EITF 08-1:

Best Practices for Adoption

An Executive Webcast With Jeffrey Werner

Welcome to Today's Event

- Viewing tips & CPE credit information
- About the webcast sponsor, Tensoft
- Introduction to today's speaker
- **Presentation: "EITF 08-1: Best Practices for Adoption"**
- Q & A

Viewing Tips & CPE Credit

- For "Full Screen," go to "View" on the Control Panel
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- CPE certificates will be emailed to everyone who is eligible within 1 week
- Slides will be available to download after the presentation

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For the Technology Industry

Who is Tensoft?

Tensoft, Inc.

- Business software solutions provider
- Focus on technology companies
- Software for revenue management (RCM)

Tensoft RCM Product Line

- Complete revenue management suite
- Billing management for contracts
- Business model transaction flow support
- Visibility, Productivity, Compliance

Frank, Rimerman Consulting

business management consultants

a division of Frank, Rimerman + Co. LLP

High Value ERP and Technology Solutions Based on our Clients Unique Business Needs

Who is FRC?

Frank, Rimerman Consulting (FRC)

- A division of Frank, Rimerman + Co. LLP
- ERP and Technology Solutions Provider
- Partner with Tensoft

Frank, Rimerman Consulting Solutions

- Dynamics GP, Dynamics AX
- Tensoft Revenue Cycle Management (RCM) & Multi-National Consolidation (MNC)
- Other software and technology solutions

