

Pharmaceuticals and Life Sciences

US GAAP

Issues and solutions for the medical technology industry
2009 edition



Foreword

Accounting under US generally accepted accounting principles (GAAP) continues to evolve, and in today's world, where there are a growing demand for greater transparency and heightened regulatory scrutiny, the challenge of determining the proper accounting for transactions has never been greater.

Many publications have discussed the broader implications of US GAAP and International Financial Reporting Standards but, to date, none has addressed the particular accounting issues the medical technology industry faces. The aim of the first edition of this publication is to highlight the industry-specific factors that need to be considered and to provide guidance on the most pertinent accounting solutions for medical technology-related companies under US GAAP.

In reality, every company deals with accounting issues that should reflect the facts and circumstances of its particular situation. The solutions in this publication provide a framework for determining the appropriate accounting answer, but individual fact patterns may give rise to a different answer. We cannot hope to address every situation that occurs—there is too much variability in the structuring of arrangements to achieve that. Rather, the solutions cover several general situations. As new trends emerge, we will consider further editions of this publication.

The content of this publication is based on guidance effective as of September 30, 2009. Accordingly, certain solutions of the publication may be superseded as new guidance and interpretations emerge. In particular, Emerging Issues Task Force (EITF) Issue 08-1, *Revenue Arrangements with Multiple Deliverables*, will supersede the guidance in EITF Issue 00-21, *Revenue Arrangements with Multiple Deliverables* (now codified in ASC 605); will provide an expanded definition of fair value for a deliverable; and will eliminate the residual method from the model. Also, the EITF completed its work on re-scoping the existing software revenue recognition model in EITF Issue 09-3, *Certain Revenue Arrangements That Include Software Elements* (now codified in ASC 985). Under the new standard, tangible products that have software components that are “essential to the functionality” of the tangible product will be scoped out of the software revenue recognition guidance. Both EITF issues are not required until January 1, 2011 for calendar year-end companies; however, early adoption is permitted.

We hope you find this publication useful in addressing and understanding the accounting for certain transactions encountered in your business. Further, we hope that this publication will encourage consistent practices by medical technology companies in financial reporting under US GAAP. This consistency will be critical to the continued usefulness of medical technology entities' financial statements.

PricewaterhouseCoopers Pharmaceutical and Life Sciences Practice

We recommend that you use the Web site “<http://www.pwc.com/medtech>” as your primary source for this publication and other thought leadership materials.

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1. Fixed asset purchases used in research and development

Background

Company A incurs costs to construct assets that will be used to produce a medical device that has not yet received FDA approval. These costs represent expenditures necessary to construct the plant and facility that will be used to produce, at commercially viable levels, the product once regulatory approval has been obtained.

Company A believes that the project is in an advanced stage where regulatory approval will be obtained, given the decision to construct the production facility, and therefore believes that use of the assets and recovery of the costs via future cash flows are probable.

Should Company A expense costs associated with the construction of tangible assets as incurred, or is there a basis for capitalization of those expenditures?

Relevant guidance

Although circumstances may exist that support capitalization of costs because of possible future alternative uses, research and development costs relating to activities that are incomplete, which include projects that have not received regulatory approval, are expensed as research and development costs under the guidance provided in ASC 730, *Research and Development* [formerly contained in FAS 2], and by analogy to the AICPA Practice Aid on In Process Research & Development (IPR&D).

Under ASC 730-10-20, research and development are defined as follows:

Research: is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (referred to as “product”) or a new process or technique (referred to as “process”) or in bringing about a significant improvement to an existing product or process.

Development: is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives, construction of prototypes, and operation of pilot plants.

Solution

The important distinction is whether the above activities represent research and development costs subject to the guidance in ASC 730 and the AICPA Practice Aid on IPR&D. Because the construction activities pertain to tangible assets that will be used to produce the end product at commercially viable levels, rather than costs associated with testing the product or the construction of a pilot facility or preproduction prototype not involving a scale that is economically feasible for commercial production, the construction project would not be considered a research and development cost as contemplated in ASC 730.

Accordingly, the costs are subject to the more general concepts of fixed asset accounting and impairment considerations. In this fact pattern, it would be appropriate for Company A to capitalize the construction costs incurred as plant and equipment. The assets would be subject to impairment testing based on the expected future cash flows of the assets, which would consider the various potential outcomes of the regulatory approval process and their associated likelihoods.

2. Research and development reimbursed by a third party

Background

Company A is a medical diagnostics company, and it conducts research and development for a new diagnostic test. The research and development activities are funded by Company B. If the research and development activities are not successful, then Company A is not obligated to refund payments previously received. Company B would own intellectual property developed under this arrangement.

Relevant guidance

Revenue recognition guidance for service contracts is provided in SAB Topic 13-A: Persuasive evidence of an arrangement exists; delivery has occurred; price to the buyer is fixed or determinable; and collectibility is reasonably assured.

Guidance related to determining whether a liability exists for research and development funding arrangements is provided in ASC 730-20, *Research and Development Arrangements* [formerly contained in FAS 68]. ASC 605-45, *Revenue Recognition—Principal Agent Considerations* [formerly contained in EITF 99-19], provides guidance related to gross vs. net presentation of revenue.

ASC 808, *Collaborative Arrangements* [formerly contained in EITF 07-1], provides guidance on reporting requirements and income statement classification for transactions between participants in a collaborative arrangement.

For government-sponsored research and development grants, the AICPA industry guide, *Audits of Federal Government Contractors* (the audit guide), addresses certain best-efforts research and development cost-sharing arrangements.

If an arrangement is not subject to the audit guide, the SEC staff's guidance may be considered. At the 2005 SEC conference, the SEC staff discussed the income statement geography for research and development reimbursements and whether such reimbursements should be treated as revenue or an offset to expense. The SEC staff acknowledged that the guidance on income statement geography is piecemeal and contained in several different areas of the accounting literature. The SEC staff emphasized that companies should evaluate the facts and circumstances of each arrangement; consistently apply reasonable judgment (e.g., refrain from cherry-picking to get a desired result); and disclose the method of accounting used, as well as the reason(s) that the chosen method is considered appropriate.

How should Company A report the research and development funding it receives from Company B?

2. Research and development reimbursed by a third party (continued)

Solution

Company A should consider the facts and circumstances involved in a particular research and development arrangement and determine the nature of the obligation it incurs when it enters into an arrangement with other parties that fund its research and development. In this fact pattern, the financial risk associated with the research and development remains with Company B. Therefore, Company A should not recognize a liability associated with this funding. Further, as the intellectual property transfers to Company B, Company A determines that it is appropriate to account for this arrangement as contract research and development services for others. Accordingly, the research and development funding should be recorded as contract revenue.

This scenario assumes the research and development services are the only deliverable in the arrangement. If other deliverables existed, revenue should be allocated to each deliverable, applying the guidance for multiple element arrangements.

Other facts and circumstances may result in a conclusion that a liability or an offset to research and development expenses is more appropriate.

If Company A provided research and development services for the federal government on a fixed price, best efforts basis and the federal government is the sole customer for such research and development, the funding should be recognized as a reduction of research and development expenses, as discussed in the AICPA industry guide, *Audits of Federal Government Contractors*.

3. Accounting for clinical trials

Background

Company A conducts clinical trials to obtain regulatory approvals for its products. Substantial portions of the company's clinical trials are contracted with third parties, such as contract research organizations, or CROs. The financial terms of these contracts are subject to negotiations, may vary from contract to contract, and may result in uneven payment flows. For example, CROs commonly require payments in advance of performing clinical-trial management services. These advance payments are commonly nonrefundable and made three to six months prior to the start of the research and development activity.

How should Company A account for clinical trial accruals?

Relevant guidance

Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, states that accrual accounting is used to record the financial effects on an entity of transactions and other events that have cash consequences for the entity in the periods in which those transactions, events, and circumstances occur rather than only in the periods in which cash is received or paid by the entity.

ASC 730-20-25-13, *Research and Development* [formerly contained in EITF 07-03], requires that nonrefundable advance payments for goods or services that have the characteristics that will be used or rendered for future research and development activities, pursuant to an executory contractual arrangement, should be deferred and capitalized. ASC 730-20-35-1 states that such capitalized nonrefundable advance payments shall be recognized as an expense as the related goods are delivered or the related services are performed.

Solution

Company A should record clinical trial expenses in its financial statements in the period when services are performed. An accrual should be recorded based on estimates of services received and efforts expended pursuant to agreements established with CROs and other outside service providers. These estimates are typically based on contracted amounts applied to the number of patients enrolled, the number of active clinical sites, the duration for which the patients will be enrolled in the study, and the percentage of work completed to date. If timelines or contracts are modified based on changes in the clinical trial protocol or scope of work to be performed, Company A should modify its estimates of accrued expenses accordingly on a prospective basis.

Nonrefundable advance payments for future clinical trial management services should initially be capitalized and expensed as the related services are performed. Company A should continue to evaluate whether it expects the services to be rendered. If services are not expected to be rendered, the capitalized advance payment should be charged to expense.

4. Accounting for a loss contingency when a settlement offer has been made in a lawsuit

Background

Company A is the defendant in a patent infringement case. Company B (the plaintiff) alleges that Company A owes it \$10 million for use of a specific patent and an additional \$25 million for revenue lost because of competition. The trial has gone through the discovery phase, and as of December 31, 20X8, Company A has offered \$15 million to settle both issues.

Company A has not received a response from the plaintiff as of December 31, 20X8. Therefore, Company A believes that the case may still be going to trial. Company A believes it is probable that a loss has been incurred, and the loss amount was estimated in the range of \$15 million (the amount of its settlement offer) to \$35 million (the maximum estimated loss in the event the case goes to trial). Company A does not believe any amount in this range represents a better estimate than any other does.

Relevant guidance

ASC 450-20-25-2, *Loss Contingencies* [formerly contained in FAS 5], requires that an estimated loss from a loss contingency be accrued if both the following conditions are met:

- Information available before the financial statements are issued or are available to be issued indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.
- The amount of the loss can be reasonably estimated.

ASC 450-20-30-1, *Loss Contingencies* [formerly contained in FIN 14], states that when some amount within a range of loss appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range shall be accrued.

Should any amount be accrued as of December 31, 20X8?

Solution

Yes. If a contingent event or situation is probable of occurring, the entity should accrue its best estimate of the contingency within the financial statements. A settlement offer is generally presumed to establish the existence of a “probable loss.” This presumption could be overcome based on the specific facts and circumstances.

Therefore, Company A should accrue for this contingent loss within its December 31, 20X8 financial statements, as the loss is deemed probable. As no estimate within the range represents a better estimate than any other does, Company A should use the low end of the range (\$15 million). Company A should also disclose the nature and amount of the accrual made.

5. Accounting for legal costs incurred in connection with a loss contingency

Background

Company A is the defendant in a patent infringement case. The case was still in discovery as of December 31, 20X8 (the Company A's year-end), and there have been no discussions of possible settlement. Company A believes it will incur at least \$2 million in litigation costs based on a similar case for which it reached a settlement; however, it cannot make a determination of what the legal costs may be if the case goes to trial. A trial is scheduled to commence in the first quarter of 20X9 should no settlement be reached.

Relevant guidance

As discussed in ASC 450-20-S99-2, *Loss Contingencies* [formerly contained in EITF Topic No. D-77], there is no definitive guidance on whether an accrual must be made for legal costs that the entity expects to incur upon defending itself in connection with a loss contingency.

When should legal costs expected to be incurred in connection with the loss contingency be accrued?

Solution

The accounting for such litigation costs is subject to an accounting policy decision by Company A. Acceptable accounting policies include: (1) accrual methodology following an approach based on when such costs are deemed to be probable and reasonably estimable, or (2) expense as incurred. Company A, upon its election, must ensure such a policy is consistently applied.

6. Accounting for the legal settlement of a patent infringement dispute

Background

Company A and Company B are parties to a cross-licensing arrangement whereby they have agreed to allow each other's use of certain patented technologies. Net royalties are being paid to Company B by Company A pursuant to the agreement.

