



Agenda (1 of 2)

- ◆ The Requirements of EITF 08-1 and EITF 09-3
 - Issue 08-1, “Revenue Arrangements with Multiple Deliverables”
 - Transition & Disclosures
 - Issue 09-3, “Certain Revenue Arrangements That Include Software Elements”

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2

Agenda (2 of 2)

- ◆ Implementation Issues
 - Hierarchy of Selling Price Evidence
 - Estimating a Standalone Selling Price
 - EITF 09-3 Implementation
 - Example of Allocating Arrangement Consideration
 - Material Modifications to Existing Arrangements
 - New Arrangements
 - Contingent Revenue
 - Interaction of EITF 08-1 with FTB 90-1
 - Implementation Steps for EITF 08-1 and EITF 09-3

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3



EITF 08-1, Revenue Arrangements with Multiple Deliverables

- Final Consensus reached and will amend EITF 00-21
 - EITF 00-21 required objective and reliable evidence of fair value (VSOE or TPE) to separate deliverables
 - EITF 08-1 requires selling prices to be based on the highest level of evidence but requires a best estimate of selling price to be made if VSOE or TPE do not exist
 - Will result in more separation of deliverables – revenue recognition at earlier point
 - Could require significant judgment in determining estimated selling price

Vendor Specific Objective Evidence (VSOE)

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Third-Party Evidence (TPE)

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Estimated Selling Price

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EITF 08-1, Revenue Arrangements with Multiple Deliverables

- Final Consensus requires the relative selling price method of allocation
 - Eliminates use of residual method
 - Requires that companies determine VSOE, TPE or estimated selling price for **ALL** deliverables that meet the other separation criteria
- Other separation criteria remain the same – standalone value and general return rights
- Contingent revenue provisions unchanged
- Qualitative and quantitative transition disclosures and expanded ongoing disclosures for all arrangements with multiple deliverables including prior transactions that continue to be accounted for under EITF 00-21

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Example – Relative Selling Price Method

- Company A provides deliverables X, Y & Z for a total price of \$100 in a customer arrangement. There are no contingent payments in the arrangement. Deliverable X does not have VSOE or TPE, however, the best estimate of selling price is \$30. Deliverables Y and Z have VSOE of \$50 and \$40, respectively. On 12/31/XX, Company A has delivered X and Y to the customer.
- Assuming all other revenue recognition criteria are met, how much revenue would Company A recognize as of 12/31/XX?
 - How much revenue is recognized under EITF 00-21?
 - How much revenue is recognized under EITF 08-1?



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10

Example – Relative Selling Price Method

	Residual Method Allocation
Arrangement Consideration	\$100
Less: Deliverable Z	\$40
Residual to Deliverables X & Y	\$60

	Selling Price	Ratio	Relative Selling Price Allocation
Deliverable X	\$30	25.0%	\$25
Deliverable Y	\$50	41.7%	\$42
Deliverable Z	\$40	33.3%	\$33
Total	\$120	100.0%	\$100

- \$60 would be recognized for deliverables X&Y under EITF 00-21
- Discount embedded in the arrangement is allocated entirely to the delivered elements
- \$67 would be recognized for deliverables X&Y under EITF 08-1
- Discount embedded in the arrangement is allocated proportionately to each element of the arrangement based on the relative standalone selling price



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11

Transition

- Effective Date**
 - Prospective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010
 - Earlier application is permitted as of the beginning of fiscal year but can be applied in a period other than the first period of a fiscal year by retrospective application to beginning of year
 - Option for retrospective application if meet practicability requirements in Statement 154 for retrospective application



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12

Disclosure Requirements - Objective

- ◆ The objective of the disclosure guidance is to provide:
 - ◆ Qualitative and quantitative information about a vendor's revenue arrangements and about the significant judgments made about the application of EITF 08-1
 - ◆ Changes in those judgments or in its application that may significantly affect the timing or amount of revenue recognition
- ◆ Specific disclosure requirements are significantly expanded under EITF 08-1 as compared to EITF 00-21 and apply to all multiple element arrangements.



