



# Issues In-Depth

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## Implementing the New EITF Consensuses on Multiple Element Revenue Arrangements

The FASB's Emerging Issues Task Force recently reached two Consensuses affecting revenue recognition. The first Consensus (EITF 08-1<sup>1</sup>) requires a vendor to allocate revenue to each unit of accounting in many arrangements involving multiple deliverables based on the relative selling price of each deliverable. It also changes the level of evidence of standalone selling price required to separate deliverables by allowing a vendor to make its best estimate of the standalone selling price of deliverables when more objective evidence of selling price is not available. The second Consensus (EITF 09-3<sup>2</sup>) excludes sales of tangible products that contain "essential" software elements from the scope of revenue recognition requirements for software arrangements. Because of these changes, revenue will be recognized earlier for many revenue transactions involving multiple deliverables and for sales of software-enabled devices.

The FASB ratified these Consensuses on September 23, 2009. Accounting Standards Updates (ASUs) 2009-13<sup>3</sup> and 2009-14<sup>4</sup> amend the *FASB Accounting Standards Codification*<sup>TM</sup> (ASC) for EITF 08-1 and EITF 09-3. This edition of *Issues In-Depth* analyzes the new standards and addresses many implementation issues that a vendor may encounter.

The *FASB Accounting Standards Codification*<sup>TM</sup> is now the exclusive authoritative reference for nongovernmental U.S. GAAP for use in financial statements issued for interim and annual periods ending after September 15, 2009. The following are the ASC references and pre-Codification standards related to the EITF Issues.

Consensus	Amends ASC	Pre-Codification Guidance
EITF 08-1 (ASU 2009-13)	Subtopic 605-25 <sup>5</sup>	EITF 00-21 <sup>6</sup>
EITF 09-3 (ASU 2009-14)	Subtopic 985-605 <sup>7</sup>	SOP 97-2 <sup>8</sup>

<sup>1</sup> EITF Issue No. 08-1, Revenue Arrangements with Multiple Deliverables, available at [www.fasb.org](http://www.fasb.org).

<sup>2</sup> EITF Issue No. 09-3, Certain Revenue Arrangements That Include Software Elements, available at [www.fasb.org](http://www.fasb.org).

<sup>3</sup> FASB Accounting Standards Update No. 2009-13, Revenue Recognition (Topic 605)-Multiple-Deliverable Revenue Arrangements, available at [www.fasb.org](http://www.fasb.org).

<sup>4</sup> FASB Accounting Standards Update No. 2009-14, Software (Topic 985)-Certain Revenue Arrangements That Include Software Elements, available at [www.fasb.org](http://www.fasb.org).

<sup>5</sup> FASB ASC Subtopic 605-25, Revenue Recognition – Multiple Element Arrangements, available at [asc.fasb.org](http://asc.fasb.org).

<sup>6</sup> EITF Issue No. 00-21, Revenue Arrangements with Multiple Deliverables, available at [www.fasb.org](http://www.fasb.org).

<sup>7</sup> FASB ASC Subtopic 985-605, Software – Revenue Recognition, available at [asc.fasb.org](http://asc.fasb.org).

<sup>8</sup> AICPA Statement of Position No. 97-2, Software Revenue Recognition, available at [www.fasb.org](http://www.fasb.org).

## EITF 08-1: Revenue Arrangements with Multiple Deliverables

EITF 08-1 changes the criteria required to separate deliverables into separate units of accounting when they are sold in a bundled arrangement. The changes amend the guidance in EITF 00-21. Entities were previously prohibited from separating multiple deliverables into individual units of accounting without vendor-specific objective evidence of fair value (VSOE) or other third-party evidence of fair value (TPE) for all *undelivered* items. Without this level of evidence, the delivered and undelivered items were treated as a single unit of accounting.

### Modification of the Separation Criteria

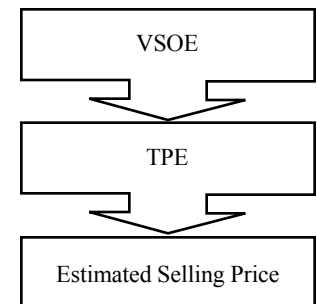
EITF 08-1 focuses on the criteria that must be met to separate deliverables in multiple element arrangements. It eliminates the requirement to have VSOE or TPE for undelivered items to separate elements in multiple element arrangements. However, it does not modify or eliminate the other separation criteria, which are:

- The delivered item or items have value to the customer on a standalone basis. They have value on a standalone basis if they are sold separately by any vendor or the customer could resell them on a standalone basis. In the context of a customer's ability to resell the delivered items, this criterion does not require the existence of an observable market for the deliverables.
- If the arrangement includes a general right to return relative to the delivered item, delivery or performance of the undelivered item or items is considered probable and substantially in the control of the vendor.

If either of these criteria is not met, the delivered and undelivered items would continue to be accounted for as a single unit of accounting. The elimination of the VSOE and TPE requirements to separate deliverables into separate units of accounting will put more focus on a vendor's assessment of whether delivered items in multiple element arrangements have standalone value.

EITF 08-1 replaced references to "fair value" with "selling price." The use of the term fair value was not consistent with its meaning under the guidance on fair value in Statement 157<sup>9</sup> (ASC Topic 820<sup>10</sup>), which defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Revenue is not allocated based on fair value under an exit price concept, but is allocated based on the customer's consideration and the standalone selling prices of deliverables.

The Consensus establishes a hierarchy of evidence to determine the standalone selling price of a deliverable based on VSOE, TPE, and estimated selling price. If VSOE



<sup>9</sup> FASB Statement No. 157, Fair Value Measurements, available at [www.fasb.org](http://www.fasb.org).

<sup>10</sup> FASB ASC Topic 820, Fair Value Measurements and Disclosures, available at [asc.fasb.org](http://asc.fasb.org).

is available, it would be used to determine the selling price of a deliverable. If VSOE is not available, a vendor would determine whether TPE is available. If so, TPE must be used to determine the selling price. If TPE is not available, then estimated selling price would be used.

EITF 08-1 does not change the definitions of VSOE<sup>11</sup> or TPE.<sup>12</sup> VSOE is generally the price that a vendor charges when it sells a product or service on a standalone basis. TPE is generally the price at which a competitor or third party sells the same or similar deliverable on a standalone basis. TPE may also include a vendor's standalone selling price for similar and largely interchangeable products or services but not the same product or service. Other TPE was commonly referred to as vendor-objective evidence (VOE). However, EITF 08-1 refers to this level of evidence as TPE, and that acronym will be used.

Many vendors have had difficulty obtaining VSOE or TPE of selling price for some deliverables because they were not sold on a standalone basis by vendors or their competitors. When this level of evidence was not available for all of the undelivered items in an arrangement, revenue deferral frequently was required. In practice, this has been the most common reason why vendors were unable to separate multiple deliverables into separate units of accounting. Some believed those requirements may unnecessarily delay revenue recognition for certain types of arrangements.

If a vendor determines that VSOE and TPE do not exist for one or more deliverables, the Consensus *requires* that an estimated selling price be used to allocate consideration to those deliverables when the standalone value and general return right separation criteria are met. There is no exception for practicability. Recognition of revenue for many multiple element arrangements will occur at an earlier point than it would under EITF 00-21.

Although the Consensus does not prescribe a single method to determine a vendor's best estimate of selling price, it states its objective and includes a few examples to illustrate an estimated selling price, which is defined as:

The price at which the vendor would transact if the deliverable were sold by the vendor regularly on a standalone basis. The vendor shall consider market conditions as well as entity-specific factors when estimating a selling price.<sup>13</sup>

### Scope

EITF 08-1 limits its scope to multiple element arrangements and does not apply to deliverables within the scope of SOP 97-2 or other authoritative literature that addresses both separation and allocation (e.g. SOP 81-1,<sup>14</sup> codified at ASC Subtopic 605-35<sup>15</sup>). However, EITF 09-3 modifies the scope of SOP 97-2 to exclude sales of tangible products. This will expand the population of arrangements that will use EITF 08-1's separation guidance to include certain software elements sold with tangible products. These elements, if undelivered, previously were required to have VSOE to account for them as separate units of accounting under SOP 97-2.

### Residual Method Eliminated

EITF 08-1 prohibits the use of the residual method of allocating arrangement consideration

<sup>11</sup> Defined in FASB ASC paragraph 605-25-25-6A.

<sup>12</sup> Defined in FASB ASC paragraph 605-25-30-6B.

<sup>13</sup> Defined in FASB ASC paragraph 605-25-30-6C.

<sup>14</sup> AICPA Statement of Position No. 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts, available at [www.fasb.org](http://www.fasb.org).

<sup>15</sup> FASB ASC Subtopic 605-35, Revenue Recognition – Construction-Type and Production-Type Contracts, available at [asc.fasb.org](http://asc.fasb.org).

to deliverables. Instead it requires the use of the relative selling price method. A vendor must determine a standalone selling price for *all* deliverables that meet the separation criteria. EITF 00-21 previously required a vendor to use the residual method of allocation when VSOE or TPE was available for all undelivered items, but was not available for all delivered items. Under the residual method, the amount of consideration allocated to a delivered item equaled the total arrangement consideration less the sum of the selling prices, based on VSOE or TPE, for the undelivered elements. Under the residual method, any discount embedded in the arrangement was allocated entirely to the delivered elements. However, under the relative selling price method, a discount embedded in the arrangement is allocated proportionately to each element of the arrangement based on the relative standalone selling prices of each element.

#### **Example A: Accounting under EITF 08-1 Compared with EITF 00-21**

A vendor designs and sells manufacturing equipment and installation services. The arrangement consideration for the bundled sale of the equipment and the installation services is \$250,000, payable on delivery. No other vendors sell the same or similar equipment on a standalone basis. The equipment has standalone value to customers because they could resell it to a third party, and the arrangement includes no general return rights. The vendor has never sold this type of equipment without installation services. However, the vendor and its competitors provide and sell installation services on a standalone basis for other types of equipment that are determined to be similar. These installation services are performed by the same labor pool that performs the installation services for the equipment that is not sold on a standalone basis. The vendor establishes that either VSOE or TPE for the installation services is \$50,000 for this arrangement. There is no VSOE or TPE for the equipment, but management's best estimate of its selling price is \$230,000.

If no other contingencies exist and all revenue recognition criteria for the equipment are met on delivery of the equipment, how much revenue would be recognized?

#### **Accounting under EITF 00-21**

The vendor has VSOE or TPE for the undelivered element (installation services) and therefore is able to separate the equipment and the installation services into separate units of accounting. The vendor applies the residual method to allocate \$200,000 of the arrangement consideration to the equipment because the delivered item (the equipment) does not have VSOE or TPE.

	<b>Residual Method Allocation</b>
Arrangement consideration	\$ 250,000
Less: Installation services – VSOE or TPE	50,000
Residual to manufacturing equipment	<u>\$ 200,000</u>

Therefore, the amount of revenue recognized at delivery under EITF 00-21 would be \$200,000.

If the vendor had not been able to establish VSOE or TPE for the installation services, the equipment could not be separated from the installation services and they would be treated as a single unit of accounting.

### Accounting under EITF 08-1

The vendor is required to estimate a selling price for the equipment in the absence of VSOE or TPE and cannot use the residual method of allocation. The vendor determines that the estimated selling price for the equipment is \$230,000. The sum of the standalone selling prices would be \$280,000 (\$230,000 for the equipment and \$50,000 for the installation services). Therefore, the arrangement fee of \$250,000 is allocated to the deliverables as:

	Selling Price	Ratio	Relative Selling Price Allocation
Manufacturing equipment	\$ 230,000	82.14%	\$ 205,350
Installation services – VSOE or TPE	50,000	17.86%	44,650
	<u>\$ 280,000</u>	<u>100.00%</u>	<u>\$ 250,000</u>

The arrangement consideration of \$250,000 is allocated to the deliverables based on their relative standalone selling prices, which results in revenue of \$205,350 being recognized on delivery of the equipment.

### Disclosure

EITF 08-1 includes expanded disclosure requirements for arrangements within its scope.

The objective of the disclosure guidance...is to provide both qualitative and quantitative information about a vendor's revenue arrangements and about the significant judgments made about the application of [EITF 08-1] and changes in those judgments or in its application that may significantly affect the timing or amount of revenue recognition.

The disclosures should be aggregated by similar types of arrangements and include the nature of the arrangements, the significant deliverables included in those arrangements, the general timing of delivery or performance, and any performance, cancellation, termination, or refund provisions. A vendor must disclose the significant judgments, inputs, methodologies, and assumptions used in the evaluation of arrangements and significant factors and estimates used to determine selling price, including whether the selling price is based on VSOE, TPE, or an estimated selling price. The effect of changes in either the selling price or the method or assumptions used to estimate the selling price for a specific unit of accounting should be disclosed if any of those changes has a significant effect on the allocation of arrangement consideration. Any other quantitative or qualitative information needed to meet the overall disclosure objective must also be disclosed.

In the year of adoption, a vendor must also make certain transition disclosures so users have the necessary information to understand the effect of adoption. The vendor should provide a qualitative description about how EITF 08-1 was adopted and how it changes the way revenue is recognized for its arrangements. At a minimum, the following qualitative information must be disclosed:

- A description of any change in the units of accounting;
- A description of the change in how a vendor allocates the arrangement consideration to various units of accounting;

- A description of the changes in the pattern of revenue recognition; and
- Whether the adoption is expected to have a material effect on periods subsequent to the period of adoption.

These qualitative disclosures must be supplemented with quantitative disclosures if the effect of adoption is material. Preparers have discretion to determine the quantitative disclosures that would achieve the overall disclosure objective. Three possible quantitative disclosure examples are provided.<sup>16</sup>

- 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 EITF 00-21.
- The amount of revenue that would have been recognized in the year before the year of adoption if the arrangements accounted for under EITF 00-21 were subject to the measurement requirements of EITF 08-1.
- For arrangements that precede the adoption of EITF 08-1, the amount of revenue recognized in the reporting period and the amount of the deferred revenue as of the end of the period from applying the guidance in EITF 00-21. For arrangements that were entered into or materially modified after the effective date of EITF 08-1, the amount of revenue recognized in the reporting period and the amount of deferred revenue as of the end of the period from applying EITF 08-1.

