DEFINING THE DIGITAL FUTURE

BUSINESS AND ACCOUNTING ISSUES

INFORMATION, COMMUNICATIONS & ENTERTAINMENT
We gratefully acknowledge our technical team in the KPMG Department of Professional Practice as the primary authors of this book. Ellen Hancock, Carol Clarke, and Denise Sumner led the efforts with significant contributions from Dennis Monson, John Ezner, Laurel Hammer, David Horn, Rich Imrisek, Sean Monahan, Landon Westerlund, and Domenic DiMeglio. We also would like to thank the Publications and Project Management group of KPMG for their contributions.

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Preface

The Internet is radically changing the way we operate. New businesses, markets and alliances are being formed every day. The rapid technological developments enabling this phenomenon provide numerous challenges and opportunities for management in the never-ending struggle to increase shareholder value.

The new business models and transaction structures in this “new economy” raise many questions for companies struggling to apply traditional accounting rules. The Financial Accounting Standards Board (FASB), the Emerging Issues Task Force (EITF), and the Securities and Exchange Commission (SEC) are grappling with these issues in their efforts to rapidly evolve existing policy. Making rules is not easy when the landscape is changing so dramatically; applying the rules is even harder.

We see clients struggling with these issues daily. To help companies with some of the business and accounting issues raised by using the Internet, KPMG has prepared this analysis of several of the major business and accounting issues. In some cases, existing guidance provides the answers. In others, practice is developing as we speak. We provide you with the current thinking on these issues, along with our analysis, perspective and some examples.

We hope you find our discussion informative and our analysis insightful. Be mindful that all relevant facts and circumstances should be evaluated on a case-by-case basis to determine the appropriate accounting for your specific transactions. Since additional guidance may become available from the FASB, EITF, SEC, or the American Institute of Certified Public Accountants, we recommend that you contact your financial advisors before finalizing the accounting for your Internet-related activities.

We are interested in your comments and reactions. If you have questions or need assistance, please contact your KPMG engagement partner or one of the KPMG leadership representatives listed on the next page. We look forward to hearing from you.

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# Table of Contents

**Section One – Introduction** ......................................................... 1

**Section Two – Income Statement Presentation** ............................ 3
   Gross Versus Net Presentation of Revenues – Do I Record All the
   Proceeds as Revenue? ......................................................... 3
   Shipping and Handling Fees – Revenue or an Expense Recovery? ........ 9
   Barter Transactions – Do They Generate Revenue? ......................... 11
   Coupons, Rebates, and Other Sales Incentives –
   Why Aren’t They Marketing Expenses? .................................... 16

**Section Three – Revenue Recognition** ......................................... 25
   Multiple-Element Arrangements – More Than One Sale? ................. 25
   Software Hosting Arrangements – Software or Service? .................. 35

**Section Four – Capitalization** ...................................................... 39
   Contractual Arrangements – Payments for Assets? ......................... 39
   Web Site Development Costs – Can I Capitalize Them? .................... 46
   Development Costs for Software Hosting Arrangements – Asset or Expense? 49

**Section Five – Transactions in an Entity’s Own Stock** ................. 51
   Using Equity Instruments as Currency – What Do They Cost? .......... 51
   Transactions in Privately-Issued Equity Securities –
   How Do You Value the Securities? ........................................... 60

**Section Six – Investments in Alliances** ........................................ 65

**Glossary** .................................................................................... 75

**References to Accounting Standards** ........................................... 79
Section One – Introduction

The Internet has revolutionized the way that companies do business. It is transforming both new economy and old economy companies’ relationships with their suppliers, customers, distributors, partners, and competitors.

At first glance, many of the issues that new economy companies face seem unique to those companies. For example, the nature of the fees that auction sites charge may seem to be the exclusive province of these companies. In fact, those fees raise issues that newspapers selling classified ads have wrestled with for years. For some new economy companies the issues are no different from the issues that old economy companies face—they are only more visible. For example, shipping and handling costs are a large expense for many companies but the classification of those costs assumes greater significance for a company that sells its products exclusively from a virtual storefront.

The goal of this publication is to identify the major business and accounting issues faced by companies engaged in e-business and to provide KPMG’s perspective on the implications and resolution of those issues.

In broad terms, the issues that we address in this publication fall into five categories:

- Income statement presentation;
- Revenue recognition;
- Capitalization;
- Transactions in an entity’s own stock; and
- Investments in alliances.

Revenue recognition issues may take on greater importance for e-business companies, because it has been asserted that investors appear to measure the performance of these companies based on the growth of their revenues rather than on the growth of their profits. Many of the issues within these five broad categories, for example, gross versus net reporting of revenue, multiple-element arrangements, and investments in alliances, are pervasive across a broad spectrum of new economy companies. In contrast, the issues raised in the discussion of digital exchanges are specific to a narrow portion of the B2B sector.

As regulators and accounting standard-setters have attempted to reduce optionality in accounting principles and enhance comparability in practice, it has become apparent that the accounting issues that are being addressed are not limited to e-business. To the extent that companies have been accounting for these fundamental aspects of their business in a variety of ways, they might be judged very differently in the marketplace even though they are essentially in the same business. In many cases, the new accounting standards will affect accounting and financial reporting by all companies. A company that is implementing these standards will need to temper its analysis of the facts and circumstances in each situation with judgment. This publication identifies existing and evolving financial reporting issues and accounting standards that affect e-business. It also addresses factors, judgments, and analyses that must be considered in addressing those issues and applying those standards.

(1) Words that are defined in the glossary are set in boldface type the first time they appear.
Section Two – Income Statement Presentation

Gross Versus Net Presentation of Revenues – Do I Record All the Proceeds as Revenue?

Agent or Principal
In the bricks-and-mortar world, it usually is obvious whose inventory is being sold and who bears the inventory risk and subsequent credit risk arising from a sale. Today, while many e-business companies serve as merchant of record, they substantially have eliminated both credit and inventory risk from their business model by accepting only online credit card purchases and by outsourcing product distribution and returns to third parties. These e-business merchants often do not take title to the products that they offer their customers. They may retain only a small portion of the sales proceeds, with the majority of the proceeds going to suppliers or other third parties. Similarly, companies may entirely outsource the delivery of services to fulfillment houses that may or may not be responsible for the overall quality of the service. Such business practices raise fundamental questions about whether a merchant is acting, in substance, as a principal or an agent.

Underlying the issue of whether a company should record revenue and costs on a gross or a net basis is a fundamental question concerning the nature of the company’s business. If a company acts as a principal in its transactions, it earns revenue from the sale of goods or services and records revenue equal to the amount that it bills to its customer (gross presentation). If a company acts as an agent, it earns revenue in the form of a commission or fee from its principal, who is the real supplier of the goods or services. Revenue recorded by an agent is limited to the commission or fee that it retains (net presentation). The facts and circumstances in one portion of a company’s business may support gross presentation, while the facts and circumstances in another portion of the business are sufficiently different to require net presentation.

Recent changes in accounting standards provide a framework to help management evaluate whether it should report the gross amount that it receives as revenue even if it receives only a portion of the sales proceeds. The new rules address situations in which companies are able to reduce the risk of loss to almost negligible levels but nevertheless remain the merchant of record.

Indicators
Historically, the analysis to determine whether a company acts as a principal or an agent has focused on whether the company bears inventory risk and credit risk. The EITF concluded in Issue No. 99-19 that decisions about whether to record revenue gross or net are a matter of judgment that should be based on a careful analysis of the facts and circumstances. The EITF identified a variety of additional indicators that a company should analyze to determine whether to record revenue gross or net.
Indicators of *gross* reporting exist if the company:

- **Is the primary obligor in the arrangement.** If the company is responsible for order fulfillment, including the acceptability of the product or services that the customer orders, that fact is a strong indication that the company is the primary obligor in the transaction.

- **Has general inventory risk.** The company has general inventory risk if it takes title to a product before the customer orders that product (that is, maintains the product in inventory) or will take title to the product if the customer returns it.

- **Has latitude in establishing price.** The company meets this condition if it has reasonable ability, within economic constraints, to establish the selling price.

- **Adds value to the product or service.** The company adds value to the product or service if the selling price of that product increases as a result of the company’s efforts.

- **Has discretion in supplier selection.** If the company has multiple suppliers for a product or service and the discretion to select the supplier that will provide the product or service to the customer, that fact may indicate that the company primarily is responsible for fulfillment.

- **Is involved in the determination of product or service specifications.** If the company determines the nature, type, characteristics, or specifications of the product or services that the customer orders, that fact may indicate that the company primarily is responsible for fulfillment.

- **Has physical loss inventory risk.** The company has physical loss inventory risk if it takes title to and is responsible for replacing any product that is lost or damaged after the customer places an order.

- **Has credit risk.** If the company assumes credit risk for the amount billed to the customer, that fact may provide weaker evidence that the company has risks and rewards as a principal in the transaction and, therefore, that it should record revenue gross for that amount. Credit risk is mitigated if the customer pays by credit card and the company obtains authorization for the charge in advance of shipping the product or performing the service. Credit risk that substantially has been mitigated is *not* an indicator of gross reporting.

Indicators of *net* reporting exist if:

- **The supplier (not the company) is the primary obligor in the arrangement.** If the supplier is responsible for order fulfillment, including the acceptability of the product or services that the customer orders or purchases, that fact may indicate that the company is acting as an agent of the supplier.