Tensoft RCM Revenue Management

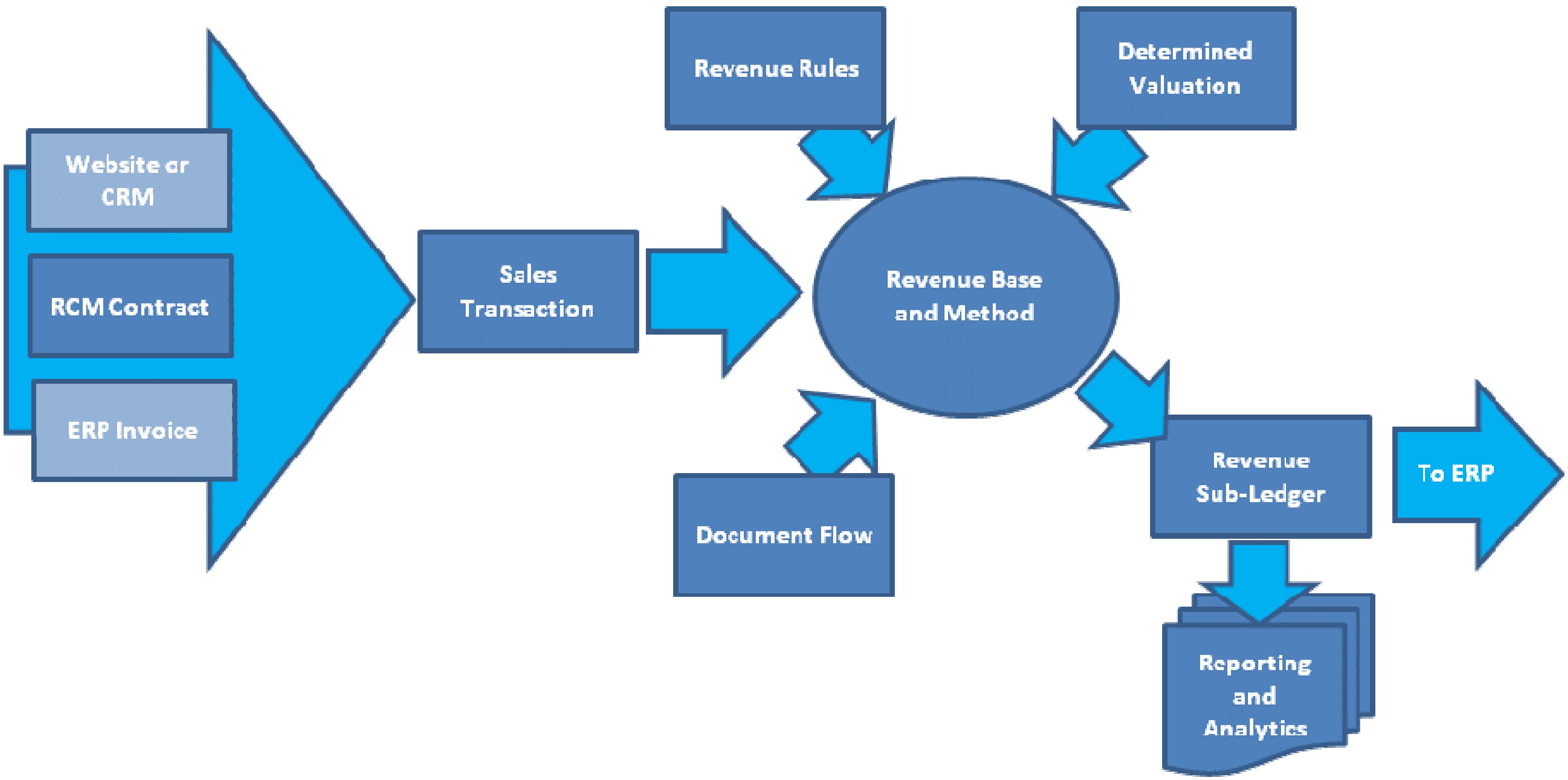
Sales Transaction

- Generated based on Go-To-Market Model
- Generated from website, ERP, Tensoft RCM Contract

Revenue Basis

- Determination of policy for document type
- Revenue base determination
  - Sales Transaction Based
  - SOP 97.2 based – residual method
  - EITF 08-01 based – relative value method
- Revenue rules, sub-ledger, and analysis

Tensoft RCM Revenue Management



Today's Presenter:

Jeffrey Werner,

Werner Consulting Group

Introduction to Werner Consulting Group

Revenue Recognition Services Include:

- Pre-Contract Negotiations and Deal Structuring
- Post-Contract Review, Analysis and Accounting
- Best Practices Implementation
- VSOE Studies and Analysis
- Customized Training Classes
- Revenue Recognition Technical Research and Whitepapers
- Revenue Recognition Policy Implementation and Improvement
- Peak Demand Contract Review
- Revenue Management Outsourcing
- Audit Assistance
- Revenue Management Software Implementation
- EITF 08-1 Implementations

Revenue Recognition

EITF 08-1:

Best Practices for Adoption

Agenda

- **ASU 2009 – 13 (EITF 08 – 1)**
  - Revenue Arrangements with Multiple Deliverables
- **ASU 2009 – 14 (EITF 09 – 3)**
  - Certain Arrangements That Include Software
- Implementation Issues
- More examples
- Conclusion

EITF 08 - 1: Revenue Arrangements with Multiple Deliverables

- **Scope**
  - All Multiple Element Arrangements not specifically addressed by other Accounting Literature such as ASC 985 605 (Software Revenue Recognition – SOP 97 - 2)

- **Prior Method – Residual Method**
  - Previously under EITF 00- 21 revenue recognition required VSOE for all undelivered elements and used the Residual Method to determine revenue of delivered items

EITF 08 - 1: Revenue Arrangements with Multiple Deliverables

- **New Method – Relative Selling Price**
  - Allocate revenue to multiple elements using relative value based on VSOE, Third Party Evidence (TPE) or Estimated Selling Price (ESP).
  - Allocation based on the relative percentage of each item to the arrangement fee – Relative Selling Price method
  - Residual Method is no longer used

- **Effective Date – Fiscal Years beginning after June 15, 2010**
  - (January 1, 2011 for calendar year end companies)

EITF 08 - 1: Revenue Arrangements with Multiple Deliverables

- **In Year of Adoption**
  - Retrospective – Restate prior years
  - Prospective – Change only most recent year
- **Disclosure requirements**
  - Disclosure of value methodology
  - Disclosure of the effect of the change in accounting

EITF 08 - 1: Revenue Arrangements with Multiple Deliverables

- **Separation, Allocation and Recognition**
  - Separation into Separate Elements
  - Allocation of Revenue to Elements
  - Recognition of Revenue for Each Element

EITF 08 - 1: Revenue Arrangements with Multiple Deliverables

- **Separation into Units of Accounting or Elements**
- **An element of an arrangement is a separate unit of accounting if:**
  - A) the delivered item has value to the customer on a stand alone basis (including resale value) or is sold separately by the vendor or any other vendor
  - B) If there is a general right of return on the delivered item, the delivery or performance of the undelivered element is probable and substantially under the control of the

EITF 08 - 1: Revenue Arrangements with Multiple Deliverables

- **Example of right of return that would not be in the control of the vendor**
  - Acceptance terms on undelivered products or services that result in refund on delivered items

EITF 08 - 1: Revenue Arrangements with Multiple Deliverables

Allocation Values

- **Vendor Specific Objective Evidence - VSOE**

  The price the Vendor sells an element for in a separate stand alone transaction

- **Third Party Evidence - TPE**

  Evidence from other companies of the value of an element in a transaction

- **Estimated Selling Price – ESP**

  The Vendor’s best estimate of the selling price of an element in a transaction.