Disclosure Requirements - Ongoing

- ◆ The specific ongoing disclosure requirements include:
 - ◆ The nature of multiple element arrangements
 - ◆ The significant deliverables
 - ◆ The general timing of delivery or performance
 - ◆ Any performance, cancellation, termination, or refund provisions
 - ◆ Significant judgments, inputs, methodologies, and assumptions used in the evaluation of arrangements



Disclosure Requirements - Ongoing

- ◆ The specific ongoing disclosure requirements include:
 - ◆ Significant factors and estimates used to determine selling price, whether based on VSOE, TPE, or an estimate
 - ◆ The effect of changes in either the selling price or the method or assumptions used to estimate the selling price for a specific unit of accounting, if any of those changes has a significant effect on the allocation of arrangement consideration



Disclosure Requirements - Transition

◆ Minimum Transition Disclosures

- Qualitative information:
 - Changes in the units of accounting
 - Changes in the allocation of arrangement consideration
 - Changes in the pattern of revenue recognition
 - Whether adoption expected to have material effect on periods subsequent to period of adoption



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16

Disclosure Requirements - Transition

◆ Minimum Transition Disclosures

- If considered material, supplement with quantitative disclosure to allow users to understand the impact of adoption and assess trends
- Preparers have discretion to determine the quantitative disclosures that would achieve the overall objective. Examples could include:
 - Amount of revenue recognized subject to EITF 08-1 and amount that would have been recognized if transactions subject to EITF 00-21
 - Retrospective disclosures for one year prior to adoption
 - Revenue recognized and the amount of deferred revenue for those arrangements still under EITF 00-21 as well as those arrangements under EITF 08-1



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17

EITF 09-3, Certain Revenue Arrangements That Include Software Elements

◆ Scoping Principle

- Modifies scope of SOP 97-2 to exclude tangible products containing both software and non-software components that function together to deliver the product’s essential functionality
- All tangible components now scoped out
 - EITF 03-5 eliminated for tangible products, but concepts retained to determine if service deliverables are considered software deliverables
- EITF 09-3 focus is on what software components will also be excluded from SOP 97-2
- Software still scoped out if it is incidental to the products or services in the arrangement as a whole
- EITF 08-1 applies to arrangements that are scoped out of SOP 97-2



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18

EITF 09-3, Certain Revenue Arrangements That Include Software Elements

- ◆ Rebuttable presumption that software elements are considered essential to functionality of the tangible product if sales of the tangible product without the software elements are infrequent
 - Exceptions should be isolated
 - A pattern of regular sales by the vendor of the hardware without the software element would indicate that the software is not essential to the functionality of the hardware
 - The following transactions do not taint this assessment
 - Standalone sales of replacement hardware
 - Standalone sales of the software



EITF 09-3, Certain Revenue Arrangements That Include Software Elements

- ◆ In some instances, two different “products” should be considered different models of the same product for the purpose of this analysis
 - If the only significant difference between similar products is that one product includes the software and the other does not, the products shall be considered the same product.
- ◆ Software elements do not need to be embedded in the hardware to be considered essential to the tangible product’s functionality.



EITF 09-3, Certain Revenue Arrangements That Include Software Elements

- ◆ The hardware components must substantively contribute to the tangible product’s essential functionality – not simply a delivery mechanism
 - Does the tangible product have other functionality or is it merely 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?
 - What is the extent of integration of the hardware and software development teams?



