Dataline

A look at current financial reporting issues

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What's inside:

At a glance 1
The main details 1
Current practice under existing guidance 2
Changes introduced by ASU 2009-13 3
New software scoping guidance under ASU 2009-14 4
Ongoing disclosure requirements 6
Effective date and transition 6
Transition disclosure requirements 7
Questions 8
Appendix A: Questions and interpretive responses 9
Appendix B: Implementation considerations 43
Appendix C: Transition and disclosure information 45

New revenue recognition guidance

A more economic approach to accounting for arrangements with multiple deliverables

At a glance

- In October 2009, the FASB issued new guidance for arrangements with multiple deliverables under which a company is required to use its best estimate of selling price for the deliverables in an arrangement when vendor specific objective evidence or third party evidence of the selling price is not available. The residual method of allocating arrangement consideration will no longer be permitted.

- Non-software components of tangible products and certain software components of tangible products have been removed from the scope of existing software revenue recognition guidance. Revenue for those products will be recognized in a manner similar to revenue for other tangible products.

- The updated guidance, including the requirement for expanded qualitative and quantitative disclosures, is effective for fiscal years beginning on or after June 15, 2010 (January 1, 2011 for calendar year-end companies). Companies may early adopt in interim or annual periods for which financial statements have not been issued. The guidance may be applied either prospectively from the beginning of the fiscal year for new or materially modified arrangements or retrospectively.

The main details

.1 Companies often provide multiple products or services ("deliverables") to their customers as part of a single arrangement. The deliverables in these arrangements are often provided to the customer over different reporting periods. Since 2003, Emerging Issues Task Force (EITF) Issue 00-21[1], *Revenue Arrangements with Multiple Deliverables*, has been a principal source of guidance for separating the deliverables in

* Question 24 was revised to reflect updated guidance on applying ASU 2009-13 to multiple-element litigation settlements.

[1] With the launch of the FASB's Accounting Standards Codification, Issue 00-21 was included in ASC 605-25, *Multiple Element Arrangements.* ASC 605-25 was amended by ASU 2009-13.

these arrangements and allocating the arrangement consideration to the separate units of accounting. Companies that were unable to separate the deliverables using the guidance in ASC 605-25 were typically required to defer the recognition of some or all of the revenue for these arrangements. In many cases, that deferral resulted in revenue recognition that was inconsistent with the underlying economics of the transactions. The new guidance, which is in ASC 605-25, *Multiple-Element Arrangements*, and is based on the consensus positions in EITF Issue 08-1, *Revenue Recognition with Multiple Deliverables* (ASU 2009-13), amends ASC 605-25 to achieve financial reporting that better reflects the economics of such arrangements.

.2 In conjunction with the EITF's deliberations on ASU 2009-13, the EITF considered whether similar changes should be made to the guidance in ASC 985, *Software*[2]. The EITF concluded that a change to the scope of that guidance was appropriate and made those changes through EITF Issue 09-3, *Certain Revenue Arrangements that Include Software Elements* (ASU 2009-14).

.3 In Dataline 2009-54, we provided our analysis and insights on the new guidance. In this new Dataline, we've updated and expanded on the discussion in Dataline 2009-54 to incorporate additional insight and implementation considerations based on our experience with companies that have early adopted the new guidance. Appendix A provides our interpretive responses to common questions about the new guidance and provides examples of how to apply the guidance to certain fact patterns. Appendix B outlines important implementation considerations in adopting the new guidance. Appendix C includes information related to transition methods and disclosures associated with adoption of the new guidance.

Current practice under existing guidance (ASC 605-25)

.4 The existing guidance addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting, and how the arrangement consideration should be measured and allocated to the separate units of accounting. The existing guidance does not address when the criteria for revenue recognition are met nor does it provide revenue recognition guidance for a given unit of accounting.

.5 Under current practice, a company evaluates all of the deliverables in a revenue arrangement to determine whether they represent separate units of accounting. The delivered item(s) should be considered a separate unit of accounting if all of the following criteria are met:

1. The delivered item(s) has value to the customer on a standalone basis;
2. There is objective and reliable evidence of the fair value of the undelivered item(s); and
3. 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 company.

.6 Once the separate units of accounting are determined, the arrangement consideration is allocated to the separate units based on relative fair value. Specifically, the overall arrangement consideration is allocated to each unit based on the unit's proportion of the fair value of all of the units in the arrangement. However, in the absence of fair value evidence for any of the delivered items, and assuming the fair value

[2] With the launch of the FASB's Accounting Standards Codification, AICPA Statement of Position 97-2 (SOP 97-2) was included in ASC 985, *Software*. ASC 985 was amended by Issue 09-3.

is available for all undelivered items, companies are required to use the residual method to allocate the arrangement consideration. Under the residual method, the amount of consideration allocated to the delivered items equals the total arrangement consideration less the aggregate fair value of the undelivered items.

.7 If a company cannot determine the fair value of the undelivered items, then the delivered items are required to be combined with the undelivered items and revenue recognition is determined for the deliverables as a single unit of accounting. As a result, the inability to determine fair value and separate the deliverables into different units of accounting typically results in the deferral of some or all revenue in the arrangement.

.8 The existing guidance stipulates that contractually stated prices for individual products or services should not be presumed to be representative of fair value. Instead, the best evidence of fair value is the price of a deliverable when the company regularly sells it on a standalone basis. This is commonly referred to as vendor specific objective evidence of fair value or VSOE. Alternatively, in the absence of standalone sales of a deliverable, a company could rely upon third-party evidence of fair value, referred to as vendor objective evidence or VOE, if available (e.g., the price the company or any competitor charges for a largely interchangeable product or service in sales to similarly situated customers).

Changes introduced by ASU 2009-13

.9 ASU 2009-13 modifies the fair value requirements by allowing the use of "best estimate of selling price"[3] (BESP) in addition to VSOE and VOE (VOE is now more aptly named third-party evidence or TPE) for determining the selling price of a deliverable. A company is now required to use its best estimate of selling price for the deliverables in the arrangement when VSOE or TPE of the selling price is not available. As such, the delivered item(s) are separate units of accounting, provided:

1. The delivered item(s) has value to the customer on a standalone basis; and

2. 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 company.

PwC observation:

While ASU 2009-13 removed the fair value criteria for determining separate units of accounting, the standalone value requirement remains unchanged from the prior guidance. As a result, some companies may continue to have transactions that result in a single unit of accounting because the delivered product or service lacks standalone value. Careful consideration should be given to the facts and circumstances of a transaction when evaluating whether the delivered product or service in an arrangement has value on a standalone basis.

.10 The best estimate of selling price should be determined in a way that is consistent with the price at which the company would sell the deliverable if the item were to be sold separately.

[3] Issue 08-1 replaces the term fair value with "selling price" to emphasize that the guidance in ASC 820-10, which incorporates FASB Statement No. 157, *Fair Value Measurements,* does not apply to the measurements used in applying Issue 08-1.

PwC observation:

The process for determining the estimated selling prices of deliverables is a key aspect of applying the new guidance. Although the new model should result in a better reflection of the economics of the transaction, it may create new challenges in estimating, documenting and supporting the "best estimate of selling price." As companies consider the financial statement effects of the new guidance, it is also important to consider whether new internal systems and processes (and related internal controls) are required to support the process of developing estimates.

.11 At the inception of the arrangement, consideration is allocated to each unit of accounting based on the relative selling price in the same manner used to allocate fair value described in paragraph 6 above. As a result of the requirement to use the best estimate of selling price when VSOE or TPE of the selling price is not available, the residual method described in that paragraph is no longer permitted.

PwC observation:

We believe ASU 2009-13 will have a significant impact on companies that are currently unable to recognize revenue related to delivered products or services in an arrangement solely because they do not meet the fair value thresholds in the existing guidance. In addition, ASU 2009-13 will affect companies that currently use the residual method to allocate arrangement consideration, as that method of allocation is no longer permitted.

Companies will also need to prepare for communications with analysts and other external users in order to help them understand how the new guidance will affect revenue trends, particularly for those companies with significant amounts of deferred revenue under the existing guidance.

New software scoping guidance under ASU 2009-14

.12 The software revenue recognition guidance (ASC 985) requires the use of VSOE of fair value to separate deliverables that are within the scope of ASC 985. The guidance does not allow alternatives for separation, such as the use of TPE of fair value. In addition, the software revenue recognition guidance requires a company to use the residual method to allocate the arrangement consideration when VSOE of fair value exists for all of the undelivered items but is not known for all of the delivered items.

.13 Due to the changes introduced by ASU 2009-13, the EITF considered whether alternatives for determining "fair value" or selling price should also apply to arrangements that have deliverables that are within the scope of ASC 985. The EITF observed that multiple deliverable arrangements in the software industry differ from multiple deliverable arrangements in other industries and, thus, the reconsideration of the revenue recognition model for software may entail considerations beyond those addressed in ASU 2009-13. As such, the higher threshold of VSOE for purposes of separating software deliverables was retained as was the use of the residual method, where appropriate.

.14 Under the existing software revenue recognition guidance, software elements are included within the scope of ASC 985 if the software elements are more than incidental to the tangible product as a whole. In addition, if a software element is essential to the functionality of any non-software elements, then the non-software elements are also within the scope of ASC 985. The EITF acknowledged that with continuing technological advances, the existing software scoping guidance captures within its scope many products that are not traditional software products, such as software-enabled devices.

This often results in a pattern of revenue recognition for tangible products that is inconsistent with the economics of the arrangement. ASU 2009-14 modifies the scope of ASC 985 in order to achieve financial reporting that better reflects the economics.

.15 The modifications exclude from the scope of ASC 985 (a) non-software components of tangible products and (b) software components of tangible products that are sold, licensed, or leased with tangible products when the software components and non-software components of the tangible product function together to deliver the tangible product's essential functionality.

PwC observation:

The guidance in ASU 2009-14 will result in many companies, such as those that sell software-enabled devices, applying the provisions of ASC 605-25 instead of ASC 985. In such cases, those companies will no longer be permitted to use the residual method and must develop a best estimate of selling price for all deliverables when VSOE or TPE of the selling price is not available.

.16 ASU 2009-14 provides factors that a company should consider 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. Those factors are as follows:

- 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.
- In cases where a company sells products that provide similar functionality (for example, different models of similar products) and the only significant difference between the products is that one includes software and the other does not, the products are considered the same product for purposes of performing the evaluation in the first bullet above.
- In cases where a company sells a tangible product containing software that it also sells on a standalone basis separate from the tangible product, the separate sale of the software should not cause a presumption that the software is not essential to the functionality of the tangible product.
- Software elements do not need to be embedded within the tangible product to be considered essential to the tangible product’s functionality.
- 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.

.17 To assist companies in determining whether they qualify for the scope exception, the above considerations should be evaluated in conjunction with the examples included in ASU 2009-14.

PwC observation:

We believe the consideration of whether the sale of a tangible product without software elements occurs on more than an "infrequent" basis should consider the specific facts and circumstances of the arrangement. In many cases, hardware is sold with a suite of embedded software products. Certain of these software products may be active upon the initial purchase of the hardware while others may be embedded

but only activated upon the payment of additional license fees at the request by the customer. This analysis requires judgment as to which software products should be considered essential to the functionality of the hardware for scoping purposes. We believe this evaluation should generally be based at the time of the initial sale of the hardware product. Subsequent activation of additional software products is generally considered a separate software sale and would be accounted for in the scope of ASC 985.