### Effective Date and Transition

EITF 08-1 can be applied on a prospective basis or in certain circumstances on a retrospective basis. If prospective adoption is elected, it is to be applied to arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010.

Earlier adoption is permitted. If an entity elects early adoption on a prospective basis, and the period of adoption is not the beginning of the reporting entity's fiscal year, the requirements are applied retrospectively to the beginning of the fiscal year. Entities that early adopt at an interim period with retrospective application to the beginning of the year would be required to disclose, at a minimum, the changes from the retrospective application on revenue, income before income taxes, net income, earnings per share, and the effects of the change for the appropriate captions presented in those previously reported interim periods.

To illustrate this transition method, assume a calendar-year-end entity would like to early adopt in 2010 but cannot in its first quarterly reporting period because of the time needed to develop estimated selling prices and implement the necessary controls and processes. As of June 30, 2010, the entity has completed these tasks. In its June 30 financial statements, the statement of operations for the six-months ended June 30 would reflect six months of revenue under EITF 08-1 for any new or materially modified arrangements entered into or modified on or after January 1, 2010. The statement of operations for the three months ended June 30 would reflect revenue for the second quarter under EITF 08-1 for those same arrangements. Because the entity did not adopt EITF 08-1 in the first quarterly reporting period, the entity

<sup>16</sup> FASB ASC paragraph 605-25-65-1(d).

would retrospectively apply the new requirements for the first quarter of 2010. A public entity would not be required to file amendments to previously filed Form 10-Qs. Disclosures should include, at a minimum, changes to revenue, income before income taxes, net income, EPS, and the effect of the change for the appropriate captions presented in the first quarterly reporting period.

EITF 08-1 permits entities to adopt its requirements through retrospective application subject to the guidance in Statement 154<sup>17</sup> (ASC Topic 250<sup>18</sup>). Retrospective application may require significant estimates of amounts, and in some cases it may be impracticable to objectively distinguish information about those estimates that:

- Provide evidence of circumstances that existed on the dates at which those amounts would be recognized, measured, or disclosed under retrospective application; and
- Would have been available when the financial statements for that prior period were issued.

An entity that concludes it is not impracticable to determine estimated selling prices for deliverables in prior periods can elect for full retrospective application as of the earliest period presented. The transition would not be limited to new or materially modified arrangements, and the transition disclosures of Statement 154 would be required.

As noted in Statement 154 (ASC paragraph 250-10-45-6), if it is impracticable to determine the retrospective application to all prior periods presented, the cumulative effect of the change should be reflected as of the beginning of the earliest period to which the new principle can be applied.

### **Summary of Changes to Separation of Multiple Element Arrangements**

In summary, EITF 08-1 makes four key changes to current practice:

- Requires estimates of a selling price for all deliverables that meet the remaining separation criteria when VSOE and TPE do not exist;
- Eliminates the residual method of allocation;
- Requires allocation of total arrangement consideration to individual elements based on the relative selling price method; and
- Expands disclosure requirements.

<sup>17</sup> FASB Statement No. 154, Accounting Changes and Error Corrections, available at [www.fasb.org](http://www.fasb.org).

<sup>18</sup> FASB ASC Topic 250, Accounting Changes and Error Corrections, available at [asc.fasb.org](http://asc.fasb.org).

## EITF 09-3: Certain Revenue Arrangements That Contain Software Elements

During the EITF 08-1 deliberations, some vendors that sell software-enabled devices (e.g. “smart” phones or networking equipment) whose transactions were within the scope of SOP 97-2 asked the Task Force to consider expanding the scope of EITF 08-1 to include those transactions.

SOP 97-2 included within its scope arrangements to sell hardware deliverables when those deliverables included a software element that was more than incidental to the hardware component. As a result, many software-enabled devices were accounted for under SOP 97-2, which requires VSOE for all undelivered elements for separation of deliverables.

Because of SOP 97-2’s VSOE requirement, revenue often was deferred for related tangible products because VSOE did not exist for all the undelivered items in the arrangement. For example, a smart phone vendor may never sell the phone and the customer support separately. Therefore, VSOE does not exist. Without VSOE for the ongoing customer support, the device and customer support could not be separated into different units of accounting, and the related revenue would be recognized as a single unit of accounting under SOP 97-2.

Because of those requirements, a vendor that sells hardware products with software elements that are more than incidental to the hardware was often required to defer revenue and recognize it on a straight-line basis over the time that the vendor provided support and upgrades for the software elements.

EITF 09-3 was added to the EITF’s agenda to address those concerns. The Task Force considered two approaches to address the issue. One considered whether the scope of SOP 97-2 should be re-evaluated to determine whether software-enabled devices should be scoped out of its guidance and, therefore, not subject to the VSOE threshold. The second approach would have reconsidered whether VSOE should be the required threshold for separation under SOP 97-2 or whether a consistent measurement threshold more aligned with the use of estimated selling prices in EITF 08-1 would be appropriate for software arrangements within the scope of SOP 97-2.

The Task Force concluded that it would reconsider the scope of SOP 97-2 because many financial statement users believed that its requirements should not be changed for software sales that do not involve hardware. That broader issue will be addressed as part of the FASB’s joint project with the IASB on revenue recognition.

### Scoping Principle

EITF 09-3 provides the following scoping principle:

Tangible products containing software components and non-software components that function together to deliver the tangible product’s essential functionality are excluded from the scope of SOP 97-2.

The scoping principle raises several questions, for example:

- When multiple software elements accompany a hardware product, how do you determine which software elements provide essential functionality? For example, a laptop computer has an operating system that allows it to operate and provides essential functionality to the hardware. Is other software, such as word processing software, also essential to the functionality of that laptop computer?
- What guidance should be applied to undelivered software-related elements such as post-contract customer support (PCS) or specified upgrade rights that are related to the software that is essential to the hardware's functionality? Would those deliverables follow the primary product to which they relate and potentially be excluded from SOP 97-2, or should they be considered software deliverables and accounted for within its scope?

To address these issues, the Task Force decided that a rebuttable presumption exists that software elements are essential to the functionality of the tangible product if sales of the tangible product without the software elements are infrequent. For example, it may be concluded that the word processing software does not contribute to the essential functionality of the laptop computer if the laptop computer is sold without the word processing software more than infrequently. A vendor should consider the following situations when assessing whether the software and non-software elements function together to deliver a product's essential functionality.

- Products with similar functionality (e.g., different models) may need to be considered the same product to determine whether the sales of the tangible product without the software elements are infrequent. If the only substantive difference between the two products is that one product includes software that the other product does not, the products should be considered the same when assessing whether the software components and non-software components function together to deliver a product's essential functionality.
- The fact that a software element included with the hardware product is also sold separately does not affect the assessment of whether the software and non-software elements function together to deliver a product's essential functionality. However, the assessment is affected by how often the hardware is sold without the software element. There could be instances in which a software element included with the hardware would be excluded from the scope of SOP 97-2 when it is sold with the hardware but would be accounted for within its scope when it is sold on a standalone basis.
- Software elements do not have to be embedded on a device to be considered essential to the functionality of the device. Therefore, non-embedded software elements could be excluded from the scope of SOP 97-2 in some instances. However, other factors such as how frequently the hardware is sold without the software elements would have to be considered when assessing whether the software elements and non-software elements function together to deliver a product's essential functionality.

The hardware elements should substantively contribute to the tangible product's essential functionality to conclude that the essential software is outside the scope of SOP 97-2. The hardware elements cannot simply be a delivery mechanism for the software. Using a hardware medium to deliver software products does not exclude the software from the scope of SOP 97-2. For example, a software vendor could not avoid the scope of SOP 97-2 by delivering its software products to customers on "read-only" storage devices.

EITF 09-3 also states that, if there are undelivered elements such as PCS or upgrade rights included in the arrangement that are related to the essential software that is excluded from the scope of SOP 97-2, those deliverables would attach to that essential software and also would be excluded from its scope. However, if those undelivered elements are related to both the essential software (or its related hardware) *and* non-essential software, those undelivered elements would be bifurcated into components that are excluded from and those that are included within the scope of SOP 97-2.

ASC paragraphs 985-605-55-211 through 55-236 include a number of cases illustrating the application of the principles of EITF 09-3 on the scope of SOP 97-2.

Note: ASU 2009-14 refers to deliverables within the scope of SOP 97-2 as *software deliverables* and to deliverables that are outside the scope of SOP 97-2 as *non-software deliverables*. This *Issues In-Depth* uses that convention.

In addition, this *Issues In-Depth* refers to software and non-software *elements* based on the nature of the deliverable rather than based on the applicable accounting literature. For example, operating system software that is “essential” software is referred to as a software *element* but a non-software *deliverable*.

When an arrangement includes software and non-software deliverables, its consideration should be allocated to the software deliverables as a group and to the non-software deliverables using the relative selling price method. Once the deliverables have been separated, EITF 08-1 applies to the non-software deliverables for the purposes of determining the number of units of accounting and allocating arrangement consideration to each unit. SOP 97-2 applies to the software deliverables for purposes of determining the number of units of accounting and allocating arrangement consideration to each unit.

Examples E1 and E2 in this *Issues In-Depth* illustrate how arrangement consideration would be allocated when an arrangement contains software and non-software deliverables and undelivered elements related to both the software and non-software deliverables.

### Disclosure and Transition

A vendor that adopts EITF 09-3 and has non-software deliverables in multiple element arrangements is required to provide the same disclosures required by EITF 08-1, including transition disclosures of qualitative and quantitative information to enable users of financial statements to understand the effect of the change in accounting principle. The transition and effective date of EITF 09-3 is consistent with EITF 08-1, which is on a prospective basis for new or materially modified arrangements in fiscal years beginning on or after June 15, 2010. Earlier application is permitted and subject to the same requirements as EITF 08-1. Retrospective application is permitted, but is not required, and is subject to the same practicality requirements as EITF 08-1.

## Questions and Answers and Examples about Applying EITF 08-1 and EITF 09-3

The questions and answers in this section of *Issues In-Depth* build on and explore the explanatory material just presented. The purpose is to focus more directly on significant issues entities may face in applying the new requirements and provide KPMG's perspective on those issues. See the Index for a complete listing of Questions and Answers (Q&A) and Examples.

### Estimating a Standalone Selling Price

#### **Question 1.1: How does a vendor estimate a standalone selling price for deliverables that meet the separation criteria when VSOE and TPE do not exist?**

**Answer 1.1:** EITF 08-1 requires a vendor to estimate a standalone selling price for deliverables in the absence of VSOE or TPE if they meet the separation criteria, even if it has never sold the deliverables on a standalone basis and has no intention to do so. An estimated selling price should reflect a vendor's *best* estimate of a deliverable's standalone selling price, which is the price at which a vendor would sell the deliverable if it were sold regularly on a standalone basis. EITF 08-1 (ASC paragraphs 605-25-30-2 and 30-6C) states that a vendor should consider market conditions as well as entity-specific factors when estimating the selling price of a deliverable.

EITF 08-1 does not prescribe a method for estimating a selling price when VSOE or TPE is not available, but its examples illustrate how a vendor might consider available evidence when estimating a selling price for a deliverable. While methodologies will likely develop over time, a vendor should consider its own particular facts and circumstances based on the nature of the deliverables and the markets where they are sold. We believe a vendor should consider all reasonably available evidence when establishing the estimated selling price. Maximizing the use of observable data may lend support to a vendor's assertion that it has arrived at its best estimate of the selling price.

Many vendors may already have robust processes for developing selling prices that consider available data points and the effects of market conditions and entity-specific factors that will be useful as they implement EITF 08-1. Others may need to develop new processes for estimating selling prices for products and services for which VSOE and TPE do not exist. The following framework may be a useful tool for estimating and documenting standalone selling prices:

- Step 1: Gather all reasonably available data points;
- Step 2: Consider adjustments based on:
  - Market conditions (e.g., demand, competition, trends, and constraints); and
  - Entity-specific factors (e.g., pricing strategies and practices, market share, and position);
- Step 3: Consider the need to stratify selling prices into meaningful groups based on customer type, deal size or customer volume, geography, distribution channel, or other relevant groups;
- Step 4: Weight available information and make best estimate; and
- Step 5: Establish processes for ongoing monitoring and evaluation.

Each of these steps is described below. The intent is to be illustrative, but not exhaustive. A vendor should always consider the available data points specific to its business and industry.

**Gather All Reasonably Available Data Points.** Various data points may be used to determine an estimated standalone selling price. The weight given to each data point will vary depending on facts and circumstances. A vendor should consider whether data points should be adjusted based on market and entity-specific factors as indicated by EITF 08-1 (ASC paragraph 605-25-30-6C). Some data points to consider include:

- **Costs incurred to manufacture or provide the deliverable.** The cost of a deliverable may be an important consideration in determining the price at which a vendor would sell the deliverable on a standalone basis. Absent market constraints, a vendor normally would be expected to price the deliverable to recover the direct and incremental costs it incurs to manufacture or provide the deliverable to the customer plus a contribution to its fixed costs, overhead, and profit. Costs would not necessarily be limited to fulfillment costs and could include other costs that a vendor expects to recover (e.g., research and development costs and selling costs). The costs included in a cost-plus margin approach should be considered when determining a reasonable margin. Q&A 1.2 provides guidance when using cost-plus a reasonable margin as a data point to determine an estimated selling price. Q&A 1.4 addresses the estimation of selling prices when fulfillment costs are not significant.
- **Profit margins.** If a vendor determines that cost-plus a reasonable margin provides a relevant data point for estimating selling price, the vendor should determine the profit margin from a standalone sale of a deliverable that it would expect to receive. The determination of a reasonable margin requires judgment and consideration of how market and entity-specific factors affect the expected profit for a deliverable. Q&A 1.3 highlights some challenges that a vendor could encounter and additional considerations when determining a reasonable profit margin for an estimated selling price.
- **Limited standalone sales.** A vendor may have a limited history of sales of a deliverable on a standalone basis. These sales may not be sufficient to represent VSOE, but could provide a useful data point to evaluate when estimating a selling price. See Q&A 1.9 for additional considerations when evaluating limited standalone sales.
- **Variable standalone sales.** A vendor may have a history of selling a deliverable on a standalone basis, but the dispersion of prices at which the deliverable is sold is so wide that VSOE cannot be established. These sales prices may provide relevant data points to consider when estimating a selling price. Q&A 1.10 discusses how a vendor could use this information to determine an estimated selling price.
- **Contractually stated prices.** Separately stated contract prices for a deliverable in a bundled arrangement should not be presumed to be representative of an estimated selling price for that deliverable. However, contractually stated prices may, in some cases, be useful in the analysis. Q&A 1.12 discusses how contractually stated prices may be considered in the evaluation.
- **Published price list.** Similar to contractually stated prices, a published price list alone may not be indicative of an estimated selling price. However, a published price list could be a relevant data point in determining an estimated selling price in certain circumstances. Q&A 1.13 discusses how price lists may be useful in determining an estimated selling price.

