support (PCS) covering both the software embedded in the product and the additional software.

Because the computer hardware and embedded software function together to deliver the computer hardware’s essential functionality, they are both considered a nonsoftware component of the arrangement and are excluded from the scope of the software revenue recognition guidance in accordance with the scope exception in ASC 985-605-15-4. The additional software is considered a software component within the scope of the software guidance in ASC 985-605 because it is not essential to the functionality of the hardware. The PCS relates to components both within (additional software) and outside (computer hardware with embedded software) the scope of ASC 985-605 and would be bifurcated into a software component and a nonsoftware component using the guidance in ASC 605-25.

The arrangement consideration would first be allocated to the software components (additional software product and related PCS) and nonsoftware components (tangible product including the embedded software and related PCS) based on the guidance in ASC 605-25. The entity would apply the separation, measurement, and allocation guidance in ASC 605-25 to determine whether the nonsoftware items can be further separated and if so, how to allocate the nonsoftware consideration to those units of accounting. The entity would apply the guidance in ASC 985-605 to determine whether the software components can be further separated and if so, how to allocate and recognize revenue for those units of accounting.

The following chapter of this document discusses the general principles of revenue recognition that can be applied to most arrangements, as well as the guidance that is widely applicable to revenue transactions.

Under CON 5, revenue must be “earned” and either “realized” or “realizable” before it can be recognized in the financial statements. Revenue is considered “earned” if an entity has substantially accomplished what it must do to be entitled to the contractual benefits (or, put another way, the entity has fulfilled substantially all obligations to the customer). Revenue is “realizable” when related assets received are readily convertible to cash or claims to cash.

SAB 104, issued in December 2003, amends SEC Staff Accounting Bulletin 101, Revenue Recognition in Financial Statements, and rescinds the related document, “Frequently Asked Questions and Answers.” SAB 104 does not create new GAAP to be followed; rather, it summarizes certain SEC staff views on applying existing revenue recognition guidance. While SEC registrants must apply the guidance in Staff Accounting Bulletins, we believe it is appropriate for private entities to also apply these concepts.

In accordance with SAB 104, revenue generally is earned and realized or realizable when all of the following criteria are met:
• **Persuasive evidence of an arrangement exists.** The requirement that persuasive evidence of an arrangement exists is intended to ensure that the understanding between the parties about the specific nature and terms of a transaction has been finalized. Determining the proper accounting treatment for a transaction depends on evidence of the final understanding between the parties, because a change in terms could lead to a different conclusion regarding the revenue recognition model to apply.
• Delivery has occurred or services have been rendered. Unless delivery has occurred or services have been rendered, the seller has not substantially completed its obligations under the terms of the arrangement, and revenue should not be recognized. Delivery is generally deemed to have occurred when the customer takes title and assumes the risks and rewards of ownership.

• The seller’s price to the buyer is fixed or determinable. Whether the price is fixed or determinable depends on many factors, including payment terms, discounts, and rebates, which can vary from arrangement to arrangement. In determining whether the price is fixed or determinable, entities should evaluate all elements of an arrangement to ensure that amounts recognized as revenue are not subject to refund or adjustment.

• Collectibility is reasonably assured. If the collection of fees in an arrangement is not reasonably assured, the CON 5 general principle of being realized or realizable is not met, and revenue recognition is precluded until collection is reasonably assured.

SAB 104 contains examples related to each of the criteria listed above. In addition, these criteria are discussed in greater detail below.

**Persuasive evidence of an arrangement**
Persuasive evidence of an arrangement is dictated by an entity’s customary business practices, which vary among entities. In addition, the customary practices of a single entity may vary by the type of customer or by the nature of the product delivered or services rendered. If an entity’s standard practice is for both parties to sign a written contract defining the terms of the arrangement, then persuasive evidence of an arrangement exists only if a written contract is signed by both parties. Entities that do not rely on written contracts may demonstrate evidence of an arrangement through some other means, for example, a binding purchase order or online authorization binding the customer to the terms of the sale. In all cases, revenue recognition is precluded until persuasive evidence of an arrangement is obtained.

The following example illustrates these concepts.

**Persuasive evidence of an arrangement**
Assume that the customary practice of Entity A is to obtain a written contract executed by both parties for all arrangements. Entity A negotiates with Entity B to sell a standard type of equipment. The equipment that Entity B has been using is out of service and, as a result, Entity B has asked Entity A to deliver the replacement equipment as soon as possible. Entity A ships the equipment (free on board [FOB] shipping point) on September 25 and receives payment from Entity B on September 30. The written contract is signed by an Entity A representative on September 28 and by an Entity B representative on October 5. Because Entity A has a customary practice of obtaining written contracts, persuasive evidence of the arrangement has not been obtained and revenue should not be recognized before October 5.
Side agreements
The existence of side agreements executed after the original agreement may call into question whether the original agreement is final and represents persuasive evidence of an arrangement. A “side agreement” may take the form of a written amendment to the contract or may result from a conversation between representatives of the vendor and the buyer. Side agreements often include provisions such as cancellations, payment term amendments, or other provisions that could impact the recognition of revenue.

Frequently, finance and accounting personnel are unaware of the existence or exact terms of side agreements because sales personnel who execute these agreements sometimes fail to communicate the existence of these amendments to the appropriate finance or accounting personnel. Management should establish appropriate policies, procedures, and internal controls to ensure that all side agreements are identified. Management should also convey to sales personnel the importance of communicating side agreements to individuals with accounting responsibility. Otherwise, revenue may not be recognized appropriately.

Determining if delivery has occurred or services have been performed
Revenue is generally earned on delivery of the product to the customer because title (risks and rewards of ownership) transfers with the physical goods from the seller to the buyer. Delivery terms, such as free on board (FOB) shipping point or FOB destination, may be explicit in the written arrangement or may be implicit based on the seller’s standard business practices. Transfer of title is a legal concept and, as a result, determining when it has occurred may require reference to local laws and/or legal counsel. In service transactions, revenue is earned as performance occurs and the customer receives value from the service. An entity should evaluate the pattern of performance in determining the extent to which the customer has received value from a service transaction.

The facts and circumstances of each specific situation should be analyzed to determine if delivery or performance has occurred. Factors used to gauge whether delivery or performance has occurred include shipping terms and customer acceptance terms. An entity should also give consideration to bill and hold transactions and consignment sale arrangements. Refer to chapter 4, “Delivery terms” and chapter 5, “Services rendered (delivery)” for detailed discussions on determining if delivery has occurred or if services have been performed.

Consignment sales and financing arrangements
In some arrangements, title does not pass to the customer on delivery or the customer has the right to return the product in certain circumstances. “Consignment sale” arrangements can take a variety of forms and revenue should not be recognized until title has passed to the consignee (customer), assuming all other revenue recognition criteria are met.
The terms of the arrangement may stipulate that the consignee will not take title to or pay for the goods until they are sold by the consignee to a third party. In other consignment arrangements, even though the goods are shipped to the consignee’s warehouse, title does not pass until the product is consumed by the consignee in production or a specified amount of time has passed.

Certain other arrangements are, in substance, consignment sales or financing arrangements and do not qualify for revenue recognition until a sale occurs. In these situations, up-front revenue recognition is inappropriate because the risks and rewards of ownership remain with the seller. Refer to chapter 4, “Consignment sales,” for additional discussion on consignment sale arrangements.

**Fixed or determinable fees**

Another prerequisite for revenue recognition is that the sales price must be fixed or determinable. The existence of uncertainties with regard to the amount of arrangement consideration to be received by the seller indicates that the fee is not fixed or determinable. While SAB 104 does not include a definition of fixed or determinable fees, it does provide examples relating to certain factors that create uncertainties with regard to the amount of consideration the seller will receive, including cancellation provisions, estimates of future returns, and contingent income. Other factors that may impact the fixed or determinable criterion include rebates and coupons, breakage, and price-protection features.

In addition, the evaluation of whether arrangement consideration is fixed or determinable is not an all-or-nothing decision. For example, a portion of the fee may be fixed or determinable at the outset of the arrangement with the remaining amount becoming fixed or determinable over time or at a future date, depending on the terms of the arrangement.

Some factors that influence the evaluation of whether a fee is fixed or determinable are discussed in greater detail here and in chapter 4, “Fixed or determinable fees.”

**Cancellation provisions**

An arrangement that includes a customer cancellation or termination provision may indicate that the arrangement is not final. For instance, the cancellation period may be a demonstration period. In arrangements that can be canceled by the customer, the sales price is neither fixed nor determinable, and revenue should not be recognized until the cancellation privileges lapse. Revenue from arrangements with cancellation provisions that expire ratably over a period of time (such as a contract term) should be recognized as the fees become determinable (that is, over the stated term). Since customary and short-term rights to return products are not deemed to be cancellation privileges, they should be accounted for using the guidance in FASB Accounting Standards Codification™ (ASC) 605-15, Revenue Recognition: Products.
Contingent income
Some arrangements contain payments that are contingent on a vendor meeting a specified target at the end of a specified period (bonuses). “Contingent payments” are another type of uncertainty related to whether the fees in an arrangement are fixed or determinable. The SEC staff addresses the accounting for contingent payments in SAB 104, which indicates that it is inappropriate for a vendor to recognize revenue based on the probability that the condition will be met. Rather, contingent amounts should be recognized as revenue when they become fixed or determinable, which is generally when the contingency is resolved. See “Contingent income,” in chapter 4 and in chapter 5 for further discussion of contingent income related to product sales and service delivery, respectively.

Right of return
Some product sales arrangements allow the customer to return the product for a cash refund, a credit, or an exchange for another product through a general right of return. Right-of-return provisions included in an arrangement should be carefully analyzed to appropriately evaluate their impact on revenue recognition. Rights of return may be either general (available to all customers) or customer-specific. ASC 605-15-25-1 through 25-2 addresses accounting for general rights of return and states that revenue should be recognized, net of an allowance for estimated returns, at the time of sale if certain conditions are met. Those conditions and other guidance related to both general and customer-specific rights of return provisions are included in chapter 4, “Right of return,” and in chapter 7.

Breakage
Breakage occurs in certain arrangements that require the customer to make an up-front, nonrefundable payment for future vendor performance. In some circumstances, the customer does not demand full performance for the payment. The difference between (1) the amount paid for a product or service and (2) the dollar value of performance ultimately received by the customer is referred to as “breakage.” Examples of arrangements where breakage may occur include gift card purchases and up-front payments for professional services (such as legal services), both of which, for various reasons, are not always fully redeemed. (Note that recognition of breakage may be a problem in many states due to escheat [unclaimed property] laws.)
The amount received by the vendor is initially recorded as a deferred revenue liability, since the vendor has not yet completed performance as stipulated by the terms of the arrangement. Breakage may be recognized when the vendor is released from its legal obligation to perform (either on redemption or expiration) or when the demand for future performance is remote and the vendor can reasonably estimate the amount of breakage. Even if breakage can be reasonably estimated, immediately recognizing that amount in revenue is generally not appropriate; rather, the amount of breakage should be recognized in proportion to a vendor’s performance or delivery. See chapter 4, “Breakage,” for greater detail and an example.

Sales incentives

“Sales incentives” are offered by vendors to motivate customers to purchase the vendor’s products or services and include rebates, coupons, and other offers for free or discounted products. The timing and the amount of revenue recognition is impacted by sales incentives offered by a vendor to its customers. Rebates or coupons for discounted products offered by vendors to their customers generally indicate that the portion of the purchase price that is subject to a potential refund or rebate is not fixed or determinable at the time of sale.

ASC 605-50, Customer Payments and Incentives, addresses accounting for consideration offered by a company to purchasers of the company’s products. This guidance addresses offers made by a vendor to purchasers of its products at any point along the distribution chain. For example, a manufacturer (vendor) may offer an incentive to an end-user that purchases the vendor’s products through a retailer or distributor (an indirect customer). An example of a sales incentive to an indirect customer is a manufacturer’s coupon offered to a consumer for redemption at a retail store. The guidance states that sales incentives provided to a customer by a vendor are presumed to be reductions of the selling price of the product or service unless certain conditions are met.

ASC 605-50 is applicable to sales of both products and services and applies in situations where the rebate or refund is based on a single purchase, or on the volume of purchases, made by the customer. See chapter 4, “Sales incentives,” for a discussion of sales incentives in greater detail.

A vendor’s offer to a customer, in connection with a current transaction, for free or discounted products or services that the customer may redeem at a future date without a further revenue transaction is a multiple-element transaction that is within the scope of ASC 605-25, Multiple-Element Arrangements. See chapter 6 for a detailed discussion of multiple-element arrangements.
Cooperative advertising
In “cooperative advertising” arrangements, which are within the scope of ASC 605-50, a vendor provides its customer with an advertising allowance (usually determined as a percentage of revenue) if certain criteria are met, including advertising spending requirements. To overcome the presumption that payment of the allowance is a reduction in the selling price, the vendor must demonstrate that (1) an identifiable benefit, separable from the goods or services purchased by the retailer (“customer”), has been or will be received and (2) the fair value of the identifiable benefit can be reasonably estimated.

In some cooperative advertising arrangements, both of these conditions are met, since the advertising can be purchased from a third party and fair value can be estimated by allocating the advertising cost incurred by the retailer based on the portion of the advertisement that includes the vendor’s products. If the fair value allocated is greater than or equal to the amount of the advertising allowance given to the customer by the vendor, then the vendor should characterize all of the allowance as expense as incurred. If the estimate of fair value is less than the advertising allowance, then, as the expense is incurred, the vendor should characterize the allowance amount equal to the fair value estimate as expense and the amount of the allowance exceeding the fair value estimate as a reduction of revenue. See chapter 4, “Cooperative advertising,” for additional discussion on cooperative advertising.

Slotting fees and buydowns
“Slotting fees” are amounts paid or credited to a retailer by a manufacturer or distributor (“vendor”) in exchange for the retailer’s services to stock and display the vendor’s products.

Slotting fees, which fall within the scope of ASC 605-50, generally do not meet the separability criteria as outlined in “Cooperative advertising” above, because the vendor would not make the payment absent the customer’s purchase of its products for resale. Such fees should therefore be accounted for as a reduction of revenue.

In a “buydown” arrangement, a vendor agrees to reimburse a retailer or reseller for shortfalls in the sales price received by the retailer or reseller for the vendor’s products during a particular promotion over a specified period of time. “Shortfalls” occur when the price received by the retailer or reseller is less than the amount paid by the retailer or reseller to the vendor in purchasing the vendor’s products for resale. In contrast to cooperative advertising arrangements, in buydown arrangements the retailer or reseller is not required to incur any expenditure for advertising or other promotional costs. As a result, the vendor does not receive an identifiable benefit for the consideration in a buydown arrangement and the amount is always characterized as a reduction of revenue. See chapter 4, “Slotting fees and buydowns,” for additional discussion of these concepts and an example of slotting fees.
Price-protection features

“Price-protection features” include terms that require a vendor to provide a credit to the buyer, either in cash or as a credit against amounts due to the vendor, for the difference between the price paid by the buyer for the goods and the new price charged by the vendor if the vendor reduces the product’s selling price over a specified period. In these situations, the vendor generally controls the amount to be refunded, and to the extent that the refund amount can be reliably estimated, revenue is recognized net of the allowance for estimated price-protection refunds. If an entity is unable to make a reasonable and reliable estimate of the refund amount, revenue should not be recognized until the uncertainty is resolved.

Price-protection features may also take the form of a guarantee to the buyer (distributor) of a minimum gross margin upon the resale of the vendor’s product. Because the vendor generally does not control the amount of gross margin the buyer receives on resale, revenue should not be recognized until (1) a reasonable and reliable estimate of the price-protection amount can be made or (2) the price-protection period lapses (that is, the product is sold by the distributor to an end customer). Price-protection features should be characterized as a reduction of revenue. See chapter 4, “Price-protection features,” for an example of these concepts.

Collectibility is reasonably assured

The final criterion in evaluating revenue recognition is that collectibility is reasonably assured. After an entity has determined that the first three general criteria for revenue recognition are met, it should assess the collectibility of the arrangement consideration. This assessment can be made by applying many of the same factors used to determine whether a receivable has become a bad debt after a period of time. The customer’s financial condition is an indicator of both its ability to pay and, in turn, whether or not revenue is realizable. If, at the outset of the arrangement, a vendor determines that the collectibility of the revenue amount from the customer is questionable, the vendor should not recognize revenue until it receives the amount due or conditions change so that collectibility is now reasonably assured.

If collectibility is reasonably assured at the outset of an arrangement, but subsequent changes in facts and circumstances indicate collection from the customer is no longer probable, the amount should be recorded as bad debt expense.
Revenue from product sales should be recognized when it has been earned and is realized or realizable in accordance with the broad recognition guidelines in FASB Statement of Financial Accounting Concepts (CON) 5, *Recognition and Measurement in Financial Statements of Business Enterprises*. As outlined in CON 5 and SEC Staff Accounting Bulletin (SAB) 104, *Revenue Recognition*, and discussed in chapter 3, entities should apply the four general principles of revenue recognition, which are listed below, in determining when to recognize revenue from product sales:

- Persuasive evidence of an arrangement exists.
- Delivery has occurred or services have been rendered.
- The seller’s price to the buyer is fixed or determinable.
- Collectibility is reasonably assured.

Product revenue is generally “earned” when the product is delivered to the customer and is “realizable” when (1) the customer has committed to pay and (2) the seller has no doubt regarding the customer’s ability to pay. However, uncertainties may exist in an arrangement that can impact the application of these general principles and, in turn, affect the timing of revenue recognition.
Revenue should not be recognized until the risks and rewards of ownership have passed from the seller to the buyer. Risks of ownership include, but are not limited to, a loss in the value of the goods as a result of a decline in the market value of the goods or technological obsolescence and a loss for lost or damaged goods. Rewards of ownership include the right to use or sell the product and to change or enhance the product, as well as gains resulting from increases in market value. The transfer of the risks and rewards of ownership generally occurs when the product is physically delivered and title transfers to the buyer. However, sometimes the risks and rewards transfer to the buyer even though the seller retains possession of the goods. In other situations, the risks and rewards of ownership may remain with the seller although the buyer has possession of the goods. As a result, it is important to understand the significant terms of each arrangement (see chapter 2).

Persuasive evidence of an arrangement
Persuasive evidence of an arrangement is dictated by an entity’s customary business practices, which vary among entities. In addition, the customary practices of a single entity may vary by the type of customer or by the nature of the product delivered or services rendered. If an entity’s standard practice is for both parties to sign a written contract defining the terms of the arrangement, then persuasive evidence of an arrangement exists only if a written contract is signed by both parties. Entities that do not rely on written contracts may demonstrate evidence of an arrangement through some other means, for example, a binding purchase order or online authorization binding the customer to the terms of the sale. In all cases, revenue recognition is precluded until persuasive evidence of an arrangement is obtained.

The following example illustrates these concepts.

Persuasive evidence of an arrangement
Assume that the customary practice of Entity A is to obtain a written contract executed by both parties for all arrangements. Entity A negotiates with Entity B to sell a standard type of equipment. The equipment that Entity B has been using is out of service and, as a result, Entity B has asked Entity A to deliver the replacement equipment as soon as possible. Entity A ships the equipment (free on board [FOB] shipping point) on September 25 and receives payment from Entity B on September 30. The written contract is signed by an Entity A representative on September 28 and by an Entity B representative on October 5. Because Entity A has a customary practice of obtaining written contracts, persuasive evidence of the arrangement has not been obtained and revenue should not be recognized before October 5.
Side agreements
The existence of side agreements executed after the original agreement may call into question whether the original agreement is final and represents persuasive evidence of an arrangement. A “side agreement” may take the form of a written amendment to the contract or may result from a conversation between representatives of the vendor and the buyer. Side agreements often include provisions such as cancellations, payment term amendments, or other provisions that could impact the recognition of revenue.

Frequently, finance and accounting personnel are unaware of the existence or exact terms of side agreements because sales personnel who execute these agreements sometimes fail to communicate the existence of these amendments to the appropriate finance or accounting personnel. Management should establish appropriate policies, procedures, and internal controls to ensure that all side agreements are identified. Management should also convey to sales personnel the importance of communicating side agreements to individuals with accounting responsibility. Otherwise, revenue may not be recognized appropriately.

Delivery terms
As previously noted, product revenue is generally earned when the product is delivered to the customer because title (risks and rewards of ownership) transfers with the physical goods from the seller to the buyer. “Free on board (FOB) shipping point” indicates that title transfers from the seller to the buyer when the goods are shipped from the seller’s location, whereas “FOB destination” means that title does not transfer to the buyer until the goods reach the destination specified by the buyer.

Delivery terms may be either explicit in a written arrangement or may be implicit based on the seller’s standard practices. For example, an entity has a written arrangement that includes delivery terms of FOB shipping point, but has a standard practice of replacing goods that are lost or damaged in transit. Because the seller’s standard business practice is to replace goods lost or damaged in transit, the risks and rewards of ownership remain with the seller until the goods are delivered to the customer. In this situation, the substantive terms of the arrangement override the written terms of the arrangement and affect the timing of revenue recognition. Entities should analyze the facts and circumstances of a specific situation to determine whether the seller’s standard business practice effectively results in the seller retaining the risks of ownership while the goods are in transit. The seller should consider the following in evaluating when the risk of ownership transfers:

- Has the seller communicated to the buyer, either orally or in writing that the seller will make the buyer whole if the goods are lost or damaged in transit?
- Does the seller’s business practice of making the customer whole if goods are lost or damaged in transit extend to all customers or just to a particular customer?
- Has the seller’s business practice or communications with the buyer created a legal obligation to make the customer whole for goods lost or damaged in transit?
Analyzing the facts and circumstances surrounding a particular situation may require discussions with individuals outside the seller’s accounting department, for example, sales and marketing personnel. Discussions with legal counsel may also be necessary to determine when risk of ownership transfers to the buyer. The seller should defer revenue recognition until risk of ownership transfers from the seller to the buyer based on an analysis of the facts and circumstances of each arrangement and all other revenue recognition criteria are met.

**Bill and hold transactions**

In some situations, a buyer takes title to and agrees to pay for goods but is not ready for the goods to be delivered. In this case, the seller completes the manufacturing of the goods and segregates them in its warehouse so that the products are available for shipment to the buyer but are not available for shipment to fill the orders of other customers. These arrangements are referred to as “bill and hold transactions.” SAB 104 sets forth the following criteria that must all be met in order to recognize revenue in transactions when delivery has not occurred:

- The risks of ownership have passed to the buyer.
- The customer has made a fixed commitment to purchase the goods, preferably in writing.
- The buyer (not the seller) requests the transaction on a bill and hold basis. The buyer must have a substantial business purpose for the request.
- A fixed schedule for delivery of the goods exists, which is both reasonable and consistent with the buyer’s business purpose.
- The seller has no specific performance obligations remaining that indicate the earnings process is not complete.
- The goods are segregated from other inventory and are not available to fill other customers’ orders.
- The product is complete and ready for shipment.

The above list is not intended as a checklist. In some situations, a transaction satisfies all of these factors but may not meet the requirements for revenue recognition. In addition to applying the criteria listed above, the SEC staff believes that a company should also consider the following factors:

- Whether the seller has modified its normal billing and credit terms
- The seller’s historical experiences with bill and hold transactions
- Whether the buyer would bear the risk of loss if the goods decline in market value
- Whether the seller’s custodial function is insurable and insured
- Whether the buyer’s business reasons for the bill and hold arrangement indicate a contingency to the buyer’s commitment to accept and pay for the goods
One of the key criteria to be met is that the buyer, not the seller, must request the transaction on a bill and hold basis and must have a substantial business purpose for this request. Therefore, the fixed schedule for delivery should be in alignment with the buyer’s stated business purpose for the bill and hold nature of the transaction. For example, a highway construction contractor enters into an arrangement with an equipment manufacturer for several large cranes to be used during the upcoming construction season. The buyer has requested that the manufacturer hold the cranes for future delivery. A delivery schedule that is established to coincide with the start of individual highway construction projects that are currently under contract might be aligned with the buyer’s stated business purpose for the bill and hold transaction.

The guidance in SAB 104 related to bill and hold arrangements is based on U.S. GAAP; therefore, we believe it is reasonable for nonpublic companies to apply that guidance, including the criterion for a fixed delivery schedule. The fixed delivery schedule must be reasonable and consistent with the buyer’s stated business purpose. If delivery has not occurred or if no fixed delivery schedule exists, we believe it would be difficult for an entity to conclude that revenue has been earned because the entity’s performance obligation has not been completed.

In a bill and hold arrangement, an entity is providing both a product and warehousing services to the customer. Accordingly, entities should consider the guidance in FASB Accounting Standards Codification™ (ASC) 605-25, Revenue Recognition: Multiple-Element Arrangements, to determine whether the product and the warehousing services are separate units of accounting. If the product cannot be separated from the warehousing services and the warehousing services are more than inconsequential or perfunctory, an entity would not recognize revenue on the product, even if the bill and hold criteria in SAB 104 have been met. Instead, the entity should apply the appropriate revenue recognition method to the entire arrangement.

In practice, we have found that it is difficult for a bill and hold arrangement to meet the criteria for revenue recognition before the goods are delivered.

At the December 2009 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff discussed an example illustrating a bill and hold arrangement in which the seller retained performance obligations and therefore, the arrangement would not qualify for revenue recognition under the bill and hold criteria. In the example, a customer asked the vendor to hold for delivery at a later date certain purchases made under a supply arrangement requiring minimum product purchases. As a result of this request, the vendor decided to maintain the products in an unfinished condition and to defer completion of processing to just prior to shipment because it was considered more cost effective. Based on the fact pattern provided, the SEC staff believes that the effort to process and complete the product when the product has not been delivered to the customer cannot be considered inconsequential or perfunctory. The SEC staff also noted that the concept of “inconsequential or perfunctory” is based on the presumption that the arrangement terms are substantially complete in order to conclude that delivery or performance has occurred.
The SEC staff also provided thoughts on how ASC 605-25 might interact with the bill and hold criteria. The SEC staff cautioned that some may consider an incomplete product as a unit of accounting separate from the manufacturing service necessary to finish the product in an attempt to satisfy the bill and hold criteria of the product being complete. In using this logic, some may allocate arrangement consideration to the incomplete product and recognize revenue when the incomplete product is segregated from other inventory. The SEC staff noted that this interpretation is questionable, since the product held by the vendor should be in the same form that the customer would receive upon delivery — that is, a complete product.

**Layaway sales**

"Layaway sales" generally occur in the retail environment when a customer makes a deposit for goods, but the retailer holds the goods until it receives the final payment from the customer. The goods are set aside, but generally the risks of ownership do not pass to the customer until the goods are delivered. If the inventory is lost or destroyed before delivery to the customer, the retailer must provide a refund of the deposit or replace the inventory. Additionally, under layaway plans, the retailer generally has not established a fixed payment schedule with, or required an installment note from, the customer.

In SAB 104, the SEC staff stated that revenue should not be recognized in a layaway transaction until inventory is delivered to the customer and all other revenue recognition criteria are met. Until the retailer receives the remaining balance of the purchase price and delivers the goods to the customer, it should recognize the cash deposit as a liability under a description such as “deposits received from customers.” Revenue recognition is prohibited before the goods are delivered to the customer because the retailer has retained the risks of ownership and the customer has not made a firm commitment to purchase the inventory. In general, private entities should follow the SEC guidance for layaway sales.

**Consignment sales**

"Consignment sale” arrangements can take a variety of forms, and revenue should not be recognized until title has passed to the consignee, assuming all other revenue recognition criteria are met. In a common consignment arrangement, the seller delivers goods to a customer but retains title to the goods shipped (which means the seller cannot invoice for the goods and has not yet passed the risks and rewards of ownership to the buyer). The terms of the arrangement may stipulate that the consignee will not take title to or pay for the goods until they are sold by the consignee to a third party. In other consignment arrangements, the goods are shipped to the consignee’s warehouse, but title does not pass until either the product is consumed by the consignee in production or a specified amount of time has passed.
Contract terms often identify consignment sales and generally specify that goods are shipped to the buyer, who pays only for what is sold and who may return any unsold product. Other consignment arrangements may apply to inventory parts shipped to a manufacturer, but the manufacturer is not obligated to pay for the parts until they are used in the manufacturing process. Certain other arrangements are in-substance consignment sales or financing arrangements and do not qualify for revenue recognition until a sale occurs even if the contract does not specifically identify it as such.

Numerous in-substance consignment arrangements exist, some of which are described below.

**Arrangements that are in-substance consignment sales**

(1) Manufacturers sell to distributors, but the distributors do not pay for the goods unless and until the goods are resold and the distributors have the right to return any goods not sold to end-users. The sales should be treated as consignment and revenue should not be recognized until the goods are resold.

(2) A distributor is granted broad rights of return, such as the right to return any product that, in the distributor’s opinion, is obsolete, damaged, or otherwise unsaleable.

(3) The formal terms of a contract do not align with a seller’s historical practices (for example, payment terms vary based on a buyer’s ability to sell the product or actual returns exceed amounts estimated by a material amount).

(4) A supplier sells product to a retailer that uses scan-based trading technology that tracks the movement of all products. Suppliers that do business with this retailer are required to participate in a pay-by-scan program. Under this program, the retailer does not take ownership of a supplier’s product until the product is scanned at the register. Consequently, the supplier cannot recognize revenue until the product is sold to the retailer’s customer.

The SEC staff has noted in SAB 104 that the presence of any of the following characteristics in a transaction would prohibit revenue recognition, even if title is transferred to the buyer when the goods are shipped:

- The buyer has the right to return the product and either of the following conditions applies:
  - The buyer does not pay the seller at the time of sale and is either (1) not obligated to pay at a specified date or (2) its obligation to pay is contractually or implicitly excused until the product is resold or consumed.
  - The transaction does not meet all the requirements of ASC 605-15-25-1, *Products*, for recognizing revenue when a right of return exists. Refer to chapter 7 for detailed discussions on right of return provisions.
- The seller is required to repurchase the product at specified prices not subject to change except for fluctuations related to finance and holding costs, and the seller’s payments are adjusted to cover fluctuations in costs the buyer incurs to purchase and hold the product, including interest.
The following are examples of such an arrangement:

– The seller either (1) provides interest-free or significantly below-market financing to the buyer beyond the seller’s customary sales terms until the products are resold or (2) pays interest to a third party on behalf of the buyer.
– The seller will refund a portion of the original sales price representing the interest expense for the buyer’s holding period until the products are resold.

• The product is delivered for demonstration purposes.
• The product is shipped to a warehouse managed by the seller and subsequently shipped to the customer on an as-needed basis.
• The buyer receives credit for unsold products from a prior sale that can be used as payment toward the next purchase.

In these situations, revenue recognition is not appropriate because the risks and rewards of ownership remain with the seller. The above list is not all-inclusive, and judgment is required to determine if the transaction is in substance a consignment, financing, or other transaction for which revenue recognition is not appropriate.

In addition, if title passes in a transaction that is not accounted for as a sale, the seller should report consigned inventory separately from other inventory, for example, under a caption such as “inventory consigned to others.”

The following example illustrates these concepts.

**Consignment sales**

Consider a situation where a small manufacturer or distributor sells goods to a large retailer. Generally, a small manufacturer or distributor has minimal leverage with a large retailer. For example, a retailer often will return products it does not sell even though the contract does not explicitly state that the sale is on consignment. If the manufacturer or distributor is unable to reliably estimate the amount of returns, it should treat the transaction as a consignment arrangement, and should not recognize revenue until the retailer has sold the goods.

**Customer acceptance**

Customer acceptance provisions allow the customer to cancel an arrangement or return a product if the product does not meet its expectations. Customer acceptance provisions may indicate a customer’s right to (1) evaluate the product on a trial basis, (2) require the seller to perform additional services after the product is delivered (including installation or activation services), or (3) identify other services the seller must perform before the customer accepts the product. The SEC staff indicated in SAB 104 that (1) contractual customer acceptance provisions are presumed to be substantive, bargained-for terms in an arrangement and (2) when such customer acceptance provisions exist, revenue should generally not be recognized before the customer accepts the product or the acceptance provisions lapse.
If uncertainty exists about customer acceptance, it is generally not appropriate for a vendor to recognize revenue even if past experience indicates that customer acceptance is likely. Customer acceptance provisions generally take one of the following forms. The specific terms of each customer acceptance provision should be analyzed to determine the appropriate accounting to apply.

- **Acceptance provisions for evaluation or trial purposes.** The customer agrees to receive the product from the seller solely for the purpose of evaluating the product before acceptance. Acceptance occurs either through affirmative acceptance by the customer or when the acceptance provisions lapse and the customer has not taken action to reject the delivered product. These arrangements are frequently considered in-substance consignment arrangements, since title to the product does not transfer to the customer and payment is not required before acceptance (see “Consignment sales” on page 20). As a result, the seller should not recognize revenue before the earlier of product acceptance by the customer or lapse of the acceptance provisions.

- **Acceptance provisions that grant a right of return based on subjective criteria.** For example, the customer has the right to return the product if it is dissatisfied with the product. These provisions are similar to general rights of return and should be accounted for under ASC 605-15. If the seller can reasonably estimate returns using the criteria set forth in ASC 605-15 (as explained in “Right of return” on page 35), revenue may be recognized before the return rights lapse. A large population of homogenous transactions is necessary for a seller to reasonably estimate product returns.

- **Acceptance provisions based on seller-specified objective criteria.** These provisions give the customer the right of return or replacement if the product fails to meet the seller’s published specifications. If the seller demonstrates that the product meets the specified criteria before delivery to the customer, these provisions should be accounted for as warranties in accordance with ASC 450, *Contingencies*. If the seller demonstrates that the product meets the published specifications and that the cost of correcting potentially defective goods can be reliably estimated based on a history of similar transactions, revenue should be recognized on delivery, assuming all other revenue recognition criteria are met. An estimate of the cost of providing the warranty services—that is, correcting or replacing the potentially defective goods—should be accrued when revenue is recognized.
• **Acceptance provisions based on customer-specified objective criteria.** Formal customer sign-off is the best evidence that customer-specified objective acceptance criteria are met. However, if the seller can reliably demonstrate that the product meets the customer-specified criteria before formal customer acceptance (for example, through historical experience with similar customers in similar environments), it may be possible to recognize revenue when title and the risks and rewards of ownership are transferred to the customer if all other revenue recognition criteria have been met. In these situations, the seller must evaluate whether the product performance in the customer’s environment would differ from product performance in the test environment. If the seller is unable to test the customer acceptance criteria before product delivery and installation, the SEC staff believes that revenue recognition should be deferred until the acceptance criteria are met. This could occur if the acceptance criteria require that the product function with the customer’s other equipment and software.

The SEC staff included several examples in SAB 104 to illustrate various aspects of customer acceptance provisions and the appropriate accounting in each situation.

In addition, the following examples illustrate these concepts.

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**Customer acceptance: equipment evaluation**

Entity A enters into an arrangement with Entity D to deliver and install a piece of equipment to be used in Entity D’s manufacturing process. The equipment is a new model designed to accelerate the movement of materials through the manufacturing facility. Entity D has a relatively small manufacturing facility and is unsure if the equipment will effectively operate in its environment. The arrangement terms state that title does not transfer until 60 days after installation. In addition, Entity A will not invoice Entity D for the equipment until 60 days after installation, and payment will be due 30 days after the invoice date.

Since Entity D is accepting the equipment on a trial basis, Entity A should not recognize revenue until the earlier of 1) notification of product acceptance from Entity D, or 2) the expiration of the 60-day trial period, assuming all other revenue recognition criteria are met.
Inconsequential or perfunctory activities

Sometimes a seller substantially fulfills the terms in an arrangement but minimal performance obligations remain. In SAB 104, the SEC staff indicated that revenue for a unit of accounting may be recognized in its entirety if the seller’s remaining obligation is “inconsequential or perfunctory.” SAB 104 includes factors to consider in evaluating whether the remaining performance obligations in an arrangement are inconsequential or perfunctory.

According to the SEC staff, if a remaining performance obligation is essential to the functionality of the delivered products or services, it is not considered inconsequential or perfunctory. In addition, the remaining activities are not considered inconsequential or perfunctory if the customer is entitled to a full or partial refund for the delivered product or services if the entity fails to complete the remaining activities.
According to SAB 104, the following examples indicate that undelivered services are essential to the functionality of the delivered product:

- The services are unavailable from other vendors.
- The services involve (1) building complex interfaces or connections or (2) significantly changing the features or capabilities of the delivered product.

On the other hand, the following examples indicate that the undelivered services are not essential to the functionality of the delivered product:

- The delivered product is standard.
- The services do not significantly alter the product’s capabilities.
- The services are available from other vendors.

If the undelivered service is essential to the functionality of the delivered product, the undelivered service is not inconsequential or perfunctory, and revenue for the entire unit of accounting should be deferred until the seller fulfills the remaining performance obligations. The SEC staff also noted that the following conditions indicate that a remaining obligation is substantive rather than inconsequential or perfunctory:

- The seller lacks a demonstrated history of completing the remaining tasks in a timely manner and reliably estimating their costs.
- The skills or equipment required to complete the remaining activity are specialized or are not readily available in the marketplace.
- The seller’s historical evidence in similar contracts indicates that the cost or time to perform the remaining obligations has varied significantly from one instance to another.
- The fair value of the remaining obligation, or the cost of completing that obligation, is more than insignificant in relation to amounts that can be allocated to the unit of accounting, including such items as the contract fee, gross profit, and operating income.
- There is a lengthy period of time before the remaining obligation is extinguished.

Entities should consider whether reasonably possible variations in the length of time for performance completion affect the certainty that the remaining obligations will be completed successfully and on budget.

- The customer will pay a portion of the sales price simultaneously with the seller’s completion of the remaining activity.

While SAB 104 provides guidance permitting an entity to recognize revenue if the remaining obligation is inconsequential or perfunctory, the concept of recognizing revenue when delivery is substantially complete is not appropriate for arrangements within the scope of ASC 985-605, \textit{Software: Revenue Recognition}, (see “Inconsequential or perfunctory activities” in chapter 8).
**Fixed or determinable fees**

Arrangement fees must be fixed or determinable before revenue is recognized. In SAB 104, the SEC staff notes that fees must be fixed or determinable before revenue recognition, but provides little discussion of the meaning of “fixed or determinable.” According to the SEC staff, the guidance in ASC 985-605-25-30 through 25-40 is appropriate to apply to other revenue transactions where authoritative guidance regarding fixed or determinable fees does not exist. The topics addressed in ASC 985-605-25-30 through 25-40 include variable-pricing arrangements, extended payment terms in arrangements including products that may experience technological obsolescence, reseller arrangements, and customer cancellation provisions.

A variety of other factors exist, whose presence in a product sales arrangement may indicate that the fees are not fixed or determinable. These factors include coupons, rebates, and other sales incentives; right of return provisions; and arrangements with fees subject to change based on the results of future performance. In addition, the evaluation of whether a sales price is fixed or determinable is not an all-or-nothing decision. A portion of the fee may be fixed or determinable at the outset of the arrangement, with the remaining amount becoming fixed or determinable over time or at a future date, depending on the terms of the arrangement.

**Sales incentives**

“Sales incentives” in the form of rebates or coupons for discounted products offered by vendors to their customers generally indicate that the portion of the purchase price that is subject to potential refund or rebate is not fixed or determinable. For this reason, the timing and amount of revenue recognition is impacted by rebates, coupons, and other sales incentives offered by the vendor.

ASC 605-50, *Customer Payments and Incentives*, addresses consideration offered by a company to purchasers of its products at any point along the distribution chain. For example, the manufacturer (vendor) may offer an incentive to an end-user who purchases its products through a retailer or distributor (an indirect customer). ASC 605-50 is applicable to sales of both products and services.

Rebates, coupons, and other sales incentives that are given by a vendor to a customer as cash are presumed to be reductions of the sales price of the product or service unless both of the following stipulations exist:

- In exchange for the consideration, the vendor will receive or has received an identifiable benefit. An “identifiable benefit” is one that the vendor could have purchased from a third party separately from the goods or services provided to the recipient of the consideration.
- The fair value of the benefit can be reasonably estimated.
If this presumption cannot be overcome, the cash consideration should be classified as a reduction of revenue when recognized. If both of the previously stated conditions are met, the cash consideration should be classified as a cost. If the previously stated conditions are met and the estimated fair value of the identifiable benefit is less than the consideration paid, the excess consideration should be classified as a reduction of revenue.

If the consideration is anything other than cash or equity instruments, including free products or services (such as a gift certificate for another vendor’s products or services), the consideration (that is, the free products or services) is deemed to be an element in the transaction rather than a refund or rebate of the price charged to the customer. Accordingly, the cost of the consideration should be classified as expense, and not as a reduction of revenue when recognized in the vendor’s income statement. ASC 605-50 does not provide any guidance on the expense classification; however, the SEC staff believes that amounts incurred for free product(s) or service(s) delivered at the time of sale of another product or service should be classified as cost of sales.

Under the terms of certain arrangements, customers are entitled to a rebate or refund of a specified amount of the purchase price charged to the customer at the point of sale by submitting a rebate form or claim for a refund (for example, mail-in rebates). In other arrangements the rebate or refund offered by the vendor to the customer is only redeemable if the customer remains a customer for a specified period of time or completes a specified cumulative level of revenue transactions. ASC 605-50 provides that the obligation for these rebates or refunds should be recognized with each underlying revenue transaction as the customer makes progress toward earning the rebate or refund. The total rebate or refund obligation should be determined based on an estimate of the number of customers that will earn and claim rebates or refunds under the offer. If a vendor can reasonably estimate “breakage” (the amount related to the number of customers who will not earn and/or claim the rebate or refund), that amount should be considered in the vendor’s calculation of the rebate or refund obligation. If a vendor cannot reasonably estimate breakage, it should recognize the maximum potential amount of future rebates or refunds as a liability.

A vendor’s ability to make reasonable estimates of breakage may be impaired by any one of the following factors:

- The period in which customers may claim a rebate or refund is relatively long.
- The vendor lacks historical experience with similar types of incentive programs involving similar products or is unable to apply historical experience because of changing circumstances.
- The vendor does not have a large volume of homogenous transactions necessary to estimate the amount of breakage.
When is revenue recognized for product sales?

The following examples illustrate these concepts.

**Cash consideration**
Entity A, a manufacturer of cell phones, enters into an arrangement with Retailer B to be the exclusive provider of digital cell phones to the retailer. In connection with the arrangement, Entity A agrees to give Retailer B $1 million on contract signing and Retailer B commits to purchase a minimum of $15 million of the phones.

Entity A does not receive an identifiable benefit for the cash payment, since it would not have made the payment absent the arrangement to sell digital phones to Retailer B. As a result, the payment amount is deemed to be a reduction in the purchase price to be paid by Retailer B and should be characterized as a reduction of revenue when recognized.

**Noncash consideration**
Entity A, a manufacturer of cell phones, enters into an arrangement with Retailer B to be the exclusive provider of digital cell phones to the retailer. In connection with the arrangement, Entity A agrees to give Retailer B 500 free phones on contract signing.

Since the consideration is other than cash, the free phones are deemed to be an element in the arrangement, and Entity A should characterize the cost of the free phones as a cost incurred in the income statement when recognized.

