MOODY, FAMIGLIETTI & ANDRONICO

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# Financial Reporting


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## Revised Revenue Rules May Change the Way You Do Business

**This Financial Reporting Alert was prepared to help our clients anticipate and respond to questions that may arise with the implementation of *Accounting Standards Update Nos. 2009-13, Multiple-Deliverable Revenue Arrangements* and 2009-14, *Certain Revenue Arrangements That Include Software Elements*. Both are the result of consensuses of the FASB Emerging Issues Task Force.**

### Executive Summary

For many entities, sales arrangements are often characterized by transactions with multiple deliverables. For example, in the technology industry, hardware, software, and professional services may be sold together as part of the same customer arrangement. In the biotechnology industry, a single arrangement may include an intellectual property license and research and development services. A standard equipment manufacturer may sell multiple products under the same purchase order that are delivered at different times, or provides installation services in addition to delivery of products.

At the September 2009 meeting, the Emerging Issues Task Force (EITF) reached a consensus on two Issues - 08-1[1] and 09-3[2]. These issues were codified in October 2009 with the issuance of FASB Accounting Standards Update (ASU) Nos. 2009-13 and 2009-14. These ASU's will have a major impact on the accounting for revenue recognition for multiple deliverable transactions. Although not required to be adopted by calendar year-end entities until January 1, 2011, the rules allow for early adoption either prospectively (to new or materially modified arrangements) or retrospectively. As a result of these new requirements, affected entities will need to determine: (1) how these rules will impact sales practices and policies; (2) what transition method to adopt; and (3) what systems and procedures will be necessary to report and disclose the required information upon transition and on an ongoing basis.

[1] EITF Issue No. 08-1, *Revenue Arrangements with Multiple Deliverables*

[2] EITF Issue No. 09-3, *Applicability of AICPA Statement of Position 97-2 to Certain Arrangements That Include Software Elements*

In a multiple-element arrangement, under prior rules (FASB Accounting Standards Codification (ASC) 605-25[3] - EITF Issue No. 00- 21[4]), an entity could not separate a delivered item (i.e., treat it as a separate unit of accounting and recognize related revenue) without objective and reliable evidence of the fair value of the undelivered products and services. Determining the fair value of the undelivered items commonly involved establishing vendor-specific objective evidence (VSOE) - a complicated process to establish and consistently follow. If the fair value of the undelivered items could not be established, the delivered products and services could not be separately accounted for and revenue related to the delivered items was deferred.

In practice, this sometimes resulted in accounting treatment that did not reflect the economics for these multi-deliverable transactions and often led to pricing policies that did not make business sense. For example, some entities sell current products together with rights to future products (i.e., products that have not yet been released). However, because it is difficult to establish objective and reliable evidence of fair value of future products, all revenue for these types of arrangements would typically be deferred until the future product is delivered. As a result, it has been less common for entities to include rights to future products in sales arrangements. In contrast, entities accounting for revenue using International Financial Reporting Standards (IFRS) do not have these recognition restrictions, and may include rights to future products in sales arrangements while still recognizing revenue for the current product when shipped.

To address this and other concerns, ASU 2009-13 (Issue 08-1) replaces and significantly changes some guidance in ASC 605-25 (Issue 00-21). In addition, ASU 2009-14 (Issue 09-3) amends the scope of ASC 985-605[5] (AICPA Statement of Position (SOP) 97-2[6]), to exclude certain software-enabled products. Entities that sell joint hardware and software products and meet certain criteria are no longer subject to ASC 985-605 with respect to those products and would instead follow the guidance in ASC 605-25. Other entities that sell software remain subject to ASC 985-605.

This Financial Reporting letter focuses on the new requirements of ASU 2009-13 and ASU 2009-14, specifically:

- Changes from prior rules, including illustrations of the relative selling price method of allocation;
- Application of the transition guidance; and
- Other issues to consider when applying and complying with the new rules.

## Overview of the New Rules

**ASU 2009-13**: Eliminates the prior requirement in ASC 605-25 to establish fair value of undelivered products or services and instead requires separate revenue recognition based on management's estimated selling prices when VSOE or third-party evidence (TPE) cannot be established, assuming the other criteria of ASU 2009-13 are met.