- **Third-party or industry pricing data.** Third-parties and industry trade groups may publish pricing data for products and services. This external pricing data may provide relevant data points when estimating a selling price for products and services. Careful consideration of how market conditions and entity-specific factors may affect a vendor's selling price likely will be necessary when using such external data.
- **Pricing practices of a vendor when setting prices for deliverables that are sold on a standalone basis.** A vendor may have established processes, through a pricing committee or otherwise, for establishing selling prices for certain products and services that are sold on a standalone basis. Consideration of how standalone selling prices are determined for products and services similar to those that are not sold on a standalone basis may provide relevant and useful data points for estimating a selling price. In fact, leveraging these existing processes may be a cost-efficient approach to developing estimated selling prices.

**Consider Market Conditions.** Market conditions may affect the price at which a vendor could transact if the deliverable were sold by the vendor regularly on a standalone basis. Conditions could vary for different markets. Market conditions that a vendor may need to consider include:

- **Market demand and competition.** The market demand for the deliverable and the competitive environment may affect the sales price for products or services. It may be appropriate to consider market factors for a specific geographic market. If differences exist, that could affect the price customers would pay for the product or service.
- **Market constraints.** There are other factors within the market for products or services that could constrain the amount a vendor could charge a customer for the deliverable. For example:
  - A vendor provides outsourcing services to a customer and has determined an estimated selling price for those services to be \$100 per hour. Based on the expected hours under the arrangement, the customer could perform the services internally for \$90 per hour. The fact that the customer could perform the same services at a lower cost likely would affect the amount the vendor would expect to charge if it were to sell it separately. The estimated selling price should be revised to reflect what the market would pay, which could vary by class and type of customer.
- **Market perception and awareness of product or service.** The price a market will be willing to pay for products or services will depend on the market's perceived value and awareness of those products or services.
- **Market trends.** A market may have changes in the level of interest in products or services over time, and as a result, the market may be willing to pay more or less for those products or services. It may be necessary for a vendor to consider market trends when establishing estimated selling prices. If a vendor expects a market trend to affect the level of interest in its products or services, those expectations may affect how often it re-evaluates its estimated selling prices.

**Consider Entity-Specific Factors.** The best estimate of selling price should be the price at which a *vendor* would transact if the deliverables were sold regularly on a standalone basis. Therefore, factors specific to a vendor should be evaluated to determine the best estimate of

selling price. These include:

- **Pricing strategies and objectives of a vendor.** An estimated selling price is not based solely on what the market would bear but also on how a specific vendor would price its products or services in that particular market. It will be important to understand the specific pricing strategies and objectives to determine the best estimate of the price at which a vendor would be willing to sell standalone products or services. For example, if a vendor has a strategy to be the lowest price in the market, that factor would be relevant in estimating the selling price. In that case the estimated selling price may be less than the market might otherwise be willing to pay.
- **Market share and position.** A vendor's market share and market position could affect the price at which it either could sell or would be willing to sell its products or services. For example, a vendor likely would have lower pricing than competitors when initially entering a market or attempting to increase market share. Similarly, higher pricing might be expected if a vendor offers "best in class" products or services or has a dominant market share.
- **Pricing practices used to price the overall bundled arrangement.** A vendor should consider the pricing practices for the overall bundled arrangement in making its best estimate of the selling price for each deliverable. These considerations could include many of the factors already mentioned and may provide a useful roadmap in determining what the standalone deliverable would be sold for by a vendor in that market to those classes or types of customers. For example, it may be useful for a vendor to consider its pricing practices when selling a bundled arrangement if a customer is presented with the alternative to select various products and services within the bundle.

**Consider Stratifying Selling Prices into Meaningful Groups.** When evaluating data points, a vendor may consider stratifying sales transactions into meaningful groups based on type of customer, volume of sales to customer (e.g., arrangements over a certain dollar amount), geography, distribution channel, or other relevant groupings. A standalone selling price may vary depending on the class and type of customer or the particular market to which the deliverable is being sold.

**Weight Available Evidence and Make Best Estimate.** The weighting of the various data points obtained from the observable evidence of selling price and the evaluation of market conditions and entity-specific factors will be based on a vendor's specific facts and circumstances. Some vendors may determine that one particular data point as adjusted for market and entity-specific factors, when benchmarked with the other available data points, represents their best estimate of selling price. Others may believe it is necessary to weight the evidence obtained from two or more adjusted data points to establish their best estimate of selling price. A process that maximizes the use of observable data in this analysis may best lend support that a vendor has made its best estimate of selling price.

**Establish Processes for Ongoing Monitoring and Evaluation.** An estimated selling price should reflect the price at which a vendor would transact if the deliverable were sold regularly on a standalone basis given the market conditions and entity-specific factors at the inception

of the arrangement. Once revenue has been allocated in an arrangement, the standalone selling prices, whether based on VSOE, TPE, or estimated selling price, should not be updated or revised for changes in market conditions or other facts in accounting for that arrangement unless there was an error in the standalone selling price used to allocate revenue initially at the inception of the arrangement.

Estimated selling prices likely will change over time based on changes in market conditions and entity-specific factors. Although estimated selling prices for previously allocated arrangements are not revised, new arrangements should reflect the updated estimated selling prices. Therefore, it likely will be important for a vendor to establish processes for ongoing monitoring and evaluation of estimated selling prices. The extent of the monitoring process and the frequency of necessary changes to estimated selling prices will vary based on the nature of deliverables, the markets in which they are being sold, and various entity-specific factors.

A new product offering or sales in a new geographical market may require more frequent updates to the estimated selling price as market awareness and demand may change more rapidly, which may affect the price at which a vendor would sell that product. The rate of product obsolescence or the life cycle of a product can affect the frequency of evaluation. For example, a product offering that is expected to be replaced or that will compete with new product offerings that have enhanced functionality could experience more frequent changes to its estimated selling price. Estimated selling prices may require adjustment based on seasonality and the time at which the sale occurs. The frequency of these changes to pricing practices will determine the degree to which re-evaluation is required. A vendor will need to monitor reasonably available data points to determine if changes occur that could affect the evaluation of estimated selling price. A change in the cost of a deliverable may affect the price at which a vendor would be willing to transact.

It also may be necessary for a vendor to establish processes to monitor the level of selling price evidence available for deliverables (i.e., VSOE, TPE, or estimated selling price).

EITF 08-1 requires VSOE to be used if reasonably available without undue cost and effort. If VSOE is not available, a vendor would determine whether TPE is available. If so, TPE must be used to determine the selling price. If TPE is not available, then estimated selling price would be used. If a vendor makes a business decision to begin selling deliverables on a standalone basis or if the pattern of sales changes (e.g., more frequent sales or less variable sales prices) so that VSOE can be established, that level of evidence must be used and the vendor should no longer use an estimated selling price to allocate arrangement consideration to those deliverables. This is also the case for TPE because this level of evidence is required, if available, when VSOE is not.

**Question 1.2: May a vendor use cost-plus a reasonable margin when estimating a selling price?**

**Answer 1.2:** Yes. A cost-plus margin approach may provide a relevant data point when

estimating the standalone selling price, particularly if there are no other observable data points or if a cost-plus margin approach is how a vendor routinely budgets and establishes selling prices for deliverables. A vendor would determine the costs it incurs to manufacture a product or provide a service and then add a reasonable profit margin it would expect to receive in a standalone sale to determine the estimate of a standalone selling price. Costs would not necessarily be limited to fulfillment costs and could include other costs that a vendor expects to recover (e.g. research and development costs and selling costs). The types of costs included in a cost-plus margin approach should be considered when determining a reasonable margin. For example, a margin applied to only fulfillment costs would likely be greater than a margin applied to fulfillment and selling costs. When determining what costs to include, a vendor should consider its existing pricing practices. Determining a reasonable margin in a cost-plus approach will require judgment, particularly when historical profit data has not been tracked on a disaggregated product or product grouping basis. Q&A 1.3 provides some additional guidance on determining a reasonable profit margin.

A vendor that uses a cost-plus margin as a data point to determine an estimated selling price should also consider market conditions and other entity-specific factors as discussed in Q&A 1.1 to demonstrate that a selling price represents the vendor's best estimate. Examples 6 and 11<sup>19</sup> of EITF 08-1 (ASC Section 605-25-55) illustrate the use of a cost-plus approach supplemented by an assessment of other market factors to arrive at an estimated selling price.

**Question 1.3: How does a vendor determine what margin to use when developing a cost-plus margin data point to be used in estimating a standalone selling price?**

**Answer 1.3:** Determining the margin to use requires the exercise of significant judgment, particularly when historical profit data has not been tracked on a disaggregated product or product grouping basis. That may be the case if a vendor could not separate deliverables under EITF 00-21 and revenue related to delivered items was deferred for long periods of time, recognized on a straight-line basis over extended periods, or recognized immediately but determined using the residual method. The determination of a reasonable margin to use in developing a cost-plus margin selling price data point will involve many of the considerations described in Q&A 1.1. It may be necessary for a vendor to gather reasonably available margin data points and make adjustments for market conditions and entity-specific factors to arrive at the best estimate of a reasonable profit margin. It may also be necessary to establish separate margins based on different geographical markets, customer classes, or other meaningful groups. Consideration of the following factors may be appropriate when making this estimate:

- Average profit margins within a vendor's product or service lines could provide evidence of the margin it could expect to attain if the product or service were sold separately. Adapting this margin to the specific product or service within the group will likely be necessary, particularly if there are specific deliverables in the product or service family that have characteristics that would be expected to have different margins.
- The nature of the product or service should be considered to determine whether it would warrant a premium or a discount on that average margin. For example, some items might be sold in high volumes or might not have significant value-added attributes, even though the vendor considers them all to be in the same product group.

<sup>19</sup> FASB ASC paragraphs 605-25-55-37 through 55-47 and ASC paragraphs 605-25-55-75 through 55-85, respectively.

- A competitor's profit margins realized for similar products or service lines may provide relevant data points.
  - It may be necessary to consider the competitive position of a vendor's products or services relative to competitors' products or services to determine a margin that the market would be willing to pay. For example, best-in-class products or services or those with enhanced functionality or a dominant market share likely would have higher margins than a competitor's margins. Similarly, if a competitor has products or services with enhanced functionality, or benefits from being best in class, a vendor may not expect to be able to attain a similar margin in the same market.
  - It may be necessary to consider a competitor's cost structure to determine whether its margin requires adjustment relative to the vendor's expected margin.
- Third-parties and industry trade groups may publish average profit margin data for products and services in a particular industry. This external pricing data may provide a relevant data point when determining a reasonable margin for certain products and services. A vendor should consider the effect of market conditions and entity-specific factors on a vendor's estimated margin when using such external data.
- A vendor may have established processes, through a pricing committee or otherwise, for establishing reasonable margins for certain products and services that are sold on a standalone basis. How margins are determined for products and services similar to those that are not sold on a standalone basis may provide a relevant and useful data point for determining a reasonable margin.

No one data point may be indicative of a margin that should be used in a cost-plus margin assessment, and the weight given to each data point in determining a vendor's best estimate will vary depending on facts and circumstances. Vendors are likely to have to apply significant judgment to weight the evidence when determining a best estimate of the margin for a standalone sale of a product or service.

**Question 1.4: Are there additional considerations to be made when estimating a selling price if a deliverable's costs are insignificant, primarily research and development, or highly unpredictable?**

**Answer 1.4:** Maybe. If costs are not a significant component of a deliverable, are primarily research and development, or are highly unpredictable, a vendor may need to place greater emphasis on other data points and market assessment approaches to estimate a selling price. For example, specified upgrade rights for software or other intellectual property (IP) deliverables, such as a license for proprietary drugs, may involve mainly research and development costs that are so difficult to forecast that using a cost-plus a reasonable margin approach may not provide a relevant data point. A vendor may place more emphasis in determining an estimated selling price on what customers in the market would be willing to pay for the deliverable if it were sold separately. For example, a vendor might consider how others in the market have priced deliverables with similar characteristics (e.g., a customer may have been willing to pay a certain percentage of the stated price of a similar license to obtain the right to an upgrade). Determining whether a deliverable has similar characteristics will require the use of judgment.

However, in other cases, a vendor may determine that it can reasonably estimate the amount of research and development costs it will incur to develop an IP deliverable, which would allow the vendor to use a cost-plus data point to estimate the selling price. The research and development costs may be incurred not to develop a deliverable specific to a particular arrangement, but rather to enhance existing IP product offerings to future customers as well as provide upgrades and enhancements to existing customers. In this situation, the research and development cost pool may need to be allocated between existing customer arrangements with the right to an upgrade and future sales arrangements that will benefit from the results of the research and development costs incurred. Other market conditions and entity-specific factors may affect an estimated selling price as described in Q&A 1.1.

**Question 1.5: What efforts must be taken to obtain VSOE or TPE before using an estimated selling price?**

**Answer 1.5:** EITF 08-1 (ASC paragraph 605-25-30-2) requires the selling price for each deliverable to be determined using VSOE if it exists. If not, but TPE exists, TPE must be used to determine the selling price.