In some situations, the rebate or refund amount is based on the volume of purchases made by the customer. If the rebate or refund is volume-based and the vendor can reasonably estimate the volume of customer purchases eligible for the rebate or refund, a liability would be recognized based on the estimated amount of future rebates or refunds. If the vendor cannot reasonably estimate the volume of future purchases, then it should use the maximum potential rebate or refund to record the liability. A vendor should use a cumulative catch-up adjustment to recognize changes in the estimated amount of rebates or refunds and retroactive increases or decreases in a previous rebate offer. Therefore, the vendor should immediately adjust the balance of the rebate obligation to the revised amount, and revenue on future sales would be reduced based on the revised rate.
The following example illustrates these concepts.

**Volume rebate**

Entity A, a manufacturer of office equipment, enters into a three-year arrangement to distribute paper shredders with Entity B, which is the largest distributor of Entity A’s paper shredders. In connection with the arrangement, Entity A agrees to provide Entity B a volume rebate of 5 percent if annual purchases exceed $5 million and 10 percent if annual purchases exceed $10 million. The rebate will be applied in the form of a credit against outstanding amounts receivable from Entity B in February of each year based on prior-year purchases. In exchange for the volume rebates, Entity B will exclusively purchase all its paper shredders from Entity A.

Since the credits given to Entity B are a form of cash (credit to receivable), and since Entity A will not receive an identifiable benefit from these payments, the amounts would be recorded as a reduction of revenue when recognized. A liability for the rebate should be recognized in connection with each paper shredder sold to Entity B. The amount recognized as a rebate liability would depend on whether Entity A can reasonably estimate the volume of purchases that Entity B will make each year. If Entity A can reasonably estimate that the sales to Entity B will be $6 million during the year, it would record the rebate liability as 5 percent of each paper shredder sold. If Entity A is unable to reasonably estimate the annual volume of paper shredder sales to Entity B, then it would recognize a rebate liability of 10 percent when each paper shredder is sold.

**Negative revenue**

If characterizing payments from a vendor to a customer as a reduction of revenue results in negative revenue on a cumulative basis for that customer, the amount of shortfall should be characterized as an expense. Negative revenue on a cumulative basis should be measured using information from the inception of the relationship between the vendor and the customer. A vendor should not characterize a cash payment made by the vendor to the customer at the inception of the relationship as an expense if a supply arrangement exists between the vendor and the customer that indicates it is probable that future revenue from the relationship with the customer will exceed the consideration paid.

**Consideration given to a third-party manufacturer**

Sometimes customers are required to purchase equipment from a third-party manufacturer or reseller in order to obtain services from a service provider. One such example is satellite radio services. The customer must have a satellite radio in order to receive the satellite radio services. The satellite radio service providers are not the manufacturers of the satellite radios.

In certain of these situations a service provider gives consideration to a third-party manufacturer or reseller (that is, not a customer of the service provider) to reduce the price the service provider’s customer has to pay for the equipment, thereby helping to increase the demand for the service provider’s service.
ASC 605-50-25-13 through 25-17, provides guidance on the accounting for these transactions and states that if a contractual linkage exists between (a) the consideration given by a service provider to a manufacturer or reseller (that is, not a customer of the service provider) of equipment that is necessary for an end-customer to receive service from the service provider and (b) the benefit received by the service provider’s customer, the service provider should use the guidance in ASC 605-50-45-2 through 45-3 to determine the characterization of the consideration.

Consideration given to a third-party manufacturer or reseller that is not a customer of the service provider should be accounted for based on the form of consideration directed by the service provider to be provided to its customer (that is, whether it is “cash” or “other than cash,” as defined in ASC 605-50-20). If the service provider does not control the form of consideration provided to its customer, the consideration would be characterized as other than cash for purposes of applying ASC 605-50-45-2 through 45-3. Consideration paid by a service provider that results in its customer receiving a reduced price on equipment purchased from a manufacturer or reseller should be characterized as other than cash.

The following examples illustrate these concepts.

### Consideration given by a service provider to a manufacturer: cash
To receive the services provided by Service Provider A, customers must acquire a specialized type of equipment produced and sold by a variety of third-party manufacturers. Service Provider A agrees to give a $100 incentive to Manufacturer B for each unit produced if customers purchasing the specialized equipment from Manufacturer B contract for services from Service Provider A. The arrangement between Service Provider A and Manufacturer B stipulates that the incentive must be offered to the end-customer in the form of a rebate honored by Manufacturer B.

Since Service Provider A has directed that the consideration given to its customer be in the form of cash (a rebate), it would characterize this incentive as “cash” for purposes of applying ASC 605-50-45-2 through 45-3. Service Provider A must characterize the cash incentive as a reduction of revenue.

### Consideration given by a service provider to a manufacturer: other than cash
Assume the same facts in the example above, except that the arrangement between Service Provider A and Manufacturer B stipulates that the incentive must be passed on to the end-customer in the form of a price reduction.

Because Service Provider A has directed that the incentive passed on to its customer be in the form of a price reduction, Service Provider A would characterize the incentive payment to Manufacturer B as “other than cash” for purposes of applying ASC 605-50-45-2 through 45-3. Under ASC 605-50-45-3, Service Provider A must characterize other than cash consideration as expense in the income statement.
Cooperative advertising
In “cooperative advertising” arrangements, a vendor provides its customer with an advertising allowance, usually determined as a percentage of revenue, if certain criteria are met, including advertising spending requirements. These arrangements fall within the scope of ASC 605-50, and the vendor must demonstrate that (1) it has received or will receive an identifiable benefit, separable from the goods or services purchased by the retailer (“customer”), and (2) it can reasonably estimate the fair value of the identifiable benefit to overcome the presumption that the payment is a reduction in the selling price.

Cooperative advertising programs have to be carefully evaluated to determine whether the separability aspect in the first criterion above is met. The cooperative advertising program should specify the terms of the arrangement in sufficient detail (that is, the qualitative advertising criteria and the documentation requirements) for the vendor to determine whether an identifiable benefit has been received. A retailer must maintain documentation of all advertising performed that includes the vendor’s products and must provide that documentation to the vendor. A vendor should review the retailer’s documentation to determine whether (1) the advertising meets the criteria specified in the arrangement and (2) the benefit received is sufficiently separable from the retailer’s purchase of the vendor’s products that the vendor could have purchased that advertising from another party that does not purchase its products.

If a vendor can conclude that it has received or will receive an identifiable benefit separable from the goods or services purchased by the retailer (customer), it must then determine whether it can reasonably estimate the fair value of that benefit. If a vendor is unable to reasonably estimate the fair value of the benefit, the presumption that the consideration paid to the retailer is a reduction of the selling prices of the vendor’s products has not been overcome. Generally, in order for the vendor to reasonably estimate the fair value of the benefit of the advertising, the arrangement with the customer must include sufficient specificity as to volume and type of advertising that must be purchased by the customer to qualify for the vendor allowance. The vendor may then estimate fair value either (1) through an allocation of the advertising cost incurred by the retailer for the portion of advertising that includes the vendor’s products or (2) based on the price that would be charged by a third-party advertising entity for the type and volume of advertising specified in the arrangement.
If both the criteria for separability and for estimating fair value are met, the vendor should recognize the advertising allowance paid to the customer as a cost incurred as long as the allowance does not exceed the estimated fair value of the advertising services. If the fair value estimate is less than the advertising allowance, then the allowance amount equal to that estimate should be characterized as expense, and the amount by which the allowance exceeds that estimate should be characterized as a reduction of revenue as incurred.

The following example illustrates these concepts.

**Cooperative advertising**

Entity A is a manufacturer of gardening equipment that is distributed through a variety of retail stores. Entity A enters into a cooperative advertising arrangement with Retailer B, a large national retail chain. The terms of the arrangement require Entity A to provide Retailer B with an advertising allowance of up to 2.5 percent of Retailer B’s total purchases from Entity A if the amounts are spent on advertising and if certain qualitative criteria are met. Retailer B must devote a specified amount of space to pictures and descriptions of Entity A’s products in local newspaper advertisements, and the advertising cost allocated to the space devoted to Entity A’s products must equal or exceed the 2.5 percent allowance. Retailer B must also maintain and make available to Entity A personnel documentation of the advertising provided, including copies of the ads and evidence of the cost allocated to space devoted to Entity A’s products.

Entity A receives an identifiable benefit in the form of space devoted to advertising its products, and the benefit is separable from the purchase of its products since Entity A can purchase advertising from a third party. Entity A would determine the fair value of the benefit received by referring to the price that would be charged by a third party for an equivalent amount of advertising space devoted to Entity A’s products. If the amount of the benefit equals or exceeds the 2.5 percent allowance, the allowance should be characterized as expense when recognized in Entity A’s income statement.

**Slotting fees and buydowns**

“Slotting fees” are amounts paid or credited to a retailer by a manufacturer or distributor (vendor) in exchange for the retailer stocking and displaying the vendor’s products. Vendors may pay amounts for slotting fees in one of three ways:

- Before the vendor sells any of the related products
- On a regular schedule, such as monthly or quarterly, to maintain shelf space
- Periodically, as negotiated (that is, not on a regular schedule, but each payment is separately negotiated)

The accounting for slotting fees falls within the guidance of ASC 605-50, which states that slotting fees generally do not meet its separability criteria such that the vendor is provided with an identifiable benefit, separable from the goods or services sold to the retailer, for which the fair value can be reasonably estimated. The fees, therefore, must be accounted for as a reduction of revenue (ASC 605-50-45-2 through 45-4).
The following example illustrates these concepts.

**Slotting fees**
Entity A is a manufacturer of beach toys. With the summer season approaching, Entity A agrees to pay Retailer B $100,000 to prominently display its new line of beach toys in Retailer B’s stores between June 1 and August 31.

The slotting fee payment to Retailer B would be evaluated under the sales incentive model of ASC 605-50 to determine if it can be accounted for as something other than a sales-price reduction. Entity A would not enter into such an arrangement with a party other than a reseller of its products. Because any benefit received by Entity A from the prominent display of its products cannot be separated from the product sales arrangement with Retailer B, Entity A should recognize the slotting fees as a reduction of revenue.

In a “buydown” arrangement, a vendor agrees to reimburse a retailer or reseller for shortfalls in the sales price received by the retailer for the vendor’s products during a particular promotion over a specified period of time. In exchange, the retailer agrees to run a promotion for the product in the form of a rebate, a reduced selling price, or other discount. In contrast to cooperative advertising arrangements, the retailer is not required to incur any expenditure for advertising or other promotional costs in a buydown arrangement. As a result, in a buydown arrangement, the vendor generally does not receive an identifiable benefit for the consideration that is separable from the product sale to the retailer, and the amount is characterized as a reduction of revenue (ASC 605-50-45-4).

**Price-protection features**
“Price-protection features” include arrangement terms that require a vendor to provide a buyer with either cash or a credit against amounts due to the vendor for the difference between the product price paid by the buyer and a new lower sales price charged by the vendor during a specified period of time. In these situations, the vendor generally can control the amount to be refunded. To the extent that the amount of refund can be reliably estimated, revenue should be recognized, net of the allowance for estimated price-protection refunds, assuming all other revenue recognition criteria are met. If an entity is unable to make a reasonable and reliable estimate of the refund amount, revenue should not be recognized until the uncertainty is resolved.

Price-protection features may also take the form of a guarantee that the buyer will receive a minimum gross margin upon the resale of the product. Because the vendor generally does not control the amount of gross margin the buyer receives upon product resale, the vendor should not recognize revenue until (1) a reasonable and reliable estimate of the refund can be made or (2) the price-protection period lapses (that is, the product is sold by the distributor to an end-customer). Price-protection features should be characterized as a reduction of revenue.
The following example illustrates these concepts.

**Price-protection provision**
Manufacturer A enters into an arrangement to sell computer monitors to Distributor B for $100 each. Under the arrangement’s price-protection provision, Manufacturer A will provide Distributor B with a credit against its receivable if Manufacturer A decreases its selling price of the monitors during the 30 days immediately following the date of the arrangement with Distributor B. The credit to be provided by Manufacturer A is equal to the difference between the amount paid by Distributor B—that is, $100 per monitor—and Manufacturer A’s new selling price. Based on recent selling prices and the current market, Manufacturer A does not believe the selling price will decrease below $95 per monitor during the next 30 days. As a result, Manufacturer A believes that a reasonable and reliable estimate of the maximum refund is $5 per monitor.

Therefore, Manufacturer A should recognize revenue of $95 and a price-protection allowance of $5 for each monitor at the time of shipment, assuming all other revenue recognition criteria are met. If Manufacturer A cannot reasonably and reliably estimate the price-protection exposure, all revenue must be deferred until either an estimate can be made or until the 30 day price-protection period lapses.

**Right of return**
Right-of-return provisions included in an arrangement should be carefully analyzed to appropriately evaluate their impact on revenue recognition. Rights of return may be either general (available to all customers) or customer-specific. Customer-specific return provisions provide a customer the right to a refund for amounts paid for a delivered product or service or another concession if the vendor fails to deliver any product or service remaining in the arrangement. The accounting for specific return provisions is addressed under the heading “Contingent income” on page 37. A general right of return exists in many product sales arrangements and allows the customer to return the product for a cash refund, a credit, or an exchange for another product. ASC 605-15 addresses accounting for general rights of return and states that revenue should be recognized, net of an allowance for estimated returns, at the time of sale if certain conditions are met, including all of the following:

- At the date of sale, the price is fixed or determinable.
- The buyer’s obligation to pay is not dependent on resale of the goods.
- The buyer holds the risk of loss of market value due to damage, theft, or destruction.
- The buyer has economic substance apart from the seller.
- The seller does not have a significant obligation to bring about resale of the goods.
- The seller can reasonably estimate the amount of returns.
Entities should consider many factors in evaluating whether a reasonable estimate of returns can be made; however, the existence of a large volume of homogenous transactions with the same or similar products can provide the historical experience necessary to reasonably estimate the amount of returns. Other factors to consider include the following:

- Historical experience is based on a stable business environment (changing circumstances could render an entity’s historical experience irrelevant).
- The length of time during which the product may be returned is not long.
- The product is not susceptible to technological obsolescence or other external factors.

The absence of one or more of these factors may indicate that an entity is unable to reasonably estimate returns. The SEC staff has indicated that there is no specific minimum length of time necessary to be able to estimate returns in product transactions. Rather, an entity should carefully evaluate the facts and circumstances of each situation to determine if a reasonable and reliable estimate of returns can be made. The SEC staff noted that entities that either introduce a new product or enter a new market are frequently unable to initially develop the necessary historical return experience on which to base estimates of returns. In addition, if an entity sells a wide range of products that do not have similar levels of returns, it should develop a separate estimate of returns for each product, rather than developing one estimate for all products on a combined basis.

If an entity is unable to reasonably estimate returns, it should defer revenue until (1) it can reasonably estimate returns or (2) the return period lapses. Both the revenue and cost of sales related to the products subject to return should be eliminated in the current period. It is not appropriate for a vendor to eliminate only the gross profit related to the sales subject to return.

If an entity can reasonably estimate returns, it should record an allowance for estimated returns as a reduction of revenue related to the transaction.
The following examples illustrate these concepts.

**Right of return: ability to estimate returns**
Entity A is a manufacturer and distributor of running apparel and shoes. Entity A distributes its products through national and local retail stores and has determined, based on historical experience, that it has four transaction pools for estimating returns (national – apparel, 6 percent; local – apparel, 7 percent; national – shoes, 5 percent; and local – shoes, 7 percent). On April 12, 20X0, Entity A enters into an arrangement with Local Retailer B to sell 50 pairs of running shoes at $50 per pair and 50 sets of running shorts and shirts at $40 per set. The merchandise is shipped FOB shipping point on April 30, 20X0, and the payment terms are net 30 days. Returns, if any, must be made within 120 days.

Revenue should be recognized net of an allowance for estimated returns at the time of sale because (1) the price of the goods is fixed at the date of sale, (2) Entity A has no further obligation with regard to the resale of the goods, (3) Local Retailer B’s payment to Entity A is not dependent upon resale of the goods, and (4) Entity A can reliably estimate the amount of returns based on a large pool of similar historical transactions. Entity A would record an allowance based on the estimated returns for the local retail pools at the time revenue is recognized ($175 [7 percent of $2,500] for shoes and $140 [7 percent of $2,000] for apparel).

**Right of return: no ability to estimate returns**
Entity A is a manufacturer and distributor of running apparel and shoes. Entity A has historically distributed its products only through national retail stores. In 20X0, Entity A expands distribution to include various local retailers as well. On March 22, 20X0, Entity A enters into an arrangement with Local Retailer D for the sale of 50 pairs of running shoes at $50 per pair and 50 sets of running shorts and shirts at $40 per set. The merchandise is shipped FOB shipping point on April 1, 20X0, and the payment terms are net 30 days. Returns, if any, must be made within 120 days of the date of shipment.

Since the local retailer is a new type of customer, Entity A cannot use historical information relating to transactions with national retail stores to estimate returns from Local Retailer D. Because Entity A cannot estimate returns from Local Retailer D, it would defer all revenue related to the sale until the return period lapses on July 30, 20X0.

**Contingent income**
Arrangements with contingent income provisions may take several forms. In some arrangements, revenue amounts allocated to a delivered element may be contingent on delivery of an undelivered element. A vendor should not recognize revenue for contingent amounts until the contingency has been resolved, even if payment has been received for the delivered item.

In other arrangements, payments are contingent on meeting a specified target at the end of a specified period (performance bonuses). These contingent amounts become fixed or determinable on final measurement when the specified period ends. A vendor should not recognize revenue for these contingent amounts before final measurement.
The following example illustrates these concepts.

### Contingent income

On September 15, 20X0, Entity A, a lighting manufacturer, enters into an arrangement with Retailer B, a national grocery chain, to sell fluorescent light bulbs for use in Retailer B's stores. The agreement stipulates that Entity A will be the exclusive supplier of fluorescent bulbs to Retailer B for three years. The terms of the arrangement include a provision that Entity A will receive a $200,000 bonus each year if the failure rate for light bulbs purchased during the year is below 0.5 percent. That bonus, if any, will be determined six months after each anniversary date of the arrangement.

Since the bonus amount, if any, is not determined until six months after the contract's anniversary date, the first measurement date would be March 15, 20X2. As a result, Entity A would not recognize the bonus amount, if any, until the March 15 measurement date each year.

### Breakage

Certain arrangements require the customer to make an up-front, nonrefundable payment for future vendor performance. The amount of that payment is recorded as deferred revenue, since the vendor has not yet completed performance as stipulated by the terms of the arrangement. In some circumstances, the customer does not demand full performance for the payment. Examples include gift card purchases and up-front payments for professional services (such as legal services), both of which, for various reasons, are not always fully redeemed. The difference between (1) the amount paid and (2) the dollar value of performance ultimately received by the customer is referred to as “breakage.” Recognition of breakage may be a problem in many states due to state escheat (unclaimed property) laws.

When a gift card is sold, a retailer records both an asset for the cash received and a liability for the obligation to provide goods or services in the future. When the gift card holder uses the gift card to purchase goods or services, the liability is reduced and revenue is recognized, as long as all revenue recognition criteria are met. Immediate recognition of breakage at the time a gift card is sold is unacceptable, because the retailer has not yet delivered the goods or services under the arrangement.

Accounting for breakage can be challenging, especially in situations where the obligation to perform does not lapse or there is no expiration date, such as with certain gift cards. Historically, companies have applied a variety of models to account for breakage. In one such model, companies would estimate and recognize the amount of breakage at the time of sale, with the remaining amount recorded as a liability (deferred revenue). However, the SEC staff has indicated that this approach of immediately recognizing breakage is not appropriate since the vendor has not yet performed under the arrangement.
There are a couple of acceptable models for recognizing breakage. Breakage may be recognized when the vendor is released from its legal obligation to perform (on redemption or expiration) in accordance with ASC 405-20-40-1, *Liabilities: Extinguishments of Liabilities*, or when the demand for future performance is deemed remote and the vendor can reasonably estimate the amount of breakage. To demonstrate that the demand for future performance is remote, an entity must have a large population of homogenous transactions to obtain objective and reliable historical evidence to support the estimated amount of breakage. Even if a vendor has sufficient historical information to assert that the demand for future performance is remote and to reasonably estimate breakage, it is generally not appropriate to immediately recognize that amount in revenue; rather, the amount of breakage should be recognized in proportion to a vendor’s performance or delivery.

A vendor would be able to recognize breakage in proportion to its performance or delivery only if all of the following conditions are met:

- There is only a remote likelihood that the customer will require full performance.
- There is a large population of homogenous transactions for which historical redemption patterns exist.
- The amount of breakage can be reasonably and objectively determined.
- The estimated time period of vendor performance can be reasonably and objectively determined.

We believe that a vendor should disclose its policy for recognizing breakage and the significant estimates used in the financial statements. Such disclosures should include:

- The point at which breakage is recognized or over what period
- Consideration of state escheat laws
- The line item in the income statement where breakage is recorded

The following example illustrates these concepts.

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**Breakage**

Entity A sells $1,000 in gift cards in December 20X0. The gift cards have no expiration date, but Entity A estimates that they will be redeemed over the next 24 months. Breakage is estimated at 10 percent based on historical experience. As a result, estimated breakage of $100 would be recognized over the 24-month redemption period. The SEC staff has commented that this approach is acceptable only if an entity can reasonably and objectively estimate both (1) the amount of gift card breakage and (2) the period of actual gift card redemption.


Collectibility is reasonably assured

The final criterion in evaluating revenue recognition requires that collectibility is reasonably assured, which is assessed only after it has been determined that the first three general criteria are met. Product revenue is generally earned when delivery of the product or services to the customer has occurred and the customer has committed to pay the seller. However, the seller must have no doubts regarding the customer’s ability to pay in order for the revenue to be considered realizable.

The assessment of collectibility can be made by applying many of the same factors that are applied in determining whether a receivable has become a bad debt after a period of time. For instance, a customer’s financial condition is one indication of a customer’s ability to pay and, in turn, of the realizability of revenue. If a seller determines at the outset of the arrangement that the collectibility of the revenue from the buyer is questionable, revenue should not be recognized until either the seller receives payment or the conditions change such that the collectibility of the amount is reasonably assured.

Payment terms

Payment terms could indicate whether an arrangement with a buyer represents a consignment or a financing transaction, particularly if the seller’s normal terms are modified. If an arrangement is considered a consignment or a financing transaction, collectibility may not be reasonably assured at the arrangement’s inception. In determining whether a sale is a consignment or a financing transaction, a vendor should consider whether the buyer can pay for the goods absent the resale of the goods; for example, sales that are made to field representatives who lack the ability to pay for such goods before resale should be accounted for as consignments. Revenue should not be recognized until the goods are sold to the end-user and all other revenue recognition criteria are met.

Extended payment terms in an arrangement could also indicate that collectibility of the fee is not reasonably assured, and as a result, revenue should not be recorded at the inception of the arrangement. In these situations, entities should not record revenue and bad debt expense because the revenue recognition criteria were never met. If collectibility is not reasonably assured at the outset of the arrangement, revenue should not be recognized until the earlier of when (1) fees are collected or (2) collectibility is reasonably assured.

Subsequent change in collectibility

If collectibility is reasonably assured at the outset of an arrangement but a subsequent change in facts and circumstances indicates that collectibility of the unpaid amounts is no longer probable, the amounts should be recorded as bad debt expense. ASC 450 provides guidance with respect to determining whether it is probable that amounts will not be collected.
What is the accounting for service transactions?

Arrangements requiring a vendor to provide services often present unique accounting issues compared to arrangements solely requiring the delivery of products. As with all types of arrangements, it is important to first identify the elements to be delivered, both service and nonservice elements, in the arrangement before determining which accounting literature to apply. In arrangements requiring both the delivery of products and the performance of services, a vendor should evaluate the different elements called for in the contract to determine if they can be separated for accounting purposes. These multiple-element arrangements are discussed more fully in chapter 6.

Entities should apply to service transactions the general principles of revenue recognition outlined in FASB Statement of Financial Accounting Concepts (CON) 5, Recognition and Measurement in Financial Statements of Business Enterprises, and SEC Staff Accounting Bulletin (SAB) 104, Revenue Recognition. SAB 104 requires entities to meet the following criteria in satisfying the principles of CON 5, which stipulate that revenue must be earned and either realized or realizable before it can be recognized:

- Persuasive evidence of an arrangement exists.
- Delivery has occurred or services have been rendered.
- The seller’s price to the buyer is fixed or determinable.
- Collectibility is reasonably assured.
Persuasive evidence of an arrangement
As in other types of arrangements, the criterion requiring the existence of persuasive evidence of an arrangement in a service transaction is intended to ensure that the understanding between the parties to the arrangement is finalized, including all specific terms and obligations, before revenue is recognized. If the understanding between the parties is not final, the service provider may be unable to determine the proper accounting for the arrangement.

The type of support needed to demonstrate the existence of persuasive evidence of an arrangement is dictated by the service provider’s customary business practices and may vary among entities. In addition, the customary practice of a single service provider may vary by the type of customer or by the nature of the services being performed. An entity should establish and document its policies related to obtaining and demonstrating persuasive evidence of an arrangement.

Side agreements may occur in service arrangements as they do in product sales arrangements and can take many forms, including, but not limited to, written amendments signed by all parties to the arrangement as well as oral commitments made between individuals representing the separate parties. The existence of side agreements may indicate that persuasive evidence of an arrangement did not exist before the side agreement was executed.

Fixed or determinable fees and collectibility
Fees in service arrangements must be fixed or determinable, and the collectibility of fees must be reasonably assured, before revenue can be recognized.

Evaluating collectibility in a service arrangement is similar to evaluating collectibility in a product sale transaction. The assessment is made by applying many of the same factors used in determining whether a receivable has become a bad debt after a period of time. If a service provider determines at the arrangement’s inception that the collectibility of revenue from the customer is questionable, revenue should not be recognized until the amount is received or the conditions change so that the collectibility of the amount is reasonably assured.

If collectibility is reasonably assured at the inception of the arrangement, but a subsequent change in facts and circumstances indicates it is no longer probable, the amounts owed by the customer should be recorded as bad debt expense. FASB Accounting Standards Codification™ (ASC) 450, Contingencies, provides guidance with respect to determining whether it is probable that amounts will be collected.

As with product sales, entities should evaluate the facts and circumstances of each specific arrangement to determine whether fees are fixed or determinable. There are many factors to consider, including, among others, the presence of cancellation provisions, contingent income clauses, and extended payment terms.
Cancellation provisions

Customer cancellation or termination provisions may indicate that a service transaction is incomplete. In service arrangements that can be canceled by the customer, the sales price is neither fixed nor determinable, and revenue should not be recognized until the cancellation privileges lapse. Revenue from arrangements with cancellation provisions that expire ratably over a period of time (such as the contractual term) should be recognized as the fees become determinable (over the stated term).

In SAB 104, the SEC staff illustrated its position on cancellation provisions using an arrangement involving a membership fee for a discount retailer paid in full at the beginning of the arrangement. The customer retains the unilateral right to terminate the membership at any time during the term and, on cancellation, is entitled to a full refund. Because of the customer’s unilateral right to cancel the arrangement and receive a full refund, the SEC staff believes that the price is not fixed or determinable and that revenue should not be recognized until the refund privilege expires. Even if a unilateral right to cancel the arrangement does not exist, the obligation to perform services (in this example, making available and offering products for sale at discounted prices to the member) remains unfulfilled at the outset of the arrangement, and the earnings process is not complete. In the staff’s view, revenue should not be recognized based on an assessment of the probability that significant, but unfulfilled, terms of an arrangement will be fulfilled in the future.

If an arrangement entitles a customer to (1) the seller’s substantial performance under an arrangement and (2) a cash refund of prepaid fees, then the prepaid amount should be recorded as a monetary liability and should be derecognized only if the criteria of ASC 405-20-40-1, Liabilities: Extinguishment of Liabilities are met. However, the SEC staff has acknowledged that there is another view that has evolved over time regarding the accounting for an arrangement with customer cancellation privileges, which is based on analogy to ASC 605-15, Revenue Recognition: Products. Although the scope of ASC 605-15 explicitly excludes service arrangements with customer cancellation privileges (ASC 605-15-15-3), some believe that revenue from membership fees, net of estimated refunds, may be recognized ratably over the contract period if the requirements of ASC 605-15 are met. Therefore, until the FASB provides additional guidance, the staff will not object if registrants use this method to recognize revenue on refundable membership fees, but only if all of the following criteria are met:

- The service provider can estimate terminations or cancellations and refunds for a large pool of homogenous items.
- The service provider can reliably estimate expected refunds in a timely manner. An estimate would not be reliable unless it is remote that future material adjustments to revenue, both individually and in the aggregate, would be required. In addition, either of the following conditions would indicate an inability to make reliable estimates:
  - Recurring, significant differences between estimated and actual cancellation or termination rates, even if the effect on the amount of estimated refunds is not material to the consolidated financial statements.
Recurring variances between estimated and actual refunds that are material to either revenue or net income in quarterly or annual financial statements

- Estimated refunds are based on sufficient entity-specific historical information that is expected to be predictive of future events.
- The membership fee is fixed at the outset of the arrangement, other than for the customer’s right to request a refund.

In addition, the SEC staff indicates in SAB 104 that it generally expects an entity introducing a new service to have at least two years of experience to be able to make a reasonable and reliable estimate of cancellations. If a service provider recognizes revenue over the membership period based on the preceding criteria, it should record the portion of the fee representing estimated refunds in a monetary liability account, such as “Customers’ Refundable Fees,” and the remaining deferred fee should be recorded in a nonmonetary liability account, such as “Unearned Revenues.” See chapter 12 for disclosure requirements.

**Contingent income**

Arrangements with contingent income provisions can take several forms. In some arrangements, revenue amounts allocated to a delivered element may be contingent on delivery of an undelivered element. A vendor should not recognize revenue for contingent amounts until the contingency is resolved, even if payment has been received for the delivered item.

In other arrangements, payments are contingent upon the vendor meeting a specified target at the end of a specified period (performance bonuses). These amounts become fixed or determinable, and should be recognized as revenue, on final measurement when the specified period ends.

The following example illustrates these concepts.

**Contingent income**

On September 23, 20X0, Entity A enters into an arrangement with Entity B to provide marketing services related to the launch of new product X. Under the terms of the arrangement, Entity A will receive a nonrefundable payment of $500,000 from Entity B on contract signing and will also receive 0.5 percent of gross revenue related to product X sales in the United States during the promotional period, as defined. In exchange for the consideration, Entity A will develop and implement a marketing promotion to launch the new product in the United States. Entity A is required to complete the marketing promotion development by December 15, 20X0 for the official product launch, and the promotional period will run through March 15, 20X1.

The nonrefundable payment of $500,000 is for services that Entity A will provide in developing and implementing the marketing promotion. Therefore, the $500,000 is deferred on receipt and recognized as revenue as the services are provided. The amounts to be received by Entity A based on Entity B’s sales of product X are considered contingent revenue and will become fixed or determinable as the sales occur during the marketing promotion period.
Extended payment terms

If a service arrangement contains extended payment terms, entities should analyze the facts and circumstances to determine the impact, if any, on revenue recognition. Generally, U.S. GAAP does not provide guidance on accounting for extended payment terms, except for ASC 985-605, Software: Revenue Recognition, which explains how these terms relate to software arrangements. However, extended payment terms may impact whether (1) the arrangement fee is fixed or determinable and (2) collectibility is reasonably assured.

The longer a customer has to pay for delivered services, the greater the likelihood that the service provider will offer additional products or services to entice the customer to pay the remaining balance, even if the customer is creditworthy. Therefore, the service provider should evaluate the payment terms as well as other terms in the arrangement, including customer acceptance provisions, refund rights, and warranty provisions, to determine if the presence of extended payment terms affects whether or not the fee is fixed or determinable at the arrangement’s inception. Revenue should not be recognized before an entity concludes that the fee is fixed or determinable.

Sometimes, extended payment terms indicate that collectibility of the fee is not reasonably assured, and as a result, revenue should not be recorded at the inception of the arrangement. In these situations, entities should not record revenue and bad debt expense because the revenue recognition criteria were never met. If collectibility is not reasonably assured at the outset of the arrangement, revenue should not be recognized until the earlier of when (1) fees are collected or (2) collectibility is reasonably assured.

Services rendered (delivery)

Revenue from service transactions should be recognized when it is earned, which is generally as the services are performed or when they are completed. Arrangement terms in service transactions often vary, from requiring the service provider to perform a single act at a point in time, to requiring multiple acts performed over a period of time. In some arrangements, the pattern of service delivery is clear, but in others, it is not easy to determine when delivery occurs.

If the arrangement requires the performance of only one act of service at a single point in time, the revenue recognition model is generally straightforward. Revenue is recognized using the “specific performance method” when the service is performed. Examples include having your car washed or having a plumber change a faucet in your home.

If more than one act of service is performed, it is more difficult to determine the pattern of performance and, in turn, which revenue recognition model to apply. To evaluate the pattern of delivery or performance, it is necessary for a service provider to understand its obligations. If the arrangement requires the performance of more than one act of service performed over time, it may be appropriate to apply the “proportional performance method.” The proportional performance method results in revenue being recognized as the service is performed.
If a customer does not receive any value from the service until it is completed, then the “completed performance method” may be the most appropriate revenue recognition model to apply. Under the completed performance method, revenue is recognized when the final act is completed.

Entities must carefully analyze the facts and circumstances of the service arrangement to determine which revenue recognition model—specific performance, proportional performance, or completed performance—should be applied. Each of these three methods is discussed further under separate headings later in this chapter.

Some companies have accounted for service transactions using the percentage-of-completion method under ASC 605-35, Construction-Type and Production-Type Contracts. On several occasions, the SEC staff has expressed that ASC 605-35 does not apply to service contracts other than to separate contracts for services that are essential to the construction and/or production of tangible property, such as architectural and engineering design contracts. Therefore, the percentage-of-completion method for revenue recognition should not be applied to service contracts that are outside the scope of ASC 605-35.

**Nonrefundable up-front fees**

Some arrangements require customers to pay an up-front, nonrefundable fee to a service provider to enter into an arrangement. Take, for example, a nonrefundable activation fee charged by a mobile phone service provider in connection with an arrangement to provide monthly mobile phone services. The monthly usage fee paid by the customer covers the operating costs of the mobile phone service provider. The up-front fee may or may not result in revenue recognition by the service provider, depending on whether the fee is received in exchange for services that represent an element with stand-alone value. If services providing value to the customer on a stand-alone basis are not performed in connection with the up-front fee, the arrangement is considered a single unit of accounting and the up-front fee should be deferred.

Entities must analyze the facts and circumstances of each arrangement to determine if the service conveyed in conjunction with the nonrefundable fee is useful to the customer separate from the entity’s performance of other elements in the arrangement. Often, a customer must purchase ongoing services to receive the benefit from the up-front payment, such as the mobile phone activation fee noted above. In SAB 104, the SEC staff noted that the earnings process in these arrangements is completed by performing services under the terms of the arrangements, not by originating the arrangement. In the example above, the customer likely entered into the arrangement to receive the monthly mobile phone services, and activating the mobile phone service without providing monthly services offers no separate benefit to the customer. In this situation, the up-front fee should be deferred.
The SEC staff noted in SAB 104 that up-front fees are earned (and related revenue is recognized) as the services are delivered either over the term of the arrangement or the expected period of performance. The expected period of performance may extend beyond the initial contract term if the customer subsequently renews the service for an additional period. As a result, entities receiving up-front fees for initial services that are not separable from the ongoing services under the arrangement should evaluate the estimated customer relationship period to determine the period during which the up-front fees are earned. The up-front fees should generally be recognized ratably over the period earned, that is, the longer of either the contractual term or the estimated customer relationship period.

In SAB 104, the SEC staff has indicated that even in situations where the service provider’s ongoing obligation involves minimal or no effort or cost, revenue should be recognized over time as the services are provided. According to the staff, the substance of this transaction indicates that the customer is paying for a service that is delivered over time. Revenue recognition should therefore follow the pattern of service delivery.

Sometimes the service provider incurs substantive costs in performing an initial activity to prepare the customer to receive the ongoing services under the arrangement. Companies have wondered whether it is appropriate to recognize revenue up to the amount of incremental direct costs incurred in the activation process. The SEC staff has indicated that it would generally not be appropriate to recognize revenue to the extent of incremental direct costs incurred, because no separable earnings event has occurred. The only time when it may be appropriate to recognize revenue to the extent of incremental direct costs is when authoritative literature specifically provides for it, such as in ASC 922-605-25-3, Entertainment – Cable Television: Revenue Recognition. However, the SEC staff has pointed out that in certain circumstances, it may be appropriate to capitalize certain contract acquisition or origination costs. See chapter 10 for further discussion of these costs.

The following example illustrates these concepts.

**Nonrefundable up-front fees**

Retailer A sells a one-year membership to its warehouse discount store to Customer B for a nonrefundable fee of $200. The membership provides Customer B with unlimited shopping at the discount store during the membership term. Customer B is required to pay list price for all merchandise purchased at the store. At the end of the one-year term, Customer B must renew its membership by paying $200 to continue to have access to the store.

Since Retailer A does not provide Customer B with products or services, which represent a separate element with stand-alone value, in exchange for the nonrefundable membership fee, the revenue related to the $200 fee should be deferred. Retailer A should recognize revenue related to the membership fee ratably over the one-year membership term. No estimate of the customer relationship period is needed, since Customer B is required to renew its membership each year.
Sometimes a service provider receives a nonrefundable amount from a customer before performing the services and the customer does not require full performance under the arrangement terms. The difference between (1) the amount paid for a product or service and (2) the amount of performance ultimately received by the customer is referred to as “breakage.” One example of such an arrangement is the sale of a gift card. In a gift card transaction, the service provider receives full payment when the gift card is purchased, but the holder of a gift card does not always demand full performance so the gift card is not fully redeemed. Accounting for breakage for unused gift cards is challenging, particularly for gift cards without expiration dates. The challenge lies in determining when a service provider should reduce or eliminate the liability for unused gift cards and recognize that amount in income. As part of that determination, service providers should consider the impact that escheat laws (state unclaimed property laws) have on derecognition of a liability for unused gift cards.

When a gift card is sold, a service provider recognizes both an asset for the cash received and a liability for the obligation to provide services in the future. When the gift cardholder uses the gift card to purchase services, the liability is reduced and revenue is recognized, as long as all revenue recognition criteria are met. Immediate recognition of breakage at the time a gift card is sold is unacceptable, because the service provider has not yet delivered the services under the arrangement.

Some gift cards carry expiration dates or service fees that gradually reduce the value of the card over time. A liability for unused gift cards can be derecognized when a service provider is legally released from its obligation—that is, at redemption or expiration—in accordance with ASC 405-20-40-1.

However, many major retailers currently sell cards without expiration dates or fees to remain competitive and to avoid consumer advocacy complaints. Accounting for breakage for these cards is particularly challenging. The SEC staff has said that retailers should either follow the derecognition guidance in ASC 405-20-40-1 or it might be acceptable to derecognize a liability for unredeemed gift cards if a service provider can demonstrate that the likelihood that the customer will require performance is remote.

If a service provider can demonstrate that there is a remote likelihood that the customer will require performance, the related liability may be derecognized at the point the likelihood becomes remote, provided it is not subject to escheat laws. A service provider may also choose to recognize the breakage over the gift card’s estimated useful life based on historical patterns of gift card redemptions. A service provider may recognize breakage in proportion to actual gift card redemptions only if all of the following conditions are met:

• There is only a remote likelihood that the customer will require full performance.
• There is a large population of homogenous transactions.
• The amount of breakage can be reasonably and objectively determined.
• The estimated time period of actual gift card redemptions can be reasonably and objectively determined.
The following example illustrates this concept.

**Nonrefundable up-front fees: breakage**

Entity A operates a chain of 25 fitness centers in the Midwest. The fitness centers earn revenue from the sale of monthly memberships, personal training services, and various fitness and nutrition-related classes. Entity A also sells gift cards that are redeemable for services at any Entity A fitness center location. Gift cardholders do not always redeem the gift cards for full performance under the gift card arrangements. Entity A has been in business for 15 years and has maintained documentation supporting an estimated gift card redemption rate of 90 percent. The company has, therefore, concluded that there is a remote likelihood that 10 percent of the gift cards sold will be redeemed. The gift cards do not expire and historical information shows that the cards are generally redeemed within five years of issuance.

On December 18, 20X0, Entity A sells $10,000 in gift cards to Entity B for distribution to its employees. Because Entity A believes it can reasonably and objectively estimate the amount of breakage at 10 percent of gift card sales and the redemption period as five years, revenue for the breakage amount ($1,000) would be recognized on a pro-rata basis over the 60-month estimated redemption period. Revenue for the remaining $9,000 would be recognized as the gift cards are redeemed and the services performed.

**Inconsequential or perfunctory obligations**

A service provider may recognize revenue for a unit of accounting in a service arrangement if its remaining performance obligation is “inconsequential or perfunctory,” assuming all other revenue recognition criteria are met. A performance obligation remaining after the substantial completion of the terms of the arrangement may be inconsequential or perfunctory if the customer is not entitled to receive a refund or to reject the services performed to date if the service provider fails to complete the actions.

However, as noted above, the arrangement terms should be evaluated to determine the substance of the arrangement and its impact on revenue recognition. For instance, if the substance of the arrangement is that the customer is paying for services that are delivered over time, then revenue should be recognized over time as the services are performed. SAB 104 provides factors a service provider should consider in evaluating whether a remaining obligation is inconsequential or perfunctory. See chapter 4, “Inconsequential or perfunctory activities,” for additional information.

While SAB 104 provides guidance permitting an entity to recognize revenue if the remaining obligation is inconsequential or perfunctory, the concept of recognizing revenue when delivery is substantially complete is not appropriate for arrangements within the scope of ASC 985-605. See chapter 8, “Inconsequential or perfunctory activities,” for additional information.
**Specific performance method**

The “specific performance method” is used to recognize revenue in arrangements that require the performance of only a single act of service. Under this method, revenue is recognized when the service is performed. Applying the specific performance method is appropriate for many service arrangements, including, among others, the following examples:

- Technicians providing in-home maintenance and repair services if the services are completed in a single visit
- Personal trainers providing individual training sessions at a fitness center
- Movie theaters showing a single performance of a movie
- Vehicle recovery technicians towing a stalled vehicle from the highway to a maintenance facility

**Completed performance method**

If an arrangement requires the performance of multiple acts, but the final act is significant to the arrangement as a whole, revenue should be recognized using the “completed performance method.” Under the completed performance method, revenue is not recognized before the final act is executed. The receipt of nonrefundable amounts does not impact revenue recognition since the significance of the final act implies that performance does not substantively take place until the final act is completed.

A single act of service signifying performance completion (“final act”) is generally identified by the entity while evaluating the service arrangement to determine the appropriate accounting model to apply in arrangements to be accounted for using the completed performance method. As a result, determining the timing of revenue recognition using the completed performance method is not a difficult task. Revenue is recognized once the final act is completed.

The following example illustrates these concepts.

