

# Sales, Revenue, and Other Income

## 17.2 OVERVIEW

Revenue represents the actual or expected cash inflow from sales of an entity's core products or services. A realized gain arises from the sale or other disposition of an asset at a price higher than its carrying value or from the extinguishment of a liability at an amount lower than its carrying value. An unrealized gain derives from an increase in the value of an asset still being held by the entity (i.e., a holding gain). The term "other income" is used to describe revenue from transactions that are an integral part of operating a business but are not directly associated with the entity's central products or services.

## 17.3 MEASUREMENT PRINCIPLES

Measurement principles pertain to specific items. Individual sections should be consulted for a complete discussion of those items.

### 17.3.1 SEC Staff Views

The SEC Staff has expressed its position regarding the application of GAAP in recognizing revenue. Though SAB No. 101 and the staff's interpretive document and SAB No. 104 apply only to publicly held companies, the guidance in them should be considered by privately held entities as well.

#### General Matters.

The Staff clarifies that, for transactions that are within the scope of specific GAAP pronouncements, revenue should be recognized in accordance with the criteria set forth therein. Regarding a specific arrangement that is not explicitly addressed in the authoritative literature, the Staff's position is that revenue should be recognized when *all* of the following conditions are met:

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

#### Persuasive evidence of an arrangement.

In the Staff's view, revenue may not be recognized until all elements of the arrangement have been finalized in accordance with the company's normal and customary policies and practices. When a side agreement effectively amends a master contract with a buyer, the Commission cautions that appropriate policies, procedures, and internal controls should be in place to provide reasonable assurance that sales transactions—including those affected by side agreements—are properly accounted for in accordance with GAAP.

The Staff emphasizes that revenue recognition is not appropriate for transactions that are *in-substance* consignments or financings. The presence of one or more of the following characteristics would preclude revenue recognition, even if title has passed to the purchaser:

- The buyer has the right to return the product and:
  - — The buyer does not pay the seller at the time of sale nor is it obligated to do so on a specified date
  - — Payment is not made at the time of sale; though the obligation to pay on a particular date is specified, that obligation is either contractually or implicitly excused until the buyer resells the product (or subsequently uses it).
  - — The buyer's obligation to the seller would be forgiven (or a refund granted) in the event of physical damage or theft of the product.
  - — The buyer (acquiring the product for resale) does not have economic substance independent of that provided by the seller.
  - — The seller has significant obligations for future performance to bring about the resale of the product by the purchaser.
- The product is delivered for demonstration purposes.
- The seller/manufacturer guarantees that the buyer (user of the product) will receive a minimum amount upon resale of the product after the buyer has used it.
- The seller is required to repurchase the product (or a substantially identical one) at specified prices that change only in response to finance and holding costs (e.g., interest) incurred by the purchaser. Specifically, the following attributes of a transaction indicate the existence of such an arrangement:
  - — The seller provides interest-free or below-market financing beyond the seller's customary terms until the product is resold.
  - — The seller pays the buyer's interest cost in a third-party financing.
  - — The seller has a practice of refunding to the buyer a portion of the selling price representing interest expense for the period from the time the seller is paid to the time the buyer resells the product.

If title has passed but the substance of the transaction is that of a consignment or financing, the carrying value of the underlying goods should be presented in the balance sheet separately from other inventory and under an appropriately descriptive caption. Note that, in some foreign jurisdictions, the seller retains a form of title to sold goods until the customer remits payment. Assuming all other conditions are satisfied, revenue may be recognized in such a transaction at the time of delivery if the *only* rights retained by the seller are those enabling recovery of the goods in the event of the customer's default.

## **Delivery and performance.**

Following is a brief discussion of the Staff's position regarding the condition of delivery and performance for revenue to be recognized:

- Delivery is not considered to have occurred unless the customer has taken title and assumes the risks and rewards of ownership. When delivery per se has not taken place, revenue may be recognized only when the following conditions have been met:
  - — The customer has made a fixed commitment (preferably in writing) to purchase the goods.
  - — The buyer (not the seller) has requested a "bill and hold" arrangement and has a substantial business purpose (e.g., space limitations) for doing so.
  - — There is a fixed schedule for delivery that is consistent with the buyers business purpose.
  - — The seller does not have any substantial additional performance requirements; the full amount of revenue may be recognized, however, when the seller has a remaining obligation for additional performance or delivery if (1) the obligation is inconsequential or perfunctory, and (2) the costs expected to be incurred upon

- fulfillment can be reliably estimated and they are accrued at the time the revenue is recognized. Any remaining performance is deemed substantive (i.e., not inconsequential or perfunctory) if it is essential to the functionality of the delivered products or services *and* failure to complete the remaining activities would entitle the customer to a full or partial refund for the products or services already delivered.
- — The seller has *physically* segregated the inventory and it cannot be used to fill other orders.
  - — The product is otherwise complete and ready for shipment.
  - In applying the foregoing conditions for a bill and hold sale to be recognized as revenue, the following factors should be taken into account:
    - — The date on which payment is due and whether the seller's normal billing and credit terms have been modified
    - — The seller's past experiences with the pattern of such transactions.
    - — Whether it is the buyer that will bear the loss in the event of a decline in the product's market value.
    - — Whether the seller's *custodial* risks are insurable and indeed are insured).
    - — Whether the buyer's business reasons for requesting the bill and hold transaction have introduced a contingency to the buyer's commitment to acquire the product.
  - After delivery of the product or performance of the service, if uncertainty about customer acceptance remains, revenue should not be recognized until acceptance occurs; when acceptance provisions are present (e.g., installation, testing), revenue should be recognized only after such provisions have lapsed. A formal sign-off by a customer indicating acceptance is not always necessary as a condition for recognizing revenue, provided the seller objectively demonstrates that the specified acceptance criteria have been satisfied. Revenue on transactions calling for on-site testing of equipment may be recognized before such testing occurs if the seller demonstrates that, at the time of delivery, the equipment already meets all conditions specified in the customer acceptance provisions of the contract (e.g., upon replication of the conditions of customer use in pre-shipment testing).
  - Substantial completion of the terms specified in the arrangement is a prerequisite for revenue to be recognized (i.e., only inconsequential or perfunctory actions may remain undone). If revenue is recognized upon substantial completion, all remaining costs of performance or delivery should be accrued.
  - For arrangements calling for delivery or performance of multiple elements (i.e., those not covered by GAAP pertaining to long-term contracts or multiple element *software* arrangements), the delivery of an individual element is not deemed to have occurred if the yet undelivered elements are essential to the functionality of the delivered elements. When accounting for such arrangements, a reasonable method should be used and disclosed. Such a method might include (1) a condition that, to be considered a separate element, the product or service represents a separate earnings process, and (2) a provision that allocates revenue among the various elements based on their fair values.
  - For licensing arrangements, delivery is not deemed to have taken place until the license term begins to run, regardless of whether the product has been physically delivered.
  - For transactions not obligating the customer to pay for the portion of the contract price related to delivered equipment until all the equipment is delivered or services performed, revenue on the delivered products may be recognized if the undelivered products or services are not essential to the functionality of the delivered equipment.
  - A seller's obligation to maintain and defend its rights to a patent does *not*, of itself, constitute a remaining obligation that requires deferral of revenue in a licensing arrangement (even though such a defense could cause the seller-licensor to incur additional costs).