EITF 08-1 indicates that a vendor should not ignore information that is reasonably available without undue cost or effort when determining whether VSOE or TPE exists. We believe a presumption exists that a vendor who has standalone sales of a deliverable and currently expends the effort to demonstrate that VSOE exists will be able to continue to perform an analysis of those sales to determine whether VSOE exists without additional undue cost or effort. If there is variability in the selling prices such that VSOE does not exist for the total population of a vendor's sales of a particular deliverable, it may be necessary to consider whether VSOE exists on a stratified basis (e.g., customer, class, geography, etc.). VSOE is the best evidence of selling price, and, if it exists on a stratified basis, we believe that a vendor generally should determine VSOE on that basis.

If a vendor had VSOE for the selling price of a deliverable under EITF 00-21 or SOP 97-2, we believe a presumption exists that VSOE would continue to be used to support the selling price for that deliverable after the adoption of EITF 08-1 unless the vendor subsequently changed its pricing practices and, therefore, VSOE no longer exists. Refer to Q&A 1.10 for additional discussion of analyses that may be appropriate if pricing practices change.

If VSOE does not exist for a particular deliverable, reasonable efforts should be used to determine whether TPE exists before defaulting to estimated selling prices. These efforts would include analyzing information that is reasonably available without undue cost or effort about a vendor's own similar products or competitors' sales to determine if there are standalone sales of deliverables that are largely interchangeable with its products or services.

**Question 1.6: If a vendor does not have a history of selling certain deliverables on a standalone basis, TPE does not exist for those deliverables, and the vendor determines that estimating a selling price for a deliverable would be difficult, may the deliverables be combined into one unit of accounting if they otherwise meet the criteria for separation?**

**Answer 1.6:** No. The separation criteria are not elective. All deliverables that meet the separation

criteria of EITF 08-1 (ASC paragraph 605-25-25-5) must be separated. Separation is *required* if: (1) the delivered items have standalone value and (2) the delivery or performance of the undelivered items is probable and substantially within the control of a vendor if the delivered items have general return rights. If VSOE and TPE do not exist for a deliverable, an estimate of the selling price for that deliverable *must* be made. Difficulty in estimating a selling price is not a basis for failing to separate and allocate revenue to deliverables. The Task Force specifically considered, but declined to provide, a practicability exception for estimating a selling price.

**Question 1.7: If VSOE and TPE do not exist for a delivered item, is it acceptable to use the residual method as a proxy for the estimated selling price of the delivered item?**

**Answer 1.7:** No. EITF 08-1 does not permit the use of the residual method of allocation and instead requires the use of the relative selling price method in all instances. Under the residual method, the amount of consideration allocated to a delivered item equals the total arrangement consideration less the sum of the standalone selling prices for the undelivered elements. Given the requirement to determine a standalone selling price for all deliverables that represent separate units of accounting (whether based on VSOE, TPE, or estimated selling price), using the difference between the arrangement consideration and the undelivered elements' estimated selling price would not be an appropriate proxy for the estimated selling price of the delivered item. Although the residual method of allocation is prohibited, from a practical standpoint, the amount that would be allocated using a residual method approach may be one of the data points identified in developing an estimated selling price under a relative selling price allocation approach.

**Question 1.8: Is the best estimate of selling price required to be a point estimate, or is it acceptable to use a range of prices for estimated selling prices similar to VSOE?**

**Answer 1.8:** EITF 08-1 does not specify whether a vendor should determine a point estimate as its best estimate of selling price or whether it may be acceptable for the vendor to establish a narrow range of estimated selling prices. However, it does indicate that an estimated selling price is intended to be the equivalent of what VSOE would be if a vendor regularly sold the deliverable on a stand-alone basis. While a point estimate is more precise, we believe that it may be acceptable for a vendor to establish a narrow range of prices that would constitute the estimated selling price for a deliverable. As noted in Q&A 1.1, it may be appropriate for a vendor to stratify sales transactions into meaningful groups before determining a point estimate or a range.

When determining VSOE for a deliverable, some vendors have noted that there is a range of prices charged for a deliverable when sold in standalone transactions. In practice, VSOE has been deemed to exist for a range of transaction prices when those prices are sufficiently clustered within an appropriate range. For example, a range of prices which approaches 80% of a group of similar arrangements during recent periods falling within 15% (plus or minus) of the median price of the range may constitute a range that is sufficiently clustered to permit a conclusion that VSOE of fair value exists for that group of similar arrangements. For transactions in which prices stated in contracts are also within that range, the stated price may be used for allocating the arrangement consideration.

To conclude that a range is appropriate when estimating a selling price, we believe the range should be narrow and based on an analysis that supports an assertion that any price within that range would be a valid pricing point if the deliverable were sold on a standalone basis. This

may be the case, for example, if a vendor accumulates multiple data points that, when adjusted for market and entity-specific factors, provide valid pricing points that are within a narrow range of one another or the vendor uses information obtained from standalone sales that do not constitute VSOE when estimating the selling price. However, we do not believe it would be acceptable to establish a range by determining the best estimate of selling price as a point estimate and arbitrarily considering a range of a certain percentage on either side of the point estimate to be a reasonable range of estimated selling prices. We also believe consideration should be given to whether there may be multiple ranges based on the stratification of the sales population into meaningful groups.

From an operational standpoint, a vendor may determine that using a narrow range of estimated selling prices for its deliverables is preferable to a point estimate approach. For example, if the stated contract prices within an arrangement all fall within the narrow range of selling prices established for each deliverable, the contract prices would be consistent with the estimated selling prices and, thus, it would be acceptable for the vendor to allocate arrangement consideration based on the stated contract prices. However, if the stated contract prices for *any* of the deliverables in the arrangement fall outside the narrow range of selling prices established for the deliverables, it would be necessary for the vendor to perform a relative selling price allocation of the arrangement consideration. For purposes of the allocation, the vendor should apply a consistent policy to determine which price in the range of estimated selling prices should be used for the outlier deliverables in the allocation. For example, a vendor may choose from a policy of using either (1) the midpoint of the range or (2) the outer limit of the range nearest to the stated contract price for that deliverable.

#### **Example B: Estimating Selling Price Using a Range**

ABC Corp. sells medical imaging devices and related services and has determined that these devices with embedded software and related services are outside the scope of SOP 97-2. ABC enters into an arrangement with a customer to sell a medical imaging device bundled with one year of PCS and 10 days of training for a total fee of \$564,900. The stated contract prices of the elements are \$505,000 for the medical imaging device, \$50,000 for the PCS, and \$9,900 for the training.

ABC determines a narrow range of selling prices for each of its deliverables as:

Medical imaging device	\$500,000 to \$525,000
One-year of PCS (VSOE)	\$50,000 to \$52,500
Training (VSOE)	\$960 to \$990 per day

Because all of the stated contract prices fall within the narrow ranges established by ABC, the stated contract amounts may be used to allocate revenue to the deliverables and no further allocation would be required.

Assume the same facts except that the total fee is \$551,000 with stated contract prices for the elements of \$520,000 for the medical imaging device, \$26,000 for the PCS, and \$5,000 for the training. ABC's policy is to use the midpoint of its range of selling prices for deliverables whose stated contract prices fall outside the established ranges when performing the relative selling price allocation.

Because the stated prices for PCS and training fall outside their respective estimated selling price ranges, ABC would have to perform a relative selling price allocation. Consistent with its policy, ABC allocates using the midpoint of the ranges as:

	<b>Selling Price</b>	<b>Ratio</b>	<b>Relative Selling Price Allocation</b>
Medical imaging device (stated price within range)	\$ 520,000	89.5%	\$ 493,145
One-year of PCS (midpoint of range)	51,250	8.8%	48,488
Ten days of training (midpoint of range)	9,750	1.7%	9,367
	<u>\$ 581,000</u>	<u>100.0%</u>	<u>\$ 551,000</u>

**Question 1.9: If a vendor has few standalone sales that do not constitute VSOE-level evidence of selling price, how are these sales evaluated when estimating a standalone selling price?**

**Answer 1.9:** If standalone sales are limited and do not constitute VSOE, they may still provide useful and observable data points when estimating a standalone selling price. Even though these sales may not provide sufficient evidence to establish VSOE, they could provide information about the process that a vendor uses to set the price and about how much customers would be willing to pay for the deliverable on a standalone basis. A vendor may consider the methods and assumptions used when the prices in these standalone sales were set in developing the estimated selling price for the deliverable.

The following items may be indicators that less emphasis should be placed on the selling prices in standalone transactions or that adjustments to the selling price for other transactions are necessary:

- The selling price in the standalone sale is less than the vendor's cost;
- Customers are known to have greater purchasing power; therefore, the selling price would be expected to be lower than the price that would be offered to other customers in standalone sales;
- There was a business reason to sell the product in a standalone sale either to preserve, enhance, or create a larger customer relationship;
- The standalone sales occurred in a geography that is known to have different pricing practices than the geography contemplated in current sales; and
- The customers in the standalone sales planned to use the product in a different way than customers that purchased the entire bundle.

**Question 1.10: A vendor may have established VSOE in the past, but pricing practices in a subsequent year changed, and VSOE no longer exists. How would a vendor use this information to determine an estimated selling price, assuming TPE is also unavailable?**

**Answer 1.10:** A vendor should first evaluate the change in the pricing practices and determine whether a change occurred that was specific to customer classes or markets. If the pricing

practices changed based on markets or customers to which the deliverable is sold, a vendor still may have VSOE for some markets or customer classes, and a vendor would need to determine whether VSOE exists on a stratified basis unless undue cost or effort is required. If the evaluation of the stratified data indicates that VSOE and TPE do not exist, a vendor should use its best estimate of selling price. Although VSOE does not exist because the standalone sales prices are widely dispersed, the standalone sales data may provide useful and observable evidence when estimating a selling price. For example, if there is a reasonable cluster of standalone sales prices in a narrow range in the analysis, it may be useful to determine whether the reasonably clustered sales provide evidence of the estimated selling price. It may be necessary to analyze the outliers and determine whether they are representative of the estimated selling price.

**Question 1.11: Could the sum of the standalone selling prices be less than the total arrangement consideration if the arrangement includes one or more elements whose selling price is based on an estimated selling price?**

**Answer 1.11:** Probably not. A sum of standalone selling prices that is less than the total arrangement consideration may indicate that the estimated selling price of one or more of the deliverables may need to be adjusted. Customers generally would not be willing to pay a premium for deliverables in a bundled arrangement. A vendor should re-evaluate its methods and assumptions used in its estimation of standalone selling prices in light of the implied premium. If there is an implied premium, a vendor may have to consider whether the premium is akin to an upfront fee that should be attributed to future periods as required by SAB Topic 13.<sup>20</sup>

**Question 1.12: May a vendor use the stated contract price as a data point when estimating a selling price for a deliverable?**

**Answer 1.12:** It depends. EITF 08-1 (ASC paragraph 605-25-30-7) states that contractually stated prices for individual products or services in an arrangement with multiple deliverables cannot be presumed to be representative of VSOE, TPE, or estimated selling price. However, contractually stated prices may provide a relevant data point for evaluation when determining a deliverable's standalone selling price. If the standalone price in the contract was developed using methods and assumptions consistent with a vendor's normal pricing processes and practices, the contract price may be useful in the analysis, particularly if the stated prices for a deliverable are reasonably consistent across customers regardless of what other deliverables may be bundled with the deliverable and cash consideration tied to the delivery of the deliverable is consistent with its stated price.

**Question 1.13: Would it be acceptable to use a vendor-published price list as evidence of selling price?**

**Answer 1.13:** It depends. Q&A 1.12 said that contractually stated prices for deliverables within a multiple element arrangement could not be presumed to be representative of VSOE or TPE or a vendor's best estimate of selling price. The same limitation applies to price lists published by the

<sup>20</sup> SEC Staff Accounting Bulletin Topic 13, Revenue Recognition, available at [www.sec.gov](http://www.sec.gov).

vendor. A published price list, in and of itself, would not qualify as evidence of selling price.

In many cases, a published price list serves as a starting point for price negotiations for a deliverable. A vendor may provide ranges of discounts from that price list depending on the customer, geography, timing, or other factors. It may be possible for the vendor to discern discounting practices for particular deliverables by analyzing how and when discounts are granted in similar arrangements, considering various market factors such as customer type or size, products being purchased together, or other market indicators. A vendor may sell certain deliverables included on the price list on a standalone basis. Analyzing the discounting practices for similar deliverables sold on a standalone basis could provide observable data points that are helpful in corroborating the estimated selling price for the deliverables that are not sold on a standalone basis.

**Question 1.14: Could the estimated selling price used in previous periods be questioned if a vendor began selling deliverables on a standalone basis at a price significantly different from those previously estimated?**

**Answer 1.14:** Maybe. Differences between estimated selling prices and subsequent standalone selling prices do not necessarily indicate that there was an error in the determination of the previous estimated selling price. A vendor should have appropriate evidence to support its assertion that it made its best estimate of selling price in the previous period using all reasonably available information. A vendor should consider what market factors or assumptions changed that led to the significant change in selling price.

There could be numerous valid reasons for a change in the pricing of a deliverable in subsequent periods. These may include changes in the market perception of a deliverable, changes in the cost structure, or changes in a vendor's or competitor's pricing strategies. Such changes would not lead to the conclusion that the previous estimates were erroneous. However, oversight or misuse of facts that existed at the time the estimated selling prices were determined would indicate a potential error.

**Question 1.15: What evidence is necessary to support the best estimate of selling price?**

**Answer 1.15:** The best estimate of selling price would include evaluating all reasonably available evidence. The evidence will be affected by specific facts and circumstances. Q&A 1.1 provides examples of potentially available data points, market conditions, and entity-specific factors that we believe a vendor may consider in determining estimated selling prices. These data points, if reasonably available, can provide evidence to support estimates of selling price.

Q&A 1.1 provides a framework that may be a useful tool when establishing and documenting estimated selling prices. Documenting the application of this framework could provide evidence that a vendor has (1) considered all reasonably available data points, (2) considered market conditions and entity-specific factors and made adjustments, as appropriate, to estimated selling prices, (3) considered the need to stratify selling prices into meaningful groups, (4) weighted the available information to arrive at an estimated selling price, and (5) established a process for ongoing monitoring and evaluation. Documenting a vendor's rationale for how the various factors were considered could also provide evidence to support a vendor's best estimate.