**Completed performance method**

Entity A enters into an arrangement with Customer B to provide moving services, including packing, loading, transporting, and unloading the contents of Customer B’s home to move Customer B from Seattle, WA, to Boise, ID.

Entity A has agreed to perform multiple acts for Customer B in connection with its move to Boise, ID. However, the final act of delivering and unloading the contents in Customer B’s new home may be so significant that Entity A should recognize revenue when it has completed unloading Customer B’s possessions in the new home.
Proportional performance method
The “proportional performance method” is generally applied in service arrangements that require the performance of more than one act of service. Under this method, revenue is recognized based on the pattern of performance as each act is performed. The facts and circumstances of each situation should be assessed to determine the pattern of performance. In certain arrangements, it may be difficult for an entity to determine the pattern of performance. An entity should not automatically default to straight-line revenue recognition when applying the proportional performance method. Instead, it should first assess whether an efforts-based measure exists and is a more appropriate measure for revenue recognition. If the arrangement requires the performance of a specified number of similar acts, then revenue should be recognized in equal amounts as each act is completed.

If the service arrangement requires the performance of a specified number of dissimilar acts, the arrangement is a multiple-element arrangement. The guidance of ASC 605-25, *Multiple-Element Arrangements*, should be applied to evaluate whether the dissimilar acts (“elements”) can be separated for accounting purposes. Under ASC 605-25, the elements should be separated for accounting purposes if both the following criteria are met:
- The delivered item(s) has stand-alone value to the customer.
- If a general right of return exists, delivery or performance of the undelivered item(s) is substantially in the control of the vendor and is considered probable.

The application of these criteria and other guidance in ASC 605-25 is further described in chapter 6. If the elements can be separated using the criteria in ASC 605-25, revenue should be recognized based on the relative selling price of each of the elements.

If the elements cannot be separated, then revenue should be recognized in a systematic manner over the service delivery period. The revenue recognition method selected should reasonably relate to service performance. Entities may use a straight-line basis if no other rational basis can be determined. The SEC staff believes that the cost-to-cost approach rarely provides a good estimate of proportional performance and is generally not appropriate outside the scope of ASC 605-35. Instead, the staff suggests that an output-based model is more appropriate in these situations. The staff, however, has accepted an input-based model if the input measures are deemed to be a reasonable surrogate for output measures.

If the arrangement defines the service delivery period but does not specify the number of acts to be performed by the service provider, then revenue should be recognized over the service delivery period on a straight-line basis, unless evidence of another pattern of delivery exists. For example, in an arrangement to provide lawn-care services over a one-year period, the vendor’s historical evidence may show that the majority of the services are provided during the summer months.
In an arrangement that specifies neither the number of similar acts to be performed by the service provider nor the service delivery period, an entity should estimate the service delivery period and recognize revenue ratably over that estimated period. If an entity is unable to estimate the service delivery period, then it should not recognize revenue until it completes the performance of all services or there is a break in the contract indicating performance under the arrangement terms is no longer required.

Direct costs incurred in fulfilling a service arrangement that is accounted for using the proportional performance method should be expensed as incurred. Even though the gross margin on the arrangement may fluctuate as performance occurs, this model of expensing fulfillment costs most accurately reflects the pattern of performance. Direct costs incurred in initiating a contract and direct set-up costs may be capitalized as an asset and recognized over the service performance period if certain criteria are met. Chapter 10 has further discussion on accounting for these costs.

The following examples illustrate these concepts.

**Proportional performance method: multiple similar acts**

Entity A enters into an arrangement with Entity B to provide payroll processing and data maintenance services for a period of three years. Entity B will pay total arrangement consideration of $3.6 million in three equal annual installments of $1.2 million, with the first payment due on contract signing. Entity B has a semi-monthly payroll cycle.

Even though Entity A may incur additional time for the initial set-up, these services are not separable from the payroll processing and data maintenance services that Entity B has purchased under the arrangement. As a result, no revenue is recognized on set-up. Instead, Entity A should defer the amount received at the beginning of each annual period and recognize revenue using the proportional performance method as the services are performed (on a semi-monthly basis).
What is the accounting for service transactions?

**Warranties**

Certain types of service arrangements include provisions requiring an entity to provide warranty services for a period of time in the event the service does not provide the customer with the anticipated benefits. Some examples include a roofing contractor, a lawn care provider, or an electrician. Warranties may take one of two forms: a “standard warranty,”...
which is provided to all purchasers of a service, or a “separately priced warranty,” which is a negotiated item in the contract that the customer can choose to accept or reject. In the case of a separately priced warranty, the total consideration in the arrangement varies based on the customer’s acceptance of the warranty.

**Standard warranties**

Standard warranties are provided to all customers and are embedded in the terms of arrangements between the service provider and the customer. If an arrangement contains a standard warranty, the service provider should estimate and record a liability for the costs that will be incurred in providing the warranty services when revenue is recognized. Estimating warranty amounts requires judgment. The service provider should use historical warranty and product information to calculate the estimated warranty liability.

It is generally more difficult to estimate warranty costs for a product in its infancy than for a product in the later stages of its life cycle. When a product is first launched, information related to both its performance and possible warranty-type issues is limited. As the product life cycle matures and information related to product performance increases, the service provider’s ability to reliably estimate the warranty liability is enhanced. If an entity is unable to reasonably estimate the warranty liability, revenue should not be recognized until an estimate can be made or the warranty period lapses.

**Separately priced warranties**

Separately priced warranties are offered to customers who have the choice of purchasing the services with or without the separately priced warranty. Separately priced warranties are often offered as a follow-on option to a standard warranty. For example, a contract for furnace repairs may include a standard warranty covering the first six months after the repair service, with an option for an additional extended warranty for the following two-year period.

Accounting for separately priced warranties is covered in ASC 605-20-25-1 through 25-6, Services. Under ASC 605-20-25-3, revenue related to the separately priced warranty should be deferred and recognized over the separately priced warranty period.

The following example illustrates these concepts.

**Separately priced warranty**

Entity D, a manufacturer and distributor of automobiles, enters into an arrangement with Customer B to sell an automobile for $15,000. The arrangement includes a standard one-year warranty on the vehicle. Customer B also elects to purchase an extended warranty that covers most vehicle parts for five years for an additional $1,500. The extended warranty covers the four-year period after the standard warranty expires.

The extended warranty is a separately priced warranty that is accounted for under ASC 605-20-25-1 through 25-6. As a result, Entity D would defer the $1,500 paid by Customer B for the extended warranty and recognize revenue over the four-year period that begins when the initial one-year standard warranty expires (that is, in years two through five).
How is a multiple-element arrangement evaluated?

General
Companies often provide more than one product or service in a single arrangement. These arrangements range from relatively simple transactions (for example, multiple products delivered on a single date) to highly complex customer solutions that may be delivered at a specific point in time or over a period of time. Either a single contract or multiple contracts may be used as evidence of the arrangement for interrelated products and services.

Certain accounting literature addresses multiple-element arrangements covering specific industries or specific transactions. For example, FASB Accounting Standards Codification™ (ASC or Codification) 985-605, Software: Revenue Recognition, applies to certain arrangements that contain elements that are software or software-related and that do not meet any of the scope exceptions included in ASC 985-605-15-4. Selected industry-specific and transactional guidance related to multiple-element arrangements is included in the related chapters of this document.

ASC 605-25, Revenue Recognition: Multiple-Element Arrangements, provides guidance on how to separate elements (also referred to as “deliverables”) in a single arrangement into different units of accounting and then how to allocate the arrangement consideration to those separate units of accounting. ASC 605-25 does not address the timing of revenue recognition. Once elements have been separated and consideration has been allocated using the guidance in ASC 605-25, vendors should apply other accounting literature, such as SEC Staff Accounting Bulletin (SAB) 104, Revenue Recognition, to determine revenue recognition timing.
The remainder of this chapter addresses the concepts in ASC 605-25 that should be applied to arrangements not covered by specific guidance. It also discusses how the guidance in ASC 605-25 interacts with other literature if not all elements in an arrangement are within the scope of other specific guidance. For example, in an arrangement that includes software and nonsoftware-related elements, ASC 605-25 should be applied to determine if the nonsoftware-related elements can be separated from the software elements and, if so, ASC 985-605 should be applied to the software elements.

**Scope of ASC 605-25**

ASC 605-25 applies to all industries and all elements in arrangements that obligate vendors to perform multiple revenue-generating activities, except as follows:

- Elements in a multiple-element arrangement or entire multiple-element arrangements that are within the scope of other specific guidance
- Arrangements by loyalty program operators comprising the sale of award credits
- Arrangements that include vendor offers of the following incentives to a customer who either (1) remains a customer for a specified period of time or (2) completes a specified cumulative level of transactions:
  - A cash rebate or refund of a determinable amount, which is addressed in ASC 605-50, *Customer Payments and Incentives*
  - Free or discounted products or services delivered at a future date

As noted above, ASC 605-25 provides guidance on the separability of elements in a single arrangement into different units of accounting and the allocation of the arrangement consideration to those separate units of accounting; however, it does not address revenue recognition for those units of accounting. The revenue recognition model to apply depends on the type of elements in the arrangement.

**Determining the arrangement**

As with every revenue recognition question, determining the arrangement is the first step in evaluating multiple revenue-generating activities. The terms of the arrangement might be outlined in a written contract, including side agreements or subsequent amendments, or they may be communicated orally between the parties. An entity should consider its customary business practices in determining whether evidence of an arrangement exists.
In addition to the form of an arrangement, the substance of an arrangement should be considered. Multiple contracts do not automatically mean that separate arrangements exist or that separate accounting is permitted or required. Separate contracts entered into at or near the same time with a single customer or with related parties are presumed to have been negotiated as a package and should be evaluated to determine if, in substance, they represent a single arrangement. If a vendor concludes that multiple contracts represent one arrangement, it should include all elements in the arrangement in the separation and allocation assessment under ASC 605-25. The timing and measurement of revenue recognized for an individual contract could be impacted by the combination of multiple contracts into one arrangement. The presence of any of the following factors outlined in ASC 985-605-55-4 may indicate that separate contracts, including contracts under ASC 605-25, should be considered a single arrangement:

- Negotiation or execution of the contracts occurs within a short timeframe, generally within six months.
- The function, technology, or design of the different elements is closely interrelated or interdependent.
- The fee for at least one of the agreements is subject to concession (such as a refund or forfeiture) if another agreement is not completed.
- The functionality of an element in one agreement is dependent upon the delivery of an element in another agreement.
- The payment terms of one contract correspond with performance requirements in another contract.
- The negotiations are completed concurrently with two or more parties to perform, in substance, a single assignment.

The following factors, which are not included in ASC 985-605-55-4, should also be considered in evaluating multiple contracts:

- The agreements are negotiated in contemplation of one another. This is an indicator that the agreements should be evaluated as a single arrangement.
- The customer awards the contracts after holding separate competitive bid processes. Separate competitive bid processes indicate that the contracts may be accounted for separately as stand-alone arrangements.

Refer to chapter 8, “Combining contracts,” for an example of separate arrangements that should be combined into one multiple-element arrangement for accounting purposes. Although the guidance in ASC 985-605-55-4 is in the software industry guidance of the ASC, we believe such guidance is applicable to other revenue arrangements, including those in the scope of ASC 605-25.
If elements in previous arrangements remain substantially undelivered, subsequent arrangements with the same customer should be evaluated to determine whether the new arrangement and the undelivered elements of the previous arrangement should be considered a single arrangement for accounting purposes. If the new arrangement represents an amendment to the original contract, it may need to be combined with the existing arrangement. A vendor should consider these factors in evaluating whether to combine the arrangements.

**Identifying elements in an arrangement**

After the arrangement is defined, the elements in the arrangement must be identified and individually evaluated for separation. Analyzing an arrangement to identify all of the elements requires the use of judgment since the accounting literature does not define the term element or deliverable. The term “element” is used interchangeably with the term “deliverable” in practice and generally refers to the vendor’s performance obligations in the arrangement and includes product and service elements, a license or right to use an asset, and other vendor obligations negotiated for in the agreement. Because there is no definition of element, entities must consider the facts and circumstances of each arrangement and different entities may not always identify similar elements in the same manner. For example, it may not be clear to an entity whether an exclusivity provision in a product sales or marketing arrangement is an element separate from the product or service to be provided.

All elements in an arrangement should be evaluated for separation. Each element in the arrangement should be included in the contract terms so that the seller and the customer understand the nature of each element. However, the contract terms do not need to specify a price for each element in order for it to qualify as an element.

Certain arrangements may provide the customer with an option to purchase future products or services. Determining whether an option is an element will depend on whether or not the option is substantive. A substantive option is not considered an element in the current arrangement. An option is considered substantive if the customer has a right, but not an obligation to purchase the future product or service. In addition, for an option to be considered substantive, the customer’s election to exercise the option in the future must be in question at arrangement inception. If the arrangement includes an option to purchase additional products or services that are necessary for the intended use of products or services included in the current arrangement and such additional products and services can only be provided by the vendor, the option would be deemed nonsubstantive, and thus would be considered an element and would be subject to the separation and measurement guidance in ASC 605-25.
In addition, the fact that such additional goods or services are necessary for the intended use of the delivered good or service may call into question whether they can be separated from the delivered item under the stand-alone value criterion in ASC 605-25. Refer to “Stand-alone value” section on page 63 for further discussion regarding the stand-alone value criterion. Optional future purchases that are not considered elements in the current arrangement would be considered separate arrangements when and if the customer exercises the option to purchase the item(s).

The evaluation of whether an option to purchase future products or services is substantive will also include an assessment of whether the future item is priced at a discount. If an arrangement provides a customer with the right to purchase future products or services at a discount, an entity should evaluate whether the discount represents a significant and incremental discount that should be treated as a separate element in the arrangement. Based on analogy to the guidance in ASC 985-605-15-3d, an entity should consider a discount to be significant and incremental if it meets all of the following criteria:

- The discount is incremental to the discount, if any, reflected in the price of other elements in the arrangement.
- The discount is incremental to the discounts provided by the vendor to other customers in comparable transactions.
- The discount is significant. A vendor should consider the significance of the discount to the overall transaction.

The following example illustrates these concepts.

**Incremental discounts**

Entity A enters into an arrangement with Customer B to deliver 50 bicycles for its list price of $500 per bicycle with an option for Customer B to purchase up to an additional 200 bicycles for $400 each over a six-month period. Entity A’s sales transactions are generally for less than 50 bicycles and it does not provide significant discounts to its customers. Because Entity A does not provide discounts to its customers, the discount offered to Customer B is considered incremental. As a result, the discount would be considered an element in the original arrangement for purposes of applying the separation and allocation guidance.

If Entity A had a practice of providing volume discounts and the amount of discount offered to Customer B was determined to be insignificant, the discount would not be considered incremental.

For further guidance on allocating a significant and incremental discount in a multiple element arrangement, refer to “Allocating significant and incremental future discounts” on page 75.
Accounting literature interaction in multiple-element arrangements

With the ever-increasing complexity in contract terms, arrangements often include various types of elements that do not all fall under the scope of a single Codification Topic. A single arrangement may include software, hardware, and service elements. Evaluating the individual elements in such arrangements is essential in determining the appropriate accounting to apply.

Applying the guidance on interaction with other Codification Topics in ASC 605-25-15 is complex. Entities should determine whether an element falls within the scope of specific literature without considering the order in which elements are delivered under the arrangement. ASC 605-25-15-3A provides the following descriptions of the three categories of specific literature and the application of ASC 605-25 or guidance in other Codification Topics in determining separate units of accounting and allocating arrangement consideration:

- **Category 1**: If another Codification Topic provides guidance on both the separation of elements and the allocation of arrangement consideration, then entities should apply that guidance to the arrangement or to the element(s) in the arrangement that fall within the scope of that literature. Examples include ASC 985-605 and ASC 460, Guarantees.

- **Category 2**: If another Topic provides guidance on separating elements within the scope of the other Topic from elements not within the scope, but does not provide guidance on allocating consideration to the separate units of account, then entities should apply the relative selling price method using an estimate of selling price for each of the elements to allocate consideration between elements within the scope and those not within the scope of the other Topic. For example, the provisions of ASC 605-25 should be applied to the elements outside the scope of the other Topic to determine if there should be further segregation into separate units of account.
• **Category 3:** In situations where the other Topic provides no guidance on the separation of elements that are within the scope of that other Topic and those that are not, or the allocation of arrangement consideration to elements in the scope of that Topic and those that are not, the guidance in ASC 605-25 should be applied to determine if the elements can be separated and if so, how to allocate arrangement consideration. If the separation criteria of ASC 605-25-25-5 are not met, then all elements are treated as a single unit of accounting and the appropriate revenue recognition should be determined for the combined elements. For example, ASC 605-35, *Construction-Type and Production-Type Contracts*, provides guidance on segmenting contracts (separating elements) within its scope, but does not provide guidance on separation and allocation between ASC 605-35 and non-ASC 605-35 elements. As a result, the separation and allocation guidance of ASC 605-25 would first be applied to determine whether the ASC 605-35 elements can be separated from the non-ASC 605-35 elements. If an entity determines that the non-ASC 605-35 elements are a separate unit of accounting from the ASC 605-35 elements, then the second step is to apply the provisions of ASC 605-35 to the elements within its scope to determine whether the ASC 605-35 elements can be further segmented. On the other hand, if the ASC 605-35 elements cannot be separated from the non-ASC 605-35 elements, then revenue recognition must be determined for the combined elements as a single unit of accounting.

The following examples illustrate some of the more frequently encountered types of multiple-element arrangements that require the interaction of more than one piece of authoritative accounting literature.

**ASC 985-605 and ASC 605-25**

Entity A designs, develops and markets software-driven measurement systems used by its customers in manufacturing and industrial applications. Entity A enters into an arrangement with Entity B to deliver measuring devices, including embedded measurement device software, training and optional preinstalled "conversion software." The measurement software, along with the hardware, provides the measuring device’s essential functionality. The conversion software converts measurement results from the U.S. system to the metric system, readily displays the measurement results on the device under both units of measurement and produces customizable reports.

Because the measurement software is essential to the device’s functionality, the measurement software and the device and the related training are excluded from the scope of ASC 985-605. The conversion software is a software element that is not considered essential to the device’s functionality and therefore is within the scope of the software guidance in ASC 985-605. The measurement and allocation guidance in ASC 605-25 is applied to allocate the arrangement consideration between the ASC 605-25 and ASC 985-605 components.
**Criteria for determining whether the elements in an arrangement can be separated**

All elements should be evaluated both at the inception of the arrangement and as each element is delivered to determine whether the remaining elements represent separate units of accounting. The following criteria, both of which must be met in order to account for an element as a separate unit of accounting, are established in ASC 605-25:

- The delivered item(s) has stand-alone value to the customer.
- If a general right of return exists, delivery or performance of the undelivered item(s) is substantially in the control of the vendor and is considered probable.

The separation of elements is not optional. If all of the above criteria are met, the element must be treated as a separate unit of accounting. On the other hand, if either of the above criteria is not met for a delivered item, the item must be considered together with the undelivered element(s) as a combined unit of accounting.
The evaluation of elements for separation should be performed at the inception of an arrangement and again as each element in the arrangement is delivered. The evaluation as each element is delivered is performed to identify changes in facts and circumstances that may affect whether an entity should separate or combine elements. For example, stand-alone value for the delivered item may be established through the entry into the market of a competitor that did not exist at the inception of the arrangement. Accordingly, the delivered item may qualify as a separate unit of accounting after the separate sale of the item by a competitor.

If an entity is required to change the unit of accounting (for example, separating an element that did not previously qualify for separation), the change should be considered a change in accounting estimate and accounted for on a prospective basis in accordance with ASC 250, Accounting Changes and Error Corrections. Entities should not restate accounting for periods prior to the change.

**Stand-alone value**

A delivered item is considered to have stand-alone value if either of the following conditions is met:

- The item is sold separately by the vendor or any other vendor.
- The customer could resell the item on a stand-alone basis.

In order to meet the first condition, historical evidence of stand-alone sales by either the vendor or another vendor is required. Stand-alone sales of similar competitor items would meet this criterion if those products or services have features and functionality that allow them to be used in place of the delivered item.

The existence of an observable market is not necessary to conclude that the customer can resell an item for purposes of evaluating stand-alone value. The delivered item should be sufficiently separable so that it could be used or sold independent of the other item(s) in the arrangement without impacting its quality, including its functionality. The independent sales price of the delivered item should allow the customer to substantially recover the purchase price. The ability to sell the item solely for scrap does not meet the stand-alone value criterion. If no other vendor provides the undelivered item and the customer’s use of the delivered item is dependent on the undelivered element, it is likely that stand-alone value for the delivered item does not exist.
The following examples illustrate these concepts.

**Separating elements: stand-alone value of delivered item**

Entity A is a manufacturer of office equipment. On February 15, 20X0, Entity A enters into an arrangement with Entity B for the delivery and installation of a state-of-the-art color copier/printer and ongoing maintenance for three years. The equipment is delivered and installed on February 28, 20X0. Currently, no competitors offer comparable color copier/printers. However, there is an observable secondary market for these color copier/printers. Entity A has a history of entering into maintenance agreements with secondary owners of its office equipment.

Even though there are currently no competitors, Entity A concludes that the color copier/printer has stand-alone value because a secondary market exists. The fact that Entity A provides maintenance services to secondary owners of its equipment supports the position that the copier/printer has stand-alone value in this arrangement.

**Separating elements: no stand-alone value**

Entity A manufactures and installs specialty equipment for the manufacturing environment. Entity A enters into an arrangement with Customer B for the delivery and installation of one of its specialized machines. The installation process is highly complex and requires a high degree of knowledge regarding the equipment. As a result, customers do not have the know-how to perform the installation and no other vendors provide the installation services. In addition, because Entity A owns a patent used in manufacturing the equipment, no other vendor sells similar equipment.

Because Entity A is the only vendor that can perform the installation services, it is unlikely that Customer B would have the ability to recover a substantial amount of its cost on resale of the equipment absent the installation services. As a result, the equipment does not have stand-alone value, and Entity A should treat the arrangement as a single unit of accounting in determining the appropriate revenue recognition model to apply.

**Separating elements: stand-alone value – biotech industry**

At the December 2009 AICPA National conference on Current SEC and PCAOB Developments, the SEC staff provided an example in the biotech industry to help illustrate the nuances of the stand-alone value criterion. In that example, a biotech entity entered into an arrangement to provide a technology license and proprietary research and development (R&D) services to a customer. The technology is considered unique, since no other vendor sells a similar product. The example also assumes that the R&D services are required to derive value from the technology, such that the technology is never sold without the R&D services. In addition, the arrangement includes a restriction prohibiting the customer from reselling the technology. Based on these facts, the SEC staff concluded that the license does not have stand-alone value because it is not sold separately by any vendor and the customer cannot resell the technology. Accordingly, the license should be combined with the R&D services as a single unit of accounting.

The SEC staff pointed out that if the R&D services were not proprietary and if such services could and have been provided by other vendors, then the technology license may have stand-alone value. The contractual restriction that prevents the customer from reselling the technology, coupled with the fact that R&D services are required to derive value from the technology, may not preclude stand-alone value for the technology. Under the guidance in ASC 605-25, the staff concluded that the technology may have stand-alone value, since the vendor can license the technology separately while another vendor provides the R&D services.
Is performance of the undelivered item(s) considered probable and in the vendor’s control?

The second separation criterion in the multiple-element model of ASC 605-25 addresses whether the consideration is fixed or determinable if there is a general right of return for the delivered element(s). If the vendor must still deliver outstanding elements, the customer could potentially negotiate a discount or a refund of a portion of the arrangement consideration if delivery of the remaining element(s) is outside the vendor’s control. If the vendor has control over delivery of the remaining obligation(s) and delivery is probable, it should apply the accounting under ASC 605-15, *Products*, to the delivered element(s) (see chapter 4, “Right of return”).

**Measurement and allocation of arrangement consideration**

**General**

After the units of accounting in an arrangement are determined, the vendor must allocate the consideration to the various elements in the arrangement. Total consideration allocated is limited to the amount that is fixed or determinable. A vendor should not assume the purchase of any optional goods or services by the customer or that it will earn a performance bonus, even if the vendor’s historical evidence demonstrates that a performance bonus is generally earned. Amounts for performance bonuses should be included by the vendor when the performance for the bonus is completed.

**Allocating consideration to the various elements in an arrangement**

Arrangement consideration should be allocated to all deliverables at the inception of the arrangement based on the elements’ relative selling price. The discount, if any, is allocated among the deliverables on a relative selling price basis.

An entity determines the selling price for each deliverable and allocates consideration only once: at the inception of the arrangement (described in the following section, “Determining the selling price”). A subsequent change in selling price does not affect arrangements for which the selling price and allocation have been previously determined. Any subsequent evidence regarding changes to selling price is applied prospectively to new or materially modified arrangements. For instance, if an entity allocates consideration based on the best estimate of selling price at inception, but subsequently establishes vendor specific objective evidence (VSOE) or third-party evidence (TPE) of selling price for an element included in that arrangement, the initial allocation would not be modified, even though a higher level of evidence was subsequently established.
The use of the “relative selling price method” is required to allocate arrangement consideration to the various units of accounting for arrangements under the scope of ASC 605-25. Under the relative selling price method, the total arrangement consideration is allocated to each unit of accounting on the basis of their relative selling prices, with limited exceptions as described in the following two paragraphs. Under this method, any discount or premium is allocated among all elements on a pro-rata basis. We believe that it would be rare that the sum of the selling prices of each element in an arrangement would be less than the total arrangement consideration. In those situations, we believe an entity should reassess whether it has identified all elements and has considered all available evidence in determining the estimated selling price for each element.

If other U.S. GAAP requires a unit of accounting to be recorded at fair value and subsequently marked to market each reporting period, the amount allocated to that unit of accounting should be its fair value. The remainder of the consideration should be allocated to the remaining units of accounting based on their relative selling prices.

According to ASC 605-25-30-5, another exception to the relative selling price method limits the amount allocable to a delivered element(s) to the amount that is not contingent on the delivery of other elements in the arrangement or other performance conditions.

ASC 605-25-55 contains numerous examples of how to apply the separation and allocation guidance in ASC 605-25.
How is a multiple-element arrangement evaluated?

The following examples are provided to assist in the application of the guidance in ASC 605-25 related to the separation of the elements and the allocation of arrangement consideration.

Allocating consideration: contingent amounts

On March 1, 20X0, Entity A enters into an arrangement to sell 15 desks, 15 chairs, and 10 filing cabinets to Customer A for total consideration of $10,000. The filing cabinets are delivered on March 25, 20X0 and the desks and chairs are delivered on April 15, 20X0. There is no general right of return in this transaction. Entity A sells these items separately for $700, $600, and $500, respectively.

Entity A determines that each item is a separate unit of accounting. The refrigerator is delivered on March 31, 20X0 and the oven and the dishwasher are delivered on April 10, 20X0. Because the appliances have stand-alone value to Customer D and no general right of return exists, Entity A would separate the elements and use the relative selling price method to allocate consideration. The calculation of the allocation of arrangement consideration is illustrated below.

<table>
<thead>
<tr>
<th>Selling price</th>
<th>Quantity</th>
<th>Total selling price</th>
<th>Ratio*</th>
<th>Arrangement consideration allocated*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Desks</td>
<td>$500</td>
<td>15</td>
<td>$7,500</td>
<td>68%</td>
</tr>
<tr>
<td>Chairs</td>
<td>100</td>
<td>15</td>
<td>1,500</td>
<td>14%</td>
</tr>
<tr>
<td>Filing cabinets</td>
<td>200</td>
<td>10</td>
<td>2,000</td>
<td>18%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$11,000</td>
<td>100%</td>
</tr>
</tbody>
</table>

* Ratio is computed as the individual selling price for each element divided by the sum of the selling prices for all the elements. The ratio is then multiplied by the total arrangement consideration to compute the allocation of arrangement consideration for desks, as follows: \[\frac{$7,500}{11,000} = 68\%\] x $10,000 = $6,800

Allocating consideration: relative selling price method

On March 1, 20X0, Entity E, a manufacturer and distributor of office furniture, enters into an arrangement to sell 15 desks, 15 chairs, and 10 filing cabinets to Customer A for total consideration of $10,000. The filing cabinets are delivered on March 25, 20X0 and the desks and chairs are delivered on April 15, 20X0. There is no general right of return in this transaction. Entity E sells each of the items on a stand-alone basis for the following amounts:

- Desk: $500 each
- Chair: $100 each
- Filing cabinet: $200 each

The total selling price of the items in the transaction with Customer A is $11,000, indicating a discount of $1,000. Because the filing cabinets (the delivered items) have stand-alone value to Customer A, and no general right of return exists, Entity E would separate the elements and use the relative selling price method to allocate consideration. The calculation of the allocation of arrangement consideration is illustrated below.

<table>
<thead>
<tr>
<th>Selling price</th>
<th>Quantity</th>
<th>Total selling price</th>
<th>Ratio*</th>
<th>Arrangement consideration allocated*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Desks</td>
<td>$500</td>
<td>15</td>
<td>$7,500</td>
<td>68%</td>
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<td>100</td>
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<td>1,500</td>
<td>14%</td>
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<tr>
<td>Filing cabinets</td>
<td>200</td>
<td>10</td>
<td>2,000</td>
<td>18%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>$11,000</td>
<td>100%</td>
</tr>
</tbody>
</table>

* Ratio is computed as the individual selling price for each element divided by the sum of the selling prices for all the elements. The ratio is then multiplied by the total arrangement consideration to compute the allocation of arrangement consideration for desks, as follows: \[\frac{$7,500}{11,000} = 68\%\] x $10,000 = $6,800
Determining the selling price

An entity determines the selling price for each element and allocates consideration only once, at the inception of the arrangement. A subsequent change in selling price does not affect arrangements for which the selling price and allocation have been previously determined. Any subsequent evidence regarding changes to selling price is applied prospectively to new or materially modified arrangements. For instance, if an entity allocates consideration based on the best estimate of selling price at inception, but subsequently establishes VSOE or TPE of selling price for an element included in that arrangement, the initial allocation would not be modified, even though a higher level of evidence was subsequently established.

ASC 605-25-30-2 contains the following hierarchy of evidence for determining selling price:

- VSOE of selling price should be used if it exists. “VSOE of selling price” is defined as the price charged when the same element is sold separately or, for an element not yet sold separately, the price established by management with the relevant authority.
- If VSOE of selling price does not exist, an entity should determine if TPE of selling price is available. TPE includes competitors’ sales prices for the same or largely interchangeable products or services to similar customers in stand-alone sales.
- If neither VSOE nor TPE of selling price exists, management should use its best estimate of selling price for that product or service (element). Consistent with the objective of VSOE, best estimate of selling price is defined as the price at which the vendor would transact if the element were sold by the vendor regularly on a stand-alone basis.

An entity cannot ignore evidence that is reasonably available without undue cost and effort in determining whether it has either VSOE or TPE of selling price for an element. Cost and effort will vary, depending on the specific facts and circumstances of each situation. For instance, less cost and effort might be expended to determine whether VSOE or TPE of selling price exists for elements that are never sold separately by the entity or any other vendor because separate sales are required for VSOE or TPE of selling price. We believe an arrangement that contains elements that the entity sells separately will require an analysis to determine if VSOE of selling price exists. We also believe that if an entity has a history of establishing VSOE or TPE of selling price for an element, and if no significant change in facts and circumstances results in a change in pricing practices, it should continue to perform its VSOE or TPE of selling price analysis. This analysis would be performed even if the effort and cost of that analysis is considered greater than the effort and cost of developing a best estimate of selling price.
ASC 605-25 does not require any specific approach to estimate selling price when VSOE or TPE of selling price does not exist. However, guidance is provided in ASC 605-25-55 in the form of examples to illustrate one method that an entity might use to estimate selling price. The examples all utilize a cost plus margin approach, some of which take into consideration various factors in determining the appropriate margins. Using a cost plus margin approach to estimate selling price may not be appropriate in certain situations, such as when costs consist primarily of research and development and the payments do not correlate to the costs incurred.

Considerations for developing a best estimate of selling price

ASC 605-25 requires an entity to consider market conditions in addition to entity-specific factors to determine its best estimate of selling price. Market conditions include factors such as the following:

- Overall economic conditions
- Customer demand for the element(s)
- Impact of competition for the element(s)
- Profit margins realized by entities in the industry
- Impact of geographic factors

An entity may consider the following entity-specific factors, among others, in developing its best estimate of selling price:

- The entity’s pricing practices for the element(s), including discounts or pricing strategies such as:
  - Volume discounts
  - Price reductions to gain market share or lower inventory levels due to obsolescence or an improved model
- Costs incurred by the entity to provide the element(s)
- The entity’s profit objectives for the element(s)
- Expected life of the product
- How the type or size of customer impacts pricing
- Market share goals for products
- Stand-alone sales of the element when VSOE of selling price is not achieved

In a services arrangement, it may be practicable for a customer to perform certain services themselves. The potential costs savings by the customer would be considered by the entity in determining its gross profit margin for those services.
Evaluating the evidence relating to selling price may require significant judgment. Management should consider all available evidence at contract inception in developing its best estimate of selling price for each element. Any subsequent evidence regarding changes to selling price is applied prospectively to new or materially modified arrangements. A subsequent change in selling price does not affect arrangements for which the selling price and allocation have been previously determined. For instance, if an entity allocates consideration based on the best estimate of selling price at inception, but subsequently establishes VSOE or TPE of selling price for an element included in that arrangement, the initial allocation would not be modified, even though a higher level of evidence was subsequently established.

The following examples illustrate some of the concepts for estimating selling prices for both a product and services arrangement.

**Estimating selling price: equipment**

On January 1, 20X0, Entity E, an equipment manufacturer, enters into a multiple-element arrangement to manufacture and deliver equipment A, B, and C on July 1, 20X0, October 1, 20X0, and January 1, 20X1, respectively, for total consideration of $760,000. Stated contract prices are $185,000 for equipment A, $265,000 for equipment B, and $310,000 for equipment C. The elements all meet the separation criteria in ASC 605-25, and as such, Entity E would account for each element in this arrangement as a separate unit of accounting. Because Entity E does not have VSOE or TPE for any of these products, it must estimate the selling price for each element. Entity E considered the following factors in determining its best estimate of selling price for equipment A, B, and C:

**Equipment A**

Entity E’s cost to manufacture equipment A is $160,000. Demand for equipment A has decreased due to a comparable and modernized model recently introduced by a competitor. The competitor’s product list price is $240,000. Entity E’s profit margin on this equipment has historically been 30 percent. Entity E is in the process of modernizing equipment A and expects the new model to be ready for sale and distribution by July 1, 20X1. Entity E estimates it has approximately two years of equipment A inventory on hand.

After weighing all the available evidence, Entity E estimates the stand-alone selling price for equipment A is $177,700. The selling price was determined based on the $160,000 cost to manufacture plus an estimated gross margin of 10 percent. The entity ignored historic profit margins and used a 10 percent gross margin due to the superiority of its competitor’s new product and the entity’s strategy to clear its own inventory of existing equipment A in time for the introduction of its new equipment A model on July 1, 20X1.

**Equipment B**

Entity E’s cost to manufacture equipment B is $160,000. Profit margins on this equipment have historically averaged 41 percent. Entity E is the industry leader in equipment B, with the highest rated product and the highest market share for that product. Equipment B has been on the market for only 2 years, while its competitors’ comparable equipment has been on the market for 2.5 years or longer. Entity E is not aware of any competitive threats to equipment B and believes equipment B will continue to be the market leader in the foreseeable future.

After weighing all the available evidence, Entity E estimates the stand-alone selling price for equipment B is $271,000. The selling price was determined based on the $160,000 cost to manufacture plus an estimated gross margin of 41 percent. The entity used a 41 percent gross margin due to historical trends and its position in the market place.
**Equipment C**

Entity E recently introduced equipment C to the market. Entity E’s cost to manufacture equipment C is $190,000. As part of equipment C’s research and development, studies indicated that its price could be set at $340,000 (44.1 percent margin). The pricing studies considered the fact that equipment C is in high demand and that there is limited competition. Entity E also considered that if the price was set appropriately for equipment C, it would be able to access markets and customers it historically has not accessed, while also providing exposure of its full product listing to this new customer base.

After weighing all the available evidence, Entity E estimates the stand-alone selling price for equipment C is $330,000. The selling price was determined based on the $190,000 cost to manufacture plus an estimated gross margin of 42.4 percent. Entity E used a 42.4 percent gross margin rather than the 44.1 percent gross margin indicated in its pricing study because of its strategy to attract a new customer base.

Arrangement consideration would be allocated to the elements using the relative selling price method. The table below summarizes the allocation results.

<table>
<thead>
<tr>
<th>Equipment</th>
<th>Selling price</th>
<th>Ratio*</th>
<th>Arrangement consideration allocated*</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$177,700</td>
<td>23%</td>
<td>$174,800</td>
</tr>
<tr>
<td>B</td>
<td>271,000</td>
<td>35%</td>
<td>266,000</td>
</tr>
<tr>
<td>C</td>
<td>330,000</td>
<td>42%</td>
<td>319,200</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$778,700</strong></td>
<td><strong>100%</strong></td>
<td><strong>$760,000</strong></td>
</tr>
</tbody>
</table>

* Ratio is computed as the individual selling price for each element divided by the sum of the selling prices for all the elements. The ratio is then multiplied by the total arrangement consideration to compute the allocation of arrangement consideration for equipment A, as follows: ($177,700 ÷ $778,700 = 23%) x $760,000 = $174,800
Estimating selling price: consulting services
On January 1, 20X0, Entity Z, a provider of consulting services, enters into a multiple-element arrangement to provide the following services for total consideration of $725,000.

<table>
<thead>
<tr>
<th>Service</th>
<th>Date service will be provided</th>
<th>Contract price</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>During year 20X0</td>
<td>$150,000</td>
</tr>
<tr>
<td>B</td>
<td>During years 20X0 and 20X1</td>
<td>200,000</td>
</tr>
<tr>
<td>C</td>
<td>During year 20X1</td>
<td>75,000</td>
</tr>
<tr>
<td>D</td>
<td>During years 20X0 through 20X2</td>
<td>300,000</td>
</tr>
</tbody>
</table>

$725,000

Payments of $300,000, $150,000, $150,000, and $125,000 are due and payable on January 1, 20X0, January 1, 20X1, January 1, 20X2, and January 31, 20X2, respectively. All of the services meet the separation criteria in ASC 605-25, and as such, each is considered a separate unit of accounting. Entity Z does not have VSOE or TPE for any of its services and therefore must estimate selling price for each service.

Entity Z determines pricing for its services based on an estimate of expected hours, using standard billing rates. Gross standard billing rates are set annually, based on Entity Z’s annual budget. In setting the standard billing rates, Entity Z considered overall economic conditions, customer demand, competition, and cost incurred to deliver services. Entity Z typically provides discounts from its standard billing rates, depending on various factors, including headcount, timing and type of work, geographic location, number of services purchased, leverage in contract negotiations, and other general market forces. Although the entity may occasionally receive 100 percent of its gross billing rates for services included in certain arrangements, an analysis of historic data indicates realization of approximately 60 percent for services A and B and 65 percent for services C and D.

Based on the facts and circumstances of this arrangement, the entity determined that realization is an appropriate measure to determine estimated selling price. The budgeted hours and rates for each of the consulting projects were obtained from the project managers to determine the gross billable amounts. The gross billable amounts were then multiplied by the appropriate realization for the type of work performed to determine the estimated selling price. Arrangement consideration would be allocated to the elements using the relative selling price method.

The table below summarizes the results.

<table>
<thead>
<tr>
<th>Service</th>
<th>Hours</th>
<th>Blended hourly rate</th>
<th>Estimated billings at standard rates</th>
<th>Realization</th>
<th>Selling price</th>
<th>Ratio</th>
<th>Arrangement consideration allocated</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>1,500</td>
<td>$200</td>
<td>$300,000</td>
<td>60%</td>
<td>$180,000</td>
<td>21%</td>
<td>$152,250</td>
</tr>
<tr>
<td>B</td>
<td>2,125</td>
<td>$200</td>
<td>425,000</td>
<td>60%</td>
<td>255,000</td>
<td>30%</td>
<td>217,500</td>
</tr>
<tr>
<td>C</td>
<td>500</td>
<td>$250</td>
<td>125,000</td>
<td>65%</td>
<td>81,250</td>
<td>10%</td>
<td>72,500</td>
</tr>
<tr>
<td>D</td>
<td>2,000</td>
<td>$250</td>
<td>500,000</td>
<td>65%</td>
<td>325,000</td>
<td>39%</td>
<td>282,750</td>
</tr>
</tbody>
</table>

$1,350,000 | $841,250 | 100% | $725,000
Use of contract prices
An entity should not presume that contract prices in an arrangement are representative of VSOE, TPE, or its best estimate of selling price for an individual product or service. In the absence of VSOE or TPE, an entity must develop its best estimate of selling price by considering all available evidence, including information about market conditions and entity-specific factors. Once the best estimate of selling price is developed and compared to stated contract prices, an entity with strict pricing policies that prevent significant pricing fluctuations may conclude that contractually stated prices approximate estimated selling prices. However, we believe that an entity should document its assessment of its best estimate of selling price, even when contract prices are believed to represent estimated selling price.

Utilizing a range of estimated selling prices
An entity’s best estimate of selling price should be consistent with the objective of determining VSOE, which is “the price at which an entity would transact if the element were sold by the entity regularly on a stand-alone basis.” The widely accepted bell-shaped curve method, used for testing VSOE of fair value, indicates that a range is sufficient for the purpose of establishing VSOE. Consequently, we believe that establishing a range of estimated selling price may also be acceptable. However, we also believe that the range used for estimated selling price should be narrower than the range used for VSOE, as described below, since estimated selling price, unlike VSOE, is not based on actual transactions.

Under the bell-shaped curve method used for establishing VSOE of fair value, the entire population of transactions is evaluated to determine whether the range of prices is sufficiently narrow to provide evidence of VSOE. Although judgment is required in assessing whether the range of prices is sufficiently narrow for establishing VSOE, we believe that at least 80 percent of the transactions in the population should fall within a range of ±15 percent of the midpoint of the range. In calculating the range for VSOE, the relative percent is applied to the change from the midpoint of the range. For example, if $100 is the midpoint of the range, a range of ±15 percent would be $85 to $115.
In establishing a range for an entity’s best estimate of selling prices, an entity would first determine its best estimate of selling price for each element using the previously outlined guidance. The entity would then calculate a narrow range of estimated selling prices for each element that represents the price it would accept if the element were sold regularly on a stand-alone basis. If the contract prices for the element(s) within the multiple-element arrangement are within the applicable ranges established, then the contract prices would be considered to approximate the entity’s best estimate of selling price. If the arrangement contains elements with contractually stated prices that are not within the range of estimated selling price, then the entity would not be able to use the stated contract price as the estimated selling price, and would instead use a price within the range. The entity would need to establish a policy for using prices within a range and to apply that policy consistently. Appropriate policies would include using the midpoint of the range or using the endpoint of the range nearest the stated contract price. For example, if the contractually stated price for an element is above the established range of estimated selling price, then the entity would use the high end of the range as its estimated selling price for that element.