- Revenue for the licensing of intellectual property *may* not be recognized before the license term begins (even though physical delivery may have taken place at an earlier date).
- When an entity is paid a fee calculated as a percentage of collections it receives from a third party that are then passed along to the entity's customers (e.g., in the case of a medical billing service), revenue may *not* be recognized until the amounts are collected (even if the entity has historical evidence of the portion typically paid by the third party).
- Sales made under a "layaway" program should be recognized as revenue upon delivery of the merchandise.
- When so-called up-front fees are paid to the seller (for which the buyer will pay lower unit prices for the product in the future), revenue may be recognized only if such fees are in exchange for delivered products or performed services that represent the culmination of a discrete earnings process. In substance, up-front fees (even if not refundable) may be part of an ongoing obligation to provide products or services, in which case, revenue should be deferred and recognized systematically over the period that it is earned.
- For ongoing activity tracking services (e.g., the tracking of property tax payments by homeowners, sending collection notices to overdue accounts) that require the customer to prepay for all services to be rendered over the duration of the agreement, revenue should generally be recognized on a straight-line basis over the term of the contract. When the seller has significant set-up costs at inception of the agreement but only minimal additional costs over the service period, revenue may *not* be recognized in proportion to costs incurred because doing so would bear no relationship to when the revenue was earned.

### **Fixed or determinable sales price.**

Generally, the Staff believes that the selling price is not fixed or determinable if the customer has the unilateral right to cancel the contract and receive a full refund; revenue should not be recognized by assessing the probability that customers will not cancel contracts. Specifically, the Staff's position is that:

- Fees received for services that remain refundable after the services have been performed may either be treated as a refundable deposit in accordance with SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, or, under limited circumstances, be recognized as revenue (by analogy to SFAS No. 48) when reliable estimates of customer cancellations can be made. Whichever policy is adopted should be disclosed and applied consistently. Note that the Staff will *not* object to a subsequent change from the immediate recognition method to the deposit method but *will* object to a change from the deposit method to the immediate recognition method if, at the time of original adoption of the deposit method, the company was eligible to use the immediate recognition method.
- When changing from the deposit method to the immediate recognition method (because reliable estimates can now be made), remaining deferred costs (and revenue) should be recognized, and costs of anticipated cancellations should be accrued.
- If the customer has the right to receive both the seller's performance (i.e., delivery of product or providing of services at discount prices) *and* a cash refund of prepaid fees (e.g., in the case of a retailer that charges annual refundable membership fees for the privilege of shopping in the retailer's stores), the prepaid fees received should be accounted for as a monetary liability in accordance with SFAS No. 140. Pursuant to SFAS No. 140, derecognition of a monetary liability is

appropriate only if the debtor pays the creditor or the debtor is otherwise legally discharged from its obligation. Hence, the seller's refund obligation is relieved only upon refunding cash or upon expiration of the refund privilege. These strict conditions notwithstanding, the Staff *will allow* revenue to be recognized (net of estimated refunds) over the membership term if *all* of the following criteria have been satisfied:

- — Estimates of terminations or cancellations are made for a large pool of homogeneous items.
- — Reliable estimates of expected refunds can be made on a timely basis; note that *either* recurring significant differences between estimated and actual amounts *or* recurring variances that are material to revenue or net income are considered indicative of the inability to meet this condition. The Staff will presume that reliable estimates cannot be made if the termination or cancellation period extends beyond one year.
- — Sufficient historical company-specific data exist on which refund estimates can be based and the company believes that such data are indicative of future results.
- — The amount of the membership fee is fixed.
- If revenue is recognized over the membership period (based on the foregoing criteria), the amount of the fee should be allocated (1) to a monetary liability representing customer refundable fees, and (2) to a nonmonetary liability representing unearned revenue. Both the monetary and nonmonetary liabilities should be remeasured at each balance sheet date, with the resulting adjustment as an offset to earned revenue. For each income statement presented, the following information should be disclosed:
  - — The amount of unearned revenue; and
  - — An analysis of the refund obligation, including beginning and ending balances, the amount of cash received, the amount recognized in earnings, the amount of refunds paid, and other adjustments (with explanations).
- If membership packets are distributed that include vouchers providing new members with discounts or other benefits, the costs associated with the vouchers should be charged to operations as incurred. Advertising costs to solicit members should be expensed or capitalized pursuant to the criteria specified in SOP No. 93-7, *Reporting on Advertising Costs*. Incremental direct costs of enrolling customers (e.g., commissions paid to agents) should be accounted for as follows:
  - — If revenue is deferred until the cancellation or termination privileges expire, either (1) charged to operations when incurred if the costs (commissions) are not refundable in the event a customer is granted a refund, or (2) as an asset until the earlier of termination (or cancellation) or a refund is given to the customer.
  - — If revenue is recognized over the membership term, the same percentage of incremental direct costs should be deferred and recognized in earnings on the same pattern as revenue is recognized, with the remaining portion either (1) charged to operations as incurred if the costs (commissions) are not refundable in the event of a customer refund, or (2) if the costs are refundable, capitalized until the refund is granted
- A lessor should not recognize income attributable to contingent rent until the lessee reaches the target that triggers the obligation on the lessee's part to pay such rentals.
- Revenue from receipt of an initial nonrefundable fee from a customer should be recognized over the term of the agreement (even if the seller will not incur significant additional operating costs). Similar treatment is required in the case of an activation fee for a service that will be provided over time and in the case of an up-front fee in an R&D arrangement.