Under the new scoping guidance, if software is considered essential to the functionality of the hardware, then the initial transaction deliverables (e.g., post-contract support (PCS)) will also be within the scope of ASU 2009-13. However, companies should be mindful that the renewal of software related PCS is viewed as a new software sale rather than a continuation of the original transaction. Companies should consider the potential accounting impact when structuring their ongoing support arrangements.

Ongoing disclosure requirements

.18 The new guidance includes new and expanded ongoing disclosure requirements. Specifically, companies with multiple deliverable arrangements in the scope of ASU 2009-13 are required to disclose all of the following information by similar type of arrangement:

- The nature of such arrangements
- The significant deliverables within the arrangements
- The general timing of delivery or performance of service for the deliverables
- Performance, cancellation, termination, and refund-type provisions
- A discussion of the significant factors, inputs, assumptions, and methods used to determine selling prices for the significant deliverables
- Whether the significant deliverables in the arrangements qualify as separate units of accounting and, if not, the reasons that they do not qualify
- The general timing of revenue recognition for significant units of accounting
- 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

.19 The objective of the disclosure requirements is to provide both qualitative and quantitative information necessary for a user of the financial statements to understand the nature of the judgments made in applying ASU 2009-13 and the changes in either those judgments or the application of ASU 2009-13 that may significantly affect the timing or amount of revenue recognition. Therefore, in addition to the required disclosures above, companies should disclose other qualitative and quantitative information in order to satisfy this objective.

Effective date and transition

.20 The amendments to ASC 605-25 and ASC 985 resulting from ASU 2009-13 and ASU 2009-14 are effective for arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted for years in which

financial statements have not yet been issued. However, a company must adopt the amendments to ASC 985 in the same period that it adopts the amendments to ASC 605-25. If a company elects to adopt early and the period of adoption is not the first reporting period in the company's fiscal year, the new guidance must be applied as if the change was made prospectively from the beginning of the company's fiscal year of adoption. For all previously reported interim periods in the year of adoption, companies should disclose at a minimum, revenue, income before income taxes, net income, and earnings per share and the effect of the change for the appropriate captions presented.

.21 Alternatively, a company may elect to apply the new guidance retrospectively pursuant to ASC 250, *Accounting Changes and Error Corrections*.[4] If a company elects retrospective application, the company must provide the applicable required disclosures pursuant to ASC 250. However, a company must adopt the amendments to ASC 985 using the same transition method that it uses to adopt the amendments to ASC 605-25.

Transition disclosure requirements

.22 In addition to the ongoing disclosure requirements, ASU 2009-13 includes specific transition disclosure requirements. If a company elects to apply the amendments to ASC 605-25 prospectively, the company is required to disclose, in the initial year of adoption, information that enables users of the financial statements to understand the effect of the change in accounting principle. At a minimum, companies are required to disclose the following qualitative information by similar types of arrangements:

- A description of any change in the units of accounting
- A description of the change in how a company 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 of the amendments is expected to have a material effect on financial statements in periods after the initial adoption

.23 If the effect of adopting the amendments to ASC 605-25 is material, the qualitative information must be supplemented with quantitative information in the period of adoption. Depending on a company’s facts and circumstances, the following are examples of approaches that may be used by a company (individually or in combination) to quantify the effect of the change in 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 the prior guidance under ASC 605-25.
- The amount of revenue that would have been recognized in the year before the year of adoption if the arrangements accounted for under prior measurement requirements of ASC 605-25 were subject to the new measurement requirements of ASC 605-25.
- The amount of revenue recognized in the reporting period and the amount of deferred revenue as of the end of the reporting period from applying the prior guidance under ASC 605-25, and the amount of revenue recognized in the reporting period and the amount of deferred revenue as of the end of the period from applying the amendments to ASC 605-25.

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[4] With the launch of the FASB's Accounting Standards Codification, FAS 154, *Accounting Changes and Error Corrections* was included in ASC 250, *Accounting Changes and Error Corrections.*

.24 If a company elects to apply the amendments to ASC 985 prospectively, the company should provide the transition disclosures required when applying the amendments to ASC 605-25.

PwC observation:

The amendments significantly expand the existing disclosure requirements and may require additional record keeping. Accordingly, companies should carefully consider how they may be impacted by the new accounting and disclosure requirements, including system or process changes that may be necessary to comply with the new requirements.

Questions

.25 PwC clients who have questions about this Dataline should contact their engagement partner. Engagement teams that have questions should contact members of the Revenue team in the National Professional Services Group at (973) 236-7804.

Appendix A: Questions and interpretive responses

This section provides questions and interpretive responses to issues companies may encounter when applying or considering the impact of the new revenue recognition guidance. The questions and interpretive responses are grouped into the following categories:

I. Application and scope
II. Standalone value
III. Interaction with other guidance
IV. Disclosure
V. Transition and adoption
VI. Additional illustrative examples

We expect new interpretive guidance to emerge as companies adopt these new standards and encounter implementation issues.

I. Application and scope

Question 1

Under ASU 2009-13, may a company use the residual method to allocate the arrangement consideration between the delivered and undelivered items when neither VSOE nor TPE of the selling price is available for a delivered item?

Interpretive response

No. ASU 2009-13 eliminates a company's ability to use the residual method for arrangements that are within its scope. Companies are required to determine the selling price for all of the deliverables in a multiple deliverable arrangement. In circumstances in which VSOE or TPE of the selling price for a delivered item is not available, the company is required to use BESP for the delivered item, and use the relative selling price method to allocate the arrangement consideration. In contrast to the residual method, this has the effect of allocating any inherent discount in a multiple deliverable arrangement to each of the deliverables on a proportionate basis.

PwC observation:

Although new guidance has eliminated the residual method as an allocation methodology, we believe that the amount that was historically allocated to the delivered element(s) using a residual method approach may be one of the data points to consider when developing BESP. Since the residual approach historically resulted in the discount being allocated in its entirety to the delivered element(s), this may represent the "floor" or low end of the BESP range in some circumstances (see Question 9 for additional guidance).

Question 2

Under ASU 2009-13, may a company use BESP even if VSOE or TPE of the selling price is available?

Interpretive response

No. The selling price for a deliverable must be determined using a hierarchy of (1) VSOE, (2) TPE, then (3) BESP. As such, a company may only use BESP for a deliverable after the company has determined that neither VSOE nor TPE of the selling price is available. In deciding whether the company can determine VSOE or TPE of the selling price, the company should not ignore information that is reasonably available without undue cost and effort.

Question 3

What is the difference between determining VSOE of the selling price by reference to a price established by management having relevant authority, and determining BESP?

Interpretive response

When establishing VSOE of the selling price by reference to a price established by management, management must intend to ultimately sell the item separately at the established price. However, the determination of management's BESP does not require a stated intent by management to sell the item separately. Rather, BESP is the price at which the company would transact if the deliverable were sold regularly on a standalone basis.

Question 4

In situations when VSOE or TPE is not available, is it ever acceptable to conclude that a company cannot determine BESP?

Interpretive response

No. A company must determine BESP for any product or service that it sells whenever VSOE or TPE is not available.

Question 5

How should a company determine its BESP for its products or services?

Interpretive response

ASU 2009-13 does not prescribe a specific method for estimating a selling price when VSOE or TPE is not available. The method used to determine BESP should be consistent with the method used by the company to determine prices for new products or services that are sold regularly on a standalone basis.

Companies typically should begin their BESP analysis by focusing on existing pricing practices. Obtaining information about existing practices generally includes an evaluation of entity-specific factors that are relevant to the company's pricing decisions. Examples of such factors include:

- Position in the market (e.g., market leader vs. new entrant)
- Expected profit margins
- Customer or geographic segments
- Distribution channel
- Entity-specific cost structure

Market conditions that could affect the price at which a company would sell its product on a standalone basis should also be considered. Examples of such conditions include:

- Supply and demand
- Competition
- Costs that would be incurred by the customer if it were to perform the services itself
- Market perception
- Trends
- Geography-specific factors

Considering the above factors may result in the segmentation or stratification of transactions based on the life-cycle stage of the product, market penetration opportunities, geographic segmentation or other marketing strategies of a company.

Once a company has understood and developed the factors that may have an effect on its pricing process, an assessment should be made with respect to the amount of fluctuation or discounts that are generally accepted. This may include the level of discounts that are provided by the sales force without requiring additional approvals. This will also include the levels of discounting or incentives that require senior management approval. Understanding the process and rationale around price adjustments enables companies to determine the potential range of prices at which they would sell a product on a standalone basis.

Where a company does not have a robust pricing practice process, it should consider various methods to establish BESP. Such a process should consider reasonably available data, market conditions and entity-specific factors. Examples of methods a company may use include, but are not limited to:

- Cost plus a reasonable margin
- Percentage of the primary or related product or service fee
- Standalone sales prices of the same or similar products, if available
- Targeted rate of return
- Cash flow models or other valuation techniques

PwC observation:

Early adopters of the new guidance have used varying methods or calculations to determine a product or service offering's BESP. The method or methods that will yield the most appropriate BESP will vary from company to company based on the specific facts and circumstances. As a result, companies should use the most relevant information available. In general, external data that is observable in the marketplace is presumed to be better evidence than internal data.

Companies should ensure a thorough analysis is performed and that conclusions are corroborated with reliable and supportable data in order to provide adequate support for the BESP.

The level of significance placed on each of the data points in the BESP analysis should be based on a company's specific facts and circumstances. Some companies may find certain information more relevant than others. As a result, the determination of BESP should be evaluated for reasonableness in order to ensure that the conclusion yields an answer that appropriately reflects the company's pricing strategy. This evaluation may include comparing pricing to similar products or services offered by the company or similar competitor products or services sold in equivalent marketplaces, and analyzing the underlying costs to determine whether the BESP represents an amount that yields an acceptable margin. Significant judgment is involved and a thorough analysis will be necessary in all circumstances.

PwC observation:

Some early adopters of the guidance have underestimated the time and effort that was necessary to complete a sufficient analysis to support BESP. Examples of areas that have required significant effort include: the amount of information and judgment necessary to derive a reasonable BESP, the development of new or enhanced processes, the change to systems to accumulate data or automate pricing practices, and the establishment and testing of controls over new processes.

Example 5.1

A company enters into an arrangement that includes a license, research services, and a participatory steering committee. Assuming each of these deliverables is a separate unit of accounting, and VSOE or TPE do not exist, the considerations related to establishing BESP could be complex. Certain factors a company may want to consider when establishing BESP for these items might be:

License

The appropriate model for determining BESP will depend on the nature of and specific rights associated with the license. Historically, models have been used with respect to valuation for tax or business combination purposes that might provide useful data points with respect to determining BESP. For example:

Income approach
Examples of the income approach include the discounted cash flow method and the transfer pricing or profit split method. Key areas of judgment in this approach may include: cash flow projections, risk adjustment for stage of development, discount rate selection, and level of expected returns.

Cost approach
In applying a cost approach, companies should consider costs incurred to date in developing the intellectual property and what amount constitutes a reasonable profit margin or return on investment. Key areas of judgment in this approach may include: identifying relevant direct or indirect costs and determining the appropriate return rate.

Because the income approach relies heavily on cash flow projections, this approach may be more relevant in instances where a license is already in use or is expected to be exploited within a relatively short timeframe. Alternatively, the cost approach may be more relevant to licenses in the early stage of their life cycle where reliable forecasts of revenue or cash flows may not exist.