Over the last several years, the companies were in a legal dispute with regard to the scope of the cross-licensing agreement. In defending its interests related to this dispute, Company A has incurred, on average, \$10 million a year in legal defense costs. In the current year, Company A wanted to settle the dispute to reduce legal costs and the overhang of an active lawsuit. Company A continues to believe that Company B's claim has no merit.

A settlement was reached whereby Company A would pay \$20 million to Company B and both Company A and Company B would enter into a "covenant not to sue" on a portfolio of their respective technologies. As part of the settlement, Company A did not admit to any wrongdoing and continues to contend that Company A has never infringed on Company B's patents not included in the cross-licensing agreement. Under the settlement agreement, Company A has effectively been given a license to Company B's patented technologies, as Company A will continue to utilize all of the same technology utilized before the settlement.

Relevant guidance

A speech was given by the SEC staff at the December 2007 AICPA National Conference ("Remarks before the 2007 AICPA National Conference on Current SEC and PCAOB Developments" by Eric C. West) that discusses a similar fact pattern and provides additional considerations in determining the substance of these types of transactions and resulting accounting model.

The SEC staff noted that accounting for litigation settlements requires judgment in determining the elements within the arrangement, when to recognize those elements, and the value to allocate to them.

Should Company A recognize an intangible asset for the license it has received to use Company B's technology as part of the settlement transaction? How should Company B classify the one-time payment on its income statement?

6. Accounting for the legal settlement of a patent infringement dispute (continued)

Solution

The transaction should be evaluated as a multiple element arrangement with each element accounted for individually. In order for Company A to record an intangible asset for its right to utilize Company B's technology, it would need to determine whether Company B's technology will result in a probable future economic benefit to Company A.

In this fact pattern, Company A does not believe it has infringed on Company B's technology and that the purpose of the settlement was economic in nature (i.e., pay \$20 million now to save \$10 million of litigation costs annually). Company A would need to support that the nontransferable license it received in settlement of the lawsuit has value in order to record an asset for the license of Company B's technology.

If Company A decided that it would not use Company B's technology going forward and concluded that the license it received has no value, the payment of \$20 million would be considered a settlement of litigation (subject to a review of the arrangement's other elements) and would be reflected as such in Company A's income statement.

Although many litigation settlement payments are recorded as an operating expense, the income statement geography is subject to judgment. If a company and the plaintiff have an existing relationship, a cash settlement should be evaluated under the guidance for customer payments and incentives provided in ASC 605-50-45-2, *Revenue Recognition—Customer Payments and Incentives* [formerly contained in EITF 01-09], and potentially be recorded as a reduction in revenue.

Company B should also evaluate the transaction as a multiple element arrangement and identify all the deliverables, such as rights to future patents, technology updates, etc. Depending on the facts and circumstances, a one-time payment from litigation settlement could represent payment of past royalties, prepayment of future royalties, and/or compensation for future deliverables. Company B should allocate the litigation settlement to all the deliverables, and the accounting and classification should be based on the nature of each deliverable.

7. Amortization of acquired intellectual property

Background

Company A acquires Company B in a business combination accounted for under ASC 805, *Business Combinations* [formerly contained in FAS 141(R)]. As part of the business combination, Company A acquires the intellectual property of Company B that meets the contractual-legal criterion for separate recognition of an intangible asset apart from goodwill.

Relevant guidance

Pursuant to ASC 805, an intangible asset that meets the contractual-legal criterion or separability criterion is considered identifiable and is recognized at fair value using the market participant framework contained in ASC 820, *Fair Value Measurements and Disclosures* [formerly contained in FAS 157]. Intangible assets are amortized over their estimated useful lives. If the precise length is unknown, intangible assets should be amortized over a company's best estimate of the assets' useful life. In determining the useful lives of intangible assets, companies should consider ASC 350-30-35-2 through 35-4, *Intangibles—Goodwill and Other* [formerly contained in FAS 142].

Further, the classification of amortization expense should generally be determined based on the asset's intended use and recorded in the income statement accordingly.

When should Company A begin amortizing acquired intellectual property, over what period, and how should the costs be classified in the income statement?

Solution

Amortization of intangible assets should begin at the acquisition date, which is generally the date the asset is available for its intended use.

ASC 350-30-35-2 states that the useful life of an intangible asset to an entity is the period over which the asset is expected to contribute directly or indirectly to the future cash flows of that entity. The estimate of an intangible asset's useful life should be based on all pertinent factors. In particular, ASC 350-30-35-3 prescribes the following factors that an entity should consider when estimating the useful life of an intangible asset:

- a. The expected use of the asset by the entity
- b. The expected useful life of another asset or a group of assets to which the useful life of the intangible asset may relate
- c. Any legal, regulatory, or contractual provisions that may limit the useful life

7. Amortization of acquired intellectual property (continued)

Solution (continued)

- d. The entity's own historical experience in renewing or extending similar arrangements, consistent with the intended use of the asset by the entity, regardless of whether those arrangements have explicit renewal or extension provisions. In the absence of that experience, the entity shall consider the assumptions that market participants would use about renewal or extension, consistent with the highest and best use of the asset by market participants, adjusted for entity-specific factors in this paragraph.
- e. The effects of obsolescence, demand, competition, and other economic factors (such as the stability of the industry, known technical advances, legislative action that results in an uncertainty or changing regulatory environment, and expected changes in distribution channels)
- f. The level of maintenance expenditures required to obtain the expected future economic benefits from the asset (for example, a material level of required maintenance in relation to the carrying amount of the asset may suggest a very limited useful life). As in determining the useful life of depreciable tangible assets, regular maintenance may be assumed but enhancements may not.

None of the above factors should be considered more presumptive than any other, and companies should consider all the facts and circumstances when estimating an asset's useful life. Further, companies should evaluate the remaining useful lives of their intangible assets each reporting period to determine whether events and circumstances warrant revisions to the estimated useful lives. A change in the estimated useful lives of intangible assets is considered a change in an accounting estimate and should be accounted for prospectively in the period of change and future periods.

Income statement classification of an intangible asset's amortization expense should reflect the nature of the asset's use. Paragraph 10.3.3 of PricewaterhouseCoopers' "A Global Guide to Accounting for Business Combinations and Noncontrolling Interests" provides examples in determining the appropriate classification of amortization expense related to intangible assets. Determining the appropriate classification on the income statement may require significant judgment. If the technology is utilized to manufacture goods, the presumption is that amortization should be recorded as part of cost of goods sold.

8. Accounting for patent-related costs

Background

Company A has filed a number of patent applications and has incurred certain external legal and related costs in connection with the applications. Company A also has incurred legal costs in defense of its patents.

Relevant guidance

Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, paragraph 25, states, "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events."

Statement of Financial Accounting Concepts No. 6, paragraph 247, states that "... the legal and other costs of successfully defending a patent from infringement are 'deferred legal costs' only in the sense that they are part of the cost of retaining and obtaining the future economic benefit of the patent."

AICPA Technical Practice Aids, Technical Questions and Answers Section 2260, *Other Assets*, states, "If defense of a patent lawsuit is successful, costs may be capitalized to the extent of an evident increase in the value of the patent. Legal costs that relate to an unsuccessful outcome should be expensed."

How should Company A account for patent-related costs?

Solution

Generally, capitalizing or expensing patent application costs has evolved to an accounting policy decision. If patent application costs are capitalized, there must be probable future economic benefit. For example, if Company A has a product that is currently under research and development and is not currently approved for market, costs incurred in connection with patent application should generally be expensed in the income statement because there is uncertainty to the future economic benefits of the asset, if capitalized. If a future economic benefit is probable or an alternate future use is available to the company, such costs can be capitalized and amortized over the expected life of the patent.

Company A can also capitalize external legal costs incurred in the defense of its patents when it is believed that the future economic benefit of the patent will be increased and a successful defense is probable. Capitalized patent defense costs are amortized over the remaining life of the related patent. Where the defense of the patent maintains rather than increases the expected future economic benefits from the patent, the costs would generally be expensed as incurred.

9. Accounting for contingent insurance proceeds

Background

Company A is waiting to hear from Company B, an insurance company, with respect to a claim that was filed in the second quarter of 20X9. The claim was filed as a result of an accident at one of Company A's production facilities that occurred late in the first quarter of 20X9, resulting in a period of business interruption.

The accident involved a production machine, which is an important component of one of Company A's production lines. The machine will need to be completely refurbished and will not be available until the fourth quarter of 20X9.

Company A maintained an appropriate level of insurance coverage to cover the full amount of the claim (\$15 million; \$5 million to repair the machine and \$10 million in lost revenues anticipated from the first quarter through the date the refurbished machine will be placed back in service). Company A also believes that it is clear that its claim will be covered under its insurance policy and does not anticipate coverage disputes by its carrier.

How should Company A analyze the components of the insurance claim?

Relevant guidance

ASC 605-40-25-2, *Revenue Recognition—Gains and Losses* [formerly contained in FIN 30], discusses accounting for involuntary conversions of nonmonetary assets to monetary assets and states that conversions of nonmonetary assets to monetary assets are monetary transactions for which gain or loss shall be recognized. As discussed in ASC 450-30-25-1, *Contingencies* [formerly contained in FAS 5], in order to recognize a gain contingency, the gain must be realized or realizable.

ASC 450-20-25-2, *Loss Contingencies* [formerly contained in FAS 5], requires that an estimated loss from a loss contingency be accrued if both the following conditions are met:

- Information available before the financial statements are issued or are available to be issued indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements
- The amount of the loss can be reasonably estimated

ASC 410-30-35, *Asset Retirement and Environmental Obligations* [formerly contained in SOP 96-1], provides guidance for loss recoveries from environmental obligations, which states that an asset should be recognized if the loss recovery is probable.

Solution

Company A should analyze the two components of this insurance claim separately.

The claim for lost revenues (business interruption) should be assessed using a gain contingency model under ASC 450-30. Therefore, recognition of the gain would likely not be appropriate prior to the carrier acknowledging that the claim is covered under the policy as well as the amount to be paid to Company A.

The accounting analysis for a loss recovery (property and casualty claim associated with the machine) is similar to that of a loss contingency under ASC 450-20. If Company A believes that recovery of these losses from the insurer is probable, it should recognize an asset representing the best estimate of the amount it will recover. This amount should not exceed the amount of actual loss to which the recovery relates. This accounting treatment is consistent with the guidance in ASC 410-30-35 (recoveries related to environmental remediation liabilities). In performing this probability assessment, Company A would likely consider (among other things) the terms of the existing agreement with Company B, the viability of Company B, and whether Company A has an established history of prior claims with Company B. Any potential proceeds in excess of the loss recorded on the asset for accounting purposes (i.e., if asset was destroyed and claim will be for its fair value, which exceeded its book value) are considered a gain contingency and treated similarly as described above.

10. Selling raw materials to and purchasing finished goods from a subcontractor

Background

Company A outsources the manufacturing of certain products to Company B. Company A purchases and then sells the raw materials to Company B, which processes the raw materials into finished goods. Company A then buys the finished goods from Company B.

At the time of sale of the raw materials, Company A invoices Company B and executes a purchase order to purchase from Company B a specific quantity of finished goods. Company B invoices Company A for the finished goods when delivered to Company A. Company B has physical risk of loss associated with the raw materials once received. The price of the finished goods purchased by Company A far exceeds the price Company B pays to buy the raw materials from Company A.

Relevant guidance

It is appropriate to analogize to the guidance in ASC 470-40, *Debt—Product Financing Arrangements* [formerly contained in FAS 49]. Although this fact pattern is not explicitly in the scope of ASC 470-40, the guidance in ASC 470-40-25-2(a) states that a sale transaction should not occur in situations where a company sells a product to another entity and, in a related transaction, agrees to repurchase the product (or a substantially identical product) or processed goods.

Should Company A record revenue and cost of goods sold at the time of the sale of raw materials to Company B?

Solution

Generally, no. The “sale” and related invoicing for the raw materials lack commercial substance because of the commitment to repurchase. Even though physical risk of loss resides with Company B, the general inventory risk still remains with Company A.

Consistent with ASC 470-40-25-2(a), Company A should retain the raw materials on its books (effectively, as consigned inventory) when they are “sold” to Company B. Any consideration received from Company B in advance of Company A’s repurchase of the finished goods should be accounted for as a deferred liability. The liability would be relieved upon payment to Company B for the finished goods.