- **The amount the company earns is fixed.** If the company earns a fixed dollar amount per transaction or a stated percentage of each transaction, regardless of the amount that it bills to the customer, that fact may indicate that the company is an agent of the supplier.

- **The supplier (not the company) has credit risk.** If credit risk exists, but the supplier assumes that risk, that fact may indicate that the company is an agent of the supplier.
The EITF’s guidance builds on the framework that the SEC staff established in SAB No. 101. That framework identifies four factors that the staff will apply in analyzing gross versus net presentation issues. The SEC staff will consider whether a company:

- Acts as principal in the transaction;
- Takes title to the products;
- Has risks and rewards of ownership, such as the risk of loss for collection, delivery, or return; and
- Acts as an agent or broker (including performing services, in substance, as an agent or broker) with compensation on a commission or fee basis.

If a company performs as an agent or broker without assuming the risks and rewards of ownership of the goods, the company should report sales on a net basis. The SEC staff acknowledged that it may be appropriate to consider other factors in addition to these four criteria; however, it left the details to the EITF to develop. We expect the SEC staff to rely on the guidance in EITF Issue No. 99-19 when it considers filings that contain these issues.

**How to Evaluate Specific Indicators**

While none of the indicators that the EITF identified is considered presumptive or determinative, a company should consider the relative strength of each indicator based on individual facts and circumstances. For example, a merchant that requires up-front payment by credit card essentially reduces credit risk to a negligible amount for all of its sales. Thus, credit risk would not be a key indicator in determining whether to record revenue on a gross or on a net basis. Alternatively, a merchant that invoices its customers when it delivers its products and subsequently collects payment retains significant credit risk. Thus, in this example, credit risk would be a strong indicator that it is appropriate to record revenue on a gross basis.

Because of the wide variation in factors from industry to industry, the EITF concluded that it would be impossible to create a hierarchy that companies could apply without considering the individual facts and circumstances of each industry or business. In some industries, for example, the retail electronics industry, companies may have very little latitude to establish prices because of limits set by manufacturers. For companies in industries that face those limits, latitude in establishing prices would be a weak indicator for gross presentation. Management of such companies would need to look to other indicators to resolve gross versus net presentation issues.

In addressing gross versus net revenue issues, SAB No. 101 states that the SEC staff will consider whether the registrant took *title* to the product. Although the EITF generally intended Issue No. 99-19 to be consistent with SAB No. 101, the EITF did not specifically list taking title as a key indicator, in part because title is a legal term that can vary by country and because a company can take title for an *instant* without any substantive inventory risk exposure. Physical loss inventory risk exists if a company takes title to a product before a customer has ordered that product, or if a company agrees that it will take title if the product is returned to the company. While title indicates that a company has inventory risk, we do not believe that a company must take physical possession or title to inventory to be a principal in a transaction. For example, e-business companies often instruct suppliers to ship inventory directly from a distributor to a customer without taking title. Alternatively, a company could establish
its own warehouse space within the distributor’s location. The distributor would then move the product through that area (thus altering title) before shipping the product directly to the customer. In our opinion, passage of title in the second scenario does not alter the fundamental substance of the transaction. Under the guidance in EITF Issue No. 99-19, we believe that the substance of a transaction is more important than its form. Companies should look to all of the indicators that the EITF identified to determine whether the merchant is functioning as a principal or as an agent.

Consider a strategic alliance in which:

Retailer maintains a storefront on its Web site. The store is labeled to incorporate Retailer branding and trademarks. Internet Company created the custom storefront; hosts and maintains the storefront on its server; processes and fulfills customer orders; provides customer service; and processes credit card payments, cancellations, and returns.

Various distributors ship product directly to the customer and customers ship returns to Internet Company.

Retailer, as the merchant of record, assumes all risk related to fraud, product returns, failure to deliver on a timely basis, and chargebacks arising from or relating to the sale of products through the custom storefront. Retailer determines pricing and selects the products to be sold.

On a semimonthly basis, Internet Company submits a detailed report to Retailer of the net sales proceeds generated (sales price less the product cost and fulfillment fee adjusted for returns and other charges). The fulfillment fee to Internet Company is 50 percent of the margin for each product that is sold through the custom storefront with a minimum fee to Internet Company of 5 percent of the sale price for each product that it sells.

We believe that, in substance, Retailer is acting as a principal in this business and that it should record the gross amount of revenue from sales, despite the fact that the fulfillment function has been entirely outsourced. Retailer is the merchant of record, and controls pricing and the type of merchandise sold. Although credit risk and inventory risk have been reduced to very low levels, Retailer has nevertheless contractually assumed 100 percent of these risks.

Internet Company is responsible for fulfillment but is not subject to the risks and control usually associated with a principal in a transaction. Internet Company receives a guaranteed minimum payment for each transaction regardless of Retailer’s margins, similar to a commission earned by an agent. In our view, Internet Company is acting as an agent and should recognize revenues only to the extent of the fees it earns for providing services to Retailer.

Focus on Substance over Form

Management must analyze the facts and circumstances of each type of transaction to determine whether, in substance, a company is acting as a principal or as an agent. The likelihood that revenue should be recorded at the gross amount billed increases as more indicators are present in a transaction. A few strong indicators pointing toward net presentation may outweigh a greater number of weak indicators pointing toward gross presentation. We believe the overriding issue remains: What is the substance of the arrangement?
The SEC staff’s focus on substance over form is illustrated by the following, which is based on an example provided in a 1999 SEC staff speech and in EITF Issue No. 99-19:

AppsCo contracts with College to place College’s application form on AppsCo’s Web site, check the applicant’s credit, and charge the applicant’s credit card for the application fee. Notwithstanding the fact that AppsCo is the merchant of record in charging credit cards and bears the risk of loss for the full amount of the fee, the SEC staff concluded that AppsCo is an agent or broker and should report its revenue on a net basis.

The SEC staff concluded that AppsCo could not make a compelling argument that it could act for College in any capacity other than as a processor of applications; that is, it could not provide to the applicant any of the other services that a college is in business to provide. Thus, the substance is that AppsCo is acting as an agent of College and not as a principal on its own account.

Consider also the following example (developed by the EITF to illustrate its consensus in Issue No. 99-19) of a travel discounter that negotiates with major airlines to obtain access to airline tickets at reduced rates compared with the cost of tickets that the airline sells directly to the public:

Travel Discounter determines the price at which it will sell the airline tickets to its customers and markets the tickets through advertisements in newspapers and magazines, and via the Internet. Travel Discounter’s ads identify a carrier that is available for the trip; however, the customer chooses the carrier that ultimately provides the service. Travel Discounter negotiates in advance the reduced rate that it pays to the airline for each ticket and pays for only the tickets that it sells to customers. Customers pay for airline tickets using credit cards, and Travel Discounter is the merchant of record. Although credit card charges are preauthorized, Travel Discounter incurs occasional losses if there are disputed charges. Travel Discounter is responsible for delivering the airline ticket to the customer and bears the risk of physical loss while the ticket is in transit (although the airline has procedures for refunding lost tickets). Travel Discounter also assists its customers in resolving their complaints about the service that the airlines provide; however, once a customer receives a ticket, the airline is responsible for fulfilling all obligations that are associated with the ticket, including remedies to the customer for dissatisfaction with the service.

Travel Discounter should record revenue net because the airline is the primary obligor from the customer’s perspective. Although there are indicators of gross reporting (including pricing latitude, physical loss of the ticket during shipping, and credit risk for collecting amounts charged to credit cards), those indicators are weaker than the fact that the airline is the primary obligor. Travel Discounter also should consider whether it has discretion in selecting the airline. In this example it does not, because it may only suggest an airline to a customer; the customer has the discretion to accept or reject that suggestion. One of the indicators of gross reporting, general inventory risk, is not present in this example.

In contrast, consider a variation of the preceding example in which Ticket Consolidator agrees to buy a specific number of tickets and pays for those tickets, regardless of whether it is able to resell the tickets. All other facts are the same as above.
Ticket Consolidator should report revenue for the gross amount that it bills to the customer. Ticket Consolidator has general inventory risk for the tickets that it purchases, which is a strong indicator of gross reporting. Ticket pricing also points to gross reporting, as Ticket Consolidator has complete latitude to set sales prices for tickets, and the amount that Ticket Consolidator earns will vary as a result. Weaker indicators of gross reporting are present for physical loss inventory risk (loss of the tickets during delivery) and credit risk for collecting customer credit card charges. The fact that the airlines are the primary obligors is an indicator of net reporting, as only the airlines can provide the transportation service. However, Ticket Consolidator assists its customers in resolving service complaints, thereby performing a function that normally is associated with the primary obligor.
Shipping and Handling Fees – Revenue or an Expense Recovery?

Most companies that sell goods incur some form of shipping and handling costs. In general, shipping costs include costs to move the product from the seller’s place of business to the buyer’s location, regardless of whether a company’s own employees or a third-party shipper moves the product. Handling costs, although less easily defined, generally are understood to consist of the costs (including allocated overhead, if any) to store, move, and prepare a product for shipment from the time the product is removed from finished goods inventory until it is delivered to the shipper.