Research services

Many companies may consider the amount of effort necessary to perform research services as the most appropriate unit of measurement. This might include cost rates for full time equivalent (FTE) employees and the expected amount of resources to be committed. Key areas of judgment regarding pricing may include: selection of FTE rates for different levels of commitment or experience, inclusion of appropriate levels of profit margin, and comparisons to similar services offered in the marketplace. Key areas of judgment regarding quantity may include: estimated total number of FTE hours, potential contractual requirements, and the estimated period over which the development process will occur.

Steering committee

Steering committees, as well as certain upgrade rights, are deliverables that were not historically valued by many companies due to the fair value requirement of the prior accounting guidance and, therefore, the inclusion of these deliverables in an arrangement often resulted in either full deferral or ratable revenue recognition. Companies may find valuing these items particularly challenging as it may be difficult to determine the expected level of hours to be incurred and rates to be used. Depending on the nature of the services, some companies may determine that steering committee efforts include time related to meeting preparation, attending the steering committee meetings, and working on any follow-up matters that result from the meetings. In addition, examples (not all inclusive) of information that might be considered when establishing rates may include an evaluation of compensation paid to individuals of similar experience or fees paid to consultants on an advisory board. These assessments will need to consider the specific facts and circumstances in each arrangement.

Question 6

What costs should be included when using a cost-plus a reasonable margin approach for determining BESP?

Interpretive response

If a company determines that a cost-plus approach is appropriate, it should consider the costs it includes in its analysis to determine the price it will charge when going to market (i.e., normal pricing practices) and adopt a consistent methodology for establishing BESP. Consideration should be given to direct and indirect costs as well as pre-commercialization costs, such as research and development.

Assessing whether the margin is reasonable may also include evaluation of the following:

- Margins achieved on standalone sales of similar products
- Market data related to historical margins
- Industry averages
- Current market conditions
- Required rates of return and profit objectives

Determining the margin to use for a cost-plus analysis requires significant judgment, particularly when detailed or historical data is not readily available or when a company is using a cost-plus approach on a product or service that has not been previously sold on a

standalone basis. Often, the determination of a reasonable margin will require an assessment of the entity-specific and market factors noted above, which may result in different margins depending on the type of product or service, geography, or customer segment.

For example, if a company determined a cost-plus margin of 40% as BESP but experience with similar products shows that most transactions actually result in 25% margin, then it may appear that the conclusion for BESP may not be reasonable. Items such as PCS or specified upgrades could be particularly difficult to value using this method given a company's cost structure and ability to segregate or allocate appropriate costs at the individual unit of accounting level. Ultimately, determining the reasonableness of the margin used and the costs to which the margin is applied is critical in supporting a cost-plus approach for BESP.

Question 7

Some companies may price PCS as a percentage of the related product price. May a company's pricing methodology for PCS be a suitable means for determining BESP?

Interpretive response

If using a percentage of the related product price is consistent with the company's normal pricing practices for that service or similar services and is in line with the company's pricing strategy, we believe it would be an acceptable method for determining BESP.

Example 7.1

Company A prices PCS at 15% of the associated hardware's net price. The net price of the hardware may fluctuate depending on a number of factors, which could include the class of product purchased, the specific functionality desired by the customer, or negotiation of pricing of similar hardware to different customers.

As long as the PCS renewal rate is expressed as a consistent percentage of the stipulated hardware fee and is substantive, the PCS renewal rate could be considered in determining the BESP of PCS. If the pricing is substantive and the company renews at the stated rate, the pricing may constitute VSOE.

Question 8

Would it be acceptable to use a company-published price list to determine its BESP for that product or similar products?

Interpretive response

Published price lists typically represent the high end of possible selling prices and often times represent the point at which price negotiations begin. In such cases, the price list would not be evidence of BESP. If there are published price lists, the vendor may have experience selling those or similar items on a standalone basis. Standalone sales may be used to establish VSOE or be used as data points in determining BESP.

Question 9

Is BESP a single data point or may a company develop a range for its estimated selling prices?

Interpretive response

Issue 08-1 indicates that the company shall use its BESP for a deliverable when VSOE or TPE is not available. It further states that a company is required to determine its BESP "in a manner that is consistent with the objective of determining vendor-specific objective evidence of selling price for the deliverable." While a "best estimate" could be a single estimated amount, VSOE is often established using an appropriate range of standalone sales prices (e.g., using a bell curve approach). Therefore, we believe it would also be acceptable for a company to establish its BESP for a deliverable as a range of estimated selling prices providing that range is reflective of reasonable pricing of that product or service as if priced on a standalone basis. As noted in Question 5, a company may determine different BESPs for different customer segments, distribution channels, etc.

In situations where standalone sales exist, but do not constitute VSOE because of an inconsistency in pricing, we would expect a company to consider whether TPE is available prior to using BESP based on standalone sales.

Absent VSOE or TPE, a company would be expected to consider standalone sales prices, if available, as data points in determining BESP. If the range of standalone selling prices is too wide, other approaches to determining BESP may be more appropriate.

PwC observation:

Companies should be cautious when applying an approach to BESP similar to that which was used in establishing VSOE. If a bell-curve approach is used to establish a range for BESP, the population of data that is used should include the standalone selling prices of the deliverable. For example, it may not be appropriate if a Company's bell-curve approach is based on prices that were part of a bundled transaction as those amounts would not represent standalone sales prices. However, if a company does not have standalone sales prices on which to perform this analysis, the results may still be utilized as a data point for establishing BESP.

If a range is utilized for BESP (or for VSOE or TPE), there may still be situations in which a company prices the deliverable outside of that range. In those cases, the selling price should be adjusted for purposes of allocating the arrangement consideration. In doing so, a company should apply a consistent method of determining the point to use within the range.

Example 9.1

Company A enters into a contract to deliver Products A, B, and C to its customer. The stated contract prices for Products A, B, and C are $100, $70 and $140, respectively. VSOE of Products B and C are $80 and $160, respectively. However, neither VSOE nor TPE are available for Product A and Company A determines its BESP for Product A as a range between $80 and $90. Product A is delivered at inception of the arrangement and Products B and C are undelivered.

When performing the relative selling price allocation to the deliverables, the Company will need to use a consistent policy of selecting the point within the BESP range that it will use for Product A, since Product A's stated contract price is outside of the BESP range. If Company A's policy is to use the mid-point within the range, the relative selling price allocation would be performed as follows:

	Selling Price	Relative Selling Price Allocation	
Product A [1]	$85 Mid-point	$85/$325 x $310 =	$81
Product B	$80 VSOE	$80/$325 x $310 =	$76
Product C	$160 VSOE	$160/$325 x $310 =	$153
	$325		**$310**

[1] If Company A had priced Product A within the BESP range, the stated contract price would be used for its selling price in the allocation.

Question 10

Would it be acceptable to use the stated contract price for each deliverable as evidence of selling price?

Interpretive response

ASU 2009-13 indicates that stated contract prices may not be presumed to be representative of VSOE, TPE or BESP. However, if the stated contract price is substantive and is within the range of BESP that was determined in a manner consistent with how a company would have normally developed its selling price for standalone sales of that deliverable, then it would be appropriate to rely on that stated contract price.

Question 11

What type of policies, procedures, and documentation should a company maintain to support BESP?

Interpretive response

Policies and procedures used to establish BESP should include the same process and rigor as the company's normal pricing practice for products and services that they sell on a standalone basis.

The use of BESP (and for that matter, TPE) may have a significant impact on a company's financial statements. As such, for public companies, documentation of the policies and procedures to establish BESP would likely need to be sufficient to evidence the existence and operating effectiveness of the related process and controls, consistent with other key management estimates, as required by Section 404 of the Sarbanes-Oxley Act. This may include but not be limited to the following:

- Written documentation that describes the process and identifies key controls
- Consideration of reasonably available data points
- Evaluation of applicable entity-specific factors or market conditions considered
- Evaluation of the significance of information obtained or considered in making conclusions and the impact of contrary information identified
- Retention of the data used to initially determine and/or reassess the BESP
- Minutes of meetings at which key pricing decisions were made that support the estimates or subsequent change in those estimates

Question 12

How often should a company update BESP?

Interpretive response

A company should update or reassess BESP consistent with the frequency with which it updates or reassesses pricing for items sold on a standalone basis or more frequently if other factors or triggering events indicate a change in estimate may be warranted.

Question 13

Are there ever times when the amount allocated using the relative selling price method to a delivered item with standalone value cannot be recognized?

Interpretive response

Yes. When performing the allocation using the relative selling price method, the amount of consideration allocated to a delivered item will continue to be limited to the amount that is not contingent upon the delivery of additional items or meeting a specified performance condition (the noncontingent amount). In some cases, stated contract prices may create contingent revenue, precluding recognition of some or all of the arrangement consideration allocated to delivered items until the contingency lapses.

Example 13.1

Company A enters into an arrangement with its customer to sell Product A for $200, Product B for $300 and Product C for $100. VSOE or TPE is not available, and Company A's BESP for Products A, B, and C are $250, $275 and $100, respectively. As such, allocation of the total arrangement consideration of $600 using the relative selling price method would be as follows:

	Estimated Selling Price	Relative Selling Price Allocation
Product A	$250	$250/$625 x $600 = $240
Product B	$275	$275/$625 x $600 = $264
Product C	$100	$100/$625 x $600 = $96
	$625	**$600**

While the allocation of the arrangement consideration to Product A is $240 using the relative selling price method, the amount that could be recognized upon the delivery of Product A is limited to the noncontingent consideration. Based on the stated contract prices for each of the products, $400 of the total arrangement consideration is contingent upon the delivery of Products B and C, leaving $200 of noncontingent consideration upon delivery of Product A. Company A would limit the revenue recognition for Product A to $200 and would recognize the remaining consideration when the contingency lapses (i.e., when Products B and C are delivered).

Example 13.2

An arrangement calls for the sale of Product A for $200 and Service B for $200. The vendor has concluded that the BESP for Product A is $300 and the BESP for Service B is $200. Product A is delivered immediately following the signing of the agreement. Service B will be delivered over a one-year period. Product A and Service B qualify as separate units of accounting. All consideration is received up-front and there are no refund provisions or extended payment terms.

A relative allocation of the total contract consideration allocates the $400 of total consideration in the following manner:

Deliverable	Contract Amount	BESP	Relative Allocation
Product A	$200	$300	$240
Service B	$200	$200	$160
Total	**$400**	**$500**	**$400**

There are two potential approaches to recording the amounts allocated in this example, which impact the classification, but not the timing, of amounts recognized (see Example 16.2 for the impact of contingent consideration on recognition).

Approach 1

In this approach, $200 would be recognized upon the delivery of Product A. $200 is the maximum amount allocable to Product A since the contractual consideration for Product A is $200. The remaining $40 would be allocated to Service B for a total of $200. At the completion of delivery for this arrangement, a total of $200 would be recognized as product revenue and $200 would be recognized as service revenue.

Approach 2

In this approach, $200 would be recognized upon the delivery of Product A. The remaining $40 would be recognized as product revenue as Service B is performed since that amount of the contractual consideration is contingent upon the delivery of Service B. At the completion of delivery under this approach, a total of $240 would be recognized as product revenue and $160 would be recognized as service revenue.