### Establishing a range of estimated selling prices

Assume the same facts as the “Estimating selling price: equipment” example in the “Considerations for developing a best estimate of selling price” section on page 70, except that the entity determined a narrow range of estimated selling prices, based on its facts and circumstances, as follows.

<table>
<thead>
<tr>
<th>Equipment</th>
<th>Contract price</th>
<th>Range of estimated selling prices</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>High</td>
</tr>
<tr>
<td>A</td>
<td>$185,000</td>
<td>$182,000</td>
</tr>
<tr>
<td>B</td>
<td>265,000</td>
<td>278,000</td>
</tr>
<tr>
<td>C</td>
<td>310,000</td>
<td>338,000</td>
</tr>
</tbody>
</table>

The entity adopted a policy to use the midpoint of the range of estimated selling prices for elements with stated contract prices that fall outside the range.

The table below summarizes the results of the relative selling price allocation.

<table>
<thead>
<tr>
<th>Equipment</th>
<th>Contract price</th>
<th>Selling price</th>
<th>Ratio</th>
<th>Arrangement consideration allocated</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$185,000</td>
<td>$177,500</td>
<td>23%</td>
<td>$174,800</td>
</tr>
<tr>
<td>B</td>
<td>265,000</td>
<td>265,000</td>
<td>34%</td>
<td>258,400</td>
</tr>
<tr>
<td>C</td>
<td>310,000</td>
<td>330,000</td>
<td>43%</td>
<td>326,800</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$772,500</td>
<td>100%</td>
<td>$760,000</td>
</tr>
</tbody>
</table>
Documentation considerations for developing a best estimate of selling price
In developing its best estimate of selling price, management should document, in sufficient detail, the considerations relating to market conditions and entity-specific factors, as well as other factors and pertinent data points used in the analysis. In addition, consideration should be given to documenting the reason why a certain factor or data point did not have an impact on the selling price determination.

Allocating significant and incremental future discounts
If an arrangement provides the customer with a significant and incremental discount on the purchase of future products or services, we believe the accounting should be based on analogy to ASC 985-605-55-83 through 55-85. ASC 985-605-15-3d defines a more-than-insignificant discount as “a discount that is: (1) incremental to the range of discounts reflected in the pricing of the other elements of the arrangement, (2) incremental to the range of discounts typically given in comparable transactions, and (3) significant.”

Under ASC 985-605-55-83 through 55-85, a proportionate amount of the discount should be allocated to each element based on the relative selling price of each element without regard to the discount. If the future products or services to which the discount will be applied are not specified in the arrangement but the maximum amount of the discount is known, a portion of the consideration should be allocated to current and future elements assuming that the maximum discount will be obtained. If the entity is unable to quantify the maximum amount of the discount because the amount of future purchases is not specified, the revenue amount allocated to each element should be reduced by the discount rate. In this scenario, the vendor would recognize the discount amount allocated to the delivered element(s) ratably over the discount period or, if no discount period is specified, over the estimated period the additional purchases are made.

The following example illustrates these concepts.

**Allocating incremental discounts**
Entity A enters into an arrangement with Customer B to deliver 50 bicycles for its list price of $500 per bicycle with an option for Customer B to purchase up to an additional 200 bicycles for $400 each over a six-month period. The selling price of each bicycle is $500. Entity A determines that the $100 per bicycle discount offered to Customer B on the optional bicycle purchases is significant and incremental.

Entity A should allocate a proportionate amount of the total possible discount to each bicycle. As a result, Entity A would recognize revenue of $420 [(50 x $500) + (200 x $400) = $105,000 ÷ 250] per bicycle as the bicycles are delivered to Customer B. Any deferred revenue remaining after the six-month period has expired because Customer B purchased less than 250 bicycles, would be recognized as revenue after the option period has expired.
Accounting for costs of a delivered item when revenue cannot be separately recognized

In certain situations, a delivered element might meet the separation criteria of ASC 605-25, but no revenue is allocated to the element because of a contingent revenue provision in the arrangement. If the vendor expenses the costs as incurred, a loss would result on delivery of that item. Therefore, it may be appropriate to defer the direct and incremental costs associated with the delivered element, provided the vendor expects to generate profits on the remaining elements under the terms of an enforceable contract. While ASC 605-25 does not provide guidance related to accounting for direct costs in an arrangement with multiple elements, the SEC staff has commented on the topic in various speeches and in SAB 104. This topic is discussed in detail in chapter 10.
What is the accounting for a right of return?

Right-of-return provisions included in an arrangement should be carefully analyzed to appropriately evaluate their impact on revenue recognition. Right-of-return provisions may be general (available to all customers) or customer-specific. The accounting for right-of-return provisions varies, depending on the type of right granted to the customer.

**General rights of return**

Many arrangements for product sales include terms that allow the customer to return the item for a stated period of time for any reason (“general right of return”). *FASB Accounting Standards Codification™* (ASC) 605-15, *Revenue Recognition: Products* provides accounting guidance for general rights of return.

A general right of return exists in many product sales arrangements and allows the customer to return the product for a cash refund, a credit, or an exchange for another product. ASC 605-15-25-1 through 25-4, which addresses the accounting for general rights of return, states that revenue should be recognized, net of an allowance for estimated returns, at the time of sale if certain conditions are met, including all of the following:

- At the date of sale, the price is fixed or determinable.
- The buyer’s obligation to pay does not depend on resale of the goods.
- The buyer holds the risk of loss of market value due to damage, theft, or destruction.
- The buyer has economic substance apart from the seller.
- The seller does not have a significant obligation to bring about resale of the goods.
- The seller must be able to reasonably estimate the amount of returns.
Entities must consider many factors and circumstances in evaluating whether they can reasonably estimate the amount of returns. The existence of a large volume of homogenous transactions is helpful in providing an entity with the historical experience necessary to establish a reasonable estimate of returns. Other factors to consider include assessing whether:

- Historical experience with the same or similar products in a stable business environment exists (however, changing circumstances could make this experience irrelevant).
- The established return period is not long.
- The product is not susceptible to technological obsolescence.

The absence of one or more of these factors may indicate that an entity is unable to reasonably estimate returns. The SEC staff has indicated that there is no specific minimum length of time necessary to be able to estimate returns in product transactions. Rather, an entity should carefully evaluate the facts and circumstances of each situation to determine if a reasonable and reliable estimate of returns can be made. The SEC staff noted that entities that either introduce a new product or enter a new market are frequently unable to initially develop the necessary historical return experience on which to base estimates of returns. In addition, if an entity sells a wide range of products that do not have similar levels of returns, it should develop a separate estimate of returns for each product, rather than developing one estimate for all products on a combined basis.

If an entity is not able to make a reliable estimate of returns, it should defer revenue until either (1) a reasonable estimate of returns can be made or (2) the return period lapses.

If a reasonable estimate of returns can be made, the allowance for estimated returns should be recorded as a reduction of the revenue related to the transaction. Both the revenue and cost of sales related to the products subject to return should be eliminated in the current period. It is not appropriate for a vendor to eliminate only the gross profit related to the sales subject to return.

The following example illustrates these concepts.

**General right of return**

Entity A manufactures and sells plastic containers primarily to local retailers. The arrangements provide the retailers with a general right of return for the containers. Entity A has been selling the containers under the same terms for many years and is not obligated to assist the retailers with the resale of the containers. The fees under these arrangements are fixed at inception and the payment terms are net 30 days.

Entity A has information related to the amount of the containers returned during each quarter over the last seven years. This information provides evidence of a stable pattern of returns of approximately 15 percent each year. Because Entity A has a large volume of homogenous transactions and a stable history of sales and returns, it can reasonably estimate the amount of returns, which is approximately 15 percent. Therefore, Entity A can recognize revenue, net of an allowance for the estimated returns on delivery, assuming all other revenue recognition criteria are met.
Specific rights of return

Customer-specific rights of return are a form of customer acceptance provision that must be carefully evaluated on a contract-by-contract basis to determine the appropriate accounting.

Customer acceptance provisions allow the customer to cancel an arrangement or return a product if the product does not meet the customer’s expectations. Customer acceptance provisions may indicate a customer’s rights to:

- Evaluate the product on a trial basis
- Require the seller to perform additional services after delivery (including installation or activation services)
- Require the seller to perform other services before customer acceptance of the product

The SEC staff in SEC Staff Accounting Bulletin (SAB) 104, Revenue Recognition, indicates there is a presumption that contractual customer acceptance provisions are substantive, bargained-for terms in an arrangement and that when such customer acceptance provisions exist, revenue should not be recognized before the earlier of customer acceptance or the lapse of the acceptance provisions.

Customer acceptance provisions generally take one of the following forms. The specific terms of these provisions within an arrangement should be analyzed to determine the appropriate accounting to apply.

- **Acceptance provisions for evaluation or trial purposes.** The customer agrees to receive the product from the seller solely to evaluate the product before acceptance. Acceptance occurs either through affirmative acceptance by the customer or when the acceptance provisions lapse and the customer has not taken action to reject the delivered product. These arrangements are frequently considered in-substance consignment arrangements, because title to the product does not transfer to the customer and payment for the product is not required before acceptance. As a result, revenue should not be recognized before the earlier of acceptance by the customer or the lapse of the acceptance provisions.

- **Acceptance provisions that grant a right of return based on subjective criteria.** For example, if the customer can return the product if it is dissatisfied, the arrangement contains subjective acceptance provisions. These provisions are similar to general rights of return and should be accounted for under ASC 605-15-25-1 through 25-4. If a reasonable estimate of returns can be made using the criteria set forth in ASC 605-15-25-1, as explained in “General rights of return” on page 77, revenue should be recognized at the time of sale if all other revenue recognition criteria are met. A large population of homogenous transactions is necessary for a company to reasonably estimate product returns.
• **Acceptance provisions based on seller-specified objective criteria.** These provisions give the customer the right of return or replacement if the product fails to meet the seller’s published specifications. In situations where the seller has demonstrated that the product meets the specified criteria, these provisions should be accounted for as warranties in accordance with ASC 450, *Contingencies*. If the seller demonstrates that the product meets the published specifications and that the cost of correcting potentially defective goods can be reliably estimated based on a history of similar transactions, revenue would be recognized on delivery, assuming all other revenue recognition criteria are met. An estimate of the cost of providing the warranty services (correcting or replacing the potentially defective goods) should be accrued at the time of revenue recognition.

• **Acceptance provisions based on customer-specified objective criteria.** Formal customer sign-off is the best evidence that customer-specified objective acceptance criteria have been met. However, if the seller can reliably demonstrate that the product meets the customer-specified criteria before formal customer acceptance, it may be possible to recognize revenue when title and the risks and rewards of ownership are transferred to the customer, assuming all other revenue recognition criteria are met. In these situations, the seller must evaluate whether the product performance in the customer environment would differ from performance in the test environment. According to the SEC staff, if the seller is unable to test the customer acceptance criteria before delivery and installation, revenue recognition should be deferred until the criteria are met, for example, if the acceptance criteria require that the product work when integrated with other customer equipment and software.

The SEC staff includes several examples in SAB 104 to illustrate various aspects of customer acceptance provisions and the appropriate accounting for each situation.

In addition, the following examples illustrate these concepts.

---

**Customer acceptance: equipment evaluation**

Entity A enters into an arrangement to deliver and install a piece of equipment to be used in Entity D’s manufacturing process. The equipment is a new product designed to accelerate the movement of materials through the manufacturing facility. Entity D has a relatively small manufacturing facility and is not sure the equipment will effectively operate in its environment. The arrangement terms state that title to the equipment does not transfer until 60 days after installation. In addition, Entity A will not invoice Entity D for the equipment until 60 days after installation, and payment will be due 30 days after the invoice date.

Since Entity D is accepting the equipment on a trial basis, revenue should not be recognized until the earlier of (1) notification of acceptance from Entity D or (2) the expiration of the 60-day trial period, assuming all other revenue recognition criteria are met.
Customer acceptance: seller-specified objective criteria

Entity B enters into an arrangement with Entity E to deliver a standard x-ray machine. Entity B has sold, and expects to continue to sell, a significant volume of these machines. Title to the machine transfers on delivery to Entity E. If the equipment does not perform to Entity B’s published specifications, acceptance provisions within the contract allow Entity E to (1) require Entity B to repair the equipment, (2) return the equipment for a full refund, or (3) request a replacement machine. Customer acceptance is evidenced by either a formal sign-off by Entity E or the passage of 60 days without a claim under the acceptance provisions.

Entity B has tested the x-ray machine in its facility before shipment and has no reason to believe the machine will not operate as expected in Entity E’s facility. As a result, revenue would be recognized on delivery, assuming all other revenue recognition criteria are met. Entity B would evaluate the acceptance provision as a warranty under ASC 450 and would recognize an estimate of the amount of the related warranty obligation as a liability concurrent with revenue recognition.

Customer acceptance: customer-specified objective criteria

Entity B enters into an arrangement with Entity E to deliver a standard x-ray machine modified to integrate with other equipment used in Entity E’s facility. Entity B has never performed the modifications required by Entity E. Title to the machine transfers on delivery to Entity E. Acceptance provisions within the contract provide Entity E with a right to a full refund if the equipment does not work on an integrated basis with Entity E’s existing equipment.

Entity B completes the modifications and the modified machine meets all of Entity B’s published specifications; however, Entity B is not able to duplicate Entity E’s operating environment to evaluate whether the modified x-ray machine will meet the customer-specified criteria before shipment.

Because (1) the contract includes acceptance provisions that are based on customer-specified objective criteria and (2) Entity B is not able to demonstrate performance to the specified criteria before shipment, Entity B would not recognize revenue before receipt of objective evidence of acceptance by Entity E (for example, formal acceptance or written confirmation that the equipment meets the defined specifications) and all other revenue recognition criteria are met.
Chapter 8

What is the revenue recognition model applied to a software arrangement?

**General**
The guidance in *FASB Accounting Standards Codification™ (ASC) 985-605, Software: Revenue Recognition*, should be applied in recognizing revenue for licensing, selling, leasing, or otherwise marketing computer software. Arrangements within the scope of ASC 985-605 range from those that provide a single license of a software product to those that require significant production, modification, or customization of software.

ASC 985-605 applies to software activities by all types of entities. Assessing whether an arrangement that contains only software is within the scope of ASC 985-605 may be relatively simple, but the fact is that many products today contain embedded software and determining whether a particular arrangement is within the scope of ASC 985-605 can require significant professional judgment. The determination of whether an arrangement is within the scope of ASC 985-605 may have a significant effect on an entity’s revenue recognition policies.

**Scope**
Arrangements that include a license to use computer software, a lease to use computer software for a specified term or an outright sale are all within the scope of ASC 985-605. Arrangements that include tangible products may also require an evaluation as to whether the product is in the scope of ASC 985-605, such as when the product contains embedded software. An arrangement that includes software and software-related components that are more-than-incidental to the product or service as a whole is within the scope of ASC 985-605, unless it qualifies for a scope exception in ASC 985-605-15-4.
In addition, if an entity offers a “more-than-insignificant” discount on future purchases of software or other elements that are within the scope of ASC 985-605, the discount is another element in the arrangement that must be accounted for using the guidance in ASC 985-605. Certain hosting arrangements are also within the scope of this guidance, as further described in chapter 8, “Hosting arrangements.”

ASC 985-605-15-4 contains the following scope exceptions:

- Arrangements that include software that is incidental to the products or services as a whole
- Software leases that include a tangible product, if the software is incidental to the product as a whole or the software and nonsoftware components to the tangible product function together to deliver the tangible product’s essential functionality
- Marketing and promotional activities that are not unique to software transactions, such as the following:
  - Insignificant discounts on future purchases offered by a vendor
  - Discounts that are not incremental to discounts typically given in comparable transactions
- Nonsoftware components of tangible products
- Software components of a tangible product that is sold, licensed or leased when the software components function together with the product’s nonsoftware components to deliver the product’s essential functionality (also referred to as “essential software”)
- Undelivered elements that relate to the essential software in the above-described tangible products

**Determining whether an arrangement is in the software revenue recognition guidance**

Determining whether the software is incidental to the product (or services) as a whole is critical in an entity’s selection of the appropriate revenue recognition model to apply. Many products currently manufactured include embedded software to enhance their functionality or even require software for their intended use. The entities that produce these products span various industries such as telecommunications, medical devices and consumer products. Because these entities may not consider themselves to be software companies they may not realize that ASC 985-605 could apply to them. However, if the embedded software is more than incidental to the product as a whole, ASC 985-605 would apply, unless the product and related software qualify for a scope exception in ASC 986-605-15-4.
ASC 985-605-15-3(c) lists the following three indicators to help determine whether the software is incidental to a product or service as a whole. The presence of any of these factors is an indicator that the software is significant in relation to the transaction as a whole, and therefore the guidance of ASC 985-605 should be applied, unless a scope exception in ASC 985-605-15-4 is met:

- The software is a significant focus of the marketing effort or is sold separately.
  - Is the functionality of the software a focus of the product marketing?
  - Is the software element sold separately by the company?
  - Can the software be included in another vendor’s products?
- The vendor is providing postcontract customer support.
  - Does the vendor provide enhancements, upgrades, or bug fixes to the product via software?
  - Does the support provided to the customer include support for the software element?
- The vendor incurs significant costs that are within the scope of ASC 985-20, *Costs of Software to Be Sold, Leased, or Marketed.*

This list is not all-inclusive and other factors may need to be considered based on the facts and circumstances of the situation. The SEC staff has commented that it may review marketing materials, the entity’s website, public statements made by management, and the business section of annual reports filed with the SEC in evaluating the importance of software elements embedded in products and services.

The following illustrations demonstrate the application of the indicators included in ASC 985-605-15-3(c) for determining if software is more than incidental.

**Software is incidental**

Entity A manufactures and sells alarm clocks that include software that adds functionality to the product. Entity A does not market the alarm clock based on the performance or functionality of the software component and the software is not sold on a stand-alone basis. In addition, upgrades to the software are not provided to consumers that purchase the alarm clocks.

These facts indicate that the software in the alarm clock is incidental to the product as a whole and, as a result, the provisions of ASC 985-605 do not apply for revenue recognition.
However, determining whether software is more than incidental to the product or services in an arrangement as a whole may not be necessary if an arrangement qualifies for the scope exceptions discussed below. The scope exceptions below would apply even if software is considered to be more than incidental.

**Software revenue recognition guidance scope exceptions**

Arrangements with tangible products containing both software components and nonsoftware components that function together to deliver the tangible product’s essential functionality are excluded from the scope of ASC 985-605. In addition, undelivered elements that relate to software that is essential to the functionality of the tangible product are also excluded.

Entities are required to consider the following factors in determining whether software and nonsoftware components function together to deliver a tangible product’s essential functionality:

- If the entity infrequently sells the tangible product without the software components, there is a rebuttable presumption that software components are essential to the functionality of the tangible product.
- If an entity sells tangible products with similar functionality, such as different models, and the only substantive difference between the products is that one product includes software that the other product does not, the products are considered the same product for purposes of evaluating the factor in the first bullet.
• If an entity sells a tangible product with software, but also sells the software on a stand-alone basis, the separate sale of the software does not affect the evaluation of whether the software is essential to the functionality of the tangible product.
• Software elements are not required to be embedded within a product to be considered essential to the product’s functionality.
• Nonsoftware components must substantively contribute to the tangible product’s essential functionality (in other words, the tangible product cannot just be a delivery mechanism for the software).

Based upon the above guidance, we believe hardware components of a tangible product containing software components will generally be excluded from the scope of ASC 985-605. ASC 985-605-55-212 through 55-233 provides numerous examples illustrating the factors above for determining whether software and nonsoftware components function together to deliver a tangible product’s essential functionality. In addition, below is an example that illustrates some of these concepts. Also refer to “Interaction with other accounting literature” on page 94 for additional information on allocating arrangement consideration to elements within and outside the scope of ASC 985-605.

The following example illustrates these concepts.

**Scope exception example**
Entity A sells a PC with an operating system that, along with the hardware, provides the PC’s essential functionality. Entity A never sells the PC and the operating system separately. Also included in the arrangement is a specified upgrade right for the next version of the operating system and postcontract customer support (PCS), including a right to when-and-if-available upgrades of the operating system.

• Since the hardware (nonsoftware component) and operating system (software component) function together to deliver the tangible product’s essential functionality, these components are excluded from the scope of ASC 985-605.
• In addition, because the PCS and the specified upgrade right relate to the software that is essential to the PC’s functionality, they are also excluded from the scope of ASC 985-605.
• The entire arrangement is assessed for separation, measurement, and allocation in accordance with the guidance in ASC 605-25.
Recognizing software revenue
If the software does not require significant production, modification, or customization, then ASC 985-605-25-3 requires that revenue should be recognized when all of the following criteria are met:
• Persuasive evidence of an arrangement exists.
• Delivery has occurred.
• The vendor’s fee is fixed or determinable.
• Collectibility is probable.

These criteria are based on the general revenue recognition principles in FASB Statement of Financial Accounting Concepts (CON) 5, Recognition and Measurement in Financial Statements of Business Enterprises, and are discussed in more detail in this chapter. The term “probable” in the fourth criterion is defined in ASC 450, Contingencies, as “the future event or events are likely to occur.”

Under ASC 985-605, arrangements requiring significant production, modification, or customization of software are accounted for using contract accounting in conformity with ASC 605-35, Revenue Recognition: Construction-Type and Production-Type Contracts. Contract accounting is further described in chapter 9 of this document.

Multiple-element arrangements

General
Software arrangements often include more than one element. The elements may include software, as well as software-related and nonsoftware-related elements. Examples of software-related elements as indicated in ASC 985-605-25-5 are upgrades, enhancements, postcontract customer support (PCS), and other services. An example of a nonsoftware-related element in a software arrangement includes computer hardware for which the software is not essential to its functionality.
Combining contracts
Software vendors may execute more than one contract or agreement with a single customer. The fact that separate agreements are executed to cover different software products and/or services does not necessarily mean that the elements covered by each agreement should be accounted for independently. ASC 985-605-55-4 addresses when a group of contracts should be treated as a single multiple-element arrangement in determining the appropriate amount of revenue to be recognized under ASC 985-605. According to ASC 985-605-55-4, the existence of any of the following factors may indicate that a group of contracts should be accounted for as a single arrangement:

- The contracts or agreements are negotiated or executed within a short time frame of each other.
- The different elements are closely interrelated or interdependent in terms of design, technology, or function.
- The fee for one or more contracts or agreements is subject to a refund, forfeiture, or other concession if another contract is not completed satisfactorily.
- One or more elements in one contract or agreement are essential to the functionality of an element in another contract.
- Payment terms under one contract or agreement coincide with performance criteria of another contract or agreement.
- Contract negotiations are conducted jointly with two or more parties (for example, personnel from different divisions of the same company) for activities that essentially comprise a single project.

This list is not all-inclusive, and other factors may exist that indicate closely related contracts should be considered as a single arrangement. The facts and circumstances of each situation should be carefully evaluated to determine whether separate transactions should be linked as a multiple-element arrangement under ASC 985-605.

The following example illustrates these concepts.

**Combining multiple contracts between two parties**
Entity A enters into an arrangement with Entity B on September 30, 20X7 that includes a software license for product X and related PCS for one year. On October 15, 20X7, Entity A enters into a separate arrangement with Entity B that includes a software license for product Y and related PCS. Should the separate arrangements be viewed as one multiple-element arrangement when determining the appropriate amount of revenue to be recognized in accordance with ASC 985-605?

Because the separate software licensing arrangements for products X and Y were entered into within 15 days of each other, there is a presumption that the contracts represent one multiple-element arrangement. This presumption may be overcome if (1) the arrangements were negotiated independently by two separate sales representatives in Entity A and two separate purchasing representatives in Entity B and (2) the arrangements are unrelated to and not in contemplation of each other.
Allocating consideration

The fees for arrangements that include more than one software element should be allocated based on vendor-specific objective evidence (VSOE) of fair value. Separate amounts stated in the contract should not be considered in determining the allocation of the total consideration from the arrangement. In deliberating AICPA Statement of Position (SOP) 97-2, *Software Revenue Recognition* (Codified in ASC 985-605), the AICPA Accounting Standards Executive Committee (AcSEC now Financial Reporting Executive Committee (FinREC)) considered various fair value models, including the use of competitors’ prices or industry averages, before concluding that the evidence of fair value must be vendor-specific. In the Basis for Conclusions of SOP 97-2, AcSEC stated that software products of different vendors are inherently different and that only vendor-specific evidence of fair value is sufficiently objective to be used in the allocation of consideration to various elements of the arrangement.

ASC 985-605-25-6 limits VSOE of fair value to the following:

- The price charged when the same element is sold separately.
- For an element 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 element into the marketplace.

We believe that for management to assert that it is probable that the price will not change, the time between management establishing the price and separately introducing the element into the marketplace should generally not exceed 30 days.

In evaluating the probability that the price established by management having the relevant authority will not change before the element is separately introduced (and separately sold) in the marketplace, consideration should be given to (1) the estimated time until separate sale of the element and (2) the historical evidence comparing prices established by management before market introduction with the actual selling prices when the elements are separately sold. If the evidence shows that prices established by management change when the elements are separately sold, this could be an indicator that prices established by management are not sufficiently fixed before the elements’ separate sales to serve as evidence of fair value. Additionally, if the actual selling price of the element when it is introduced in the market is different from the price used as evidence of VSOE of fair value for the element before the separate sale, this change in sales price could be an indicator that the vendor did not have sufficient evidence of fair value before the separate sale, which in turn could indicate an error in the prior period financial statements (see ASC 250, *Accounting Changes and Error Corrections*).
When a new element is introduced by a software vendor, we believe it is difficult to demonstrate VSOE of fair value based solely on a price established by management having the relevant authority before the element is sold separately in the marketplace. This evaluation requires management to assess the likelihood that marketplace participants will (1) accept the new element for purchase separately from a bundled arrangement and (2) be willing to pay the price established by management for the separate element.

ASC 985-605 includes the following rules to apply in allocating the arrangement fee to various elements in an arrangement:

- Amounts allocated to undelivered elements are not subject to adjustment.
- If an arrangement includes a discount (that is, the total consideration is less than the aggregate of fair value of all elements), the discount should be applied proportionately to each element based on the relative fair value of each element. This provision is applicable only if sufficient VSOE of fair value exists for each element in the arrangement. However, a discount should not be allocated to any specified upgrade rights, because it is difficult to determine which version of the software induced the customer to enter into the arrangement.
- If sufficient VSOE of fair value does not exist for each element in an arrangement, no allocation of the arrangement fee should be made, and all revenue should be deferred until the earlier of (1) the point when sufficient VSOE of fair value exists or (2) all elements in the arrangement have been delivered. ASC 985-605 includes the following exceptions to this guidance:
  - If the only undelivered element is PCS, the entire fee should be recognized ratably.
  - If the only undelivered element is services that do not involve significant production, modification, or customization of software (for example, training or installation), the entire fee should be recognized during the period when the services are expected to be performed.
  - If the arrangement includes an obligation for the vendor to deliver unspecified additional software products in the future, no allocation should be made to any of the products and the entire fee should be recognized ratably (see “Additional software elements” on page 119).
  - If the fee is based on the number of copies of multiple software products delivered, allocation of the arrangement fee to individual products may not be possible at the arrangement’s inception because the revenue allocable to each product depends on the customer’s choice of products (see “Multiple copies of software products versus multiple licenses” on page 103).
– If sufficient VSOE of fair value exists for the undelivered element(s) but not for the delivered element, fair value should be allocated to the undelivered element(s) and deferred, and the difference between the total arrangement fee and the amount allocated to the undelivered element(s) should be allocated to the delivered element and recognized as revenue when all other applicable revenue recognition criteria described are met. This is known as the residual method and can be applied only if (1) VSOE of fair value exists for all undelivered elements and (2) the fair value of all undelivered elements is less than the arrangement fee (ASC 985-605-25-11).

The following examples illustrate the arrangement consideration allocation methods permitted by ASC 985-605.

### Allocating consideration: relative fair value method

Entity A enters into an arrangement that includes a perpetual software license, implementation services, and one year of PCS for total consideration of $250,000. Entity A separately sells the software license for $175,000 and the implementation services for $75,000. The PCS has an annual renewal rate of $40,000.

Since VSOE of fair value exists for each element in the arrangement (the amounts at which the vendor sells each element separately), the relative fair value method should be used to allocate consideration in the arrangement, as follows:

<table>
<thead>
<tr>
<th>Elements</th>
<th>VSOE</th>
<th>Ratio*</th>
<th>Arrangement consideration allocated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Software license</td>
<td>$175,000</td>
<td>60%</td>
<td>$150,000</td>
</tr>
<tr>
<td>Implementation services</td>
<td>$75,000</td>
<td>26%</td>
<td>65,000</td>
</tr>
<tr>
<td>PCS</td>
<td>$40,000</td>
<td>14%</td>
<td>35,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$290,000</td>
<td>100%</td>
<td><strong>$250,000</strong></td>
</tr>
</tbody>
</table>

Note: This example demonstrates the relative fair value method of allocating consideration; however, software is generally not licensed without PCS. Therefore, it is rare that an entity would apply the relative fair value method to allocate consideration if a software license and PCS are the only elements in an arrangement because there would not be VSOE for the license since it is not sold separately.

* Ratio is computed as the individual VSOE for each element divided by the sum of the VSOE for all the elements. The ratio is then multiplied by the total arrangement consideration to compute the arrangement consideration allocated. For example, the software license calculation is as follows: 
\[
\text{Ratio} = \frac{175,000}{290,000} = 60\%
\]
\[
\text{Arrangement consideration allocated} = \frac{150,000}{250,000} \times 100 = 60\%
\]
What is the revenue recognition model applied to a software arrangement?

**VSOE of fair value established after the balance-sheet date**

VSOE of fair value established after the balance-sheet date but before the issuance of the financial statements is considered a nonrecognized subsequent event, as discussed in ASC 855, *Subsequent Events*. In that situation, revenue should be deferred because VSOE has not been established at the balance-sheet date. In contrast, evidence of fair value that exists at the balance-sheet date but is not compiled until after that date should be used to evaluate whether sufficient VSOE exists to recognize revenue in the period ending on the balance-sheet date.

The following example illustrates these concepts.

**VSOE established after balance-sheet date**

Entity A is a calendar-year entity that sells software programs and training services in multiple-element arrangements. At December 31, 20X7, management was unaware of separate transactions for the training services that would have provided evidence of VSOE of fair value of the training services. Therefore, Entity A deferred all revenue related to arrangements for which software had been delivered but the training services had not been provided at the end of 20X7. On January 10, 20X8, in connection with the preparation of the financial statements for the year ended December 31, 20X7, Entity A identifies separate transactions for the training services that occurred during the fourth quarter of 20X7.

Because the evidence related to the separate training services transactions already existed at December 31, 20X7, Entity A would use the evidence identified in January 20X8 to determine if there was sufficient VSOE of fair value to recognize revenue for the software at December 31, 20X7.
Interaction with other accounting literature

In multiple-element arrangements that include software-related and nonsoftware-related elements, an entity should apply the guidance of ASC 605-25: *Multiple-Element Arrangements*, to determine if the nonsoftware-related elements can be separated from the other elements for accounting purposes. If so, ASC 605-25 is also applied to determine the amount of arrangement consideration to allocate to those nonsoftware-related elements. The remaining consideration is allocated to the software-related element(s) in the arrangement. The software-related elements are evaluated for further separation and recognition under ASC 985-605.

For example, if a multiple-element arrangement includes a tangible product with both essential and nonessential software components, the arrangement consideration should first be allocated to the software and nonsoftware components based on the guidance in ASC 605-25. An entity should then apply the separation, measurement, and allocation guidance in ASC 605-25 to determine whether the nonsoftware items can be further separated and if so, how to allocate the nonsoftware consideration to those units of accounting. An entity should apply the guidance in ASC 985-605 to determine whether the software components can be further separated and if so, how to allocate and recognize revenue for the units of accounting.

If a single undelivered element relates to software components that are both within and outside the scope of ASC 985-605, the undelivered element must be bifurcated into a software element and a nonsoftware element using the guidance in ASC 605-25. The resulting software element is accounted for under the guidance of ASC 985-605 and the nonsoftware element is accounted for under other appropriate revenue guidance.

Applying the above guidance is dependent on the facts and circumstances of the arrangement. The following example illustrates some of these concepts.

### ASC 985-605 and ASC 605-25

Entity A designs, develops and markets software-driven measurement systems used by its customers in manufacturing and industrial applications. Entity A enters into an arrangement with Entity B to deliver measuring devices, including embedded measurement device software, training and optional preinstalled “conversion software.” The measurement software, along with the hardware, provides the measuring device’s essential functionality. The conversion software converts measurement results from the U.S. system to the metric system, readily displays the measurement results on the device under both units of measurement and produces customizable reports.

Because the measurement software is essential to the device’s functionality, the measurement software, the device and the related training are excluded from the scope of ASC 985-605. The conversion software is a software element that is not considered essential to the device’s functionality and therefore is within the scope of the software guidance in ASC 985-605. The measurement and allocation guidance in ASC 605-25 is applied to allocate the arrangement consideration between the ASC 605-25 and ASC 985-605 components.
The following examples illustrate how arrangement consideration is allocated among elements in an arrangement containing a tangible product and both essential and nonessential software components, including PCS that covers both the essential and nonessential software.

**PCS within and outside the scope of ASC 985-605 (no VSOE for PCS)**

On January 1, 20X0, Entity A enters in an arrangement to sell a medical device with diagnostic software that, along with the hardware, provides the device’s essential functionality. Entity A never sells the device and the software separately. The device also includes pre-installed advanced reporting and analysis software (collectively, the “reporting software”), which is sold both installed on the device and separately from the device. The reporting software enables users to manipulate data, prepare customized reports, and interface data with other software. The arrangement also includes one year of PCS covering both the diagnostic software and the reporting software. The reporting software is never sold without one year of PCS when it is sold separately from the medical device. Total arrangement consideration is $1,200. The PCS does not qualify as a separately-priced extended warranty under ASC 605-20-25-3.

Because the hardware (nonsoftware component) and diagnostic software (software component) function together to deliver the device’s essential functionality, these components (collectively the “nonsoftware component”) are excluded from the scope of ASC 985-605. The reporting software is a software element that is not considered essential to the device’s functionality and therefore is within the scope of the software guidance in ASC 985-605. All of the elements have stand-alone value and the arrangement does not contain any refund rights. Due to significant fluctuations in renewal pricing, Entity A does not have VSOE or third-party evidence (TPE) of selling price for PCS sold in any of its arrangements. Because the PCS in this arrangement relates to components both within (reporting software is not essential to the medical device’s functionality) and outside (diagnostic software is essential to the device’s functionality) the scope of ASC 985-605, it must be bifurcated between the software and nonsoftware components using the relative selling price method in the guidance in ASC 605-25. Entity A determined that the estimated selling prices for the nonsoftware and software components, each, as a group, are $975 and $325, respectively. The nonsoftware group is comprised of the medical device (including the diagnostic software) and the related PCS. The software group includes the reporting software and the related PCS.

Entity A would allocate the arrangement consideration to the software and nonsoftware component groups using the relative selling price method. The table below summarizes the results of the relative selling price allocation.

<table>
<thead>
<tr>
<th>Group</th>
<th>Elements</th>
<th>Selling price</th>
<th>Ratio</th>
<th>Arrangement consideration allocated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonsoftware</td>
<td>Medical device (including essential diagnostic software) and related PCS</td>
<td>$975</td>
<td>75%</td>
<td>$900</td>
</tr>
<tr>
<td>Software</td>
<td>Reporting software and related PCS</td>
<td>325</td>
<td>25%</td>
<td>300</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$1,300</td>
<td>100%</td>
<td>$1,200</td>
</tr>
</tbody>
</table>
Entity A would assess the appropriate guidance in ASC 605-25 and ASC 985-605 for the nonsoftware and software components, respectively, to determine whether further separation of elements within the groups should be made.

The nonsoftware components fall within the scope of ASC 605-25. Entity A determined that the medical device (including the essential software) and the related PCS meet the separation criteria. Entity A also determined that its best estimate of selling price for the device (including the essential software) and for the related PCS that was bifurcated to the essential diagnostic software is $885 and $90, respectively.

Entity A would allocate the arrangement consideration to the nonsoftware elements using the relative selling price method in the guidance in ASC 605-25. The table below summarizes the results of the relative selling price allocation.

<table>
<thead>
<tr>
<th>Elements</th>
<th>Selling price</th>
<th>Ratio</th>
<th>Arrangement consideration allocated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical device (including diagnostic software)</td>
<td>$885</td>
<td>91%</td>
<td>$819</td>
</tr>
<tr>
<td>Related PCS</td>
<td>90</td>
<td>9%</td>
<td>81</td>
</tr>
<tr>
<td></td>
<td>$975</td>
<td>100%</td>
<td>$900</td>
</tr>
</tbody>
</table>

Assuming all other revenue criteria have been met, Entity A would recognize $819 upon delivery of the medical device and $81 ratably over the one-year PCS service period.

Since the software group falls within the scope of ASC 985-605, it is held to the VSOE threshold for separating elements. Entity A does not have VSOE for the PCS related to the reporting software. As a result, it would account for the reporting software and the related PCS as a single unit of accounting. Assuming all other revenue criteria have been met, Entity A would recognize revenue of $300 for the software components ratably over the one-year PCS service period.
PCS within and outside the scope of ASC 985-605 (with VSOE for PCS)

Assume the same facts as the last example, except that Entity A previously established VSOE for PCS based on renewals (stand-alone sales), as follows:

<table>
<thead>
<tr>
<th>Arrangement</th>
<th>VSOE</th>
</tr>
</thead>
<tbody>
<tr>
<td>PCS for medical device and essential diagnostic software</td>
<td>$85</td>
</tr>
<tr>
<td>PCS for reporting software</td>
<td>$50</td>
</tr>
</tbody>
</table>

Also assume Entity A determined that its best estimate of selling price for the medical device (and essential diagnostic software), without PCS, is $900.

Entity A would allocate the arrangement consideration to the software and nonsoftware component groups using the relative selling price method. The table below summarizes the relative selling price allocation.

<table>
<thead>
<tr>
<th>Group</th>
<th>Elements</th>
<th>Selling price*</th>
<th>Ratio</th>
<th>Arrangement consideration allocated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonsoftware</td>
<td>Medical device (including diagnostic software) and related PCS</td>
<td>$985</td>
<td>75%</td>
<td>$900</td>
</tr>
<tr>
<td>Software</td>
<td>Reporting software and related PCS</td>
<td>325</td>
<td>25%</td>
<td>300</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$1,310</td>
<td>100%</td>
<td>$1,200</td>
</tr>
</tbody>
</table>

*Selling price for the nonsoftware component is computed as $900 for the medical device (including essential diagnostic software) based on the entity’s best estimate of selling price, plus $85 VSOE for the PCS related to the essential diagnostic software. Selling price for the software component was determined to be $325 based on the entity’s best estimate of selling price.
Entity A would further allocate the nonsoftware arrangement consideration of $900 between the medical device and the related PCS using the relative selling price method.

The table below summarizes the relative selling price allocation.

<table>
<thead>
<tr>
<th>Elements</th>
<th>Selling price</th>
<th>Ratio</th>
<th>Arrangement consideration allocated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical device (including essential diagnostic software)</td>
<td>$900</td>
<td>91%</td>
<td>$819</td>
</tr>
<tr>
<td>Related PCS</td>
<td>85</td>
<td>9%</td>
<td>81</td>
</tr>
<tr>
<td>Total</td>
<td>$985</td>
<td>100%</td>
<td>$900</td>
</tr>
</tbody>
</table>

Assuming all other revenue criteria have been met, Entity A would recognize $819 upon delivery of the medical device and $81 ratably over the one-year PCS service period.

The $300 of consideration relating to the software component falls within the scope of ASC 985-605 and is allocated based on that guidance. Since Entity A has VSOE for the undelivered element—that is, PCS related to the reporting software—it would allocate arrangement consideration to the software component elements using the residual method. Under the residual method, $50 representing VSOE of the PCS related to the productivity software is allocated to the $300 software component. The remaining $250 is allocated to the productivity software.

Assuming all other revenue criteria have been met, Entity A would recognize $250 upon delivery of the medical device, which includes the reporting software, and $50 for the related PCS ratably over the one-year service period.

Evidence of an arrangement

One of the criteria for recognizing revenue in a software arrangement is that persuasive evidence of an arrangement must exist. Whether evidence of an arrangement exists is based on the normal business practice of an entity. Some entities document the terms of all customer arrangements in written contracts. For these entities, evidence of an arrangement does not exist until a written contract is finalized and signed by both the vendor and the customer. If a vendor’s customary practice is to use approved third-party purchase orders or online authorizations to document customer arrangements, the purchase order or online authorization is appropriate evidence of the arrangement. The documentation used by the vendor to demonstrate persuasive evidence of an arrangement must be final and should include (or reference) all pertinent terms and conditions of the arrangement. Legal assistance may be required to determine whether persuasive evidence of an arrangement exists if the vendor does not have a customary practice of using written documentation.
The form of evidence of an arrangement for a vendor may vary by type of element or by class of customer. For example, a vendor markets its software to both large corporate users and to individual customers. The vendor’s customary business practice is to obtain signed written contracts for corporate users and online authorization for individual customers.

The form of evidence customary to a particular transaction must be received before recognizing revenue. If a vendor relies on signed contracts, the contract must be signed by both parties before the end of the reporting period to recognize revenue in that period. If one of the parties signs the contract subsequent to the period-end, the criteria for recognizing revenue has not been met in the earlier period. If a vendor customarily relies on a form of evidence other than a signed contract, that form of evidence must be obtained before recognizing revenue. If a vendor does not customarily obtain signed written contracts for arrangements, but a signed contract is executed for a particular arrangement, revenue should not be recognized for that arrangement before the contract is signed by both parties.

The following examples illustrate these concepts.

**Persuasive evidence of an arrangement: contract required**
Entity A has a fiscal year-end of June 30 and has a customary practice of obtaining signed written contracts to evidence its software licensing arrangements. On June 15, 200X, Entity A receives an authorized purchase order for a perpetual license to a software package for $50,000. The software is delivered to Customer B on June 30, 200X. Included in the shipping package is a written contract that has been appropriately signed by Entity A. On July 5, 200X, Customer B signs and returns the executed contract to Entity A.

Because Entity A has a customary business practice of executing written contracts, no revenue should be recognized until the contract has been signed by Customer B evidencing the arrangement, even though all other revenue recognition criteria have been met before June 30.

**Persuasive evidence of an arrangement: no contract required**
Entity A sells off-the-shelf engineering software and has a business practice of shipping the software to customers after receiving a signed customer purchase order. Entity A does not use signed contracts for its arrangements. On December 29, 200X, Entity A receives a signed purchase order from Entity B for 200 units of engineering software at $100 per unit. The software is delivered to Entity B on December 30, 200X.

Since Entity A’s customary business practice is to accept a signed purchase order as evidence of an arrangement, Entity A can recognize the revenue upon shipment to Entity B, assuming all other revenue recognition criteria are met.
Vendors should establish a written policy regarding the type of documentation that is considered persuasive evidence of an arrangement. The policy should (1) cover evidence of an arrangement for each significant type of element and class of customer, (2) be based on past history and current business practice, and (3) be consistently applied.