EITF 08 - 1: Revenue Arrangements with Multiple Deliverables

- **Example – Three Elements under EITF 08-1**

  $115,000 Hardware product that includes software

  Support and maintenance for one year included

  Support sold separately for $15,000 (VSOE)

  Hardware product value established by Third Party Evidence (TPE) of $75,000

  Software Estimated Selling Price (ESP) of $60,000

- **EITF 08 –1 Accounting**

  Revenue recognized using the Relative Selling Price Method

EITF 08 - 1: Revenue Arrangements with Multiple Deliverables

- **Example - Three Elements under EITF 08 – 1**

- **Relative Selling Price Method**

  $ 75,000 hardware (based on TPE) - 50%

  $ 60,000 software (based on ESP) - 40%

  <u>$ 15,000</u> support (based on VSOE) - 10%

  $150,000 total value of transaction

EITF 08 - 1: Revenue Arrangements with Multiple Deliverables

- **Example - Three Elements under EITF 08 – 1**

- **Allocation of Revenue**

  Revenue for each element is based on the relative value to the total transaction

  $ 57,500 hardware (50% x $115,000) – on delivery

  $ 46,000 software (40% x $115,000) – on delivery

  $ 11,500 support (10% x $115,000) – ($958 per month)

EITF 08 - 1: Revenue Arrangements with Multiple Deliverables

Contingent Revenue

- Allocation of revenue to the elements
- Limitation of revenue to recognize to non-contingent revenue

EITF 08 – 1: Revenue Arrangements with Multiple Deliverables

Contingent Revenue

If Product B is subject to a refund until delivery, the revenue recognition allocated to Product A is limited until Product B is delivered

	Contract	ESP	%	Allocation	Limit
Product A -	$200	$300	60%	$240	$200
Product B -	$200	$200	40%	$160	
Total	$400	$500		$400	

EITF 09 – 3: Certain Arrangements That Include Software Elements

- **ASU 2009 – 14 (EITF 09 – 3)**
  - Certain Arrangements That Include Software
  - **Determination of software or non-software elements**

EITF 09 – 3: Certain Arrangements That Include Software Elements

- **Prior Method**
  - Previously ETIF 00 – 21 (now called ASC 605 25 05) required companies selling a tangible product that combined hardware and software (where software is more than incidental) to use Software Revenue Recognition accounting under SOP 97 – 2 (Residual Method)

EITF 09 – 3: Certain Arrangements That Include Software Elements

- **New Method**
  - Tangible products with hardware and software components that work together to deliver the product functionality (where software is more than incidental) are considered non-software products.
  - Follow separation and allocation accounting guidance ASU 2009 – 13 (EITF 08 – 1)
  - Use Relative Selling Price Method rather than Residual Method

EITF 09 – 3: Certain Arrangements That Include Software Elements

- **Factors to determine if software is essential to the tangible product**
  a) Sales without software are infrequent
  b) Vendor may sell products with similar functionality with and without the software
  c) Vendor may sell software on stand alone basis – this does not create a presumption that the software is not essential to the tangible product
  d) Software does not need to be embedded
  e) Non-software elements substantially contribute to the functionality (not just a medium for delivery)

EITF 09 – 3: Certain Arrangements That Include Software Elements

- **EITF 09-3 has a series of twelve Cases (A – L) that describe whether elements are in or out of software accounting**
- **Case A**
  - Computer always sold with operating system
  - Considered non-software elements, excluded from 985 605 (SOP 97-2)
- **Case B**
  - Computer sold with operating system, frequently sold without the operating system
  - Computer is consider a non-software element, excluded from 985 605 (SOP 97-2)
  - Operating system is a software element, included in 985 605 (SOP 97-2)

EITF 09 – 3: Certain Arrangements That Include Software Elements

- **ASU 2009 – 14 has a series of twelve Cases (A – L) that describe whether elements are in or out of software accounting**

- **Case E**
  - PDA sold with phone, camera, music player and games
  - Music player and games excluded more than infrequently
  - PDA, phone and camera are non-software elements, excluded from 985 605 (SOP 97-2)
  - Music player and games are a software element, included in 985 605 (SOP 97-2)

EITF 09 – 3: Certain Arrangements That Include Software Elements

If there are both software and non-software elements in an arrangement

- Divide into non-software and software elements and value using the relative selling price method
- Apply revenue recognition methods of 2009-14 and SOP 97-2 to each group of elements (non-software and software).