## Application of EITF 09-3's Scoping Principle and Resulting Accounting Treatment

Reminder: ASU 2009-14 refers to deliverables within the scope of SOP 97-2 as *software deliverables* and to deliverables that are outside the scope of SOP 97-2 as *non-software deliverables*. This *Issues In-Depth* uses that convention.

In addition, this *Issues In-Depth* refers to software and non-software *elements* based on the nature of the deliverable rather than based on the applicable accounting literature. For example, operating system software that is "essential" software is referred to as a software *element* but a non-software *deliverable*.

**Question 2.1: When determining whether a product contains software elements and non-software elements that function together to deliver the product's essential functionality, there is a rebuttable presumption that software elements are essential if sales of the tangible product without the software elements are infrequent. What is meant by infrequent?**

**Answer 2.1:** Judgment is required when determining what constitutes infrequent.

When deliberating this issue, the Task Force noted that its intent was that if sales of the product without the software are infrequent, then the software would be presumed to be essential to the functionality of the product. In making its recommendations to the Task Force, the FASB staff considered various alternative descriptions to clarify this point such as the tangible product is "typically," "normally," "usually," or "predominantly" sold with the software. These terms were not used because they could be interpreted to mean a lower threshold than was intended.

We believe that infrequent in this context means that the vast majority of sales of the tangible product also include the software element and that exceptions should be isolated. A pattern of regular sales of the hardware without the software element would indicate that the software is not essential to the functionality of the hardware.

**Question 2.2: How should an arrangement that involves a tangible product and significant production, modification, or customization of related software be accounted for if the software and non-software elements are scoped out of SOP 97-2?**

**Answer 2.2:** When the FASB mapped the scoping guidance from SOP 81-1 to ASC Subtopic 605-35, it modified that guidance to directly include within the scope of that Subtopic arrangements to deliver software, either alone or together with other products and services, that require significant production, modification, or customization of the software (see ASC paragraph 605-35-15-3(f)). Previously, these arrangements were in the scope of SOP 81-1 by virtue of paragraph 74 of SOP 97-2.

ASC paragraph 605-35-15-3(f) was not amended by EITF 09-3, and we believe the Task Force did not intend to change the accounting for these arrangements. Even though EITF 09-3 excludes tangible products and related essential software from the scope of software revenue recognition guidance, we believe these arrangements, including related tangible products, should continue to be accounted for using a contract accounting model, based on the guidance in ASC Subtopic 605-35 (SOP 81-1).

**Question 2.3: Would a tangible product and its essential software elements that are scoped out of SOP 97-2 be considered one deliverable for the purpose of allocation under EITF 08-1?**

**Answer 2.3:** Yes. If it is determined that a tangible product containing both software and non-software elements, whether embedded or otherwise, function together to deliver the tangible product's essential functionality and, thus, are scoped out of SOP 97-2, the software and non-software elements are considered to be a single deliverable. A vendor would then look to EITF 08-1 for guidance to separate this deliverable from other elements (e.g., PCS, extended warranty), if any.

**Example C: Initial Allocation of Arrangement Consideration**

ABC Corp. sells a personal computer (computer processor and operating system software) and provides one year of PCS on the operating system software for \$1,200. ABC rarely sells personal computers without the operating system software but regularly sells the operating system software bundled with one year of PCS for \$400. A customer can elect to renew PCS annually for \$100. The separation criteria in EITF 08-1 have been met.

Because the personal computer's software and non-software elements function together to deliver the computer's essential functionality, they are considered to be one deliverable that is excluded from SOP 97-2. Because the PCS relates to software that is essential to the tangible product's functionality, it is also considered to be a separate deliverable excluded from SOP 97-2. The fact that ABC sells the operating system software bundled with PCS for \$400 does not affect the assessment.

ABC has established VSOE of selling price for the PCS at \$100 and has determined that the estimated selling price of the personal computer with the operating system software (treated as a single deliverable) is \$1,150. Based on the separation criteria of EITF 08-1, ABC would allocate the arrangement consideration using the relative selling price method for the deliverables. Therefore, the arrangement fee of \$1,200 would be allocated as:

	Selling Price	Ratio	Relative Selling Price Allocation
Personal computer with operating system software	\$ 1,150	92 %	\$ 1,104
One-year of PCS related to software	100	8 %	96
	<u>\$ 1,250</u>	<u>100 %</u>	<u>\$ 1,200</u>

Because all deliverables are included within the scope of EITF 08-1, assuming all other revenue recognition criteria are met, \$1,104 of revenue would be recognized for the personal computer on delivery and \$96 would be recognized for the PCS ratably over the one-year period. See Q&A 6.1 for guidance when considering whether contingent revenue exists in this example.

**Question 2.4: If an arrangement contains a software element and a non-software element that function together to deliver the tangible product's essential functionality, would a related specified upgrade right that is bundled in the arrangement also be excluded from the scope of SOP 97-2?**

**Answer 2.4:** Yes. If a vendor determines that a tangible product containing both software and non-software elements is outside of the scope of SOP 97-2, a specified upgrade right included in the bundled transaction that is related to the essential software would also be outside its scope.

**Question 2.5: If a specified upgrade right is related to a non-software deliverable, would it be considered a separate deliverable if customers are only entitled to the specified upgrade if they have also purchased PCS?**

**Answer 2.5:** Yes. A specified upgrade right is generally evidenced through a vendor's agreement or other explicit commitment to deliver an upgrade software with specific features and functionality. We believe that if a vendor agrees to provide a customer with a specified upgrade right related to the software elements considered non-software deliverables, the specified upgrade right should be accounted for as a separate (non-software) deliverable of the arrangement, even if the right to the specified upgrade is included in the terms of a PCS arrangement.

**Example D: Accounting for a Specified Upgrade Right**

ABC Corp. sells a medical imaging device with embedded software that is scoped out of SOP 97-2 under EITF 09-3. This medical imaging device is sold with one year of PCS. At the time of sale, ABC promises to deliver a specific upgrade of the software embedded in the device with specified features and functionality as part of the PCS arrangement. ABC will provide this specified software upgrade to all its customers who purchase PCS on this medical imaging device.

ABC concludes that it has three deliverables: the medical imaging device, one year of PCS, and the specified upgrade. We believe that the specified upgrade right should be considered a separate deliverable. Assuming VSOE or TPE does not exist for the specified upgrade, ABC must determine its best estimate of the selling price of the specified upgrade right and allocate the total arrangement consideration to each of the deliverables within the arrangement based on EITF 08-1.

**Question 2.6: How should a vendor account for a standalone sale of an upgrade relating to a software element that was considered a non-software deliverable in a previous sale?**

**Answer 2.6:** A standalone sale of a software upgrade would be within the scope of SOP 97-2, even if the original sale of the related software was outside its scope under EITF 09-3. In Example C, the computer processor, operating system software, and related PCS are outside the scope of SOP 97-2. If ABC subsequently sold a standalone upgrade of its operating system software to a customer in a separate transaction, the upgrade sale would be within the scope of SOP 97-2.

**Question 2.7: How should a vendor allocate consideration for a multiple element arrangement if some, but not all, of the deliverables are within the scope of SOP 97-2?**

**Answer 2.7:** Based on EITF 09-3 (ASC paragraph 985-605-25-10(f)), a vendor should first allocate arrangement consideration to the software deliverables "as a group" and to the non-software deliverables based on the relative selling price of the deliverables, following the guidance in EITF 08-1 (ASC paragraph 605-25-15-3A). For example, a software vendor that bundles non-software deliverables in arrangements with multiple software deliverables will be required to determine the standalone selling price of the software deliverables as a group (i.e., what the group as a whole would be sold for on a standalone basis) for purposes of the initial allocation of the arrangement consideration. EITF 08-1 does not specify whether multiple non-software deliverables in an arrangement should be "grouped" for purposes of the initial allocation. Therefore, a vendor will need to determine whether the overall arrangement

consideration should be allocated to the non-software deliverables as a group or individually. If a vendor generally sells the non-software deliverables as a group, that may indicate that allocating the overall arrangement consideration to non-software deliverables as a group may be appropriate. If they are not generally sold as a group (e.g., unrelated tangible products), that may indicate that allocating overall arrangement consideration individually may be appropriate. A vendor should establish policies to allocate overall arrangement consideration to non-software deliverables and should use a consistent approach for similar arrangements.

Once arrangement consideration has been allocated to the software deliverables as a group, a vendor would follow the guidance in SOP 97-2 to determine whether the separation criteria for software revenue recognition have been met for the elements within the software group. A vendor would also determine whether EITF 08-1's separation criteria are met for the non-software deliverables. If so, and if arrangement consideration has been allocated to the non-software deliverables as a group, the vendor must further allocate consideration to those individual units of accounting using the relative selling price method.

#### **Example E1: Allocating Arrangement Consideration to Software and Non-Software Deliverables**

Using the same facts as Example C, assume that ABC also sells security software that protects the computer from viruses and other security risks. ABC sells the personal computer bundled with the security software and one year of PCS (covering both the operating system software and security software) for \$1,400. ABC separately sells the security software bundled with one year of PCS for \$250. The security software is never sold without PCS. A customer that purchases the security software, whether separately or with a personal computer, may renew the PCS on the security software for an annual fee of \$50. Because the security software is not necessary for the essential functionality of the personal computer, the software sale is within the scope of SOP 97-2.

ABC has VSOE for one year of PCS on the operating system of \$100. ABC estimates the selling price of the personal computer (including the operating system software) to be \$1,150. ABC also has VSOE for the software deliverables as a group (the security software and one year of related PCS) of \$250. Because ABC frequently sells the personal computer with the operating system software bundled with one year of PCS as a group, ABC determined that the arrangement consideration should be allocated to both the non-software deliverables and the software deliverable as a group using the relative selling price method. Therefore, the arrangement fee of \$1,400 would be allocated to the deliverables as:

	<b>Selling Price</b>	<b>Ratio</b>	<b>Initial Relative Selling Price Allocation</b>
<b>Non-Software Deliverables</b>			
Personal computer with operating system software and one-year of PCS (group)	\$ 1,200	82.76 %	\$ 1,159
<b>Software Deliverables</b>			
Security software and PCS (group)	250	17.24 %	241
	<u>\$ 1,450</u>	<u>100.00 %</u>	<u>\$ 1,400</u>

ABC would follow the guidance in EITF 08-1 to determine whether it is appropriate to separate the non-software deliverables and, if so, how to allocate the \$1,159 to those units of accounting. Assuming the separation criteria in EITF 08-1 have been met, ABC would further allocate the non-software deliverables as:

	Selling Price	Ratio	Relative Selling Price Allocation
<b>Non-Software Deliverables</b>			
Personal computer with operating system software – estimated selling price	\$ 1,150	92%	\$ 1,066
One-year of PCS related to the operating system software – VSOE	100	8%	93
	\$ 1,250	100%	\$ 1,159

Assuming all of the other revenue recognition criteria are met, ABC would recognize \$1,066 of revenue on delivery of the personal computer (computer processor and operating system software) and \$93 for the PCS related to the operating system software ratably over the one year PCS period. See Q&A 6.1 for guidance when considering whether contingent revenue exists in this example.

ABC would then follow the guidance in SOP 97-2 to determine whether it is appropriate to account for the security software and PCS separately and, if so, how to allocate the \$241 to those units of accounting. ABC has VSOE of the PCS of \$50 based on a stated renewal rate. However, ABC does not have VSOE for the security software because it is never sold without the PCS.

	<b>Residual Method Allocation</b>
<b>Software Allocation under SOP 97-2</b>	
Software group allocation	\$ 241
Less: VSOE of the PCS	50
Security software – residual	\$ 191

Assuming all of the other criteria for separation and revenue recognition are met, ABC would recognize \$191 of revenue on delivery of the security software, using the residual method. ABC would recognize \$50 for the PCS related to the security software ratably over the one-year PCS period.

<sup>21</sup> EITF Issue No. 00-3, Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware, available at [www.fasb.org](http://www.fasb.org).

### Example E2: Allocating Arrangement Consideration to Software and Non-Software Deliverables

ABC Software Co. enters into an arrangement with a customer that includes Software Product A, one of year of PCS for Product A, and Software Product B on a hosted basis for total arrangement consideration of \$1.2 million. ABC determines that the hosting service for Product B does not contain a separate software deliverable within the scope of SOP 97-2 under the provisions of EITF 00-3<sup>21</sup> (ASC paragraphs 985-605-55-121 through 55-125) because the customer does not have the right to take possession of the Product B software. Therefore, the hosting service is a non-software deliverable in the arrangement.

ABC regularly sells Product A bundled with one year of PCS on a standalone basis for \$1.6 million, which constitutes VSOE for the software elements as group. In addition, ABC has determined that VSOE for the hosting service is \$400,000 and VSOE of PCS is \$250,000. Product A is never sold on a standalone basis, so VSOE does not exist for Product A. ABC would allocate the arrangement consideration to the software deliverables as a group and to the non-software element as:

	Selling Price	Ratio	Initial Relative Selling Price Allocation
<b>Non-Software Deliverables</b>			
Hosting service	\$ 400,000	20%	\$ 240,000
<b>Software Deliverables</b>			
Product A and PCS (group)	1,600,000	80%	960,000
	<u>\$ 2,000,000</u>	<u>100%</u>	<u>\$ 1,200,000</u>

If ABC had concluded that VSOE and TPE do not exist for Product A and PCS as a group, ABC would be required to estimate a selling price for the group.

ABC would recognize the hosting service as the service is provided. ABC would follow the guidance in SOP 97-2 to determine whether it is appropriate to account for Product A and PCS separately and, if so, how to allocate the \$960,000 to those units of accounting. ABC has VSOE for the PCS of \$250,000, but ABC does not have VSOE for Product A because it is never sold without the PCS.

<b>Software Allocation under SOP 97-2</b>	<b>Residual Method Allocation</b>
Software group allocation	\$ 960,000
Less: VSOE of the PCS	<u>250,000</u>
Software Product A – residual	<u>\$ 710,000</u>

Assuming all of the other criteria for separation and revenue recognition are met, ABC would recognize \$710,00 of revenue on delivery of Software Product A using the residual method. ABC would recognize \$250,000 for the PCS ratably over the one-year PCS period.