EITF 09-3, Certain Revenue Arrangements That Include Software Elements

◆ Other guidance

- Stand alone sales of "essential" software are under SOP 97-2
- Undelivered elements (e.g. PCS and upgrades) within the arrangement that are related to the "essential" software are scoped out of SOP 97-2
- Bifurcate undelivered elements into software and non-software
- Apply EITF 08-1 to separate software deliverables accounted for under SOP 97-2 from hardware and related software deliverables scoped out
 - Initially allocate consideration to software deliverables as a group and non-software deliverables
 - Look to SOP 97-2 to further separate software deliverables

◆ Disclosures, transition and effective date consistent with EITF 08-1



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Example – EITF 09-3 Scoping

- ◆ Vendor sells a personal computer that includes an operating system that, along with the hardware, provides the basic functionality of a personal computer. The vendor rarely sells the personal computer without the operating system but does sell the same operating system for the personal computer separately.
- ◆ The personal computer including the operating system would be excluded from the scope of SOP 97-2. Sales of the personal computer without the operating system are infrequent and the fact that the operating system is also sold separately does not affect the assessment of the essential nature of the operating system when sold with the computer. However, a stand-alone sale of the operating system would be included in SOP 97-2.



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23



Implementation Issues



24

EITF 08-1, Hierarchy of Evidence to Determine Selling Price

- ◆ VSOE or TPE must be used if available
 - Cannot ignore information that is reasonably available without undue cost and effort
- ◆ VSOE or TPE may exist on a stratified basis
- ◆ If VSOE exists currently, it should continue to be used after adoption of EITF 08-1 unless business practices change such that VSOE no longer exists



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EITF 08-1, Estimating a Standalone Selling Price

- ◆ EITF provides no specific guidance but added two examples and modified one example in EITF 00-21 to include considerations in estimating a stand-alone selling price
- ◆ A **best** estimate of selling price shall be consistent with the objective of determining VSOE
- ◆ Estimated selling price shall be the price at which the vendor would transact if the deliverable were sold by the vendor regularly on a standalone basis considering market conditions as well as entity-specific factors
- ◆ Must be “best” estimate and shall consider market conditions as well as entity-specific factors



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EITF 08-1, Estimating a Standalone Selling Price – Practical Framework

- ◆ Practical Framework (Five Steps) for establishing best estimate of selling price:
 - STEP 1: Gather all reasonably available data points (e.g. limited or widely-dispersed standalone sales, product costs and margins, published price lists, available third-party or industry pricing data)
 - STEP 2: Consider adjustments based on:
 - Market Conditions (e.g. demand, competition, trends, constraints)
 - Entity-specific Factors (e.g. pricing strategies and practices, market share and position)



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EITF 08-1, Estimating a Standalone Selling Price – Practical Framework

- ◆ Practical Framework (Five Steps) for establishing best estimate of selling price:
 - STEP 3: Consider whether necessary to stratify selling prices into meaningful groups (e.g. type of customer, deal size or customer volume, geography, distribution channel, or other relevant groups)
 - STEP 4: Weight available information and make best estimate
 - STEP 5: Establish process for ongoing monitoring and evaluation



EITF 08-1, Estimating a Standalone Selling Price – Cost-Plus Data Point

- ◆ Consider existing pricing practices
- ◆ Determine costs to include
 - ◆ May include all costs the vendor would expect to recover
- ◆ Estimate an appropriate margin
 - ◆ Should be consistent with the costs included
 - ◆ Factors to consider
 - ◆ Nature of the product
 - ◆ Profit margin within the product or service line
 - ◆ Competitors’ profit margins
 - ◆ Competitive position of the vendor’s products
- ◆ Consider other market conditions and entity-specific factors



EITF 08-1, Estimating a Standalone Selling Price – Other Data Points

- ◆ Stated contract prices
 - ◆ Were they developed in a manner consistent with the vendor’s normal pricing practices?
 - ◆ Are they reasonably consistent within a class of customer or geography, regardless of the other deliverables in the arrangements?
 - ◆ Is cash consideration tied to delivery consistent with the stated price?
- ◆ Vendor’s price list
 - ◆ Were they developed in a manner consistent with the vendor’s normal pricing practices?
 - ◆ Is there consistency in discounting practices within class of customer or geography (or across all customers)?
 - ◆ Use the discounted amount actually charged



EITF 08-1, Estimating a Standalone Selling Price – Other Data Points

- ◆ Standalone sales that do not constitute VSOE
 - ◆ Advantage: Sales are observable
 - ◆ Consider the methods and assumptions used to determine the standalone selling price
 - ◆ Consider whether there are factors indicating that less emphasis should be placed on the selling prices in standalone transactions