### Scope

The scope of ASU 2009-13 remains the same as the previous scope in ASC 605-25. The ASU generally applies to all deliverables (i.e., products, services, or rights to use assets) within contractually binding arrangements (whether written, oral, or implied) in which an entity will perform multiple revenue-generating activities. The scope of ASU 2009-13 does not apply to deliverables that are within the scope of other sections of the FAS B ASC, for example leases, real estate sales, construction arrangements and software licensing transactions. However, as previously indicated, ASU 2009-14 modified the scope of ASC 985-605 such that many arrangements containing hardware and software that were previously accounted for using software revenue recognition rules are no longer subject to those rules, and are now subject to the revised requirements in ASU 2009-13.

The ASU does not address when the criteria for revenue recognition are met or provide revenue recognition guidance for a given unit of accounting.

### Unit of Accounting

ASU 2009-13 addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting. Consistent with existing guidance, the ASU indicates that absent sufficient evidence to the contrary, separate contracts with the same entity or related parties that are entered into at or near the same time are presumed to have been negotiated as a package and should be evaluated as a single arrangement in considering whether there are one or more units of accounting.

The ASU modifies the separation criteria of ASC 605-25 by eliminating the criterion for objective and reliable evidence of fair value (ASC paragraph 605-25-25-5(b)). As a result, under ASU 2009-13, revenue arrangements with multiple deliverables must be divided into separate units of accounting if the deliverables meet both of the following criteria:

- The delivered item(s) has value to the customer on a standalone basis[7]
- If the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the vendor.

[3] FASB ASC 605-25, Revenue Recognition, Multiple-Element Arrangements
[4] EITF Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*
[5] FASB ASC 985-605, Software, Revenue Recognition
[6] AICPA Statement of Position 97-2, *Software Revenue Recognition*

[7] ASU 2009-13 does not change the criteria for standalone value. As stated in the Issue, "Item(s) have value on a standalone basis if it is sold separately by any vendor or the customer could resell the delivered item(s) on a standalone basis. In the context of a customer's ability to resell the delivered item(s), this criterion does not require the existence of an observable market for that deliverable(s)."

**MFA Insight:** *As a result of this change, more deliverables are expected to meet the separation criteria. In addition, we expect many entities with multiple deliverable arrangements to change their pricing policies and sales practices to employ greater variability in pricing products and services. For example, value-based pricing strategies will become easier to implement in some situations.*

## Measurement and Allocation of Arrangement Consideration

Once the arrangement is separated into specific units of accounting, ASU 2009-13 addresses how to allocate the total arrangement consideration to each of the units.

ASC 605-25 had required the use of the relative fair value allocation method only when objective and reliable evidence existed for all units of accounting in the arrangement. In the absence of objective and reliable evidence for the delivered item(s) in the arrangement, an entity had to apply the residual allocation method. The residual allocation method requires an entity to first allocate consideration to the undelivered item(s) based on fair value, and allocate the remainder or residual, if any, to the delivered items(s).

The new rules eliminate the use of the residual method of allocation. Instead, arrangement consideration must be allocated at the inception of the arrangement to all deliverables based on their *relative selling prices* (i.e., the relative selling price method). Under ASU 2009-13, an entity must determine the selling price of all deliverables that qualify for separation using a hierarchy of: (1) VSOE, (2) TPE, and (3) best estimate of selling price. ASU 2009-13 replaces the term fair value with the term "selling price", i.e., ASC 820[8] does not apply to the measurements used in applying ASU 2009-13.

The ASU requires that an entity use its best estimate of selling price only after the entity has determined that VSOE or TPE of the selling price do not exist. If VSOE or TPE of selling price do not exist for a deliverable, an entity must use its best estimate of the selling price for that deliverable to allocate consideration among the deliverables in the arrangement.

ASU 2009-13 defines the three levels of the hierarchy as follows:

- *Vendor-specific objective evidence of selling price* is limited to either of the following: (a) the price charged for a deliverable when it is sold separately or (b) for a deliverable not yet being sold separately, the price established by management having the relevant authority (it must be probable that the price, once established, will not change before the separate introduction of the deliverable into the marketplace).
- *Third-party evidence of the selling price* is the price of the vendor's or any competitor's largely interchangeable products or services, in standalone sales to similarly situated customers.
- *The vendor's best estimate of selling price* must be consistent with the objective of determining VSOE of selling price for the deliverable; that is, the price at which the vendor would transact if the deliverable were sold by the vendor regularly on a standalone basis. The vendor should consider market conditions as well as entity-specific factors when estimating the selling price.