**Question 2.8: Would a subsequent PCS renewal constitute a standalone sale of a software deliverable even if the PCS was previously determined to support a non-software deliverable?**

**Answer 2.8:** Yes. A separate standalone sale of a software element is accounted for under the guidance in SOP 97-2 even if that software element was previously considered a non-software deliverable when sold with a tangible product. Similarly, a separate future standalone sale of PCS related to the essential software (e.g., in the form of PCS renewal) also would be within the scope of SOP 97-2. This identical PCS may have been considered a non-software deliverable when it was previously sold in a bundled transaction with a tangible product and essential software.

**Example F: Accounting for PCS Renewal and Subsequent Purchase of a New Software Product**

On January 1, 20X1, ABC Corp. sold a personal computer (computer processor and operating system software) bundled with one year of PCS on the operating system software to Customer X. Because the personal computer included software elements that were necessary to deliver the computer's essential functionality, the operating system software was considered a non-software deliverable that was excluded from the scope of SOP 97-2. Because the PCS was related to the essential operating system software, it was also considered a non-software deliverable.

On January 1, 20X2, Customer X entered into an arrangement to renew the PCS for another one-year term and license an additional software application (Software B) for \$250. Software B is currently under development and it is estimated it will be delivered to Customer X in six months.

The one-year PCS renewal and the license of Software B would be considered separate sales of software elements. Thus, the software elements would be considered software deliverables and accounted for under SOP 97-2.

Assuming VSOE exists for the PCS (\$100) but not for Product B, all \$250 of revenue would be deferred until Software B is delivered as required by SOP 97-2. If Software B is delivered before the end of the PCS period, then ABC would consider whether it may separate Software B from the remaining PCS at that time.

**Question 2.9: When a transaction includes an undelivered element that relates to both a software and a non-software deliverable, EITF 09-3 states that the undelivered element should be "bifurcated" into a software and non-software deliverable. How would a vendor bifurcate the undelivered element included in the arrangement?**

**Answer 2.9:** While EITF 09-3 does not specify how to bifurcate an undelivered element into separate software and non-software deliverables, we believe that the undelivered element would be considered two deliverables requiring an estimated selling price when allocating the arrangement consideration using the relative selling price method. Therefore, a vendor would need to separate the component of the undelivered element considered a software deliverable

from the component considered a non-software deliverable. See Q&A 2.7 and Example G for guidance about allocating arrangement consideration when an arrangement contains both software and non-software deliverables.

**Question 2.10: If a vendor previously established VSOE for a PCS deliverable that relates to both a software and non-software deliverable, could the bifurcation of that PCS result in the loss of VSOE for each bifurcated component if VSOE does not exist for the component on an individual basis?**

**Answer 2.10:** No. If VSOE exists for a PCS deliverable as a whole, we do not believe that the intent of the bifurcation requirement was to suggest that a vendor would have to sell each bifurcated component of the PCS separately for each deliverable to establish VSOE. We believe that a vendor could make its best estimate of the selling price for the bifurcated PCS and that the amounts resulting from the bifurcation still would constitute VSOE. The following example illustrates this point.

**Example G: Bifurcating an Undelivered PCS Element between a Software and a Non-Software Deliverable**

ABC Corp. sells a tangible data storage device that contains embedded operating system software (essential software considered to be a non-software deliverable) and other software applications. Although the other software applications add various features to the data storage device, they are considered software deliverables (non-essential software) because the data storage device is sold without the other software applications on a more than infrequent basis. ABC regularly bundles one year of PCS in its arrangements that relates to both the essential and any non-essential software included in the arrangement.

The arrangement includes the data storage device, other software applications, and PCS relating to both the essential and non-essential software for total arrangement consideration of \$100. ABC determines that no VSOE or TPE exists for the data storage device and therefore estimates that the selling price of the data storage device is \$75. ABC also determines that its best estimate of the selling price of the other software applications and related PCS as a group is \$30. Before adopting EITF 09-3, ABC concluded that VSOE of the PCS for its arrangements was \$25 when other software applications were sold with the tangible product and \$20 when no other software products were sold with the tangible product. While ABC has VSOE for PCS on a combined basis and for PCS on just the embedded (essential) software, it has never sold PCS separately for the other application software.

ABC allocates the overall arrangement consideration of \$100 using the relative selling price method under EITF 08-1 and determines that \$76 relates to the non-software deliverables and \$24 relates to the software deliverables.

ABC must follow the guidance in SOP 97-2 to determine whether it is appropriate to account for the other application software and PCS separately and, if so, how to allocate the \$24 to those units of accounting. ABC would bifurcate the VSOE of combined PCS of \$25 into separate software and non-software components. Because ABC charges \$20 for PCS in arrangements that do not include any other software products, ABC concludes that \$20 is VSOE of PCS related to the non-software deliverable. ABC's best estimate of the standalone selling price of the PCS related to the other software application is \$10. ABC bifurcates the combined PCS using the relative selling price method as:

<b>Bifurcation of PCS</b>	<b>Selling Price</b>	<b>Ratio</b>	<b>Relative Selling Price Allocation</b>
PCS – related to essential software (VSOE)	\$ 20.00	66.67%	\$ 16.67
PCS – related to other application software (estimated selling price)	10.00	33.33%	8.33
	<u>\$ 30.00</u>	<u>100.00%</u>	<u>\$ 25.00</u>

ABC concludes that the allocated VSOE for the other application software is \$8.33. Because VSOE exists for the combined PCS, it is appropriate for ABC to conclude that it has VSOE for the PCS related to the other application software when applying the separation criteria of SOP 97-2 to the software deliverables. ABC does not have VSOE of the other application software because it is never sold separately. Therefore, the residual method of allocation is used. The \$24 initially allocated to the software deliverables as a group would be allocated as:

<b>Software Allocation under SOP 97-2</b>	<b>Residual Method Allocation</b>
Software group allocation	\$ 24.00
Less: VSOE of the PCS – bifurcated	8.33
Other application software – residual	<u>\$ 15.67</u>

Assuming all of the other criteria for revenue recognition are met, ABC recognizes \$15.67 of revenue on delivery of the other application software and recognizes \$8.33 for the PCS related to the other application software over the one-year PCS period.

**Question 2.11: What should a vendor consider when determining whether the non-software elements of a tangible product substantively contribute to the tangible product’s essential functionality?**

**Answer 2.11:** A vendor will need to apply judgment when determining whether the non-software elements of a tangible product substantively contribute to a tangible product’s essential functionality. EITF 09-3 (ASC paragraph 985-605-15-4A) states that if the tangible product is simply a delivery mechanism for the software, the software element would still be considered a software deliverable within the scope of SOP 97-2. Consideration of whether a tangible product is simply a delivery mechanism will require judgment, particularly for a traditional software vendor whose primary product offering is predominantly software and software-related deliverables. Although no single factor is necessarily determinative and all facts and circumstances should be considered, some factors that may assist a vendor in making this determination are:

- How would the tangible product function without the software element? If the tangible product does not have any separate functionality without the software element, that may indicate that the hardware is more than simply a delivery mechanism.
- How would a customer use the vendor’s tangible products? If a vendor sells software elements on the tangible product (e.g. software element almost always installed on a low-cost laptop with minimal functionality), and most customers purchase the tangible product only for the

software element (e.g., the customer does not plan on using the laptop to run the software), that may indicate that the software is not essential to the tangible product's functionality.

- How are tangible products described in the vendor's marketing materials or other industry publications? These descriptions may provide evidence about whether the non-software components substantively contribute to the functionality of the product.
- What is the extent of the integration of the hardware and software development teams? If there is a high level of integration of the hardware and software development teams, that may be an indicator that the software and non-software elements function together to deliver the tangible product's essential functionality.

The following are examples of arrangements in which traditional software vendors sell tangible products with software elements and the non-software elements of the tangible product substantively contribute to the tangible product's essential functionality.

#### **Example H: Firewall Software and Firewall Security Gateway Device – Scoped Out of SOP 97-2**

Softco A is a software vendor whose primary business is licensing security software to its customers through perpetual licenses. Softco A licenses a firewall management software product bundled with 12 months of PCS and requires its customers to purchase a separate hardware device (firewall security gateway). Neither the hardware device nor firewall management software is sold separately. The hardware device filters Internet traffic to protect against security threats, while the firewall management software analyzes the filtered traffic to provide real-time security information. The firewall management software and firewall security gateway function together to deliver the essential functionality of the product. The tangible product and the essential software (along with the related PCS) are considered non-software deliverables and are excluded from the scope of SOP 97-2.

#### **Example I: Hardware Device and Engineering Software – Scoped Out of SOP 97-2**

Softco B is a software vendor whose primary business is licensing chip engineering software to customers under multi-year time-based licenses. Softco B sells an integrated emulation system that includes a hardware device (integrated circuit boards and chips), engineering software, and 12 months of PCS. The essential functionality of the integrated emulation system allows customers to emulate the operation of chips using the engineering software. Softco B rarely sells the hardware device without the engineering software. However, Softco B sometimes sells replacement or additional hardware devices to customers subsequent to their initial purchase. The hardware device cannot function without engineering software; however, Softco B does sell the engineering software on a standalone basis as it functions without the hardware device. The hardware device and the engineering software both function together to deliver the essential functionality of the integrated emulation system. The integrated emulation system and the related PCS are considered non-software deliverables and are excluded from the scope of SOP 97-2.

The following is an example of an arrangement where a traditional software vendor sells a tangible product with software elements where the non-software element of the tangible product does not substantively contribute to the tangible product's essential functionality and is simply a delivery mechanism for the software element.

#### **Example J: Software Sold with a Flash Drive – Not Scoped Out of SOP 97-2**

Softco C is a software vendor that sells operating system software to customers and frequently delivers its operating system software on a flash drive. Softco C never sells a flash drive without the operating system software. However, the operating system software is often sold without a flash drive (e.g., the software is downloaded or delivered on a disk). Although the flash drive is never sold without the software, it simply delivers the operating system software to the customer and does not substantively contribute to the essential functionality of the deliverable, which is the operating system software. The operating system software and related PCS would be within the scope of SOP 97-2 and the flash drive would be excluded from SOP 97-2.

#### **Interaction of EITF 08-1 and EITF 09-3 with Other Guidance**

**Question 3.1: Could PCS that is determined to be a non-software deliverable be considered a separately priced product maintenance contract to be accounted for under FTB 90-1<sup>22</sup> (ASC Subtopic 605-20<sup>23</sup>)?**

**Answer 3.1:** It depends. First, a vendor should determine whether the PCS deliverable is separately priced within the arrangement. If it is not separately priced, the PCS deliverable would not be in the scope of FTB 90-1. A contract is *separately priced* if the “customer has the option to purchase an extended warranty or a product maintenance contract for an expressly stated amount separate from the price of the product.” Second, if the PCS is separately priced, it would be necessary to evaluate the nature of the PCS services under the arrangement to determine whether they fall within the scope of FTB 90-1.

FTB 90-1 defines a *product maintenance contract* as “an agreement to perform certain agreed-upon services to maintain a product for a specified period of time.” The nature of PCS services provided for tangible products and related essential software may take various forms. For example, PCS arrangements can range from those that relate entirely to the maintenance of the hardware elements of the tangible product to those that only include the rights to upgrades and enhancements of the software elements and related telephone support. Therefore, determining whether a PCS deliverable falls within the scope of FTB 90-1 requires analysis of the nature of the services.

A PCS deliverable related only to the maintenance of the hardware elements of a tangible product likely would fall within the scope of FTB 90-1 if it were separately priced. Alternatively, if a PCS deliverable includes the rights to unspecified upgrades and enhancements of the software element and a vendor has a history of providing upgrades and enhancements that substantively increase the functionality of the product, the PCS likely would not fall within the scope of FTB 90-1 because such service is more than maintaining the product for a period of time. PCS deliverables related to tangible hardware and related software elements that are separately priced and fall somewhere in between these two

<sup>22</sup> FASB Technical Bulletin No. 90-1, Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts, available at [www.fasb.org](http://www.fasb.org).

<sup>23</sup> FASB ASC Subtopic 605-20, Revenue Recognition – Services, available at [asc.fasb.org](http://asc.fasb.org).

scenarios will require the use of judgment to determine whether the services are primarily maintaining the functionality of the product or substantively enhancing it.

We would expect that extended warranty and product maintenance contracts previously accounted for under FTB 90-1 would continue to be accounted for under the same guidance.

**Question 3.2: How do EITF 08-1 and EITF 09-3 interact with EITF 03-5<sup>24</sup> (ASC paragraph 985-605-15-3(c))?**

**Answer 3.2:** EITF 03-5 addressed the issue of whether non-software elements included in an arrangement that contain software elements that are more than incidental to the products or services as a whole are included within the scope of SOP 97-2. With the adoption of EITF 09-3, tangible products are no longer within the scope of SOP 97-2 even if certain software elements sold with tangible products continue to remain within its scope. However, in arrangements that contain software elements and services, if the software element is essential to the functionality of the services, it would remain within the scope of SOP 97-2. EITF 09-3 does not change the guidance in EITF 03-5 related to services.

**Example K: Interaction with EITF 03-5**

A vendor sells enterprise resource planning (ERP) software bundled with one year of PCS and one year of hosting services for the ERP software for \$1 million. The vendor has VSOE of PCS and the hosting services, and has determined that the ERP software is a software element within the scope of SOP 97-2 under EITF 00-3 (ASC paragraphs 985-605-55-121 through 55-125). For the vendor to determine if the hosting service is considered a software-related element within the scope of SOP 97-2 or a non-software element, the guidance in EITF 03-5 would be considered. Because the software is essential to the functionality of the hosting service in the arrangement, the vendor would conclude that the hosting services are within the scope of SOP 97-2.

**Question 3.3: How does EITF 08-1 interact with EITF 01-9<sup>25</sup> (ASC Subtopic 605-50<sup>26</sup>) in the recognition of sales incentives offered to customers by a vendor?**

**Answer 3.3:** The Task Force did not address this issue and EITF 08-1 did not amend any guidance in EITF 01-9.

EITF 01-9 states that cash consideration given by a vendor to a customer is presumed to be a reduction of the selling price of the vendor's products or services and, therefore, should be characterized as a reduction of revenue when recognized in the vendor's income statement. Although the Task Force did not change the accounting for sales incentives that are within the scope of EITF 01-9, there may be more instances where the accounting for consideration offered by a vendor to a customer is not solely attributed to the delivered item. This may occur because EITF 08-1 eliminates the residual method.