11. Pre-launch inventory

Background

Company A is developing a new product and needs to have sufficient quantities of inventory on hand in anticipation of commercial launch once regulatory approval (i.e., approval to market the product) has been obtained.

Because of lead-time requirements and/or manufacturing capacity constraints, Company A has made a business decision to begin manufacturing commercial quantities of the inventory in advance of regulatory approval (pre-launch inventory). If regulatory approval is not obtained, the inventory has no alternative use.

Relevant guidance

Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, paragraph 25, states, “Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.”

Should Company A capitalize the pre-launch inventory?

Solution

The pre-launch inventory can be capitalized if it has a probable future economic benefit. Determining whether the pre-launch inventory has a probable future economic benefit depends on the individual facts and circumstances. Factors to consider would include:

- Whether key safety, efficacy, and feasibility issues have been resolved,
- Status of any advisory committee reviews, and
- Understanding of any potential hurdles to regulatory approval.

In the above scenario, if Company A determines regulatory approval is probable and the pre-launch inventory will generate a future economic benefit, the pre-launch inventory may be capitalized at the lower of cost or market under ASC 330, *Inventory* [formerly contained in ARB 43, chapter 4].

Once the determination to capitalize the pre-launch inventory has been made, periodic reassessments (i.e., each reporting period at a minimum) of the probability of regulatory approval and useful life (e.g., expiry prior to sale) of the product should be made, among other things, to determine whether the inventory continues to have a probable future economic benefit.

Additionally, Company A should consider disclosing its policy on pre-launch inventory, the amount of pre-launch inventory capitalized, the status of obtaining regulatory approval, the shelf life of product on hand, the potential exposure in the event of an unfavorable outcome on regulatory approval, the risks and uncertainties surrounding market acceptance once approved, and the impact of the build-up of pre-launch inventories on the company’s liquidity and results of operations.

12. Timing of inventory capitalization — product in development

Background

Company A is a manufacturer of laboratory instruments. A new instrument is under development. In an effort to get the new product to market in advance of a competitor, Company A has made a decision to begin commercial production of the new instrument in advance of completing all of the final quality control procedures. Although there are no regulatory approval hurdles for Company A to overcome prior to commercial launch, Company A needs to complete its internal quality control evaluation of the new instrument before commercial launch.

Relevant guidance

In accordance with ASC 330-10-20, *Inventory* [formerly contained in ARB 43, chapter 4], the term *inventory* is used to designate the aggregate of those items of tangible property that (1) are held for sale in the ordinary course of business, (2) are in process of production for such sale, or (3) are to be currently consumed in the production of goods or services to be available for sale.

Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, paragraph 25, states, “Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.”

What factors should be considered in determining the appropriate timing of inventory capitalization?

Solution

Inventory costs can be capitalized to the extent the inventory has probable future economic benefit. Ultimate conclusions around the timing of when to begin capitalizing costs will depend on individual facts and circumstances. Examples of considerations are:

- Whether the new instrument has demonstrated technical feasibility at the time Company A decides to pursue commercial production,
- Assessment of the remaining quality control evaluation steps and the likelihood and impact of any negative outcomes,
- The nature and complexity of the new instrument and Company A’s experience in developing similar new instruments in the past,
- Any shelf life considerations for any components of the new instrument and the evaluation of the remaining time to complete the development period,
- Whether components of the instrument have alternative uses in Company A’s other products that could potentially be capitalized in advance of demonstrating technological feasibility of the new instrument.

13. Accounting for demonstration equipment

Background

Company A provides its sales representatives and potential customers with demonstration or loaned equipment that typically remains with the customer for a period of time before sale to the customer or return to Company A.

Relevant guidance

Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, paragraph 25, states, "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events."

The term *fixed assets* is used for long-lived, physical assets that are intended for use in normal business operations and are not intended for resale. In accordance with ASC 330-10-20, *Inventory* [formerly contained in ARB 43, chapter 4], the term *inventory* is used to designate the aggregate of those items of tangible property that (1) are held for sale in the ordinary course of business, (2) are in process of production for such sale, or (3) are to be currently consumed in the production of goods or services to be available for sale.

How should Company A account for demonstration equipment?

Solution

Demonstration equipment is classified as inventory or fixed assets depending on a number of factors, including the nature of the products, the length of time the units remain in the field prior to being sold, and management's intent (i.e., to sell, place with another customer, or loan). The longer a unit remains in the field before being sold, the more likely it is that the equipment is a productive asset of the company and should be classified as a fixed asset and depreciated over its estimated useful life down to its estimated recoverable value. Units that remain in the field for a relatively short period prior to sale are generally classified as inventory. In addition, equipment that can be readily repaired or restored is more likely to be inventory than is a product that cannot. The need for a reserve for estimated costs to refurbish the inventory or to write the units down to net realizable value as a result of technological advances should be considered.

14. Accounting for new product warranty

Background

Company A offers a standard warranty on a new product. Company A has no historical experience selling a similar product and has not offered a similar warranty on a different product in the past.

Relevant guidance

ASC 460-10-25, *Guarantees* [formerly contained in FAS 5], provides guidance on warranty obligations incurred in connection with the sale of goods or services.

ASC 450-20-25-2, *Loss Contingencies* [formerly contained in FAS 5], provides guidance on when it is appropriate to record an accrual for contingent losses. The criteria for recognizing an accrual are as follows:

- Information available before the financial statements are issued or are available to be issued indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.
- The amount of the loss can be reasonably estimated.

How should Company A account for the standard warranty?

Solution

In this fact pattern, Company A has no prior experience selling the product or selling a product with a similar warranty, and thus does not possess specific historical experience necessary to estimate the loss. Because of the uncertainty surrounding claims that may be made under warranties, warranty obligations fall within the definition of a contingency. Losses from warranty obligations shall be accrued when the conditions in ASC 450-20-25-2 are met. However, satisfaction of the second condition set forth in ASC 450-20-25-2 (the amount can be reasonably estimated) will normally depend on the experience of the company or other available information. In the case of a company that has no experience of its own (as is the case in this example), reference to the experience of other companies in the same business may be appropriate.

Note that the inability to make a reasonable estimate of the amount of warranty obligation at the time of sale (caused by the uncertainty of possible claims and the inability to reference the experience of other companies) may question whether the recording of a sale is appropriate prior to expiration of the warranty period, or until sufficient experience has been gained to reasonably estimate the obligation.

15. Recognition of warranty-related costs

Background

Company A is a value-added reseller of medical equipment and accounts for the sale of equipment in accordance with SAB Topic 13-A. As part of its normal sales terms, Company A offers its customers a standard warranty that ensures the product will be free from defects and will operate in accordance with its published specifications.

The sale of equipment includes a manufacturer's standard warranty, such that in the event there is defect with the equipment, Company A will submit a warranty claim to the manufacturer, which will either replace or repair the defective product. Company A has concluded that it is the primary obligor of the warranty to all of its customers who purchase the equipment.

How should Company A account for the standard warranty to its customers?

Relevant guidance

In accordance with ASC 460-10-25, *Guarantees* [formerly contained in FAS 5], which provides guidance on warranty obligations incurred in connection with the sale of goods or services, because of the uncertainty surrounding claims that may be made under warranties, warranty obligations fall within the definition of a contingency.

Accounting for contingencies in ASC 450-20-25-2, *Loss Contingencies* [formerly contained in FAS 5], provides guidance on when it is appropriate to record an accrual for contingent losses. The criteria for recognizing an accrual are as follows:

- Information available before the financial statements are issued or are available to be issued indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.
- The amount of the loss can be reasonably estimated.

Solution

Although the manufacturer will ultimately fulfill the standard warranty claims, Company A is liable as the primary obligor to its customers. A corresponding receivable may be recorded for the portion covered by the manufacturer's warranty. Company A is not permitted to offset the recorded liability with the receivable. The warranty accrual and other receivable would be reversed in the period in which the manufacturer completes the repair, replaces the product, or when the warranty expires.

This accounting would be different for resellers that do not directly warrant a manufacturer's product. In those situations, a customer would be required to file any warranty claims directly with the manufacturer. The reseller, in this circumstance, would not record a warranty expense but should consider its accounting for any returns related to the defective product under ASC 605-15-25-1 through 25-4, *Revenue Recognition—Products* [formerly contained in FAS 48].

16. Standard product warranty vs. an extended product warranty

Background

Company A includes a standard product warranty as part of its standard sales contract terms. The standard product warranty is an agreement to provide warranty protection by the manufacturer for a specific period of time and is included in the price of the product.

Company A also offers an extended warranty to provide warranty protection in addition to the scope of coverage of the original standard warranty.

Finally, Company A offers a product maintenance contract to perform certain agreed-upon services to maintain its product for a specific period of time.

Does the existence of a product warranty in a sales contract constitute a deliverable in the arrangement (and thus the need to apply a separation and allocation model for a multiple deliverable arrangement)?

Relevant guidance

In accordance with ASC 605-20-25-3, *Revenue Recognition—Services* [formerly contained in FTB 90-1], revenue from separately priced extended warranty and product maintenance contracts should be deferred and recognized in income over the period in which the seller is obligated to perform.

ASC 450-20-25-2, *Loss Contingencies* [formerly contained in FAS 5], provides guidance on when it is appropriate to record an accrual for contingent losses. The criteria for recognizing an accrual are as follows:

- Information available before the financial statements are issued or are available to be issued indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.
- The amount of the loss can be reasonably estimated.

ASC 605-25 *Revenue Recognition—Multiple Element Arrangements* [formerly contained in EITF 00-21] provides separation and allocation guidance for arrangements with multiple deliverables.

Solution

Standard warranty: No. ASC 450-20 and ASC 460-10 specifically address the accounting for product warranties (refer to Issue #14).

Extended warranty: Yes. Extended product warranties and product maintenance contracts are separate deliverables, and would need to be evaluated for separation and allocation as part of a multiple element arrangement. If the extended product warranty and/or product maintenance contract(s) is/are priced separately, then they should be accounted for pursuant to ASC 605-20-25-3. If they are not priced separately, they would be evaluated for separation and allocation in accordance with ASC 605-25.

17. Allocating consideration for an extended warranty priced separately

Background

Company A sells a medical device with a one-year warranty. The customer may also purchase from Company A an extended warranty for an additional three years.

Relevant guidance

In accordance with ASC 605-20-25-3, *Revenue Recognition—Services* [formerly contained in FTB 90-1], revenue from separately priced extended warranty and product maintenance contracts should be deferred and recognized in income over the period in which the seller is obligated to perform.

ASC 605-25 *Revenue Recognition—Multiple Element Arrangements* [formerly contained in EITF 00-21] provides separation and allocation guidance for arrangements with multiple deliverables. ASC 605-25-55-30 through 55-36 (which addresses the sale of home appliances with installation and maintenance services) illustrates the interaction between the guidance for separately priced extended warranty and multiple element arrangements.

Should Company A allocate consideration on a relative fair value basis in an arrangement for the sale of a medical device that also includes the sale of a separately priced extended warranty?

Solution

No. ASC 605-20-25-3 requires allocation of the fee to the extended warranty service in an amount equal to the service's separate price (effectively its full fair value). Any remaining deliverables in the arrangement are subject to the separation and allocation process for multiple element arrangements.

18. Allocating consideration for an extended warranty that is not priced separately

Background

Company A runs a promotion by selling medical equipment for \$1,800 (its regular price) with a “free” extended three-year warranty (which is regularly sold for a separate price of \$300). Customers must take the extended warranty.

Does the fact that the extended warranty is not priced separately but, instead, is reflected in the total pricing of the arrangement, change the way the consideration is allocated?

Relevant guidance

ASC 605-20-25-3, *Revenue Recognition—Services* [formerly contained in FTB 90-1], applies to separately priced extended warranties and to product maintenance (extended coverage) for which the customer has the option to purchase the extended warranty services for an expressly stated amount separate from the price of the product.