EITF 09 – 3: Certain Arrangements That Include Software Elements

- **Example with Facts Similar to Case B**
- A vendor sells a computer with an operating system. The sales price of $10,000 includes one year support on both the computer and the operating system. The vendor frequently sells the computer without the operating system. VSOE does not exist for the support.
- **Vendor Estimated Selling Prices (ESP)**

$ 7,000	Computer (56%)
$ 3,000	Operating system (24%)
$ 1,250	Support on computer (10%)
$ 1,250	Support on operating system (10%)
$12,500	

EITF 09 – 3: Certain Arrangements That Include Software Elements

Revenue Allocation

$ 5,600	Computer (56% x $10,000)
$ 2,400	Operating system (24% x $10,000)
$ 1,000	Support on computer (10% x $10,000)
$ 1,000	Support on operating system (10% x $10,000
$10,000	Total fee

EITF 09 – 3: Certain Arrangements That Include Software Elements

- **Revenue Recognition non-software**

  $ 5,600 Computer - on delivery (ASC 2009-13)
  <u>$ 1,000</u> Support on computer ratably over 1
  $ 6,600 year support period

- **Revenue Recognition software**

  $ 2,400 Operating system
  <u>$ 1,000</u> Support on operating system
  $ 3,400 Total software related revenue ratably over one year due to the absence of VSOE

Implementation Issues

Companies Affected:

- Computer Hardware
- Medical Devices
- Consumer Electronics
- Communications
- Biotech
- Companies with multiple element arrangements not addressed by other specific accounting literature

Implementation Issues

- **Early Adopters**

  – Apple
  – retrospective approach
  – restated 2 prior years

  – Cisco
  – prospective approach
  – disclosed impact before and after change

Implementation Issues

- **Apple**
  - 2009 rev increased 15% ($6.4 B on $42.9B)
  - ESP $25 iPhone upgrades & support
    - ESP based on price expects customers would pay
    - $5 or 20% change = $50m

- **Cisco**
  - Q1 2010 revenue increased 1% to $9.8B from $9.7B
  - ESP considers geographies, market conditions, competitive landscape, internal costs, gross margin objectives and pricing practices

Implementation Issues

- Auditor Interpretation of ESP
- SEC Interpretation of ESP
- SAB 104 still in effect – 4 Principles
- Evolution of Best Practices
- Changes Are Required – not Optional
  - Residual Method No Longer GAAP for most multiple element arrangements (except software)

Implementation Issues

- **Implementation**
  - Manual or Automatic Application
  - Establishment of TPE and ESP
  - Documentation of TPE and ESP
  - Product and SKU tie to Non-software / Software and revenue recognition method
    - Some products may have two methods depending on other elements in transaction
    - Software sold with a computer may be “non-software” but if sold separately might be “software”

ESP Issues

Establishing Estimated Selling Price

- Cost / Gross Margin Method
- VSOE Light / Historical Pricing
- Consistent pricing
- Renewal Rates
- Combination – Historical Pricing / Proposed Pricing

ESP Issues

Establishing Estimated Selling Price

- ESP in Ranges
- Segmenting the population
  - Product Families
  - Distribution Channels
  - Industry
  - Customer Size
- Products and Accounting based on context
  - Multiple SKUs or Formula to Determine

ESP Issues

- Startups – use proposed pricing until history or other methods are available
- Ongoing compliance issues
- Monitoring and changing ESP
- Pricing and Marketing Aspects of ESP

Implementation Issues

- Refundable services or elements may require deferral of revenue at contract value
- Refunds and Contingent Revenue need to be Addressed
- Quality of Data

Implementation Plan Outline

- Information Gathering and Understanding Products
- Analyze Data and Develop Potential Approaches
- VSOE and ESP Analysis and Documentation
- Determination of Relative Selling Price Allocation Method
- Test of Data
- Revenue Allocation
- Review Results and Manual Adjustments
- Implementation Memo
- Ongoing Analysis and Documentation

Implementation Memo Outline

- Company Background
- Effective Date and Adoption Timing
- Scope of Transactions Affected
- Software or Non-Software Determination
- Distribution Models
- Separation and Revenue Allocation
- VSOE & ESP Methodology
- Application of the Relative Selling Price Method for MEAs
- Other Issues
- Disclosures
- ESP Review and Quarterly Updates
- Summary

More Examples - BioTech

- **Example Facts – BioTech Company**
- A Biotech Company enters into an arrangement with a customer to license existing technology A, to research and develop new technology B and provide services. There is an option to license the new technology B if accepted.

