Frank, Rimerman + Co. LLP certified public accountants

Recent Developments in Revenue Recognition

Brian Kreischer
Tim Perotti

December 14, 2010

Trends in Revenue Recognition

- Convergence with international standards
- Principles rather than rules based
  - Less prescriptive guidance
  - More likely to reflect the economics of the transaction
  - More judgment required
  - Greater disclosure burden
- Applying broad concepts across all industries
- Prevalence of fair value over cost models

Scope of ASU 2009-13

- Does not trump other industry-specific guidance
- If you’re reporting under 97-2 (now section 985-605), this new ASU will ***not*** apply

The New Rules: ASU 2009-13

- Ability to separate elements
  - Objective reliable evidence of fair value no longer required
  - Will mean more arrangements can be accounted for separately than under the old rules
- Evidence of fair value
  - Introduces estimated selling price concept
- Allocation method
  - Allocations based on relative selling price, residual method has been eliminated
  - Changes the timing of accounting for discounts

Criteria for Separability

To be accounted for separately, delivered elements must:

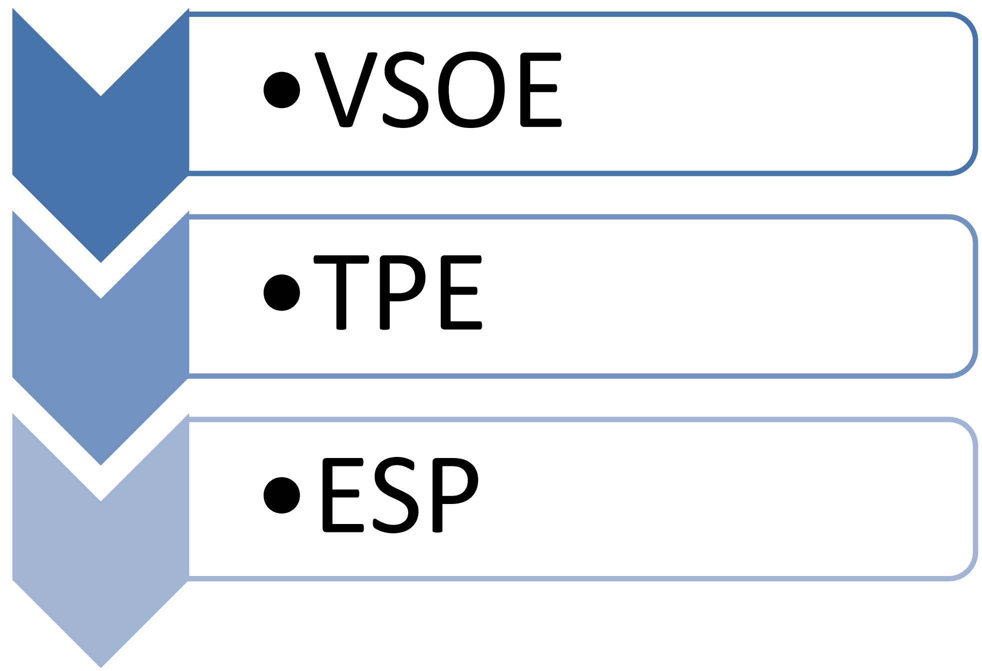
- Be of value to the customer on a standalone basis. Standalone value is established if the item is sold separately by *any* vendor or if it could be resold by the customer.
- If a general right of return applies to the delivered item, delivery of the undelivered elements is considered probable and substantially in the control of the vendor

The Selling Price Hierarchy

Always use the best evidence available.

The hierarchy (best to worst) is:

- Vendor Specific Objective
  - Evidence (VSOE)
- Third Party Evidence (TPE)
- Estimated Selling Price (ESP)



Vendor Specific Objective Evidence

VSOE:

- Price charged for a deliverable when it is sold separately.
- For a deliverable not yet being sold separately, use the price established by management with the relevant authority.

Third Party Evidence

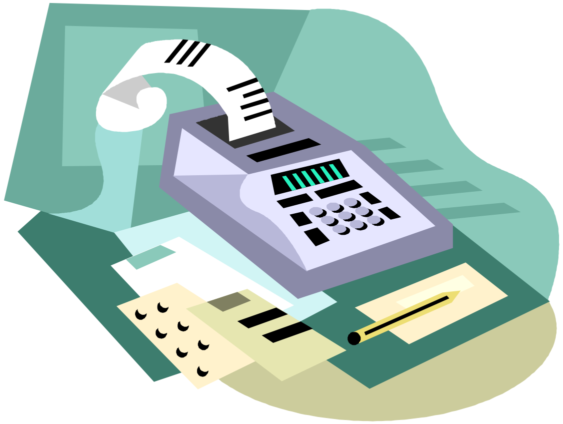
TPE:

- Price of the vendor's or any competitor's largely interchangeable products or services in stand-alone sales to similarly situated customers.