Under this model, the best estimate of selling price is used for both the undelivered and delivered items that do not have VSOE or TPE of the selling price. In deciding whether the entity can obtain VSOE or TPE of the selling price, the entity should not ignore information that is reasonably available without undue cost and effort.

See Appendix A for examples that illustrate the use of the relative selling price method for allocating the consideration received.

**MFA Insight:** *Many entities currently use the residual method and as a result do not need to track the selling prices of delivered items for purposes of allocating arrangement consideration. Elimination of the residual method may result in many entities having to expand their procedures for collecting data relevant to estimating selling prices of the delivered items. While we expect that this data already exists internally, it may now become a more formal part of the accounting process.*

## Estimating the Selling Price

ASU 2009-13 does not elaborate on how to estimate the selling price but states that the entity's best estimate of selling price should be consistent with the objective of determining VSOE of selling price for the deliverable, that is, the price at which the entity would transact if the deliverable were sold by the entity regularly on a standalone basis. When determining the best estimate of selling price, the entity should consider market conditions as well as entity-specific factors that are consistent with its normal pricing practices (e.g., cost of a product plus a normal profit margin). For future estimates, the entity should develop a standard methodology and monitor operations for changes in circumstances that may impact the estimation process. For example, an entity may track its various selling prices to use as a starting point in its estimates, and changes (e.g., changes in its pricing strategy or business model or the introduction of brand new products or services) should be monitored throughout the reporting period so that the entity is indeed using its best estimate of selling price in recording revenue for its various arrangements. However, once the arrangement consideration is allocated (at the inception of an arrangement), an entity would not

[8] FASB ASC 820, Fair Value Measurements and Disclosures

reallocate such consideration for subsequent changes in the estimate of selling price, even if the entity later determines VSOE or TPE of selling price, or develops revised estimated selling prices for use with new transactions.

Despite entities' best efforts to develop estimation methodologies, some estimates may still be quite subjective for products that:

- Are never sold separately
- Have a wide range of selling prices
- Are not yet available for release until some future date

ASU 2009-13 includes examples that address the determination of "best" estimate of the selling price.

> ***MFA Insight:*** *We believe management will be in the best position to estimate selling prices based on information readily available to them in managing their operations, and this should not typically require outside expertise. In situations where there is considerable judgment involved in estimating selling prices, particularly for new or future products that have not yet been sold, or in situations where a product is being sold at a wide range of prices, we recommend that management discuss the proposed approach with their accounting firm early in the process.*

## *Limitation on Allocation of Revenue*

As with prior revenue recognition rules, the new guidance indicates that the amount allocable to delivered items is limited to the amount that is not contingent on delivery of additional items or meeting other specified performance conditions. Note that in practice, this will often preclude allocation of an amount of total arrangement consideration to the delivered item that is greater than the contractually specified amount for the delivered item. This can occur when VSOE or estimated selling price for a delivered item is greater than the stated-contractual price.

## *Contingent Consideration*

The new guidance specifies that the total consideration must be fixed and determinable. Accordingly, when allocating total arrangement consideration, contingent consideration such as royalty or usage based payments would not be considered, since these amounts are not fixed and determinable. An entity's determination of VSOE or estimated selling price, however, would not be expected to differ solely because all or a portion of arrangement consideration for a deliverable is contingent and not considered fixed and determinable. As a result, entities should carefully consider how to apply the new guidance to arrangements that include royalty or usage based payments.

Example 2 in Appendix A illustrates the application of the new guidance to an arrangement that includes consideration that is not fixed and determinable.

## *Use of Ranges When Establishing VSOE and Estimated Sell ing Prices*

As mentioned above, an entity will use its best estimate of selling price only when VSOE or TPE is not available and this estimate is required to be consistent with VSOE objectives. In practice, VSOE is generally not a single estimate, but rather is established as a sufficiently narrow range of estimated prices. For example, if the VSOE of selling price for 80% of separate transactions for a particular product or service in a given period fall within a range of + / - 15% of a midpoint, this would typically be considered sufficient to conclude that VSOE of fair value exists for a deliverable. VSOE is then viewed as the + / - 15% range of pricing that has been established. If VSOE or TPE does not exist, we believe estimated selling prices can also be established as a sufficiently narrow range, as opposed to a point estimate.