## **Income statement presentation.**

When a company takes orders for another and receives only a commission (i.e., it does not act as a principal in the transaction as in the case of a company operating an Internet site on which it processes orders for products and passes the orders onto manufacturers or distributors for fulfillment), revenue should be reported *only* in the amount of the commission. Reporting revenue in the full amount of the selling price with separate reporting of the cost of sale to arrive at gross profit equal to the commission is inappropriate when the entity acts only as an agent or broker. In operationalizing the SEC Staff's position in SAB No. 101, the EITF concluded that, whether revenue should be recognized in the gross amount billed to a customer or in the net amount retained (i.e., the amount billed less the amount paid to the supplier) is a matter of judgment that depends on the relevant facts and circumstances. The Task Force set forth the following factors that should be taken into account in making that determination.

#### **Indicators of gross reporting:**

- The entity (not the supplier) is the primary obligor in the transaction and it is responsible for fulfillment of the order and for the customer's acceptance of the goods or services sold.
- The entity bears general inventory risk (i.e., it takes title to the goods) before the customer's order is placed or upon the customer's return.
- The entity (within market constraints) has reasonable latitude to establish the selling price.
- The entity has the discretion to select the supplier (among many) for a product or service ordered by the customer.
- The entity is involved in the process of determining the product's specifications.
- The entity bears physical loss inventory risk (i.e., title to the product is transferred to the entity at the supplier's shipping point and then to the customer upon delivery).
- The entity bears credit risk for the amount billed to the customer and thus must pay the supplier in the event the selling price is not fully collected.

#### **Indicators of Net Reporting**

- The supplier (not the entity) is the primary obligor in the transaction.
- The amount per transaction the entity earns is fixed or is a stated percentage.
- The supplier (not the entity) bears credit risk in the event of nonpayment by the customer.

Note that the existence of any of the foregoing indicators should not be considered determinative or presumptive; rather, the relative strength of each (or in combination) should be evaluated.

Likewise, retailers that lease or license store space should include only rental income in gross revenue, although the Staff will not object to footnote disclosure of the amount of lessee sales. If the retailer assumes the risk of bad debt on sales of merchandise made by lessees, the expense of such uncollectible accounts should be included as part of the entity's other bad debt expense—not as an offset to rental income. If the arrangement is not a lease but rather a service arrangement in which the retailer receives a fee of commission, such fee or commission should be recognized as revenue when earned.

#### **Accounting for certain costs of revenue.**

When both costs and related revenue are deferred, the costs should be charged to operations proportionately over the same period that the revenue is recognized. Contract acquisition and origination costs may either be charged to expense as incurred or deferred; in either case, the accounting policy should be disclosed and consistently applied.

### 17.3.2 Sales Incentives

The EITF reached the following consensus regarding the accounting treatment by vendors for sales incentives:

- The cost of an incentive not resulting in a loss on the sale itself should be recognized at the *later* of (1) the date at which the related revenue is recognized, or (2) the date at which the incentive is offered, if after the date of sale
- For rebates and coupons entitling the customer to receive a refund or reduction of the prior purchase price (made at the point of sale), a liability (or deferred revenue) should be established, based on estimated amounts of customer claims, at the later of the dates that revenue was recognized or the incentive was offered; if a reasonable estimate cannot be made, the liability should be at the maximum potential amount. Note that the following factors may impair the ability to make a reasonable and reliable estimate:
  - — The rebate or refund may be claimed over an extended period
  - — The absence of past experience
  - — The lack of a large volume of relatively homogeneous transactions
- For incentives that will result in a loss on the sale itself, a liability should not be set up before the date on which the related revenue is recognized. Note that a loss on the sale may indicate impairment of the underlying inventory.
- When recognized, the reduction in or refund of the selling price from a sales incentive should be classified as a *reduction* of revenue; if, however, the incentive is a free product or service delivered to the customer at the time of sale (e.g., a gift certificate or airline ticket to be honored by another entity), the cost of the free product or service should be classified as an *expense* (or as part of cost of sales)

### 17.3.3 Shipping and Handling Costs and Fees

The EITF has concluded that all amounts billed to customers in a sale transaction representing shipping and handling charges should be classified as revenue. The classification of costs incurred for shipping and handling is a matter of accounting policy (which should be disclosed). Note that, if such costs are significant and not charged to cost of sales, the amount should be disclosed as well as their location in the income statement.

### 17.3.4 Time-Based or Volume-Based Incentive Offers

The EITF addressed the issue of accounting for an offer to a customer to rebate or refund a specified amount of cash if the customer (1) provides a given cumulative level of revenue, or (2) remains a customer for a required length of time. Such offers are typically referred to as membership-based loyalty programs.

The Task Force reached a consensus that the cash rebate or refund obligation should be recognized (as a reduction of revenue) based on a systematic and rational allocation of the progress by customers toward becoming eligible for the rebates or refunds.

Measurement of the obligation should take into account, if reasonably estimable, the number of customers that will ultimately earn and claim such rebates or refunds. If a reasonable estimate cannot be made, the liability should be recognized at the maximum potential amount. Factors that could impair the ability to make a reasonable estimate include:

- A relatively long duration over which a rebate or refund may be claimed.
- The absence of experience with similar types of incentive programs covering similar products or the inability to apply experience due to changing conditions.
- The absence of a large volume of relatively homogeneous transactions.