Cataloguers and companies that engage in e-business, as well as many manufacturers, often charge their customers a separate fee to cover shipping and handling costs. Those fees may represent the actual shipping and handling costs, or they may be a flat amount that is not related directly to the costs incurred. Other companies may offer free shipping and handling. Companies that charge shipping and handling fees report them in their income statement in a variety of ways. Some companies record the charges as revenues while others net the charges against the related costs. Further, some companies include shipping and handling costs in cost of goods sold, while others include those costs in selling or general and administrative expenses.

In the absence of a clear definition of what constitutes a shipping or handling cost, companies have included very different types of costs in the shipping and handling cost category. Companies also may have very different systems for accumulating these costs. For example, one company may not separately identify or quantify the time and materials necessary to prepare the product for shipment, while another company may have complex distribution systems with complex cost accounting systems to allocate costs to shipping and handling activities.

The SEC staff became interested in this issue because it noticed that many e-business companies record these fees as revenue. In contrast, the SEC staff believes that the predominant practice for non-Internet mail-order companies has been to offset the shipping and handling fees against the related costs. Because shipping and handling fees and costs are significant to many companies engaged in e-business, the SEC staff is interested in enhancing financial statement comparability across companies related to the classification of these expenses and the treatment of shipping and handling fees.

Formal Accounting Guidance Is Developed

In Issue No. 00-10, the EITF addressed the income statement classification for shipping and handling fees and costs by companies that record revenue based on the gross amount billed to customers under Issue No. 99-19; that is, situations in which a company is acting as a principal, not as an agent. Specifically, the EITF discussed how a seller of goods should classify in the income statement:

- Amounts that it bills to a customer for shipping and handling; and
- Costs that it incurs for handling and shipping its products to customers.

The EITF consensus states that a company should classify as revenue all amounts related to shipping and handling that it bills to a customer and that the classification of
shipping and handling costs is an accounting policy decision that a company should disclose in its financial statements. Furthermore, if shipping or handling costs are significant and are not included in cost of sales, a company should disclose the amount of the costs and the line item in which they are included in the income statement. The EITF also concluded that deducting shipping and handling costs from revenue is not appropriate. The EITF decided not to provide guidance on the types of costs that a company should include in shipping and handling.

**What if a Company Acts as Agent?**

EITF Issue No. 00-10 applies only to companies that record revenue based on the gross amount billed to customers. Thus, there is no authoritative guidance for companies that are deemed to be acting as agents and recording revenue on a net basis (for example, a fulfillment company that performs warehousing and order processing services on behalf of a retailer). A company must determine whether it is acting as a principal or as an agent with respect to the shipping and handling services. We believe that companies that act as agents for goods and services should apply the guidance in EITF Issue No. 99-19 to evaluate whether the shipping and handling charges should be recorded as revenue or net of the related costs. (Refer to page 3 for a discussion of gross versus net presentation of revenues.)

For example:

Internet Retailer outsources its order processing and inventory maintenance responsibilities to Fulfillment Company. Fulfillment Company receives a fixed fee for handling each order shipped and for billing the customer. Internet Retailer selects the shippers, negotiates shipping prices with them, and maintains the ongoing relationship. Fulfillment Company bills Internet Retailer for its fixed fee plus the actual shipping costs due to the common carrier and remits moneys collected to the common carrier.

In this situation, we believe that Fulfillment Company is acting as an agent with respect to shipping and handling services and should record the shipping and handling charges on a net basis. Fulfillment company has no authority to select common carriers or to negotiate pricing. It merely collects cash from Internet Retailer and passes it through to the common carrier.

In contrast, consider a situation in which Fulfillment Company selects the shippers, negotiates the prices, and maintains the ongoing relationship. Furthermore, Fulfillment Company performs all the activities associated with preparing a product order for shipment.

In this situation, we believe that shipping and handling is a service that Fulfillment Company is providing to Internet Retailer. Fulfillment Company has latitude in establishing price, has discretion in supplier selection, and is involved in determining the service specifications. Accordingly, Fulfillment Company is acting as a principal with respect to shipping and handling services and should record as revenue the shipping and handling charges that it bills to the customer.
Barter Transactions – Do They Generate Revenue?

A barter transaction takes place when two companies agree to exchange goods and services with each other. Such transactions have been common practice in many industries for years. For example, media companies exchange space such as television airtime, radio spots, newspaper ads, and billboard faces; real estate companies exchange land and buildings; pharmaceutical companies exchange intellectual property; and computer companies exchange hardware and software products. The following discussion focuses on barter transactions in advertising and software.

As the Internet has evolved as an advertising medium, Internet companies have embraced the practice of barter advertising. Current projections are that Internet advertising revenues will be approximately $8 to $10 billion dollars for the year 2000, and it is estimated that 5 percent of reported Internet advertising revenue is noncash. These barter transactions are especially appealing during an Internet company’s start-up phase, because the company will receive advertising services without a cash outlay. These transactions also are appealing in that they may allow Internet companies to use excess capacity and receive some benefit in return.

In a typical Internet barter transaction, Clothing Retailer receives advertising space on Shoe Retailer’s Web site and Shoe Retailer receives advertising space on Clothing Retailer’s Web site. Advertisements exchanged could include banner ads, buttons, toolbars, sponsorships, superimposed on-screen images, and priority placements. The type of advertising exchanged could be identical (for example, a banner-for-banner exchange) or it could be different (for example, a banner ad for sponsorship exchange). The exchange agreement also would specify the duration of the advertising placement, either for a specified number of impressions or for a period of time.

APB Opinion No. 29 and EITF Issue No. 93-11 provide the general framework under which to account for barter transactions. That guidance generally presumes that nonmonetary exchanges for barter credits should be recorded at the fair value of the assets surrendered, assuming fair values can be determined reliably. Thus, many Internet companies were recording revenue and expense for what they determined to be the fair value of the Web space sold and for the Web space purchased, respectively. That practice has no effect on net income (assuming both are reported in the same period) but it increases the amount of reported revenue and expenses.

Because the advertising space that is bartered between Internet companies is not always sold for cash, determining the fair value of the advertising exchanged often is difficult, and can be highly subjective. Thus, companies were not computing fair value in a consistent manner. Given the difficulties in determining fair value, other companies were recording advertising barter transactions at the book value of the space they exchanged, which typically would be zero.

In an effort to promote consistent reporting of these transactions, the EITF addressed the accounting for barter advertising. Specifically, the EITF considered whether companies that engage in such transactions should record revenue and expense at the fair value of the advertising surrendered or received in the exchange, or at book value. The EITF’s consensus applies to all preparers of financial statements, not just Internet companies.
The EITF concluded in Issue No. 99-17 that companies should record revenue and expense for barter advertising transactions at fair value, if fair value is determinable. The EITF also developed specific guidance on determining fair value and advised that in the absence of a reliable measure of fair value, exchanges of advertising should be recorded only at their cost, which typically is negligible.

The fair value of advertising space is determinable if a company has a historical practice of receiving cash (or other consideration that is readily convertible to a known amount of cash) for similar advertising from a buyer that is not related to the counterparty in the transaction. In general, historical practice refers to a period of up to six months before the date of the barter transaction. (A company may not take into account cash transactions after the barter transaction date as evidence of fair value.) However, a company should use a period shorter than six months if transaction volume and changes in economic circumstances demonstrate that transactions during that shorter period would be more representative of the company’s current advertising business and, therefore, would be more relevant in estimating fair value.

For a company to conclude that advertising that it sold for cash is similar to advertising that it exchanged in a barter transaction, the advertising must be in the same medium and within the same advertising vehicle (for example, the same publication, Web site, or broadcast channel) and must have the following reasonably comparable characteristics:

- Circulation, exposure, or saturation within an intended market;
- Timing (time of day, day of week, daily, weekly, 24 hours a day/7 days a week, and season of the year);
- Prominence (page on Web site, section of periodical, location on page, and size of advertisement);
- Demographics of readers, viewers or customers; and
- Duration (length of time advertising will be displayed).

Fair value cannot be determined by an exchange of checks for equal amounts, nor can it be determined by industry statistics or an independent third-party appraiser. If the fair value of the advertising exchanged is not determinable within the parameters of the EITF guidance, a company should record exchanges of advertising based on the carrying amount of the advertising that it surrendered, which likely will be at or near zero. For example:

Clothing Retailer enters into an advertising barter transaction with Shoe Retailer in which Clothing Retailer places a banner advertisement on Shoe Retailer’s Web site and Shoe Retailer places a banner advertisement on Clothing Retailer’s Web site. The companies exchange 10,000 impressions of these advertisements. Clothing Retailer has previously sold a total of 20,000 impressions in a similar cash transaction at a CPM (cost per thousand) of $10. This is Clothing Retailer’s first barter transaction.

Clothing Retailer has established a fair value of $.01 per impression (a CPM of $10). It should record revenue of $100 (10,000 impressions/1,000 x $10 CPM fair value) from Shoe Retailer’s advertisement on its Web site, and should record an expense of $100 (10,000 impressions/1,000 x $10 CPM fair value) from its advertisement on Shoe Retailer’s Web site.
A company can recognize advertising barter revenue only up to the dollar amount of past cash transactions that are similar to the current barter transaction. Therefore, a past cash transaction that served as evidence of fair value for a barter transaction cannot serve as evidence of fair value for another barter transaction. Furthermore, a barter transaction whose fair value is determined by reference to a cash transaction cannot serve as a reference point for determining the fair value of a subsequent barter transaction. These limitations could result in a company recording revenue for some barter transactions but not for other identical barter transactions, because the company does not have sufficient past cash transactions to support their fair value. Continuing with the example above:

Assume that Clothing Retailer now enters into a barter transaction with Book Retailer in which Clothing Retailer places a banner advertisement on Book Retailer’s Web site and Book Retailer places a banner advertisement on Clothing Retailer’s Web site. The companies exchange 15,000 impressions of these advertisements.