When VSOE or estimated selling prices have been established as a range, and contractual pricing of individual deliverables in an arrangement are all within the established ranges, then no reallocation of selling prices or discounts would be necessary. However, if one or more deliverables are priced outside of the established VSOE or estimated selling price range, or if deliverables in an arrangement are not separately priced, then it would be necessary to allocate the total consideration using point estimates of VSOE and/or estimated selling price of each of the deliverables. Point estimates would typically be either the midpoint or low end of the range, however, where the contractual price of a deliverable is within the range, that contractual price would typically be used. Entities should follow a consistent allocation approach.

Example 3 in Appendix A illustrates the use of ranges to establish VSOE and estimated selling prices.

> ***MFA Insight:*** *Use of ranges should significantly simplify the implementation and recordkeeping aspects of this new standard for many entities. However, in order to benefit from this approach, entities might structure their multiple deliverable arrangements to contain separately stated prices for individual deliverables that can be compared to the established ranges. Contracts with bundled pricing would still require an allocation calculation based on point estimates.*

## SAB 104: *Inconsequential and Perfunctory Performance Obligations*

SEC Staff Accounting Bulletin (SAB) 104 states that incomplete, inconsequential and perfunctory performance obli-

gations in a revenue arrangement do not preclude revenue recognition. The SEC's interpretive guidance is only applicable to a unit of account that does not qualify for further separation under ASC 605-25. The interpretive guidance in SAB 104 was most commonly applied when a unit of account could not be separated because the criterion to establish objective and reliable evidence of fair value of the remaining performance obligations could not be met, but the remaining performance obligations were determined to be inconsequential and perfunctory based on the guidance in SAB 104. Now under ASU 2009-13, entities will no longer have a single unit of account solely due to not being able to establish fair value of remaining performance obligations, since that criterion has been eliminated. As a result, in these situations, SAB 104's interpretive guidance pertaining to inconsequential and perfunctory deliverables will no longer be applicable. Instead, the remaining performance obligations would be required to be separated using estimated selling prices, assuming the other remaining criteria for separation in ASC 605-25 are met. Alternatively, in some instances, entities might choose to not allocate revenue to performance obligations previously considered inconsequential and perfunctory on a basis of materiality.

**MFA Insight:** *Upon adoption of ASU 2009-13, it is unclear whether SAB 104's guidance with respect to inconsequential and perfunctory obligations would continue to be applicable in any situations. Any entity considering whether to apply this SAB 104 guidance after adoption is strongly encouraged to consult with the SEC before adopting such an interpretation.*

## On-Going Disclosure Requirements

The prior disclosure requirements under ASC 605-25 were not very specific. Entities were required to disclose their accounting policy for recognition of revenue from multiple- deliverable arrangements and provide a description and nature of such arrangements, including performance, cancellation, termination, or refund-type provisions.

The new disclosures in ASU 2009-13 are more extensive than those required by ASC 605-25, and include both qualitative and quantitative information regarding the significant judgments made in applying this ASU that may significantly affect the timing or amount of revenue recognition. ASU 2009- 13 specifically requires disclosure of the following information by similar type of arrangement:

- The nature of multiple-deliverable arrangements
- The significant deliverables within the arrangements
- The general timing of delivery or performance of service for the deliverables within the arrangements
- Performance, cancellation, termination, and refund-type provisions
- A discussion of the significant factors, inputs, assumptions, and methods used to determine selling price (whether vendor-specific objective evidence, third party evidence, or estimated selling price) for the significant deliverables
- Whether the significant deliverables in the arrangements qualify as separate units of accounting, and the reasons that they do not qualify as separate units of accounting, if applicable
- The general timing of revenue recognition for significant units of accounting
- Separately, the effect of changes in either the selling price or the method or assumptions used to determine selling price for a specific unit of accounting if either one of those changes has a significant effect on the allocation of arrangement consideration.

**MFA Insight:** *Revenue policy disclosures are likely to require expansion as a result of the above requirements and may require more frequent updating. In some cases, the required disclosures could be competitively sensitive.*

## Tangible Products Containing Software

**ASU 2009-14**: Under the new rules all tangible products containing both software and non-software components that function together to deliver the product's essential functionality will no longer be within the scope of ASC 985-605. In other words, entities that sell joint hardware and software products that meet the scope exception (i.e., essential functionality) will be required to follow the guidance in ASC 605-25.