The appropriate treatment for incentives may depend on the specific facts and circumstances. For example, if it is clear that the sales incentive relates only to the delivered item, it may be appropriate to attribute the incentive entirely to that item. On the other hand, if it is not clear that the sales incentive relates to only the delivered item or if the vendor intended to offer the sales incentive to the customer at the outset of the arrangement even though the offer was made to

<sup>24</sup> EITF Issue No. 03-5, Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software, available at [www.fasb.org](http://www.fasb.org).

<sup>25</sup> EITF Issue No. 01-9, Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products), available at [www.fasb.org](http://www.fasb.org).

<sup>26</sup> FASB ASC Subtopic 605-50, Revenue Recognition – Customer Payments and Incentives, available at [asc.fasb.org](http://asc.fasb.org).

the customer later, that may indicate that the incentive should be treated as if it were a discount on the original arrangement consideration and allocated to all elements within the arrangement. However, under this approach the vendor would need to consider whether the allocation of the sales incentive to an undelivered element on a relative selling price basis would be limited under the contingent revenue provisions of EITF 08-01.

#### Example L: Interaction with EITF 01-9

On July 1, 20X1, ABC Corp. enters into an arrangement with a Reseller and delivers 5,000 units of Product A (hardware device with embedded software) bundled with one year of PCS for \$1,000 each (\$5 million in the aggregate). On December 31, 20X1, ABC offers a \$300,000 cash incentive to help the Reseller sell its remaining inventory. Deferred revenue related to the PCS on December 31, 20X1 is \$250,000. ABC determines that VSOE exists for PCS on one unit of Product A of \$100 (\$500,000 in the aggregate). ABC does not have VSOE for Product A.

Under SOP 97-2, assuming all other revenue recognition criteria were met, ABC would have recognized \$4.5 million of revenue for 5,000 units of Product A on delivery on July 1, 20X1 and recognized the PCS of \$500,000 ratably over a one-year period under the residual method. ABC would have accounted for the sales incentive on December 31, 20X1, the date that it was offered, as a reduction in the revenue attributable to Product A. None of the sales incentive would have been attributed to the PCS, because under the residual method, all discounts are attributed to the delivered items regardless of whether the incentive was attributed solely to the delivered item or considered a discount in the original arrangement.

With the elimination of the residual method under EITF 08-1, the question of whether the incentive relates to the delivered item, the undelivered item, or both, should be considered. Because it is not clear in this case, one acceptable approach may be to account for the sales incentive (price reduction) as a reduction in the arrangement consideration to be allocated to both the delivered and undelivered items under EITF 08-1. Assuming the estimated selling price of a unit of Product A is \$900, the \$300,000 sales incentive would be allocated to both Product A and the PCS in proportion to the amount of revenue recognized versus deferred as:

	<b>Amount</b>	<b>Ratio</b>	<b>Allocation</b>
Product A and PCS – revenue recognized	\$ 4,750,000	95%	\$ 285,000
PCS – revenue deferred	250,000	5%	15,000
	\$ 5,000,000	100%	\$ 300,000

In other words, the \$300,000 sales incentive would be allocated to all elements within the arrangement as if it were a discount on the original arrangement consideration. The \$285,000 allocated to revenue recognized on Product A and PCS would be recorded as a reduction to revenue on December 31, 20X1. The \$15,000 allocated to the unrecognized PCS would be recorded as a reduction of the \$250,000 of deferred revenue on December 31, 20X1 and therefore would be recognized ratably over the remaining six month PCS term. Under this approach, ABC would need to consider whether the allocation of the sales incentive on a relative selling price basis would be limited under the contingent revenue provisions of EITF 08-1 because the amount of deferred revenue related to PCS would be less than the amount that would be refunded to the customer if the remaining PCS is not provided. See Q&A 6.1.

### Transition to EITF 08-1 and EITF 09-3

**Question 4.1: The transition guidance states that EITF 08-1 and 09-3 are effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. What would be considered a material modification of an existing arrangement?**

**Answer 4.1:** Judgment should be applied to determine whether a modification is considered material. A material modification generally would result from a substantive renegotiation or amendment of an existing arrangement and *would not* be expected to arise from non-substantive changes such as granting concessions to customers (e.g., providing an additional deliverable with no corresponding appropriate increase in the arrangement consideration).

The determination of whether a modification to an existing revenue arrangement represents a new arrangement or a material modification will require the use of judgment and should consider the relevant facts and circumstances that exist when an arrangement is modified.

One approach that a vendor might consider is based on the FASB's deliberations in the Joint FASB/IASB Revenue Recognition Project. The FASB recently discussed the accounting for contract modifications and reached the following tentative decision:

The Board... decided that when an entity modifies an existing contract, the modification should be accounted for as a separate contract if it is priced independently from the original contract. If the prices are interdependent, an entity should account for the original contract and modification as a single net contract position, recognizing the effect of the modification on a cumulative catch-up basis.

This tentative decision by the Board focuses on the interdependency of the pricing of the modification with the pricing of the deliverables in the existing arrangement. In addition, paragraph 64 of SOP 81-1 (ASC paragraph 605-35-25-29) provides the following guidance when determining whether a contract addition is treated as a separate contract when accounting for a long-term production-type or construction-type contract:

An option or addition to an existing contract shall be treated as a separate contract in any of the following circumstances:

- a. The product or service to be provided differs significantly from the product or service provided under the original contract.
- b. The price of the new product or service is negotiated without regard to the original contract and involves different economic judgments.
- c. The products or services to be provided under the exercised option or amendment are similar to those under the original contract, but the contract price and anticipated contract cost relationship are significantly different.

We believe that the principles discussed by the FASB in its deliberations of the Joint Revenue Recognition Project and those contained in SOP 81-1 may be helpful in making the determination of whether an arrangement has been materially modified or is considered a new arrangement under the guidance in EITF 08-1.

Other factors to consider may include:

- If new deliverables are included as a result of the modification, is the increase in the price under the modified contract consistent with the price customers would pay in a standalone sale? If so, this may be an indicator that the new deliverables in the contract modification are part of a separate new arrangement as opposed to a modification of the existing arrangement.
- Are any new deliverables included in the modification closely interrelated with the deliverables in the original arrangement in terms of design, technology or function? If so, this may be an indicator that the new deliverables included in the contract modification are not part of a separate new arrangement, but a modification of the existing arrangement.
- Is there evidence that the pricing of the modification included consideration of the pricing in the existing arrangement? For example, was the modification priced considering the current market price of the deliverables from the original contract and the new deliverables, if any? If so, this may be an indicator that the contract modification is not a new arrangement itself, but a modification of the existing arrangement.
- Is the contract modification a unilateral grant of a concession by a vendor without a *bona fide* renegotiation of the original arrangement? We believe that a unilateral grant of a concession by a vendor without a bona fide renegotiation would not constitute a material modification of the contract. However, if there was a bona fide renegotiation that resulted in a contract modification, we believe that it could constitute a material modification of the contract.

#### **Example M: Amendment Not Considered a Modification of the Original Arrangement**

On June 30, 20X9, Biotech Corp. entered into an agreement with Pharma Corp. to license certain rights (IP) for five years and provide research and development (R&D) services through two full-time equivalents (FTEs). The objective of the R&D is to develop a drug using the IP. Pharma and Biotech agree to form a Joint Steering Committee (JSC) in which both parties are required to participate for an indefinite period of time. Biotech expects to continue collaborating with Pharma on the JSC for 10 years. Fees under this arrangement are:

- Up-front nonrefundable payment of \$5 million;
- \$2 million on meeting each of the following defined milestone payments:
  - Pharma's initiation of Phase II clinical trials
  - Pharma's initiation of Phase III clinical trials

Consistent with Example 12 of EITF 08-1 (ASC paragraphs 605-25-55-86 through 55-93, formerly Example 6 of EITF 00-21), Biotech concludes that the IP does not have standalone value to Pharma because the license has no value to Pharma without the Biotech's ongoing R&D services. The JSC is considered a participatory committee and a separate deliverable under the arrangement.

Under EITF 00-21, Biotech has VSOE for the R&D services at \$500,000 per FTE per year but does not have VSOE or TPE for the joint steering committee participation deliverable.

Biotech concludes that the deliverables are one unit of accounting and recognizes all revenue under the arrangement ratably over the expected term of the JSC participation, which is 10 years.

Biotech adopts the provisions of EITF 08-1 prospectively on January 1, 20Y0. Two years into the arrangement, on July 1, 20Y1, Biotech and Pharma sign an amendment to the existing agreement whereby Biotech will provide two additional FTEs at \$500,000 per FTE per year, which is the current market rate.

Because the two additional FTEs are priced at the current market rate, we believe that Biotech has effectively entered into a new arrangement with Pharma and would conclude that the original arrangement has not been materially modified. Biotech would continue to recognize revenue under the original arrangement over its initial 10-year term under EITF 00-21 and would account for the modification as a new arrangement under EITF 08-1.

#### **Example N: Amendment Considered a Modification**

On June 30, 20X9, ABC Corp. entered into an arrangement with Customer Y to deliver one water metering device and five years of outsourced monitoring service for a non-refundable fee of \$700. The contract prices are \$200 for the device and \$100 for each year of monitoring service. ABC accounted for this arrangement under EITF 00-21. ABC delivered the water metering device on June 30, 20X9, and the five-year outsourced service period runs from July 1, 20X9 through June 30, 20Y4. ABC concluded that it did not meet the separation criteria under EITF 00-21 because it did not have VSOE or TPE of fair value for the metering device or the outsourced service. ABC recognizes the entire \$700 fee ratably over the five-year service period. In its financial statements for the year ended December 31, 20X9, ABC recognized revenue of \$70 for this arrangement.

ABC adopted the provisions of EITF 08-1 prospectively on January 1, 20Y0. Two years into the arrangement, on July 1, 20Y1, ABC and Customer Y agree to amend the existing arrangement whereby ABC will deliver an additional water metering device to Customer Y and extend the outsourced services for two years for an additional non-refundable fee of \$275. There are no stated prices in the amendment.

When comparing the pricing for the services under the original arrangement to the pricing of those services under the amendment, it appears that the parties have effectively renegotiated the price of the remaining three years of outsourced services and extended the term an additional two years. Under the original arrangement, the pricing for one device and two years of outsourced services would have been \$400 (\$200 for the device and \$100 per year for the monitoring service) compared with \$275 (\$200 for the device and \$75 per year for the additional two years of service, less a reduction of \$25 on each of the remaining three years of service under the existing arrangement). We believe that ABC has substantively renegotiated its existing arrangement with Customer Y and conclude that the original arrangement has been modified and should be accounted for under EITF 08-1.

**Question 4.2: How should a vendor account for an existing arrangement that did not meet the separation criteria under EITF 00-21 (because VSOE and TPE did not exist) if that arrangement is materially modified after EITF 08-1 is adopted under the prospective method?**

**Answer 4.2:** The Task Force did not address this issue. There have been three potential views identified about how a vendor might account for unrecognized revenue from an existing arrangement that has been materially modified after adopting EITF 08-1. Under these views, the remaining unrecognized revenue from the existing arrangement would be added to any additional consideration under the modification (total remaining revenue) using one of these three methods:

- **View A:** Allocate all of the total remaining revenue to the undelivered items under the modified arrangement using the relative selling price method.
- **View B:** Allocate consideration to the undelivered items under the modified arrangement in an amount equal to their undiscounted standalone selling prices (based on VSOE, TPE, or estimated selling price), and recognize the excess of the total remaining revenue over the total allocated to the undelivered items as revenue on the date of material modification.
- **View C:** Allocate consideration to the undelivered items as if the arrangement had been accounted for under EITF 08-1 from its inception (including all interim modifications), and recognize the excess of the total remaining revenue over the total allocated to the undelivered items as revenue on the date of material modification.

For SEC registrants that could not previously separate multiple element arrangements into separate units of accounting but can separate on the adoption of EITF 08-1, based on informal discussions with the SEC staff, we understand that the SEC staff's current view is that View C generally would be the appropriate way to account for materially modified arrangements. View C would require a vendor to estimate the selling prices for all elements of the original arrangement plus any amendments to perform the relative selling price allocation. This approach may be onerous in some cases, particularly for those arrangements that have been outstanding for a number of years or have been amended a number of times. The SEC staff has indicated that View B may also be an acceptable alternative. These views may evolve over time.

We believe a vendor should disclose the method of accounting and effect on revenue for materially modified arrangements.

**Question 4.3: Are contract renewals considered new arrangements?**

**Answer 4.3:** It depends. We believe that a substantive contract renewal of an existing revenue arrangement occurring on or after the adoption date of EITF 08-1 and EITF 09-3 would be considered a new arrangement when electing to adopt the Consensus on a prospective basis. To be considered substantive, the renewal terms cannot be significantly below a vendor's normal pricing practice such that renewal was reasonably assured at the inception of the arrangement. Judgment is necessary to evaluate whether or not the renewal terms are substantive.

In addition, judgment is necessary to determine whether an early renewal represents a material modification of an existing arrangement or a new arrangement. The closer a renewal occurs to the end of a contract expiration date, the more likely it is that it would be considered a new arrangement. A vendor's typical experience with the timing of renewals with other customers and its regular business practices for contacting customers to negotiate renewals would be relevant in making this judgment.

Some vendors enter into master purchase agreements with customers that specify the basic terms and conditions for subsequent transactions between the parties. Under these arrangements, customers request products through purchase orders that specify the products and quantities without executing a new contractual agreement. Generally, purchase orders that are executed under the master purchase agreement are considered standalone agreements, unless they are executed in contemplation of one another, in which case they should be combined as one arrangement under TPA 5100.39<sup>27</sup> (ASC paragraph 985-605-55-4). A vendor should continue to use its customary business practices to determine when purchase orders are considered executed.