The amount of consideration recognized should consider any potential contingent revenue limitations. As a result, the amount available to be recognized as revenue upon delivery of an item is the lesser of the amount initially allocated using the relative selling price method or the noncontingent amount. As noted in Example 13.2, there may be alternative approaches to accounting for the contingent revenue provisions in ASC 605-25-30-5. We believe Approach 1 in this example is consistent with the example in ASC 605-25-55-12. Ultimately, the approach utilized by a company should reflect the economics of the underlying transaction and should be applied consistently.

PwC observation:

We have observed that the elimination of the residual method has had a significant impact on the number of companies that have contingent revenue deferrals. This is due to the fact that all discounts were generally reflected in the residual amount that was recognized under this method. Now that a relative selling price allocation is required, the amount of consideration recognized once each item is delivered is potentially a higher amount since discounts in the arrangement are allocated proportionately across all of the units of accounting. Therefore, the use of the relative selling price method may result in the need to evaluate arrangements for contingent revenue limitations. As a result, some companies have changed their contract pricing strategies to address this issue.

Question 14

Should contingent deliverables be identified as separate elements within a multiple element arrangement?

Interpretive response

ASU 2009-13 does not provide guidance on the accounting for contingent deliverables. As such, companies will need to use judgment when determining how and whether to account for such deliverables based on specific facts and circumstances. When a

deliverable is contingent upon a future event, it may be appropriate to exclude it from the allocation performed at the inception of the arrangement. In this regard, companies should consider whether the deliverable is contingent upon a future event that is not exclusively within the control of the customer, in which case it may be excluded from the initial allocation. For example, a deliverable that is contingent upon regulatory approval is not exclusively within the control of the customer.

Even when it is concluded that the contingent deliverable should be excluded from the initial allocation, a company would need to determine whether that contingent deliverable is being offered at a significant incremental discount. If so, the discount itself may be considered a separate deliverable requiring that a portion of the arrangement consideration be deferred at inception (see Question 44 for additional guidance).

Question 15

Is an option to buy additional products or services in the future at a specified price considered a deliverable in the original arrangement?

Interpretive response

If the option is substantive, the company would not be obligated to deliver the products or services until the customer exercises the option and, therefore, the option would not be considered a deliverable in the original arrangement.

When determining whether an option is substantive, a company should consider whether the exercise of that option by the customer represents a separate buying decision. For example, the option to buy unrelated additional products or services at a price equal to fair value may be considered a separate buying decision and, if so, would not be a deliverable in the original arrangement. However, if the additional products or services were essential to the functionality of another deliverable in the arrangement and no other vendor could provide the necessary products or services, the customer would effectively be required to exercise the option and, therefore, it would not be considered a substantive option. In such a case, the products or services to be delivered upon the exercise of that option would be accounted for as a deliverable in the original arrangement.

Finally, even when an option is determined to be substantive, a company would need to evaluate whether that option has been offered at a significant incremental discount. In such cases, the "in-the-money option" would be considered a separate deliverable requiring a portion of the arrangement consideration to be deferred at inception (see Question 44 for additional guidance).

Question 16

Should arrangement consideration related to a performance bonus be included in the total arrangement consideration to be allocated at the inception of an arrangement?

Interpretive response

No. The amount of arrangement consideration allocable is limited to amounts that are fixed or determinable. Performance bonuses are contingent upon meeting specified performance criteria, and therefore, would not be considered part of the fixed or determinable fee prior to the performance criteria being achieved. As such, arrangement consideration attributable to these events should not be included in the amount allocable at the inception of the arrangement.

Depending on the facts and circumstances, a performance bonus may either be (1) recognized in its entirety in the period the performance criteria have been met (e.g., by a company following the substantive milestone method) or (2) allocated to all deliverables

using the relative selling price method. Under the latter approach, the amount allocated to delivered items should be recognized immediately assuming those delivered items are separate units of accounting and all other revenue recognition criteria have been met.

Example 16.1

A biotechnology company (Biotech) enters into a license and collaboration arrangement with a pharmaceutical company (Pharma) to jointly develop a potential drug that is currently in Phase II clinical trials. As part of the arrangement, Biotech agrees to provide Pharma a perpetual license to the company's proprietary intellectual property (IP). Biotech also agrees to provide research and development (R&D) services to Pharma to develop the potential drug. Biotech receives an upfront payment of $20 million at the inception of the arrangement and is eligible to receive milestone payments of $10 million at the commencement of the Phase III trial and $25 million upon regulatory approval.

In assessing what consideration should be included in the initial relative selling price allocation, Biotech needs to consider which payments are fixed or determinable at the inception of the arrangement. It is common for arrangements in the biotechnology industry to include contingent consideration such as milestone payments. Milestone payments are generally payable to the vendor upon the achievement of certain events such as the commencement of a clinical trial or receipt of regulatory approval. These and other similar types of additional arrangement consideration need to be carefully assessed before being included in the arrangement consideration at the inception of an arrangement.

In this case, Biotech concludes that there are two deliverables in the arrangement: a license and R&D services. Further, Biotech views all consideration aside from the upfront payment to be contingent at the inception of the arrangement, such that only the upfront fee is fixed or determinable at the inception of the arrangement. Based on the estimated selling price for the two deliverables, the following represents the initial relative selling price allocation (in millions):

	Estimated Selling Price	Relative Selling Price Allocation	
License	$30	$20 x 75% ($30/$40) =	$15
R&D services	$10	$20 x 25% ($10/$40) =	$5
	$40		**$20**

As the license is delivered and has standalone value (see Section II below for more considerations on standalone value), Biotech recognizes $15 million upon delivery of the license and will recognize revenue for the R&D services as the services are performed.

Example 16.2

Assume the same facts as example 16.1; however, Biotech is also being reimbursed under the contract for the R&D services they will provide which is expected to add $12 million of consideration. Therefore, the initial contractual consideration that is fixed or determinable at the inception of the arrangement is $32 million.

The initial relative selling price allocation changes as follows (in millions):

	Estimated Selling Price	Relative Selling Price Allocation	
License	$30	$32 x 75% ($30/$40) =	$24
R&D services	$10	$32 x 25% ($10/$40) =	$8
	$40		**$32**

There are multiple approaches that could be used to account for the consideration received when the delivered item is allocated more value in the initial relative selling price allocation than consideration received at the onset of the arrangement. The following are two of the approaches that we believe would be acceptable; however, there may be other acceptable approaches. In each of these approaches, it was concluded that the $32 million of consideration was fixed or determinable for the purposes of initial revenue recognition. Additionally, the milestones included in the arrangement do not meet the criteria in ASC 605-28 to be accounted for as substantive milestones.

Approach 1

This approach is based on the guidance ASC 605-25-30-2 and 5 which calls for the arrangement consideration to be allocated to the separate units of accounting based on their relative fair values with initial revenue recognition limited to the noncontingent amount allocable to the delivered item. Once the contingencies are satisfied the remaining contract consideration would be recognized based on the relative fair value allocation.

Under this approach, it would be appropriate to recognize the entire upfront payment of $20 million related to the license deliverable as revenue at the inception of the arrangement because the allocated value is greater than the upfront noncontingent consideration. The remaining $12 million of the $32 million of initial fixed or determinable consideration would be allocated as $4 million for the license deliverable and $8 million to the R&D services. When the $10 million milestone is satisfied, the payment would be allocated between the license and R&D services similar to the original percentages (75%/25%).

Approach 2

This approach is also based on the guidance ASC 605-25-30-2 and 5. However, under this approach the amount that can ultimately be recognized as revenue for the delivered item is limited to the amount initially allocated to the delivered item that is not contingent upon the delivery of additional items or specified performance conditions. This allocation is based on the amounts that are determined to be fixed or determinable at the inception of the arrangement.

Under this approach, it would be appropriate to recognize the entire upfront payment of $20 million related to the license deliverable as revenue because the allocated value is greater than the upfront noncontingent consideration. All subsequent amounts will be allocated to the R&D services (the undelivered item) as Biotech is unable to allocate additional consideration to the delivered item (i.e., the license) after initial recognition based on limitations in ASC 605-25-30-5. We believe the approach in this alternative is consistent with the example in ASC 605-25-55-12.

As illustrated by these examples, judgment is required in evaluating the allocation of arrangement consideration when there are milestones or other contingent fees.

Question 17

After a company's initial allocation of revenue at the inception of an arrangement, can the company later reallocate the consideration based on changes in estimates of the selling price for a deliverable?

Interpretive response

Once an allocation of the arrangement consideration is performed at the inception of an arrangement, a company would not reallocate such consideration for subsequent changes in estimates of the selling price. This includes circumstances in which a company performed an allocation of revenue at the inception of the arrangement using BESP for a deliverable and the company subsequently determined VSOE or TPE of the selling price for that deliverable.

Question 18

May a company determine the selling price for a combination of deliverables or must the company determine the selling price for each deliverable separately?

Interpretive response

ASU 2009-13 indicates that the objective of determining the BESP for a deliverable should be consistent with the objective of determining VSOE. Specifically, it is the price at which the company would sell the individual deliverables if it were sold on a standalone basis. However, where the company's strategy is to normally offer the deliverables as a group (e.g., Product A and Product B are always sold as a group) and such products are delivered at the same time or over the same period of time, it would be acceptable to determine the BESP for those deliverables on a combined basis.

Question 19

If an arrangement includes hardware and software that function together to deliver the product's essential functionality, how should the postcontract customer support on the software included in the arrangement be treated for purposes of separation and allocation?

Interpretive response

If the hardware and software are determined to be non-software deliverables, then all deliverables related to the non-software deliverables will also be considered non-software deliverables and excluded from the scope of ASC 985. Arrangement consideration would be allocated to all deliverables, including the PCS, based on their relative selling price under ASU 2009-13.

Question 20

An arrangement includes hardware with essential software, PCS, and a software subscription (i.e., rights to unspecified future products). Would the software subscription affect the allocation of the arrangement fees to the tangible product?

Interpretive response

Previously, an arrangement of this type would have been in the scope of ASC 985, which would have resulted in a single unit of accounting because the company would not be able to establish VSOE for the rights to unspecified future products. Therefore, the existence of the software subscription without VSOE would have required the entire arrangement consideration to be recognized ratably.

Under ASU 2009-13, the existence of the software subscription would not affect whether arrangement consideration can be separated and allocated to the tangible product. ASU 2009-13 requires that arrangement consideration "be allocated at the inception of the arrangement to all deliverables" using the relative selling price method.

Question 21

How should unspecified additional products related to software be accounted for subsequent to the adoption of ASU 2009-13 and ASU 2009-14, if the related software is considered essential to the functionality of the tangible product?

Interpretive response

Previously, unspecified additional products related to software were accounted for as subscription arrangements following the guidance in ASC 985-605-25-58. Following the adoption of ASU 2009-14, these deliverables may now be considered non-software elements if the related software is essential to the functionality of the tangible product, provided they are sold together. As such, these unspecified additional products would no longer be in the scope of ASC 985 and the accounting will need to follow the provisions of ASU 2009-13. ASU 2009-13 requires the arrangement consideration to be allocated at the inception of the arrangement to all deliverables using the relative selling price method. A company will need to develop its BESP for the unspecified additional products where VSOE or TPE is not available. By analogy to ASU 985-605-25-58, we believe the portion of the arrangement consideration allocated to the unspecified additional products would be recognized ratably over the term of the arrangement beginning with the delivery of the first product, or over the estimated economic life of the products covered by the arrangement if the term is not specified.