In determining whether a tangible product is delivered with software components and non-software components that function together to deliver the tangible product's essential functionality, the ASU requires that an entity consider all of the following:

1. If sales of the tangible product without the software elements are infrequent, a rebuttable presumption exists that software elements are essential to the functionality of the tangible product.
2. A vendor may sell products that provide similar functionality, such as different models of similar products. If the only significant difference between similar products is that one product includes software that the other product does not, the products shall be considered

[9] The determination of whether an arrangement has been materially modified is a matter of judgment and should be based on the individual facts and circumstances of the arrangement.
[10] FASB ASC 250, Accounting Changes and Error Corrections

the same product for purposes of evaluating item (1) above.

3. A vendor may sell software on a standalone basis. The vendor may also sell a tangible product containing that same software. The separate sale of the software shall not cause a presumption that the software is not essential to the functionality of the tangible product.
4. Software elements do not need to be embedded within the tangible product to be considered essential to the tangible product's functionality.
5. The non-software elements of the tangible product must substantively contribute to the tangible product's essential functionality. For example, the tangible product should not simply provide a mechanism to deliver the software to the customer.

The ASU also includes certain exceptions to the guidance above that entities should consider, as well as numerous examples illustrating how entities would apply the revised scope provisions.

Example 4 in Appendix A illustrates the determination as to whether certain units in a multiple- deliverable revenue arrangement, which includes both tangible products and software, are considered within the scope of ASC 605-25 or remain within the scope of 985-605.

If an arrangement includes both software that is part of delivering a product's essential functionality and other software that is not related to the product's essential functionality, the software would be separated, based on the guidance in ASC 605-25, and the nonrelated software would still be within the scope of ASC 985-605.

The new rules do not expand the disclosure requirements of ASC 985-605; however, because the rules change the scope of ASC 985- 605, and because more arrangements will be subject to the guidance in ASC 605-25, entities affected by ASU 2009-14 will be subject to the significantly expanded disclosure requirements of ASU 2009-13.

## Effective Date and Transition Guidance for ASUs 2009-13 and 2009-14

ASUs 2009-13 and 2009-14 have the same effective date and transition guidance and provide entities with considerable flexibility when adopting the new requirements. Acceptable methods of adoption are as follows:

- *Prospectively for fiscal years beginning on or after June 15, 2010.* In other words, for a calendar year-end entity, all new or materially modified arrangements[9] entered into on or after January 1, 2011 would follow the new rules. Under this transition approach, arrangements that are deemed to be legacy transactions would continue to be accounted for under the prior guidance in ASC 605-25 (Issue 00-21).
- *Prospectively, but adopt early.* In this case, entities can elect to apply the rules immediately. However, if electing to early adopt in an interim period other than the beginning of a fiscal year, an entity must apply the ASU from the beginning of its fiscal year. So, for example, assume a December 31, 2009 year-end entity elects to early adopt the ASU prospectively in its September 30, 2009 reporting period. It must reassess revenue recognition for all new arrangements entered into since January 1, 2009 and is required, for all prior interim reporting periods of that fiscal year, to provide specific disclosures that explain the effect of the adjustments on the prior interim periods' revenue, income before taxes, net income, and earnings per share. Public entities would disclose the effects of adoption in their third quarter Form 10-Q or Form 10-K if adopted in the fourth quarter. No amendment of prior filings would be necessary. These required disclosures are in addition to the transition disclosures that are required for prospective adoption discussed in Appendix B.
- *Retrospective adoption for all periods presented (except for periods where it is impracticable do so).* In this case, an entity would follow the existing disclosure requirements in ASC 250[10] (250-10-50). Retrospective adoption can occur in the fiscal year beginning on or after June 15, 2010, or at any time prior. We do not expect this transition option to be selected that often in practice as the benefits of retrospective application will likely not be perceived as outweighing the costs.

An entity is required to adopt the amendments in ASU 2009-14 in the same period using the same transition method that it uses to adopt the amendments in ASU 2009-13.

As discussed above, when adopting prospectively, including on an early basis, existing arrangements entered into prior to adoption continue to be accounted for under the prior guidance in ASC 605-25 (Issue 00-21), unless the arrangements are subsequently materially modified. As a result, if the residual method had been previously applied to a legacy arrange-

[11] We understand that a registrant usually does not need to file revised annual financial statements in order to file a new registration statement on Form S-8. The instructions to Form S-8 require a registrant to disclose material changes in a filing that is incorporated by reference in the Form S-8. The manner in which material changes may be disclosed is a matter of judgment. In that regard, even though a change would require revising the annual financial statements if the offering was registered using a different registration statement form, it is usually possible to adequately disclose the change in a Form S-8 without revising the financial statements.