Estimated Selling Price

ESP:

- Price at which the vendor would transact if the deliverable were sold by the vendor regularly on a standalone basis.
- Vendor must consider market conditions as well as entity-specific factors in estimating selling price.



ESP and Separability

- If you're using ESP, the product *must be resalable*:
  - To be separable, must be either sold separately or resalable
  - If sold separately, then you should have VSOE or TPE

Estimating Selling Price

No single best method to determine a vendors estimated selling price, but it is defined as the "price at which the vendor would transact if the deliverables were sold by the vendor regularly on a stand-alone basis. The vendor should consider market conditions as well as entity-specific factors

Market Factors:

-Market Demand
-Competition
-Market Constraints
-Market Perception
-Geography
-Impact of Foreign Currencies

Entity Factors:

-Costs Incurred
-Profit Margins
-Limited/Variable Stand-Alone Sales
-Contract Prices
-Published Price Lists
-3rd Party/Industry Pricing Data
-Pricing Strategies
-Market Share/Position

Transition Rules

Effective Date

- Applied to arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010
- Early adoption permitted (must be adopted retrospectively to at least the beginning of the fiscal year of adoption)

Transition Method

- Prospective
- May be applied retrospectively

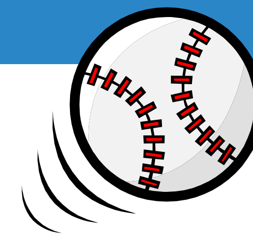
Disclosure Requirements

- Year of Adoption, Qualitative Description of:
  - Changes in units of accounting
  - Changes in how consideration allocated among units
  - Changes in pattern & timing of revenue recognition
  - If expected to have a material impact in future

- If the impact of adoption is material, also requires quantitative disclosures sufficient to enable understanding of the impact (eg proforma disclosures for prior year)

Disclosure Requirements

- Aggregated by similar types of arrangements:
  - Nature of arrangement
  - Significant deliverables
  - Timing of delivery or performance
  - Any performance, cancellation, termination or refund provisions
  - Significant judgments, inputs, methodologies, estimates and assumptions used in determining selling price
  - Basis of selling price (VSOE, TPE or ESP)



Case Study 1

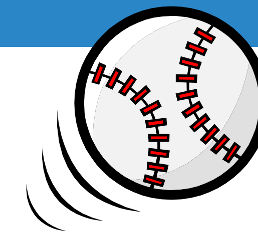
Multiple Manufacturers

- Baseball Company manufactures the required pieces of equipment to produce baseballs but is not the only manufacturer.
- The production of baseballs involves utilizing two different pieces of equipment along with 10 days of training for a total fee of $900,000. Title transfers upon shipment and there is no general or specific refund rights to customers.

Case Study 1

Multiple Manufacturers

- Baseball Company sells each piece of equipment and the training SEPARATELY. The selling prices are $400,000 for Machine 1, $550,000 for Machine 2 and training for 10 days at $5,000 per day.
- Some customers only purchase one machine or the other. Some customers pay for additional training at the list price of $5,000 per day. No customer has ever purchased the machines without the initial training.

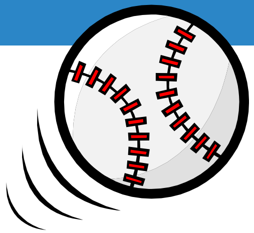


Case Study 1

Three Separate Deliverables

- Allocation of consideration using the relative selling price method.