Accordingly, if an extended warranty is not priced separately, it needs to be evaluated as a deliverable in a multiple element arrangement under ASC 605-25 *Revenue Recognition—Multiple Element Arrangements* [formerly contained in EITF 00-21].

Solution

Yes. The arrangement has two deliverables: (1) medical equipment and (2) extended warranty services. As the customer does not have the option to purchase the extended warranty services separately, the extended warranty is not within the scope of ASC 605-20-25-3. In this case, the multiple element arrangement separation and allocation guidance should be applied. In accordance with ASC 605-25, the \$1,800 consideration is allocated to each deliverable based on the relative-fair-value method, resulting in an allocation of \$257 to the warranty (the ratio of the price when the deliverables are sold separately [\$300] over the sum of the deliverables' fair value [\$2,100]), multiplied by the arrangement consideration [\$1,800]) and an allocation of \$1,543 to the medical equipment (\$1,800 divided by \$2,100 multiplied by \$1,800).

19. Right of return

Background

Company A sells medical equipment and related disposables through a network of distributors. The disposables have a shelf life of 18 months from their manufacture date and distributors can return the disposables from six months before to six months after the expiration date, regardless of when they purchased the disposable product.

Company A has sold the medical equipment and the related disposables for the past two years. Through December 31, 20X8, 3% of the disposable products sold have been returned.

On December 31, 20X8, Company A delivered two medical equipment units and 500 disposable products to Distributor Z for \$500 and \$1 each, respectively, for a total sale of \$1,500. These represent the fair values for each product.

Can Company A recognize the full \$1,500 as revenue at December 31, 20X8?

Relevant guidance

ASC 605-15-25-1, *Revenue Recognition—Products* [formerly contained in FAS 48], specifies the following criteria for revenue recognition by the seller when the buyer has the right, explicitly or implicitly, to return the product:

- The seller's price to the buyer is substantially fixed or determinable at the date of sale.
- The buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product. If the buyer does not pay at time of sale and the buyer's obligation to pay is contractually or implicitly excused until the buyer resells the product, then this condition is not met.
- The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product.
- The buyer acquiring the product for resale has economic substance apart from that provided by the seller. This condition relates primarily to buyers that exist on paper, that is, buyers that have little or no physical facilities or employees. It prevents entities from recognizing sales revenue on transactions with parties that the sellers have established primarily for the purpose of recognizing such sales revenue.
- The seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer.
- The amount of future returns can be reasonably estimated.

19. Right of return (continued)

Solution

No, Company A should not recognize the full \$1,500 as revenue at December 31, 20X8.

Company A will need to utilize significant judgment in determining the exact amount of revenue to recognize at that date. Company A will first need to determine whether it has sufficient evidence to determine a reliable estimate of disposable products to be returned. Company A will need to analyze its return volume, return patterns, current demand levels, the level of inventory currently in the distribution channel, and any new or upcoming Company A or competitor products that may render the disposable product obsolete, among other factors. If Company A is unable to reliably estimate disposable product returns, all disposable product revenue would be deferred until such time as it can make a reliable estimate or the return period has expired.

Although Company A has sold the disposable product for 2 years and has a history of returns, because of the extended nature of the return policy, it will need to carefully analyze the timing of those returns to determine what the appropriate historical return rate is and whether there is sufficient history over the entire life cycle of the product. If Company A meets all the requirements specified in ASC 605-15-25-1, including the ability to produce a reliable estimate of product returns, it should reduce the revenue recognized as of December 31, 20X8, by the amount of the estimated returns. For example, if Company A estimates a 3% return rate, it would recognize net revenue of \$1,485 (\$1,500 total order - (3% x \$500 disposable product sales)) at December 31, 20X8.

20. Accounting for registry arrangements

Background

Company A, a medical device manufacturer, sells products to doctors and hospitals for use in performing certain medical procedures. The Company separately enters into contracts with the doctors to obtain information regarding the use of the products in surgery and postoperative information regarding patient recovery.

Company A concluded it was not possible to obtain this information from someone other than the doctors who perform the procedure and manage the postoperative care.

The doctors collect and maintain the information in a patient registry, which is made available to Company A on an exclusive and controlled basis. Company A pays the doctors a fee in exchange for the registry management service.

How should Company A account for the registry management service payments?

Relevant guidance

ASC 605-50-45-2, *Revenue Recognition—Customer Payments and Incentives* [formerly contained in EITF 01-09], states that cash consideration given by a vendor to a customer is presumed to be a reduction of the selling prices of the vendor's products and therefore should be characterized as a reduction in revenue when recognized. That presumption can be overcome, and the consideration should be characterized as cost incurred if both of the following conditions are met:

- The vendor receives, or will receive, an identifiable benefit in exchange for the consideration. In order to meet this condition, the identified benefit must be sufficiently separable from the recipient's purchase of the vendor's products such that the vendor could have entered into an exchange transaction with a party other than a purchaser of its products in order to receive that benefit; and
- The vendor can reasonably estimate the fair value of the benefit identified under the preceding condition. If the amount of consideration paid by the vendor exceeds the estimated fair value of the benefit received, that excess amount shall be characterized as a reduction of revenue when recognized in the vendor's income statement.

Solution

In this fact pattern, Company A is unable to separate the identifiable benefit (i.e., registry management service) it receives from the doctors' purchases of its products. Company A cannot receive registry management service from parties other than the purchasers of its products and therefore should characterize the registry management service payments as a reduction of revenue.

21. Gross vs. net arrangements

Background

Company A manufactures and sells a surgical instrument. The instrument requires a disposable that is manufactured and sold by Company B. In order to facilitate sales to its customers, Company A offers for sale both the surgical instrument and the disposables to its customers.

Company A guarantees the performance of the disposables and offers a full refund to its customers on nonconforming parts. Company A has a right to return the disposables for returns made by customers to Company A for a replacement or a full refund from Company B.

While Company A has agreed with Company B not to sell the disposables for less than Company B's list price, Company A can charge any price at or above list price for its disposable sales. Company A receives a 10% discount off the list price when it purchases disposables from Company B.

Should Company A record revenue from the sale of disposables on a gross or net basis?

Relevant guidance

ASC 605-45-45, *Revenue Recognition—Principal Agent Considerations* [formerly contained in EITF 99-19], includes a number of indicators of gross and net arrangements. Indicators to evaluate gross treatment include:

- The seller is the primary obligor in the transaction.
- The seller has inventory risk (general inventory risk before customer order is placed or upon customer return or risk of loss after customer order or during shipping).
- The seller has latitude in establishing price.
- The seller changes the product or performs part of the service.
- The seller has discretion in supplier selection.
- The seller is involved in the determination of product or service specifications.
- The seller has physical loss inventory risk.
- The seller has credit risk.

Indicators of net treatment include:

- The seller is not the primary obligor.
- The amount the seller earns is fixed.
- The seller does not have credit risk.

The determination of gross vs. net reporting is a matter of judgment, and the above factors should each be evaluated.

Solution

The transaction should be evaluated against the indicators detailed in ASC 605-45-45 to determine whether the revenue from the sale of disposables should be recognized on a gross or a net basis. In this example, Company A is the primary obligor, as even though Company A has a right of return, the customer will look to Company A first to resolve any issues with the disposables. Company A also has taken on credit risk in the transaction and has latitude in setting pricing for disposable sales. While judgment is required, and the information above includes indicators of both gross and net arrangements, the facts detailed above would indicate that gross treatment of the disposable sales is appropriate.

22. Installation obligation — separate units of accounting

Background

A customer issues a purchase order to Company A, a medical equipment company, for equipment and installation services. Company A will install the equipment at the customer site shortly after delivery.

Company A has determined that the delivered item (equipment) has stand-alone value to the customer and has established fair value for the undelivered element (installation). Company A considers the fair value of the installation as an amount equal to a service representative's installation effort, measured in hours, multiplied by the service billable rate per hour. Other third parties could complete the installation for similar fees. Company A does not expect to have any sales returns.

Relevant guidance

When there are multiple elements within an arrangement, a determination of the units of accounting needs to be made in accordance with ASC 605-25, *Revenue Recognition—Multiple Element Arrangements* [formerly contained in EITF 00-21], in order to assess the appropriate accounting treatment for each element of the arrangement.

ASC 605-25 requires that revenue arrangements with multiple deliverables be divided into separate units of accounting if 1) the delivered items have value on a stand-alone basis, 2) there is objective and reliable evidence of fair value of the undelivered items, and 3) if the arrangement includes a general right of return relative to the delivered item, and delivery or performance of the undelivered item is considered probable and is substantially within the control of the vendor.

How should Company A recognize revenue for the sale of the equipment and installation obligation?

Solution

Company A must evaluate the arrangement in accordance with ASC 605-25 in order to assess the appropriate accounting treatment: single unit of accounting or separate units of accounting. Company A satisfied the separation criteria in ASC 605-25-5 including 1) determining that the delivered element (equipment) has stand-alone value to the customer, 2) establishing fair value for the undelivered element (installation), since the value of the installation represents an amount equal to a service representative's installation effort multiplied by the service billable rate per hour and is similar to a fee other third parties could complete the installation for, and 3) assessing the likelihood of sales returns. Based on this, Company A would recognize the elements as two separate units of accounting. Accordingly, the total revenue would be allocated to each unit of accounting based on its relative fair value. The allocated revenue associated with the equipment would be recognized upon shipment (provided all other revenue recognition criteria have been met), and the allocated revenue of the installation would be recognized when the installation services are completed.

23. Installation obligation — single unit of accounting

Background

Company A sells to its customer medical equipment and installation services. Company A will install the equipment at the customer site. Company A has completed its analysis of this multiple element arrangement under ASC 605-25, *Revenue Recognition—Multiple Element Arrangements* [formerly contained in EITF 00-21], and concluded the equipment and installation do not qualify as separate units of accounting. This may be because the equipment does not have value to the customer on a stand-alone basis, there is no objective and reliable evidence of fair value for the installation, or there is a general right of return when the installation is not considered probable and in control of the vendor. The equipment and installation services will be accounted for as one unit of accounting.

Can Company A recognize revenue upon delivery of the equipment, or should it wait until the completion of the installation services?

Relevant guidance

SAB Topic 13-A (3c), question 3, provides the following guidance:

Examples of indicators that installation is essential to the functionality of the equipment include:

- The installation involves significant changes to the features and functionality of the equipment or building complex interfaces or connections.
- The installation is unavailable from other vendors.

Conversely, examples of indicators that installation is not essential to the functionality of the equipment include:

- The equipment is a standard product.
- Installation does not significantly alter the equipment's capabilities.
- Other companies are available to perform the installation.

Solution

It depends. Pursuant to SAB Topic 13-A, assuming all other revenue recognition criteria are met, revenue for a unit of accounting may be recognized in its entirety if the seller's remaining obligation is inconsequential or perfunctory. Company A must therefore determine if the installation services are inconsequential or perfunctory. SAB Topic 13-A (3c), question 2, states that a remaining performance obligation is not inconsequential or perfunctory if it is essential to the functionality of the delivered products or services. In addition, remaining activities are not inconsequential or perfunctory if failure to complete them would result in the customer receiving a full or partial refund or rejecting the products delivered or services performed to date.

The SEC staff also considers the following factors, which are not all-inclusive, to be indicators that a remaining performance obligation is substantive rather than inconsequential or perfunctory:

- The seller does not have a demonstrated history of completing the remaining tasks in a timely manner and reliably estimating their costs;
- The cost or time to perform the remaining obligations for similar contracts historically has varied significantly from one instance to another;
- The skills or equipment required to complete the remaining activity is specialized or is not readily available in the marketplace;

23. Installation obligation — single unit of accounting (continued)

Solution (continued)

- The cost of completing the obligation, or the fair value of that obligation, is more than insignificant in relation to such items as the contract fee, gross profit, and operating income allocable to the unit of accounting;
- The period before the remaining obligation will be extinguished is lengthy; and
- The timing of payment of a portion of the sales price coincides with completing performance of the remaining activity.

If Company A determines that the installation services are not essential to the functionality of the equipment, and that such services are inconsequential or perfunctory, it may recognize revenue upon delivery of the equipment as long as no portion of the fee is contingent upon the installation services. If a portion of the fee is not payable until the installation service is delivered, the portion of the fee that is withheld or refundable should be deferred until the installation service is delivered, because that portion of the fee would not be realized or realizable.