When the size of the cash rebate or refund is subject to change based on a customer's aggregate transaction volume, the liability should be (1) recorded in the maximum potential amount if an estimate of a customer's future purchases cannot be made, or (2) based on the projected volume if such an estimate can be reliably determined.

Changes in the estimated liability based on revised projections of future purchases or on retroactive modification to a prior offer should be recorded as a cumulative catch-up adjustment.

The following example illustrates application of the foregoing consensus:

### **Example 1. Changes in Estimate of Future Rebates**

#### **FACTS**

Assume that Client Company, Inc. offers a 5% rebate to all customers purchasing at least 1,000 units of its product during any calendar year. The rebate is retroactive to the first 1,000 units when the threshold level of annual purchases is met. The unit price is \$100. Client Company originally estimates that 650 of its 2,000 customers will qualify for rebates. On September 30, however, Client Company increases its estimate to 850 customers. Also assume that, as of September 30, 500,000 units have already been sold to the group of 650 customers originally estimated to qualify and that 100,000 units have been sold to the additional 200 customers now expected to be entitled to the rebates.

#### **SOLUTION**

Based on the first estimate, Client Company would record \$95 of each \$100 unit sale to customers in the original qualifying group as revenue and \$5 as a rebate obligation. For sales to its other customers, the full \$100 is recognized as revenue. Based on the revised estimate on September 30, the refund obligation would be increased by \$500,000 (100,000 units having been sold to date to 200 additional qualifying customers × \$5 in retroactive rebates); revenue for the year to date would be reduced by a corresponding amount. Subsequent to the catch-up adjustment, Client Company would record \$95 of each \$100 unit sale to the revised group of 850 customers as revenue and \$5 as a rebate obligation. For all other customers, \$100 would be recognized as revenue.

## **17.3.5 Characterization of Consideration Paid to a Reseller**

The Emerging Issues Task Force addressed the issue of income statement characterization of amounts paid to a reseller of the vendor's products and reached the following consensus:

- In general, cash consideration paid to a reseller is presumed to be a reduction of the selling price of the product(s) and thus should be characterized in the vendor's income statement as a reduction of revenue. Note, though, that non-cash consideration should be shown as a cost incurred if (1) the vendor receives an identifiable benefit in return for the consideration, (2) the vendor could have entered into an exchange transaction with a party other than the reseller to receive the benefit, and (3) the vendor is able to estimate the fair value of the benefit. If the amount of consideration paid exceeds fair value of the benefit received, the excess should be recorded as a reduction of revenue (with the fair value portion of the amount paid recognized as a cost).
- In applying the foregoing, negative revenue for a given period could arise (i.e., when the consideration paid in a given period exceeds the amount of actual product revenue). Generally, no portion of negative revenue may be reclassified as an expense, unless the vendor can demonstrate that characterization as a reduction of revenue results in negative revenue for a specific customer over the period since inception of the customer relationship; in such a case, the amount of the cumulative shortfall may be reclassified as an expense. Note that a single customer should be defined in accordance with SFAS No. 131, *Disclosure about Segments of an Enterprise and Related Information* (i.e., a group of entities under common control).

Companies may provide services to their customers that require customers to purchase equipment in order to utilize such services. The equipment may be manufactured and distributed by third parties and sold to the service provider's end customers directly or through resellers without the service provider's involvement. As part of such arrangement, the service provider, for the purpose of stimulating demand for the equipment (and thus indirectly to increase demand for the service provider's services), may provide incentives to the third-party manufacturers of the equipment (or their resellers) to reduce the equipment's selling price on sales to the service provider's end customers. The Task Force reached the following consensus regarding incentives given by service providers to third-party equipment manufacturers:

- If the incentives can be contractually linked to the benefit received by the service provider's customer, the service provider should account for as a reduction of revenue if the consideration is in the form of cash or as a cost if the consideration is in a form other than cash.
- The consideration given should be characterized as "cash" or "other than cash" based on the form of consideration to be provided (i.e., passed along) to the service provider's customer.
- Consideration should be deemed as "other than cash" if (1) the form of the consideration is stipulated to be anything other than "cash consideration", (2) the service provider does not control the form of the consideration to be passed along, or (3) the customer receives a reduced price (but not a cash rebate) on equipment purchased from the manufacturer or reseller.

The EITF addressed the situation under which consideration is received by a reseller from a vendor representing reimbursement for the reseller having honored the vendor's sales incentives offered directly to consumers (e.g., in the form of rebate or price-off coupons). The EITF reached a consensus that, if the reimbursement is not influenced by or negotiated in conjunction with other incentive arrangements between the vendor and the

reseller, the consideration for having honored the vendor's incentives offered directly to consumers may be reported by the reseller as a reduction of cost of sales.

### **17.3.6 Reimbursements Received for Out-of-Pocket Expenses Incurred**

The EITF has concluded that reimbursements received for out-of-pocket expenses incurred on behalf of clients or customers should be reported as revenue, rather than as a deduction from operating revenue.

### **17.3.7 Revenue Arrangements with Multiple Deliverables**

It is not unusual for revenue arrangements to have what are referred to as multiple deliverables. Generally, multiple deliverables involve delivery or performance of multiple products, services, or rights to use assets. Such delivery or performance (i.e., deliverables) may take place at different points in time (or over time) during the term of the arrangement.

The EITF reached a consensus that revenue arrangements with multiple deliverables should be divided into separate accounting units only if the deliverables meet all of the following conditions:

- The delivered item has value to the customer on a standalone basis (i.e., the item is otherwise sold separately by any vendor or the customer could resell the item on a standalone basis). Note that the existence of an observable market for one or more deliverables is not required.
- Objective and reliable evidence exists of the fair value of the undelivered items.
- When a customer has the general right of return on a delivered item, delivery or performance of the undelivered items must be considered probable and substantially within the vendor's control.