**Question 4.4: For a vendor adopting EITF 08-1 on a prospective basis, what constitutes a new arrangement entered into on or after the effective date of adoption?**

**Answer 4.4:** We believe a new arrangement is one in which the key terms of the arrangement are agreed to between a vendor and its customers. Consistent with how a vendor determines that persuasive evidence of that arrangement exists, if a vendor enters into a binding agreement with customers and concludes that evidence of the arrangement existed prior to the date of adoption of EITF 08-1, the vendor should account for those arrangements under EITF 00-21, even if the first deliverable is delivered after the date of adoption.

**Example O: New Arrangement Prior to the Period of Adoption**

ABC Corp. and Customer Z sign a multiple deliverable arrangement contract on December 15, 2010. The first deliverable under the contract is delivered to Customer Z on January 15, 2011.

ABC adopts the provisions of EITF 08-1 on a prospective basis on January 1, 2011.

Even though the first item is delivered after EITF 08-1 is adopted, this arrangement is not considered a new arrangement for purposes of prospective adoption, because persuasive evidence of the arrangement (contract signed by both parties) existed on December 15, 2010 (prior to the adoption date). The arrangement should be accounted for under EITF 00-21.

**Question 4.5: May EITF 08-1 and EITF 09-3 be early adopted?**

**Answer 4.5:** Yes. A vendor may early adopt the Consensus beginning in any interim or annual period for which financial statements have not been issued. The amendments are required to be adopted for fiscal years beginning on or after June 15, 2010. If a vendor elects to early adopt on a prospective basis in an interim period other than the first interim period in a fiscal year, the adoption of the guidance is applied retrospectively to the beginning of the fiscal year of adoption. Further, if a vendor elects to adopt in an interim period other than the first interim period of a fiscal year, it must disclose the following information, at a minimum, for all previously reported interim periods in the fiscal year of adoption: revenue, income before income taxes, net income,

<sup>27</sup> AICPA Technical Practice Aid No. 5100.39, *Software Revenue Recognition for Multiple-Element Arrangements*.

earnings per share, and the effect of the change for the appropriate captions presented. A public entity would not be required to file amendments to previously filed Form 10-Qs. Rather, it would recast the quarterly information to reflect the retrospective adoption in the next Form 10-Q filed that includes these interim periods on a comparative basis.

For example, if a calendar-year-end entity elected to adopt in the quarter ended either September 30 or December 31, 2009, it would apply the provisions retrospectively to new or materially modified arrangements entered into on or after January 1, 2009. If that entity adopted in 2010 in any quarter other than the first quarter, it would apply the provisions retrospectively to new or materially modified arrangements entered into on or after January 1, 2010. If the entity chose not to early adopt the provisions, it would be required to adopt the provisions on January 1, 2011.

Alternatively, an entity may adopt the Consensus retrospectively to prior fiscal years following the guidance in Statement 154 (ASC Topic 250), unless it is determined that it is impracticable to do so based on paragraph 11 of Statement 154 (ASC paragraph 250-10-45-9), which states:

It shall be deemed impracticable to apply the effects of a change in accounting principle retrospectively only if any of the following conditions exist:

- a. After making every reasonable effort to do so, the vendor is unable to apply the requirement.
- b. Retrospective application requires assumptions about management's intent in a prior period that cannot be independently substantiated.
- c. Retrospective application requires significant estimates of amounts, and it is impossible to distinguish objectively information about those estimates that both:
  1. Provides evidence of circumstances that existed on the date(s) at which those estimates would be recognized, measured, or disclosed under retrospective application
  2. Would have been available when the financial statements for that prior period were issued.

Determining whether it is impracticable to estimate the selling prices for deliverables on a retrospective basis requires judgment. The volatility in pricing for a deliverable may affect this determination.

If it is not impracticable to determine estimated selling prices for deliverables in prior years, a vendor may choose full retrospective application as of the earliest year presented. This would require applying the new guidance to all arrangements outstanding during each year presented, not just those entered into or materially modified after the beginning of the earliest year. The transition disclosures of Statement 154 (ASC Topic 250) would be required.

As noted in Statement 154 (ASC paragraph 250-10-45-6), if it is impracticable to determine the retrospective application to all prior years presented, the cumulative effect of the change should be reflected as of the beginning of the earliest year to which the new principle can be applied.

Full retrospective application requires the following:

- a. The cumulative effect of the change to the new accounting principle on periods prior to those presented shall be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented.
- b. An offsetting adjustment, if any, shall be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period.
- c. Financial statements for each individual prior period presented shall be adjusted to reflect the period-specific effects of applying the new accounting principle.<sup>28</sup>

**Question 4.6: May a private entity that has not issued audited financial statements for prior fiscal years early adopt EITF 08-1 and EITF 09-3 on a prospective basis for years prior to 2009?**

**Answer 4.6:** It depends. We believe that an entity may early adopt the Consensuses on a prospective basis for new or materially modified arrangements entered into on or after the beginning of any annual period for which financial statements have not been issued. However, financial statements may be “issued” even if they have not been audited by an independent auditor. Generally, financial statements are considered issued when they are distributed for general use and reliance in a form and format that complies with generally accepted accounting principles (GAAP). To adopt on a prospective basis in prior periods, an entity would need to assess whether those prior year financial statements have been distributed to a third party that would rely on them. If those prior year financial statements have been provided to a third party, they would be considered issued, and early adoption of the Consensuses for those years on a prospective basis would not be permitted.

However, an entity may elect to adopt the Consensuses with full retrospective application to all prior periods if it is not impracticable to do so based on Statement 154 (ASC Topic 250). See Q&A 4.5 for a description of retrospective adoption.

The guidance and concerns about practicability may also be relevant for an entity prospectively adopting in prior fiscal years for which financial statements have not been previously issued. That is, an entity may determine that it is impracticable to apply the Consensuses in those prior years because it is unable to make appropriate estimates related to arrangements entered into in those years.

<sup>28</sup> FASB ASC paragraph 250-10-45-5.

## Ongoing and Transition Disclosures

### **Question 5.1: EITF 08-1 requires that a vendor disclose information by similar type of arrangement. What is meant by similar type of arrangement?**

**Answer 5.1:** When deliberating its recommendations to the Task Force, the EITF 08-1 disclosures working group considered various alternative approaches to aggregating disclosures about multiple element arrangements. One approach was to require aggregation by reportable segment. However, some members of the working group observed that multiple element arrangements may include products and services that cut across multiple segments, and therefore aggregating by segment would not be meaningful. The working group recommended that disclosures be aggregated by similar type of arrangement to allow an entity to aggregate the information in a meaningful way based on its business practices and standard arrangements. The Task Force supported the working group's recommendation.

An entity may find it helpful to consider the following aspects of its multiple element arrangements when determining what constitutes similar arrangements:

- **The products and services sold in the arrangements.** An entity may sell various products across reporting segments and the sale of these products typically also includes installation and training. Even though the products may not be identical, it may be appropriate for an entity to group the arrangements for disclosure purposes because they contain similar products and services, particularly if the timing of revenue recognition for the elements is similar and the methods used to determine selling prices are similar.
- **The customers and markets to whom the arrangements are sold.** An entity may sell the same products and services into different market channels (e.g., end users versus original equipment manufacturers). Even if the products and services in these arrangements are the same, significant terms of the arrangements may be different for these different classes of customers, and therefore grouping arrangements by customers or markets may be a meaningful way to aggregate disclosures.
- **The terms of the arrangements.** Even within arrangements with similar products and services sold to similar customers, there may be differences in the terms of arrangements that may make it meaningful to aggregate on this basis. For example, the pattern of revenue recognition may be affected if the deliverables have different payment terms or delivery patterns. If so, it may be appropriate for an entity to aggregate this information for disclosure purposes.
- **The types of evidence available for determining the selling price of the deliverables (VSOE, TPE, or estimated selling price).** We believe that financial statement users generally perceive estimated selling prices to be less reliable than selling prices that are based on VSOE or TPE. Aggregating arrangements on this basis may provide users with meaningful information, if an entity's approach to estimating selling price is similar across certain arrangements.

**Question 5.2: EITF 08-1 requires an entity to disclose 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. What changes would trigger this disclosure requirement?**

**Answer 5.2:** Judgment is required to determine what a triggering point is for disclosure. The purpose of these disclosures is to provide financial statement users with information about changes in selling prices that would indicate a change in patterns or future trends in revenue. In this context, we believe that changes that cause a significant acceleration or deceleration of revenue recognition, for example, by allocating more revenue to items that are usually delivered first in a vendor's standard arrangements, generally should be disclosed. An entity may also need to disclose changes affecting the estimated selling price of deliverables that are included in its non-standard arrangements. We believe that the effects should be described both qualitatively and quantitatively.

#### **Example P: Ongoing Disclosure Requirements**

ABC Corp. increases its selling price used in the allocation of arrangement consideration for products in Product Line X by 20%, which results in a 10% increase in consideration allocated to the products that are typically delivered at the outset of the arrangement. That increase may have been caused by increases in raw material prices that were passed along to its customers, with an increase in the bundled arrangement fee, but not proportionately for all elements of the arrangement.

It likely would be appropriate for ABC to qualitatively discuss that there has been an increase in the amount of arrangement consideration allocated to products in Product Line X that are included in multiple deliverable arrangements and that products in Product Line X are usually delivered first when bundled in multiple element arrangements. Other quantitative information, such as the amount of Product Line X revenue recognized from multiple deliverable arrangements, might also be disclosed.

**Question 5.3: If a vendor's accounting for a multiple deliverable arrangement is not affected by EITF 08-1, would the new disclosure requirements still apply?**

**Answer 5.3:** Yes. The new ongoing disclosure requirement (ASC paragraphs 605-25-50-1 and 50-2) apply to *all* multiple element arrangements, including those previously accounted under SOP 97-2 that are now scoped into EITF 08-1 by EITF 09-3. Once an entity has adopted EITF 08-1, it will be required to provide disclosures for all multiple element revenue arrangements, including those accounted for under EITF 00-21.

## Other Considerations

**Question 6.1: How would a vendor allocate arrangement consideration when there are amounts that are contingent on the delivery of additional items or meeting other specified performance conditions?**

**Answer 6.1:** EITF 08-1 does not change the contingent revenue guidance in EITF 00-21 (ASC paragraph 605-25-30-5), which states that the arrangement consideration allocated to delivered items is limited to the amounts that are not contingent on the delivery of additional items or meeting other specified performance conditions. This amount would be the lesser of the amount initially allocated using the relative selling price method or the non-contingent amount.

Because many vendors used the residual method of allocation under EITF 00-21, the requirement to use the relative selling price method likely will result in differences in how the arrangement consideration is allocated to the deliverables under EITF 08-1. The change to the relative selling price method may result in the conclusion that contingent revenue exists. The following example illustrates a situation in which there was no contingent revenue under the residual method, but there is contingent revenue under the relative selling price method.

### Example Q: Contingent Revenue Considerations

ABC Corp. sells a personal computer (computer processor and operating system software) and provides one year of PCS on the operating system software for \$1,200. ABC rarely sells personal computers without the operating system software but regularly sells the operating system software bundled with one year of PCS for \$400. A customer can elect to renew PCS annually for \$100. The customer is entitled to a refund equal to the pro-rata amount of the undelivered PCS using the one-year renewal rate of PCS (\$100) if it is not provided. The separation criteria in EITF 08-1 have been met.

Because the personal computer's software and non-software elements function together to deliver the computer's essential functionality, they are considered one deliverable and excluded from SOP 97-2. Because the PCS relates to software that is essential to the tangible product's functionality, it is also considered a separate deliverable excluded from SOP 97-2. The fact that ABC sells the operating system software bundled with PCS for \$400 does not affect the assessment.

Under the residual method, ABC would have deferred \$100 for the PCS. There would be no contingent revenue because none of the consideration allocated to the personal computer is contingent upon delivery of the PCS.

Under the relative selling price method, the arrangement consideration is allocated as:

	Selling Price	Ratio	Initial Relative Selling Price Allocation
<b>Non-Software Deliverables</b>			
Personal computer with operating system software	\$ 1,150	92 %	\$ 1,104
One-year of PCS related to software	100	8 %	96
	<u>\$ 1,250</u>	<u>100 %</u>	<u>\$ 1,200</u>

Because \$4 of the consideration allocated to the personal computer is contingent on the delivery of PCS, only \$1,100 may be allocated to the personal computer. Because the contingent revenue provision lapses ratably over the PCS period, the \$4 deferred would be recognized ratably over the PCS period.

**Question 6.2: What are some other transition considerations for vendors that previously evaluated arrangements for separation under EITF 00-21 or SOP 97-2?**

**Answer 6.2:** Given the significance of the changes resulting from EITF 08-1 and EITF 09-3, vendors should begin considering the effect of these changes on its revenue recognition processes, including internal control over financial reporting (ICOFR).

Vendors may need to implement new internal controls or modify existing controls over its processes for identifying VSOE or TPE or for developing an estimated selling price. Vendors may need to create new or modify existing system-generated reports to determine data inputs to be used in supporting VSOE, TPE, or estimated selling price. They may also need to consider changes to revenue processes to reflect the changes in the allocation of arrangement consideration due to the elimination of the residual method.

SEC registrants should consider the effect of any changes in ICOFR on management's requirement to make certain quarterly and annual disclosures and certifications about the issuer's disclosure controls, procedures, and ICOFR, including disclosure of changes in the entity's ICOFR that occurred during the most recent fiscal quarter (the issuer's fourth fiscal quarter in the case of an annual report) that have materially affected, or are reasonably likely to materially affect, the issuer's ICOFR.

Many vendors, knowing that adoption of EITF 08-1 and EITF 09-3 can affect how they recognize revenue under multiple element arrangements, may also consider changing their existing business models and providing their sales forces with more flexibility to negotiate prices. For example, vendors may have implemented specific business practices to establish VSOE for certain deliverables to meet the separation criteria of either EITF 00-21 or SOP 97-2. They might consider discontinuing those practices if it can now estimate a selling price for those deliverables. Vendors exploring new strategies should consider the accounting implications of those strategies as well as the business and organizational concerns that are the context for the strategies.

Entities should also consider whether the changes in revenue recognition practices for financial reporting purposes will affect their tax accounting methods. The changes in reporting revenue may also affect deferred taxes and may require changes in the processes used in accumulating and reporting deferred tax information.

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