- **Contract Elements and Pricing**

  $ 100,000 Technology License A per Year

  $ 250,000 Research and Development Technology B

  <u>$ 50,000</u> Services

  $ 400,000 Total Contract Price

  $ 150,000 Optional Technology License B per Year

More Examples - BioTech

- **Example – BioTech Company**
- **Element Values**

  $ 100,000 Technology A License per Year (ESP based on renewal)

  $ 300,000 R & D Technology B (ESP based on cost plus)

  $ 100,000 Services (ESP based on standard pricing per day)

  $ 500,000 Total Element Values

- **Relative Values**

  $ 100,000 20% License A

  $ 300,000 60% R & D Technology B

  $ 100,000 20% Services

  $ 500,000 Total Element Values

More Examples - BioTech

- **Example – BioTech Company**
- **Revenue Allocation**

$ 80,000 20% License

$ 240,000 60% R & D

$ 80,000 20% Services

$ 400,000 Total Contract Price

- **Revenue Recognition**

$ 80,000 License - when delivered and term begins

$ 240,000 R & D – on acceptance

$ 80,000 Services – as provided on daily basis

$ 400,000 Total Contract Price

Optional license B recognized when elected, delivered and term begins

More Examples - Hardware

- **Example Facts – Hardware Company**
- A Hardware Company enters into an arrangement with a customer to delivery product A, product B and provide services.

- **Contract Elements and Pricing**

  $ 30,000 Product A

  $ 50,000 Product B

  $ 20,000 Services

  $ 100,000 Total Contract Price

More Examples - Hardware

- **Example – Hardware Company**
- **Element Values**

  $ 50,000 Product A based on ESP

  $ 75,000 Product B based on TPE

  <u>$ 25,000</u> Services based on VSOE

  $150,000 Total Element Values
- **Relative Values**

  $ 50,000 33% Product A

  $ 75,000 50% Product B

  <u>$ 25,000</u> 17% Services

  $150,000 Total Element Values

More Examples - Hardware

- **Example – Hardware Company**
- **Revenue Allocation**

$ 33,000	33% Product A
$ 50,000	50% Product B
<u>$ 17,000</u>	17% Services
$100,000	Total Contract Price

- **Revenue Recognition**

$ 33,000	Product A - when delivered
$ 50,000	Product B – when delivered
<u>$ 17,000</u>	Services – as provided on daily basis
$100,000	Total Contract Price

More Examples - Software & SaaS

- **Example Facts – Software and SaaS**
- A Software Company enters into an arrangement with a customer to delivery software License A, support on License A, one year SaaS service B and provide services.
- **Contract Elements and Pricing**

$ 100,000	License A
$ 20,000	Support on License A
$ 50,000	SaaS Service B
$ 30,000	Services
$ 200,000	Total Contract Price

More Examples - Software & SaaS

- **Example – Software and SaaS**
- **Element Values**

$ 130,000	License A based on ESP
$ 20,000	Support on License A based on VSOE
$ 60,000	SaaS Service B based on VSOE
$ 40,000	Services based on VSOE
$ 250,000	Total Element Values

- **Relative Values**

$ 130,000	52%	License A
$ 20,000	8%	Support on License A
$ 60,000	24%	SaaS Service B
$ 40,000	16%	Services
$ 250,000		Total Element Values

More Examples - Software & SaaS

Example – Software and SaaS

Revenue Allocation

$ 104,000	52%	License A
$ 16,000	8%	Support on License A
$ 48,000	24%	SaaS Service B
$ 32,000	16%	Services
$ 200,000		Total Contract Price

More Examples - Software & SaaS

- **Example – Software and SaaS**
- **Revenue Recognition - software**
  - $100,000 License A on delivery
  - $ 20,000 Support ratably over one year at VSOE
  - $120,000 Total Contract Price revenue
- **Revenue Recognition – non-software**
  - $ 48,000 SaaS Service B ratably over one year
  - $ 32,000 Services as provided on a daily basis
  - $ 80,000 Total non-software revenue

$200,000 Total revenue

EITF 08 - 1 Recap

- The Relative Selling Price Method
- Separation and Allocation of Revenue to Elements
- Contingent Revenue
- Software and Non-software Elements
- Estimated Selling Price (ESP)
- Implementation
- Documentation and Disclosure

Conclusion

Revenue Recognition Resources

- Auditor Revenue Recognition Guides
- Auditor Revenue Recognition Whitepapers
- AICPA
- FASB / EITF
- SEC Filings
- Webcasts
- Web Searches

Q & A

To submit a question now, please click on "Question and Answer."

Then just type your question in the space under "Enter a Question"

Additional questions or comments?

Please contact:

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December 8, 2011

Thanks for Joining Us Today