In the previous example, Clothing Retailer had past cash transactions to support the fair value of 20,000 impressions. The transaction with Shoe Retailer used 10,000 of those impressions to establish fair value, so Clothing Retailer now has remaining past cash transactions to support only 10,000 of the 15,000 impressions exchanged with Book Retailer. Therefore, the revenue (and associated expense) of the exchange with Book Retailer would be limited to $100 (10,000 impressions/1,000 x $10 CPM fair value). The remaining 5,000 impressions would be recorded at their carrying amount of zero.

A company should disclose the amount of revenue and expense related to barter advertising transactions for each period for which it presents an income statement. If a company engages in barter advertising transactions for which it cannot determine fair value within the limits of EITF Issue No. 99-17, it should disclose that fact and the volume and type of advertising that it surrendered or received (for example, the number of equivalent pages, the number of minutes, or the overall percentage of advertising volume).

**Barter Transactions Involving Software**

A software product that a company develops represents a valuable asset that can be exchanged for other goods and services at little or no incremental cost to the company. This makes trading software for goods and services an appealing alternative to paying cash, especially for companies with limited cash resources. This factor, combined with the relatively high cost of purchasing software products, has led to an increase in the number of companies that conduct barter transactions using software products.

In **AICPA** Technical Practice Aids 5100.46 and 5100.47 (which rely on the principles of APB Opinion No. 29 and EITF Issue No. 86-29), the AICPA Software Revenue Recognition Task Force addressed when it is appropriate for a company to record revenue for an exchange of software. In contrast with barter advertising, for which the fundamental issue relates to measuring the amount that should be recorded in the income statement, the fundamental issue in accounting for software barter is whether the exchange should be recorded in the income statement at all. The Technical Practice Aids conclude that software barter should be recorded as revenue only when the fair value is determinable and when the transaction represents the culmination of an
earnings process, that is, when the revenue from the sales transaction can be considered earned. That determination is based on the intended use of the software that a company receives in the exchange.

A software vendor may exchange its software product for another party’s software product, which the first software vendor intends to sell on a stand-alone basis or include as a component of software that it sells in the same line of business. For example:

A software company that develops general ledger accounting software exchanges a license for its general ledger system for a license to database software that it will interface with the general ledger accounting software and license to future customers.

This represents an exchange of product held for sale in the ordinary course of business. The software received in the exchange will be used to generate future sales to other customers in the same line of business and, therefore, the exchange is not the culmination of an earnings process. The software company should not record revenue, but should record the software that it received at the carrying value of the software that is surrendered. The culmination of an earnings process will occur when the acquired software is subsequently sold or relicensed to other customers.

In contrast, a software vendor can exchange its software product for another party’s software that will be used in the software vendor’s internal operations. For example:

A software company that develops general ledger accounting software exchanges a license for its product for a license to database software that it will use internally.

In this exchange, the vendor has received a productive asset for a product that the vendor held for sale in the ordinary course of business. Thus, the exchange would be considered the culmination of an earnings process.

The software vendor also may exchange its software product for another party’s software product in a situation in which it intends to resell the software in a different line of business. For example:

A software company that develops general ledger accounting software and health care management software exchanges a license for its general ledger product for a license to database software that it will incorporate into the health care management software and license to future customers.

Although it is an exchange of a product held for sale in the ordinary course of business, the software surrendered will not be used in the same line of business as the software received and, thus, can be considered the culmination of an earnings process.

If an exchange of software is determined to be the culmination of an earnings process, Technical Practice Aid 5100.46 indicates that the company should record revenue at fair value if:

(a) It can determine the fair value of the products exchanged within reasonable limits, with vendor-specific objective evidence as if the vendor had received or paid cash; and

(b) The vendor expects to use the products that it received in the exchange, and the value that the vendor ascribes to the transaction reflects that expected use.
If these conditions are not met, the vendor should record the software that it received at the carrying value of the software that it surrendered.

Furthermore, if software is received in an exchange but is not subsequently used by the software vendor either in its operations or for resale purposes, this would indicate a possible impairment of the asset.
Coupons, Rebates, and Other Sales Incentives – Why Aren’t They Marketing Expenses?

Sales incentives include coupons, point of sale discounts, mail-in rebates, introductory offers, free products and services, volume discounts, loyalty programs, slotting fees, cooperative advertising, and buydown arrangements. The use of these sales incentives is not unique to e-business companies—old economy companies have been using sales incentives for decades. However, many e-business companies have adopted these practices in an attempt to attract new customers, build customer loyalty, create affiliations with more established entities and, ultimately, to increase sales and market share.

There is little published guidance on the accounting for these incentives. The result is that companies account for them in a variety of ways. In some cases, the financial statements of companies that appear to be engaged in similar promotion activities may look very different. Further, because these incentives can be significant, the SEC staff has expressed concern that the diversity in accounting treatment could be confusing to investors.

Many companies consider all types of sales incentives to be part of their overall advertising and marketing activities and, therefore, believe that it is appropriate to record them as marketing expense. In contrast, other companies record sales incentives as a reduction in revenue because they believe that the incentives reduce the effective sales price to the customer. Because of the numerous varieties of sales incentives and the diversity that exists in accounting for them, a series of issues have been referred to the EITF for discussion. This discussion addresses the accounting issues that are raised by the various types of incentives. It does not apply to equity instruments that are granted in connection with selling goods or services, which are addressed in “Using Equity Instruments as Currency” on page 51.

Sales Incentives Offered in the Form of Coupons, Point of Sale Discounts, and Mail-in Rebates

Some incentives to customers take the form of coupons, point of sale discounts, mail-in rebates, introductory offers, and free products. These are most commonly offered to consumers but also could be offered to another party to a transaction, such as a distributor or retailer. The EITF addressed these types of incentives in Issue No. 00-14. The primary accounting issues are (1) what is the appropriate income statement classification for sales incentives and (2) when should the sales incentives be recorded?

The EITF distinguishes between sales incentives that will not result in a loss to the company (vendor, retailer, manufacturer, or distributor) if the customer redeems them and sales incentives that will result in a loss if the customer redeems them.

Sales Incentives that Will Not Result in a Loss to the Company if the Customer Redeems the Incentive

On the date that a company offers a sales incentive to customers, the company should determine whether it already sold the goods or services on which it is offering the discount.
If at the time that it offers the sales incentive the company has not yet sold the goods or services that will be discounted, and the sales incentive will not result in a loss to the company if the customer redeems the incentive, the company should record the cost of the sales incentive as a reduction in revenue when it sells the goods or services. This generally will be the case for sales incentives that are offered and redeemed by retailers. For example:

An Internet Vitamin Retailer (Retailer) distributes coupons to consumers through newspaper ads, mass mailings, e-mail, and via download from Retailer’s Web site. Each coupon gives the consumer a discount code that entitles him to receive a $10 discount on a purchase with a $50 minimum. Assume Retailer’s cost is $25; thus, this discount will not result in a loss to Retailer.

Retailer would record the $10 coupon redemption as a reduction in revenue when the coupon is presented at the time of sale.

A manufacturer may offer a sales incentive to a consumer on merchandise that it previously sold to distributors or retailers. In that situation, the manufacturer should record the cost of the sales incentives as a reduction in revenue on the date that it offers the incentive to the customer (the consumer). The estimate of cost would be based on the company’s historical experience with redemptions. For example:

On January 1, 2001, Cosmetic Manufacturer distributes to consumers a coupon for $2 off a purchase of its product from Retailer. Cosmetic Manufacturer will reimburse Retailer for the dollar amount of coupons that consumers redeem. Cosmetic Manufacturer sold the cosmetics to Retailer during fiscal year 2000, and the coupon redemptions will not result in a loss to Cosmetic Manufacturer. Cosmetic Manufacturer has offered similar coupons for ten years and has sufficient historical experience to estimate that consumers will redeem 4 percent of the coupons.

Cosmetic Manufacturer should accrue a liability and a reduction of revenue equal to 4 percent of the coupons on January 1, 2001, the date on which they are distributed to consumers, even though the sales were recorded in a previous fiscal year.

Sometimes a company does not have sufficient historical experience to estimate the volume of incentives that will not be redeemed by consumers, referred to as breakage. The estimate is based on the facts and circumstances in each situation. The following factors may be indicators that the company is not able to make a reasonable and reliable estimate of breakage:

- The rebate/coupon has a long period until expiration.
- The company does not have a history of offering similar sales incentive programs for the same or similar products, or the historical experience is not relevant because of changing circumstances. (Companies cannot use competitor or industry data in estimating breakage.)
- The company does not have a large volume of similar transactions.