[12] We understand that a registrant usually does not need to file revised annual financial statements in order to conduct or continue an offering using an already effective registration statement. We understand that a registrant may continue to offer securities pursuant to an effective registration statement unless the revision to the financial statements would constitute a fundamental change. Determining whether a change is so significant that it constitutes a fundamental change is a legal question. In practice, fundamental changes are rare. However, an underwriter might request an issuer to voluntarily file revised financial statements or present them in a prospectus supplement.

ment, then it should continue to be applied until all deliverables in that arrangement have been delivered.

For purposes of assessing which arrangements are subject to the new rules upon adoption, arrangements subject to an existing master purchase agreement could be viewed either as a legacy arrangement or a new arrangement, depending on the facts and circumstances. If terms and deliverables are already substantially agreed upon, then an arrangement could more likely be viewed as part of the legacy agreement. On the other hand, ongoing purchases under existing supply or distributor agreements could more likely be viewed as new arrangements.

***MFA Insight:*** *Private entities that have not yet issued financial statements for 2009 may be more likely to consider early adoption to take advantage of the new rules, particularly if they have not previously released interim financial statements during the year. In addition, entities in the IPO process or contemplating an IPO within the next two or three years may elect (at the recommendation of their underwriters) to apply the guidance retrospectively in order to present more comparable and meaningful revenue trends.*

## Transition Disclosure Requirements for Prospective Adoption

If an entity elects to apply ASU 2009-13 prospectively, it is required to make certain qualitative disclosures in the initial year of adoption. The transition disclosure requirements could require a fair amount of work on the part of the preparer. See Appendix B for a discussion of the requirements.

The transition disclosure requirements for prospective application are not applicable to entities that elect to adopt through retrospective application. However, those entities are instead required to provide the disclosures in ASC 250-10- 50-1 through 50-3.

## The Impact of Retrospective Adoption on Incorporating Financial Statements by Reference in Registration Statements

As discussed in the effective date and transition section of this letter, entities have the option to adopt ASUs 2009-13 and 2009-14 retrospectively or prospectively. Entities should consider the consequences of the method they choose as they evaluate the financial statement requirements of registration statements that are filed or become effective (or are post-effectively amended) after their first Form 10- Q is filed that reflects the adoption of ASUs 2009-13 and 2009-14.

This could be important because if the effect of adopting ASUs 2009- 13 and 2009-14 is material and a registrant has: (a) retrospectively adopted the ASUs and (b) filed interim financial statements for a period that includes the date of adoption, the SEC staff will expect the registrant to revise its prior period annual financial statements, selected financial data and management's discussion and analysis before incorporating them by reference or presenting them in a new registration statement (other than one filed on Form S-8).[11 12]

Conversely, if a registrant elects to adopt the ASUs only on a prospective basis, or if retrospective application of the ASUs is not material, its registration statement may incorporate by reference its most recent Form 10-K (assuming the prior financial statements don't require revision for other purposes). This would include its historical annual financial statements for periods prior to the adoption of ASU 2009-13 and 2009-14.

## IFRS Requirements

International Accounting Standard 18, Revenue, requires that revenue be measured at the fair value of consideration received or receivable for each separable component of a transaction. IFRS does not dictate or prescribe the method to be used in determining the fair value of each separately identifiable component. Similarly, IFRS does not prescribe a method for allocating revenue to the components, as long as the method

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# Appendix A:

## Illustrations and Guidance for New Requirements

The following examples illustrate the use of the relative selling price method for allocating the consideration received. ASU 2009-13 contains numerous additional examples that can also be considered.

### Example 1:
### Standard Equipment Manufacturer

Entity X sells multiple products under the same purchase order and provides installation services in addition to the equipment. Entity X sells three pieces of equipment (A, B and C) and installation services for each to Entity Y for $500,000. Equipment A can be purchased on a stand-alone basis for $100,000. Equipment B and C have never been sold separately, and no other entity sells the same or similar equipment (i.e., there is no VSOE or TPE of selling price). The separation criteria of ASU 2009-13 have been met.