PwC observation:

Developing BESP for unspecified additional products or for products that may have never been sold separately (e.g., specified upgrades, intellectual property licenses, joint steering committees, etc.) can be challenging. Significant judgment will be required and the most appropriate approach will be based on a company's specific facts and circumstances. One method used by early adopters has been to determine BESP for these types of deliverables using a cost-plus approach. However, identifying the appropriate underlying costs as well as segregating those costs from unrelated activities may be difficult for some companies. Additionally, in the case of licenses or upgrades, determining the expected number of products to be sold, as well as the expected margin also requires significant judgment. Therefore, companies should evaluate whether there is other data available to corroborate estimates made using a cost-plus approach. We anticipate that the process for determining BESP for these types of deliverables will continue to evolve over time. A robust estimation process that leverages as much objective or verifiable data as possible is critical in driving consistency when valuing these items.

Question 22

How should a company allocate the consideration for specific deliverables in a multiple deliverable arrangement that relates to both a deliverable within the scope of ASC 985 and a deliverable that is not within the scope of ASC 985?

Interpretive response

ASU 2009-14 includes guidance on how the arrangement consideration should be allocated to the deliverables in a multiple deliverable arrangement that includes software within the scope of ASC 985 as well as non-software deliverables that are not within the scope of ASC 985. The guidance states that, in such arrangements, a company should allocate the arrangement consideration to the non-software deliverables and to the software deliverables as a group, in accordance with ASU 2009-13. Therefore, the arrangement consideration should be allocated to the non-software deliverables based on their relative selling prices and to the software deliverables, as a group, based on its selling price.

Once a portion of the consideration is allocated to the software group using the guidance in ASU 2009-13, the company would then use the separation and allocation guidance in ASC 985 to further allocate this consideration to the individual software deliverables within the group. ASC 985 requires a company to have VSOE of the selling price to separate deliverables in a multiple deliverable arrangement. ASC 985 does not allow the use of TPE or BESP. As a result, any arrangement consideration allocated to the software group may only be further allocated to the individual software deliverables within the group if the company has VSOE of the selling price for all of the undelivered items.

We believe that the requirement to bifurcate PCS into a non-software element and a software element would not preclude a company from asserting it has VSOE for the software related PCS. If VSOE exists for PCS prior to bifurcation, the portion of PCS allocated to the software element would be considered VSOE for allocation purposes under ASC 985.

ASU 2009-14 does not specifically describe how a combined element should be separated. For example, consider an arrangement that includes ongoing maintenance that supports both a tangible product and software that is not essential to the functionality of the tangible product.

We believe that the arrangement consideration allocated to a specific deliverable that requires allocation between the software component and the non-software component should be bifurcated using a relative selling price method.

Example 22.1

Facts: Company A sells a computer with an operating system, productivity software and PCS that relates to both the operating system and the productivity software for $10,000. The operating system is considered essential to the functionality of the computer and is therefore a non-software element in the scope of Issue 08-1, whereas the productivity software is a software element in the scope of SOP 97-2.

Analysis and conclusion: The company should determine the selling price for each of the deliverables. The PCS should be bifurcated into two separate deliverables related to the operating system and the productivity software. In this example, selling prices were determined using a best estimate of selling price (VSOE or TPE was not available) as follows:

Computer and operating system	$6,000
Productivity Software and PCS	$5,800
PCS - Operating System	$200

Example A: Assume VSOE for the combined PCS does not exist.

Step 1: Determine software versus non-software deliverables:

Non-software deliverables:	Software deliverables:
Computer with operating system	Productivity software
PCS on operating system	PCS on productivity software

Step 2: Allocate arrangement consideration using the relative selling price method to each of the deliverables:

Computer with operating system	$6,000/$12,000 x $10,000 =	$5,000
PCS - non-software portion	$200/$12,000 x $10,000 =	$167
Non-software group		**$5,167**
Software group	**$5,800/$12,000 x $10,000 =**	**$4,833**

Step 3: Allocate the arrangement consideration following the guidance in SOP 97-2 for the software group:

Software group $4,833 (single unit of accounting)

In this example, the software deliverables would be accounted for as a single unit of accounting because VSOE of the undelivered item does not exist.

Example B: Assume that the contract included a stated renewal rate of $900 for the combined PCS that represented VSOE.

Steps 1 and 2 above are the same.

Step 3: Bifurcate the PCS into software and non-software elements using the relative selling price method:

PCS - non-software portion	$200 (1) /$1,000 x $900 =	**$180**
PCS - software portion	$800 (1) /$1,000 x $900 =	**$720**

(1) For purposes of bifurcation, selling prices of PCS for the software and non-software element were determined using a BESP.

Step 4: Allocate the arrangement consideration following the guidance in SOP 97-2 for the software group:

Productivity software	$4,113	
PCS - software	$720	(considered VSOE)
Software group	**$4,833**	

In this example, the productivity software did not have VSOE and, therefore, the residual method was used for allocation within the software group.

Note that the arrangement consideration allocated to the delivered items in both examples would be further limited to the noncontingent consideration, if a contingency existed.

Question 23

If, as a result of purchasing PCS, a customer is also entitled to specified upgrade rights, would the specified upgrade rights be considered a separate deliverable?

Interpretive response

Specified upgrade rights generally provide a customer with specific features and added functionality, and are viewed differently than PCS. A company may make an offer to provide specified upgrades contingent upon the customer agreeing to buy PCS. However, the specified upgrade rights and the PCS should be considered two separate deliverables.

Question 24

Although ASC 605-25 provides guidance on allocating revenue, in a speech at the 2007 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff indicated that it may be appropriate to apply a similar approach in accounting for multiple-element litigation settlements. Consistent with ASC 605-25, the SEC staff noted that it would be acceptable to allocate consideration paid or received using relative fair values. However, the staff observed that it is often difficult to reliably estimate the fair value of the litigation component of a settlement. As a result, the staff indicated that to the extent one of the elements in the arrangement just can't be valued, a residual approach may be a reasonable solution.

Does the issuance of ASU 2009-13 impact the accounting for multiple-element litigation settlements?

Interpretive response

We believe that generally a company would now follow the guidance in ASU 2009-13 when accounting for litigation settlements. However, in cases where a company could not establish a best estimate of selling price for one of the elements in a litigation settlement, such as the litigation component, consistent with the 2007 speech, a residual approach may be used to allocate the consideration paid or received.

Question 25

How does a company apply ASU 2009-13 to existing deferred revenue that relates to a revenue arrangement accounted for under the prior ASC 605-25 guidance or ASC 985 that is materially modified?

Interpretive response

ASU 2009-13 does not provide specific guidance on this issue. We believe there are two acceptable methods to account for existing deferred revenue as of the modification date.

Alternative 1 - Reassess the arrangement under ASU 2009-13 as if all modifications since inception were part of the original arrangement. This would require determining BESP for all deliverables where VSOE or TPE is not available. Assumptions used in developing the BESP for a specific deliverable should reflect economic conditions as of the date such deliverable was included in the arrangement to the extent practicable. Total arrangement consideration would be allocated to each deliverable based on the relative selling price method. Any excess of recorded deferred revenue over the amount of deferred revenue computed under this transition method as of the modification date would be recognized as revenue in the period of modification.

Example 25.1

Facts - An existing arrangement provides for the sale of Product A and Service B for \$200. Product A was delivered and all cash was paid to the vendor. Service B will be delivered over 4 years. The company did not have VSOE or TPE for either Product A or Service B, and, therefore, the entire \$200 was deferred and is being recognized ratably over the 4-year term of Service B. The contract was modified after the first year to reduce the term of Service B to 3 years and add Product C (to be delivered in 6 months). Total consideration was increased to \$225, thus requiring the payment of an additional \$25 to the vendor upon delivery of Product C. At the date of the modification, the company had recognized \$50 of revenue, leaving \$150 in deferred revenue. The company determines that BESP for Product A, Service B for three years, and Product C are \$100 each.

Analysis and conclusion - Applying Alternative 1 would require the company to reevaluate the contract as if the terms of the modified arrangement were in existence at the inception of the arrangement. The company would allocate the $225 of total arrangement consideration using the relative selling price method, resulting in $75 each being allocated to Product A, Service B, and Product C.

At the time of the material modification, the company should have recognized $100 of revenue (related to the delivery of Product A, $75, and one year of Service B, $25). This would result in a cumulative catch-up adjustment to recognize an additional $50 of revenue at the date of the modification, reducing the deferred revenue balance from $150 to $100.

Alternative 2 - Establish the selling price for the undelivered items under the modified arrangement and recognize any excess of deferred revenue over the amount of the selling prices for the undelivered items as revenue at the date of modification. Under this approach, any discount in the arrangement would be allocated to the delivered items.

Example 25.2

Following the same fact pattern in Example 25.1, Alternative 2 would be applied as follows:

Step 1: Calculate the deferred revenue balance at the date of the modification plus any additional amounts to be collected under the arrangement (and not yet in deferred revenue).

Deferred revenue balance	$150
Plus: Additional amounts to be collected	$25
	$175

Step 2: Calculate the sum of selling prices established for the remaining undelivered items.

Service B for the remaining 2 years	$67 [(1)]
Plus: Product C	$100
	$167

[(1)] $100 BESP for 3 years of service/3 years x 2 years remaining = **$67**

Step 3: Calculate the excess of the amount calculated in Step 1 over the amount calculated in Step 2:

Step 1 amount	$175
Less: Step 2 amount	$167
Excess/(Shortfall)	**$8**

At the time of the material modification, the company should have recognized $58 of revenue (related to the delivery of Product A and one year of Service B), leaving the full selling price of the undelivered items to be recognized in the future upon delivery. This would result in a cumulative catch-up adjustment to recognize the excess of $8 as revenue at the date of the modification, resulting in a deferred revenue balance of $142 (which excludes the $25 of additional consideration not yet collected).

While Alternative 1 is conceptually more consistent with the guidance in ASU 2009-13, we believe either method is acceptable. Whichever method is selected constitutes an accounting policy election that should be applied consistently to similar arrangements.

When applying these alternatives, a company would need to consider the accounting for up-front fees as discussed in Question 43.

A material modification of an arrangement being transitioned to the new guidance would likely result in the recognition of some or all of the previously deferred revenue in situations where deferral was necessary due to an inability to establish VSOE or TPE. There could be circumstances where a material modification would result in the revenue that was recognized prior to modification being in excess of the revenue determined under either alternative above. In those situations, we generally believe a modification should not result in the reversal of previously recorded revenue.

Question 26

The new guidance is effective for revenue arrangements that are entered into or materially modified in fiscal years beginning on or after June 15, 2010. When is an arrangement considered to be materially modified?

Interpretive response

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. We believe a materially modified arrangement would have all of the following characteristics:

- The modification affects the deliverables under the existing arrangement or there is a pricing interdependency between the new deliverables and the existing deliverables.
- The modification is the result of a bona fide renegotiation.
- The modification is quantitatively material. The EITF did not provide guidance on what constitutes "material." We believe materiality should be measured relative to the specific arrangement being modified.
- There is a substantive business reason for the modification. A modification made solely for the purpose of achieving an accounting result that lacks economic substance would not satisfy this criterion.

See Questions 27 through 32 for additional guidance.

Contract modifications should continue to be evaluated to determine whether a concession was granted to the customer and, if so, whether that concession affects the determination of whether arrangement consideration for future transactions meets the fixed or determinable fee and collectibility requirements.