If a company cannot reasonably and reliably estimate the amount of breakage, it should recognize a liability for the maximum potential amount of the sales incentive. This particularly affects e-businesses that have been operating for a relatively short period or that operate in a changing environment such that any data available no longer are relevant. For example:
Internet Travel Agency is offering a promotion whereby customers who purchase certain travel packages are entitled to apply for a $100 rebate at the conclusion of their trip. The travel package operator will not reimburse Internet Travel Agency for the cost of the rebate, and the rebate does not exceed Internet Travel Agency’s commission for selling the package. This is the first rebate program that Internet Travel Agency has offered.

Because Internet Travel Agency does not have historical experience with which to estimate the expected number of travelers who will not apply for the rebate at the conclusion of their trip, it should record the maximum potential rebate ($100) for each vacation package that it sells. Internet Travel Agency should record a liability for the $100 rebate and a reduction of sales for the same amount at the time it records the sale of a vacation package. The portion of this liability that relates to unclaimed rebates should be reversed, with a corresponding credit to sales, only when the right to claim a rebate expires.

Sales Incentives that Will Result in a Loss to the Company if the Customer Redeems the Incentive

If a company will incur a loss on the sale of goods or services when it honors the sales incentive, the company should not recognize a loss for that sales incentive before the date on which it recognizes the sale. On the date on which it offers a sales incentive that will result in a loss, the company should assess whether that loss indicates that the carrying value of its inventory is not realizable. For example:

Internet Retailer issues coupons to end-users (consumers) for $400 off the purchase price of a computer. The manufacturer will not reimburse Internet Retailer for the coupon. The amount of the discount will cause Internet Retailer to incur a loss on the sale of the computer.

Internet Retailer should record the discount as a reduction in revenue at the time of sale. It should not accrue for the loss before the date of the sales transaction. However, because Internet Retailer plans to sell the computers at a loss, it should assess whether that indicates that the realizable value of the inventory has decreased since the purchase date and, therefore, whether Internet Retailer needs to write down its inventory in accordance with the lower of cost or market convention.

Promotional Items

Promotional items generally are free items or heavily discounted items provided by a company to a customer who completes a sale transaction. As discussed in the consensus to EITF Issue No. 00-14, if a free or heavily discounted product or service is delivered to the customer at the time of sale, the seller should record the cost of the free product or service as additional cost of goods sold. The cost of the promotional item is classified as cost of goods sold, not as a reduction in revenue, because the free product does not represent a return, refund, or rebate of a portion of the sales price paid by the customer. For example:

Internet Drugstore gives a customer a free $5 telephone calling card when it ships a new prescription to that customer.

Internet Drugstore should record the cost of the telephone calling card as cost of goods sold when it ships the prescription to the customer. Internet Drugstore should record cards that it purchases in advance of order fulfillment as inventory.
There also are situations in which the terms of sale include the customer’s right to receive specified promotional items, but the promotional items will not be delivered to the customer until a future date. The EITF is addressing the appropriate accounting in Issue No. 00-22 and has not yet reached a consensus. The views currently under consideration in EITF Issue No. 00-22 include: (1)—The arrangement may qualify as a multiple-element arrangement that should be addressed using the guidance in EITF Issue No. 00-21 or (2)—The offer is a form of advertising to encourage the customer to purchase from the vendor; therefore, the company should recognize all revenue from the transaction when the transaction has been completed, and the company should record a corresponding accrual for the estimated cost of honoring the offer. For example:

Internet Drugstore offers a customer a free $5 telephone calling card when the customer fills a new prescription. Internet Drugstore mails the card to the customer only after receiving a request from the customer.

Applying the two views described in EITF Issue No. 00-22, view 1 would consider the transaction to be a multiple-element arrangement, which would require Internet Drugstore to allocate revenue between the sale of the prescription and the sale of the calling card. (See further discussion on “Multiple-Elements Arrangements” in Section Three of this publication.) Under view 2, the sale transaction essentially is complete at the time the prescription is delivered. The phone card is considered a promotional activity. Therefore, Internet Drugstore would record all of the revenue from the transaction at the time the prescription is delivered, and a corresponding expense accrual for the estimated cost of fulfilling the request for the phone card.

**Point and Loyalty Programs**

Some Internet businesses offer loyalty programs to attract and retain customers. Loyalty programs have been used for years by many companies, most notably in the airline industry. Loyalty programs generally award points to customers based on specified criteria, including the dollar amount of purchases, volume of transactions, or length of membership. Customers can redeem specified quantities of points for awards such as free or discounted products or services.

Current accounting standards do not provide guidance on the accounting for loyalty programs and practice is diverse. In September 2000, the EITF began to discuss Issue No. 00-22. This issue is expected to provide broad accounting guidance that can be applied to existing and future loyalty plans and incentive programs employed in all industries.

**Loyalty programs**

Many companies have established loyalty programs that satisfy customer awards with their own products or services, or with products or services purchased from others expressly for that purpose. For example:

Airline A operates a frequent flyer program. Members earn mileage credits for each flight on Airline A. Members may redeem specified quantities of mileage credits for flight benefits such as free airline tickets and class-of-service upgrades.

Historically, the airline industry (and other industries that offer loyalty programs) have not deferred revenue related to points awarded to customers. Instead, they have accrued the expected incremental costs related to the expected future redemptions based on historical redemption rates.
Companies that offer loyalty programs to their own customers also may make their mileage credits or loyalty points available for sale to customers or other strategic partners. At that point, the company also may be acting as a program operator, as discussed below. Continuing the example above:

Strategic partners of Airline A, such as hotels and car rental companies, can purchase mileage credits from Airline A. These partners award Airline A's mileage credits to customers for transactions completed with the partners.

Currently, airlines record revenue immediately on the sale of mileage credits to business partners and accrue the estimated incremental cost of redeeming the awards. However, in response to the issuance of SAB No. 101, airlines will defer a portion of the revenue from credits sold to strategic partners until the awards are redeemed or expire. The remainder of the revenue (related to services provided by the airline) will be recorded as revenue in the period in which the mileage credits are sold to the strategic partner.

In Issue No. 00-22, the EITF will consider three views of the accounting for these types of loyalty programs: (1)—Record revenue at the time of sale and recognize a liability for an award when the customer has accumulated the minimum number of points required to receive a benefit; (2)—Record revenue at the time of sale and recognize a liability for the expected cost of the awards as the points are awarded; or (3)—Treat the transaction as a multiple-element transaction in accordance with the guidance in Issue No. 00-21.

Advocates of views 1 and 2 consider the airline industry’s loyalty programs to be a type of marketing expense and believe that the customer is purchasing only the primary transaction (that is, an airline ticket), not the points. Therefore, under these views, it is not appropriate to defer revenue. Advocates of view 3 believe that the customer is purchasing two items: an airline ticket and mileage credits that may be used toward the acquisition of a future airline ticket. Therefore, they believe that revenue should be allocated between the two sales and recognized separately when each is earned. (See further discussion in “Multiple-Element Arrangements” on page 25.)

Program operators of loyalty programs

Some companies act as program operators and administer customer loyalty programs for a large number of vendors and participants. For example:

Program Operator manages customer loyalty programs for e-business companies. Program Operator sells the “points” to the e-business companies at a fixed price. The companies distribute the points to their customers in accordance with their own published program. Program Operator maintains a Web site at which the customer can monitor his or her point balance and redeem points for products and services. Program Operator also is responsible for purchasing and delivering the rewards.

In the Internet environment, we believe operators of loyalty programs use one of two accounting practices:

(1) The operator recognizes revenue as the customer earns the points. Generally, the operator accrues the estimated future cost of the redemption of the points when it recognizes revenue; or
(2) The operator allocates revenue between the service and product components. The service component is recognized over the term of the award program as the operator maintains the customer accounts, Web site, and so forth. The remainder of the revenue is recognized when the points are redeemed and the award is delivered. Costs related to the award are recorded at the time of redemption.

In Issue No. 00-22, the EITF will consider three views of the accounting for these types of loyalty programs: (1)—Record revenue at the time of sale and recognize a liability for the expected cost of delivering products or services when the award is redeemed; record the corresponding cost as an expense at the time of sale; (2)—Defer proceeds from the sale of award credits until the award credits are redeemed or expire; record the corresponding cost as an expense at the time that the awards are redeemed; or (3)—Treat the transaction as a multiple-element transaction in accordance with the guidelines in Issue No. 00-21. (See further discussion in “Multiple-Element Arrangements” on page 25.)

Volume Discounts

Manufacturers and retailers traditionally have sponsored programs that offer cash refunds to customers for achieving a cumulative level of purchases or for remaining a customer for a specified period of time. These practices are being adopted by Internet companies in both the B2B and B2C markets.

We believe companies are recording transaction-specific discounts as a reduction of revenue at the time of sale. For example:

Internet Retailer provides a 5 percent volume discount on any individual order greater than $100,000. The amount invoiced to the customer is reduced by this discount.

Retailer has reduced the effective sales price to the customer in this situation and, under current practice, records the sale at $95,000.

If the cash discounts are calculated based on accumulated purchase levels and are paid by the company at a specified future date, the discount program functions more like a customer retention mechanism.

Internet Retailer provides a 5 percent volume discount on all purchases during a calendar year if the total purchases for the year are greater than $100,000. The volume discount is mailed to the customer after the end of the calendar year.