EITF 08-1, Estimating a Standalone Selling Price – Market Conditions

- ◆ Market supply and demand
- ◆ Market perception of vendor’s products
- ◆ Market trends
- ◆ Competitor pricing
- ◆ Ability of customers to source internally



EITF 08-1, Estimating a Standalone Selling Price – Entity-Specific Factors

- ◆ Pricing strategy
 - ◆ For example, if the vendor has a strategy of being the lowest price in the market, the estimated selling price may be less than what the market might otherwise be willing to pay.
- ◆ Market position
 - ◆ The greater the market share, the higher the price the vendor may be able to demand.
 - ◆ The lower the market share, the lower the price the vendor may be able to demand.
- ◆ Pricing practices for bundled arrangements



EITF 09-3 Implementation

- ◆ Initial allocation of arrangement consideration to SOP 97-2 deliverables and non-SOP 97-2 deliverables
 - EITF 09-3 states to allocate to the software deliverables “as a group”
 - EITF 09-3 is silent on whether to allocate to the non-software deliverables individually or as a group
 - If the non-software deliverables are generally sold as a group, consider grouping those deliverables to initially allocate revenue
 - If they are not generally sold as a group, consider allocating revenue individually to those deliverables
 - Establish a policy for allocating to non-software deliverables and apply consistently to similar arrangements



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Example – Allocating Arrangement Consideration

- ◆ ABC Corp. sells a personal computer with operating system software and security software and one year of postcontract customer support (PCS) for \$1,400. ABC sells personal computers without the security software more than infrequently but never sells them without the operating system software.
- ◆ ABC sells the security software with one year of PCS on a standalone basis for \$250, and customers may renew PCS on the security software for one year for \$50.
- ◆ Customers who buy the computer without the security software pay \$1,200 and may renew PCS on the operating system software for \$100. ABC estimates that the standalone selling price of the personal computer (hardware and operating system) without PCS is \$1,150.



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Example – Allocating Arrangement Consideration

- ◆ ABC Corp. concludes that:
 - The security software is nonessential software, because ABC sells personal computers without the software more than infrequently. The security software and related one year of PCS are therefore within the scope of SOP 97-2.
 - The operating system software is essential software, because ABC infrequently (in this case, never) sells personal computers without the operating system. The operating system software and related one year of PCS are therefore outside the scope of SOP 97-2.



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Example – Allocating Arrangement Consideration

- ◆ ABC has VSOE for the PCS of \$50 based on the renewal rate. However, ABC does not have VSOE for the security software, because it is never sold without PCS.
- ◆ Assuming all the other criteria for separation and revenue recognition are met, ABC would allocate revenue using the residual method and recognize \$191 (\$241-\$50) upon delivery of the security software and \$50 (VSOE) for the PCS ratably over the one year service period.



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Prospective Transition – Material Modification

- ◆ EITF 08-1 may be adopted prospectively for revenue arrangements entered into or *materially modified* in fiscal years beginning on or after June 15, 2010.
- ◆ The determination of whether a modification represents a new arrangement or a material modification will require the use of judgment
- ◆ A material modification generally:
 - ◆ Would result from a substantive renegotiation or amendment of an existing arrangement
 - ◆ Would not be expected to arise from non-substantive changes such as granting concessions to customers



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Prospective Transition – Material Modification

- ◆ Some possible guidance to consider:
 - ◆ FASB's deliberations in the Joint FASB/IASB Revenue Recognition Project (June 2009) on the interdependency of pricing of the modification with pricing of deliverables in existing arrangements
 - ◆ Paragraph 64 of SOP 81-1 (ASC paragraph 605-35-25-29) for guidance when determining whether contract additions are treated as separate contracts



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Prospective Transition – Material Modification

- ◆ Other factors to consider when determining whether an arrangement is materially modified:
 - ◆ If new deliverables are included as a result of the modification, is the increase in the price under the modified contract consistent with the price customers would pay in a standalone sale?
 - ◆ Are any new deliverables included in the modification closely interrelated with the deliverables in the original arrangement in terms of design, technology or function?
 - ◆ Is there evidence that the pricing of the modification included consideration of the pricing in the existing arrangement?
 - ◆ Is the contract modification a unilateral grant of a concession by a vendor without a bona fide renegotiation of the original arrangement?