24. Training obligation

Background

Company A, a medical device company, sells a new surgical device. Surgeons are required to receive a significant amount of training prior to operating the surgical device independently. As part of the training, a surgeon needs to perform five procedures with Company A's representatives present before the surgeon is able to utilize the new surgical device independently. Given this, Company A has a training obligation associated with the first five procedures a surgeon performs. Once the five procedures are complete, Company A does not have a training obligation associated with sales to a particular surgeon.

Company A does not sell the training services separately and does not have a fair value for the training services.

When should Company A recognize the sale of the new surgical device?

Relevant guidance

Revenue is realized and earned when all of the following criteria are met in accordance with SAB Topic 13-A:

- Persuasive evidence of an arrangement exists;
- Delivery has occurred;
- Price to the buyer is fixed or determinable; and
- Collectibility is reasonably assured.

Where there are multiple elements within an arrangement, a determination of the units of accounting needs to be made in accordance with ASC 605-25, *Revenue Recognition—Multiple Element Arrangements* [formerly contained in EITF 00-21], in order to assess the appropriate accounting treatment for each element of the arrangement. ASC 605-25 requires that revenue arrangements with multiple deliverables be divided into separate units of accounting if: 1) the delivered items have value on a stand-alone basis, 2) there is objective and reliable evidence of fair value of the undelivered items, and 3) the arrangement includes a general right of return relative to the delivered item and delivery or performance of the undelivered item is considered probable and substantially within the control of the vendor.

SAB Topic 13-A (3c), question 2, provides a list of factors that should be considered in assessing whether remaining obligations are inconsequential or perfunctory. Remaining activities are not inconsequential or perfunctory if failure to complete the activities would result in the customer receiving a full or partial refund or rejecting the products delivered or services performed to date.

Solution

Company A must first evaluate the arrangement in accordance with ASC 605-25 in order to assess the appropriate accounting treatment for each element of the arrangement (surgical device and training). In this example, Company A has not satisfied the separation criteria in ASC 605-25 since it does not have fair value for the undelivered element, which is training.

After evaluating the separation criteria in ASC 605-25, Company A must determine if the training is perfunctory or inconsequential. In order for the training service obligation to be considered perfunctory or inconsequential, Company A would have to demonstrate that the training is not essential to the functionality of the surgical device and the failure of Company A to fulfill such an obligation would not result in the customer having the right to receive even a partial refund.

In this example, the training is essential to the functionality of the new surgical device because without the training, the surgeon will not be able to properly utilize the surgical device. As a result, revenue for the entire arrangement would be recognized over the period in which the training is performed.

25. Bill and hold arrangements

Background

A customer issues a purchase order to Company A, a medical equipment company, for a large standard product that requires installation at the customer site. Company A will also perform the installation. The order is received and processed by Company A on December 31, 20X8. The customer requested that Company A defer the planned delivery and segregate the product because the facility modifications that will enable the installation and operation of the equipment have been unexpectedly delayed. The customer has insured its purchase and will take delivery on January 25, 20X9, when the facility modifications are expected to be completed.

Company A typically recognizes revenue for similar arrangements upon shipment with respect to the equipment (provided all the other revenue recognition criteria are met) and defers an amount equal to the fair value of the installation until the installation is completed.

Relevant guidance

SAB Topic 13-A (3a) addresses the revenue recognition criteria in the absence of delivery (commonly referred to as “bill and hold”). Bill and hold transactions involve arrangements where the customer agrees to purchase goods and the seller bills the customer for the goods prior to shipment, but the seller retains possession of the goods for some period of time prior to delivery to the customer. The SEC staff believes that delivery generally is not considered to have occurred unless the customer has taken title and assumed the risks and rewards of ownership of the products specified in the customer’s purchase order or sales arrangement.

In SAB Topic 13-A (3a), the SEC staff set forth criteria to be met in order to recognize revenue when delivery has not occurred. These include:

- The risks of ownership must have passed to the buyer;
- The customer must have made a fixed commitment to purchase the goods, preferably in written documentation;
- The buyer, not the seller, must request the transaction be on a bill and hold basis. The buyer must have a substantial business purpose for ordering goods on a bill and hold basis;
- There must be a fixed schedule for delivery of the goods. The date for delivery must be reasonable and must be consistent with the buyer’s business purpose;
- The seller must not have retained any specific performance obligations such that the earnings process is not complete;
- The ordered goods must have been segregated from the seller’s inventory and not subject to being used to fill other orders; and
- The equipment must be complete and ready for shipment.

The SEC staff also noted that in applying the above criteria to a bill and hold sale, companies should consider the following factors:

- The date by which the seller expects payment, and whether the seller has modified its normal billing and credit terms for this buyer;
- The seller’s past experiences with and pattern of bill and hold transactions;
- Whether the buyer has the expected risk of loss in the event of a decline in the market value of the goods;
- Whether the seller’s custodial risks are insurable and insured;
- Whether extended procedures are necessary in order to assure that there are no exceptions to the buyer’s commitment to accept and pay for the goods (i.e., that the business reasons for the bill and hold have not introduced a contingency to the buyer’s commitment).

25. Bill and hold arrangements (continued)

When should Company A recognize revenue on this transaction?

Solution

This is a very facts-and-circumstances based analysis. Typically, revenue would not be recognized until delivery occurs. However, in this situation, Company A can recognize revenue from the equipment portion associated with the sale to the customer at December 31, 20X8, since all of the criteria in order to recognize revenue when delivery has not occurred have been met:

- The risk of ownership has passed to the customer since the customer has insured the purchase.
- The customer has made a fixed commitment to purchase the product through issuance of the purchase order.
- The customer has a substantial business purpose for ordering the product on a bill and hold basis since the customer will not be able to take delivery of the product until its facility modifications have been completed.
- There is a fixed delivery schedule. The customer will take delivery on January 25, 20X9.
- The seller has not retained any specific performance obligations except for installation. Company A has fair value for the installation, and the fair value of the installation is deferred as of December 31, 20X8, since the installation has not occurred.
- The ordered product has been segregated from Company A's other inventory.
- The equipment is complete and ready for shipment.

Given that the criteria for bill and hold accounting are met and will therefore result in the transaction being accounted for as a sale, Company A will act as a custodian of the equipment sold and store the equipment at its site until the specified future delivery date. Therefore, the warehousing services represent a deliverable in this arrangement. Accordingly, Company A will need to assess whether the separation criteria in ASC 605-25, *Revenue Recognition—Multiple Element Arrangements* [formerly contained in EITF 00-21], are met in order to allocate portion of the total sales proceeds to the warehousing services. Generally in this situation, Company A should be able to meet the criteria to separate the product sale from the warehousing services and will therefore recognize revenue from the equipment portion of the sale at December 31, 20x8, and the warehousing services portion of the sale over the period the services are provided.

26. Distributor arrangements — sell in vs. sell through

Background

Company A is a manufacturer of laboratory instruments and related consumables. It recently entered into a new distribution agreement with Company B, which will undertake the distribution of Company A's consumable products in a new geographic territory. Title to the consumables passes to Company B upon delivery, and Company B assumes full risk of loss on any inventory that is damaged or destroyed.

Company A completed a credit assessment of Company B at the outset of the arrangement. Company B is an established distributor in the territory and has been in operation for decades.

Company A's products have never been sold in this new territory before, and there is some question as to how successful the new market will be. As a result, Company B insisted on having a right to return any consumable products that expired prior to sale to an end user. Company A also provided price protection to Company B for any unsold inventory on hand.

Company B will be selling the consumables to a mix of private physician practices and government-owned hospitals. In this territory, it is common that the end users do not pay for receivables for between 180 and 360 days. Company B insisted on 240-day payment terms.

Should Company A record revenue on a “sell in” or “sell through” basis?

Relevant guidance

Accounting for sales to a distributor includes a number of factors that can impact a company's conclusion as to when the sale price is fixed or determinable, including the need to reliably estimate product returns. ASC 605-15-25-3, *Revenue Recognition—Products* [formerly contained in FAS 48], and SAB Topic 13-A provide certain factors that may impair a company's ability to make a reasonable estimate of returns.

The SEC staff believes that the software revenue recognition guidance in ASC 985-605-25-36, *Software* [formerly contained in SOP 97-2], which contains considerations for reseller arrangements, is appropriate for non-software sales transactions where authoritative guidance does not otherwise exist.

Solution

Company A considered a number of criteria to conclude that it would record revenue on a “sell through” basis for this arrangement:

- Although title passes to Company B upon delivery, Company B has a right of return upon expiration of unsold product.
- There is a lack of historical sales information in the new territory. This is an indicator in ASC 605-15-25-3 of an inability to estimate returns.
- Company A has granted extended payment terms to Company B that would increase the likelihood of price concessions (i.e., lack of a fixed or determinable price).
- Company A has provided price protection to Company B on all product that has not been sold through, which also indicates a lack of a fixed or determinable price.

These factors, among others, led Company A to determine that a “sell through” model was more appropriate at the inception of the arrangement. Company A will continue to evaluate its revenue recognition policy going forward. As it gains experience selling in the new territory, factors could arise that might enable Company A to record revenue on a “sell in” basis.

27. Accounting for upgrades and enhancements

Background

Pursuant to a sales transaction, Company A is obligated to deliver specified future upgrades or enhancements to the medical devices sold. The sales terms also require that Company A provide unspecified, when-and-if-available upgrades/enhancements of the medical devices developed by Company A during the term of the arrangement.

Are obligations to deliver future upgrades or enhancements of a product (other than a product offered through a software arrangement) considered separate deliverables?

Relevant guidance

Multiple element arrangement guidance in ASC 605-25, *Revenue Recognition—Multiple Element Arrangements* [formerly contained in EITF 00-21], applies to all deliverables (that is, products, services, or rights to use assets) within contractually binding arrangements (whether written, oral, or implied) in all industries under which a vendor will perform multiple revenue-generating activities.

ASC 605-25 requires that revenue arrangements with multiple deliverables be divided into separate units of accounting if 1) the delivered items have value on a stand-alone basis, 2) there is objective and reliable evidence of fair value of the undelivered items, and 3) the arrangement includes a general right of return relative to the delivered item and delivery or performance of the undelivered item is considered probable and substantially within the control of the vendor.

Solution

Yes, both specified and unspecified upgrades or enhancements in a non-software arrangement qualify as deliverables under ASC 605-25 and should therefore be evaluated under the multiple element arrangement separation and allocation model. In most cases, it will be difficult for a seller to separate the yet-to-be-delivered specified or unspecified upgrades or enhancements from the initially delivered product since it is unlikely that sufficient objective and reliable evidence of the fair value of the yet-to-be-developed upgrades or enhancements exists.

In the case where a non-software sale that includes specified upgrades or enhancements is treated as a single unit of accounting, revenue should be deferred until the seller satisfies its obligation by delivering the specified upgrades or enhancements or other specified deliverables.

If a non-software arrangement includes only unspecified upgrades or enhancements (i.e., there are no undelivered specified upgrades, enhancements, or deliverables) as part of a single unit of accounting, revenue should be recognized over the period such unspecified deliverables are made available.

28. Incidental vs. nonincidental embedded software

Background

Company A is a manufacturer of medical equipment. Company A has historically viewed and marketed itself as a manufacturing company and recognized revenue for sales of its equipment upon delivery, assuming all other revenue recognition criteria are met, in accordance with SAB Topic 13-A.

In response to changing customer demand and a competitive environment, Company A made a significant investment in R&D in recent years and recently made several management changes in the sales and marketing area. The new sales and marketing leadership of Company A has begun to emphasize the improved features and functionality of its equipment to target customers.

The improved features and functionality are the result of new embedded software in Company A's equipment. Additionally, Company A has begun to offer post-contract customer support in the form of periodic software upgrades on a when-and-if-available basis as a way to assure customers that they will always have the most current equipment upgrades and enhancements. Company A does not charge for this post-contract customer support separately in its sales contracts.