The Task Force is addressing the appropriate accounting for these situations in EITF Issue No. 00-22. The current views under consideration in Issue No. 00-22 include: (1)—Record all of the revenue at the time of the sale and record an expense accrual for the rebate only when the specified threshold has been reached; (2)—Record all of the revenue at the time of the sale and record an expense accrual for the estimated rebate amount that will be paid related to that sale; and (3)—Record at the time of the sale only the amount of the revenue that would not be subject to refund. (For example, if a company receives cash for the full amount of the sale, management should record a liability for the amount of the proceeds that are subject to refund, and a corresponding reduction of revenue.) The EITF is scheduled to continue discussing Issue No. 00-22 but a consensus is not expected to be reached in 2000.
**Slotting Fees**

*Slotting fees* are payments made by a vendor to a retailer to obtain shelf space for the vendor’s products. Slotting fees have been used in the retail sector for many years. This type of fee is being paid in the e-business environment to procure space or ensure premium placement on another company’s Web site. For example:

Software Manufacturer pays a $10,000 slotting fee to Internet Retailer. In return, Internet Retailer will offer Software Manufacturer’s products for sale for a six-month period.

The accounting for slotting fees is being addressed in EITF Issue No. 00-25. The main issues are whether the vendor should capitalize payments as assets at the time of payment and amortize such assets over the expected period of benefit, and whether the payments, when recorded in the income statement, should be recorded as a reduction of revenue or as an expense. The issues related to classification of expense are very similar to those addressed in EITF Issue No. 00-14 related to certain sales incentives and Issue No. 00-22 related to point and loyalty arrangements.

**Cooperative Advertising and Buydown Arrangements**

In a cooperative advertising arrangement, a company shares in its customer’s advertising expenses. These programs generally are offered by the company to encourage the customer to include the company’s products in the customer’s advertising materials. Some companies reimburse the customer for a portion of the actual advertising expenses incurred by the customer, whereas other companies may reimburse the customer based on an agreed-upon amount per unit purchased by the customer. When reimbursement is based on actual expenditures, it may be no different from a situation in which the company paid for its own advertisements. Other reimbursements may be based on a fixed price per sales volume transacted. The accounting issue is what is the appropriate income statement classification of these payments to customers. For example:

Software Manufacturer agrees to pay Internet Retailer 25 percent of the cost of a series of advertisements that feature Software Manufacturer’s products. Internet Retailer runs the advertisements and submits a request for payment to Software Manufacturer for 25 percent of the actual costs incurred.

In this situation, Software Manufacturer has received direct advertising benefits and likely could justify classifying payments as advertising expense.

Software Manufacturer sells software products to Internet Retailer. Software Manufacturer sponsors a cooperative advertising program under which it pays to Internet Retailer one-half percent of the amount of its software purchases during the quarter if Internet Retailer agrees to feature Software Manufacturer’s products in a series of advertisements. Software Manufacturer credits the cooperative advertising fees to Internet Retailer’s account after the conclusion of each quarter.

Software Manufacturer must review the facts and circumstances in this situation to determine whether the cooperative advertising payments represent a reimbursement to Internet Retailer of a portion of the invoiced prices (similar to a volume discount), or a payment for valid advertising expenses incurred by Software Manufacturer. Generally, we believe payments based on sales volume are more likely to represent rebates that should be reported as a reduction of revenue.
Buydown programs provide for a vendor to reimburse a retailer that reduces the sales price of the vendor’s merchandise during specified promotions. As with cooperative advertising arrangements, the accounting issue relates to the appropriate income statement classification of these payments. For example:

Internet Drug Store participates in Pharmaceutical Company’s flu season promotion by offering $2 off the regular retail price of cough syrup and marketing the promotion prominently on its Web site. Pharmaceutical Company agrees to reimburse Internet Drug Store $2 for every bottle of cough syrup sold during the two-week promotion period. Internet Drug Store must submit documentation of units sold at the discounted price.

Assuming that Pharmaceutical Company sold the cough syrup to Internet Drug Store for $3 per bottle, the question arises as to whether Pharmaceutical Company earned $3 of revenue per bottle or $1 of revenue per bottle (net of the $2 buydown). The facts and circumstances should be evaluated in each situation to determine whether the buydown payments represent a reimbursement of a portion of the purchase price paid by the retailer or a payment for advertising expenses. Vendors may require certain promotional activities of the retailers as part of the buydown agreement, including endcap promotions, banners and freestanding signage in stores, eye-level merchandising, and coverage in advertising circulars. Such requirements would support a conclusion that buydown payments represent valid advertising expenses. In the example above, the pharmaceutical company is receiving marketing exposure in the form of prominent placement on the Web site. Therefore, an argument could be made that the buydown payments should be classified as advertising expense.

The EITF is attempting to develop a methodology for identifying those cooperative advertising and buydown arrangements that do not represent reductions of revenue. Because these discussions are preliminary, we are unable to predict how this issue will be resolved.

Other related vendor discounts to retailers include, but are not limited to, factory incentives, dealer holdbacks, price protection, and factory-to-dealer incentives. The accounting for payments under these arrangements, as well as cooperative advertising arrangements and buydown programs, is included in the proposed scope of EITF Issue No. 00-25, but it is not certain how it will be addressed in the final consensus, when issued.

* * * *

As discussed herein, companies employ a wide variety of sales incentives in their overall sales and marketing programs and they account for them in numerous ways. Companies that use sales incentives will need to monitor the progress of the EITF discussions and may need to change from their current accounting based on conclusions reached by the EITF.
Section Three – Revenue Recognition

Multiple-Element Arrangements – More Than One Sale?

Today’s businesspeople understand that increasing the volume of sales to existing customers often is easier and more profitable than prospecting for new customers. As a result, we find companies broadening their product lines and packaging their principal products with ancillary products or ongoing services that not only augment revenues but also extend the contract between the company and its customers beyond the traditional point of sale. This business model has led to an increase in both the number and complexity of multiple-element arrangements; that is, sales arrangements with customers that involve the delivery of more than one product, service, or other right to use assets (deliverables). The following are examples of typical multiple-element arrangements that need to be evaluated to determine if a multiple-element accounting model should be applied (with separate deliverables underlined):

- **Sale of equipment coupled with ongoing services**
  A company sells a device (for example, cellular phone, satellite television dish, or home security system) under a contract that also requires the company to provide ongoing service involving the customer’s use of that device.

- **Sale of multiple services**
  A company enters into an arrangement to design a Web site and also agrees to host that Web site for a specified period of time.

- **Sale of equipment bundled with installation**
  A company sells equipment under a contract that also requires the company to install the equipment at the buyer’s location within the next month.

- **Technology license and supply agreement**
  A company licenses technology to a customer and also contracts to supply additional material to the customer over an extended period of time. The additional material is used in connection with the customer’s use of the technology.

When a company bundles multiple revenue-generating activities into a single transaction, a question arises as to when it is necessary to unbundle the transaction into its individual deliverables for revenue recognition purposes and when it is appropriate to account for the entire arrangement as a single transaction.

**Identifying Deliverables**

Identifying individual products or services in multiple-element arrangements can be difficult. For example, some Internet portal companies provide electronic storefronts for customers on their network of Web sites in exchange for a monthly fee. On the surface, some might consider this a service transaction with one deliverable. However, portal companies often deliver a variety of services to their customers over an extended period of time. The facts and circumstances of each arrangement need to be analyzed to determine whether such common ancillary activities as designing and setting up the initial Web site, managing data and content, performing fulfillment and order processing, and designing advertising and marketing programs constitute deliverables for which separate accounting is necessary.
When Do We Earn the Revenue? How Do We Measure It?

Assume that all elements of a multiple-element transaction are delivered in the same accounting period and there are no acceptance or right of return issues that would affect revenue recognition. Under these circumstances, whether the arrangement should be viewed as a single transaction or multiple transactions for accounting purposes is moot because the revenue a company would record would be the same under either assumption. However, even when it is relatively easy to identify the separate deliverables, it can be difficult for management to determine when it has earned revenue related to individual elements and how much revenue to record in each period if products or services are delivered at different times.

Companies have accounted for multiple-element arrangements in a variety of ways. Historically, when companies have attempted to unbundle and account for individual elements separately, the most common approaches for allocating revenue between or among the elements are:

- **Relative Fair Value**: A company allocates revenue for the entire arrangement to each deliverable, based on its fair value relative to the fair value of all other elements, and records revenue proportionately as each product or service is delivered.
- **Revenue to Extent of Costs**: A company records revenue only to the extent that it incurs costs. The company defers any revenue in excess of those costs until the products or services are delivered.
- **Deferral Approach**: A company defers all revenue and related direct costs until the products or services are delivered.

Multiple-element arrangements were not addressed in the guidance that the SEC staff issued in SAB No. 101. The EITF is addressing the accounting for these arrangements in Issue No. 00-21, which still is under discussion as this publication goes to print. Until the EITF issues its guidance, the SEC staff has indicated in the Question and Answer interpretation of SAB No. 101 that it would not object to a reasoned method of accounting for multiple-element arrangements that is applied consistently and disclosed appropriately and includes the following conditions:

- To be considered a separate element, the deliverable (the product or service) represents a separate earnings process;
- Revenue is allocated among the elements based on the fair value of the elements; and
- If an undelivered element is essential to the functionality of a delivered element, no revenue is recognized on the delivered element until the undelivered element is delivered.