Selling price of Machine 1	$ 400,000
Selling price of Machine 2	550,000
Selling price of training	50,000
Total	1,000,000
Less: Arrangement Fee	900,000
Discount (for all 3) 10%	$ 100,000



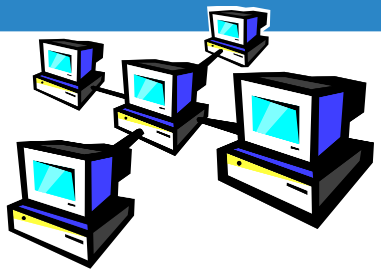
Case Study 1

Element	Contract Price (000's)	Selling Price (000's)	% of Relative Selling Price	Allocated Value (000's)
Machine 1		$400	40%	$360
Machine 2		550	55%	495
Training		50	5%	45
Total	$900	$1,000	100%	$900

Case Study 1

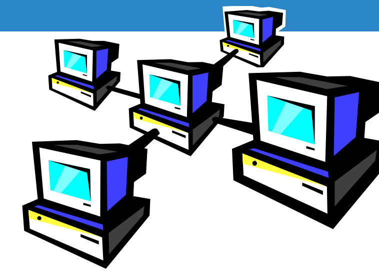
Under the old EITF 00-21 model, since they lacked VSOE for the machines, they would have applied the residual method. If the machines are delivered prior to the training, the undiscounted VSOE of the training is deferred, meaning that the entire discount is applied against the machines.

Case Study 2



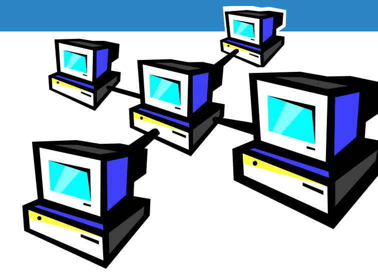
Software as a Service (SaaS)

- Company sells network traffic monitoring software to enterprises with highly dispersed network infrastructure. The software is hosted by the company and falls outside the scope of SOP 97-2 (ASC 985-605)
- In order to attract a marquee customer in a new industry, the company has significantly discounted its typical hosting fees



Case Study 2

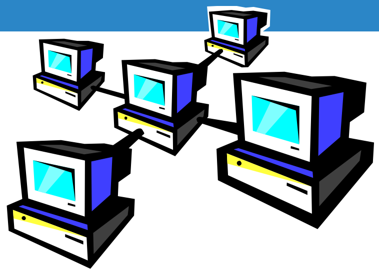
- Bundled contract includes:
  - $20,000 one-time setup fee
  - $40,000 implementation fee. Company has never sold an implementation separately, but customer could have chosen to use a third party implementer. Outside consultants generally charge $50,000 to perform similar implementation
  - $10,000 for 5 days of training (standard pricing is $2,000 per day, number of days varies based on customer requests) to be provided as scheduled by the customer (also available from 3rd party)
  - $5,000 per month access and hosting fee for minimum of 24 months, most customers of similar size on this system pay at $10,000 per month when renewing their original contracts
  - No general right of return



Case Study 2

Revenue recognition analysis:

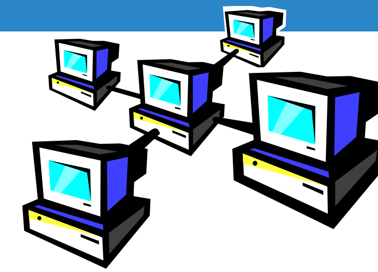
- $20,000 one-time setup fee
  - General right of return? No
  - Standalone value? No
  - Cannot be unbundled and therefore recognized with other undelivered elements, at least 24 months (may be over the estimated customer life in SaaS)



Case Study 2

Revenue recognition analysis:

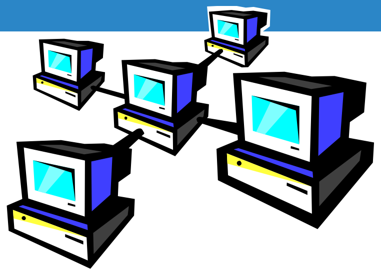
- $40,000 implementation fee
  - No general right of return
  - Does have standalone value because it can be purchased from another vendor
  - Assuming no VSOE, there's TPE at $50,000
  - Can be separated and will be recognized as implementation services are delivered



Case Study 2

Revenue recognition analysis:

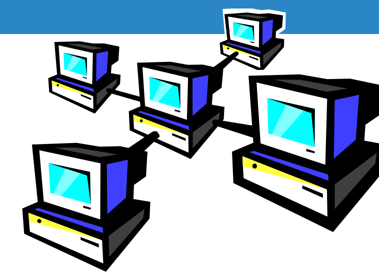
- $10,000 for 5 days of training
  - No general right of return
  - Standalone value as also sold separately
  - VSOE based on other implementations ($2,000/day)
  - Can be separated and will be recognized upon delivery of training