Relevant guidance

Software revenue recognition guidance in ASC 985-605, *Software* [formerly contained in SOP 97-2], does not apply to products or services containing software that is “incidental” to the products or services as a whole. ASC 985-605-15-3 includes some indicators of when software is more than incidental to a product as a whole. The indicators are as follows:

- The software is a significant focus of the marketing effort or is sold separately;
- The vendor is providing post-contract customer support (generally, unspecified software upgrades or telephone support); or
- The vendor incurs significant costs that are within the scope in guidance for costs of software to be sold, leased, or marketed in ASC 985-20 *Software* [formerly contained in FAS 86].

In light of the recent changes in Company A's business, is the embedded software in Company A's equipment “more than incidental”? Should Company A reevaluate its revenue recognition model to determine whether there is a need to change its revenue recognition accounting policy to the principles outlined in ASC 985-605, *Software* [formerly contained in SOP 97-2]?

28. Incidental vs. nonincidental embedded software (continued)

Solution

Based on the facts discussed above, Company A should perform an evaluation of its product to determine if the embedded software is “more than incidental.” Some factors that should be considered, in addition to the factors in ASC 985-605-15-3 noted above, include the following:

- Is the software described in detail as part of the vendor’s marketing information (e.g., marketing collateral and Web sites, Company A’s sales pitch) such that the customer can evaluate the software component relative to competitors’ products?
- Can the software element be used in another product, or is it an embedded firmware application?
- Will software upgrades and bug fixes be provided to customers in the form of post-contract customer support?
- Does Company A incur significant development costs in the scope of ASC 985-20, regardless of whether such costs are capitalized?
- Is the percentage of software development costs to total research and development costs for this product significant?
- Does the customer have to sign a software license agreement?

Based on the considerations discussed above, Company A concluded that the embedded software is “more than incidental” to its equipment.

Accordingly, Company A would need to change its revenue recognition accounting policy from SAB Topic 13-A to software revenue recognition under ASC 985-605.

Company A should reevaluate its revenue recognition model each time it updates/upgrades its products or changes its business model or product marketing, as subtle changes can alter the conclusion of the “more than incidental” evaluation. This event-driven evaluation should be part of the financial reporting controls of Company A.

29. Multiple element arrangements — evidence of fair value is available

Background

Company A, a medical device company, manufactures and markets a surgical instrument. Company A also sells disposable tips that are used in conjunction with the instrument. During the year, Company A entered into a sales arrangement with Company B that involves the surgical instrument and 100 disposable tips, both of which have been delivered by year-end. As part of the arrangement, Company A also agrees to provide Company B's surgeons with 40 hours of training over the next year, which is not essential to the functionality of the surgical instrument. The total amount to be paid under the agreement is \$300. Company A has determined the fair value of the surgical instrument, 100 disposable surgical tips, and the 40 hours of training to be \$250, \$50, and \$100, respectively.

Relevant guidance

ASC 605-25, *Revenue Recognition—Multiple Element Arrangements* [formerly contained in EITF 00-21], requires that revenue arrangements with multiple deliverables be divided into separate units of accounting if: 1) the delivered items have value on a stand-alone basis, 2) there is objective and reliable evidence of fair value of the undelivered items, and 3) the arrangement includes a general right of return relative to the delivered item and delivery or performance of the undelivered item is considered probable and substantially within the control of the vendor.

Arrangement consideration should be allocated among the separate units of accounting based on their relative fair values. Applicable revenue recognition criteria should be considered separately for separate units of accounting.

How does the presence of multiple deliverables affect the accounting for a revenue arrangement?

Solution

Company A would need to assess whether any of the three deliverables (the surgical instrument, the disposable tips, and the training) meet the criteria to be divided into separate units of accounting. If the arrangement does not include a general right of return for the surgical instrument and the disposable tips and these three deliverables are determined to have stand-alone value to the customer, consideration to be received under the arrangement would be allocated on a relative fair value basis to each unit of accounting. On a stand-alone basis, the fair value of these items is \$400 (\$250 + \$50 + \$100). The portion of the arrangement fee of \$300, that would be allocated to the delivered items, the instrument, and the disposable tips is 75% (or \$300/\$400). The \$225 (75% x \$300, total arrangement fee) related to the delivered items would be recognized as revenue upon their delivery, while the remaining \$75 (25% x \$300, total arrangement fee) would be recognized over the course of delivering the training.

30. Multiple element arrangements involving lease and other products

Background

Company A leases equipment to Company B for five years. Company A also provides training services and consumables related to the equipment. Under the multiple deliverable arrangement, the lease is subject to lease accounting under ASC 840, *Leases* [formerly contained in FAS 13], while the other deliverables (consumables and training) are not subject to lease accounting. Sufficient objective evidence of the fair value of the undelivered products/services is not readily available.

Relevant guidance

ASC 605-25-15-3/3A, *Revenue Recognition—Multiple Element Arrangements*, and ASC 605-25-55 provide guidance on how to allocate arrangement consideration to each separate unit of accounting when a multiple element arrangement contains deliverables that are within the scope of other Codification Topics and those topics provide guidance only on how to separate the deliverables.

Should the arrangement be accounted for as a single unit of accounting?

Solution

The arrangement should not be accounted for as a single unit of accounting because an element of the arrangement (the leased equipment) is under the guidance of another Codification Topic (ASC 840). If sufficient verifiable objective evidence of fair values for each element does not exist, a company must base the allocation on its “best estimate of the fair value” of the lease (ASC 840) and the non-ASC 840 deliverables. An entity’s best estimate of fair value is not limited to vendor-specific objective evidence of fair value or third-party evidence of fair value.

Pursuant to multiple element arrangement guidance in ASC 605-25, the consideration resulting from the arrangement must first be divided between the ASC 840 deliverables (the leased equipment) and the non-ASC 840 deliverables (consumables and training), based on Company A’s best estimate of their fair values. After allocating the consideration, Company A would (1) apply ASC 840 to the equipment lease deliverable and (2) use ASC 605-25 to consider further separation of the non-ASC 840 deliverables (training and consumables).

31. Multiple element arrangements involving software

Background

Company A, a medical device company, manufactures and markets respiratory equipment. This product contains software that is more than incidental to the respiratory equipment; therefore, Company A accounts for this arrangement under ASC 985-605, *Software* [formerly contained in SOP 97-2]. Hospital B has agreed to purchase the product and its software for \$1,000. As part of the arrangement, Company A also has to provide Hospital B's doctors with 40 hours of training on how to best use the product. Company A also sells the equipment and software individually for \$750 and \$375, respectively, without the training. Customers that decide that they later would like to purchase the training can do so for an additional charge of \$375.

On what basis should consideration be allocated to the deliverables in this arrangement?

Relevant guidance

For multiple element arrangements that involve the sale of software, software revenue recognition guidance in ASC 985-605-25-6 stipulates that the fee should be allocated to the various elements based on vendor-specific objective evidence of fair value, regardless of any separate prices stated within the contract for each element. Vendor-specific objective evidence of fair value is limited to the following:

- The price charged when the same element is sold separately.
- For an element not yet being sold separately, the price established by management having the relevant authority; it must be probable that the price, once established, will not change before the separate introduction of the element into the marketplace.

Solution

The \$1,000 consideration must be allocated among the elements based on the relative vendor-specific objective evidence (VSOE) of fair value of each element. Since Company A does have established prices that it charges customers for each of the three elements (which establishes vendor-specific objective evidence of their fair value) of the arrangement (the equipment, the software, and the training), it allocates the \$1,000 consideration among the deliverables using these prices. The total objective vendor-specific fair value of these items is \$1,500 (\$750 + \$375 + \$375). The consideration allocated to the equipment, software, and training would be \$500, \$250, and \$250, respectively, as calculated below.

	A	B	C	D
	Element	VSOE	Relative Value (B/B4)	Allocated Revenue (C x D4)
1	Equipment	\$750	50%	\$500
2	Software	\$375	25%	\$250
3	Training	\$375	25%	\$250
4	Total	\$1,500	100%	\$1,000

32. Price protection

Background

Company A, a medical supplies manufacturer, enters into a sales arrangement with a hospital buying group (HBG). Included in the agreement is a price protection clause that guarantees that the HBG will receive Company A's lowest selling price. If Company A sells its products to another customer at a lower price, the HBG will receive the lower price on all future purchases. Company A does not have any history of providing retroactive price adjustments to its customers.

Relevant guidance

One of the conditions to ensure that revenue is realizable under SAB Topic 13-A is that a transaction's selling price must be fixed or determinable. This type of price protection is often referred to as a "most favored nation clause." As these types of clauses are within the control of a company, it would generally result in a company concluding that the current sales are fixed or determinable, provided it can reliably estimate price concessions.

Does inclusion of this price protection clause impact the current sales to the HBG?

Solution

No. As the timing and amount of any future price decreases or sales to another customer below the HBG price are within the control of Company A, and since the price adjustment would be on future purchases, Company A concluded that the current sales price for products sold is fixed or determinable.

33. Accounting for a fixed-price trade-in credit included in a revenue transaction

Background

On 1/1/20X8, Company A, a medical instrument company, enters into an arrangement with Company B to sell version 1 of Product X for \$10,000. As part of the arrangement, Company A offers a fixed-price trade-in credit to Company B allowing it to exchange version 1 for version 2 of Product X. Version 2 has significantly different features and will be available on 6/30/20X8 for a sales price of \$12,000. The costs to produce version 1 and version 2 are \$4,000 and \$5,000, respectively.

Company B will be able to obtain version 2 by returning version 1 and paying an additional \$6,000. The fixed-price trade-in credit expires one year from the date of offer, and the fair value of the trade-in credit is determined to be \$3,000.

Relevant guidance

When there is a fixed-price trade-in credit that requires a company to make a payment (in the form of the trade-in credit) to the customer, accounting for guarantees guidance in ASC 460, *Guarantees* [formerly contained in FIN 45], should be analyzed.

Where there are multiple elements within an arrangement, a determination of the units of accounting needs to be made in accordance with ASC 605-25, *Revenue Recognition—Multiple Element Arrangements* [formerly contained in EITF 00-21], in order to assess the appropriate accounting treatment for each element of the arrangement.

What is the accounting treatment for the fixed-price trade-in credit? What is the accounting treatment for the subsequent exercise of the fixed-price trade-in credit and purchase of version 2?

Solution

Company B is receiving two deliverables: version 1 and a fixed-price trade-in credit for version 2. The fixed-price trade-in credit should be accounted for under the guidance provided by ASC 460. The fixed-price trade-in credit contains one of the base characteristics of a guarantee in that it may require the seller (Company A) to make a payment to the customer (Company B) based on changes in the price of the assets purchased.

ASC 605-25-15 provides guidance on how to allocate consideration of a multiple element arrangement when other Codification Topics address separation or allocation criteria for one or more of the deliverables. Accordingly, the fixed-price trade-in credit must be first separated at fair value under requirements of accounting for guarantees (ASC 460), before applying the multiple element arrangement model to the remaining deliverables. To determine the fair value of the ASC 460 liability, Company A should use the guidance outlined in ASC 820, *Fair Value Measurements and Disclosures* [formerly contained in FAS 157], and Statement of Financial Accounting Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. ASC 820-10-35-36 through 35-57 discusses the level of inputs to be considered in the calculation. Some of the inputs to be considered when determining the fair value of the guarantee for the customer are:

33. Accounting for a fixed-price trade-in credit included in a revenue transaction (continued)

Solution (continued)

- Probability of exercise,
- Estimated time frame of exercise,
- Guaranteed trade-in price,
- Estimated fair value of the equipment at date of trade-in, and
- Estimated selling price of version 2 at trade-in date.

After the guarantee is recognized at fair value, the residual amount of the total consideration would be allocated to the sale of version 1. Revenue for version 1 would be recognized at the time of the sale, assuming all revenue recognition criteria are met, and a liability would be established for the guarantee. ASC 460 does not prescribe how the guarantor's liability for its obligations under the guarantee should be measured subsequent to its initial recognition. ASC 460-10-35-1 does recognize that in subsequent periods, the initial liability would typically be reduced as the guarantor is released from risk under the guarantee. In this case, that release would likely arise upon exercise or lapse of the trade-in credit.