Question 27

Would a renewal or extension of a service arrangement be accounted for as a new arrangement or a modification?

Interpretive response

Judgment would need to be applied to determine whether the renewal or extension is economically a separate purchasing decision with little or no interdependence on the existing arrangement, and thus, would be viewed as a new arrangement.

For example, the addition of a one-year renewal period to a multiple-year service contract towards the end of the original term at a selling price that represents fair value would generally be considered a new arrangement. In contrast, a renegotiation of a multiple-year service contract early in its term that results in a renewal period or

extension at a selling price negotiated based on the overall contract terms would typically be considered a modification.

Example 27.1

Company A has a contract for the sale of equipment for $1,000 and a 3-year service arrangement for $150 per year. At the end of the first year of the service contract, the customer negotiates an extension of the service arrangement to add a fourth year at a discounted fee of $50.

Company A should consider the timing of the modification relative to the inception of the original contract and the price of the extension. There may be evidence to support that the addition of the fourth year at a discounted price is, in substance, a renegotiation of the aggregate price for the remaining 3 years of the service arrangement.

Conversely, if the addition of the fourth year occurred close to the end of year 3, it may be a new arrangement rather than a modification because it is unlikely that the Company would have renegotiated the pricing for services already rendered.

Question 28

Would the purchase of additional products placed under a master purchase agreement be considered a new arrangement or a modification?

Interpretive response

Purchases under a master purchase agreement would generally be considered a new arrangement since each order represents a separate purchasing decision with little or no interdependencies on existing deliverables. While a master purchase agreement may have established general terms governing transactions between the company and the customer, it may not specify all terms required to evidence the arrangement (e.g., specifying the quantity to be delivered).

Question 29

Would the addition of deliverables for no additional consideration be considered a modification?

Interpretive response

If the modification was the result of a bona fide renegotiation and had economic substance, the addition of deliverables for no additional consideration would generally be considered a modification. Whether a modification has economic substance requires the application of judgment based on specific facts and circumstances. For example, the addition of free products may, in substance, be a renegotiation of the pricing for the existing deliverables. In contrast, the addition of deliverables for no additional consideration that lacks economic substance would not be considered a modification. In those instances, the company should consider whether a concession was granted to the customer.

Question 30

Would the addition of deliverables for a fee be considered a modification?

Interpretive response

If the change does not impact the deliverables in the existing arrangement and there is no pricing interdependency between the new and existing deliverables, the change would be viewed as a new arrangement. However, the inclusion of a significant incremental discount may indicate a pricing interdependency between the existing arrangement and the additional deliverables. In those circumstances, the change may be considered a modification.

Question 31

Would changing an existing contract to reduce the quantities to be delivered, where the price per unit remained the same and total arrangement consideration was reduced proportionately, be considered a modification?

Interpretive response

A change to reduce the quantities to be delivered that was the result of a bona fide renegotiation of the contract would generally be viewed as a modification. In determining whether a bona fide renegotiation to reduce quantities has occurred, a company should evaluate whether the existing arrangement contained cancellation or return rights. In the event such rights already exist, the reduction in quantities at the request of the customer would typically not constitute a modification.

Question 32

Would a change to the pricing of deliverables in a contract be considered a modification?

Interpretive response

Generally, pricing changes to existing deliverables would be viewed as a modification. When evaluating whether the price change is "material," we believe a company would evaluate the impact of the change relative to the arrangement consideration and the impact to the overall economics of the arrangement.

For example, a company that substitutes one deliverable for another that has the same overall pricing, but yields a different margin, may be a modification.

Question 33

Are there any circumstances in which hardware will be within the scope of ASC 985?

Interpretive response

No. ASU 2009-14 modifies the scope of ASC 985 to exclude non-software components of tangible products. It also eliminates the requirement to include hardware within the scope of ASC 985 in situations where the software element is essential to the hardware's functionality. As such, there are no circumstances in which hardware will be within the scope of ASC 985.

Question 34

Could there be circumstances where the non-software elements of a tangible product do not substantively contribute to the tangible product's essential functionality?

Interpretive response

A company will need to apply judgment when determining whether a tangible product is simply a mechanism to deliver the software. ASU 2009-14 lists five factors to consider, one of which is that "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." This factor is intended to be an anti-abuse provision to preclude companies from applying ASU 2009-13 to otherwise traditional software arrangements by simply delivering that software with a tangible product.

In many cases, it may be clear when the tangible product is simply a delivery mechanism for the software. For example, a software company that uses a flash drive as a means to deliver its software would continue to apply ASC 985 in accounting for the software. In other cases, companies will need to apply judgment when determining whether the non-software elements of a tangible product do not substantively contribute to a tangible product's essential functionality.

Question 35

For sales of a tangible product that is infrequently sold without the application software, would the application software be excluded from the scope of ASC 985?

Interpretive response

If the tangible product is sold without the application software infrequently, the application software is presumed to be essential to the functionality of the tangible product when sold together. Thus, the sale of the application software would generally be excluded from the scope of ASC 985 provided that the tangible product is not simply a mechanism to deliver the software. Similarly, if the sales of tangible product included a choice of application software that performs the same basic functionality, the application software chosen by the customer would be excluded from the scope of SOP 97-2. A separate sale of the application software would be within the scope of ASC 985.

Example 35.1

Company A sells a personal digital assistant (PDA) that always includes e-mail software application. There is a rebuttable presumption that the e-mail software application is essential to the functionality of the PDA and would be excluded from the scope of ASC 985.

Likewise, Company B sells a PDA that always includes an e-mail software application, but gives the customer the choice between e-mail software A and e-mail software B, both of which have the same basic functionality. The customer's ability to choose which version of e-mail software to include does not change the fact that the tangible product is always sold with e-mail software. We believe there would be a rebuttable presumption that the e-mail software chosen by the customer is essential to the functionality of the PDA and would be excluded from the scope of ASC 985.

Question 36

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. How is "infrequent" defined?

Interpretive response

The EITF did not provide guidance on the definition of "infrequent." As such, judgment will be required based on specific facts and circumstances. Generally, we would expect the tangible product to be sold with the software in almost all cases in order to meet the definition of "infrequent."

This provision was originally drafted to require that tangible product sales "always" include the software in order to presume the software was essential. However, the EITF did not intend for a few "one-off" sales of tangible product without the software to require different accounting for the software when sold with the tangible product.

There may be circumstances in which a company's business practice is distinct enough among segments that it would be acceptable to stratify sales practices based on those segments for purposes of determining whether a tangible product is sold without the software infrequently.

Example 36.1

Company A sells to two customer segments: Original equipment manufacturers (OEMs) and end users. Company A always sells the hardware with the operating system in arrangements with end users. However, Company A frequently sells the hardware without the operating system in arrangements with OEMs.

Because of the differences in customer bases, it may be acceptable to consider the products sold to OEMs separately from the products sold to end users. Company A may conclude that the operating system when sold with the tangible product to end users is in the scope of Issue 08-1 because sales of the tangible product without the operating system are infrequent to that customer segment. However, when sold to OEMs, Company A would conclude that the operating system is in the scope of ASC 985 because it is frequently not included with the hardware.

Question 37

Would the subsequent sale of a software product that enhances the functionality of software that had been considered essential to the functionality of the tangible product in a previous arrangement be considered a software element in the scope of ASC 985?

Interpretive response

Software or software-related elements sold on a standalone basis in a separate transaction would be in the scope of ASC 985.

Question 38

If PCS in a revenue arrangement with tangible product and software is concluded to be in the scope of ASU 2009-13 because the related software is considered essential to the functionality of the tangible product, would the renewal of that PCS also be considered a non-software element in the scope of ASU 2009-13?

Interpretive response

Standalone sales of software-related elements are within the scope of ASC 985. The renewal of PCS would be considered a software deliverable if the renewal is considered a separate sale of a software-related element on a standalone basis. Likewise, the subsequent sale of specified upgrades to the software may also be in the scope of ASC 985.

II. Standalone value

Question 39

Under ASU 2009-13, are there any circumstances in which a company is not able to separate a delivered item that has standalone value from an undelivered item (assuming delivery or performance of any undelivered items is probable and in the control of the company if there is a general right of return for delivered items)?

Interpretive response

For purposes of separating and allocating the arrangement consideration, ASU 2009-13 requires a company to use its BESP for delivered and undelivered items whenever VSOE or TPE of the selling price for such deliverables is not available. This means that all delivered items that have standalone value are separate units of accounting, assuming delivery or performance of any undelivered items is probable and in the control of the company if there is a general right of return for delivered items.

Question 40

What factors might be considered when assessing whether a delivered item has standalone value?

Interpretive response

ASU 2009-13 states "the delivered item or items have value on a standalone basis if they are 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 the deliverable(s)." Although different approaches to making this assessment are acceptable, a company should assess the following in determining whether a delivered item has standalone value.

- Whether similar deliverables are sold separately by any vendor
- Whether a customer could resell the deliverable (e.g., considering legal restrictions that preclude resale)
- Whether a hypothetical customer would use the deliverable for its intended or another productive purpose (a deliverable that could only be sold for scrap value would not be considered to have standalone value)

In situations where a customer could resell a deliverable or sublicense its rights to the deliverable for a reasonable amount of consideration, the assessment that the delivered item has standalone value is driven by the fact that the customer or a third party could derive economic benefit of the delivered item. In making this determination in situations where there is not a secondary market, companies will have to use judgment to determine whether it could resell the delivered item for reasonable consideration on a standalone basis. This assessment of reasonable consideration should consider whether the company could recover a significant portion of its original purchase price in a hypothetical sale (rather than only for salvage or scrap value). If the customer determines it could resell or sublicense the deliverable for reasonable consideration, it would be appropriate to conclude that there is standalone value for the delivered item.

Another factor that may impact whether a delivered item has standalone value is whether there is a contractual right which prohibits a company from transferring the delivered item. Legal restrictions are common in many industries such as the pharmaceutical and biotechnology industries, and in the technology industry. A legal restriction that prevents a customer from reselling or sublicensing the delivered item may result in the

conclusion that the delivered item does not have standalone value if the customer is not able to derive utility from the underlying asset. Companies need to carefully consider all relevant facts and circumstances when there is a legal restriction before concluding a delivered item does not have standalone value. If a customer could exploit the delivered item through its own use or development, it may be appropriate to conclude the item has standalone value, irrespective of whether a transfer restriction exists. In instances where additional services can only be obtained from the vendor in order for the customer to exploit the delivered item, then this is an indicator that standalone value may not exist.

Generally, the majority of tangible assets have standalone value because a customer "could" resell a tangible asset even if there was no such intent. Some service deliverables, however, may not have standalone value (e.g., telecommunication "activation services").

Question 41

Could intellectual property have standalone value?

Interpretive response

Yes. The criterion for stand-alone value is the same regardless of whether the deliverable is tangible or intangible. Historically, many transactions that have included IP have not considered whether the IP had standalone value, principally because VSOE or TPE was not available for the undelivered items. Companies will need to carefully evaluate each arrangement's individual facts and circumstances to determine whether the intellectual property has standalone value.

Question 42

Does a license to a pharmaceutical compound in development have standalone value in cases where the licensor has also been engaged to perform research and development (R&D) services to advance the compound through regulatory approval?