**Delivery**
The second criterion for revenue recognition in ASC 985-605-25-3 is delivery. In most situations, determining when delivery has occurred is relatively straightforward. Delivery generally occurs when the product master is transferred or, if the product master is not being transferred, when the first copy is delivered. An exception exists in ASC 985-605-25-52 through 25-57 for arrangements in which the fee is a function of the number of copies delivered (see “Multiple copies of software products versus multiple licenses” on page 103).

**Physical delivery**
As with other types of arrangements, the terms of delivery should be evaluated in a software arrangement to ensure that the delivery criterion has been met. The contract delivery terms must be considered to determine when the risk and rewards of ownership are transferred from the vendor to the customer. If the arrangement terms are free on board (FOB) shipping point, then the delivery criterion is generally met at the time of shipment. If the terms are FOB destination, the delivery criterion is generally not satisfied until the software is physically delivered to the location indicated by the customer.

The following example illustrates these concepts.

**Delivery: FOB destination**
On December 29, 20X7, Entity A enters into an arrangement to sell 100 copies of software product X to Entity B for $100 per copy. The software is packaged and shipped from Entity A on December 31, 20X7. The delivery terms are FOB destination. As a result, assuming all other revenue recognition criteria are met, revenue should be recognized for this arrangement when the software is received at the shipping location designated by Entity B.
Electronic delivery
For software that is delivered electronically, the delivery criterion is met when the customer either (1) takes possession of the software via a download or (2) is provided with access codes that allow the customer to take immediate possession of the software on its hardware. AcSEC indicated in the Basis for Conclusions of SOP 97-2 that the delivery criterion is met by use of access codes only when software is being delivered electronically.

The following examples illustrate these concepts.

**Delivery: electronic delivery**
Entity A (a calendar-year entity) enters into an arrangement with Entity B to license architectural software developed by Entity A. Entity B has responsibility for procuring the hardware needed to run the architectural software. Entity A has a customary practice of providing a link to its customers that grants them access to download purchased software.

On December 31, 20X7, a customer service representative from Entity A sends an e-mail containing a link that provides immediate access to download the software to Entity B’s purchasing agent. The hardware on which the software will run is installed at Entity B on January 10, 20X8, and on January 11, 20X8, Entity B downloads the software.

Because Entity A has delivered the software electronically via a link to download the software, it may recognize revenue related to the license on December 31, 20X7, assuming all other revenue recognition criteria of ASC 985-605-25-3 are met. The fact that Entity B does not access the link until January 11, 20X8 does not impact revenue recognition.

**Delivery: both physical and electronic delivery required**
Entity A enters into an arrangement with Entity B for a software product. Entity B wants to have paper copies of the manuals as well as physical disks containing the software for recovery purposes and has requested both physical and electronic delivery of the software. On the last day of its fiscal year, Entity A provides a link to Entity B that allows access to a server to download the software. However, delivery of the physical disk and manuals does not occur until three days into the new fiscal year.

Since the contract specifies both electronic and physical delivery of the software, Entity A has not fulfilled its obligation until after the beginning of the new fiscal year. As a result, revenue should not be recognized before physical delivery of the software.

Customer acceptance uncertainties
Software arrangements may include a provision that outlines acceptance criteria for the vendor to meet or a time limit for the customer to accept or return the product. Customer acceptance provisions may allow the customer the right to test the software or other product or may obligate the vendor to perform additional services, such as implementation or customization, before the customer accepts the product. These acceptance provisions may indicate that delivery or performance has not occurred before the earlier of customer acceptance or the expiration of the acceptance period.
If, after delivery, uncertainty about customer acceptance exists, ASC 985-605-25-21 states that revenue should not be recognized until acceptance occurs. However, ASC 985-605-55-81 states that the guidance in ASC 985-605-25-21 is not intended to suggest that the existence of a customer acceptance provision precludes revenue recognition until formal acceptance has occurred.

Formal customer acceptance is not always required to demonstrate that the criteria specified by the customer are met. ASC 985-605-55-81 provides the following factors to consider in evaluating the effect of a customer acceptance provision on revenue recognition:

- Historical experience with similar types of arrangements or products
- Whether the acceptance provisions are specific to the customer or are included in all arrangements
- The length of the acceptance term
- Historical experience with the specific customer

Generally, if the acceptance period is relatively short and the acceptance criteria are based on normal published specifications, revenue recognition is not precluded.

Customer acceptance provisions may be included in an arrangement for a variety of reasons, including enforcing a customer’s rights to (1) test the software product, (2) require the vendor to perform additional services after delivering the software, or (3) determine if other work must be completed before accepting the software product. Arrangements that include acceptance provisions that provide the customer with an opportunity to evaluate the software during a trial period before acceptance are in-substance consignment arrangements until customer acceptance occurs. In some trial arrangements, formal customer acceptance is required, while in other situations, acceptance provisions lapse by the passage of time without the customer rejecting the delivered software. If software products are delivered for trial or evaluation purposes, revenue should not be recognized until the earlier of either formal acceptance by the customer or the lapse of the customer acceptance provisions.

The following example illustrates these concepts.

**Customer acceptance provisions: customer-specified criteria**

Entity A, a telecommunications software company, enters into a multiple-element arrangement with Entity B that includes software and PCS for total consideration of $500,000. Under the terms of the arrangement, the software must meet Entity B’s established minimum threshold for transferring wireless data from one network to another. Following installation of the software, Entity B will test the software to determine if the minimum transfer threshold has been met before notifying Entity A of its acceptance of the software.

The requirement that the software must meet a minimum transfer threshold is a customer-specified criterion that may preclude revenue recognition before Entity B completes the testing and acceptance of the software, even if all other revenue recognition criteria have been met. If Entity A can however reliably demonstrate that the software will perform at the minimum transfer threshold in a test environment similar to Entity B’s environment, revenue recognition for the software license may be appropriate at the time the software is delivered, assuming all other revenue recognition criteria in ASC 985-605-25-3 are met.
Some contracts may include a provision limiting the period during which the customer may reject the software. If the specified period passes without notification from the customer of its rejection of the software, acceptance may be deemed to have occurred. In such situations, the vendor may recognize revenue upon expiration of the specified acceptance period, provided all other revenue recognition criteria are met and the customer has not given notification of rejection of the software.

**Multiple copies of software products versus multiple licenses**

ASC 985-605 distinguishes between arrangements to use multiple copies of a software product under site licenses with users or to market multiple copies of a software product under similar arrangements with resellers, from arrangements to use or market multiple single licenses of the same software. Generally, site license and reseller arrangements are fixed fee arrangements, and the fee is payable to the vendor on delivery or transfer of the first copy. The fee is not contingent on additional copies being requested by and provided to the customer. In these fixed fee arrangements, if the vendor duplicates the software either to maintain quality control or as a convenience to the customer, duplication is considered incidental. Assuming all other revenue recognition criteria of ASC 985-605-25-3 are met, revenue should be recognized when the first copy is delivered or transferred. The estimated costs of duplicating the software should be accrued when revenue is recognized.

In situations where the fee is a function of the number of copies of the software product delivered, the delivery criterion is met as each copy is delivered to the customer. If the customer is responsible for duplication, revenue is recognized on a per copy basis as duplication occurs.

The following examples illustrate these concepts.

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**Multiple copies of software products or licenses**  
Entity A enters into an arrangement with Entity B to license up to 100 copies of software product C for total consideration of $75,000. The total consideration of $75,000 is due on delivery of the first copy and is nonrefundable. Entity A has responsibility for duplicating the software and delivering additional copies to Entity B as they are requested. On December 31, 20X5, Entity A delivers the first 25 copies of product C to Entity B and receives a payment of $75,000. On February 23, 20X6, Entity A delivers 35 additional copies of the software product to Entity B, as requested.

The fee for up to 100 copies of software product C is fixed at $75,000 and does not vary based on the delivery of fewer copies. Assuming all other revenue recognition criteria of ASC 985-605-25-3 are met, Entity A would recognize revenue of $75,000 on delivery of the first copy. In addition, Entity A should estimate and accrue the costs of duplicating up to 100 copies when revenue is recognized.
Some fixed fee software arrangements provide customers with the right to obtain multiple copies of more than one software product at a fixed price per copy, up to the total amount of an aggregate fixed fee. For example, in these arrangements, the vendor may not be able to allocate the arrangement fee to the individual products at the inception of the arrangement because (1) the customer has not yet specified the mix of products it will choose or (2) the arrangement may include products that are not yet deliverable by the vendor. If the vendor is unable to allocate the consideration at the outset of the arrangement, the vendor should recognize revenue as copies of delivered products are either reproduced by the customer or furnished to the customer if the vendor is duplicating the software, assuming all other revenue recognition criteria are met. The vendor should recognize any remaining unrecognized license fees once it has delivered the master or first copy of all products required by the arrangement to the customer, assuming all other revenue recognition criteria are met.

Certain fixed fee arrangements specify a maximum number of copies of the undelivered product that the customer may obtain and VSOE of fair value of the undelivered product exists. In these arrangements, the vendor should allocate a portion of the consideration to the undelivered products assuming the customer will elect to take the maximum number of undelivered products. The vendor should recognize revenue for the amount of consideration allocated to the delivered products when the product master or first copy is delivered to the customer, assuming all other revenue recognition criteria are met. If the customer receives enough copies of the delivered products so that revenue allocable to the delivered products exceeds the amount previously recognized by the vendor, the vendor should recognize additional revenue as the copies are reproduced or delivered. The vendor should reduce the amount of revenue allocable to the undelivered product by a corresponding amount.

**Multiple single licenses**

Entity A enters into an arrangement with Entity B to license up to 100 copies of software product C for $1,000 per copy. Payment for the software is due 30 days after delivery of each copy. The arrangement terms fix the price at $1,000 per copy for up to one year from the date the contract is executed by both parties. On November 29, 20X6, Entity A delivers 15 copies of software product C to Entity B and payment is received on December 16, 20X6. In February 20X7, Entity B requests and receives 30 additional copies of the software.

Since the total consideration is dependent on the number of copies of software product C delivered to Entity B, Entity A should recognize revenue as each copy is delivered, assuming all other revenue recognition criteria in ASC 985-605-25-3 are met.
Authorization codes
Vendors sometimes use authorization codes (commonly referred to as keys) to control customer access to software products. Keys can be permanent or temporary and are used by vendors in a variety of ways. Both permanent and temporary keys can be used to control customer access to or duplication of software. Software vendors may also use temporary keys to give a potential customer access to the software product during a demonstration period or to facilitate payment collections.

Delivery of the key is not necessarily required for revenue recognition to occur. The vendor should recognize revenue when the software is delivered if all revenue recognition criteria, as well as all of the following conditions, are met:

- The customer has licensed the software and the vendor has delivered a version of the software that is fully functional, except for a permanent key or additional keys (if additional keys are used to control software reproduction).
- The customer’s obligation to pay for the software and the payment terms, including timing, are not contingent on delivery of either a permanent key or additional keys (if additional keys are used to control software reproduction).
- The vendor intends to enforce payment terms under the original arrangement and does not have a history of failing to enforce its right to collect payment.

The delivery criterion for revenue recognition is not impacted if (1) a vendor uses a temporary key to enhance payment collectibility, (2) the above conditions are met, and (3) the vendor’s customary practice is to use a temporary key in similar circumstances. If the vendor provides the customer with a temporary key when it is customary to provide a permanent key, the use of a temporary key may indicate that collectibility is not probable or that the software is for demonstration purposes only. As a result, revenue recognition may be precluded until the permanent key is provided to the customer.

The following examples illustrate these concepts.

Authorization codes: use is customary
Entity A enters into an arrangement to license software to Entity B. Entity A’s standard practice is to use temporary authorization codes to ensure payment is received from customers. The software is delivered to Entity B on December 31, 20X6, along with an authorization code allowing use of the software for 90 days. After receiving payment on January 29, 20X7, Entity A provides Entity B with a permanent authorization code for the software.

Since Entity A regularly uses temporary authorization codes, revenue for the software may be recognized on delivery of the temporary authorization code, assuming all other revenue recognition criteria are met. Use of temporary authorization codes is not a substitute for a vendor’s evaluation of a customer’s ability to pay.
Use of fulfillment houses

If a vendor uses an agent or a fulfillment house either to deliver or to duplicate and deliver software, revenue should not be recognized when the software is delivered to the agent. The vendor is still responsible for delivering the software to the customer, even if the vendor has no direct involvement in the delivery. Revenue should be recognized when the software is delivered by the agent to the final customer and all other revenue recognition criteria in ASC 985-605-25-3 are met.

Impact of license term in initial and renewal arrangements

The four basic revenue recognition criteria in ASC 985-605-25-3 (see “Recognizing software revenue” on page 88) do not address whether the term specified in a software licensing agreement must begin before revenue may be recognized. However, ASC 985-605-55-103 states that revenue should be deferred until the initial license term begins. If all other revenue recognition criteria in ASC 985-605-25-3 are met, revenue for the license may be recognized on the date the initial license term begins.

The following example illustrates these concepts.

Initial license term

On December 15, 20X6, Entity A enters into an arrangement to license software to Entity B for a three-year term starting January 1, 20X7. On December 26, 20X6, Entity A ships the software to Entity B (terms are FOB shipping point) and collects the fee on delivery. Since Entity B does not have the right to use the software until January 1, 20X7, the revenue should be deferred at December 31, 20X6. Assuming all other revenue recognition criteria in ASC 985-605-25-3 are met, the license revenue would be recognized when the initial license term begins on January 1, 20X7.
ASC 985-605-55-105 through 55-109 addresses the extension of both a pre-existing, currently active license for the same product and a pre-existing license that has lapsed. If the customer is extending or renewing an active license and no additional products are included in the new arrangement, the vendor should recognize revenue on the date the extension/renewal arrangement is executed, assuming all other revenue recognition criteria are met. If the pre-existing license lapses before the license renewal or extension is executed, the arrangement would be treated as an initial license rather than as an extension or renewal. As a result, the revenue for the new arrangement should not be recognized before the renewal or extension license term begins.

The following examples illustrate these concepts.

### License renewal: currently active license
Entity A enters into a two-year software licensing arrangement with Entity B that begins on January 1, 20X6 and expires on December 31, 20X7. On October 15, 20X7, Entity B determines that it needs the licensed software beyond December 31, 20X7 and enters into an agreement to extend the license through December 31, 20X9. No new products are included in the extension agreement.

Because Entity B has possession of, and the right to use, the software to which the extension applies, Entity A can recognize the amount allocated to the software license renewal as revenue on October 15, 20X7, if all other revenue recognition criteria in ASC 985-605-25-3 are met.

### License renewal: pre-existing license has lapsed
Entity A enters into a two-year software licensing arrangement with Entity B that begins on January 1, 20X6 and expires on December 31, 20X7. Entity B allows the licensing arrangement to expire. However, on March 1, 20X8, Entity B determines that it still needs the licensed software and enters into an agreement to renew the license for the period from April 1, 20X8 through December 31, 20X9. No new products are included in the renewal agreement.

Because Entity B allowed the license to lapse, it no longer has the right to use the software. Accordingly, Entity A would treat the arrangement as an initial software license and would not recognize revenue before the license term begins on April 1, 20X8.

### Inconsequential or perfunctory activities
SAB 104 contains guidance that allows a vendor to recognize revenue when the remaining obligation is considered “inconsequential or perfunctory”, as defined, assuming all other revenue recognition criteria have been met. In some situations, a software vendor has substantially completed the activities related to a delivered item and considers the remaining obligation(s) inconsequential or perfunctory. However, a vendor should not apply this concept of recognizing revenue when delivery is substantially complete to transactions within the scope of ASC 985-605. As a result, when applying the provisions in ASC 985-605, a vendor should complete all of the obligations related to a delivered item before it concludes that delivery has occurred.
Fixed or determinable fees and collectibility

The final two software revenue recognition criteria in ASC 985-605-25-3 are (1) the vendor’s fee must be fixed or determinable and (2) collectibility must be probable. The vendor should assess whether the fee is fixed or determinable only at the outset of the arrangement. Many arrangements provide for fixed or determinable payments that include minimum royalties, minimum license fees from resellers, and payment periods that are relatively short in relation to the period when the customer expects to use the asset(s). Other arrangements have various terms that require careful consideration to determine whether the fees are fixed or determinable.

Extended payment terms

Extended payment terms in a software licensing arrangement may indicate that the fee is not fixed or determinable. This is true regardless of the creditworthiness of the customer. The relatively short life cycle of software products increases the possibility that the software will become technologically obsolete and its value will diminish as a result of the introduction of enhanced products by the vendor or another provider before the customer makes payment. The availability of enhanced products may cause the vendor to provide a concession to the customer to collect the outstanding amount due under the original arrangement terms (see “Concessions” on page 110). As a result of the risk of vendor concessions, any payment terms in a software licensing arrangement that are extended beyond what is normal and customary may indicate that the arrangement fee is not fixed or determinable at the outset of the arrangement.

If a significant portion of the software license fee is not due until after the license expires or more than 12 months after delivery, the vendor should presume that the license fee is not fixed or determinable. Generally, an amount greater than or equal to 10 percent of the software license fee is considered significant. The vendor may overcome this presumption with evidence that it has (1) a standard practice of using long-term contracts and (2) a history of successfully collecting payments under the original terms of the arrangement without making concessions. The vendor should consider if the arrangement is sufficiently similar to historical arrangements in terms of similar customers and products in assessing whether there is evidence of a history of successful collection. ASC 985-605-55-22 through 55-25 provides factors to consider in determining whether the arrangement is sufficiently similar to historical arrangements.
If the vendor cannot conclude at the outset of an arrangement that the fee is fixed or determinable, then the entire fee must be recognized as payments become due. If amounts are collected in advance of the payment due dates, revenue should be recognized as the fees are collected, provided all other revenue recognition criteria in ASC 985-605-25-3 are met. The practice of recognizing revenue using the “rolling 12 months method” is not permitted. Under the rolling 12 months method, all revenue due within 12 months is recognized, and additional revenue is recognized over time so that at any point in time, all amounts due within 12 months would have been recognized as revenue.

The following examples illustrate these concepts.

### Extended payment terms: beyond normal payment terms

On October 1, 20X6, Entity A enters into an arrangement with Entity B to provide a perpetual license to software product X for total consideration of $500,000. The software is delivered to Entity B on October 10, 20X6. Entity A's standard payment terms are net 60 days. The payment terms for the arrangement with Entity B are as follows:

<table>
<thead>
<tr>
<th>Month, Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>November 30, 20X6</td>
<td>$125,000</td>
</tr>
<tr>
<td>February 28, 20X7</td>
<td>125,000</td>
</tr>
<tr>
<td>May 31, 20X7</td>
<td>125,000</td>
</tr>
<tr>
<td>August 31, 20X7</td>
<td>125,000</td>
</tr>
</tbody>
</table>

$500,000

Because Entity A's standard payment terms are net 60 days, the above schedule, providing for payment of $375,000 after 60 days, represents extended payment terms in this arrangement. Therefore, assuming all other revenue recognition criteria in ASC 985-605-25-3 are met, revenue should be recognized as the payments become due. Entity A may overcome the presumption that the amounts are not fixed or determinable if it has a history of providing extended payment terms and of successfully collecting under the original terms of an arrangement without making concessions.

### Extended payment terms: significant amount due more than one year after delivery

On July 23, 20X7, Entity A enters into an arrangement with Entity B to provide a perpetual license to software product Y for total consideration of $750,000. The software is delivered to Entity B on July 31, 20X7. The payment terms for the arrangement are as follows: $250,000 due September 30, 20X7 and the remainder due 14 months after delivery on September 30, 20X8. Entity A does not customarily use long-term contracts. Entity A's fiscal year ends on August 31.

Since a significant portion of the fee is due more than one year after the software is delivered and Entity A does not customarily use long-term contracts, the fee is not fixed or determinable at the outset of the arrangement. Therefore, revenue should be recognized as payments become due, assuming all other revenue recognition criteria in ASC 985-605-25-3 are met. In this arrangement, the first payment is not due until September 30; therefore, no revenue would be recognized by Entity A in the fiscal year ending August 31, 20X7.
Concessions

“Concessions” are any actions taken by a vendor on behalf of a specific customer that were not contemplated or provided for in the original arrangement. Concessions may take many forms, and vendors should carefully evaluate the specific facts and circumstances of each potential concession to determine its impact on whether or not the arrangement fees are fixed or determinable. An action taken by the vendor that would have affected the amount or timing of revenue recognition or increased the elements to be delivered if known at the inception of the arrangement is considered a concession.

Concessions may be difficult to identify since (1) they do not always take the form of a written amendment to the original agreement and (2) they may be executed by individuals outside the accounting department. As a result, companies should develop policies, which include appropriate processes and controls, for identifying and evaluating concessions on a timely basis. According to ASC 985-605-55-18 through 55-21, the following changes to the terms of an arrangement qualify as concessions. This list is not all-inclusive:

- Changes that would have impacted the amount of revenue originally recognized
- Changes that extend the payment terms or decrease the arrangement fee, including the following examples:
  - Decreasing total payments under the arrangement, unless the reduction in payments results from customer credit problems
  - Extending payment due dates, unless the extension is related to customer credit problems
  - Making payments of financing fees on the customer’s financing arrangement if such payments were not included in the original arrangement
  - Accepting returns that were not required under the original arrangement terms
- Changes that extend the rights of the customer or increase the elements beyond the terms in the original transaction. Examples of concessions that increase the elements include the following:
  - Providing the customer access to products not included in the original arrangement without receiving appropriate consideration for the additional access
  - Giving discounted or free postcontract customer support that was not contemplated in the original arrangement
  - Providing other free or discounted services, upgrades, or products that were not in the original arrangement, beyond those that are normally provided by the vendor or that satisfy warranty provisions
  - Extending the time frame for a reseller to sell the software or the end user to use the software in a term license arrangement
  - Expanding the geographic area where a reseller may sell the software, or the number of locations where an end user may use the software, for limited licenses
ASC 985-605-55-21 includes the following examples of changes to the terms of an arrangement that are not considered concessions:

- An increase in the elements with a corresponding increase in the arrangement fee
- Elimination of the vendor’s delivery obligation with no cash refund

A software vendor that provides concessions should determine if it has established a pattern of granting concessions and, if so, the impact on whether or not fees in arrangements with extended payment terms are fixed or determinable at the outset of an arrangement. To the extent that the vendor determines it has a pattern of granting concessions, revenue should not be recognized before the fees become fixed or determinable, which is generally as the fees become due. It is not appropriate to recognize revenue and to recognize an allowance for estimated concessions.

The following examples illustrate these concepts.

**Concessions: extending payment terms**

On July 12, 20X6, Entity A entered into an arrangement with Entity B to provide a perpetual license for a software product for $500,000 plus PCS at 15 percent of the software license fee per year (or $75,000). Payments for the first year of the arrangement were made in equal quarterly installments of $143,750. This payment schedule is normal and customary for Entity A. Entity A determined that Entity B was creditworthy and that collectibility of the fee was probable at the outset of the arrangement. Entity B paid the first two installments on the payment due dates. But, as a result of a fire at its manufacturing facility, Entity B experienced a shortage of cash and was unable to make the final payments when they became due. As a result, on January 15, 20X7, Entity A extended the due dates of the final two payments for an additional six months.

Because Entity B was deemed creditworthy at the inception of the arrangement but was unable to make payments due to financial difficulties resulting from the fire, Entity A’s extension of the payment dates does not represent a concession. Entity A should consider whether it needs to record bad debt expense related to the remaining receivable.

If Entity B had not experienced credit problems but had still requested and received revised payment terms, Entity A would evaluate the revised terms to determine if they represent a concession. If the revised payment terms existed at the arrangement’s inception and Entity A lacked a history of collecting receivables under the revised terms, Entity A would conclude that the fee was not fixed or determinable and that a concession had therefore been granted. The concession may not change the accounting for the existing arrangement if (1) no new undelivered elements are added and (2) Entity A recognized the license fee on delivery and the fees related to the PCS services over the initial one-year period. However, Entity A would include the concession in its analysis of evaluating whether it has a history of successfully collecting payments without providing concessions for the purpose of evaluating future arrangements.
Because the existence of a concession may imply that the arrangement fee is not fixed or determinable, vendors must consider the impact of a concession on not only the specific arrangement to which the concession applies, but also on all other similar arrangements, including future arrangements.

A vendor’s evaluation of whether a concession indicates that it has a history of granting concessions requires judgment and consideration of the facts and circumstances surrounding each specific customer concession. The vendor should consider the reason for granting the concession to the customer. That consideration may provide insight into whether the concession represents an isolated incident or the vendor is likely to grant other customers similar concessions. A recent increase in the frequency of concessions may call into question the continuing relevance of an established history of successful collections under extended payment terms.
**Financing arrangements**

On occasion, customers obtain financing to satisfy an obligation to a vendor for a software arrangement. These customer financing arrangements raise questions about what impact, if any, the financing has on revenue recognition. The impact is affected by the vendor’s level of participation in the customer financing arrangement.

If the arrangement does not include extended payment terms and the customer obtains financing for the software from a third party without the vendor’s participation, the vendor may recognize revenue for the software on delivery, assuming all other revenue recognition criteria in ASC 985-605-25-3 are met.

Even if a vendor transfers to an independent third party the right to receive amounts due under an extended payment arrangement, the nature or structure of the transaction between the vendor and the customer remains unchanged. As a result, the vendor cannot overcome the presumption that the fee is not fixed or determinable in an arrangement with extended payment terms, even if the transfer to the independent third party is without recourse.

The following example illustrates these concepts.

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**Customer financing: no vendor participation**

On September 15, 20X7, Entity A sells a software package to Entity B for total consideration of $2 million. The consideration is due in quarterly installments of $500,000, with the final payment due on September 14, 20X8. Entity A’s normal payment terms are net 60 days. Therefore, the payment schedule with Entity B represents extended payment terms. Entity B obtains third-party financing without the participation of Entity A and makes payments to Entity A in advance of the scheduled payment dates.

Since Entity B made the payments in advance of the scheduled due dates and Entity A did not participate in the financing, Entity A should recognize revenue as the amounts are received, assuming all other revenue recognition criteria are met. The fact that Entity B obtained third-party financing does not overcome the presumption that the fee is not fixed or determinable, so Entity A should recognize revenue as the amounts are received, not up-front when the third-party financing is obtained.

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If an arrangement contains extended payment terms and the customer obtains financing from a third party with the vendor’s participation that allows it to make payments in advance of the scheduled due dates, there may be incremental risk that the vendor will provide a refund or concession to the customer or the financing party.
The vendor’s participation in customer financing may preclude revenue recognition before the customer’s payments are due to the financing party, even if the arrangement with the customer contains standard payment terms. The presence of any of the following conditions would result in incremental risk and a presumption that the fee is not fixed or determinable:

- The vendor is required to indemnify the financing party above and beyond the standard indemnification provisions contained in the arrangement between the vendor and the customer.
- The vendor is required to make customer acceptance representations to the financing party above and beyond the written acceptance documentation received by the vendor from the customer.
- In the event of default under the financing by the customer, the vendor is obligated to take action on behalf of the financing party against the customer, which would result in more than insignificant incremental costs, unless the customer explicitly authorizes the vendor under the original terms of the arrangement to take such action if the financing party requests it.
- The vendor is required to certify, guarantee, or otherwise attest to the financing party that the customer meets the qualification criteria of the financing party.
- The vendor is prohibited from entering into, or has limited ability to enter into, additional arrangements with the customer for the same or similar product if the customer defaults under the financing, unless the customer explicitly authorizes the vendor under the original terms of the arrangement to take such action against the customer if the financing party requests it.
- In the past, the vendor has induced payment to financing parties by providing concessions to customers or financing parties.
- The software vendor guarantees the customer’s indebtedness to the financing party.

If a vendor participates in the customer’s third-party financing, the vendor should demonstrate that it has (1) a standard business practice of entering into similar arrangements with financing parties and (2) a history of not providing concessions or refunds to the financing party or the customer to overcome the presumption that the fee is not fixed or determinable in an arrangement. If the vendor has a history of providing concessions to customers or unrelated financing parties in similar arrangements with extended payment terms, it is not able to overcome the presumption that the fee is not fixed or determinable. If this presumption is not overcome, revenue should not be recognized before the amounts become due and payable to the financing party.
In addition, if a vendor’s guarantee of the customer’s indebtedness to the financing party indicates that it has assumed incremental risk of a concession, the vendor should evaluate whether the guarantee is within the scope of ASC 460, Guarantees. If, because of the guarantee, a vendor concludes that the arrangement fee is not fixed or determinable and, as a result, revenue is recognized as payments from the customer become due and payable to the financing party, the guarantee is not within the scope of ASC 460. However, if the presumption that the arrangement fee is not fixed or determinable is overcome, the vendor should recognize a liability for the guarantee in accordance with the guidance in ASC 460.

An estimate of the guarantee’s fair value should be recognized as a liability at the inception of a guarantee that is issued as part of a multiple-element transaction with an unrelated party in accordance with ASC 460-10-30-2b. This guarantee liability should be reduced by a credit to earnings as the vendor is released from the risk under the guarantee.

In general, the following actions would not cause the vendor to assume an incremental risk of providing a concession or refund to either the customer or the unrelated financing party:

- The vendor introduces the customer to the financing party.
- The vendor assists the customer in pre-qualifying for financing, provided the vendor does not guarantee, certify, or otherwise attest that the customer meets the qualification criteria of the financing party.
- The vendor represents to the financing party that the vendor has free and clear title to the licensed software or the right to sublicense the software, provided the vendor makes the same representations in the software arrangement with the customer.
- The vendor makes customary recourse provisions related to warranties for defective software.
- The vendor makes a similar warranty to both the financing party and the customer that the software functions according to the vendor’s written specifications.
- The vendor takes action to terminate the license agreement or to not enter into another arrangement for the same or similar product, provided the customer explicitly authorizes such action in the original arrangement.
The following example illustrates these concepts.

**Customer financing: vendor participation**

Entity A enters into an arrangement with Entity B to provide a software system for total consideration of $1 million. Entity A’s standard terms require payment in four equal monthly installments beginning 30 days after delivery of the software. Entity B obtains third-party financing and makes payment to Entity A 15 days after the software is delivered. In connection with the financing arrangement between Entity B and the third-party financing company, Entity A certifies that Entity B meets the financing company’s lending qualifications.

Entity A’s participation in the financing arrangement in the form of certifying Entity B’s qualification precludes revenue recognition before the amounts become due and payable to the financing party. The fact that the original arrangement between Entity A and Entity B contains standard payment terms does not overcome the presumption that the arrangement fees are not fixed or determinable at the outset of the arrangement.

Vendors should evaluate whether fees are fixed or determinable at the inception of the arrangement. If, at that time, the vendor concludes that the fees are not fixed or determinable, revenue may only be recognized at the earlier of the payment due dates or when cash is received from the customer. Receiving the first year of payments on a timely basis under a three-year arrangement where fees are not deemed to be fixed or determinable does not allow the vendor to overcome its assessment made at the inception of the arrangement that the remaining payment amounts are not fixed or determinable.

If determining whether the fees are fixed or determinable in an arrangement depends on the transfer of the transaction’s future cash flows to a third party, it is unlikely that revenue recognition is appropriate on transfer. ASC 860, *Transfers and Servicing*, applies only to the transfer of recognized financial assets (for example, trade receivables). If a vendor sells the underlying cash flows related to a transaction that is not yet (1) recognized as income or (2) reflected in the balance sheet as a receivable (because the fees are not fixed or determinable absent the transfer), then the transaction is likely the sale of future revenue and, accordingly, should be accounted for in a manner similar to a financing transaction, as set forth in ASC 470-10-25-1 through 25-2, *Debt*. The SEC staff has noted that an entity should review the specific facts and circumstances of each case and evaluate the accounting for these types of arrangements by determining whether revenue and a corresponding receivable would otherwise be recognized absent the transfer.
**Resellers**

The distribution of software through resellers can provide different challenges in evaluating whether the fees are fixed or determinable on delivery. Resellers are sometimes new and undercapitalized entities that lack the ability to pay for software before reselling it to end users or they may be larger companies that can exert influence over the vendor. Arrangements that do not obligate the reseller to pay for the software until after it is sold to the end user should be accounted for as consignment transactions, and the revenue should not be recognized before the resale. Other factors to consider in evaluating collectibility and determining whether fees are fixed or determinable in reseller arrangements are listed below:

- The newness of the product, the existence of competitive products, or other uncertainties about the number of copies to be sold by the reseller may indicate that the amount of future returns cannot be reasonably estimated at the time of delivery.
- If the arrangement with the reseller includes a price-protection provision and the vendor is unable to reasonably estimate future price changes, the fee is not fixed or determinable. Price-protection provisions generally require the vendor to rebate or credit a portion of the original fee if the price of the product is subsequently reduced by the vendor.
- Competitive pressures, business practices, the reseller’s operating history, or other causes indicate that payment to the vendor is contingent upon the reseller’s distribution of the product.

The following example illustrates these concepts.

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**Reseller: right of return**

Entity A enters into an arrangement with Reseller B to sell 2,500 units of its accounting software. The arrangement provides Reseller B with a specific right to return up to 10 percent of the units to Entity A for a full refund. Entity A is in the process of introducing future products and, therefore, the current software product is susceptible to technological obsolescence. Entity A just recently began to offer return rights and, as a result, has no historical basis for estimating future returns.

Because of the product’s susceptibility to technological obsolescence, coupled with the company’s inability to estimate future returns, Entity A would be precluded from recognizing revenue until either the reseller sells the software to end users or the company receives payment for the software from the reseller and all other ASC 985-605-25-3 revenue recognition criteria are met.
Software vendors sometimes agree to assist resellers in identifying customers or to provide other marketing services in their arrangements. Vendors should evaluate the additional obligation to determine if their continuing obligation is another element in the arrangement or in some other way impacts revenue recognition.

The following example illustrates these concepts.

**Reseller: additional element**

Entity A enters into an arrangement with a reseller to sell a software license for 1,600 users for total consideration of $4 million. The contract requires payment of the full amount at the arrangement’s inception and includes a provision whereby Entity A must provide specific co-marketing services related to the software to the reseller. Entity A has not established VSOE of fair value for the co-marketing services.

Since the contract outlines specific services to be provided by Entity A, the co-marketing services would be considered a separate element in the arrangement. In addition, since Entity A has not established VSOE of fair value for the undelivered co-marketing services, none of the $4 million would be recognized as revenue on delivery of the software license.

**Collectibility**

A vendor should evaluate each arrangement at inception to determine if collectibility of the arrangement fee is probable. ASC 450, *Contingencies*, defines “probable” as “the future event or events are likely to occur.” As a result, after the vendor determines that the first three ASC 985-605-25-3 criteria of revenue recognition are met, it should assess the information available at the inception of the software arrangement to determine if it is likely that the customer will pay the arrangement fee. A vendor may apply many of the same factors used to determine whether a receivable has become a bad debt after a period of time, including the customer’s financial condition, in evaluating collectibility.

In addition, the arrangement terms may indicate that the collectibility criterion is not met. Arrangement fee amounts that are subject to refund, forfeiture, or another concession if the vendor fails to deliver any undelivered elements do not meet the collectibility criterion. This applies even if the amounts are allocated to delivered elements. A vendor should evaluate all available evidence, not just the specific terms of the arrangement, in determining whether revenue is subject to refund, forfeiture, or another concession.
ASC 985-605-25-13 provides the following factors to consider in evaluating evidence that may indicate revenue is not subject to refund, forfeiture, or another concession:

- Acknowledgement of products not to be delivered currently or not currently available
- Separately stated prices for each element in the arrangement
- Defined default and damage terms in the arrangement
- Enforceable payment terms for the delivered elements that are not dependent on delivery of the undelivered elements, together with the vendor’s intent to enforce those payment rights for the delivered elements
- Use of delivered and installed software
- Telephone or other support services associated with the delivered software that are currently being provided by the vendor

A vendor’s history of providing refunds or other concessions that are not required under the original terms of those arrangements is considered to be more persuasive in the evaluation of possible concessions than terms included in the arrangement indicating that no concessions are required.

**Additional software elements**

In connection with an arrangement to deliver software, a vendor may agree to deliver additional software—upgrades or enhancements or other additional software products—in the future. An “upgrade/enhancement” is defined in ASC 985-605-20 as “an improvement to an existing product that is intended to extend the life or improve significantly the marketability of the original product through added functionality, enhanced performance, or both.” Additional software products may be specified or unspecified, and it is important for a vendor to distinguish between the two, as this determination could have a significant effect on the accounting for the arrangement.

**Specified additional software products**

Specified additional software products are generally identified in the arrangement terms and include a vendor’s obligation to deliver a specific software product or a product with specific features and functionality. A vendor’s obligation to deliver a specific software product or a product with specific features and functionality on a when-and-if-available basis should also be accounted for as a specified additional software product rather than as PCS.
A vendor should separately account for specified additional software products by allocating a portion of the arrangement fee to the additional software product based on VSOE of fair value. If VSOE of fair value does not exist for the additional software product, all arrangement revenue is deferred until (1) sufficient VSOE of fair value does exist or (2) all elements in the arrangement have been delivered, and all other revenue recognition criteria in ASC 985-605-25-3 are met. Because software products are generally sold with PCS rather than on a stand-alone basis, it may be difficult for a vendor to establish VSOE of fair value for additional software products.

**Unspecified additional software products**

In an arrangement with unspecified additional software products, the customer has the right to obtain any new products the vendor introduces over a limited time period. Because the future software products are unspecified, a vendor cannot determine VSOE of fair value. In addition, since the vendor is obligated to deliver the future software products only if they become available during the specified time, there may be situations where delivery is never required.

Accordingly, the entire software-related fee for arrangements including unspecified additional software products would be recognized on a subscription basis (that is, ratably) over the term of the arrangement once the first product is delivered, assuming all other revenue recognition criteria in ASC 985-605-25-3 are met. If an arrangement does not have a stated term, a vendor should recognize revenue ratably over the estimated economic life of the products covered by the arrangement, beginning with the delivery of the first product, assuming all other revenue recognition criteria in ASC 985-605-25-3 are met.

**Upgrades or enhancements**

Upgrades (or enhancements) may also be specified or unspecified. If the obligation is to deliver an unspecified upgrade to the customer on a when-and-if-available basis, then the vendor would account for the upgrade right as PCS. When a customer has knowledge of or expects a future upgrade or enhancement, the upgrade right is specified.

Determining whether a vendor has provided a specified upgrade right to a customer may require professional judgment since the right is not always explicitly stated in the arrangement terms. The upgrade right may be implied based on the level of information regarding future product enhancements the vendor communicates to the customer. If a vendor has provided sufficient detail regarding the features and functionality of an enhancement, a customer may have an expectation that the enhancement will be provided by the vendor without significant additional cost. This expectation may have influenced the customer’s current buying decision. If a multiple-element arrangement includes an obligation to deliver a specified upgrade to the customer, the vendor would account for the upgrade right as an additional software element, and the guidance related to multiple software elements in ASC 985-605-25-5 through 25-14, would apply.
The fee for a software arrangement containing a right to a specified upgrade (or enhancement) should be allocated between the elements based on VSOE of fair value. In the Basis for Conclusions of SOP 97-2, AcSEC stated that in a multiple-element arrangement offering a specified upgrade right, it would be difficult for the vendor to conclude which version of the software—the original or the upgraded version—the customer really desires. For example, a customer may license the existing software in order to obtain the anticipated upgrade when it is introduced to the market. As a result, if an arrangement containing an upgrade right is offered at a discount, no part of the discount would be allocated to the upgrade right. The vendor would allocate an amount to the upgrade right that equals the price it would charge other existing users of the software product for the upgrade (VSOE of fair value). The residual amount, if any, would be allocated to the initial software product that was delivered and to any other elements in the arrangement. The amount allocated to the upgrade right would be deferred until the upgrade is delivered, when the amount would be recognized as revenue, assuming all other revenue recognition criteria in ASC 985-605-25-3 are met. If the vendor records revenue based on the relative fair value for each element, then too much revenue could be allocated to the delivered software.

If VSOE of fair value for the specified upgrade does not exist, the vendor should defer all revenue until (1) sufficient VSOE of fair value does exist or (2) all elements in the arrangement have been delivered. We believe it is difficult for a vendor to establish VSOE of fair value for specified upgrades or enhancements because they are generally sold in arrangements with other elements (such as software products with PCS) and are rarely sold on a stand-alone basis.

Not all customers will want the benefits of upgrades or enhancements, so not all of them will take advantage of these rights when they are offered by vendors. ASC 985-605-25-45 provides guidance allowing vendors to estimate “breakage,” that is, the percentage of customers that are not expected to exercise the upgrade right if sufficient VSOE of fair value exists. The amount allocated to the upgrade right would be reduced for breakage. As with other estimates, the vendor must be able to reasonably estimate the amount of breakage expected for each upgrade right. A reliable estimate of breakage can be made if a large group of homogenous transactions exists that the vendor can evaluate. Absent a large pool of homogenous transactions, it would be difficult for the vendor to demonstrate the existence of objective evidence for the estimate; therefore, revenue should not be recognized for customers that do not exercise their right to upgrade until that right expires.

In contrast to arrangements including upgrades or enhancements where it is possible that not all customers will exercise their right to an upgrade or enhancement, it is likely that all customers will elect to receive an additional software product. As a result, a vendor should not reduce the amount allocated to additional software products by an amount based on the estimate of customers that will not exercise their right to receive the additional products.
The following examples illustrate these concepts.

### Additional elements: specified upgrades

Entity A licenses software and related PCS. Entity A currently is selling version 2.0 of the software, but will be introducing version 3.0 in 30 days. As part of the current license arrangements, Entity A includes the right to receive version 3.0 for no additional consideration.

On January 10, 20X7, Entity A enters into an arrangement with Entity B that includes a perpetual license of the software, one year of PCS, and the right to receive version 3.0 when released, for total consideration of $115,000.

Because the arrangement specifies that Entity B will receive version 3.0 on its release, the right to receive version 3.0 must be accounted for as a separate element.

### Additional elements: unspecified upgrades / enhancements

Entity A licenses software and related PCS. Included in the PCS is the right for the customer to receive all future upgrades when and if such upgrades are released by the vendor, as long as the customer has a current arrangement for PCS.

On January 10, 20X7, Entity A enters into an arrangement with Entity B that includes a perpetual license to the software and one year of PCS. The PCS can be renewed each year for 15 percent of the initial consideration.

The right to receive unspecified upgrades on a when-and-if-available basis is generally not considered to be an element separate from the PCS. However, Entity A may have implied a specified upgrade right if it has made public announcements regarding the features and functionality of a soon-to-be-released upgrade. This public announcement may have been in the form of marketing materials, information on the website, or other communication. If an arrangement includes an implied specified upgrade right, that upgrade right should be treated as a separate element.