The following entries should be recorded by Company A:

Record the sale of version 1 and recognize the trade-in right

Dr. Cash	\$10,000
Dr. COGS (Version 1)	\$4,000
Cr. Revenue	\$7,000
Cr. Guaranteed Liability	\$3,000
Cr. Inventory	\$4,000

Exercise of the fixed-price trade-in credit, customer returns version 1, pays \$6,000 in cash, and receives version 2

Dr. Guaranteed Liability	\$3,000
Dr. Cash	\$6,000
Dr. Inventory (Version 1)	\$3,000 (based on estimated fair value at trade-in date)
Dr. COGS (Version 2)	\$5,000
Cr. Revenue	\$12,000
Cr. Inventory (Version 2)	\$5,000

33. Accounting for a fixed-price trade-in credit included in a revenue transaction (continued)

Solution (continued)

Note that the total revenue recognized when the customer exercises the fixed-price trade-in right is greater than the amount of cash received. This is acceptable as Company A is recognizing the fair value of the inventory being returned as additional proceeds (i.e., cash received for the total arrangement is \$16,000 and the revenue recognized for the total arrangement is \$19,000 as the fair value of the inventory being returned is \$3,000).

One possible exception to the above model would be a transaction where the economic substance is not representative of a fixed-price trade-in credit. This would be the case where the customer, in substance, is not making an independent decision to purchase version 2. That is, the customer initially wanted version 2 and is only buying version 1 because version 2 is not yet available. The customer is only using version 1 on a temporary basis and is fully expected to trade in version 1 once version 2 is available. The substance of that transaction would be a fee for the use of version 1 and a purchase of version 2. In those situations, Company A should defer revenue in an amount sufficient to recognize the full sales price of version 2.

In determining whether the customer has made an independent decision to purchase version 2, Company A should consider the following:

- What was the level of information that was provided during the initial sales process in regard to version 2?
- Has the customer taken physical delivery of version 1?
- Are payment terms linked to the delivery of version 2?
- Can the customer use version 1 to meet its current needs?

34. Extended payment terms

Background

Company A sells consumable health-related products through a network of distributors and recognizes those sales upon delivery of goods to the distributor, when all of the criteria of SAB Topic 13-A have been met.

Company A develops a new product, Product Z, which it will sell directly to the end users. Historical payment terms required the distributors to pay Company A within 60 days of product delivery. Company A requires its end users for Product Z, being small businesses, to pay within 150 days of delivery. Internal controls provide reasonable assurance that Product Z will be sold only to customers of high credit quality.

Will the longer payment terms prevent Company A from recognizing revenue upon delivery of Product Z?

Relevant guidance

The SEC staff stated in SAB Topic 13-A that a vendor of products with a higher risk of technological obsolescence should also apply software revenue recognition guidance contained in ASC 985-605-25-33 through 25-35, *Software* [formerly contained in SOP 97-2]. This guidance imposes a rebuttable presumption that fees due more than a year after delivery are neither fixed nor determinable. Fees that are neither fixed nor determinable may be recognized only as payment becomes due.

To overcome the presumption that fees are not fixed or determinable in extended payment term arrangements, requirements in ASC 985-605-55-22 through 55-25 [formerly contained in TPA 5100.57] should be considered. The vendor must have a history of successfully collecting under the original payment terms of comparable arrangements without making concessions. Further, in evaluation of a vendor's history, the historical arrangements should be comparable to the current arrangement relative to terms and circumstances to conclude that the history is relevant. Although a nominal increase in the length of payment terms may be acceptable, a significant increase in the length of the payment terms may indicate that the terms are not comparable.

Solution

No, the mere presence of extended payment terms should not preclude revenue recognition. When an arrangement contains extended payment terms, the seller should evaluate whether those terms indicate that the fee is neither fixed nor determinable and consider the requirements of ASC 985-605-55-22 through 25 (e.g., when it is likely that a price concession will be granted before the customer pays). This concern is particularly important when the product is subject to rapid obsolescence.

Extended payment terms may also (i) increase the risk that the customer's ability to pay will deteriorate, thereby undermining the collectibility assertion, and (ii) make it more difficult for the vendor to estimate future product returns. In this situation, if Company A concludes that the fee is fixed or determinable and collectibility is reasonably assured when the goods are delivered, it should recognize revenue when the other criteria in SAB Topic 13-A are satisfied.

35. Rebates given to end users

Background

Company A enters into a sales arrangement with a large distributor for disposable medical products that are ultimately sold to end users, including hospitals and medical doctors. The sales arrangement entitles the distributor's end customers to a sales rebate for the first 100 purchases that provides them with a 25% discount.

The unit selling price for each product is \$100. Company A believes that it has sufficient basis to estimate that the end customer will purchase 1,000 units during the year.

How should Company A account for rebates to be paid to the end user, and what is the appropriate classification in the income statement?

Relevant guidance

Accounting for customer payments and incentives in ASC 605-50, *Revenue Recognition—Customer Payments and Incentives* [formerly contained in EITF 01-09], is the relevant guidance and would indicate that the rebate should be recognized on a systematic and rational basis. Measurement of the total rebate should be based on the estimated number of purchases that the customer will ultimately earn under the arrangement. However, if the amount of future rebates cannot be reasonably estimated, a liability should be recognized for the maximum potential amount of the rebate.

ASC 605-50-45-1 through 45-5 contains the relevant guidance for determining the appropriate classification in the income statement for a rebate given to an end user. Cash consideration (including a sales incentive) given by a vendor to a customer anywhere in the distribution chain is presumed to be a reduction of the selling prices 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.

Solution

The rebate would be accrued as a charge to revenue on a systematic and rational basis that is meant to approximate how the customer is earning the rebate over each of the revenue transactions that lead up to the rebate. Measurement of the rebate would be based on the estimated number of units that the customer will purchase. If it is not estimable how many customers will earn the rebate, then the maximum potential amount of refund or rebate should be accrued. In this situation, as Company A has a sufficient basis to estimate that 1,000 units will be purchased, Company A should estimate the total rebate that the customers will earn for the year and divide that by the 1,000 units. The total rebate on 1,000 units would be \$2,500 (25% rebate on the first 100 units x \$100 unit selling price). As each unit is shipped, Company A would recognize a rebate accrual of 2.5% ($\$2,500 \text{ total rebate} / \$100,000 \text{ annual sales}$). This methodology meets the "systematic and rational" requirement of how to accrue a rebate.

There may be other acceptable methodologies. At the end of each quarter, Company A would revise the annual estimate of sales and true up the calculation and rebate that will be due at the end of the year. This true up would include a cumulative adjustment on shipments through that date.

Even though the product was sold to a distributor and the rebates are paid to subsequent end users, the classification of the payment is still as a reduction of revenue under ASC 605-50-45-1 through 45-5.

36. Rebates on volume purchases

Background

Company A has a multiyear contract with Company B to purchase disposable medical products and agrees to pay Company B an annual rebate if it completes a specified cumulative level of purchases during any year during the contract period. The contract specifies that the amount of rebate will vary based on a tiered structure agreed to in the contract as follows (note that the rebate earned is not retroactive to prior purchases):

Purchases	Rebate
1-10	0%
11-20	2%
Greater than 21	5%

The unit price for each product is \$100. Company A believes that it has a sufficient basis to estimate that the customer will purchase 30 units during the year.

Relevant guidance

Accounting for customer payments and incentives in ASC 605-50, *Revenue Recognition—Customer Payments and Incentives* [formerly contained in EITF 01-09], is the relevant guidance and would indicate that the rebate or refund should be recognized on a systematic and rational basis. Measurement of the total rebate or refund obligation should be based on the estimated number of purchases that the customer will ultimately earn under the arrangement. However, if the amount of future rebates or refunds cannot be reasonably estimated, a liability should be recognized for the maximum potential amount of the refund or rebate.

How should Company A account for the rebate expected to be paid to the customer at the end of the year?

Solution

As Company A has a sufficient basis to estimate that 30 units will be purchased, Company A should estimate the total rebate that Company B will earn for the year and divide that by the 30 units. The total rebate on 30 units would be \$70 (no rebate on the first 10 units + 10 units x \$100 unit cost x 2% + 10 units x \$100 unit cost x 5%). As each unit is shipped, the Company would recognize a rebate of 2.33% (\$70 total rebate / \$3,000 annual sales). This methodology meets the “systematic and rational” requirement of how to accrue a rebate. There may be other acceptable methodologies. At the end of each quarter, Company A would revise the annual estimate of sales and true up the calculation and rebate that will be due at the end of the year. This true up would include a cumulative adjustment on shipments through that date.

37. Volume purchase agreements

Background

Company A enters into a two-year arrangement with Company B for the purchase of medical devices. The terms of the agreement do not specify any contractual minimum purchases by Company B. However, once the number of purchases exceeds the first 1,000 units of the medical device, the price per unit decreases from \$12 per unit to \$8 per unit for each unit purchased thereafter (which is often referred to as a volume purchase arrangement).

On October 31, 20X8, Company B issues a purchase order for 1,000 units of the medical device. On January 15, 20X9, prior to the issuance of Company A's financial statements, Customer B issues a second purchase order for another 1,000 units of the medical device.

Relevant guidance

One of the four criteria under SAB Topic 13-A to ensure that revenue is realizable is that a transaction's selling price must be fixed or determinable. The inclusion of future discounts on a current transaction must be considered to conclude whether all the revenue from a current transaction is considered fixed or determinable.

In some cases, the future discount on future purchases would be accounted for at the time of the future purchase, and in other cases, the future discount may be applied to both the current and future purchases. To make this determination, a company needs to evaluate whether the current and future purchases are considered separate buying decisions. To assist in making this judgment, a company should determine whether the future discount is considered a significant incremental discount or whether there are minimum purchases in the arrangement.

How should Company A account for the sale of the first 1,000 units of the medical device?

Solution

Provided that it can be established that the second purchase of 1,000 units of the medical device represented a separate purchasing decision by Company B, Company A should recognize revenue for the first 1,000 units in accordance with the terms of the contract. The reporting of revenue would therefore be based on the price per unit stated in the agreement following the volume purchase arrangement schedule. That is, Company A would record revenue of \$12 per unit for the first 1,000 units sold.

If in substance the arrangement relates to a single purchasing decision, the recognition of revenue at the higher purchase price for the first 1,000 units would likely not be appropriate. For example, if the arrangement was structured such that Company B was required to purchase a minimum of 2,000 units from Company A (a take or pay-type arrangement), it is unlikely the second thousand units would be considered a separate purchasing decision. In this case, revenue should be recorded by Company A at an average sales price per unit based on the total fee for the minimum sales commitment (i.e. $(\$12 \times 1,000 \text{ plus } \$8 \times 1,000) \text{ divided by } 2,000$). Company A would then recognize revenue based on the amount calculated when multiplying the quantity delivered by the average price per unit (\$10 in this example).

38. Future discount on next-generation equipment

Background

Company A sells a medical device to Company B. Company A is currently developing the next-generation product, which it expects to release in six months. As an incentive for Company B to purchase the current model, Company A offers a 40% discount on the next-generation model when it is released. Management has not determined what the fair value (i.e., selling price) of the next-generation model will be.

Relevant guidance

There is no specific guidance related to incentive discounts under SAB Topic 13-A. However, accounting for significant incremental discounts in ASC 985-605-55-82 through 55-85, *Software* [formerly contained in TPA 5100.51], provides a model for accounting for discounts or future discounts related to software transactions and may be analogized for nonsoftware transactions.

The software model first requires the determination of whether the discount is incremental and significant. If the discount is not considered a significant incremental discount, it does not affect the revenue accounting for the current transaction. If the discount is considered a significant incremental discount, a proportionate amount of the discount is applied to each element covered by the arrangement based on the element's fair value. A key element will be whether the amount of discount can be quantified (e.g., is the fair value of the future equipment known, or can the maximum discount be quantified).

How should Company A account for the discount being offered on the next-generation product?