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Example – Material Modification

- ◆ On June 30, 20X9, ABC Corp. enters into an agreement to deliver one piece of equipment and 5 years of services for an aggregate fee of \$700. The contractually stated prices are \$200 for the equipment and \$100 for each year of service.
- ◆ ABC adopts the provisions of EITF 08-1 prospectively on January 1, 20Y0.
- ◆ Two years into the arrangement, on July 1, 20Y1, the agreement is modified.



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Example – Material Modification

- ◆ Scenario 1: The service arrangement is extended for an additional two years at \$125 per year, which is the current market price for the services.
 - ◆ Assessment: The modification likely would represent a new arrangement, rather than a material modification.
- ◆ Scenario 2: Because the customer is contemplating switching to a competitor’s equipment in the future, ABC agrees to provide an additional year of service at no additional cost.
 - ◆ Assessment: The modification appears to represent a unilateral concession and therefore would not represent a material modification.



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Example – Material Modification

- ◆ Scenario 3: The service arrangement is extended an additional 2 years. The current market price of the services is \$90. The price charged for the 2 year extension is \$150 in the aggregate.
 - ◆ Assessment: The pricing of the extension (at a \$30 discount to current market price) appears to compensate the customer for the decline in market price (from \$100 to \$90) on the remaining 3 years of service under the original arrangement. The vendor would likely conclude that this represents a material modification of the original arrangement.



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Accounting for a Material Modification

- ◆ The Task Force did not address this issue. Three views have been identified on how to account for a material modification of an arrangement in which deliverables could not be separated under EITF 00-21 but may be separated under EITF 08-1:
 - ◆ View A: Total remaining revenue is allocated to all undelivered items under the modified arrangement using the relative selling price method
 - ◆ View B: Allocate consideration to the undelivered items based on their standalone selling prices; recognize “excess” consideration as revenue on the date of the modification
 - ◆ View C: Allocate consideration to the undelivered items as if the arrangement had been accounted for under EITF 08-1 from its inception; recognize “excess” consideration as revenue on the date of the modification



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Accounting for a Material Modification

- ◆ Based on informal discussions with the SEC staff, we understand that the SEC staff’s current view is that View C generally would be the appropriate way to account for materially modified arrangements if deliverables could not be separated under EITF 00-21 and now may be separated under EITF 08-1.
- ◆ The SEC staff has indicated that View B may also be an acceptable alternative.
- ◆ These views may evolve over time.



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Prospective Transition – New Arrangements

- ◆ **When does a new arrangement exist?**
 - ◆ Arrangement considered new in the period that the key terms of an arrangement are agreed to between a vendor and its customers, consistent with persuasive evidence of an arrangement
 - ◆ New arrangements may include:
 - ◆ Substantive contract renewals
 - ◆ Purchase orders under master purchase agreements
 - ◆ For example, Company A and Customer Z sign a multiple deliverable arrangement on December 31, 2010 but delivery takes place January 15, 2011. If Company A adopts EITF 08-1 prospectively on January 1, 2011, this arrangement would still be accounted for under EITF 00-21.



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Contingent Revenue

- ◆ **Contingent Revenue**
 - EITF 08-1 does not change the existing contingent revenue guidance
 - Arrangement consideration allocated to delivered items is limited to amounts not subject to contingency
 - Amount would be the lesser of amount initially allocated on a relative selling price method or non-contingent amount
 - The change to the relative selling price method from the residual method may result in the conclusion that contingent revenue exists resulting in differences in how arrangement consideration is allocated



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Example – Contingent Revenue

- ◆ **Contingent Revenue**
 - Consider a vendor that sells hardware and installation services for \$100. VSOE for the installation service is \$25 which is also the stated contractual price.
 - The estimated selling price of the hardware is \$100.
 - \$50 of the total fee is contingent on the completion of the installation services. Assume that installation services were not provided on delivery of the hardware.
 - Under the relative selling price method, the arrangement consideration would be allocated as follows:
 - Hardware – \$80 [$\$100 \times (\$100/\$125)$]
 - Installation services – \$20 [$\$100 \times (\$25/\$125)$]
 - However, because \$50 of the total fee is contingent on the delivery of installation, \$30 of the fee allocated to the hardware would be deferred.