The EITF concluded that consideration received by the seller (i.e., revenue) should be allocated among the separate units of accounting based on their relative fair values (referred to as the fair value method). When there is objective and reliable evidence of the fair values of undelivered items but no such evidence exists for the items already delivered, the amount of consideration allocated to the delivered items should be computed as the remainder of the total consideration in the arrangement, less the aggregate fair value of the undelivered items (referred to as the residual method).

In general, the "reverse" residual method is unacceptable (i.e., the amount allocated to the undelivered items should not be the remainder of the total consideration received, less the aggregate fair value of the delivered items). Note though, that to the extent that any separate unit of accounting (including a delivered item) is required by GAAP to be recorded at fair value (and then marked to market at each reporting date thereafter), the amount of revenue allocated to that unit should be its individual fair value. In such a case, the remaining consideration should be allocated pursuant to the fair value method or the residual method, as appropriate.

The amount of consideration allocable to delivered items is limited to the non-contingent portion (i.e., the amount that is not contingent upon the delivery of additional items or other specified performance conditions). Thus, the amount allocable to delivered items

may not exceed the lesser of (1) the amount otherwise allocable based on application of either the fair value or residual method, or (2) the non-contingent amount.

The Task Force also concluded that, in measuring revenue of each period, the calculation should be based on the assumption that the arrangement will not be cancelled.

A recorded asset representing the excess of revenue recognized over the amount of cash or other consideration received since inception of the arrangement should not be greater than the total amount to which the seller is legally entitled (including cancellation fees). In determining the amount of the asset, the seller should take into account whether it intends to enforce its contractual rights in the event of customer cancellation.

Stated prices for individual products or services in an arrangement with multiple deliverables should not be presumed to represent fair value. Rather, the best evidence of fair value is the price of the deliverable when it is regularly sold on a standalone basis. Vendor-specific objective evidence (VSOE) should be used to determine fair value whenever such evidence is available. VSOE is limited to:

- The price charged for a deliverable when it is sold separately, or
- For a deliverable not yet being sold separately, the price, once established by management, is not likely to change before separate introduction of the deliverable item into the marketplace.

When VSOE is not available, third-party evidence of fair value (i.e., either the vendor's price or a competitor's price for largely interchangeable products or services) may be used.

Note that, regarding the application of the foregoing consensus:

- If a higher-level pronouncement provides guidance concerning the determination of separate units of accounting and the method of allocating consideration to such units, the arrangement should be accounted for in accordance with that pronouncement.
- If a higher-level pronouncement does not specify the manner of allocating consideration (but does provide guidance concerning the separation of deliverables within its scope), allocation should be made on a fair value basis between the deliverables within the scope of that pronouncement and those that are outside its scope. In such a case, identification of separate units of accounting (and allocation of value thereto) is governed by the provisions of the EITF consensus.

### **17.3.8 Sales of Vaccines and Bio-Terror Countermeasures to U.S. Government Stockpiles**

Because questions have arisen in respect of the timing of recognizing revenue on sales by manufacturers of various vaccines and bio-terror countermeasures to government stockpile programs (specifically, for placement into the Pediatric Vaccine Stockpile or the Strategic National Stockpile), the SEC has provided guidance on accounting for such sales. The primary objective of government vaccine stockpile programs is to be able to access vaccines on demand - rather than to take delivery thereof. In addition, because of their limited shelf life, the vaccine stockpile must be periodically rotated.

Pursuant to CON No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, revenue may be properly recognized only when it is earned and realized (or realizable). To qualify as earned revenue, the selling entity must have substantially completed the conditions necessary to be entitled to the benefits represented by such revenue. In most cases, both conditions are met by the time the product is delivered. Under SEC rules (principally, SAB No. 104, *Revenue Recognition in Financial Statements*), to recognize revenue on so-called bill-and-hold sales (among other criteria, as discussed above): (1) a fixed schedule for delivery of the goods must exist; and (2) the seller must have physically segregated the goods from its inventory. Often, because of their nature, sales of vaccines to government stockpiles will not satisfy the foregoing GAAP or SEC requirements for revenue recognition.

In light of the urgent public policy objectives, the Commission has provided an exception to existing GAAP and SEC financial reporting rules for recognizing revenue on sales of certain vaccines to the federal government's stockpile programs. In particular, the SEC will not object to the recognition of revenue, provided that, except in respect of product delivery and inventory segregation, all other revenue recognition requirements for bill-and-hold sales are satisfied. Only the following vaccines (referred to as enumerated vaccines) qualify for the exception:

- Childhood disease vaccines.
- Influenza vaccines.
- Other vaccines and countermeasures to be placed in the Strategic National Stockpile.

Upon adoption of the exception, affected companies should consider disclosing the following information:

- A discussion of the material terms and conditions of contracts to sell the enumerated vaccines to which the allowed exception of recognizing revenue was applied, including: (1) the amount of fees received; and (2) identification of the covered vaccines sold to the stockpiles.
- A description of the nature of any continuing involvement with the stockpiles, including the process of periodic vaccine rotation.
- A discussion of the accounting policy adopted for the enumerated vaccines sold to stockpiles.
- The quantified effects of having adopted the allowed exception on relevant balance sheet and income statement line items, including sales, cost of sales, inventory, and deferred revenue.
- The market value of inventory available for rotation out of vaccine stockpiles.
- The amount of sales made to third parties that were filled from vaccine stockpiles.
- Quantities of enumerated vaccine products (and related sales revenue) actually delivered out of stockpiles to the Centers for Disease Control or other party for use during the period.

### **17.3.9 Presentation of Government Imposed Tax on Revenue Transactions**

The EITF reached a consensus that: (1) any tax assessed by a governmental authority directly imposed on a revenue-producing transaction between a seller and customer may be presented in the seller's income statement either on a gross basis (i.e., included in revenues and costs) or on a net basis (excluded from revenues); (2) the method selected represents an accounting policy decision that requires disclosure pursuant to APB Opinion

No. 22, *Disclosure of Accounting Policies*; and (3) under the gross basis, separate disclosure should be made of the amounts of taxes included in revenues and costs.