Case Study 2

Revenue recognition analysis:

- $5,000 per month access and hosting fee
  - No general right of return
  - Does have standalone value to the customer as competing solutions are sold by other vendors
  - VSOE at $10,000 per month based on actual renewal rates
  - Will be recognized, along with the setup fee, ratably over the 24 month period



Case Study 2

Element	Contract Price (000's)	Selling Price (000's)	% of Relative Selling Price	Allocated Value (000's)
Setup fee	20	0	0%	0
Implementation (TPE)	40	50	17%	32
Training (VSOE)	10	10	3%	6
Hosting (VSOE)	120	240	80%	152
Total	190	300	100%	190

Case Study 3

Electric SUV

- Company introduces the market's first fully electric SUV, using a proprietary battery technology
- SUV is sold for $75,000 with 2 years of battery replacement service
- SUV and battery service have never been sold separately yet.
- SUV could be retrofitted with a competing battery technology, but such batteries do not require a similar replacement service.

Case Study 3

- How would you evaluate the selling prices of the SUV and the battery service?
- What additional information would you like to know for this analysis?

Case Study 3

Possible additional information:

- Cost of SUV
- Expected cost of battery service
- Selling price of non-electric SUV’s
- “Normal” margins for SUV sales
- Is the SUV a “loss leader” being discounted?
- How has the Company priced other products?

ASU 2009-14 Tangible Products with Software Elements

- Tangible products that include software & non-software components that function together to deliver the product's essential functionality are scoped out of the software revenue recognition guidance (ASC 985-685)
- Will accelerate recognition of revenue in many arrangements

Evaluating Essential Functionality

- Sales of the tangible product without the software are infrequent—creates a rebuttable presumption that software is essential to the functionality of the tangible product
- Separate sale of the software on a standalone basis does not create a presumption that software is *not* essential
- Software elements do not need to be embedded to be essential
- Non-software elements must substantively contribute to the essential functionality

Evaluating Essential Functionality

- Does the tangible product have other functionality or merely serve as a storage device?
- Do customers usually run the software on the tangible product or do they typically load the software onto other hardware and then discard the tangible product?
- How are the tangible products described in the vendor's marketing materials and on the website?
- What is the extent of integration of the hardware and software development teams?

EITF 09-3 / ASU 2009-14

Example 1:

- Company licenses security software through a perpetual license. The typical arrangement includes 12 months of PCS and customers are required to purchase a separate hardware device. Neither the hardware nor software are sold separately. The hardware device filters Internet traffic, while the software analyzes the filtered traffic to provide real-time security information.
- Conclusion:

  The software and the hardware function together to deliver the essential functionality of the product; therefore, the tangible product, essential software and PCS are excluded from SOP 97-2 with EITF 08-1 being applicable.

EITF 09-3 / ASU 2009-14

Example 2:

- Company sells operating system software and related PCS and frequently delivers the software on a flash drive. The Company never sells the flash drive without the software; however, the software is often delivered electronically (without a flash drive).
- Conclusion:

  Although the flash drive is never sold without the software, it simply delivers the software to the customer and does not contribute to the essential functionality of the product. The software and associated PCS would remain within the scope of SOP 97-2.

EITF 09-3 / ASU 2009-14

Example 3:

- Company sells a medical imaging device with embedded software that is determined to fall under EITF 09-3. The device is sold with one year of PCS. At the time of sale, the Company promises to deliver certain specific future upgrades to the embedded software. Only customers that purchase PCS will receive the upgrades.
- Conclusion:

  The Company concludes that it has 3 deliverables; the medical device, one year of PCS and the specified upgrades. Assuming VSOE or TPE does not exist for the specified upgrades, the Company must determine its estimated selling price based on application of EITF 08-1, and allocate the total consideration to each of the deliverables.

Apple iPhone

- Apple adopted the new standard and applied it retroactively to 2009, 2008 & 2007
- Buyers of iPhone's and AppleTV were entitled to unspecified upgrades, when-and-if-available.
- Since there was no objective reliable evidence of the FV of the upgrade right, most of the sales proceeds were recognized on a subscription basis.