### Discounts on future software elements

If an arrangement provides the customer with a significant and incremental discount on the purchase of future software products or services, the vendor should account for the arrangement using the provisions of ASC 985-605-55-83 through 55-85. ASC 985-605-15-3d defines a *more-than-insignificant discount* as “a discount that is (1) incremental to the range of discounts reflected in the pricing of the other elements of the arrangement, (2) incremental to the range of discounts typically given in comparable transactions, and (3) significant.”
The following example illustrates these concepts.

**Significant discounts**
Software Vendor A enters into an arrangement with Customer B to sell 20 licenses of software product C for $100 per copy, with an option for Customer B to purchase up to 30 copies of software product D for $50 per copy over a six-month period. Vendor A has VSOE of fair value of $100 each for software products C and D based on separate sales of the software products. Vendor A generally does not provide significant discounts to its customers. Therefore, the discount provided to Customer B is considered more-than-insignificant (“incremental”).

If Vendor A has a history of providing discounts to its customers and the discount provided to Customer B is similar to the discount provided to other customers in similar arrangements, the discount may not be considered more-than-insignificant.

Under ASC 985-605-55-82 through 55-85, a proportionate amount of the discount should be allocated to each element based on the fair value of each element without regard to the discount. If the arrangement does not specify the future products or services eligible for the discount, or if VSOE of fair value for these elements does not exist but the maximum amount of the discount is known, a portion of the consideration should be allocated to current and future elements, assuming that the maximum discount will be obtained. If the entity is unable to quantify the maximum amount of the discount because either the amount of future purchases is not specified or evidence of the fair value of the future elements does not exist, the revenue amount allocated to each element should be reduced by the discount rate. In this scenario, the vendor would recognize the discount amount allocated to the delivered element(s) ratably over the discount period or, if no discount period is specified, over the estimated period when the additional purchases will be made.

The following examples illustrate these concepts.

**Allocating incremental discounts**
Assuming the same facts given in the example above entitled “Significant discounts,” the discount offered to Customer B on software product D is $50 per copy and has been determined by Vendor A to be significant and incremental. Customer B may purchase up to 30 copies of product D, and VSOE of fair value for 30 copies is $3,000. Vendor A should allocate a proportionate amount of the total discount to each copy of products C and D. As a result, Vendor A would recognize revenue of $70 per copy of product C and product D, assuming all revenue recognition criteria in ASC 985-605-25-3 have been met.

**Significant discount without maximum discounts**
Assuming the same facts given in the example above entitled “Significant discounts,” however, there is no limit on the quantity of software product D that Customer B may purchase during the six-month period. Because Vendor A is unable to quantify the maximum discount, it must reduce the amount of revenue recognized for product C by the discount rate of 50 percent. As a result, Vendor A would recognize revenue of $50 per copy of product C when all revenue recognition criteria have been met. The discount amount would be recognized ratably over the six-month discount period.
Hosting arrangements

In certain arrangements, instead of selling software to a customer, the functionalities of the software are made available to the customer under a hosting arrangement on either the vendor’s or a third party’s server. Access to the software is provided over the internet. This application delivery model, referred to as software as a service (SaaS) or an application service provider (ASP) based model, may be beneficial for certain customers compared to the traditional software licensing model. SaaS vendors emphasize that customers may incur lower overall costs compared to software ownership, for reasons such as lower implementation costs and less in-house IT resources.

Because there is a software component to a hosting arrangement (the right to use software) but the software is often not delivered to the customer, ASC 985-605-55-121 through 55-122 states that hosting arrangements are within the scope of ASC 985-605 if both of the following criteria are met:

- The customer has a contractual right to take possession of the software at any time during the hosting period without incurring a significant penalty.
- The customer has the ability either to run the software on its own hardware or to contract with another party unrelated to the vendor to host the software without incurring a significant penalty.

Therefore, vendors should consider whether or not both of the following conditions are met in evaluating whether the customer would incur a “significant penalty”, as contemplated in ASC 985-605-55-121:

- Can the customer take possession of the software without incurring a significant financial cost?
- Can the customer make separate use of the software without a significant decrease in value or utility?

If the customer is required to pay a significant additional amount for delivery of the software, then a financial penalty exists. Similarly, if the software received from the vendor would have significantly less functionality than the software available in the hosting environment, there is a functional penalty associated with the arrangement.

If an arrangement meets the above criteria and is thus within the scope of ASC 985-605, delivery occurs when the customer has the ability to take immediate possession of the software. In arrangements where the customer has the option to take delivery of the software, an entity should apply the allocation criteria in ASC 985-605-25-6 to determine if consideration for the software element can be recognized on delivery of the software (see “Allocating consideration” on page 90). In such arrangements, the hosting portion of the arrangement fee should be recognized as the services are delivered—that is, ratably over the hosting period.
In situations where the customer would incur a significant financial cost or would experience a significant decrease in value or utility in taking possession of the software, the hosting arrangement is not within the scope of ASC 985-605 and should be accounted for as a service arrangement using other applicable revenue guidance (for example, SAB 104 and ASC 605-25). Judgment is required in determining whether the criteria of ASC 985-605-55-121 through 55-122 are met.

The following examples illustrate these concepts.

**Hosting arrangement: no software element**

Hosting Entity A enters into an arrangement to grant a nonexclusive perpetual software license and to provide hosting services for a one-year period to Customer B for total consideration of $600,000, due at the arrangement’s inception. The hosting services can be renewed in subsequent periods for $200,000 per year. Customer B does not have the ability to take possession of the software at any time during the arrangement.

Because Customer B does not have the ability to take possession of the software, ASC 985-605 does not apply and the entire arrangement would be accounted for as a service contract. The $200,000 annual renewal fee indicates that there is an incremental up-front fee of $400,000 ($600,000 total for the first year compared to $200,000 for each annual renewal period). The up-front amount of $400,000 would be attributed to the entire arrangement period, including expected renewals, and revenue would be recognized ratably, on a straight-line basis, over the expected arrangement period, assuming all other revenue recognition criteria are met. The $200,000 attributed to the hosting services would be recognized ratably over the initial one-year period.

**Hosting arrangement: software element**

Hosting Entity A enters into an arrangement to grant a nonexclusive perpetual software license and to provide hosting services for a period of two years to Customer B for total consideration of $500,000, due at the arrangement’s inception. At the end of the two-year period, the hosting services can be renewed for an additional year for $200,000. Customer B has the right to take possession of the software at any time during the arrangement without significant penalty and can feasibly run the software on its own hardware. The software is essential to the functionality of the hosting element in this arrangement.

Since the customer has the right to take possession of the software without incurring a significant penalty and the software can feasibly run on the customer’s hardware, this arrangement contains a software element under the provisions of ASC 985-605. In addition, the hosting service is a software-related element subject to ASC 985-605, since the software is essential to the functionality of the hosting element.

The software license is the first element delivered and is not sold separately from the hosting service. As a result, VSOE of fair value for the software license does not exist. Entity A concludes that VSOE of fair value for the hosting service exists in the form of the annual renewal rate of $200,000. VSOE of fair value for the undelivered element—the hosting service—exists, but does not exist for the delivered element, the software license. Therefore, the residual method would be used to allocate the arrangement consideration, and $400,000 would be allocated to the hosting service and recognized ratably over the two-year service period included in the initial arrangement fee. The residual amount of $100,000 would be allocated to the software license and recognized as revenue on delivery, assuming all other revenue recognition criteria in ASC 985-605-25-3 are met.
Multiple-element hosting arrangements with software element

An arrangement that meets the criteria of ASC 985-605-55-121 through 55-122 above may include multiple elements such as hosting services, hardware, and support services. A vendor should determine whether all or some of the elements in the hosting arrangement are software-related using the guidance in ASC 985-605-15-3(c) (see “Determining whether an arrangement is in the software revenue recognition guidance” on page 84). The guidance, including all revenue recognition criteria in ASC 985-605, should be applied to all software-related elements (including VSOE of fair value of all undelivered software-related elements) to determine whether revenue should be recognized for the portion of the fee allocated to the software on delivery, as well as whether and when to recognize revenue for any other software-related elements.

Multiple-element hosting arrangements with no software element

Hosting arrangements that are outside the scope of ASC 985-605 because the customer does not have the right or ability to take possession of the software sometimes include licensing fees payable at the arrangement inception. Since software is not delivered in hosting arrangements outside the scope of ASC 985-605, these payments are akin to nonrefundable upfront payments discussed in SAB 104. The SEC staff indicates that activities associated with up-front payments often do not represent the culmination of a separate earnings process and even if considered a deliverable to be evaluated under ASC 605-25, would rarely provide value to the customer on a stand-alone basis. The customer derives value from these hosting-related elements through its entire hosting relationship with the vendor. Consequently, the up-front payment amount should be considered earned as the hosting services are delivered. The amount should be deferred and recognized ratably over the term of the arrangement or the expected period of performance, which may be longer than the initial hosting contract term. The vendor should recognize revenue from the up-front payment over the estimated customer relationship period, rather than the initial hosting contract period if the customer continues to benefit from the payment of the upfront fee in renewal periods.

A vendor should estimate the customer relationship period based on sufficient objective historical evidence of similar transactions (that is, similar types of products and customers). If a vendor does not have a sufficient history of similar transactions, it may consider other factors in developing an estimate of the customer relationship period including, but not limited to, the following:

- Similar transactions of other vendors in the industry. However, given the proprietary nature of software, it may be difficult for a vendor to identify other vendors with sufficiently similar transactions.
- Marketing studies
- Information used to set prices
- Discussions with customers
Under SAB 104, the vendor can recognize the up-front fee over the initial contract term rather than the estimated customer relationship period, if the initial contract term is substantive and the customer does not continue to benefit from the up-front payment in renewal periods. The fact that the initial contract term is less than the initial renewal period would indicate that the initial contract term is not substantive. For example, if the initial period is six months and the vendor generally renews hosting arrangements for one year, the initial period would not be considered substantive. In addition, if the up-front payment amount is so significant in relation to the overall arrangement, such that the customer would be compelled to renew the service, the vendor should amortize the up-front amount over the estimated customer relationship period.

Hosting arrangements may also include obligations to deliver additional elements, such as set-up or implementation services, training, consulting, and upgrades or support services. The separation and allocation guidance in ASC 605-25 should be applied to multiple-element hosting arrangements outside the scope of ASC 985-605. If the vendor has negotiated to receive an up-front payment from the customer for professional services, a question arises about whether revenue should be recognized for these services as they are provided or over a longer period of either the initial contract term or the estimated customer relationship period. The separation criteria in ASC 605-25-25-5 must be met in order to recognize revenue from the professional services in advance of the hosting services. To do that, there must be (1) stand-alone value for the professional services and (2) if there is a right of return on the delivered item, delivery of the undelivered elements must be probable and in the control of the vendor.

Meeting the criterion for stand-alone value could be difficult. To conclude that the professional services have stand-alone value, any vendor must sell the services separately or the customer must be able to resell the services on a stand-alone basis. In the context of a hosting arrangement, the second criterion regarding resale by the customer is generally inapplicable. In addition, the nature of hosting arrangements generally makes it unlikely that the vendor would sell the professional services separately from the hosting services or that another vendor would be able to provide the professional services for the customer. Factors to consider in evaluating whether the customer could have purchased the professional services from another vendor include the following:

- Could the services sold by another vendor be used in place of the services in the arrangement? Are there other vendors that are experienced in providing such services?
- Are there unique features to the professional services or knowledge requirements that only the vendor could provide the services?
- Are the professional services necessary for the customer to access and utilize the hosted software? Can the customer use the hosting services without having to purchase professional services?
If the professional services meet the criteria for separation, then the vendor should allocate the total arrangement consideration to each unit of accounting in the arrangement on a relative selling price basis as required by ASC 605-25. Rates charged on hosting renewals may provide VSOE of selling price of the hosting services if (1) the vendor has a history of customer renewals for the services and (2) the renewal arrangements are sufficiently similar in nature in terms of both services and customers. Revenue should be recognized as the respective services are provided assuming all other revenue recognition criteria are met.

In situations where the professional services cannot be separated from the hosting service, the vendor should recognize revenue over the estimated customer relationship period since the customer will benefit from the services over the entire customer relationship. If the relationship is terminated before the end of the estimated customer relationship period, the vendor should recognize remaining deferred revenue, if any, at that time.

The following example illustrates these concepts.

**Multiple-element hosting arrangement: no software element**

Hosting Entity A enters into an arrangement to license software and provide hosting services to Customer B for a period of two years. In addition, Entity A will provide implementation services to assist Customer B in setting up the interface with the customer. Customer B is not entitled to take possession of the software at any time during the arrangement. The fees for the services total $1.2 million, with $700,000 due at contract inception and $500,000 due after one year. Under the contract, the payments are allocated as $200,000 for the implementation services and $500,000 for each year of hosting services. Other customers have renewed the hosting services at $500,000 per year. No other vendors can provide the implementation services.

Entity A has estimated a selling price for the hosting services at $500,000 per year based on renewal transactions with other customers. However, the implementation services lack stand-alone value, since no other vendors can provide the implementation services and Customer B cannot sell the implementation services on a stand-alone basis. As a result, the arrangement should be accounted for as a single unit of accounting. The up-front fee for the implementation services is considered significant in relation to the fee for the initial term and likely would compel Customer B to renew the hosting services at the end of the initial two-year contract term. Consequently, revenue for the implementation services should be recognized over the estimated customer relationship period, which may exceed the initial contract term. The fee for the hosting services, or $1 million, should be recognized ratably over the initial two-year hosting period, assuming all other revenue recognition criteria are met.
What is the revenue recognition model applied to a software arrangement?

**Services subsequent to the initial installation**

In many situations, after the initial rollout of the hosting services, a customer negotiates with the vendor to provide additional elements under a new arrangement. For example, a customer may request consulting services to add features to the functionality of the software while retaining access to the original functionality of the software as those modifications are being made. Since the hosting services are currently being delivered, the vendor should evaluate the contracts to determine whether the arrangements can be accounted for separately or whether they are in substance a single multiple-element arrangement. The vendor should analogize to the guidance in ASC 985-605-55-4 to determine whether the arrangement for the follow-on elements should be combined with the original hosting services arrangement. If an entity concludes that the arrangement for the follow-on elements should be combined with the original hosting services arrangement, the separation criteria established in ASC 605-25 should be applied to determine if more than one unit of accounting exists.

Fees for subsequently negotiated elements that do not meet the separation criteria should be combined with fees for the original hosting arrangement, and the total should be recognized as a single arrangement, generally ratably over the longer of the remaining contractual term or the expected customer relationship term. If the separation criteria are met, revenue for the follow-on services should be recognized when delivered if all the other revenue recognition criteria are met. We believe it is difficult for subsequent elements to meet the stand-alone value criterion in a hosting arrangement because the customer generally derives value from the additional element only through the ongoing hosting services.

The following example illustrates these concepts.

**Hosting arrangements: subsequently negotiated elements**

On March 10, 20X1, Entity A enters into an arrangement with Customer D to provide software hosting services for an accounting application for an initial term of three years beginning April 1, 20X1. The hosting arrangement is under the scope of ASC 605-25. The fees will be billed monthly at $30,000 per month. On May 1, 20X2, Entity A enters into a second arrangement with Customer D to provide consulting services to add features to the existing software, which are designed to reduce the time it takes Customer D to prepare its monthly financial statements. The total fees related to the consulting services are $200,000 and Entity A estimates that the work will be completed by August 31, 20X2.

Because the hosting services are necessary for Customer D to realize the benefit of the additional features resulting from the May 1, 20X2 contract, the consulting services must be considered with the ongoing hosting arrangement. As a result, Entity A must determine whether the consulting services represent a separate unit of accounting. If so, the related fee can be recognized apart from the hosting services. The consulting services may have stand-alone value if another vendor provides such services. If Entity A cannot allocate and separately recognize revenue for the consulting services, the fee related to the consulting services must be recognized as the hosting services are delivered, that is, over the estimated remaining customer relationship period, assuming all other revenue recognition criteria are met.
**Software with significant production, modification, or customization**

An arrangement to deliver software or a software product that requires significant production, modification, or customization should be accounted for using contract accounting in accordance with ASC 605-35 (see chapter 9). Because the service element in such an arrangement does not meet the separation criteria for services in ASC 985-605-25-78, the software and the related production, modification, and customization services must be accounted for using the guidance in ASC 605-35. ASC 985-605-25-88, however, cautions against using contract accounting for transactions normally accounted for as product sales as a means of avoiding the delivery requirements associated with product sales for revenue recognition.

A multiple-element software arrangement may include elements that must be accounted for using contract accounting, such as software and services, and other elements not subject to contract accounting. A vendor should evaluate such arrangements to determine whether VSOE of fair value exists so that the elements subject to contract accounting can be separated from the elements that are not subject to contract accounting. If VSOE of fair value exists and the elements can be separated, a vendor should recognize revenue for the elements subject to contract accounting (software and related production, modification, and customization services) using the guidance in ASC 985-605-25-89 through 25-107. Revenue for the other elements should be recognized using other provisions of ASC 985-605.

Some believe that if a software arrangement includes significant production, modification, or customization and PCS, and if VSOE of fair value of the elements does not exist, the entire arrangement should be accounted for using contract accounting. This position is based on provisions in ASC 985-605-25-2, which state that an entire software arrangement should be accounted for using the guidance in ASC 605-35 if significant production, modification, or customization of software is required. However, it would be rare that a vendor would be able to prepare reasonable estimates of contract costs or of progress toward completion when the contract includes PCS. Such estimates must contemplate the costs of providing when-and-if-available upgrades and enhancements, as well as other services that would be provided to the customer pursuant to PCS. The provisions of ASC 605-35 require the use of the completed-contract method when reliable estimates of costs cannot be made. As a result, no revenue would be recognized until the PCS term expires.
We believe that if the elements cannot be accounted for separately because VSOE of fair value does not exist, all revenue from the arrangement should be recognized by analogy to ASC 985-605-25-9. This paragraph requires revenue to be deferred until the earlier of when (1) VSOE of fair value exists or (2) all elements in the arrangement have been delivered. However, ASC 985-605-25-10 contains an exception if PCS or other services that are not essential to the functionality of the software are the only remaining undelivered elements and if VSOE of fair value for those services does not exist. This exception indicates that the vendor would defer the entire amount of consideration until the software production, modification, or customization is completed and then would recognize this amount ratably over the remaining PCS or other service delivery period. If a vendor does not anticipate a loss on the contract, the related software production, modification, or customization costs should also be deferred and recognized ratably with the revenue, if all other revenue recognition criteria in ASC 985-605-25-3 are met.

VSOE of fair value for PCS does not often exist for software with significant production, modification, or customization because (1) the software is being customized for a specific customer’s application and (2) it is unlikely that the vendor has previously sold the same elements. However, if VSOE of fair value for PCS exists in a software arrangement with significant production, modification, or customization, then the vendor should allocate to the PCS an amount equal to its fair value and recognize revenue for that amount ratably over the PCS delivery period, if all other revenue recognition criteria in ASC 985-605-25-3 are met. If an arrangement includes only software with customization and PCS, fair value would be allocated to the PCS, and the residual amount would be recognized using contract accounting, as described below.

**Software with significant customization and PCS**

On September 15, 20X7, Entity A enters into an arrangement with Customer B to license engineering software and to provide significant software customization services. The arrangement includes one year of PCS beginning when Customer B accepts the customized software. Total consideration is $2 million. The terms require Customer B to pay $1 million on contract signing and $1 million on acceptance. Entity A does not have VSOE of fair value for any of the elements in the arrangement. Entity A completes customization of the software and receives formal acceptance from Customer B on March 23, 20X8.

Because VSOE of fair value does not exist for any of the elements in the arrangement, Entity A should defer all revenue and the costs of customizing the software until formal acceptance is received from Customer B. Revenue and costs should be recognized ratably over the one-year PCS term commencing on March 23, 20X8.
ASC 605-35-05-5 describes two acceptable methods to apply in contract accounting, the “percentage-of-completion method” and the “completed-contract method.” However, ASC 605-35-05-5 also states that these two methods are not acceptable alternatives for the same circumstances and judgment should be applied in determining the appropriate method for each particular arrangement.

The percentage-of-completion method should be applied if the vendor can make reasonably dependable estimates of progress toward completion, contract revenues, and contract costs (see “Percentage-of-completion method” below). In addition, all of the following conditions should exist if an entity uses the percentage-of-completion method:

- Contracts executed by the parties include provisions that clearly specify the enforceable rights regarding goods or services to be provided and received by the parties, the amount of consideration to be exchanged, and the manner and terms of settlement.
- The buyer can be expected to satisfy its obligations under the contract.
- The contractor can be expected to perform its contractual obligations.

An entity that regularly provides services in the scope of contract accounting generally has the ability to make the estimates necessary to apply percentage-of-completion accounting. However, if reasonable estimates cannot be made or inherent hazards cast doubt on the estimates, completed-contract accounting should be applied instead. “Inherent hazards” include contract conditions and external factors that raise questions about the vendor’s or the customer’s ability to satisfy its performance obligations under the arrangement. Under the completed-contract method, revenues are not recognized until a contract is completed or substantially completed.

**Percentage-of-completion method**

ASC 605-35 provides guidelines to approaches for measuring progress toward completion under the percentage-of-completion method. The approaches are generally grouped into those using input measures and those using output measures. Measuring progress toward completion using input measures is based on efforts devoted to satisfying contract obligations, whereas an approach that uses output measures is based on results achieved. “Input measures,” which are indirect, assume a relationship between a unit of input and productivity. They are based on costs and efforts expended (for example, labor hours or labor dollars in a software arrangement). “Output measures” focus on results achieved and include methods based on units produced, units delivered, contract milestones, and value added. Milestones are an example of an output measure in a software contract. Since output methods measure results directly, they are generally the best measure of progress toward completion. Whichever approach is adopted should be applied consistently to elements or arrangements with similar characteristics.
Input measures
Determining progress toward completion using input measures is based on efforts devoted to satisfying contract obligations. For software arrangements, cost methods for measuring progress toward completion include cost-to-cost measures, while efforts expended methods include those based on labor hours or labor dollars. As previously noted, input measures are indirect and are generally not the best measure of progress toward completion. They are, however, frequently used in software arrangements because of the ease of determining and verifying the inputs expended. One drawback of using input measures is that the progress toward completion may not be representative of actual progress achieved if inefficiencies exist.

Vendors using a method that employs costs incurred to measure progress toward completion should include costs only to the extent that they relate to contract performance. Off-the-shelf software and hardware purchased from third parties should not be included in the measurement of progress toward completion since (1) those items were not produced specifically for the arrangement and (2) including the costs may inappropriately accelerate the recognition of revenue.

Core software projects require labor-intensive customization. As a result, labor hours are a good measure to use in determining progress toward completion for arrangements involving core software modification or customization.

Output measures
Because contract revenue is measured in terms of results achieved, output measures generally provide a better approximation of progress toward completion than input measures; however, output measures can be more difficult to verify. Unless a software arrangement includes delivery of multiple modules, it is generally more difficult to identify an objective output measure to use in evaluating progress toward completion. As a result, input measures are more often used in evaluating progress toward completion in software arrangements.

Postcontract customer support, including unspecified upgrades
Postcontract customer support (PCS) includes the right to receive support services and unspecified product upgrades or enhancements. PCS may be explicit in the written terms of a licensing agreement or implicit in the vendor’s customary practice of providing PCS to its software customers. PCS is always considered a separate element in a software arrangement, even if PCS is implied from a vendor’s pattern of performance. PCS generally begins at the start of the license period.
In multiple-element software arrangements including PCS, the total consideration should be allocated to each element based on VSOE of fair value. ASC 985-605-25-67 indicates that the price that the customer will be required to pay for the PCS when it is sold separately should be used as evidence of fair value. This separate price may be a renewal rate if the software vendor has a history of customer renewals for PCS arrangements with similar types of customers and software products.

Amounts allocated to PCS should generally be recognized ratably over the PCS arrangement term. If sufficient VSOE of fair value exists indicating that (1) the PCS costs under similar arrangements have been incurred in other than a straight-line manner and (2) it is probable that costs will be incurred in a similar pattern under the current arrangement, then revenue allocated to PCS should be recognized in proportion to the costs expected to be incurred.

Because the timing, frequency, and significance of unspecified upgrades or enhancements can vary significantly, it would not be appropriate to use the point at which unspecified upgrades and enhancements are expected to be delivered as a basis to support recognizing revenue from PCS on other than a straight-line basis.

Establishing VSOE of fair value of PCS

VSOE of fair value is defined in ASC 985-605-25-6 and ASC 985-605-25-67. ASC 985-605-25-6 addresses VSOE of fair value for all elements in a software arrangement, while ASC 985-605-25-67 speaks specifically about VSOE of fair value of PCS.

ASC 985-605-25-6 limits VSOE of fair value to the following:

- The price charged when the same element is sold separately.
- For an element 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 element in the marketplace.

ASC 985-605-25-67 states that vendors should refer to the price that the customer will be required to pay when PCS is sold separately (the “renewal rate”) in determining the fair value of PCS. The stated renewal rate should be used as VSOE of fair value only if (1) the renewal rate and renewal term are substantive and (2) the software vendor has an established history of customer renewals for similar PCS arrangements that provides sufficient evidence for the stated renewal rate. To provide sufficient evidence, the historical PCS renewal arrangements should be for similar customers (by size and purchase volume) and similar software products. In addition, the renewal rates must fall within a narrow range (see “Bell-shaped curve method” on page 136).
Evaluating whether the renewal rate and renewal term are substantive requires professional judgment. The stated renewal rate should be compared to the initial arrangement fee to determine if it is substantive. ASC 985-605 does not provide a definition of substantive, but ASC 985-605-55-63 indicates that a renewal rate that is significantly below the vendor’s normal pricing practices is not substantive.

We believe that a PCS renewal rate that is less than 10 percent of the initial arrangement fee indicates that the renewal rate is not substantive. The vendor should evaluate the facts and circumstances of each arrangement to determine if it can demonstrate why a renewal rate of less than 10 percent of the software license fee is substantive. For example, the initial arrangement includes significant hardware with embedded software that is essential to the device’s functionality and other nonessential software, while the renewal rate is only for PCS related to the software components. In this situation, the renewal rate may be considered substantive, even though it is less than 10 percent of the initial arrangement fee, because of the significance of the hardware in the initial arrangement.

Under ASC 985-605-55-63, the renewal term is not substantive if the initial PCS period bundled with the software is relatively long compared to the term of the software license. For example, an arrangement for a five-year time-based license includes bundled PCS covering the first four years and a specified renewal rate for the final year of the license. In addition, the aggregate PCS renewal period must be equal to or greater than the initial PCS period to be considered substantive. For instance, in an arrangement for a five-year license with an initial PCS period of three years, the two annual renewals would not be considered substantive.

An entity may vary its PCS pricing based on different factors and should stratify the population of its PCS transactions accordingly when analyzing arrangements to establish or update VSOE of fair value. Factors to consider when stratifying the transactions include customer size, geographical location, product type, and level of support. The analysis should be performed at least annually and even more frequently by entities with more than minimal variability in their PCS renewal rates.

There are two widely accepted methods for establishing VSOE of fair value of PCS: the “bell-shaped curve method” and the “substantive renewal rate method.” Each method should be applied to groups of similar arrangements (for example, similar types of customers and software products) containing a sufficient number of transactions. These methods and their related application are discussed in detail on the next few pages.
Bell-shaped curve method

Under the bell-shaped curve method, the entire population of separate PCS renewals (if PCS is sold independently of other elements) is evaluated to determine whether the range of prices paid in the separate PCS renewals is sufficiently narrow to provide evidence of VSOE of fair value. Judgment is required in assessing whether the range of prices is sufficiently narrow; however, we believe that at least 80 percent of the transactions in the population should fall within the range. In calculating the range, the relative percent, not percentage points, is applied to the change from the midpoint of the range. For example, if 18 percent is the midpoint of the range, a range of ±15 percent would be 15 percent to 21 percent, not 3 percent to 33 percent.

If VSOE of fair value is established using the bell-shaped curve method, the range—not a single point within the range—represents VSOE of fair value. PCS renewal rates should be compared to the range and outlying rates should be carefully evaluated to determine (1) the reason why the rates fall outside the range and (2) whether the transaction has any impact on the vendor’s conclusion that VSOE of fair value exists for PCS. If the result of the analysis indicates that there is greater than 15 percent variability, VSOE of fair value does not exist. If VSOE of fair value exists for PCS and the PCS renewal rate in an arrangement is below the low end of the range, an entity must make an accounting policy election to use either the low end of the range or the midpoint of the range. The policy chosen should be consistently applied.

If the contractual renewal rate for PCS exceeds the high end of the range, the terms of the arrangement must be carefully analyzed to determine the amount to allocate to the PCS. Customers generally have the right to a refund on cancellation of a PCS arrangement. ASC 985-605-25-13 limits the amount of the arrangement fee allocated to the delivered element to the amount that meets the collectibility criterion (see “Collectibility” on page 118). Amounts subject to forfeiture, refund, or other concession if the undelivered elements are not delivered do not meet the collectibility criterion. Therefore, a vendor should defer and recognize the contractually stated PCS amount over the stated term.

The following examples illustrate these concepts.

Bell-shaped curve method: renewal rate within the range

Entity A uses the bell-shaped curve method to establish VSOE of fair value of PCS. Entity A has established VSOE of fair value of PCS for software product X sales ranging from $15,300 to $20,700, with a median of $18,000, for its large customer class, as defined. Entity A enters into an arrangement with Entity B, a large customer, to provide a perpetual license for software product X for total consideration of $100,000. The arrangement includes one-year of bundled PCS and a specified PCS renewal rate of $17,000.

The PCS renewal rate is within the range of VSOE of fair value established by Entity A of PCS for software product X sold to its large customer class. Therefore, assuming all other revenue recognition criteria in ASC 985-605-25-3 are met, Entity A would recognize $83,000 ($100,000 – $17,000) when the software is delivered. The $17,000 allocated to the PCS would be recognized ratably over the one-year PCS term.
What is the revenue recognition model applied to a software arrangement?

Substantive renewal rate method
Under the substantive renewal rate method, the renewal rate stated in the contract may be considered VSOE of fair value, provided the vendor can demonstrate that the renewal rate and the renewal term are substantive and that the rate will be consistently applied. A renewal rate significantly below the vendor’s normal pricing range would not be considered substantive and VSOE of fair value does not exist. The substantive renewal rate method is based on the guidance in ASC 985-605-25-67 that states that “the fair value of PCS shall be determined by reference to the price the customer will be required to pay when it is sold separately (that is, the renewal rate).”

If no renewal rate is specified in the contract or if the stated renewal rate is not substantive, VSOE of fair value for that arrangement does not exist, and the software license cannot be separated from the PCS. If the software license cannot be separated from the PCS and if PCS is the last undelivered element, the total contract consideration should be recognized ratably over the stated PCS term, assuming all other revenue recognition criteria are met.

Bell-shaped curve method: renewal rate above the range
Entity A uses the bell-shaped curve method to establish VSOE of fair value of PCS. VSOE of fair value of PCS for software product Y is in the range of 17 percent to 23 percent. Entity A enters into an arrangement with Customer B to provide a perpetual license for software product Y for total consideration of $100,000. The arrangement includes one year of bundled PCS and a specified PCS renewal rate of 25 percent.

Since the specified PCS renewal rate is greater than the high end of the range for VSOE of fair value, Entity A should defer $25,000 (25 percent of total consideration of $100,000) and recognize $75,000 on delivery of the software, assuming all other revenue recognition criteria in ASC 985-605-25-3 are met. Revenue recognition for the delivered software is limited to the amount that is not subject to refund in the event of cancellation and nondelivery of the PCS.

Bell-shaped curve method: renewal rate below the range
Entity A uses the bell-shaped curve method to establish VSOE of fair value of PCS. VSOE of fair value of PCS for software product X is in the range of 17 percent to 23 percent. Entity A enters into an arrangement with Customer B to provide a perpetual license for software product X for total consideration of $100,000. The arrangement includes one year of bundled PCS and a specified PCS renewal rate of 15 percent.

Entity A has elected a policy of deferring an amount equal to the low end of the range if the PCS renewal rate is below the low end of the range of VSOE of fair value. As a result, Entity A should evaluate the reason for the pricing below the range of VSOE of fair value and consider whether the transaction has any impact on its conclusion that VSOE of fair value of PCS exists. Assuming Entity A determines that the decrease in the PCS renewal rate for this transaction does not impact its conclusion that VSOE of fair value exists, it should defer and recognize an amount equal to $17,000 over the PCS period.
The following examples illustrate these concepts.

**Substantive renewal rate method: substantive renewal rate**

Entity A enters into an arrangement to license software product Y and to provide related PCS to Customer B for total consideration of $2 million. The initial bundled PCS is for a term of one year and may be renewed for subsequent annual periods at a rate of 15 percent of the initial software license fee, or $300,000 per year. Based on actual PCS renewals, Entity A has established a practice of pricing its PCS renewals between 15 percent and 18 percent for software product Y.

Because the stated PCS renewal rate in the arrangement is substantive, Entity A would allocate $300,000 of the initial arrangement consideration to PCS. Accordingly, using the residual method, Entity A would recognize revenue of $1.7 million when the software is delivered, assuming all other revenue recognition criteria are met. The $300,000 of revenue allocated to PCS would be deferred and recognized ratably over the initial one-year PCS period.

**Substantive renewal rate method: renewal rate not substantive**

Entity D enters into an arrangement to license software product X and to provide related PCS to Customer E for total consideration of $2 million. The initial bundled PCS is for one year and may be renewed for subsequent annual periods at a rate of 9 percent of the initial software license fee, or $180,000 per year. Based on actual PCS renewals, Entity D has established a practice of pricing its PCS renewals at or above 12 percent for software product X.

Since the stated PCS renewal rate in the arrangement with Customer E is below the low end of the vendor’s history of renewal prices, the renewal rate is not substantive and Entity D lacks VSOE of fair value of the PCS in this arrangement. As a result, the software license cannot be separated from the PCS for revenue recognition purposes, and the total consideration of $2 million should be recognized as revenue ratably over the PCS period, assuming all other revenue recognition criteria are met.

**VSOE of fair value does not exist for PCS**

In multiple-element software arrangements where PCS is the only undelivered element and the total consideration cannot be allocated to the separate elements because VSOE of fair value does not exist for the PCS, the entire arrangement fee should be recognized ratably over (1) the period during which the PCS is expected to be provided if PCS is implied, or (2) the contractual PCS period if PCS is an explicit contractual obligation.
The following example illustrates these concepts.

**No VSOE of fair value: PCS only undelivered element**

On June 14, 20X7, Entity A enters into an arrangement with Entity B to provide a three-year license for architectural software for total consideration of $100,000. The software is delivered and the license period begins on June 21, 20X7. The arrangement does not include an explicit obligation for Entity A to provide PCS; however, Entity A has historically provided telephone support and unspecified upgrades for this software, as they become available, to customers who have purchased this architectural software product. Entity A does not separately sell PCS.

Because Entity A has historically provided PCS for this product, in the form of telephone support and unspecified upgrades, the arrangement with Entity B includes implied PCS. Although PCS is generally accounted for as a separate element in software arrangements, Entity A does not sell PCS services separately; therefore, VSOE of fair value of the PCS does not exist and the PCS cannot be accounted for separately. On June 21, 20X7, the PCS is the only undelivered element in the arrangement and, as a result, the entire arrangement fee should be recognized ratably over the period during which the PCS is expected to be provided, assuming all other revenue recognition criteria in ASC 985-605-25-3 are met.

In limited circumstances, it is possible to recognize PCS revenue with the initial license fee on delivery of the software if all of the following conditions are met:

- The initial license fee includes the PCS fee.
- The PCS included with the initial license is for one year or less.
- The estimated cost of providing PCS is insignificant.
- Unspecified upgrades or enhancements have historically been, and are expected to continue to be, minimal and infrequent.

A vendor should support its conclusion that upgrades or enhancements offered in connection with the PCS arrangement are expected to be minimal or infrequent with evidence of minimal or infrequent upgrades or enhancements in prior PCS arrangements. If the vendor is expected to offer more than minimal and infrequent upgrades or enhancements in connection with the current PCS arrangement, the PCS should be accounted for separately from the software, regardless of whether the history of upgrades or enhancements has been minimal or infrequent.

If the above conditions for recognizing PCS revenue with the initial license fee on delivery of the software are met, the estimated costs of providing the PCS services, including upgrades or enhancements, should be accrued when revenue is recognized. Generally, the situations where these conditions apply are limited to licenses of prepackaged software where telephone support is provided to the customer within a short time. The higher the level of service and the longer the support period, the more difficult it will be for a vendor to demonstrate that the cost of providing the service is insignificant.
The following example illustrates these concepts.

**Recognizing PCS on software delivery**

Entity A enters into an arrangement with Entity B to license prepackaged software and to provide related PCS. The software license period is one year. Entity A has sold this software product for seven years. Other than periodic updates for minor bug fixes, Entity A has not provided upgrades or enhancements to customers and does not expect to provide any in the future. The bug-fix updates can be downloaded from Entity A’s website free of charge. Based on recent historical information, Entity A estimates that the cost of providing PCS, including bug-fix updates, is insignificant at less than 3 percent of the sales price of the software.

Because the estimated cost of providing PCS is insignificant, and because Entity A has no history of providing unspecified upgrades or enhancements and does not anticipate providing any in the future, Entity A can recognize the total amount of arrangement consideration as revenue when the software is delivered, assuming all other revenue recognition criteria in ASC 985-605-25-3 are met. The estimated cost of providing the PCS would be accrued when revenue is recognized.

**VSOE of fair value of PCS in short-term time-based licenses**

ASC 985-605-55-59 through 55-61 addresses accounting for an arrangement that provides for a short-term, time-based software license (12 months or less) and a shorter initial period of PCS services with a renewal option. In these situations, ASC 985-605-55-59 indicates that it is difficult to demonstrate VSOE of fair value of the PCS due to the short time period (the remaining software licensing term) during which unspecified upgrades can be used by the licensee. Therefore, arrangements to provide both a software license and PCS with a term of one year or less should be accounted for as a single unit of accounting, with revenue for the entire arrangement fee recognized ratably over the term of the PCS if all revenue recognition criteria in ASC 985-605-25-3 are met.

The following example illustrates these concepts.

**VSOE of fair value of PCS in short-term, time-based licenses**

Entity A enters into an arrangement with Entity B to provide a one-year software license and six months of related PCS for total consideration of $50,000. The PCS can be renewed for an additional six-month period for $10,000.

Since the term of the software license is one year, the license and the PCS should be accounted for as a single unit of accounting, and the total consideration should be recognized ratably over six months (the contractual PCS period) in accordance with ASC 985-605-25-70, assuming all other revenue recognition criteria in ASC 985-605-25-3 are met.
**VSOE of fair value of PCS in multiple-year time-based licenses**

If an arrangement includes a multiple-year software license and initial PCS services for only a portion of the license term, a stated renewal rate for the PCS may be considered VSOE of fair value of the PCS if both the renewal rate and renewal term are substantive. ASC 985-605-55-63 provides that the following conditions indicate that a renewal rate or renewal term is not substantive:

- The initial period of PCS services is long compared to the term of the software license (for example, a five-year software license with four years of initial PCS services, with a stated PCS renewal rate for the remaining year).
- The aggregate PCS renewal term is less than the initial PCS services period (for example, a five-year license term with an initial bundled PCS term of three years and two annual renewal terms).
- The time-based software license is for a relatively short period of time and the PCS renewal rate is significantly below the vendor’s normal pricing practices (for example, a two-year software license that includes one year of bundled PCS for total arrangement consideration of $800,000, and a one-year PCS renewal rate of $20,000 when the vendor normally prices annual PCS at a much higher rate).

The following examples illustrate these concepts.

**Multiple-year, time-based license: VSOE of fair value is not established**

Entity A licenses an employee scheduling software package to the retail industry. All arrangements include time-based licenses and related PCS. Entity A enters into a five-year term licensing arrangement with Entity B that includes three years of PCS. Total consideration is $1.3 million and is payable in full at the arrangement’s inception. Entity B has the option to renew the PCS in years four and five for $100,000 annually.

Since the aggregate renewal term (two years) is less than the initial PCS services period (three years), the renewal term is considered not substantive; therefore, the renewal rate does not represent VSOE of fair value of the PCS.

**Multiple-year, time-based license: VSOE of fair value is established**

Entity A licenses an employee scheduling software package to the retail industry. The arrangements include time-based licenses and related PCS. Entity A enters into a five-year term licensing arrangement with Entity B that includes one year of PCS for total consideration of $1.2 million, which is payable in full at inception. Entity B has the option to renew the PCS in years two through five for $200,000 each year.

Since the PCS renewal term and fee are substantive, the renewal rate constitutes VSOE of fair value of the PCS.
PCS during deployment stage

ASC 985-605-55-53 addresses accounting for PCS in a software arrangement when the software is deployed in stages. The PCS fee in the contract increases over time as the customer’s deployment of the product progresses. If the vendor has established a renewal rate for the PCS on a fully deployed basis only and has a practice of making available all unspecified upgrades or enhancements released during the deployment phase once the software is delivered, the vendor does not have VSOE of fair value of the PCS when the software product is less than fully deployed. If the PCS period does not begin when the software is delivered, but the upgrades or enhancements are made available to customers from the software delivery date to the start of the formal PCS period, there is an implied PCS period that begins with the software delivery. In such a situation, the vendor should (1) use the fully deployed renewal rate as VSOE of fair value to allocate the arrangement fee and (2) defer the portion of the arrangement fee related to the initial PCS term plus the implied PCS (deployment) period.
The following example illustrates this concept.

**PCS during deployment stage**

Software Entity A enters into an arrangement with Customer B in which Customer B licenses 600 seats of software product X for $5,000 per seat. Customer B plans to install 200 seats per year for three years and, per the agreement, will receive PCS related to the licensed product. The license fee of $3 million is payable in full at the inception of the arrangement.

The PCS fee is payable annually at 18 percent of the license fee, based on the number of seats to be installed each year ($180,000 in year one, $360,000 in year two, and $540,000 in year three). The PCS is renewable in year three at 18 percent of the total license fee of $3 million, or $540,000. Based on actual PCS renewals, Entity A’s VSOE of fair value of the PCS ranges from 16 percent to 20 percent.

Since the stated PCS renewal rate on full deployment in the arrangement is within the range of established VSOE of fair value, Entity A should separate the revenue for the software licenses from revenue for the PCS. The PCS period for all seats effectively begins with the delivery of the first seat because Customer B is getting upgrades for all seats, regardless of whether the seat is installed at the date of the upgrade. Therefore, $540,000 should be recognized for PCS for each year during the deployment period. As a result, Entity A should defer from the up-front fee of $3,180,000 an amount equal to the first-year bundled PCS fee of $180,000, plus the difference between the fully deployed renewal rate of $540,000 per year and the amount Customer B will pay for PCS during the deployment period in years one and two. The calculation follows:

| PCS for year one bundled in initial license fee | $180,000 |
| $540,000 less $180,000 (the PCS rate payable under the arrangement terms for year one [200 seats installed at 18% of $5,000 each]) | 360,000 |
| $540,000 less $360,000 (the PCS rate for year two [400 seats installed at 18% of $5,000 each]) | 180,000 |
| Total amount deferred at inception for PCS | $720,000 |

The residual amount of $2,460,000 ($3,180,000 – $720,000) should be recognized by Entity A on delivery of the software, assuming all other revenue recognition criteria in ASC 985-605-25-3 are met. The $720,000 of revenue deferred for PCS should be recognized so that a total of $540,000 is recognized ratably for PCS in each of the three deployment years.
Various other PCS issues

PCS in a perpetual software license
If the fee for a perpetual software license includes PCS services for two years, but the contractual renewal rate is for one year, the renewal terms may provide VSOE of fair value of the PCS services, if both the renewal rate and renewal term are substantive. A vendor should multiply the annual renewal rate by two to determine the VSOE of fair value for the two-year bundled PCS services included in the arrangement terms.