Interpretive response

The fact that the company has also been engaged to perform the R&D services would not preclude it from concluding that the license has standalone value. Some of the factors that may be relevant in making this determination include (1) whether the delivered item (i.e., the license) could be transferred/sold to another party by the customer, (2) whether the customer has (or had) the right to engage other parties to perform the R&D services (or alternatively perform it themselves). The fact that the company might perform the R&D services in a more effective and efficient manner than a third party or the customer would not preclude the company from concluding there is standalone value to the license. Conversely, if the license contained significant transfer restrictions and the R&D services could only be performed by the company (because the vendor was the only party with the requisite technical capabilities), that would suggest that the license did not have standalone value.

At the December 2009 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff addressed the issue of standalone value. The comments during this speech focused on a biotechnology arrangement and whether a delivered item (in this case a license) could have standalone value if the delivered item is not sold separately and the customer is legally prohibited from reselling the delivered item. The SEC staff noted that there could be instances where the license would have standalone value if the customer could either perform the R&D services necessary to bring the IP to completion or engage a 3rd party to perform R&D services to complete the technology.

Example 42.1

A biotechnology company (Biotech) enters into a license and collaboration arrangement with a pharmaceutical company (Pharma) to jointly develop a potential vaccine that is currently in Phase II clinical trials. As part of the arrangement, Biotech agrees to provide Pharma an immediate license to the company's proprietary intellectual property (IP), however, Pharma is restricted from reselling or sublicensing its rights to the IP. The agreement allows Pharma to determine who will perform the R&D services and Pharma has no obligation to use Biotech to perform the R&D services. However, due the unique features of the vaccine technology and proprietary development requirements, Pharma contracts with Biotech to perform the R&D services as they are the only party with the requisite knowledge needed to complete the technology.

In assessing whether the license has standalone value to Pharma, Biotech needs to assess several factors. These factors include whether it or a third party has sold similar deliverables separately in the past, whether the customer could resell the item and whether there are any other features in the arrangement that would impact the assessment of standalone value.

In assessing this arrangement, Biotech concludes that the license does not have standalone value to Pharma due to several factors. These factors include (a) Biotech has not sold a similar item in the past, (b) the legal restriction on reselling the license placed on Pharma and (c) Biotech is the only party that has the requisite knowledge to perform the R&D services to complete the technology (i.e., Pharma could not perform the services internally or contract the services to a third party).

Importantly, the assessment of whether the company or a third party could perform the research needed to complete the technology will require companies to apply significant judgment.

III. Interaction with other guidance

Question 43

Does Issue 08-1 impact the existing guidance in SAB Topic 13A for the payment of an up-front fee? Specifically, under the guidance in ASU 2009-13, should an up-front fee in a multiple deliverable arrangement be included within the consideration that is allocated to the deliverables at inception?

Interpretive response

ASU 2009-13 does not modify the existing guidance for an up-front fee; however, ASU 2009-13 might impact how a company applies the guidance to multiple deliverable arrangements.

SAB Topic 13A indicates that unless an up-front fee is in exchange for products delivered or services performed that represent the culmination of the earnings process, an up-front fee should be deferred and recognized systematically over periods that the fees are earned.

In cases in which an up-front fee is not related to specific products or services, the fee should be excluded from the consideration that is allocated to the deliverables and be recognized over the longer of the initial contractual term of the arrangement or the estimated period the customer is expected to benefit from the payment of the up-front fee (i.e., the customer benefit period). When all or a portion of an up-front fee is related

to a specific deliverable(s) within the arrangement, the up-front fee, or a portion thereof, should be included within the consideration that is allocated to the deliverables using the relative selling price method.

In many cases under the prior guidance in ASC 605-25, companies were unable to identify the specific earnings process related to up-front fees in a multiple deliverable arrangement because delivered items are required to be combined with undelivered items to form a single unit of accounting. In such cases, up-front fees often are recognized on a straight-line basis over the initial term of the arrangement or the customer benefit period.

By providing the alternative for determining selling price using a best estimate, Issue 08-1 may result in a greater number of deliverables that will be separate units of accounting. As such, a company's specific earnings process associated with an up-front fee may be more easily identifiable to specific deliverables. As a result, there may be a greater number of cases where a company can allocate an up-front fee to the various deliverables in the arrangement using a relative selling price method. However, in cases where an up-front fee is not related to specific products or services, the fee should continue to be excluded from the consideration that is allocated to the deliverables.

Question 44

How are rights to significant incremental discounts on a customer's future purchase(s) included in an arrangement accounted for under ASU 2009-13?

Interpretive response

If the discount in an arrangement is more than insignificant, a presumption is created that an additional deliverable is being offered in the arrangement. Future discounts were neither addressed nor referred to in ASU 2009-13. As such, we believe that the guidance in ASC 985-605-15-3(d) may be applied in order to evaluate whether a discount is more than insignificant. ASC 985-605-15-3(d) presents factors that can be used to evaluate (1) the significance of the discount, (2) whether the discount is incremental in the range of discounts on other deliverables in the arrangement, and (3) whether the discount is incremental compared with the discounts offered to other customers. Once it is determined that there is a significant incremental discount, the guidance in ASC 985-605-55-82 through 55-85 may be applied by analogy to determine how to account for that discount. It may also be acceptable to treat the significant incremental discount as any other deliverable for which a best estimate of selling price must be determined, and include it in the relative selling price allocation.

Question 45

When accounting for sales incentives given by a company to a customer following the provisions of ASC 605-50, *Customer Payments and Incentives,*[5], should the company use the estimated selling price in place of fair value referenced in ASC 605-50?

Interpretive response

ASU 2009-13 and ASU 2009-14 did not amend the guidance in ASC 605-50, *Customer Payments and Incentives*,, which continues to require that if the amount of consideration paid by the company exceeds the estimated fair value of the benefit received, that excess should be accounted for following the provisions of ASC 605-50.

[5] With the launch of the FASB's Accounting Standards Codification, EITF 01-9 was included in ASC 605-50, *Customer Payments and Incentives.*

Question 46

Do the requirements of ASU 2009-13 more closely align US GAAP to International Financial Reporting Standards (IFRS)?

Interpretive response

The principles in IAS 18, *Revenue*, require 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 selected best reflects a transaction's substance.

In practice, under IFRS, although the price that is regularly charged for an item when sold separately provides the best evidence of a component's fair value, other methods such as cost plus a reasonable margin may be employed in the absence of such evidence. Examples of allocation methods include the relative fair value, residual method, cost plus a reasonable margin, and, in certain circumstances, the reverse residual method. IFRS permits the use of a combination of estimation and allocation methods if that combination best reflects a transaction's substance.

Accordingly, while differences remain between the two frameworks in the area of multiple deliverables, ASU 2009-13 more closely aligns U.S. GAAP to IFRS by allowing entities to use a best estimate approach when neither VSOE nor TPE of the selling price exists.

PwC observation:

The FASB and IASB continue to work toward a converged revenue recognition standard with a final standard expected to be released during 2011. We expect that the standard will be effective no earlier than for fiscal periods beginning in 2014. Refer to Dataline 2010-28 for a detailed discussion of our perspectives regarding the impact of the proposed revenue recognition guidance.

Question 47

Did ASU 2009-14 change the accounting for software with services that involve significant production, customization, or modifications that were accounted for in conformity with the provisions of ASC 605-35, *Construction-Type and Production-Type Contracts*[6]?

Interpretive response

Arrangements to deliver software and services that involve significant production, customization, or modifications should continue to be accounted for in conformity with the provisions of ASC 605-35.

Question 48

What guidance should be applied if it is determined that one or more of the milestones in an arrangement are not substantive?

[6] With the launch of the FASB's Accounting Standards Codification, SOP 81-1 was included in ASC 605-35, *Construction-Type and Production-Type Contracts.*

Interpretive response

If a company determines that one or more milestones within an arrangement are not substantive, the provisions of ASC605-28 may still be applied to other milestones within that arrangement. If a milestone is not substantive, that milestone payment may be treated as additional arrangement consideration. If a multiple-element arrangement does not meet the criteria for separating deliverables and the deliverables are accounted for as a single unit of accounting, the non-substantive milestone will be allocated to the single unit of accounting.

IV. Disclosure

Question 49

ASU 2009-13 requires that a company disclose information by similar type of arrangement. What is meant by similar type of arrangement?

Interpretive response

We believe companies should consider the following aspects of its multiple element arrangements when determining what constitutes similar arrangements:

- The products and services sold in the arrangements
- The customers and markets to which the arrangements are sold
- The terms of the arrangements

Question 50

What changes in either the selling price or the methods or assumptions used in determining the selling price would require disclosure?

Interpretive response

ASU 2009-13 requires an entity to disclose the effect of changes in either the selling price or the method and/or assumptions used to determine selling price for a specific unit of accounting if changes have a significant effect on the allocation of arrangement consideration. One objective of this disclosure requirement is to provide information about changes in revenue trends. This objective should be considered when making judgments about whether such a change needs to be disclosed. For example, we would expect changes in BESP that cause a material change in the timing of revenue recognition to be disclosed.

Question 51

Do the new disclosure requirements apply to existing multiple element arrangements if the accounting remains the same even after adopting Issue 08-1 and Issue 09-3?

Interpretive response

Once a company has adopted ASU 2009-13 and ASU 2009-14, the disclosure requirements will apply to all multiple element arrangements that are now in their scope as well as those that continue to be accounted for under the prior ASC 605-25guidance pursuant to the transition provisions.

V. Transition and adoption

Question 52

Are companies required to adopt ASU 2009-13 and 2009-14 concurrently?

Interpretive response

Yes. Companies are required to adopt ASU 2009-13 and 2009-14 in the same period using the same transition method.

Question 53

May a company adopt the new guidance before the effective date?

Interpretive response

Early adoption is permitted. A company (public or private) may elect to early adopt in any interim or annual financial statements that have not been previously issued. If a company elects to adopt early and the period of adoption is not the first reporting period in the company's fiscal year, the new guidance must be applied as if the change was made prospectively from the beginning of the company's fiscal year of adoption.

For example, a calendar year-end company that early adopts the new guidance on a prospective basis in the fourth quarter (i.e., interim period ended December 31, 2010) must apply the new guidance as if the change was made prospectively from January 1, 2010. As a result, the company should retroactively adjust any information related to prior 2010 reporting periods in its year-end financial statements to reflect the new guidance.

Alternatively, a calendar year-end company may adopt the new guidance in the interim period ended December 31, 2010 through retrospective application pursuant to ASC 250, *Accounting Changes and Error Corrections*[7].

Question 54

In applying the new guidance retrospectively, a company is able to determine the impact for the year immediately preceding the year of adoption; however, it is impracticable to apply the effects of the new guidance to the earliest year presented (i.e., two years prior to the year of adoption). Can the company still apply the new guidance retrospectively?

Interpretive response

If it is impracticable to determine the effect of the change in accounting principle for any prior period pursuant to ASC 250, the new guidance should be applied as if the change was made prospectively as of the earliest date practicable. Therefore, the company would apply the new guidance for revenue arrangements that are entered into or materially modified after the earliest date that it is practicable to determine the effect of applying the new guidance. In such cases, a company must disclose the reasons why it was impracticable and include a description of the method that was used to apply the new guidance.

Question 55

Upon adoption, are there situations where a company will have to revise its previously issued financial statements before filing its next annual report?

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[7] With the launch of the FASB's Accounting Standards Codification, FAS 154 was included in ASC 250, *Accounting Changes and Error Corrections*.