## **17.4 DISCLOSURES**

There are a great many disclosures required by GAAP in connection with sales, revenue, and other income. Individual sections should be consulted. However, the following are some of the more common sources of sales, revenue, and other income:

- Sales of products and services.
- Revenue by industry segment (required only of publicly held companies).
- Sales to affiliates.
- Significant sales to one customer or a group of customers.
- Revenue applicable to discontinued operations of a business segment.
- Revenue recognition from leasing operations.
- Amortization of deferred or unearned revenue.
- Sales of property, plant, and equipment, or other operating assets.
- Net realized gains from the sale of marketable securities.
- Net unrealized gains on marketable equity securities.
- Income from investees accounted for by the equity method.
- Dividends from investees.
- Exchange gain in connection with foreign operations.
- Gains for debtors in connection with troubled debt restructuring.
- Franchise fee revenue.
- Sales of real estate.
- Revenue recognition when the right of return exists.

For revenue arrangements with multiple deliverables, the following disclosures are required:

- An entity's accounting policy for recognizing revenue from multiple-deliverable arrangements (including whether deliverables have been divided into separate accounting units).
- The nature of such arrangements, including provisions relating to performance, cancellation, termination, and refunds.

See Section 18 , costs and expenses, for guidelines on preparing an income statement.

### **17.4.1 Examples**

## **CTI Molecular Imaging. Inc. (2004 Form 10-K)**

## Example .

### Revenue Recognition

We record revenue in accordance with the guidance of the SEC's *Staff Accounting Bulletin SAB No. 104* (SAB 104), which supersedes SAB No. 101 in order to encompass EITF No. 00-21, *Revenue Arrangements with Multiple Deliverables* (EITF 00-21). Our revenue is derived from sales of scanners, calibration sources, spare parts, detector materials, cyclotrons, radiopharmaceuticals, medical image analysis applications, sales and marketing services, and the provision of services on equipment sold, including site planning and installation, preventive maintenance and repair, training, technical support and assistance with licensing. Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the contract price is fixed or determinable, and collectibility is reasonably assured. No right of return privileges are granted to customers after shipment. Revenues derived from the sale of scanners, cyclotrons, calibration sources, spare parts, medical image analysis applications and detector materials are recognized upon either shipment or arrival at destination depending on shipment terms. We account for sales of scanning equipment and related installation and associated training services as multiple-element arrangements. We recognize revenue for the elements separately as (i) the sales of the equipment, installation and training services represent separate earnings processes, (ii) revenue is allocated among the elements based on the fair value of the elements and (iii) installation and associated training are not deemed essential to the functionality of the equipment. We determine the value of the equipment and installation and training services based on sales of the equipment both with and without installation and training. We also recognize as revenue reimbursements for certain sales and marketing services as such services are provided to Siemens and as the Company is the primary obligor for the expenses incurred in providing these services.

For arrangements with multiple deliverables, such as scanner and cyclotron sales, we recognize product revenue by allocating the revenue to each deliverable based on the fair value of each deliverable in accordance with EITF No. 00-21 and SAB No. 104, and recognize revenue for equipment upon delivery and for installation and other services as performed. EITF No. 00-21 was effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003.

Revenues derived from distribution of radiopharmaceuticals are recognized upon delivery of the product. Equipment maintenance service contracts are typically three or more years in duration and related revenues are recognized ratably over the respective contract periods as the services are performed. For other services, revenue is recognized upon completion of the service.

Our contracts typically require customer payments in advance of revenue recognition. These deposit amounts are reflected as customer advances and recognized as revenue when the Company has fulfilled its obligations under the respective contracts.

Revenues derived from our software license sales are recognized in accordance with Statement of Position (SOP) SOP No. 97-2, "Software Revenue Recognition," and SOP No. 98-9, "Modifications of SOP No. 97-2, Software

Revenue Recognition with Respect to Certain Transactions.” For software license sales for which any services rendered are not considered essential to the functionality of the software, we recognize revenue upon delivery of the software, provided (1) there is evidence of an arrangement, (2) collection of our fee is considered probable and (3) the fee is fixed and determinable. If professional services are considered essential to the functionality of the software, we record revenue for the license and professional services over the implementation period using the percentage of completion method, measured by the percentage of labor hours incurred to date to estimated total labor hours for each contract.

## **MTI Technology Corp. (2005 Form 10-K)**

Example .

### (1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### *Revenue Recognition*

The Company derives revenue from sales of products and services. The following summarizes the major terms of the contractual relationships with customers and the manner in which the Company accounts for sales transactions.

#### *Hardware revenue*

Hardware revenue consists of the sale of disk and tape based hardware. The Company recognizes revenue pursuant to Emerging Issues Task Force No. 00-21, “Revenue Arrangements with Multiple Deliverables” (EITF 00-21) and Staff Accounting Bulletin No. 104, “Revenue Recognition in Financial Statements” (SAB 104). In accordance with these revenue recognition guidelines, revenue is recognized for a unit of accounting when all of the following criteria are met:

- persuasive evidence of an arrangement exists;
- delivery has occurred;
- fee is fixed or determinable; and
- collectability is reasonably assured.

Generally, product sales are not contingent upon customer testing, approval and/or acceptance. However, if sales require customer acceptance, revenue is recognized upon customer acceptance. Product sales with post-delivery obligations generally relate to professional services, including installation services or other projects. Professional services revenue is not recognized until

the services have been performed, while product revenue is recognized at time of shipment as the services do not affect the functionality of the delivered items. In sales transactions directly to an end user, generally there are no acceptance clauses. However, the Company also sells to leasing companies who in turn lease the product to their lessee, the end user. For this type of sale, generally there are lessee acceptance criteria in the purchase order or contract. For these transactions, revenue is deferred until written acceptance is received from the lessee. Credit terms to customers typically range from net 30 to net 60 days after shipment.