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57

Interaction of EITF 08-1 with FTB 90-1

◆ FTB 90-1

- EITF 08-1 does not change the existing guidance in FTB 90-1
- FTB 90-1 defines a product maintenance contract as “an agreement to perform certain agreed-upon services to maintain a product for a specified period of time.”
- The PCS deliverable must be separately priced within the arrangement to be within the scope of FTB 90-1
- A PCS deliverable that relates only to the maintenance of the hardware elements of a tangible product is likely within scope of FTB 90-1
- A PCS deliverable that includes rights to unspecified upgrades and enhancements of the software element is likely outside scope of FTB 90-1



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58

EITF 08-1, Implementation Steps

1. Inventory the arrangements and deliverables

- Identify typical deliverables within an arrangement that generally have not been separable under EITF 00-21 because VSOE or TPE did not exist
- Identify the specific “delivered” elements where revenue was based on the residual method of allocation.

2. Consider the other separation criteria

- Stand-alone value
- General return rights



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59

EITF 08-1, Implementation Steps

3. Determine whether VSOE or TPE is available for all deliverables/elements

- Reasonable effort required to obtain VSOE or TPE if it exists
- If VSOE or TPE was used to separate deliverables previously, use the same level of evidence for those deliverables

4. Develop approach for determining estimated selling price for all deliverables for which there is no VSOE or TPE

- Consider nature of the deliverable and best approach to estimating a stand-alone selling price
- There is no practicability exception for estimating selling prices for elements



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EITF 08-1, Implementation Steps

5. **Assess requirements associated with elimination of residual method and use of relative selling price method**
 - Update allocation methodology – systematic or manual
 - Consider whether contingent revenue exists as a result of the change
6. **Consider impact on data collection, processes, controls and systems**
 - Obtain data from system generated reports and external data sources
 - Document data considered and conclusions reached
 - Adapt existing processes or create new processes for pricing deliverables to estimate selling price
 - Determine the need to either change processes and systems to automate revenue calculations or establish processes for calculations to be performed outside the systems, manually with spreadsheets or other tools
 - Establish processes to support new ongoing and transitional disclosure requirements



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61

EITF 08-1, Implementation Steps

7. **Consider changes to business practices and other implications**
 - Pricing Strategies
 - Give salespeople *more* flexibility in setting pricing to customers because objective evidence of selling price is no longer required
 - Give salespeople *less* flexibility in setting pricing, to establish narrow ranges of selling prices to increase the likelihood that stated contract prices can be used to allocate arrangement consideration
 - Modify sales compensation plans to be in line with sales strategy
 - Modify the terms of standard agreements to embed contingent revenue features that effectively result in using the residual method
 - Recast business models, forecasts, and budgets
 - Board, analysts and key investors will require education of changes
 - Metrics present in key agreements (e.g., customer agreements, loan agreements) may need to be negotiated and reset
8. **Establish process for ongoing monitoring and evaluation for changes in VSOE, TPE or estimated selling price**



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62

EITF 09-3, Implementation Steps

1. **Identify arrangements accounted for under SOP 97-2 that contain hardware elements**
 - The hardware elements are outside the scope of SOP 97-2
2. **Determine whether any software element is also scoped out of SOP 97-2 along with the hardware –which software elements function together with the non-software elements to deliver the tangible product’s essential functionality**
 - Are sales of the product without the software infrequent?
 - Is the tangible product substantially contributing to the functionality of the product (i.e., more than merely a delivery mechanism)?



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63