Solution

Under the current equipment sale, the maximum amount of the discount cannot be determined because the next generation's fair value is not yet determined. Guidance in ASC 985-605-55-82 through 55-85 indicates that if the maximum discount is not quantifiable, each element should be reduced by the rate of the discount. Therefore, for the current product sale, Company A should defer 40% of the selling price until either the end of the discount period (if there is one), the customer purchases the next-generation product, or the fair value of the next-generation equipment becomes known and the maximum discount can be determined. Under this last scenario, Company A would apply the discount to both transactions based on the fair values so that a consistent discount rate is applied to both transactions. Thus, a portion of the 40% discount originally deferred would become recognizable once the fair value of the next-generation product becomes known.

39. Free products or services

Background

Company A sells a surgical instrument to Customer B. In connection with the sale, Company A agrees to provide free disposables to Company B. Company A has established fair value for both the surgical instrument and disposables based on their individual separate sales. The surgical instrument and disposables also have value to Company B on a stand-alone basis.

Relevant guidance

When free products are offered as part of multiple deliverable transactions, total consideration should be separated and allocated between the elements in accordance with ASC 605-25, *Revenue Recognition—Multiple Element Arrangements* [formerly contained in EITF 00-21].

How should Company A recognize the free disposables provided to Company B?

Solution

Company A should allocate total consideration in this arrangement between the surgical instrument and disposables based on their relative fair values and recognize revenue for each element when all the criteria in SAB Topic 13-A have been met.

40. Accounting for payments to a customer as part of an arrangement with a group purchasing organization

Background

Company A sells disposable medical products to hospitals through a network of distributors at list price. Company A has agreements in place with various group purchasing organizations (GPOs) to give a discount of 20% to specific hospitals affiliated with these GPOs. When a GPO-affiliated hospital purchases the disposable medical products from a distributor, it purchases them at the discounted amount, and a request for reimbursement is submitted by the distributor to Company A.

During 20X8, Company A sells 1,000,000 disposable units to its distributors at a price of \$1 per unit. Also during 20X8 Company A reimburses distributors \$75,000 for discounts given to GPOs.

Relevant guidance

The guidance in SAB Topic 13-A and accounting for customer payments and incentives in ASC 605-50, *Revenue Recognition—Customer Payments and Incentives* [formerly contained in EITF 01-09], should be considered when assessing the revenue to be recognized.

In addition, the considerations for arrangements with right of return discussed in ASC 605-15-25-1 *Revenue Recognition—Products* [formerly contained in FAS 48] relative to factors that may impact the ability to make a reasonable estimate of product returns can be considered in assessing the Company's ability to estimate discounts to be paid to the distributors.

What is the net revenue Company A should recognize in 20X8 related to disposable product sales?

Solution

In order to determine the net revenues to be recognized in 20X8, Company A will need to perform an assessment of the estimated discounts to be paid on sales made to distributors that will be ultimately purchased by the GPOs. This assessment will need to include an assessment of historical sales to GPOs as a percentage of overall sales, projected changes to that percentage based on current events and trends, lag time between sales to the distributor and processing of the discounts by Company A, and estimated inventory in the distribution channel, among other factors. Assuming Company A has information available on which to base a reliable estimate of discounts to be given on sales made through December 31, 20X8 to the distributors, Company A should recognize the net amount of revenue ultimately expected to be realized on those sales.

Assuming that Company A can reliably estimate that 50% of its sales ultimately are purchased by GPOs receiving the discount, it would recognize \$900,000 of net revenue in the year ended December 31, 20X8 (\$1,000,000 gross revenue x 50% sold to GPOs x 20% discount = \$100,000 reduction in revenue). If Company A is not able to reliably estimate the mix of sales to GPOs and non-GPOs, revenue would be recognized based on the sell-through method.

41. Embedded leases

Background

Company A is a medical device company that provides customers with disposable supplies used in conjunction with a specialized medical device. As part of Company A's arrangement with Company B, Company A gives the right to use specialized equipment for no cost. In return, Company B agrees to purchase the disposables required for the operation of the equipment from Company A. The following are certain elements of this arrangement:

- There are no minimum purchase requirements; expected volume of purchases is 1,000 disposables.
- Company B is not required to purchase disposables, but if it does purchase disposables for the specialized equipment, it will need to do so from Company A.
- The agreement is for 12 months, title remains with Company A, and the equipment will be returned at the end of the period.
- Purchase price and fair value for the disposables are \$1 each. Fair value of equipment rental for 12 months is \$100.

How should Company A allocate the arrangement consideration between the deliverables?

Relevant guidance

The key determination is whether the loaned equipment meets the requirements to be considered an embedded lease. If it does, then the equipment will be accounted for in accordance with lease accounting in ASC 840, *Leases* [formerly contained in FAS 13], while the disposables are accounted for in accordance with SAB Topic 13-A.

If it is determined that the arrangement contains multiple deliverables, the arrangement consideration must be allocated between the deliverables in accordance with ASC 605-25, *Revenue Recognition—Multiple Element Arrangements* [formerly contained in EITF 00-21]. ASC 605-25-15-3/3A and ASC 605-25-55 require arrangement consideration to be allocated between a lease deliverable and a nonlease deliverable based on the relative fair value of the deliverables, using the best estimate of those fair values.

41. Embedded leases (continued)

Solution

As Company B is not required to purchase disposables, the entire fee arrangement is considered contingent. Therefore, no revenue should be recognized until a purchase of disposables occurs. Revenue would be split between the lease deliverable (specialized equipment) and the nonlease deliverable (disposables) based on the 9/91% split calculated below:

	A	B	C	D (C/C3)	E (D * C1)
	Deliverable	Cost Structure	Fair Value of Expected Volume	%	Relative FV of Expected Volumes
1	Disposables	Variable	\$1,000	91%	\$910
2	Equipment rental	Fixed	100	9%	90
3	Total		\$1,100		\$1,000

For every dollar of disposable sales, \$0.09 would be recognized as rental revenue. If actual volume differs from the expected volume (is less or greater than the expected volume), Company A can elect to either 1) continue to allocate revenue between the lease deliverable and nonlease deliverable based on the original fair value percentage or 2) stop revenue recognition on the lease deliverable at the point at which the fee allocated to the lease deliverable equals the fair value of the lease deliverable. The Company would need to make a policy election and ensure that the economics of the transaction are consistent with the policy election.

Company A would also capitalize the equipment and depreciate it over the estimated useful life of the equipment.

42. Accounting for certain guarantees to a buyer of equipment that is leased to an end user

Background

Company A manufactures equipment and sells the equipment to a third-party finance company. The finance company, in turn, leases the equipment under an operating lease to an end user lessee. Company A retains the following risks of ownership through guarantees provided to the finance company:

- A credit guarantee to protect the finance company from first dollar losses incurred from default by the lessee, and
- A residual value guarantee to protect the finance company from decreases in fair value of the equipment below a specified threshold (when it is returned by the end user at the end of the lease term).

Can Company A recognize a sale of the equipment to the finance company even though it provides certain guarantees?

Relevant guidance

Accounting guidance for the transfer of leased property in ASC 840-20-40-3, *Leases* [formerly contained in FAS 13], applies to this fact pattern because (a) there are three parties involved (the end user, intermediary, and manufacturer), (b) there is an underlying lease, (c) the contractual terms of the lease (e.g., payments) are known at or near the time of sale by the manufacturer to the intermediary, and (d) the underlying lease is classified as an operating lease.

ASC 840-20-40-3 states, “The sale of property subject to an operating lease (or of property that is leased by or intended to be leased by the third-party purchaser to another party) shall not be treated as a sale if the seller or any party related to the seller retains substantial risks of ownership in the leased property.”

Solution

If (i) the lease from the finance company to the end customer is an operating lease and (ii) the present value of the maximum exposure to the manufacturer for both the credit guarantee and residual value guarantee (combined) is more than 10% of the fair value of the equipment sold, a sale would not be recognized as it would be precluded under ASC 840-20-40-3. Rather, the transaction would be accounted for as a secured financing in the manner specified in ASC 840-20-35-4, with revenue recognized over the term of the underlying end user lease.

If (i) the lease from the finance company to the lessee is an operating lease, and (ii) the present value of the maximum exposure to the manufacturer for the guarantees is 10% or less of the fair value of the equipment, the sale would be recognized and a liability pursuant to ASC 460, *Guarantees* [formerly contained in FIN 45], would be established for the guarantees.

43. Types of costs that can be deferred relating to the sale of products and services

Background

Company A deferred its products and services revenue as a result of not meeting all the recognition criteria. Company A has a policy of deferring costs.

Relevant guidance

There is limited authoritative guidance on the treatment of costs associated with revenue-generating transactions. The SEC staff accepts a policy of expensing these costs except where specific guidance prohibits expensing costs as incurred.

Certain types of costs incurred prior to revenue recognition may be capitalized if they meet the definition of an asset. Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, paragraph 25, states, "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events."

Since Company A's policy is to defer costs, what types of costs can it defer?

Solution

When deferring costs related to product sales, inventory costs capitalizable under ASC 330-10, *Inventory* [formerly contained in ARB 43, chapter 4], should be used as the basis for determining the amount of deferred costs.

When deferring costs of services, two models are acceptable:

- (1) A model based on the guidance for nonrefundable fees and other costs discussed in ASC 310-20, *Receivables* [formerly contained in FAS 91], where costs eligible for deferral are those related directly to a specified loan and are either (a) incremental direct costs incurred with third parties, or (b) certain internal direct costs related to origination activities; or
- (2) A model based on the accounting for separately priced extended warranty discussed in ASC 605-20-25-1 through 25-6, *Revenue Recognition—Services* [formerly contained in FTB 90-1], where only direct and incremental solicitation costs should be deferred.

Company A's accounting policy/method for deferring costs should be applied consistently. When the impact of a deferral could be material, Company A should disclose its deferral policy. Company A should also disclose in its policy the nature of the costs that are deferred.

44. Accounting for sales commissions

Background

Company A sells products that result in the deferral of revenue at the time of sale.

Historically, Company A did not pay sales commissions except in select agent arrangements. Beginning in fiscal 20X8, Company A adopted a sales commission plan that paid commissions at a target rate of the contract amount. Commissions are payable when the customer accepts the product or service from Company A. Sales commissions are generally paid on sales meeting the criteria for sales commission payment in the subsequent accounting period.

Relevant guidance

SAB Topic 13-A (3f) Question 3 states that incremental direct costs (e.g., sales commissions) incurred related to the acquisition or origination of a customer contract in a transaction that results in the deferral of revenue may be either expensed as incurred or deferred in using the guidance for separately priced extended warranty ASC 605-20-25-1 through 25-6, *Revenue Recognition—Services* [formerly contained in FTB 90-1], or guidance for nonrefundable fees and other costs discussed in ASC 310-20, *Receivables* [formerly contained in FAS 91].

What is the appropriate cost model to account for sales commissions?

Solution

It is an accounting policy election that should be disclosed and applied consistently.

When deferring costs of services, two models are acceptable:

- (1) A model based on the guidance for nonrefundable fees and other costs discussed in ASC 310-20, *Receivables* [formerly contained in FAS 91], where costs eligible for deferral are those related directly to a specified loan and are either (a) incremental direct costs incurred with third parties or (b) certain internal direct costs related to origination activities; or
- (2) A model based on the accounting for separately priced extended warranty discussed in ASC 605-20-25-1 through 25-6, *Revenue Recognition—Services* [formerly contained in FTB 90-1], where only direct and incremental solicitation costs should be deferred.

If Company A adopts a policy of deferring sales commissions, any costs deferred must meet the definition of an asset under Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements* (i.e., probable future economic benefit is obtained by Company A as a result of a past transaction or event). The deferred costs would not be considered an asset merely as a result of Company A having deferred an upfront payment in an amount equal to or greater than the deferred costs if such payments are refundable.

The Company must demonstrate that there is sufficient probable revenue to cover any cost deferrals on a transaction-by-transaction basis. This can be achieved through probable future revenues, customer forfeiture of upfront payments upon contract termination, or contract termination fees sufficient to cover the deferred cost.

If Company A has a legal right and intent to claw-back or chargeback the sales commission from the salesperson in the event the underlying sale is canceled, such deferred costs would be considered to meet the Statement of Financial Accounting Concepts No. 6 definition of an asset.

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