If a company can identify all deliverables in an arrangement and can allocate an appropriate amount of the total revenue to each deliverable, the company would record the portion that is allocated to each deliverable when the revenue is realized and earned. In SAB No. 101, the SEC staff indicated that revenue generally is realized and earned when all of the following conditions have been satisfied: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred or services have been rendered, (3) the consideration is fixed and determinable, and (4) collectibility is reasonably assured.
When a company lacks sufficient evidence on which to allocate the consideration among the elements of an arrangement, the company should not record revenue earned on delivered elements until that evidence exists or until it delivers all of the elements to the customer and the customer accepts those elements. If a portion of the consideration is not due or is refundable if the customer does not ultimately accept delivery of an element, a company should not record any revenue related to that element until the customer accepts delivery.

**Does a Deliverable Have a Separate Earnings Process?**

In general, the SEC staff believes that a company should account separately for a product, service, or other right only if that element constitutes a separate earnings process. According to the SEC staff, the best indicator that a separate earnings process exists is a vendor’s ability to sell an element by itself. We believe an equally strong indicator is another company’s practice of selling the same or a similar product by itself. In the absence of an observable market in which individual elements are sold on a stand-alone basis, simply stating a separate price for an element in the sales agreement generally is not a conclusive indicator that an element constitutes a separate earnings process. For example, while a health club may charge a separate fee for membership initiation, a customer typically would not pay that fee unless he or she also could obtain the right to use the health club facilities on an ongoing basis. Therefore, the health club initiation fee likely would not be a separate element of an arrangement.

**How Is Revenue Allocated Based on Relative Fair Value?**

When it is appropriate to account for elements of a multiple-element transaction separately, the SEC staff has indicated that companies should use the relative fair value approach to allocate the total consideration between or among the elements. The SEC staff stated that fair value should be reliable, verifiable and objectively determinable. However, the evidence does not have to meet the standards of vendor-specific objective evidence unless the transaction includes the sale or licensing of software; that is, there is no requirement for a company to sell each element on a stand-alone basis to establish fair value of the individual elements. Thus, we believe that the SEC staff will permit a company to allocate fees to elements in *non-software* transactions based on other information such as competitor prices for similar products or renewal prices for services. Refer to the discussion of vendor-specific objective evidence in “Software Hosting Arrangements.”

Discussions with the SEC staff have indicated that even when vendor-specific objective evidence is not available, companies still must be able to demonstrate that amounts used accurately reflect the fair value of each deliverable. The SEC staff does not believe that a *cost-plus-normal-profit-margin* approach that is not specific to the particular product or service is an acceptable basis for allocating revenue because, in the absence of other evidence of fair value, there is no objective means to verify a profit margin for a specific element. We believe that the SEC staff expects companies that were not previously following the relative fair value approach to change to that approach concurrent with their adoption of SAB No. 101 at the end of 2000. Additional changes may be necessary when the EITF completes its deliberations of Issue No. 00-21.
Sometimes, when multiple elements are bundled into a single arrangement, the customer receives a discount from the amount that it would be required to pay if it purchased each element separately. The challenge is determining the appropriate methodology to allocate that discount among the elements. The relative fair value approach allocates any discount based on the fair value of each element relative to the fair value of the whole. Another method—the residual method—has been developed to address situations in which the fair value cannot be established for each element in an arrangement. Under the residual method, as long as the fair value can be established for all undelivered elements, the full fair value of undelivered elements is deferred and the residual amount is recognized as revenue for the delivered elements. This approach ensures that revenue associated with undelivered elements is not recognized prior to their delivery. It is important to note that it is not appropriate to use the residual method in reverse situations where fair value is known for the delivered elements but is not known for the undelivered elements.

Is the Undelivered Element Essential to the Functionality of the Delivered Element?

The SEC staff also believes a company must consider whether an element is essential to the functionality of the other element(s) when evaluating the accounting for a multiple-element transaction. We believe that the following indicators suggest that one element is essential to the functionality of another: (a) the undelivered element is available only from the company (that is, it may not be purchased from a third party), (b) the customer’s requirement to pay under the arrangement coincides with the delivery of all elements (or the last element), and (c) the customer’s ability to use a delivered element depends on or is significantly affected by the delivery of another element. Consider an enterprise software package that a company purchases along with implementation services. From the customer’s perspective, the implementation services may be essential to the functionality of the software, because the customer often is not in a position to implement the software on its own. However, if the implementation services frequently are provided by other third parties and the customer’s obligation to pay for the software license does not depend on the seller’s providing those implementation services, it may be appropriate to account for the software license separately.

Other Issues Related to Multiple-Element Arrangements

Other important factors to consider when evaluating multiple-element arrangements include the following:

- The SEC staff distinguishes between multiple-element arrangements and arrangements that include an up-front fee that is not the culmination of a separate earnings process (for example, membership initiation fees or service activation fees). If there is no culmination of a separate earnings process, the staff believes that a company should record a liability (that is, deferred revenue) arising from an initial cash receipt and amortize it over the estimated term of the customer relationship, even if the cash that the company receives is nonrefundable. (For a discussion of issues from the buyer’s perspective, see page 39, in “Contractual Arrangements.”)
The fact that elements are included in separate contracts does not necessarily mean that each element qualifies for separate accounting, even if those contracts were not entered into on the same day. For example, companies may have separate contractual relationships with the same customer that were entered into at or near the same time and involve deliverables that are interrelated or may have linked payment structures—for example, payments under one contract may be subject to refund or other concession if other contracts are not satisfactorily completed. In these situations, the group of contracts may be so closely related that they are, in effect, parts of a single contract that would qualify for separate accounting only if the criteria discussed earlier in this section have been met.

Companies also may enter into reciprocal service arrangements with customers, such as cooperative advertising or revenue sharing arrangements that result in cash payments among the parties in equal (or near equal) amounts. These situations raise issues of gross versus net accounting and whether the arrangement should be accounted for as a nonmonetary exchange.
Digital Exchanges – What Happens When Buyer Meets Seller?

The evolution of the Internet as a medium for conducting commerce has spurred a substantial growth in the formation of digital exchanges (also known as digital marketplaces). A digital exchange creates an online marketplace that efficiently brings buyers and sellers together to exchange goods and services. The objectives of the exchange are to lower transaction costs for buyers and sellers, thus reducing the buyers’ effective cost to acquire goods and services, and to increase the sellers’ exposure to new buyers. Although it is difficult to determine the number of digital exchanges that exist today, current estimates are that there are more than 1,000 exchanges.

Digital exchanges have been created primarily to facilitate B2B commerce. B2B exchange customers tend to be companies that may not be price sensitive and are likely to seek a valued ongoing relationship with the vendor as well as other potential services related to the transaction. B2B purchasers usually have a procurement process that includes a series of formal approvals and other internal controls. Industry leaders often form B2B exchanges (also known as consortia) to create markets in which to fulfill the procurement needs of their supply chain partners.

To a lesser extent, the term digital exchanges encompasses B2C exchanges. In a B2C exchange, a retailer may provide goods and services to its customers via the Internet. Typical customers of B2C exchanges are individual consumers who generally are sensitive to price and often are inclined to make impulsive purchase decisions. B2C exchanges sometimes follow auction-based formats that permit a seller to list items for sale and a buyer to bid on items of interest. As with any auction, a digital exchange auction derives revenues primarily from listing fees that it charges the seller to list items for auction, and transaction fees (sometimes referred to as success fees) that it charges when an item is sold.

B2B Business Models

Despite the large number of B2B digital exchanges that currently exist, most still are in a start-up or technology-building phase and are just beginning to engage in the transactions for which they were created. Very few B2B exchanges have begun to generate significant revenues.

A fundamental question must be answered early in the life of a B2B exchange: How will it make money? There is an expectation that the business models under which B2B exchanges operate will continue to evolve. The activities that the exchanges perform likely will expand and the types of fees that they charge will change accordingly. In their infancy, most exchanges rely on transaction fees and basis point fees (described below) as the primary sources of revenue. Some observers note that the perceived value of matching buyers with sellers is declining and B2B exchanges are coming under increasing pressure to reduce transaction fees. To the extent that transaction fees do not represent a significant revenue growth opportunity, an exchange may seek alternative revenue sources. The next logical step in an exchange’s revenue growth strategy may be to move from performing a matching function (and largely satisfying its obligation when the match takes place) to providing various fulfillment services such as arranging for shipment of the product, taking delivery of and repackaging products for shipment, or providing ancillary financial services, including credit evaluation and insurance.
Current business models generate revenue from a variety of sources, including:

- **Listing or transaction fees**—A fee for each transaction that occurs on the digital exchange; the fees usually are a flat fee for each transaction or are based on a percentage of the total transaction (*basis point fees*).

- **Subscription fees**—In lieu of transaction fees, some digital exchanges charge a flat subscription fee to use the exchange for a period of time. Subscription fees help buyers to control costs while encouraging unlimited use of the exchange. Currently, these fees are paid for the most part by buyers to gain access to a Web site for a fixed period of time (usually a longer period than is covered by a listing fee). In certain industries, it is possible that the market will evolve so that both buyers and sellers will pay subscription fees.

- **Auction services**—Some B2B exchanges provide auction services; currently, revenue that is derived from auction fees represents a relatively minor part of the B2B market.