Apple SEC Filing

Note 2 – Retrospective Adoption of New Accounting Principles

In September 2009, the FASB amended the accounting standards related to revenue recognition for arrangements with multiple deliverables and arrangements that include software elements. In the first quarter of 2010, the Company adopted the new accounting principles on a retrospective basis. The Company believes retrospective adoption provides the most comparable and useful financial information for financial statement users, is more consistent with the information the Company's management uses to evaluate its business, and better reflects the underlying economic performance of the Company. The financial statements and notes to the financial statements presented herein have been adjusted to reflect the retrospective adoption of the new accounting principles.

The following table presents the effects of the retrospective adoption of the new accounting principles to the Company's previously reported Condensed Consolidated Balance Sheet as of September 26, 2009 (in millions, except share amounts):

	September 26, 2009		
	As Reported	Adjustments	As Amended
Current assets:			
Cash and cash equivalents	$ 5,263	$ —	$ 5,263
Short-term marketable securities	18,201	—	18,201
Accounts receivable, less allowance of $52	3,361	—	3,361
Inventories	455	—	455
Deferred tax assets	2,101	(966)	1,135
Other current assets	6,884	(3,744)	3,140
Total current assets	36,265	(4,710)	31,555
Long-term marketable securities	10,528	—	10,528
Property, plant and equipment, net	2,954	—	2,954
Goodwill	206	—	206
Acquired intangible assets, net	247	—	247
Other assets	3,651	(1,640)	2,011
Total assets	$ 53,851	$ (6,350)	$ 47,501

	September 26, 2009		
	As Reported	Adjustments	As Amended
Current liabilities:			
Accounts payable	$ 5,601	$ —	$ 5,601
Accrued expenses	3,376	476	3,852
Deferred revenue	10,305	(8,252)	2,053
Total current liabilities	19,282	(7,776)	11,506
Deferred revenue – non-current	4,485	(3,632)	853
Other non-current liabilities	2,252	1,250	3,502
Total liabilities	26,019	(10,158)	15,861
Commitments and contingencies			
Shareholders' equity:			
Common stock, no par value; 1,800,000,000 shares authorized; 899,805,500 shares issued and outstanding	8,210	—	8,210
Retained earnings	19,538	3,815	23,353
Accumulated other comprehensive income	84	(7)	77
Total shareholders' equity	27,832	3,808	31,640
Total liabilities and shareholders' equity	$ 53,851	$ (6,350)	$ 47,501

The following table presents the effects of the retrospective adoption of the new accounting principles to the Company’s previously reported Condensed Consolidated Statements of Operations for the three months ended December 27, 2008 (in millions, except share amounts):

	Three Months Ended December 27, 2008		
	As Reported	Adjustments	As Amended
Net sales	$ 10,167	$ 1,713	$ 11,880
Cost of sales	6,635	738	7,373
Gross margin	3,532	975	4,507
Operating expenses:			
Research and development	315	—	315
Selling, general and administrative	1,091	—	1,091
Total operating expenses	1,406	—	1,406
Operating income	2,126	975	3,101
Other income and expense	158	—	158
Income before provision for income taxes	2,284	975	3,259
Provision for income taxes	679	325	1,004
Net income	$ 1,605	$ 650	$ 2,255
Earnings per common share:			
Basic	$ 1.81	$ 0.73	$ 2.54
Diluted	$ 1.78	$ 0.72	$ 2.50
Shares used in computing earnings per share:			
Basic	889,142	—	889,142
Diluted	901,494	—	901,494

Apple iPhone

- Impact of adoption was to increase revenue:
  - $1.7 billion for the Qtr presented above(17%)
  - $6.4 billion in 09 (15%)
  - $5.0 billion in 08 (13%)
  - $572 million in 07 (2%)
- Factors cited in estimating ESP:
  - Apple historical pricing practices
  - Nature of the upgrade rights
  - Relative ESP of upgrade rights compared to total selling price of the product

Apple ESP Policy Disclosure

For all periods presented, the Company's ESP for the software upgrade right included with each iPhone and Apple TV sold is $25 and $10, respectively. The Company's process for determining its ESP for deliverables without VSOE or TPE considers multiple factors that may vary depending upon the unique facts and circumstances related to each deliverable. The Company believes its customers, particularly consumers, would be reluctant to buy unspecified software upgrade rights related to iPhone and Apple TV. This view is primarily based on the fact that upgrade rights do not obligate the Company to provide upgrades at a particular time or at all, and do not specify to customers which upgrades or features will be delivered in the future. Therefore, the Company has concluded that if it were to sell upgrade rights on a standalone basis, such as those included with iPhone and Apple TV, the selling price would be relatively low. Key factors considered by the Company in developing the ESPs for iPhone and Apple TV upgrade rights include prices charged by the Company for similar offerings, the Company's historical pricing practices, the nature of the upgrade rights (e.g., unspecified and when-and-if-available), and the relative ESP of the upgrade rights as compared to the total selling price of the product. In addition, when developing ESPs for products other than iPhone and Apple TV, the Company may consider other factors as appropriate including the pricing of competitive alternatives if they exist, and product-specific business objectives.