The following examples illustrate these concepts.

PCS in a perpetual license: renewal rate is not substantive
Entity A enters into a perpetual licensing arrangement with Entity B that includes two years of PCS for total consideration of $500,000. The PCS can be renewed for three additional one-year periods for an annual fee of $15,000.

The PCS renewal rate is not considered substantive because it is less than 10 percent of the consideration in the initial bundled arrangement. As a result, the PCS and the software license should be considered one unit of accounting, and the entire arrangement fee should be recognized ratably over the initial two-year PCS term, assuming all other ASC 985-605-25-3 revenue recognition criteria are met.

PCS in a perpetual license: renewal rate is substantive
Entity A enters into a perpetual licensing arrangement with Entity B that includes two years of PCS for total consideration of $500,000. The PCS can be renewed for three additional one-year periods for an annual fee of $90,000.

The PCS renewal rate and fee are considered substantive. As a result, $180,000 (or $90,000 annual renewal rate x 2 years) would be allocated to the PCS and, assuming all other revenue recognition criteria in ASC 985-605-25-3 are met, the residual amount of $320,000 would be recognized when the software license is delivered.

PCS with a consistent renewal percentage
A substantive renewal rate expressed as a consistent percentage of the stated software license fee could be the VSOE of fair value of the PCS services even if the dollar amounts of the license fees vary for the same software product. The key is for a vendor to use a consistent percentage (for example, 15 percent of the license fee) in determining the PCS renewal rate.
The following example illustrates these concepts.

**PCS renewal rate as a consistent percentage of the license fee**
Entity A enters into an arrangement with Entity B that includes a software license and one year of PCS for total consideration of $500,000. Entity B can renew the PCS for additional one-year periods for 18 percent of the license fee. Entity A also enters into an arrangement with Entity C to license the same software and to provide one year of PCS for total consideration of $400,000. The annual renewal rate for PCS is also 18 percent of the license fee. Other customers have consistently renewed the PCS for 18 percent of their license fee.

The PCS renewal rate of 18 percent of the license fee is considered substantive. Since the PCS renewal rate is a consistent percentage of the license fee and is considered substantive, the renewal rate would be considered VSOE of fair value of PCS.

**VSOE of fair value of PCS established after the balance-sheet date**
VSOE of fair value of PCS established after the balance-sheet date but before the issuance of the financial statements is considered a nonrecognized subsequent event as discussed in ASC 855, Subsequent Events. This evidence of fair value of PCS established after the balance-sheet date should not be used for purposes of revenue recognition at the balance-sheet date. In that situation, revenue should be deferred at the balance-sheet date. However, evidence of fair value that exists at the balance-sheet date but is compiled after that date should be used to evaluate whether sufficient VSOE of fair value of PCS exists to recognize revenue in the period ending on the balance-sheet date.

The following example illustrates these concepts.

**VSOE of fair value of PCS established after balance-sheet date**
Entity A is a calendar-year entity that licenses software and sells related PCS in multiple-element arrangements. The software is never licensed on a stand-alone basis. Because Entity A is a startup entity that is trying to gain market acceptance of its products, PCS renewal rates prior to December 31, 20X7 were not consistent among customers and therefore, evidence of VSOE of fair value of the PCS did not exist in 20X7. Beginning January 1, 20X8, Entity A included stated PCS renewal rates of 15 percent of the consideration in the initial bundled arrangement.

Because the evidence related to the consistent pricing of PCS renewal rates did not exist at December 31, 20X7, Entity A would not use the evidence related to the January 20X8 transactions to determine if there was sufficient VSOE of fair value of PCS to recognize revenue from the software at December 31, 20X7. Entity A would apply the information in its evaluation of whether VSOE of fair value of PCS exists in 20X8 for possible separation of 20X8 transactions.
Exchange or return rights

Some software arrangements provide the customer with the right to return or exchange software for products that have no more than minimal differences in features, functionality, or price. Determining whether a software transaction is a return, an exchange, or an additional software product is not always easy, but it is essential in selecting the appropriate accounting model to apply. Vendors may need to account for a transaction as an exchange or a return of software even though the software is not physically returned. If a customer does not physically return previously delivered software and retains the contractual right to use it, the newly delivered software should be accounted for as an additional software product (see “Additional software elements” on page 119). If the previously delivered software is not physically returned but the customer no longer has the contractual right to use it, the transaction should be accounted for as a return or an exchange, as discussed below. The facts and circumstances of each arrangement must be carefully evaluated to select the appropriate accounting model.

An exchange right exists when a customer has the right to return the original software and to receive another software product that is similar and has no more than minimal differences in features, functionality, or price than the previously delivered software. An exchange right is accounted for as a right to a like-kind exchange, and there is no effect on revenue recognition for the delivered software.

Exchanges are considered returns if the customer returns the original software for another software product that has more than minimal differences in features, functionality, or price or is a dissimilar software product. Accounting for these transactions should follow the guidance of ASC 605-15, Products, (see chapter 7). ASC 605-15-25-1 lists the criteria that must be met in order to recognize revenue at the time of the initial sale. If these criteria are not met at the time of sale, revenue should not be recognized until either the right of return lapses or the expected amount of returns can be reasonably estimated.

If a customer has the right to exchange a software product for a new product that is not available when the original product is delivered, the vendor should have persuasive evidence demonstrating that no more than minimal differences exist between the two products’ features, functionality, and price; otherwise, the vendor cannot conclude that the customer’s right to the other product qualifies as an exchange. In addition, a vendor that expects to incur significant development costs associated with the introduction of the new product should presume that there will be more than a minimal difference in the functionality of the products and that the new product should be treated as an additional software product for accounting purposes.
Vendors sometimes grant software resellers the right to exchange unsold software for other software. In these situations, the reseller is not the ultimate customer, and the exchanges should be accounted for as returns under the right-of-return guidance in ASC 605-15. The criteria in ASC 605-15-25-1 should be applied, even if the reseller is obligated to take additional software products in exchange for the returned software.

The following example illustrates these concepts.

**Software exchange / return rights**

Entity A sells inventory tracking software to manufacturers in the pharmaceutical industry. The inventory tracking software has two versions, products X and Y. Product Y has greater functionality and more features than product X. The selling prices are $10,000 and $20,000 for product X and product Y, respectively. In sales arrangements for product X, the customers have the right to return product X software for a full credit toward the purchase of product Y within two years of the arrangement’s original date. Historically, 20 percent of product X software has been returned to purchase product Y software.

On June 30, 20X7, Entity A enters into an arrangement with Entity B to license product X for $10,000. The terms of the arrangement provide Entity B with the right to return the product X software and to receive a full credit toward the purchase of product Y software for up to two years.

Because (1) Entity B can return product X for a credit toward the purchase of product Y and (2) there are more than minimal differences in the features, functionality, and price between the two products, Entity A would follow the guidance in ASC 605-15 to account for the right to return product X. As a result, assuming all other revenue recognition criteria are met, Entity A would recognize software revenue of $10,000 on delivery of product X software and establish an allowance for returns in the amount of $2,000, recorded as a reduction of revenue.

**Platform-transfer rights**

Some arrangements provide the customer with the right to transfer software from one platform to another. A vendor should evaluate the circumstances of each platform transfer to determine whether it should be accounted for as a return, an exchange, or an additional software product. The platform-transfer right is considered an additional software product (see “Additional software elements” on page 119) if the customer retains the contractual right to use the software as originally delivered, in addition to the software delivered for use on the new platform. The exercise of the platform-transfer right should be accounted for as an exchange if the platform-transfer right is (1) for the same product and (2) does not increase the number of concurrent users or number of copies of the software product available. The product is considered the same product if there are no more than minimal differences in features, functionality, and price between the two products.
The following example illustrates these concepts.

**Platform-transfer rights**

Entity A sells inventory-tracking software to manufacturers in the pharmaceutical industry. On June 20, 20X8, Entity A enters into a perpetual arrangement to license the inventory-tracking software on platform 1 for $100,000 to Entity B. The terms of the arrangement provide Entity B with the right to transfer the software from platform 1 to platform 2 at any time for no additional cost. The inventory-tracking software products for platforms 1 and 2 have the same features and functionality. Entity B’s right to use the software on platform 1 ceases when the software is transferred to platform 2.

Since Entity B’s right to use the software on platform 1 ceases when the software is transferred to platform 2 and there are no differences in features and functionality between the two software products, the arrangement is considered an exchange of software. As a result, Entity A would recognize revenue of $100,000 on delivery of the software to platform 1, assuming all other revenue recognition criteria in ASC 985-605-25-3 are met.

**Arrangements with both software and services**

Arrangements may include both software and service elements other than PCS services which may include installation, training, or consulting. If an arrangement contains both software and service elements, a vendor must determine whether the services can be separated from the software for revenue recognition purposes. If the nature of the services is such that the service element does not qualify for separate accounting treatment as a service, the vendor must apply contract accounting, as described in ASC 985-605-25-88 through 25-107, to both the software and service elements (see “Software with significant production, modification, or customization” on page 130). Criteria to consider in determining whether the services can be separated from the licensed software are discussed in ASC 985-605-25-78 and in the next section. If the service element can be separated, the vendor should allocate arrangement consideration between the service and software elements based on VSOE of fair value and recognize revenue related to services as they are performed. If no pattern of performance is evident for the services, the revenue should be recognized on a straight-line basis over the period the services are performed.

**Separating services from the software**

Vendor-specific objective evidence of fair value must exist in order to separately account for the service and software elements in an arrangement using the criteria in ASC 985-605-25-6. Those criteria stipulate that VSOE of fair value is limited to (1) the price charged when the same element is sold separately or (2) the price established by management with the relevant authority, as long as it is probable that the established price will not change before the separate element is introduced in the market. Also, the contract must include a description of the services such that the total price of the arrangement would be expected to fluctuate as a result of the inclusion or exclusion of the services. Finally, the services must not be essential to the functionality of any other element in the arrangement.
If the separation criteria are met, the vendor should allocate the arrangement fee to the service and other elements based on VSOE of fair value, which may differ from the elements’ separate prices, if any, included in the arrangement contract. Revenue allocated to the service element should be recognized as the services are performed or on a straight-line basis over the service period if no pattern of performance can be identified. If VSOE of fair value for the service element does not exist, and if services that do not involve significant production, modification, or customization of the software are the only undelivered element, the vendor should recognize consideration for the entire arrangement as the services are performed or on a straight-line basis over the service period if no pattern of performance can be identified, assuming all other revenue recognition criteria in ASC 985-605 are met.

**Service element essential to functionality of software**

Evaluating whether the software included in the arrangement is core software or off-the-shelf software is an important consideration in determining whether the service element is essential to the functionality of the software. “Off-the-shelf software” is sold as a stock item and can be used with little or no customization. Off-the-shelf software can be added to an arrangement with minimal changes and can be used by the customer for its intended purpose on installation. Software is considered “core software” if significant modifications must be made to off-the-shelf software to meet the customer’s specifications.

If software is other than off-the-shelf software or is off-the-shelf software that requires significant modification to meet the customer’s purpose, then the software cannot be separated from the service. The vendor should use contract accounting for both the service and the software elements.

ASC 985-605-25-84 through 25-85 states that the following factors indicate that the service element is essential to the functionality of the other elements in the arrangement:

- The software is not off-the-shelf.
- The functionality and features of the off-the-shelf software are significantly altered by the services.
- Complex interfaces must be built for the vendor’s software to be functional in the customer’s environment.
- Customer-specific acceptance criteria affect the realizability of the fee for the software license.
- Payments for the software are timed to coincide with the performance of the services.
To qualify for separate accounting, the services must be stated separately in the contract (arrangement terms) and must have one or more of the following characteristics:

- Other vendors provide the services.
- The services do not carry a significant degree of risk or unique acceptance criteria.
- The vendor is experienced in providing the services.
- The services are primarily implementation services, which may include implementation planning, loading software, data conversion, training, running test data, assisting in the development and documentation of procedures, and building simple interfaces.
- Customer personnel are committed to participate in the performance of the services.

Judgment is required in determining whether the service element in an arrangement with both service and software elements should be accounted for separately from the software element.

The following example illustrates these concepts.

**Software and services: services essential to software functionality**

Entity A, a software development company, enters into an arrangement with Entity B to sell software and provide integration services for total consideration of $1 million. Payment will be made in two installments: $500,000 at inception and $500,000 when the services are completed. The software will not operate as intended on Entity B’s platform without the integration services, and the integration services will result in significant modifications to the software.

Because the software will not operate as intended without the integration services, the services are essential to the functionality of the software. In addition, the integration services include significant modifications to the software. Therefore, Entity A should use contract accounting for the entire arrangement.

**Funded software-development arrangements**

Some software-development arrangements are partially or fully funded by a party other than the vendor developing the software. These arrangements typically provide the funding party with some or all of the following benefits, which continue beyond the development period:

- Discounts on future purchases of products produced under the arrangement
- Royalties payable to the funding party based solely on future sales of the product by the software vendor (“reverse royalties”)
- A nonexclusive sublicense to the funding party, at no additional charge, for the use of any product developed
A software vendor should first determine whether the funded software-development arrangement is within the scope of ASC 730-20, Research and Development: Research and Development Arrangements. That determination depends on the terms of the arrangement and the stage of development of the funded software product. Unless technological feasibility, as described in ASC 985-20, is established before the funding arrangement begins, the accounting provisions of ASC 730-20 would apply.

Funded-development arrangements within the scope of ASC 730-20 are considered “borrowing transactions” if the software vendor is obligated to repay the amounts funded, regardless of the results of the research and development efforts. In contrast, the arrangement may be a “contract research and development” arrangement if the risks and future use of the research and development results are transferred to the funded party. The facts and circumstances of each funded software-development arrangement must be carefully analyzed to determine the appropriate accounting model to apply.

If amounts funded must be repaid by the software vendor regardless of the results of the research and development efforts, the funded party should recognize the proceeds received as a liability and expense the research and development costs as incurred. If repayment is not required or depends on the research and development efforts yielding a future economic benefit (such as a royalty stream for sales of the developed product), then amounts received should be recognized as revenue when earned.

If technological feasibility, as described in ASC 985-20, is established before the funding arrangement begins, the software product is no longer considered to be in research and development. As a result, the accounting provisions of ASC 730-20 do not apply, and the arrangement should be accounted for pursuant to ASC 985-605-25-87. In these circumstances, income from the funding party under a funded software-development arrangement should first be credited to reduce the amount of development costs capitalized, if any, pursuant to ASC 985-20. If the funding received exceeds the amount of software-development costs capitalized, the excess should be deferred and offset against future amounts that qualify for capitalization. Deferred amounts remaining after the project has been completed should be recognized as income. The project is completed when the software is available for general release to customers and capitalization of software-development costs has ceased.
Arrangements sometimes take the form of a long-term service contract to build a facility or manufacture goods to match a customer’s specifications, and it is not always clear which accounting literature to apply to these arrangements. FASB Accounting Standards Codification™ (ASC) 605-35, Revenue Recognition: Construction-Type and Production-Type Contracts, provides revenue recognition guidance for such arrangements, which generally includes construction-type or production-type contracts where services are performed to customer specifications. The types of contracts covered by ASC 605-35, as defined therein, may include fixed price contracts, time-and-material contracts, cost-type contracts or unit-price contracts.

Although entities must use judgment to appropriately identify when contract accounting should be applied, ASC 605-35-15-3 lists the types of arrangements within its scope (generally construction-type or production-type contracts where services are performed to customer specifications), while ASC 605-35-15-6 lists certain arrangements outside its scope, including the following transactions:

- Sales of goods from inventory or sales of homogenous goods from continuing production
- Sales of goods produced in a standard manufacturing operation in the ordinary course of business and marketed using the vendor’s regular marketing channels, even if the products are made to customer specifications
- Service provided over an extended period of time (for example, health club memberships)
- Magazine subscriptions
In addition, ASC 605-35-15-3(f) requires the use of contract accounting, as specified in ASC 605-35, for arrangements covering the delivery of software or a software system that includes significant production, modification, or customization of the software. In these arrangements, the service element does not qualify for accounting separate from the software.

ASC 605-35-15-6(j) states, and the SEC staff has reiterated, that entities should not apply the guidance in ASC 605-35 to service arrangements that are not discussed in ASC 605-35-15-2. ASC 605-35-15-2 indicates that separate contracts to provide services essential to the construction or production of tangible property (for example, design, engineering, procurement, and construction management) should be accounted for using the guidance of ASC 605-35. The accounting for service arrangements outside the scope of ASC 605-35, including use of the proportional performance model, is discussed in chapter 5.

While ASC 605-35 provides guidance on the separation of elements that are within its scope, it does not provide guidance on the separation of elements outside its scope. Some arrangements include construction elements within the scope of ASC 605-35 and related services, such as outsourcing and maintenance services that are outside the scope of ASC 605-35. In these situations, an entity should apply the guidance of ASC 605-25, Multiple-Element Arrangements, to determine if the nonconstruction-related elements should be separated from the ASC 605-35 elements (see chapter 6).

In accordance with the provisions of ASC 605-25-15-3A(c), if elements that are not within the scope of ASC 605-35 cannot be separated from elements within the scope of ASC 605-35, the arrangement should be accounted for as one unit of accounting. An entity must apply judgment to determine the appropriate revenue recognition guidance to apply to the combined unit of accounting.

The following example illustrates these concepts.

**ASC 605-35 and ASC 605-25**

Entity A enters into an arrangement to design and manufacture complex monitoring equipment to specifications determined by Entity B. In addition, Entity A will maintain the equipment for an initial period of two years, with an option for Entity B to renew the maintenance arrangement for three additional annual periods.

The design and manufacture of the equipment falls within the scope of ASC 605-35, but the maintenance services are outside the scope of ASC 605-35. As a result, ASC 605-25 would be applied to determine if the elements within the scope of ASC 605-35 can be separated from the maintenance services. If the ASC 605-35 elements can be separated from the maintenance services, ASC 605-25 would also be applied to determine the amount of consideration to allocate to the separate units of accounting.

If the maintenance services cannot be separated from the ASC 605-35 elements, then the entire arrangement would be accounted for as a single unit of accounting. As a single unit of accounting, revenue would be deferred until delivery of the final element. Since the final element delivered in this arrangement is the maintenance services, which are delivered over a period of time, all revenue would be recognized ratably over the two-year maintenance period.
ASC 605-35 provides two acceptable methods of accounting for long-term construction-type contracts, the percentage-of-completion and completed-contract methods. These accounting methods are not intended to be interchangeable, and ASC 605-35 provides guidance on when each method is appropriate. The appropriate method should therefore be applied based on the facts and circumstances of each specific arrangement.

The first method, “percentage-of-completion” accounting, should be used when an entity can reasonably and dependably estimate revenues and costs. Additionally, both of the following conditions must be met:

• The contract executed between the parties provides enforceable rights regarding goods and services to be provided and received, the consideration to be exchanged, and the terms of settlement.
• Both the buyer and the seller are expected to fulfill their contractual obligations.

An entity engaged on a continuing basis in the production and delivery of goods and services is presumed to have the ability to make estimates that are sufficiently dependable to support the use of the percentage-of-completion method. Producing and continually updating reasonable estimates is essential so that the entity can estimate and recognize an anticipated loss as soon as it is evident, as required by U.S. GAAP. Contractors that use the percentage-of-completion method recognize revenue and costs as work under the contract progresses.

The second acceptable method, “completed-contract,” should be used if the financial statement results—that is, the balance sheet and income statement—would not vary significantly from the results using the percentage-of-completion method. For example, consider a contract for services that are expected to be delivered in a relatively short period of time, such as a single accounting period. Under the completed-contract method, no revenue is recognized until performance is completed or substantially completed.

A contractor whose general accounting policy is to use the percentage-of-completion method should apply the completed-contract method if reasonably dependable estimates cannot be made or if there are inherent hazards that make estimates doubtful. “Inherent hazards” include contract conditions or external factors that raise questions about either the contractor’s or the customer’s ability to perform its obligations as required by the contract terms. Such hazards differ from inherent business risks in that they are unrelated to the contractor’s normal business environment and would not normally be considered in the preparation of contract estimates.

Before recognizing revenue using contract accounting, a legally enforceable, binding agreement must exist between the buyer and the seller. The agreement must set forth the buyer’s specifications and the compensation to be paid to the seller. Third-party specifications from, for example, a government or regulatory agency or a financial institution that are imposed on the buyer are deemed to be buyer specifications.
**Completed-contract method**

Applying the completed-contract method is relatively straightforward, but might result in an irregular stream of revenue and income if contracts have a duration that spans accounting periods. Revenue and costs are not recognized until completion or substantial completion of the contract. Costs incurred during performance are accumulated in the balance sheet until completion, when they are recognized along with the related contract revenue.

A contract may be considered substantially completed when remaining costs are insignificant. Conditions that may indicate a contract is completed include the delivery of the product, customer acceptance of the product or service, and compliance with performance specifications. An entity should disclose the criteria it follows in determining that a contract is substantially completed in the notes to the financial statements. In addition, those criteria should be applied consistently to all arrangements using the completed-contract method.

**Percentage-of-completion method**

A binding contract entered into by the parties generally provides both a buyer and a seller with enforceable rights. For example, the buyer has the right to require specific performance under the contract and the right to take possession of the asset under construction as the work progresses. The seller typically has lien rights, with no ownership claim to the work-in-progress.

The percentage-of-completion method allows a vendor to recognize revenues and costs over the service delivery period. However, before applying the percentage-of-completion method of accounting to a contract or even a portion of a contract, the contractor must be able to make reasonably dependable estimates of contract fees, contract costs, and progress toward completion.

**Measuring the extent of progress toward completion**

In applying the percentage-of-completion method, a contractor must select an approach to measure the extent of progress toward completion. Some of the approaches include the cost-to-cost method, efforts-expended method, and the units-of-delivery method.

**Input versus output measures**

The methods to measure the extent of progress toward completion can be categorized as either input or output measures. “Input measures” are based on the contractor’s effort toward fulfilling the contract terms. Cost-to-cost and efforts-expended are input-based methods. “Output measures” are based on results achieved by the contractor, including methods based on units delivered or units produced.
Output-based methods are a more direct measure of progress and therefore are considered the best measure to use, but it is not always possible to establish an output measure. If output measures cannot be established, input measures must be used. While input measures are easier to determine, they rely on the assumption that a relationship exists between a unit of input and productivity. Due to inefficiencies or other factors, this relationship does not always exist. A contractor must use judgment and should consider the specific facts and circumstances of each contract in determining the most appropriate method to use in measuring progress toward completion.

The “cost-to-cost method” measures progress toward completion based on the ratio of costs incurred to date to total estimated costs. A company using the cost-to-cost method should exclude up-front costs incurred that are unrelated to contract performance from the ratio calculation. For example, a contractor may acquire large amounts of materials that are not specific to a project. The cost of these materials should not be included in the calculation of progress toward completion until they are expended in completing a specific contract. Additionally, in a production-type arrangement, the contractor may purchase in advance large components representing a significant portion of the estimated total costs for a specific contract (for example, computer hardware or other equipment). Even though the amount is incurred for a specific contract, the cost of the equipment should not be included in the progress-toward-completion calculation until the equipment is installed in the element. Revenue could be improperly recognized on an accelerated basis if the cost is included before installation occurs.

In the “efforts-expended method,” the extent of progress toward completion is based on a measure of the work. These measures include labor hours, labor dollars, machine hours, or material quantities. For example, a contractor using labor hours to measure progress toward completion would calculate the percentage of completed progress using the ratio of labor hours incurred to date to total estimated labor hours (“labor-hours method”). The pool of labor hours should include all labor hours that both the contractor and any subcontractors are expected to incur under the arrangement. If the subcontractor’s hours cannot be reliably estimated but are expected to be significant, the labor-hours method should not be used. In addition, a contractor’s use of the efforts-expended method may not result in a representative relationship between efforts incurred and actual progress toward completion due to inefficiencies incurred in performing under the contract.
Zero profit margin approach
If the contractor has determined there will be no loss on the contract but is unable to reasonably estimate costs, billings, and/or progress toward completion, it may be appropriate for the contractor to apply the “zero profit margin” approach to account for the contract. The zero profit margin approach is appropriate only if the contractor is contractually protected from a loss on the contract (for example, in a cost-plus contract). In applying the zero profit margin approach, the contractor recognizes an equal amount of costs and revenue related to the contract in each reporting period until reasonable estimates can be made or until completion. By applying the zero profit margin approach, a contractor is able to provide financial statement users with an indication of the company’s business volume.

Combining or segmenting contracts
ASC 605-35 provides guidance on combining and separating contracts within its scope, but it does not provide guidance on multiple-element arrangements containing both construction-type and nonconstruction-type elements. If the contract contains both construction-type and nonconstruction-type elements, a contractor must consider whether various pieces of interacting accounting literature apply. For example, a contractor may need to use ASC 605-25 to determine if the nonconstruction-type elements can be separated from the remaining construction elements. The interaction of accounting is discussed in greater detail in “Accounting literature interaction in multiple-element arrangements” in chapter 6. If a contract contains only construction-type elements, an entity should apply the guidance in ASC 605-35-25-10 through 25-14 to determine if the contract can be segmented. An addition or an option to an existing contract should be treated as a separate contract if any of the following circumstances are present:

- The price of the new service or product is negotiated using different economic judgments and without regard to the original contract.
- The service or product provided under the amendment or option is significantly different from the service or product provided under the original contract.
- The service or product provided under the amendment or option is similar to those provided under the original contract, but the anticipated contract cost and contract price relationship are significantly different.

If the exercised contract option or addition does not meet one of these conditions, it may be combined with the original contract if the criteria in ASC 605-35-25-8 or ASC 605-35-25-9 are satisfied. Those criteria are discussed in the following section, “Combining contracts.” Exercised contract options or additions that do not meet the criteria to be combined with the original contract or to be treated as a separate contract should be treated as a change order to the original contract, as discussed in “Change orders” on page 160.
Combining contracts
A group of separate contracts may need to be combined for accounting purposes if they are so closely related that they are, in effect, a single project with an overall profit margin. ASC 605-35-25-5 through 25-9 provide guidance on combining a group of separate contracts for accounting purposes. Contracts may be combined only if they meet all of the following criteria:

• They are negotiated as a package with a single overall profit margin objective. Contracts executed at different times may be considered a negotiated package if the time between execution of the individual contracts is reasonably short.
• In substance, the contracts constitute an agreement to complete a single project.
• They are performed concurrently or in a continuous sequence under the same project management.
• They require closely interrelated construction activities with significant common costs that cannot be separated.
• They constitute in-substance an agreement with a single customer.

Contracts that meet all of the above criteria may be combined for accounting purposes, including recognizing profits and determining the need for a provision for losses. The criteria should be applied consistently to all contracts with similar criteria.

Segmenting contracts
A single contract may include several elements or phases that the contractor has negotiated separately and agreed to perform without regard to the other elements in the arrangement. The criteria for “segmenting contracts” that otherwise meet the criteria for combining contracts is fairly strict. A contract must meet all of the following criteria to qualify for segmenting:

• The contractor must submit bona fide proposals on the separate components and for the entire project.
• The customer must have the right to accept the proposals on either a separate or a combined basis.
• When aggregated, the individual proposal amounts on the separate components equal approximately the proposed amount for the entire project.

If a contract does not meet all of the criteria above, a project can be segmented only if it meets all of the following conditions:

• The scope and terms of the project clearly call for separable phases or elements.
• The separate phases or elements of the project are often bid or negotiated separately.
• Different gross profit rates are assigned by the market to the segments as a result of different levels of risk or differences in the relationship of supply and demand for the services provided in different segments.
• The contractor has a significant history of providing other customers with similar services under separate contracts for each significant segment that is ascribed a profit margin that exceeds the overall profit margin on the project.
• The “significant history” referred to in the preceding bullet is relatively stable in terms of pricing policy.
• The excess of the aggregated prices of the separate elements over the price of the total project is attributable to cost savings resulting from the combined performance of the contract obligations. Absent evidence of such cost savings, a substantial difference in price between the separate elements and the total project indicates that the contractor has accepted different profit margins and, as a result, segmenting is not appropriate.
• The contractor documents and verifies the similarity of the services in the contract segments and the prices of such services contracted separately to other customers.

**Change orders**

“Change orders” are modifications of an original contract that are initiated by either party to change designated provisions, including changes in specifications, design, equipment, materials, manner of performance, or period of completion. Often, change orders initially specify modifications in the work to be performed but do not include a contract price adjustment. Sometimes the scope and/or price of the change order are disputed with the customer. The accounting to be applied to change orders may vary with the underlying circumstances and requires judgment if there are disputes between the contractor and the customer.

If the contractor uses the completed-contract method, it should defer costs associated with unpriced change orders together with other contract costs if it is probable that the aggregate costs (including change order costs) will be recovered. The recovery of costs for unpriced change orders is deemed probable if the future events necessary for recovery are likely to occur. Some of the factors a contractor should consider in assessing whether recovery is probable include:
• Written customer approval of the scope of the change order
• Documentation of change order costs that are identifiable and reasonable
• Historical experience confirming that the contractor has favorably negotiated change orders in the past, particularly for similar types of contracts and change orders
If the percentage-of-completion method is used and the contractor and the customer agree on both the scope and price of a change order, contract revenues and costs should be adjusted to reflect the change order. ASC 605-35-25-87 includes the following guidelines for accounting for unpriced change orders:

- If it is not probable that costs related to an unpriced change order will be recovered through a change in the contract price, those costs should be treated as costs related to contract performance in the period the costs are incurred.
- If it is probable that the costs of the change order will be recovered by adjusting the contract price, the costs incurred should be deferred until the parties agree on the change in price. Alternatively, the costs can be treated as costs of contract performance in the period they are incurred, with a corresponding increase in contract revenues (that is, no margin is recognized on the change order).
- If it is probable that the contract price adjustment will exceed the costs attributable to the change order and that the excess can be reliably estimated, the contract price should be adjusted to reflect the increase when the costs are recognized as costs of contract performance. Revenue exceeding the costs should not be recorded, unless realization of the additional revenue is assured beyond a reasonable doubt. Realization is assured beyond a reasonable doubt if the contractor’s historical experience provides such assurance or the contractor receives a bona fide pricing offer from the customer and records only the amount of the offer as revenue.

Change orders that are not approved or are in dispute with regard to scope and price should be evaluated as claims.

**Claims**

“Claims” are amounts in excess of the agreed contract price that result from any of the following:

- Change orders that are disputed or unapproved
- Customer-caused delays
- Contract terminations
- Errors in designs or specifications
- Other causes of unanticipated additional costs that the contractor seeks to recover from customers or others
Amounts related to claims should be recognized only if it is probable that the claim will result in additional contract revenue and the amount can be reliably estimated. All of the following conditions must be met to satisfy those two requirements:

- The contractor has evidence of a legal basis to the claim, or a legal opinion is obtained stating there is a legal basis for the claim.
- The evidence supporting the claim is objective and verifiable, that is, it is not based on unsupported representations or management’s intuition.
- Additional costs are the result of unforeseen circumstances at the contract date and not the result of deficiencies in the contractor’s performance.
- Costs associated with the claim are identifiable and reasonable in view of the work performed.

If the above requirements are met, revenue from the claim should be recorded, up to the amount of claim-related costs incurred. If the amounts recorded are material, the contractor should disclose such amounts in the notes to the financial statements. The contractor may also elect to record revenue related to claims only after the amounts have been awarded or received. If the contractor uses this approach, the amount of the claim should be disclosed.

If the claim exceeds the recorded contract costs or if the above requirements are not met, a contingent asset should be disclosed in accordance with ASC 450-30-50-1, Contingencies: Gain Contingencies.

**Loss contracts**

If an entity determines that the current estimates of total contract revenue and contract costs will result in a loss, it should recognize a provision for the entire expected loss in the period when the loss becomes evident. Contracts that have been combined for accounting purposes based on the criteria of ASC 605-35 should be treated as a unit in determining the need for a loss provision. Similarly, if contracts have been segmented for accounting purposes, an entity should evaluate the individual segments separately to determine if a loss provision is necessary.

Provisions for contract losses should be recognized as additional contract costs in the income statement. If the amount is material, it may be necessary to show it separately in the income statement as a component of cost included in the gross profit computation. Contract loss provisions, if significant, should be shown separately as liabilities in the balance sheet, unless the related costs are accumulated on the balance sheet, in which case, the provisions may be deducted from the accumulated costs.
Entities incur a variety of costs in delivering products or performing services associated with generating revenues, including, but not limited to, customer acquisition, set-up, and fulfillment costs. Direct costs incurred by an entity in obtaining a customer and finalizing the agreement between the parties are considered “customer acquisition costs.” “Set-up costs” include costs incurred by an entity to prepare for the delivery or performance of the predominant element in an arrangement. Typically, these costs are incurred before revenue is recognized. Whether these costs should be expensed as incurred or capitalized is a question that is often raised. Costs incurred in delivering the product or performing the service are considered “fulfillment costs.” Certain fulfillment costs may be inventory costs that should be capitalized pursuant to FASB Accounting Standards Codification™ (ASC) 330, Inventory.

While accounting literature contains specific guidance related to the treatment of certain costs, such as inventory, start-up activities, intangible assets, and advertising, many other costs are not specifically addressed in U.S. GAAP. The SEC staff has indicated in speeches and in Staff Accounting Bulletin (SAB) 104, Revenue Recognition, that there may be situations where it is appropriate to defer costs related to delivered elements and to recognize those costs over the same period that the related revenue is recognized.

**Customer acquisition and set-up costs**

In SAB 104, the SEC staff specifically discusses the accounting for customer origination costs of a contract that results in the deferral of revenue. In reaching its conclusions, the staff analogizes the situation to the accounting guidance for loan origination costs in ASC 310-20 Receivables: Nonrefundable Fees and Other Costs, and to the guidance for contract acquisition costs in ASC 605-20-25-4 through 25-5, Revenue Recognition: Services.
According to the SEC staff, whether an entity defers or expenses incremental direct costs associated with the acquisition or origination of a customer contract that results in the deferral of revenue is an accounting policy decision that should be disclosed and consistently applied. Entities electing to defer those costs should also include in their financial statements a footnote disclosure of their policy for determining which costs to capitalize.

The following descriptions summarize the types of costs that can be deferred in accordance with ASC 310-20 and ASC 605-20:

- **ASC 310-20-25-2 and ASC 310-20-35-2** states that direct loan origination costs should be deferred and recognized over the life of the loan. Direct loan origination costs are limited to the following costs incurred in successful loan origination: (1) incremental direct costs incurred with independent third parties specifically for the loan and (2) certain costs directly related to activities performed by the lender for that loan, including a portion of employees’ total compensation and payroll-related benefits directly related to time spent on activities to originate that loan. Under ASC 310-20-25-7, internal sales commissions may be capitalized if the payment is for participation in loan origination activities rather than loan solicitation activities.

- **ASC 605-20-25-4** provides for the deferral of incremental direct contract acquisition costs, that is, costs that would not have been incurred except in acquiring that contract. Employees’ salaries generally do not qualify for capitalization under ASC 605-20 because they would be incurred regardless of whether the contracts are sold. Sales commissions earned only if and when a sale is completed would qualify for capitalization under the guidance of ASC 605-20. Costs deferred in accordance with ASC 605-20 are expensed in proportion to the revenue recognized.

The following example illustrates these concepts.

**Capitalization of costs under ASC 310-20 or ASC 605-20**

Entity A enters into an arrangement with Customer B to provide data management services. The initial contract term is four years. Consideration for the arrangement is $1 million, which Entity A receives and defers at the contract’s inception and recognizes over the four-year term. Entity A incurs the following customer initiation and setup costs related to the arrangement with Customer B:

- $10,000 in hardware equipment purchased from a third-party
- $50,000 in labor costs for Entity A’s salaried employees to install hardware, initialize data files, and transfer data
- $10,000 in commissions paid to an Entity A sales representative for selling the contract

If Entity A’s accounting policy is to capitalize direct and incremental customer set-up costs based on analogy to ASC 310-20, then $60,000 is deferred and recognized over the contractual period. Since the sales commission is a solicitation expense, these costs cannot be capitalized under ASC 310-20.

If Entity A’s accounting policy is to capitalize costs by analogizing to ASC 605-20, then $20,000 is deferred and recognized over the contractual period. The internal labor costs cannot be capitalized under ASC 605-20 since they are not incremental and would be incurred by Entity A regardless of whether any contracts are sold.
Fulfillment costs

In some revenue arrangements, a vendor incurs costs to fulfill its obligations under the terms of the arrangement, but recognizes little or no revenue when the costs are incurred. This situation could occur if the fee allocated to the delivered item is contingent on delivering additional elements or on satisfying other specified performance conditions. According to ASC 605-25, *Multiple-Element Arrangements*, the contingent amount should be excluded from the amount allocated to a delivered item. As a result, a loss would be incurred under certain arrangements if the costs related to the delivered item cannot be capitalized.

Unfortunately, there is little guidance on the appropriate accounting for those costs other than an SEC staff speech delivered at the 2003 AICPA National Conference on Current SEC Developments. The SEC staff said that an asset should be recognized in connection with a multiple-element arrangement with contingent revenues only if an asset is generated and a loss is incurred on the delivered item. In this scenario, the loss may be considered an investment in the remainder of the contract if the amount allocated to the remaining elements is greater than the aggregate fair value of those undelivered items.

However, the staff stated that it is inappropriate for an entity to defer costs to produce a normal profit margin on a delivered item. An entity must evaluate the facts and circumstances of a specific arrangement to determine whether or not it is appropriate to recognize an asset for costs incurred that are related to a delivered element.

The following example illustrates these concepts.

**Contingent revenue and deferred costs**

Entity A enters into an arrangement with Entity B to deliver products X and Y for total consideration of $2,000. The payment terms are $500 on delivery of product X and $1,500 on delivery of product Y. Entity A has determined that objective and reliable evidence of fair value is $1,000 each for products X and Y and incurs costs of $700 per product to deliver X and Y.

Products X and Y meet the separation criteria in ASC 605-25-25-5. Using the relative fair value method in ASC 605-25, Entity A would allocate $1,000 each to products X and Y. However, because $1,500 is contingent on delivery of product Y, Entity A would allocate only $500 to product X.

Entity A would incur a $200 loss associated with the delivery of product X and the delivery of product Y is estimated to generate profit of $800. As a result, Entity A would defer the costs incurred related to the delivery of product X that exceed the amount of revenue allocated to product X (that is, costs of $700 less revenue of $500, or $200). The deferred costs would be recognized with the revenue for product Y, assuming all other revenue recognition criteria are met.
Entities should apply the guidance in the FASB Conceptual Framework to determine whether the costs incurred related to a delivered item represent an asset to be capitalized. FASB Statement of Financial Accounting Concepts (CON) 6, *Elements of Financial Statements*, defines assets as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” According to CON 6, an asset has the following three essential characteristics:

- It embodies a probable future benefit that involves a capacity to directly or indirectly contribute to future net cash flows.
- An entity can obtain the benefit and control access to it.
- The transaction giving rise to the entity’s right to or control of the benefit has occurred.

Costs incurred in delivering an item for which an entity defers nonrefundable revenue generally meet the definition of an asset because (1) there is a probable future benefit the entity can receive (the recognition of the deferred revenue) and (2) the transaction giving rise to the entity’s right to the benefit has occurred (the item has been delivered to the customer). Deferred revenue should generally not be recorded for contingent revenue; rather, the contingent revenue should be allocated to future elements.

**Recoverability of capitalized costs**

If an entity elects to defer costs incurred on a delivered item, the capitalized costs should be evaluated for recoverability both before they are recorded and at the end of each reporting period. In addition, capitalized costs should be assessed for recoverability when indicators of impairment exist as a result of changing facts and circumstances. Factors to consider in evaluating the recoverability of capitalized costs include, but are not limited to, the following:

- The amount of deferred revenue related to the transaction
- The terms of the arrangement
- The intent of management to enforce those terms

An entity with a history of not enforcing the terms of arrangements may lack sufficient evidence to support its assertion that capitalized costs are recoverable if recoverability upon termination depends on contractual terms.
If capitalized costs are less than or equal to the deferred revenue recorded for a delivered item, those costs are generally recoverable through future recognition of the deferred revenue. Capitalized costs that exceed the deferred revenue for a delivered item should be further evaluated to determine if they are recoverable. All of the following conditions should be present to conclude that capitalized costs exceeding deferred revenue are recoverable:

- A legally enforceable arrangement exists that is related to the capitalized costs.
- Management intends to enforce the terms of the arrangement.
- Objective evidence exists supporting that the future operating margin—that is, net revenues less related direct costs—will exceed the amount of capitalized costs.

If an entity determines upon reassessment that capitalized amounts are no longer recoverable because of changing facts and circumstances, it should expense as a period cost the amount that exceeds future net revenues less related direct costs.

The following example illustrates these concepts.

**Recoverability of capitalized costs**

Entity A enters into an arrangement with Customer B to provide retirement recordkeeping and administration services. In accordance with the arrangement terms, Customer B makes an up-front, nonrefundable payment of $50,000, and will make monthly payments of $20,000 during the four-year contractual term. The estimated monthly delivery costs for Entity A are $15,000. Entity A also incurs the following customer initiation and set-up costs in connection with the arrangement:

- $90,000 in labor costs for employees preparing the data files and transferring existing data
- $10,000 in sales commission paid to the individual who sold the contract

Since Entity A capitalizes customer initiation and set-up costs by analogy to ASC 310-20, $90,000 in direct and incremental costs are deferred. The sales commission is considered a solicitation cost and may not be capitalized under ASC 310-20. Entity A concludes that the capitalized costs are recoverable at inception based on the following:

- Entity A has a legally enforceable contract with Customer B.
- Deferred revenue of $50,000 recorded on receipt of the nonrefundable up-front payment will be recognized as the services are delivered.
- Operating margins of $240,000 are expected over the four-year term of the arrangement.
What is the proper accounting for research and development arrangements?

Research and development (R&D) arrangements can take a variety of forms including, but not limited to, cost reimbursement arrangements, partially or fully funded projects, loans or other obligations to repay the funding party, or research and development contract services. It is not always clear whether amounts received from a customer should be recognized as revenue or treated as a loan. Even if the amounts received from a customer do not constitute a loan, an entity may find it is difficult to determine the appropriate revenue recognition model to apply.

An entity should evaluate both the form and substance of an arrangement to determine whether it has an obligation to repay the funding party. Some arrangements require the entity to repay the funding party all or a portion of the funds provided regardless of the results of the R&D efforts. If any portion of the funding must be repaid to the funding party, a liability equal to the estimated repayment amount should be recognized.