Entity X estimates that the selling prices for B and C (should they ever be sold separately), and the total installation price for A, B, and C together are as follows:

Equipment B: $200,000
Equipment C: $225,000
Installation: $60,000 (assume the individual installation charges for each of A, B, and C are approximately the same)

Under the relative selling price method the following amounts would be allocated to each piece of equipment and to the installation for each individually:

Total estimated selling price: $100,000+$200,000+$225,000+$60,000=$585,000. This is the combination of the VSOE for Equipment A and the best estimate of selling price for both B and C and the installation for A, B, and C. The allocation of the consideration ($500,000) is as follows:

Equipment A: $85,470 = (100,000/585,000) * $500,000

Equipment B: $170,940 = ($200,000/585,000) * $500,000

Equipment C: $192,308 = ($225,000/$585,000) * $500,000

Installation: $17,094 each = [(($60,000/$585,000) * $500,000)/3]

If Equipment A and B are delivered and installed the journal entry to record the allocation would be as follows:

| | | |
|---|---|---|
| Dr. Cash ` | $500,000 | |
| Cr. Sales Revenue | | $290,598 |
| Cr. Deferred Revenue | | 209,402 |

In the period that Equipment C is delivered and installed the deferred revenue would be recognized as follows:

| | | |
|---|---|---|
| Dr. Deferred Revenue | $209,402 | |
| Cr. Sales Revenue | | $209,402 |

**Example 2:**
**Biotechnology Industry - Royalty Arrangements**

Biotech Entity enters into a technology licensing agreement under which the customer obtains immediate license rights to use Patent A in the manufacture and sale of products, and rights to use additional unpatented proprietary Technology B, also for use in the manufacture and sale of products, that will be delivered to the customer once ready for commercialization in approximately six months. Patent A has standalone value and the licenses to Patent A and Technology B are the only deliverables in the arrangement. Payments under the agreement consist of an upfront amount of $100,000 for the license to Patent A, and ongoing royalty payments for the license to Technology B of $8 per unit manufactured and sold containing Technology B.

The estimated selling price of Patent A is $100,000 based on other similar licensing transactions for Patent A. The estimated selling price of Technology B is $160,000. This is based on Biotech's estimate of the customer's sales volume of 20,000 units based on forecasts provided by the customer and used in negotiations, and Biotech's internal estimates that the selling price of this type of technology is approximately $8 per unit. The internal estimates are based on knowledge of the role of the technology in the end products and past experience with somewhat similar royalty based arrangements.

Total estimated selling price is $260,000 ($100,000 + $160,000)

Under the relative selling price method, $38,461 would be allocated to Patent A: ($100,000/$260,000) * $100,000 (non contingent consideration). The remainder of $61,539 would be allocated to Technology B.

Note: The allocated consideration of $100,000 excludes estimated royalty consideration for future estimated sales of product containing Technology B as required by ASC 605-25-30-2. The license to Technology B is a deliverable under this royalty arrangement but estimated royalty revenue from sales of product containing Technology B is excluded from the allocated consideration since the future royalty payments would not be considered fixed and determinable until the sales occur.

When the license to Patent A is delivered the journal entry to record the allocation would be as follows:

| | | |
|---|---|---|
| Dr. Cash | $100,000 | |
| Cr. Sales Revenue | | $38,461 |
| Cr. Deferred Revenue | | 61,539 |

When the license to Technology B is delivered the journal entry would be as follows:

| | | |
|---|---|---|
| Dr. Deferred Revenue | $61,539 | |
| Cr. Sales Revenue | | $61,539 |

When the customer reports sales of 5,000 units of product containing Technology B, the royalty revenue would be recognized as follows:

| | | |
|---|---|---|
| Dr. Royalty Receivable | $40,000 | |
| Cr. Sales Revenue | | $40,000 |

**Example 3:**
**Use of Ranges When Establishing VSOE and Estimates Selling Prices**

RevCo's sales department uses an approved standard price list for products and services that includes internal guidelines with respect to discounts that can be offered to customers, with additional approval requirements based on the level of discount. RevCo sells a standard Product A and always includes one year of bundled maintenance services with Product A. List prices for Product A and related maintenance is $40,000 and $8,000 per year, respectively.

