EITF 00-21: Revenue Arrangements with Multiple Deliverables

A Member of FASB's Emerging Issues Task Force

Shares Insights on New Guidance for Revenue

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About the Author

Ashwinpaul C. Sondhi is currently a member of the Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board (FASB).

He has been a member of the Global Financial Reporting Advocacy Committee of the CFA Institute; the Planning Subcommittee and Accounting Standards Executive Committee of the AICPA; the Financial Accounting Policy Committee of the CFA Institute; the FASB Task Force on Accounting for Impairments of Long-lived Assets; and the Statement of Cash Flows Steering Committee of the International Accounting Standards Committee. Mr. Sondhi was also an advisor to the FASB on its' project comparing U.S. and International Financial Reporting Standards.

Mr. Sondhi is a co-author of The Analysis and Use of Financial Statements, Third Edition, which is a recommended text for the Chartered Financial Analysts (CFA) program. Mr. Sondhi has also edited Credit Analysis of Nontraditional Debt Securities, co-authored Impairments and Write-offs of Long-Lived Assets, and co-edited CFA Readings in Financial Statement Analysis, and Off-Balance Sheet Financing Techniques.

Mr. Sondhi serves on the Board of Directors of an investment advisory services firm and one charitable foundation. He is also an advisor to several U.S. and foreign companies (list available by accessing www.acsondhi.com). His consulting activities include consolidation policy issues related to variable interest entities, revenue recognition practices in the software industry, revenue arrangements with multiple deliverables, financial reporting requirements for foreign operations, securitizations and transfers of financial assets, credit analysis, and the analysis of company-wide financial reporting decisions.

Introduction

Complex contracts that require the separate delivery of multiple goods and/or services are increasingly commonplace. Contracts with multiple deliverables raise questions about:

(1) The appropriate level of disaggregation for each deliverable (separate earnings processes), and

(2) The amount and timing of revenue recognition for the separate deliverables.

Consider the following examples:

- Under what conditions should one segregate and apply different revenue recognition methods to the deliverables in a hospital construction contract that includes the installation of complex diagnostic tools, the sale of related software and a contract to operate the hospital upon completion?
- At the inception of a cellular phone contract offering a free phone to all customers who agree to a two-year contract, how much revenue should the company recognize when the phone is delivered?
- In a software transaction, how should one account for a customer's right to return the software or receive a refund of all or a portion of the purchase price in the event the vendor does not provide adequate post-contract support?

Prior to EITF 00-21, GAAP lacked a comprehensive definition of a deliverable or a separate unit of accounting and did not include consistent segmentation provisions[1] or guidelines to determine:

- When and how to divide an arrangement into separate units of accounting ("separation criteria"), and
- How to measure and allocate the total sales price to the separate units of accounting ("measurement and allocation requirements").

In addition to these issues, EITF 00-21 provides guidance on accounting for contingent revenue when a customer has the right to receive a refund in the event of nonperformance by the vendor. EITF 00-21, however, does not address the deferral of costs incurred to deliver products and services for which revenue recognition must be delayed due to the contingent nature of one or more components of the transaction.

[1] The "separation criteria" and the "measurement and allocation requirements" are collectively referred to as segmentation provisions.

EITF 00-21 and Existing GAAP

EITF 00-21 does not address revenue recognition guidelines for deliverables in bundled arrangements. Whether the guidance of EITF 00-21 or higher-level literature (HLL) applies depends on the type of higher-level literature applicable to the transaction.

Category 1: HLL must be used when it contains segmentation provisions. For example, the segmentation provisions of SOP 97-2, Software Revenue Recognition, must be applied to the deliverables within its scope. This standard requires separation of software from post-contract maintenance, bug fixes, and upgrades. It also requires the allocation of the total purchase price to the different components of the arrangement on the basis of their relative fair values.

Category 2: The arrangement consideration must be allocated on a relative fair value basis if HLL provides guidance on the separation of deliverables within its scope from deliverables outside its scope but does not specify how the arrangement consideration must be allocated to those separate units of accounting.

Category 3: EITF 00-21 applies to deliverables for which HLL provides no guidance regarding the separation or allocation of the total arrangement consideration.

Example

Consider an arrangement that includes the customization and development of software (SOP 81-1 deliverables) and the operation of the equipment using that software (a non-SOP 81-1 deliverable). Although SOP 81-1 provides both separation and allocation guidance (segmentation provisions) for deliverables within its scope, it does not contain similar separation and allocation guidance for SOP 81-1 and non-SOP 81-1 deliverables. The segregation provisions of EITF 00-21 must be applied to this arrangement.

SOP 81-1 segmentation guidance must be applied if EITF 00-21 separates customization and development deliverables from the operation of the final product. If EITF 00-21 does not permit the separation of the customization and development components from the operation deliverable, they must be combined with the operation deliverable and revenue recognition criteria must be established for the combined deliverable.