In these situations, the entity is effectively receiving a loan from the funding party. Since none of the financial risk associated with the R&D efforts is transferred to the funding party, the entity should not recognize revenue. FASB Accounting Standards Codification™ (ASC) 730-20-25-4, Research and Development: Research and Development Arrangements, provides the following examples of arrangements where the financial risk associated with the R&D is not transferred to the funding parties and, as a result, the entity is committed to repayment:

- The entity has a contractual commitment or guarantees repayment of the amounts provided by the funding parties, regardless of the results of the research and development.
• The funding parties can require the entity to purchase their interests in the research and development regardless of the results.
• The entity will distribute debt or equity securities to the funding parties on termination or completion of the research and development, regardless of the results.

In some situations the written agreement under the arrangement does not require the entity to repay any of the funds provided by the funding parties, but other conditions (such as those listed below) indicate that it is probable the entity will bear the risk of failure of the R&D efforts. There is a presumption that the entity has an obligation to repay the funding parties if conditions suggest that it is likely the entity will repay any or all of the funds regardless of the results of the research and development. Overcoming that presumption requires substantial evidence to the contrary.

The following examples from ASC 730-20-25-6 outline conditions leading to the presumption that the entity will repay the funding parties:
• The entity has indicated its intent to repay all or a portion of the funds provided, regardless of the results of the research and development.
• The entity would suffer a severe economic penalty if it failed to repay any of the funds provided regardless of the outcome of the R&D effort. An economic penalty is severe if an entity would choose to pay the funding parties rather than incur the penalty in the normal course of business. The penalty is severe, for example, if the entity would lose the rights to technology necessary for its ongoing operations if it fails to purchase the funding party’s interest in the R&D effort.
• The research and development project is substantially completed before the entity enters into the arrangement.
• A significant related-party relationship exists between the entity and the funding parties at the time the entity enters into the arrangement.

The SEC staff has indicated that a significant related party relationship exists if 10 percent or more of the funding party is owned by related parties of the entity. In some situations, ownership of less than the 10 percent of the funding party level may also indicate a significant related party relationship. The SEC staff has also stated that an entity’s apparent inability to repay the funds in cash does not demonstrate that the funding parties have accepted the entire risk of the research and development activities and thus precludes the entity from recognizing a liability. The entity could repay the funds by issuing stock or by some other means.
If an entity is obligated to repay the funding parties, the research and development costs should be recognized as expense as incurred. If the amount of funds provided by the funding parties exceeds the entity’s liability to repay the funds, the entity should charge to expense its portion of the research and development costs in the same manner as the liability is incurred. For example, the liability might be incurred on a pro rata basis or as the initial funds are expended.

If the repayment of funds depends solely on the results of the research and development having future economic benefit, then the financial risk associated with the research and development is transferred to the funding party and the entity should account for its obligation as a service contract (see chapter 5).

The following examples illustrate these concepts.

**Research and development funding: repayment required**
Entity A, a start-up entity that holds a patent for certain advanced-materials technology, enters into an arrangement with Entity B, a third-party entity, to continue development on a specific application for the technology. Entity B agrees to provide funding of $1,750,000 toward the development. Entity A has no obligation to repay the funds if the application is developed for commercial use within a two-year period. If the development efforts do not result in a commercial product within two years, then Entity A must repay Entity B $750,000.

Since Entity A has an obligation to repay a portion of the funds if the development efforts are not successful within two years, it has transferred to Entity B only the portion of the financial risk associated with the amount that does not need to be repaid under any circumstances—that is, $1 million. Entity A should record a liability for the first $750,000 received from Entity B and recognize that amount as revenue only when Entity A is relieved of its obligation to repay Entity B—that is, if the application is developed for commercial use within a two-year period. The costs should be accounted for using the guidance in ASC 730-10-25-1 through 25-2.

**Research and development funding: repayment depends on results**
Entity A, a start-up entity that holds a patent for certain advanced-materials technology, enters into an arrangement with Entity B, a third-party entity, to continue development of a specific application for the technology. Entity B agrees to provide funding of $1,750,000 toward the development and has the rights to commercialize the product that results from the development efforts. Entity B is entitled to the first $1,750,000 earned on commercialization of the product. If the development efforts do not lead to product commercialization, Entity A has no obligation to reimburse Entity B for the amount of funding provided.

Because Entity B’s recovery of the funding provided is dependent on the commercial success of the product under development, this arrangement should be accounted for as a service contract.
Service arrangements
Companies sometimes partner with another entity in research and development activities. These arrangements take on a variety of forms and may include multiple elements, including a license to technology, research and development activities with milestone payments, contract manufacturing, when-and-if available elements, and other obligations such as participation on a joint steering committee. The payment terms often include a large up-front payment as well as ongoing payments for the R&D activities, including payments on the achievement of milestones.

The terms of R&D service arrangements are often complex and vary among arrangements, making it difficult for an entity to determine the appropriate revenue recognition model to apply. If an arrangement includes more than one element, an entity should apply the guidance of ASC 605-25, Revenue Recognition: Multiple-Element Arrangements, to determine the units of accounting, assuming none of the elements falls within the scope of higher-level literature. Chapter 6, “Accounting literature interaction in multiple-element arrangements,” gives further information on the interaction of accounting literature in multiple-element arrangements.

ASC 730-20 does not address the accounting for R&D service arrangements. Rather, an entity should apply the concepts of SEC Staff Accounting Bulletin 104, Revenue Recognition, to the facts and circumstances of each situation to determine the appropriate accounting model to apply. There are three widely accepted approaches to recognizing revenue in R&D service arrangements. Two of the approaches are performance-based models based on analogy to ASC 980-605, Regulated Operations: Revenue Recognition, and the third approach is a milestone-based model.

Milestone-based model
ASC 605-28, Milestone Method, provides guidance to address the accounting for arrangements in which an entity satisfies its performance obligations over time, with all or a portion of the consideration contingent on future events, referred to as “milestones.” Certain multiple-element arrangements containing milestone payments include elements that often do not meet the separation criteria in ASC 605-25 because of a lack of stand-alone value for the delivered item. ASC 605-28 provides guidance related to the accounting for milestone payments associated with elements that are considered a single unit of accounting.
Scope
The guidance in ASC 605-28 applies to arrangements with research or development activities where an entity satisfies its performance obligations over a period of time and all or a portion of the consideration is contingent upon achieving a milestone.

Entities may not apply the milestone method guidance if it conflicts with other authoritative literature that provides revenue recognition guidance for a single unit of accounting. For example, entities with arrangements that fall under the scope of either ASC 605-35, Construction-Type and Production-Type Contracts, or ASC 985-605, Software: Revenue Recognition, must follow such guidance.

Milestone definition
ASC 605-28 defines a “milestone” as an event that meets the following conditions:

- There is “substantive uncertainty,” on the date the arrangement is entered into, about whether the event will be achieved.
- Achievement of the event is based in whole or in part on either the vendor’s performance or a specific outcome resulting from the vendor’s performance.
- Achievement of the event results in additional payments due to the vendor.

The intent of the term “substantive uncertainty” implies that the vendor’s uncertainty in achieving the milestone is genuine at the arrangement’s inception and that the related milestone payment is not a disguised up-front payment. Substantive uncertainty is not precluded just because the vendor expects to achieve a milestone. An event that occurs as the result of a counterparty’s performance or that is contingent solely on the passage of time does not qualify as a milestone under the guidance in ASC 605-28.

Substantive milestones
A vendor must determine whether a milestone is substantive at the inception of the arrangement. For a milestone to be considered substantive, the payment associated with its achievement must have all of the following characteristics:

- Relate solely to the vendor’s past performance
- Be reasonable, relative to all of the elements and payment terms in the arrangement
- Be commensurate with either the vendor’s effort required to achieve the milestone or the enhanced value of the delivered item(s) as a result of the milestone achievement
A milestone is not considered substantive if any portion of the associated payment relates to the remaining elements in the unit of accounting, such as when a portion of an “earned” milestone payment can be refunded based on future performance or nonperformance. In this scenario, the milestone payment does not relate solely to past performance. However, if an arrangement contains multiple milestones and an individual milestone within the arrangement is determined to be nonsubstantive, an entity would not be precluded from using the milestone method for the other milestones.

In addition, ASC 605-28 prohibits a vendor from bifurcating an individual milestone payment into substantive and nonsubstantive components. In other words, a milestone must be substantive in its entirety.

Determining whether a milestone is substantive requires judgment, and the level of effort that an entity expects to expend in achieving the milestone is a significant consideration when making this assessment. For example, the amount of labor and other costs incurred by the vendor to achieve a milestone is a strong indicator in determining whether a milestone is substantive. For certain arrangements, milestone payments that are due near the contract’s inception date may indicate that the amount of consideration is not commensurate with the vendor’s effort in such a short period of time to achieve the milestone. Such milestones may not be considered substantive, but rather a form of a disguised up-front payment.

An up-front payment is deemed to be attributed to the entire performance period and, therefore, is recognized on a systematic and rational basis over the performance period. An entity should determine if information related to efforts expended and to total efforts expected to be expended is available in order to recognize the up-front amount on a proportional performance basis. If no such information is available, the up-front amount should be recognized ratably using a time-based method, that is, on a straight-line basis.

In many arrangements, an entity is unable to reasonably estimate the level of effort that is required to fulfill the R&D obligations. As a result, the measure of performance for up-front payments should be based on time rather than on efforts expended in the R&D activities; in other words, the up-front payment amounts should be recognized ratably over the expected R&D performance period. If an entity cannot reasonably estimate the expected R&D performance period, the up-front payment amount should be deferred until such estimate can be made.
The following example illustrates these concepts.

**Example: substantive considerations**

An arrangement contains three milestones that are considered to require equal effort from the vendor to achieve each milestone. Payment terms for achieving the milestones are as follows:

- First milestone – $175,000
- Second milestone – $100,000
- Third milestone – $25,000

Under ASC 605-28, the first milestone is not considered “substantive” because it fails to meet two of the required characteristics described above:

- The first milestone payment is not considered reasonable relative to all the deliverables and payment terms in the arrangement because the level of effort involved is equal for all milestones.
- The payment is not considered commensurate with the vendor’s effort required to achieve the milestone.

Based on this simplified fact pattern, we would expect the first milestone payment to approximate $100,000 in order for the milestone to be considered substantive, assuming all other criteria are met.

ASC 605-28 allows an entity to adopt an accounting policy to recognize arrangement consideration that is contingent on the achievement of a substantive milestone in its entirety in the period the milestone is achieved. The use of the milestone method is not mandatory, nor is it the only acceptable revenue attribution model for transactions that meet the specified criteria in ASC 605-28.

However, ASC 605-28 precludes the use of other methods that result in the recognition of arrangement consideration in its entirety in the period the milestone is achieved. A vendor is not precluded from electing a policy that results in the deferral of some portion of the arrangement consideration. The proportional performance method, which lacks specific authoritative guidance and has several variations, is an example of a revenue recognition method that may result in the deferral of some portion of the arrangement consideration. An entity’s accounting policy for milestone arrangements must be applied consistently to similar elements or units of accounting.
The following example illustrates the application of the milestone method.

**Milestone method example**

On January 1, 20X0, a biotechnology entity (Biotech) with a calendar year end, enters into an arrangement with a pharmaceutical entity (Pharma) whereby Biotech agrees to license to Pharma the use of its intellectual property (IP) to develop drug candidate A (Drug A). The agreement also requires Biotech to provide research and development (R&D) services on a best efforts basis to develop a viable drug candidate using its intellectual property. The license provides Pharma the exclusive right to manufacture, distribute, and market the drug for 12 years, beginning with the effective date of the agreement.

The IP license does not meet the separation criteria of stand-alone value included in ASC 605-25 because the IP is considered unique and only Biotech can perform the R&D services required to develop Drug A to allow Pharma to derive value from the IP. Biotech would receive the following payments from Pharma under the arrangement:

- $10 million for the license upon the arrangement’s inception
- $300,000 per year for ten full-time equivalent employees to perform R&D activities
- Milestone payments (listed in order, 1 through 4)
  - $5 million upon successful completion of Phase I clinical trials, of which $2 million is refundable if FDA approval is not obtained
  - $3 million (nonrefundable) upon successful completion of Phase II clinical trials
  - $3 million (nonrefundable) upon successful completion of Phase III clinical trials
  - $8 million (nonrefundable) upon FDA approval of Drug A
- Royalties of 5 percent of Pharma’s sales of Drug A

**Analysis**

The elements, which include the license and R&D services, are accounted for as a single unit of accounting because the license (the delivered item) does not have stand-alone value. The following summarizes how Biotech would account for the various payments and elements under this arrangement using the guidance in ASC 605-28:

- **License and R&D services:** Assuming all other revenue recognition criteria are met, the $10 million up-front payment for the license would be recognized as revenue on a systematic and rational basis (for example, straight-line) over the license term, beginning with the date the R&D services begin. Annual consideration for the R&D services would be recognized as the services are performed.

- **Milestones:** Biotech is required to determine if the milestones are substantive. For purposes of this example, assume Biotech has concluded that each milestone meets the following criteria at the inception of the arrangement:
  - The milestone payment is reasonable relative to all of the deliverables and payment terms in the arrangement.
  - The milestone payment is commensurate with Biotech’s effort required to achieve the milestone.

  Milestones 2, 3, and 4 meet the other substantive criterion, requiring a milestone payment to relate solely to past performance. However, the first milestone does not meet this criterion because a portion of the consideration is refundable if FDA approval does not occur. As a result, the milestone method cannot be applied to Milestone 1, therefore, the $5 million payment cannot be recognized in its entirety upon achievement of Phase I clinical trials. In addition, ASC 605-28 precludes Biotech from bifurcating the payment amount into substantive and nonsubstantive components. As a result, Biotech would recognize the nonrefundable amount of the first milestone payment over the performance period.

Biotech is not precluded from applying the milestone method to the other milestones in the arrangement. Biotech would recognize the milestone payments for Milestones 2, 3, and 4 in their entirety upon achievement of each milestone.

- **Royalties:** Royalties do not represent a milestone payment and, as a result, would not be evaluated under the milestone method. Assuming all other revenue recognition criteria are met, royalty payments would be recognized when earned.
Performance-based models
As noted, ASC 980-605 provides the basis for the accounting in the performance-based models. Under the model in ASC 980-605, revenue is recognized based on the lesser of (1) the amount calculated using the proportional performance to date and (2) the amount due under the terms of the contract for work that has already been performed. For example, if an entity has provided 50 percent of the service but only 45 percent of the total fee has become due, revenue recognition would be limited to 45 percent.

The first performance-based model uses total expected revenue. The second model uses only the up-front payments plus payments for service performed and milestones already achieved in determining the amount of service that has been provided under the ASC 980-605 model. Both methods limit the amount that can be recognized as revenue to the nonrefundable amounts that are due under the terms of the contract.

An entity should apply the following steps to calculate the amount of revenue to be recognized in a period:

- Estimate the percentage of services that have already been performed in relation to the total services to be provided.
- Multiply the percentage above by either the total amount of expected payments (expected revenue method) or the nonrefundable payments to date, including amounts contractually due but not yet received (actual revenue method), depending on which method the entity elects to use.
- Compare the amount calculated in the bullet above to the total nonrefundable payments received to date (including amounts contractually due, but not yet received), and recognize cumulative revenue for the lesser amount.
The following examples illustrate these concepts.

**Performance-based model: expected revenue**

In addition to the facts outlined in the preceding example for the milestone-based model, Biotech estimates it will require three years to complete the R&D activities through to FDA approval and it estimates the related total R&D costs at $8 million. As of December 31, 20X0, Biotech has incurred costs of $1,600,000.

Nonrefundable payments received as of December 31, 20X0 are as follows:

<table>
<thead>
<tr>
<th>Payment Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up-front payment</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Milestone #1</td>
<td>5,000,000</td>
</tr>
<tr>
<td>FTE payments</td>
<td>300,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$15,300,000</strong></td>
</tr>
</tbody>
</table>

The following represents revenue recognized by Biotech in fiscal 20X0 using the expected revenue method:

<table>
<thead>
<tr>
<th>Costs incurred to date</th>
<th>$1,600,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total costs expected to be incurred</td>
<td>8,000,000</td>
</tr>
<tr>
<td>Percent complete at year-end</td>
<td>20%</td>
</tr>
<tr>
<td>Total expected revenue</td>
<td>29,900,000</td>
</tr>
<tr>
<td>Amount recognized using expected revenue method</td>
<td>$5,980,000</td>
</tr>
</tbody>
</table>

**Performance based model: actual revenue**

In addition to the facts in the example above for the milestone-based model, Biotech estimates it will require three years to complete the R&D activities through to FDA approval and it estimates the related total R&D costs at $8 million. As of December 31, 20X0, Biotech has incurred costs of $1,600,000.

Nonrefundable payments received as of December 31, 20X0 are as follows:

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<tbody>
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</tr>
<tr>
<td>Milestone #1</td>
<td>3,000,000</td>
</tr>
<tr>
<td>FTE payments</td>
<td>300,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$13,300,000</strong></td>
</tr>
</tbody>
</table>

The following represents revenue recognized by Biotech in fiscal 20X0 using the actual revenue method:

<table>
<thead>
<tr>
<th>Costs incurred to date</th>
<th>$1,600,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total costs expected to be incurred</td>
<td>8,000,000</td>
</tr>
<tr>
<td>Percent complete at year-end</td>
<td>20%</td>
</tr>
<tr>
<td>Amounts received to date</td>
<td>13,300,000</td>
</tr>
<tr>
<td>Amount recognized using actual revenue method</td>
<td>$2,660,000</td>
</tr>
</tbody>
</table>
Other considerations

R&D service arrangements often include other elements and obligations that should be evaluated to determine their impact on revenue recognition. These may include, but are not limited to, software, product sales, when-and-if available improvements, and joint steering committee obligations. The presence of software elements in an R&D arrangement could mean that a portion or all of the arrangement falls within the scope of ASC 985-605, Software: Revenue Recognition, (see chapter 8). If an R&D arrangement includes when- and-if available elements, such as improvements or upgrades, an entity should analogize to the guidance in ASC 985-605.

Joint steering committees are often established through collaborative research and development agreements to ensure that the parties reach their mutual goals. Participation on the joint steering committee may be obligatory if the vendor has unique skills or know-how needed to reach the collaboration goals, or it may be optional, providing the vendor a means to protect or govern its interest in the arrangement. If an arrangement includes joint steering committee participation, an entity should apply judgment in evaluating whether the participation is a protective right or an obligation. “Protective rights” are generally included in an arrangement for the benefit of the entity. On the other hand, a buyer may require participation by the entity on the joint steering committee to ensure that all elements of an arrangement are maximized. If an entity controls its involvement in the activities of the committee, it has a protective right, not an obligation. However, if the following factors are present, an entity’s participation on a joint steering committee may qualify as an obligation:

- The arrangement explicitly requires participation.
- A distinct action by the entity is required
- Failure to participate would result in a significant penalty to the entity.
- The arrangement consideration would vary by more than an insignificant amount if the joint steering committee element was not included.

Additional factors to consider in evaluating whether joint steering committee participation is a right or obligation include the following:

- Did one party negotiate for the committee?
- Are there payments related to steering committee performance?
- Is there a penalty for not attending meetings?
- Does one party have ultimate decision-making authority?
If an entity determines its participation on a joint steering committee is an obligation, it should evaluate that obligation as an element in the arrangement and apply the separation criteria of ASC 605-25 to determine if the obligation is a separate unit of accounting. If an entity cannot separate the joint steering committee obligation from other elements in the arrangement, it should recognize revenue for the combined unit of accounting over the estimated performance obligation period. If an entity is not able to reasonably estimate the performance obligation period, then it should defer revenue until it can reasonably estimate when the performance obligation period will cease. Additionally, if the separation criteria in ASC 605-25-25-5 are met, and if the obligation to sit on the steering committee is for an indefinite period of time, the vendor must estimate the expected term over which to recognize the related revenue. If a vendor cannot estimate the expected term, it must defer revenue recognition until it can estimate the time period or until it fulfills the obligation.

**Collaborative arrangements**

In some situations, entities may enter into arrangements with other entities to participate in a joint operating activity. These arrangements may involve the joint development and commercialization (for example manufacturing, distributing, and marketing) of intellectual property, such as a drug candidate, motion pictures, and computer software. However, these arrangements are not limited to specific industries or to arrangements that involve intellectual property. For instance, an arrangement may involve the activities of a jointly operated facility, such as a hospital.

ASC 808, *Collaborative Arrangements*, defines a “collaborative arrangement” as a contractual arrangement that involves two or more parties, all of which are both (1) involved as active participants in a joint operating activity and (2) exposed to significant risks and rewards that depend on the commercial success of the joint operating activity. Some activities, for example, research and development, in a collaborative arrangement may be the primary responsibility of only one participant or may be a shared responsibility of two or more participants.

Collaborative arrangements within the scope of ASC 808 are not primarily conducted through a separate legal entity, although a legal entity may be used for a specific activity in the arrangement or for a specific geographic area. The portion of the collaborative arrangement conducted through a separate legal entity should be accounted for under ASC 810-10, *Consolidation*; ASC 323, *Investments – Equity Method and Joint Ventures*; or other applicable accounting literature.

Determining whether a contractual arrangement is a collaborative arrangement is a matter of judgment based on consideration of all relevant facts and circumstances. This determination should be made at the inception of the arrangement and should be reconsidered if facts and circumstances indicate a significant change in a participant’s role or in its exposure to risks and rewards.
Active participation
Evidence of active participation may include, but is not limited to, the following:
- Directing and carrying out the activities of the joint operating activity
- Participating in the governance and oversight of the arrangement, for instance, by participating on a steering committee
- Holding a contractual or other legal right to the underlying technology

A party that only provides financial resources to an arrangement is generally not considered an active participant.

Significant risks and rewards
Some examples of terms and conditions in an arrangement that might indicate that participants are not exposed to significant risks and rewards include the following:
- Services are performed for fees at the prevailing market rate.
- A participant can exit the arrangement without cause and recover a significant portion of its economic participation to date.
- Initial profits are allocated only to one participant.
- The reward that accrues to a participant is limited.

The expected duration or extent of a party’s financial participation in the arrangement in relation to the total expected life or total expected value of the arrangement should also be considered as part of the evaluation of a participant’s exposure to risks and rewards.

Income statement classification
A participant in a collaborative arrangement must report the costs incurred and revenues generated on sales to third parties at gross or net amounts, depending on whether the participant is the principal or the agent in the transaction, pursuant to ASC 605-45, Principal Agent Considerations. Accordingly, the participant deemed to be the principal for a particular transaction should report that transaction on a gross basis in its income statement (see chapter 12, “Presentation”).
The income statement presentation of payments between participants pursuant to a collaborative arrangement should be determined as follows:

- If the payments are within the scope of authoritative accounting literature on income statement presentation, the entity should apply the relevant provisions of that literature.
- If the payments are not within the scope of authoritative accounting literature, the entity should classify the payments based on analogy to authoritative literature.
- If the payments are not within the scope of other authoritative accounting literature and there is no appropriate analogy, the entity should base its income statement presentation of the payment on a reasonable, rational, and consistently applied accounting policy.

The determination of the appropriate income statement classification for payments between participants should be based on an evaluation of the relevant facts and circumstances, including the nature and contractual terms of the arrangement, the nature of the participant’s operations, and the provisions of other authoritative accounting literature.
Chapter 12

How should revenue be presented and disclosed?

After an entity determines the appropriate accounting for revenue-generating activities, it must determine the appropriate financial statement presentation and disclosure of the results. Sometimes financial statement preparers do not give the same level of attention to presentation and disclosure issues as they do to accounting for revenue-generating activities. However, investors, auditors, and regulatory bodies focus on financial statement presentation and disclosures to obtain information about the types of revenue-generating activities and the accounting for each activity. While more guidance exists for financial statement presentation and disclosure issues facing public entities than for private entities, many private entities have adopted the public company requirements as a best practice.

Presentation

The financial statement presentation of revenue-generating activities is not always straightforward. Some of the questions raised in evaluating how best to present the results of revenue-generating activities are as follows:

- Should the revenue be reported gross or net? Is the entity principal or agent in the transaction?
- How should a vendor record consideration given to the customer as an incentive in a revenue-generating activity? (This question has been addressed for product transactions in chapter 4.)
- Should the transaction be classified as a gain or as revenue?
- Are any revenue amounts required to be presented separately?
- How are shipping and handling and out-of-pocket expenses billed to customers recognized in the income statement?
**Gross versus net presentation**

In certain arrangements, particularly those involving the sale of products, a vendor may participate in the transaction, but may not always perform all of the tasks necessary in order to recognize the sales price as revenue and the cost of inventory delivered as cost of sales. For example, a vendor may offer products or services that will be supplied by a third party, including those delivered under a drop shipment arrangement. Another example is a travel agent that sells an airline ticket to a customer, but is not responsible for providing a seat on a flight. In situations where the vendor does not meet the criteria to recognize the gross amount of the sales transaction, it should recognize as revenue the net amount retained by the vendor—in effect, a commission or fee received for participation in the transaction.

*FASB Accounting Standards Codification™ (ASC) 605-45, Revenue Recognition: Principal Agent Considerations*, provides indicators of gross and net reporting as well as examples that entities should consider in determining whether to recognize revenue at the full amount billed to the customer or the net amount retained. The guidance in ASC 605-45 applies to transactions in all industries, except for those governed by specific guidance (for example, financial assets, lending transactions, insurance and reinsurance premiums, and transactions in specialized industries).

Entities must use judgment in analyzing the specific facts and circumstances of an arrangement, along with the indicators outlined in ASC 605-45, to determine whether gross or net reporting of revenue is appropriate. Although the relative strength of each indicator should be considered, none of the indicators is considered determinative or presumptive.

**Indicators of gross reporting**

The following factors should be evaluated to determine whether an entity is the principal in a transaction and therefore should recognize as revenue the gross amount billed to the customer.

- **The entity is the primary obligor in the arrangement.** This means the entity is responsible for providing the purchased product or service. Representations made by the entity while marketing the product or service and the terms of the sales contract generally provide evidence as to whether the entity or the supplier is responsible for fulfilling the ordered product or service and for ensuring the acceptability of the product or service to the customer. The fact that the entity is the primary obligor in an arrangement is a strong indicator that the entity has the risks and rewards of a principal and should report revenue gross based on the amount billed to the customer.
• **The entity has general inventory risk.** General inventory risk exists if the entity takes title to the goods before the product is ordered or if it will take title to the product on customer return. Two strong indicators that revenue should be reported gross are (1) unmitigated general inventory risk and (2) services transaction risk (for example, if an entity is required to compensate a third-party service provider, regardless of whether the customer accepts the work). Inventory risk may be mitigated if an arrangement with the supplier provides the entity with the right to return unsold products or to inventory price-protection.

• **The entity has latitude in setting the price charged to the customer.**

• **The entity changes the product or performs part of the service requested by the customer.** Sales price increases that result from the entity’s participation in either changing a product (more than just packaging) or providing a portion of the services ordered by the customer may indicate that the entity is primarily responsible for fulfillment. However, price increases resulting from the entity’s marketing skills, distribution system, or reputation are not sufficient to indicate gross reporting.

• **The entity has discretion in selecting a supplier.** If multiple suppliers for the product or service ordered by the customer exist and the entity has discretion in selecting the supplier, this may be an indicator that the entity is primarily responsible for fulfillment.

• **The entity is involved in the determination of product or service specifications.** Involvement in the determination of the nature, type, characteristics, or specifications of a product or service provided to the customer may be an indicator that the entity is primarily responsible for fulfillment.

• **The entity has physical loss inventory risk.** Physical loss inventory risk exists if title to a product is transferred to the entity either after it receives the customer order or during shipping. Because the amount of risk in taking title during this time is low, this is a weak indicator compared to general inventory risk.

• **The entity has credit risk.** Credit risk exists if an entity must collect the amount billed to the customer and must pay the supplier, regardless of whether the sales price is collected from the customer. Credit risk is generally considered a weak indicator of gross reporting.
Indicators of net reporting

The presence of any of the following factors in an arrangement may indicate that an entity is an agent in the transaction and, as a result, should record revenue for the net amount retained.

- **The primary obligor in the arrangement is the third-party supplier.** Representations that the entity makes while marketing a product or service and the terms of the sales contract usually provide evidence about the customer’s understanding of whether the entity or the supplier is responsible for fulfilling the ordered product or service.

- **The entity earns a fixed amount.** An agency relationship with the supplier may be indicated if an entity earns either a fixed dollar amount per transaction, regardless of the amount billed to the customer, or a stated percentage of the amount billed to the customer.

- **The third-party supplier has credit risk.**

Entities should consider the nature of the costs and risks associated with the indicators present in evaluating the substance of an arrangement. As noted, none of the indicators is determinative or presumptive, but certain factors should be assessed as carrying more weight in this evaluation. For example, if the entity is responsible for providing the product or service ("primary obligor"), this is a strong indicator that the entity is a principal in the transaction and should record revenue on a gross basis. Another strong indicator that the entity is the principal in the transaction is if the entity has assumed unmitigated inventory risk. Weak indicators of gross reporting are physical inventory loss and credit risk. On the other hand, if the supplier, not the entity, is responsible for fulfillment, it is likely that the entity’s role in the transaction is that of an agent and revenue should be recorded on a net basis.
The following examples illustrate these concepts.

**Reporting revenue on a gross basis**

Entity A is an operator of a bed and breakfast (B&B). Customers make reservations and prepay for nights at the B&B through an internet reservation system administered by a third-party. The third party administrator retains 5 percent of the room rate and remits the remaining amount to Entity A. Entity A establishes the room rates and is responsible for providing the room required by the reservation and for resolving any service issues identified by the customers.

Entity A concludes it is acting as the principal in the transactions with its customers. Therefore, it should record revenue on the gross amount billed to its customers, because it is responsible for providing the services to the customer, has inventory risk associated with any unsold rooms, and has latitude in establishing room rates.

**Reporting revenue on a net basis**

Entity A is a supplier of internet travel services. Customers may reserve and purchase transportation, hotel, and rental car services from a variety of service providers through a website that has been developed and is maintained by Entity A. Customer B purchases an airline ticket through Entity A’s website. Entity A collects the amount due via credit card payment at the time of sale and remits the amount to the airline, net of its 5 percent commission earned in the transaction. The airline is responsible for providing a seat on the specified flight. Entity A may work with the customer and the airline in resolving issues related to the contracted service, but ultimately, the airline has responsibility for resolving customer service issues.

Entity A would be considered an agent in the transaction between Customer B and the airline and would record revenue on a net basis since the transaction does not have any of the indicators of gross reporting, except for credit risk. On the other hand, the transaction has two of the three indicators of net reporting:

- The airline has the principal responsibility for providing the services, not Entity A.
- Entity A receives a stated percentage of the transaction amount.

In addition, Entity A does not change the services provided and does not assume risk of inventory loss. The 5 percent commission would be the amount of revenue recognized by Entity A.
There are numerous other examples illustrating the application of the indicators of gross versus net revenue reporting in ASC 605-45-55-2 through 55-45.

An entity should present revenues (and related cost of revenues) separately if it records some transactions gross and some transactions net. Doing so provides information to the financial statement reader regarding the different gross margins realized by the entity.

The following illustrates presentation of product revenue and related cost of revenue on a gross basis and commission revenue recognized on a net basis.

**Gross versus net presentation**

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<tr>
<th>Description</th>
<th>Amount</th>
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<tbody>
<tr>
<td>Product revenue</td>
<td>$12,857,000</td>
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<tr>
<td>Commission revenue</td>
<td>3,267,000</td>
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<tr>
<td>Other revenue</td>
<td>1,729,000</td>
</tr>
<tr>
<td><strong>Total revenue</strong></td>
<td>17,853,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of product revenue</td>
<td>10,738,000</td>
</tr>
<tr>
<td>Cost of commission revenue</td>
<td>-</td>
</tr>
<tr>
<td>Cost of other revenue</td>
<td>1,231,000</td>
</tr>
<tr>
<td><strong>Total cost of revenue</strong></td>
<td>11,969,000</td>
</tr>
</tbody>
</table>

**Gross profit** $5,884,000

**Revenue or gain classification**

Transactions that produce either revenues or gains both result in enhancements in assets or in settlements of liabilities. Because revenues are generally a significant measure to financial statement users, it is important for an entity to determine which classification is most appropriate in reporting a transaction. FASB Statement of Financial Accounting Concepts (CON) 6, *Elements of Financial Statements*, addresses the differences between revenues and gains. Under CON 6, revenues result from activities that constitute an entity’s *ongoing major operations*, while gains are increases in net assets resulting from an entity’s *incidental transactions*.

Because of differences in the nature of operations among entities, a transaction that results in revenue for one entity may be more appropriately reported as a gain by another entity. For example, an investment company may report the results of investment activities as revenue and expense, but a manufacturing entity may report those same activities as a source of gains and losses.
Nonmonetary exchanges

At the 2004 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff noted that there is little guidance related to either the timing or classification of the income statement effects resulting from nonmonetary exchanges of products and services that culminate the earnings process. The SEC staff observed that the “earned and realized criteria” of FASB Concepts Statement 5, Recognition and Measurement in Financial Statements of Business Enterprises, and the “performance and delivery” principles in SAB Topic 13 should be applied in assessing the timing of revenue and gain recognition. The earned and realized criteria are usually met when the product is delivered or services are rendered to customers and the performance and delivery principles are met, including such considerations as customer acceptance and FOB shipping terms.

Registrants should look to the guidance in CON 6 to determine income statement classification. For the exchange to be considered revenue the exchanged items should result from activities that constitute the company’s central operations. If the activities are incidental to the entity’s operations, then gain classification may be appropriate. The staff further noted that the expense characterization should be based on similar considerations. Rule 5-03 of Regulation S-X and ASC 845-10, Nonmonetary Transactions, also should be considered when determining the appropriate income statement classification.

Shipping and handling fees and related costs

ASC 605-45-45-20 requires an entity to classify shipping and handling fees billed to customers as revenue. According to ASC 605-45-50-2, the classification of shipping and handling costs is an accounting policy election made by an entity; however, shipping and handling costs should not be classified as a reduction of revenue. If an entity elects to present shipping and handling costs outside of cost of sales and the amount is significant, the entity should disclose both the amount and line item on the income statement that includes the amount.

Sales incentives

In general, cash sales incentives are recorded as a reduction of revenue in the vendor’s income statement and as a reduction of cost of sales in the customer’s income statement; however, exceptions exist, as described under “Sales incentives” in chapter 4.

SEC presentation requirements

Separate presentation of significant revenue categories

The SEC requires issuers to separately present sales (and the related cost of sales) from tangible products, revenues from services, income from rentals, and other revenues on the face of the entity’s income statement. However, if a category is less than 10 percent of total revenue, it may be combined with another category.
Rule 5-03(b) of Regulation S-X requires vendors to separately display revenue from products and revenue from services in the income statement. But vendors unable to separate the elements for revenue recognition purposes sometimes find it challenging to separate product and service revenue from multiple-element arrangements for presentation purposes. The SEC staff has stated that it will not object to the separate presentation of product and service revenue in an arrangement that cannot be separated for accounting purposes if the vendor has a reasonable basis for developing a separation methodology. The separation methodology developed by a vendor should be consistently applied and clearly disclosed.

A registrant should apply a rational and systematic methodology to separate product and service revenue for income statement presentation. A methodology based on contractually stated amounts is insufficient. However, estimates based on verifiable inputs used to derive a reasonable approximation of fair value might be appropriate. For arrangements within the scope of ASC 985-605, *Software: Revenue Recognition*, a vendor may use third-party evidence of fair value (such as a comparison to peers with products or services that are sufficiently comparable), or the residual method if the entity customizes its core product, when allocating product and service revenue for presentation purposes. A vendor should apply judgment and consider which form of presentation is most meaningful to investors.

Sales should be presented net of expected returns, trade discounts, customer allowances, and coupons.

The following example illustrates separate presentation of products and services revenues.

### Separate presentation

Entity A has earned revenues from the sale of products and services. Its statement of operations is presented below.

<table>
<thead>
<tr>
<th></th>
<th>Year ended December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2007</td>
</tr>
<tr>
<td><strong>Net revenues</strong></td>
<td></td>
</tr>
<tr>
<td>Product revenues</td>
<td>$5,300,000</td>
</tr>
<tr>
<td>Service revenues</td>
<td>2,300,000</td>
</tr>
<tr>
<td>Total net revenues</td>
<td>7,600,000</td>
</tr>
<tr>
<td><strong>Cost of revenues</strong></td>
<td></td>
</tr>
<tr>
<td>Product costs</td>
<td>3,440,000</td>
</tr>
<tr>
<td>Service costs</td>
<td>690,000</td>
</tr>
<tr>
<td>Total cost of revenues</td>
<td>4,130,000</td>
</tr>
<tr>
<td><strong>Gross profit</strong></td>
<td>$3,470,000</td>
</tr>
</tbody>
</table>
Related party transactions
SEC Regulation S-X, Rule 4-08(k) requires an entity to present related party transactions, including those affecting an entity’s revenue, on the face of its income statement, as well as on its balance sheet and statement of cash flows.

Taxes collected from customers
ASC 605-45-50-3 through 50-4 addresses the presentation of government-assessed taxes that are both imposed on and concurrent with a specific revenue-producing transaction between an entity and its customer. These taxes may include, but are not limited to, sales, use, value added, and certain excise taxes. Under ASC 605-45-50-3 through 50-4, such taxes may be reported on either a gross basis (included in revenues and costs) or a net basis (excluded from revenue). If an entity chooses to present these taxes on a gross basis, it should disclose the amounts of those taxes, if significant, for each period an income statement is presented. This disclosure can be made on an aggregate basis. An entity should disclose this accounting policy decision.

Disclosures
Financial statement disclosure requirements for revenue-generating activities can be quite extensive, depending on the nature of the revenue. The disclosures should be entity-specific and enable the financial statement user to understand the sources of revenue, the method of accounting for revenue-generating activities, and significant contract provisions that impact revenue recognition, such as rebates, returns, installation, and acceptance. Additionally, material changes to standard contract terms that impact revenue recognition should be disclosed.

There are many disclosure requirements that relate to entities in specific industries. The general disclosure requirements discussed here are not all-inclusive and an entity should refer to the appropriate accounting literature to determine whether it has included all required disclosures in its financial statements.

Accounting policies
All entities should include disclosure of their accounting policies related to revenue-generating activities, including the following:

- Sources of revenue and when revenue is recognized for each type of revenue, such as on delivery of the product or on completion of services; ratably over the terms of the contract; using the percentage-of-completion or completed-contract method; or on delivery of separate components of a multiple-element arrangement.
- Information regarding the nature of the arrangement and each significant unit of accounting, as well as the related accounting for multiple-element arrangements.
• Significant assumptions, estimates, and uncertainties that affect the recognition of revenue, for example, an entity’s policy for recognizing revenue related to breakage. If the percentage-of-completion method is used in accordance with ASC 605-35, Construction-Type and Production-Type Contracts, an entity should disclose the method or methods used to measure the extent of progress toward completion.

• How revenue subject to future performance contingencies is recognized, the nature of the related contracts, and the amounts recognized based on a performance-based incentive fee.

• The nature and terms of sales incentives, including the type of consideration given and the accounting policy used for each type of arrangement in accordance with the provisions of ASC 605-50, Customer Payments and Incentives.

• The accounting policy for revenue-related items, such as capitalizing incremental direct costs associated with customer contracts.

Accounting policy disclosures should be reassessed each reporting period to determine whether any changes are required.

**Multiple-element arrangements**

ASC 605-25, *Multiple-Element Arrangements*, places significant reliance on judgment and estimates and, as a result, includes a disclosure objective that requires an entity to disclose both qualitative and quantitative information about its revenue arrangements, including the following:

• Significant judgments made in applying the amended guidance ASC 605-25

• Changes in judgments or in the application of ASC 605-25, as amended, that may significantly affect either the timing or amount of revenue recognition

In light of this objective, the amended guidance prescribes specific information to be disclosed for similar types of multiple-element arrangements, including all of the following:

• The nature of the arrangements

• The significant deliverables included in the arrangements

• The timing of delivery of products or performance of services

• Provisions, such as performance, refund, cancellation, and termination

• The significant factors, inputs, assumptions, and methods used in determining the selling price for significant deliverables

• Whether significant deliverables can be accounted for separately and if not, why

• Revenue recognition timing for significant units of accounting

• The effect of significant changes in the selling price or in methods or assumptions used in determining the selling price for a unit of accounting if those changes result in a significant change in the allocation of consideration
ASC 605-25 includes guidance that is effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. ASC 605-25-65-1 includes additional transitional disclosure requirements required in the year of adoption, which will vary depending on the adoption method.

**Milestone method**

Entities that elect to adopt the milestone method under ASC 605-28, *Milestone Method* must disclose all of the following:

- Description of the overall arrangement
- Description of each milestone, whether each is considered substantive and the related contingent consideration for each
- Factors considered in determining whether the milestone(s) is substantive
- Total amount of revenue recognized during the period for milestones

ASC 605-28 includes guidance that is effective for milestones achieved in fiscal years and in interim periods within those years beginning on or after June 15, 2010. ASC 605-28-65-1 includes additional transitional disclosure requirements required in the year of adoption, which will vary depending on the adoption method.

**Collaborative arrangement disclosures**

A participant in a collaborative arrangement must disclose the following for annual periods:

- The nature and purpose of the participant’s collaborative arrangements
- The participant’s rights and obligations under the arrangements
- The participant’s accounting policy in accordance with ASC 235, *Notes to Financial Statements*, for collaborative arrangements
- The income statement classification and amounts attributable to transactions between the participants arising from collaborative arrangements for each income statement period presented

The disclosures for individually significant collaborative arrangements should not be aggregated.
SEC disclosure requirements
SEC registrants should consider the following in addition to U.S. GAAP disclosure requirements:

- An entity that recognizes revenue over the service period based on proportional performance, separate contract elements or milestones, or progress toward completion should disclose
  - How progress is measured (for example, cost to cost, time and materials, units of delivery)
  - The types of contract milestones and how they relate to substantive performance and revenue recognition events
  - Whether multiple contracts with a single counterparty are combined or separated

- An entity that accounts for product sales that are subject to return in accordance with ASC 605-15, *Products*, as discussed in chapter 3, should disclose
  - Material changes, if any, in the amount of estimated returns
  - The fact that a material change in estimate could occur in the near term if it is reasonably possible, as well as the nature of the uncertainty

- If service revenue includes refundable amounts that are accounted for by analogy to ASC 605-15, the entity should disclose
  - The accounting policy used to record these fees
  - Estimates of cancellation
  - Amounts of unearned revenues and refund obligations as of the beginning of each income statement period presented, the amount of cash received from customers, the amount of refunds paid, the amount of revenue recognized in earnings, any other adjustments, and the balances at the end of each period
How should revenue be presented and disclosed? 195
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410.685.4000
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<tr>
<td></td>
<td>Milwaukee</td>
<td>414.289.8200</td>
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