RevCo regularly sells maintenance at a significant discount from list since RevCo's direct costs of providing maintenance are not very significant. Based on a recent study, RevCo ascertained that 80% of separate sales of maintenance had been priced within a range of $5,500 to $7,500 per year, which approximates a + / - 15% range, and RevCo has concluded that this range represents VSOE of fair value of maintenance for Product A.

Since RevCo never sells Product A without first year maintenance, RevCo is unable to establish VSOE for Product A. Also, Product A is unique, so third party pricing data is not available to RevCo. For purposes of establishing the estimated selling price of Product A, RevCo considered contractual pricing in recent sales arrangements, margin trends and its knowledge of the market for Product A. RevCo has concluded that the estimated selling price of Product A is a range of $32,000 to $40,000.

RevCo completes a sale of Product A and first year maintenance with contractual pricing of $32,000 and $3,000, respectively. Since maintenance is priced below the estimated selling price range of $5,500 to $7,500, the $35,000 total sales price must be allocated. For allocation purposes, RevCo uses the stated contractual price of Product A since it is priced within the estimated selling price range and the midpoint of the VSOE or estimated selling price range for maintenance since it was priced outside of the range. Based on this methodology, RevCo allocates the total sales price of $35,000 as follows:

Product A : $29,091 = ($32,000 / $38,500) * $35,000
Maintenance : $5,909 = ($6,500 / $38,500) * $35,000

The following example illustrates the determination as to whether certain units in a multiple-deliverable revenue arrangement that includes both tangible products and software are considered within the scope of ASC 605-25 or remains within the scope of 985-605. ASU 2009-14 provides numerous additional examples for consideration.

**Example 4:**
**Personal Digital Assistant**

Vendor sells a personal digital assistant. The personal digital assistant provides several functions, such as phone, camera, and computing functionality that allow the user to access and use various software programs, such as a music player and games. The personal digital assistant contains an operating system that allow the customer to access the functionality of the device, including the ability to utilize software that is necessary to provide the phone, camera, and other functionality.

The phone and camera software are frequently included on the personal digital assistant, but the music player and game software are excluded more than infrequently. The phone, camera, and music player software are not sold separately, but the game software is sold separately.

The personal digital assistant hardware, operating system, phone, and camera software are essential to the functionality of the personal digital assistant and would be considered one deliverable that is outside the scope of ASC 985-605 and therefore fall under ASC 605-25. The music player and game software would be considered software deliverables within the scope ASC 985-605 because the product also is sold more than infrequently without this software. Whether the software is sold separately does not affect the conclusion in this example.

# Appendix B:

## Summary of Transition Disclosure Requirements

In addition to the ongoing disclosure requirements, ASU 2009-13 includes specific transition disclosures in order to assist users in understanding the effect of adopting the new ASU. Entities that adopt ASU 2009-13 prospectively, including on an early prospective basis, must provide, for each reporting period in the year of adoption, the following qualitative transition disclosures (at a minimum) by similar types of arrangements:

- A description of any change in the units of accounting
- A description of the change in how a vendor allocates the arrangement consideration to various units of accounting
- A description of the changes in the pattern and timing of revenue recognition
- Whether the adoption is expected to have a material effect on financial statements in periods after initial adoption.

If the effect of adoption is material, the qualitative information is required to be supplemented with quantitative information in the period of adoption. The ASU does not prescribe any specific disclosures, but provides the following suggested methods that may be used by an entity (individually or in combination) to quantify the effect of the change on accounting.

- The amount of revenue that would have been recognized in the year of adoption if the related arrangements entered into or materially modified after the effective date were subject to the measurement requirements of ASC 605-25 (before the amendments resulting from ASU 2009-13).
- The amount of revenue that would have been recognized in the year before the year of adoption if the arrangements accounted for under ASC 605-25 (before the amendments resulting from ASU 2009-13) were subject to the measurement requirements of ASU 2009-13.
- For arrangements that precede the adoption of ASU 2009-13, the amount of revenue recognized in the reporting period and the amount of the deferred revenue as of the end of the period from applying the guidance in ASC 605-25 (before the amendments resulting from ASU 2009-13). For arrangements that were entered into or materially modified after the effective date of ASU 2009-13, the amount of revenue recognized in the reporting period and the amount of deferred revenue as of the end of the period from applying ASU 2009-13.

The above disclosure requirements are not applicable to entities that elect to adopt through retrospective application. However, those entities are instead required to provide the disclosures in ASC 250-10-50-1 through 50-3.