Product returns are estimated in accordance with Statement of Financial Accounting Standards No. (Statement) 48, "Revenue Recognition When Right of Return Exists." Customers have a limited right of return which allows them to return non-conforming products. Accordingly, reserves for estimated future returns are provided in the period of sale based on contractual terms and historical data and are recorded as a reduction of revenue. The Company also ensures that the other criteria in Statement 48 have been met prior to recognition of revenue: the price is fixed or determinable; the customer is obligated to pay and there are no contingencies surrounding the obligation or the payment; the customer's obligation would not change in the event of theft or damage to the product; the customer has economic substance; the amount of returns can be reasonably estimated; and we do not have significant obligations for future performance in order to bring about resale of the product by the customer.

#### *Software revenue*

The Company sells various software products ranging from software that is embedded in the hardware to add-on software that can be sold on a stand-alone basis. Software that is embedded in the hardware consists of tools that provide a user-interface and assist the customer in the configuration of storage disks as well as provide performance monitoring and troubleshooting features. This software cannot be sold on a stand-alone basis and is not a significant part of sales or marketing efforts. This embedded software is considered incidental to the hardware and is not recognized as a separate unit of accounting apart from the hardware. If a maintenance contract is sold related to this software, it is accounted for in accordance with EITF 00-21, whereby the total arrangement revenue is first allocated to the maintenance contract based on fair value and the remaining arrangement revenue is allocated to the hardware elements in the transaction. Revenue from maintenance contracts is recognized ratably over the term of the contract.

The Company also sells application software that is sold as add-on software to existing hardware configurations. This software is generally loaded onto a customers' host CPU and provides additional functionality to the storage environment, such as assisting in data back-up, data migration and mirroring data to remote locations. Based on the factors described in footnote two of AICPA Statement of Position (SOP) 97-2 "Software Revenue Recognition," the Company considers this type of software to be more-than-incidental to hardware components in an arrangement. This assessment is based on the fact that the software can be sold on a stand-alone basis and that maintenance contracts are generally sold with the software. Software products that are considered more-than-incidental are treated as a separate unit of accounting apart from the hardware and the related software product revenue is recognized upon delivery to the customer. The Company accounts for software

that is more-than-incidental in accordance with SOP 97-2, as amended by SOP 98-9, whereby the total arrangement revenue is first allocated to the software maintenance contract based on vendor specific objective evidence (VSOE) of fair value and is recognized ratably over the term of the contract. VSOE is established based on stand-alone renewal rates. The remaining revenue from the sale of software products is recognized at the time the software is delivered to the customer, provided all the revenue recognition criteria noted above have been met, except collectability must be deemed probable under SOP 97-2 versus reasonably assured under SAB 104.

In transactions where the software is considered more-than-incidental to the hardware in the arrangement, the Company also considers EITF 03-05, "Applicability of AICPA Statement of Position 97-2, Software Revenue Recognition, to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software" (EITF 03-05). Per EITF 03-05, if the software is considered not essential to the functionality of the hardware, then the hardware is not considered "software related" and is excluded from the scope of SOP 97-2. All software sold by MTI is not essential to the functionality of the hardware. The software adds additional features and functionality to the hardware and allows the customer to perform additional tasks in their storage environment. The hardware is not dependent upon the software to function and the customer can fully utilize the hardware product without any of the software products. Therefore, in multiple-element arrangements containing hardware and software, the hardware elements are excluded from SOP 97-2 and are accounted for under the residual method of accounting per EITF 00-21 and SAB 104.

#### *Service revenue*

Service revenue is generated from the sale of professional services, maintenance contracts and time and materials arrangements. The following describes how the Company accounts for service transactions, provided all the other revenue recognition criteria noted above have been met. Generally, professional services revenue, which includes installation, training, consulting and engineering services, is recognized upon delivery of the services. If the professional service project includes independent milestones, revenue is recognized as milestones are met and upon acceptance from the customer. Maintenance revenue is generated from the sale of hardware and software maintenance contracts. These contracts generally range from one to three years. Maintenance revenue is recorded as deferred revenue and is recognized as revenue ratably over the term of the related agreement.

#### *Multiple element arrangements*

The Company considers sales contracts that include a combination of systems, software or services to be multiple element arrangements. Revenue related to multiple element arrangements is separated in accordance with EITF 00-21 and SOP 97-2. If an arrangement includes undelivered elements, the residual method is used, whereby the fair value of the undelivered elements is deferred and the residual revenue is allocated to the delivered elements. Discounts are allocated only to the delivered elements. Fair value is determined by examining renewed service contracts and based upon the price charged when the element is sold separately or, for transactions accounted for under EITF 00-21, prices provided by vendors if sufficient stand-alone sales information is not available.

Undelivered elements typically include installation, training, warranty, maintenance and professional services.

#### *Other*

Certain sales transactions are initiated by EMC and jointly negotiated and closed by EMC and MTI's sales force. The Company recognizes revenue related to these transactions on a gross basis, in accordance with EITF 99-19, because it bears the risk of returns and collectability of the full accounts receivable. Product revenue for the delivered items is recorded at residual value upon pickup by a common carrier for Free Carrier (FCA) origin shipments. For FCA destination shipments, product revenue is recorded upon delivery to the customer. If the Company subcontracts the undelivered items such as maintenance and professional services to EMC or other third parties, it records the costs of those items as deferred costs and amortizes the costs using the straight-line method over the life of the contract. The Company defers the revenue for the undelivered items at fair value based upon list prices with EMC according to EITF 00-21. At times, MTI's customers prefer to enter into service agreements directly with EMC. In such instances, the Company may assign the obligation to perform services to EMC, or other third parties, and therefore does not record revenue nor defer any costs related to the services.

The Company may allow customers that purchase new equipment to trade in used equipment to reduce the purchase price under the sales contract. These trade-in credits are considered discounts and are allocated to the delivered elements in accordance with EITF 00-21. Thus, product revenue from trade-in transactions is recognized net of trade-in value.