Interpretive response

Yes. If a company adopts the new guidance during an interim period covered by financial statements included or incorporated by reference in a new or amended registration statement, proxy/information statement, or private offering memorandum and retrospective application is elected, then the company must retrospectively adjust its prior period annual financial statements that are included or incorporated by reference (subject to materiality considerations when the financial statements are only incorporated by reference).

In addition, if a company early adopts the new guidance in a period that is not the first reporting period in the company's fiscal year and applies the guidance prospectively from the beginning of the fiscal year, the company may need to revise prior interim period financial statements if the company's independent public accountant provides comfort on those earlier interim periods.

Question 56

If a calendar year-end company prospectively adopts Issue 08-1 in the quarter ended December 31, 2010, what arrangements would be subject to the provisions of Issue 08-1?

Interpretive response

All revenue arrangements entered into on or after January 1, 2010 and any revenue arrangements that existed prior to January 1, 2010 that were materially modified after January 1, 2010 should be evaluated to determine whether those arrangements would be in the scope of ASU 2009-13.

Question 57

For companies adopting the new guidance prospectively, may the provisions of ASU 20009-13 or ASU 2009-14 be applied to the remaining deliverables of an arrangement that was entered into prior to adoption?

Interpretive response

Unless the arrangement is materially modified subsequent to adoption, a company must continue to apply the prior ASC 605-25 guidance to all deliverables in arrangements that were entered into prior to the adoption of ASU 2009-13. Further, companies that used the residual method for arrangements entered into prior to the adoption of ASU 2009-13 must continue to apply the residual method to those arrangements after adoption.

VI. Additional illustrative examples

Example #1 - Manufacturing equipment

Background: A company sells new and highly specialized manufacturing equipment, which consists of Components X, Y, and Z. The company markets the equipment separately. However, the company has yet to sell the components separately, and no other company sells similar equipment either individually or collectively. In addition, because this is new technology, there is no market for any used equipment. On December 31, 201X, the company entered into an arrangement to sell these components to a customer and immediately delivered Component X. There is no general right of return in the arrangement and any payments made for components prior to their final delivery are not refundable. Neither VSOE nor TPE of the selling prices exist for Components X, Y, and Z.

How should the company separate and then measure and allocate the arrangement consideration under ASU 2009-13?

Evaluation: Assume the components have standalone value. Additionally, there are no general rights of return in the arrangement, so the second criterion in the standard (see paragraph 9 above) is not applicable. Therefore, the components should be recognized as separate units of accounting.

Because the company does not have evidence of VSOE or TPE of the selling price for the deliverables, the company must develop its BESP for Components X, Y, and Z and apply the relative selling price method on December 31, 201X.

Example #2 - Build and run

Background: A manufacturer enters into a contract to build, run, and maintain a highly customized, complex piece of electronic equipment for a period of five years, commencing upon the delivery of the equipment. There is a fixed fee for each of the build, run, and maintenance deliverables, and any progress payments made are not refundable. In addition, there is no general right of return in the arrangement. Assume all of the deliverables have standalone value, and TPE of the selling price exists for both the build and maintenance but not for the run.

How should the manufacturer separate and then measure and allocate the arrangement consideration under ASU 2009-13?

Evaluation: The build, run, and maintenance deliverables should be recognized as separate units of accounting because the delivered items have standalone value. The second criterion in the standard (see paragraph 9 above) is not applicable because there are no general rights of return in the arrangement.

Because the manufacturer does not have evidence of VSOE or TPE of the selling price for the undelivered run, the manufacturer must develop its BESP for the run and apply the relative selling price method at the inception of the arrangement. Once the allocation is performed, the company would recognize revenue independently for each unit of accounting.

Example #3 - Biotechnology license

Background: A biotechnology company (Biotech) enters into a license and collaboration arrangement with a pharmaceutical company (Pharma) to jointly develop a potential drug. As part of the arrangement, Biotech agrees to provide Pharma an immediate license to the company's proprietary intellectual property (IP). The agreement allows Pharma to determine who will perform the R&D services and Pharma has no obligation to use Biotech to perform the R&D services. However, the parties have agreed that Biotech will perform the R&D services. In addition, although Pharma will receive the manufacturing rights and is under no obligation to contract with Biotech, Biotech will manufacture the drug on behalf of Pharma during the commercialization phase of the arrangement. In exchange, Biotech will receive an up-front, non-refundable payment, as well as future contract manufacturing payments, if the drug is sold in the market.

Reliable evidence of VSOE or TPE of the selling prices of the license does not exist; however, Biotech is able to ascertain the TPE of the selling price for the R&D and manufacturing services.

How should Biotech separate and then measure and allocate the arrangement consideration under ASU 2009-13?

Evaluation: The license and R&D services should be recognized as separate units of accounting because the delivered items have standalone value and the second criterion (see paragraph 9 above) is not applicable since there are no general rights of return in the arrangement. The license to the IP has standalone value to Pharma without the ongoing R&D services because Pharma could have used another company or performed the R&D itself.

Because Biotech does not have evidence of VSOE or TPE of the selling prices of the license, Biotech should develop its BESP for the license deliverable and apply the relative selling price method at the inception of the arrangement to allocate the arrangement consideration between the license and R&D service deliverables. The manufacturing services and related consideration would not be considered in applying the relative selling price method as this deliverable is a contingent deliverable at the inception of the arrangement. However, if there is a significant incremental discount for the manufacturing services, Biotech would need to defer a portion of the consideration received. Once the allocation is performed at the inception of the arrangement, the company would recognize revenue independently for the license and R&D services.

Appendix B: Implementation considerations

Revenue is a key performance indicator for most businesses, so the new revenue guidance related to arrangements with multiple deliverables will likely impact many companies well beyond their financial reporting requirements. Stakeholder performance expectations, debt covenant compliance, and product pricing strategies are just a few of the areas that may be affected by the implementation of these new standards.

The standard setters established January 2011 (for calendar year-end companies) as the effective date for the new guidance recognizing that they needed to allow companies sufficient time to plan and manage the impacts of adoption. A systematic approach, involving appropriate representatives from all aspects of the business, is important to ensuring a thorough assessment of the potential impacts across all functional areas and business units of a company. Some of the areas that could be impacted are included below.

Impact on operations and performance metrics

- Stakeholder expectations and performance indicators
- Debt covenants
- Pricing strategies
- Incentive compensation targets
- Taxes - both income levels and state apportionment factors

Impact on people: Education and training

- Implementation team education and training
- Executive team, sales force, and investor relations training
- Analyst education and information packages

Impact on controls and processes

- Additional controls required for estimations (BESP), including maintaining evidence of judgments made
- Controls to ensure data integrity concerning information used in determining BESP
- Controls over data accumulation for added disclosure requirements and sensitivity analysis
- Controls over manual workarounds where systems are not yet in place to deal with the new accounting
- Controls surrounding pricing committee meetings - consider frequency, composition, documentation, and data gathering

Impact on information systems

- System modifications that may be needed to account for the change from the residual method to the relative selling price allocation method
- Data accumulation for added disclosure requirements and sensitivity analysis
- Cost accumulation systems for cost-plus BESP approaches
- Cash costs of transition and systems changes
- Manual patches and calculations versus automated system changes
- Internal controls over spreadsheet-based work-arounds

Impact on financial reporting

- Proposed adoption methodology
- Evaluation of standalone value for those deliverables not previously separated
- Cost accumulation to support cost plus pricing models
- Accounting policy and convention decisions around BESP
- Additional footnote and MD&A disclosure (significant inputs, assumptions and methods, judgment made in the qualification for separate unit of accounting, and effect of changes in selling price and methods on results)
- Incremental transition disclosure requirements
- Potential changes to customer contract terms

Appendix C: Transition and disclosure information

Information from early adopters of the new guidance has become available as companies begin implementing the guidance. Below is a brief summary of publicly available information. The excerpts and analysis are provided solely to increase the awareness and understanding of the types of disclosures that individual registrants have made in particular situations. As these disclosures are specific to the facts and circumstances of the individual company to which they relate, we do not provide these as the suggested solution for the required disclosure information nor do they represent the required level of disclosure for all companies. They have been included herein in order to provide some perspective to those companies that are evaluating the impact of this new guidance.

Information from early adopters has shown that approximately 90% of these companies have adopted the standards on a prospective basis, with the remaining 10% adopting on a retrospective basis. However, the population of early adopters does not incorporate those companies that have undertaken a lengthy adoption process and have not yet completed their analysis. As such, the results herein may include companies that had a relatively easy adoption due to an insignificant impact between the new and existing guidance based on their specific facts and circumstances.

In terms of how companies complied with the transition disclosure requirements, approximately 70% discussed only the qualitative effects of adoption (i.e., not expected to have a significant impact), while the remaining entities included the quantitative effects of the change. Depending on a company's specific facts and circumstances, the following are examples of approaches that may be used (individually or in combination) to quantify the effect of the change in accounting:

- Approach 1: 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 Issue 00-21. This approach was used by approximately 60% of early adopters.

- Approach 2: 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 were subject to the new measurement requirements of ASU 2009-13. This approach was used by approximately 5% of early adopters.

- Approach 3: The amount of revenue recognized in the reporting period and the amount of deferred revenue as of the end of the reporting period from applying Issue 00-21, and the amount of revenue recognized in the reporting period and the amount of deferred revenue as of the end of the period from applying the amendments to ASC 605-25. This approach was used by approximately 35% of early adopters.

For those companies that disclosed the quantitative impact of adoption, approximately 85% estimated the impact to be less than 5% of reported revenue.

This information is based on a population of a small number of companies that elected to early adopt the new guidance. The potential effect on a company's revenue will depend on an entity's specific facts and circumstances as well as the nature of transactions, historical accounting treatment, overall business model, and specific go-to-market strategy.

The SEC staff has also begun to review the disclosures associated with the early adoption of the new guidance. The following examples are from publicly available comment letters

received by registrants. Companies adopting the new guidance may want to consider the types of questions and perspectives offered by the SEC staff as part of their compliance efforts.

Example 1

We note that in the first quarter of fiscal 2010 you retrospectively adopted accounting standards related to revenue recognition for arrangements with multiple deliverables and arrangements that include software elements (i.e., ASC 605-25 and 985-605) and you determined the estimated selling price ("ESP") for unspecified upgrades and features for certain products to be $XX and $XX, respectively. Please provide us with further detail behind the considerations you disclosed in determining ESP and confirm it represents your best estimate of the price at which you would transact if the undelivered elements were sold regularly on a standalone basis. In this regard, please elaborate on the following: · what offerings you considered to be similar to unspecified upgrades and features provided for these products and their respective pricing; if you considered the pricing of similar products for these products; the nature of your historical pricing practices; how you determined the percentage of ESP in comparison to the total selling price of the product was representative of fair value; why ESP was established at one rate when multiple versions of the product exist; how you weighted all of the available information, and; any other quantitative or qualitative information that had a significant impact on ESP.

Example 2

We see your disclosure that you have elected to early adopt FASB ASC Update 2009-13 regarding multiple deliverables. Please revise your future filings to include a more detailed description of your multiple-deliverable arrangements, the significant deliverables within your arrangement, general timing of delivery or performance of such deliverables and the related revenue recognition, and the significant factors and estimates used to determine vendor specific objective evidence, third party evidence or estimated selling prices.

Example 3

Please tell us if you considered specifying in your disclosures what products you considered to be "similar offerings" in determining the estimated selling price of unspecified upgrades.

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