Deliverable(s) subject to HLL not meeting EITF 00-21 criteria for separation must be combined with other undelivered items to determine appropriate revenue recognition methods for those combined deliverables.

Key Concept

Revenue recognition guidance in current GAAP is generally limited to a single deliverable. It is very difficult, if not impossible, to find a revenue recognition method that applies to combined deliverables. In most such cases, companies will only be able to recognize revenues on a straight-line basis over the contract term.

Financial Reporting Principles

Both at the inception of the contract and as each item is delivered, all deliverables meeting the criteria of this EITF must be evaluated to establish whether they are separable units of accounting. The total arrangement consideration must first be allocated among the separate units of accounting based on their relative fair values, and applicable revenue recognition criteria must then be considered for the amount of revenue allocable to each separately identified accounting unit.

Separation Criteria:

A deliverable should be segmented and accounted for separately if:

(1) The delivered item has value to the customer on a standalone basis,

(2) There is objective and reliable evidence of the fair value of the undelivered items, and

(3) The arrangement includes a general right of return for the delivered items and delivery or performance of the undelivered items is considered probable and substantially in control of the vendor.

A deliverable has value on a standalone basis if the vendor sells it separately, or the customer has the ability to resell the delivered item on a standalone basis.

Example

In their Annual Report for the year ended December 31, 2004, Akamai Technologies, Inc. reported that for most multiple element service arrangements to date, the fair value of each element was not objectively determinable. Therefore, all revenue under those arrangements was recognized ratably over the related service period.

Measurement and Allocation Requirements

The arrangement consideration must be allocated to separate units on the basis of their relative fair values when objective and reliable evidence of fair value is available for all units of accounting in the arrangement. When such evidence is available for the undelivered items but not for the delivered items, the residual method is used to allocate the arrangement consideration.

The best evidence of fair value is the price at which the deliverable is regularly sold on a standalone basis. Contractually stated or list prices are not necessarily representative of fair value.

Key Concept

These requirements highlight the need for comprehensive objective and reliable evidence of the fair value of all different deliverables in a company's operations. The lack of such evidence increases the probability of having to combine deliverables.

The arrangement consideration allocated to a delivered item can not include any amount contingent on delivery of additional items or meeting any other specified performance criteria, and it should not be adjusted for the effect of any general right of return. Revenue per period is limited to the amount based on completion of the arrangement - that is, no cancellation is assumed.

Any portion of the arrangement consideration allocable to a delivered item that does not meet the separability criteria must be combined with the amounts allocable to other applicable undeliverable items within the arrangement. Applicable revenue recognition criteria must then be established for the combined deliverables. As more deliverables are combined, the straight-line revenue recognition method will have to be used.

Example

Beckman Coulter reports sales arrangements that include undelivered elements, primarily installation and training that the company had historically considered incidental and perfunctory. Consequently, the company had not previously deferred the revenue related to those elements, and had instead recorded an accrual for the estimated cost of providing them.

Upon adoption of EITF 00-21, the company now allocates revenues to all components of its multiple element arrangements, including installation and training. The impact of deferring revenue for undelivered installation and training on multi-element contracts entered into during the quarter ended September 30, 2003, resulted in a $4.0 million reduction of reported revenues. The estimated cost that would have been accrued to cost of sales for such undelivered elements in these specific contracts prior to the adoption of EITF 00-21 was approximately $3.0 million. Therefore, the impact of adopting EITF 00-21 related to installation and training was a reduction to earnings before income taxes of approximately $1.0 million ($0.7 million after taxes) for the year ended December 31, 2003.

Contingent Revenues

Some arrangements allow customers to delay payments or receive refunds for specified types of nonperformance. Contingent revenue is the portion of the total arrangement consideration that is a function of delivery or other specified performance requirements. Although contingent revenue must be allocated to deliverables, it cannot be recognized as revenue on delivery.

Disclosure Requirements

- The accounting policy for revenue recognition in multiple-element arrangements, and
- The description and nature of such contracts, including any cancellation-, termination-, or refund-type provisions.

Effective Date and Transition

This EITF Consensus applied to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. Alternatively, entities may use the cumulative effect adjustment. Early application was permitted.

Example

In the 3rd quarter of 2003, EDS adopted 00-21 reporting a $1.42 billion cumulative effect of a change in accounting principle. The adjustment resulted primarily from the reversal of unbilled revenue associated with the company's IT service contracts which had been accounted for as a single unit using the percentage of completion method.

The reversal was required because the typical termination provisions of an IT service contract do not provide for the recovery of unbilled revenue in the event the contract is terminated for the Company's nonperformance. The adjustment also reflects the deferral and subsequent amortization of system construction costs.

About Softrax

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