#### *Shipping*

Products are generally drop-shipped directly from suppliers to MTI's customers. Upon the supplier's delivery to a carrier, title and risk of loss pass to MTI. Revenue is recognized at the time of shipment when shipping terms are Free Carrier (FCA) shipping point as legal title and risk of loss to the product pass to the customer. For FCA destination point shipments, revenue is recorded upon delivery to the customer.

## **CVS Corp. (2005 Form 10-K)**

Example .

### (1) Significant Accounting Policies

Revenue recognition - The Company recognizes revenue from the sale of merchandise at the time the merchandise is sold. Customer returns are immaterial. Service revenue from the Company's pharmacy benefit management

segment, which is recognized using the net method under Emerging Issues Task Force ("EITF") Issue No. 99-19, "Reporting Revenue Gross as a Principal Versus Net as an Agent," is recognized at the time the service is provided. Service revenue totaled \$201.8 million in 2005, \$129.3 million in 2004 and \$96.0 million in 2003. Premium revenue from the Company's pharmacy benefit management segment is accounted for under SFAS No. 113, "Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts," and is recognized over the period of the contract in proportion to the amount of insurance coverage provided. Premiums collected in advance are deferred. Premium revenue totaled \$91.6 million in 2005. There was no premium revenue in 2004 or 2003.

Vendor allowances - The Company accounts for vendor allowances under the guidance provided by EITF Issue No. 02-16, "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor", and EITF Issue No. 03-10, "Application of EITF Issue No. 02-16 by Resellers to Sales Incentives Offered to Consumers by Manufacturers." Vendor allowances reduce the carrying cost of inventory unless they are specifically identified as a reimbursement for promotional programs and/or other services provided. Funds that are directly linked to advertising commitments are recognized as a reduction of advertising expense in the selling, general and administrative expenses line when the related advertising commitment is satisfied. Any such allowances received in excess of the actual cost incurred also reduce the carrying cost of inventory. The total value of any upfront payments received from vendors that are linked to purchase commitments is initially deferred. The deferred amounts are then amortized to reduce cost of goods sold over the life of the contract based upon purchase volume. The total value of any upfront payments received from vendors that are not linked to purchase commitments is also initially deferred. The deferred amounts are then amortized to reduce cost of goods sold on a straight-line basis over the life of the related contract. The total amortization of these upfront payments was not material to the accompanying consolidated financial statements.

## **Abaxis, Inc. (2005 Form 10-K)**

### **Example . The Company and Summary of Significant Accounting Policies**

The Company periodically provides incentives in the form of free goods or extended maintenance agreements to customers in connection with the sale of its instruments. In addition, the Company periodically offers trade-in programs from time to time in which it will either provide incentives in the form of free goods to customers for purchasing its instruments or reduce the sales price of the instrument. Revenue from such sales is allocated separately to the instruments and free goods based on the relative fair value of each element. Revenue allocated to free goods is deferred until the goods are shipped to the customer, which is then recorded as an increase in revenues.

Revenue associated with extended maintenance agreements are recognized ratably over the life of the contract. Amounts collected in advance of revenue recognition are recorded as a current or long-term liability based on the time from the balance sheet date to the future date of revenue recognition.

The Company offers cash rebates to customers who purchase instruments during a promotional period. The cash rebate is recorded as a reduction to gross revenues. The Company also offers distributor pricing rebates to distributors upon meeting the sales volume requirements during the qualifying period. The distributor pricing rebate is recorded as a reduction to gross revenues during the qualifying period.

**Shipping and Handling** - The cost of shipping products to customers is included in cost of goods sold. Amounts billed to a customer in a sale transaction related to shipping and handling are classified as revenue.

## **Munro Muffler Brake, Inc. (2005 Form 10-K)**

Example .

### **NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES**

#### ***Vendor Rebates and Cooperative Advertising Credits***

In accordance with Emerging Issues Task Force Issue No. 02-16 ("EITF 02-16"), "Accounting by a Customer (Including a Reseller) for Cash Consideration Received from a Vendor," for vendor agreements entered into or modified after December 31, 2002, the Company accounts for vendor rebates and cooperative advertising credits as a reduction of the cost of products purchased, except where the rebate or credit is a reimbursement of costs incurred to sell the vendor's product, in which case it is offset against the costs incurred. Vendor rebates and credits associated with vendor agreements entered into prior to December 31, 2002 are recognized as cooperative advertising income as earned and are classified as a reduction of selling, general and administrative expenses.

## **MedImmune, Inc. (2005 Form 10-K)**

Example .

## **New Accounting Standards—**

**In December 2005, the SEC issued an interpretive release entitled “Commission Guidance Regarding Accounting for Sales of Vaccines and Bioterror Countermeasures to the Federal Government for Placement into the Pediatric Vaccine Stockpile or the Strategic National Stockpile.” This release addresses the timing of revenue recognition for the sale of vaccines related to Federal governmental stockpile programs and allows revenue earned under these programs to be recognized when all of the revenue recognition criteria specified under GAAP and Commission rules and regulations are met, with the exception of those criteria that require a fixed schedule for delivery of goods and that the ordered goods must be segregated from the seller's inventory. The alternative accounting method described in this release is effective on January 1, 2006. The new interpretive release does not have any impact on the Company's consolidated financial position or results of operations as of and for the year ended December 31, 2005. However, the interpretive release may ease revenue recognition criteria for sales to the federal government under certain stockpile programs, in which the Company may participate in the future.**

### **17.5 RELATED TOPICS**

Section 2 , Marketable Securities

Section 3 , Notes and Accounts Receivable

Section 6 , Investments in Less Than Majority Owned Companies

Section 10 , Notes Payable, Bonds, and Other Debt

Section 11 , Deferred Credits and Other Noncurrent Liabilities

Section 23 , Extraordinary Items

Section 24 , Discontinued Operations

Section 26 , Accounting Changes

Section 27 , Accounting Policies

Section 34 , Contract Accounting

Section 38 , Foreign Operations

Section 40 , Installment Accounting and Other Revenue Recognition Methods

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