Revenue Recognition (Topic 605)
Exposure Draft

"Proposed Accounting Standards Update"

Issused: June 24, 2010 Comments due: October 22, 2010

- Joint project of FASB and IASB
- Applicable to entities that enter into contracts to provide goods and services.
- For US GAAP, proposed guidance would supersede most of Topic 605 on revenue recognition.

Trends in Revenue Recognition

- Convergence with international standards
- Principles rather than rules based
  - Less prescriptive guidance
  - More likely to reflect the economics of the transaction
  - More judgment required
  - Greater disclosure burden
- Applying broad concepts across all industries
- Prevalence of fair value over cost models

Revenue from Contracts with Customers

- Main Principles:
  a) Identify the contract(s) with a customer
  b) Identify the separate performance obligations in the contract
  c) Determine the transaction price
  d) Allocate the transaction price to the separate performance obligations, and
  e) Recognize revenue when the entity satisfies each performance obligation.

Revenue from Contracts with Customers

- SCOPE – Applies to all contracts except:
  1. Lease contracts (Topic 840)
  2. Insurance contracts (Topic 944)
  3. Contractual rights or obligations within Topic 310 on receivables, 320 on debt & equity securities, 405 on extinguishment of liabilities, 470 on debt, 815 on derivatives & hedging, 825 on financial instruments, and 860 on transfers & servicing.
  4. Guarantees (Topic 460)
  5. Nonmonetary exchanges between entities in same line of business

Identifying Contracts & Performance Obligations

- Identifying Contracts
  - Generally applied to single contracts
  - May need to combine or segment related contracts depending on pricing interdependency
- Identifying Performance Obligations
  - Sold separately (by anyone) OR
  - Distinct function and distinct margin (could be sold separately)

Determining the Transaction Price

- Measurement
  - Transaction price = probability-weighted amount of consideration that an entity expects to receive from customers in exchange for transferring goods and services. However, for most contracts, transaction price is readily determinable (fixed amount of consideration).
  - Recognize revenue from satisfying a performance obligation only if transaction price can be reasonably estimated – need both:
    1. Entity has experience with similar types of contracts
    2. Entity's experience is relevant to the contract

Determining the Transaction Price

- Measurement (continued)
  - In determining the transaction price, you must consider:
    1. Collectability
    2. Time value of money
    3. Noncash consideration, and
    4. Consideration payable to the customer

Allocating Transaction Price to Performance Obligations

- Transaction price allocated in proportion to stand alone selling price of the separate performance obligations
- Stand alone selling price based on directly observable pricing
- If no directly observable price, then selling price is estimated
- Sound familiar? (Think VSOE, TPE, ESP)

Recognizing Revenue

- Revenue recognized when each performance obligation is satisfied
  - Based on a control model—when does the customer control the asset?
- If performance obligations are satisfied on a continuous basis, apply a model that best depicts the transfer of goods or services to the customer (input or output models, passage of time)

Revenue from Contracts with Customers

- Contract Costs
  - Entity shall recognize an asset if such costs:
    1. Relate directly to a contract AND
    2. Generate or enhance resources of the entity in satisfying performance obligations AND
    3. Are expected to be recovered
  - Examples are direct labor, materials, depreciation of tools and machinery, costs explicitly chargeable to customer under contract. Other costs such as costs of obtaining a contract or related to past performance obligations are all expensed when incurred.

Revenue from Contracts with Customers

- ## Presentation:
  - When either party has performed, entity presents the contract in the statement of financial position (formerly balance sheet) as either contract asset or a contract liability, depending on the relationship between the entity's performance and the customer's performance.
- ## Disclosure:
  - Qualitative and Quantitative information:
    1. Contracts with customers
    2. Significant judgments and changes in judgment
    3. Performance obligations
    4. Methods used to recognize revenue, and
    5. More
- ## Examples:
  - There are 31 examples in this proposed ASU