- **Product sales and markup fees**—Some exchanges act more like typical resellers than agents by taking title to the goods and marking up the price to reflect the value they add to the transaction (for example, volume buying from manufacturers; offering products from multiple manufacturers in a single location; and inspecting, repackaging, and reshipping the goods). The exchange will profit by selling the goods at a markup, depending on what the market will bear.

- **Membership/storefront fees**—Similar to a subscription fee, some exchanges charge participating merchants a membership or storefront fee to use the exchange over a certain period of time. In addition, the merchant will receive a personal Web page on the exchange’s Web site on which the merchant can post promotional materials, product lists, and prices.

- **Content subscription fee**—Content (referring to tagging, structuring, and ordering data to enhance the reliability of transactions) is critical to facilitating transactions on a B2B exchange. Buyers and sellers must reach a common understanding of the attributes of the products and services that are offered on the exchange. Thus, an exchange may create and maintain a catalog or database in which sellers list their products in a standardized format. This enables buyers to easily gather information about a seller’s product (for example, specifications and price) and compare that information with competing products. These fees, which are not common now, generally would be derived from contracts that span multiple years.

- **License fees**—Some exchanges develop and license software that buyers or sellers use to facilitate transactions on the exchange.

- **Third-party services**—An exchange may resell services that specialists provide and may receive a share of the service fees, similar to a commission.

An exchange may provide other value-added services to augment transaction-fee revenue. These services may include credit-checking or logistics services. The services may be billed separately or bundled with the transaction fee. There also is an expectation of considerable potential for exchanges to earn fees from benchmarking information. That information could be licensed either for a fee for one-time delivery of the information or with an understanding that the exchange will issue future updates of the information.
Revenue Recognition Models

The increasing variety of digital exchange companies and the increasing number of such companies becoming subject to periodic financial reporting as a result of an IPO have caused management, regulators, and auditors to focus more attention on the revenue recognition policies of these entities. In addition to the issues related to gross versus net presentation of revenues as addressed in Section Two of this publication, there has been considerable discussion concerning the timing of recognition of an exchange’s revenue. For example, some exchanges that charge auction listing fees record those fees as revenue at the beginning of the listing period, even though the exchange has agreed to maintain a listing on its Web site for a specified period of time. (The SEC staff does not accept the immediate recognition approach; the staff believes that listing fees should be recorded over the listing period.) Furthermore, some B2C auction exchanges recognize transaction fees at the end of each auction, despite the fact that the fees may be contingent on the actual closing of transactions. Although these exchanges have asserted that they are not responsible for completing the transaction between the buyer and the seller, the SEC staff has challenged their revenue recognition practices in this area.

Generally accepted accounting principles provide that revenues should be recognized only when they are realized or realizable, and when they are earned. The first criterion requires that revenue not be recognized until an exchange has taken place with a third-party buyer in which a seller receives cash or a right to receive cash that is reasonably expected to result in a future receipt of cash. The earned criterion requires that before recording revenue an entity must have performed substantially all that it is obligated to do to be entitled to the revenue. SAB No. 101 illustrates the SEC staff’s interpretation of how these general principles should be applied to a variety of transactions, some of which are similar to those typically occurring on digital exchanges. As such, SAB No. 101 provides useful guidance, directly or by analogy, for evaluating the appropriateness of recognition policies relating to revenues typically earned by digital exchange companies. Our views concerning recognition of the more common types of digital exchange revenues are as follows:

- **Transaction fees**—The following guidance is appropriate for digital exchanges that have no further obligation after the transaction closes and that essentially are acting as an agent. This discussion assumes that the digital exchange has met the criteria to act as an agent. In this scenario, the digital exchange does not take ownership of the product and records revenue on a net basis. We believe that the recognition of transaction fees can be analogized to the discussion in SAB No. 101 concerning refundable membership fees. Therefore, even if transaction fees are contingent on closing the transaction, we believe that a digital exchange can record revenue, net of estimated future refunds/credit memos, at the time that the exchange charges the fees to the seller (presumably when the buyer and seller have agreed to execute the transaction) if the exchange meets all of the following conditions:
  - Estimated refunds/cancellations are based on a large pool of homogeneous items;
  - Reliable estimates are made for future refunds/cancellations on a timely basis;
  - Estimated refunds are based on an entity-specific historical base of at least two years of comparable transactions; and
  - The company earns a fixed fee for the transaction, other than the contingency for the transaction closing.
Given the unique attributes of different B2B exchanges and the start-up nature of most exchanges, it may be very difficult to demonstrate that an entity possesses sufficient entity-specific history to record an estimate of refunds. (This may raise an issue of when the entity should record revenue, for example, when the goods are shipped or when the cash is received. The answer will depend on the facts and circumstances in the situation.)

In addition, as described earlier, a digital exchange may provide other services in connection with the transaction and charge for those services as part of the transaction fee. In this instance, the digital exchange should evaluate whether the transaction is a multiple-element arrangement in determining the appropriate policy for recording revenue if the elements are delivered at different times. Refer to Section Three of this publication for further discussion of multiple-element arrangements.

- **Subscription fees and listing fees**—We believe that a digital exchange should record subscription fees and listing fees over the performance period (that is, the listing period or the contractual subscription term). We base this conclusion on our belief that customers are purchasing the ongoing rights, products, or services that the exchange provides throughout the subscription or listing period. In our view, an exchange completes the earnings process by performing over the entire term of its arrangement, not simply when it originates a revenue-generating contract.

- **Storefront fees**—Storefront fees may provide the customer with two distinct elements—a customized Web page within the exchange’s marketplace and the ongoing rights and services that the exchange provides throughout the membership period. Even though the exchange may create the customized Web site at the beginning of the arrangement, this Web page typically has little or no value to the customer on a stand-alone basis and is not functional without ongoing participation in the exchange. To the extent that it takes little or no effort for the exchange to set up the storefront, we believe that the digital exchange generally should recognize the entire fee over the membership term which, in our view, is the performance period. However, the exchange should consider the specific facts and circumstances, as there may be situations in which creating the storefront is a substantial exercise and the storefront is useful in other contexts. In those situations, creating the storefront may be an element that should be recorded separately using a relative fair value approach to determining the revenue that is associated with each element.

- **Content subscription fees**—Content fees generally are recognized over the term of the related contract similar to subscription or storefront fees.

- **Markup, license fees and third-party services**—In our experience, the primary issues involving the recognition of revenues from markup, licensing and third-party services transactions relate to the issues discussed in “Gross Versus Net Presentation of Revenues” and “Shipping and Handling Fees” as discussed in Section Two. Generally, the exchange is acting as a principal in the transaction; therefore, the exchange will record the revenue on a gross basis (product plus markup). Revenues from transactions that include software license fees are subject to the guidance in SOP No. 97-2, unless the software is incidental to the arrangement as a whole.
The following examples illustrate the revenue recognition issues that a B2C exchange that charges listing and transaction fees is likely to encounter:

Seller contracts to list an antique painting on Exchange for six months for a stated minimum price. Seller pays Exchange a listing fee. Exchange facilitates the transaction; it does not take title to the goods. As a result, Exchange has no control over the quality, safety, or legality of the items that sellers advertise; the truth or accuracy of the listings; the ability of sellers to sell items; or the ability of buyers to buy items.

We believe that Exchange should recognize the listing fee as revenue over the six-month listing period.

Before the end of the auction period, Exchange notifies via e-mail both the Seller and the Buyer making the highest bid for the painting. The Buyer and Seller then consummate a transaction independent of the Exchange. At the time it sends the e-mail notification, Exchange charges the seller a transaction fee. Exchange’s transactions are homogeneous in that the nature of the services is the same for each transaction and the classes of customers have similar characteristics. Additionally, Exchange has sufficient history on which to base reliable estimates of cancellations.

We believe that Exchange should recognize transaction fee revenue when it charges the fee to Seller.

The following example illustrates a gross versus net issue that a B2B exchange might encounter in a markup transaction:

Computer Consortium provides a B2B digital exchange for the computer equipment market. On a daily basis, numerous computer hardware and component vendors submit to Computer Consortium listings of available inventory to be sold, with indicated pricing. Computer Consortium prices each product based on a 5 to 10 percent markup on the vendor’s indicated pricing. Based on expected transaction volume, Computer Consortium orders and receives the product from the vendor, inspects the product for quality control purposes, repackages the product in Computer Consortium packaging and maintains the product in inventory until it is used to complete a customer order. Computer Consortium holds title to the inventory from the time it receives the inventory from the vendor until it is delivered to a common carrier for shipment to Customer. Computer Consortium, which is the merchant of record, invoices Customer at the time it ships the product.

In our view, Computer Consortium bears inventory and credit risk in the above transactions and, therefore, is acting as a principal in transactions with its customers. As such, it should record the revenues and costs related to this markup transaction on a gross basis in its income statement when it ships the product. Depending on whether Computer Consortium assumes responsibility for potential product defects, it also may be necessary to record a warranty provision.
Software Hosting Arrangements – Software or Service?

The evolution of the Internet and rapid increases in communications bandwidth have enabled software vendors to distribute their products through a new channel—the Internet itself. Software hosting arrangements enable a company to license software to its customers without the need for customers to install the software on their own hardware. Rather, the host (a software vendor or application service provider (ASP)) maintains the application on an off-site server and provides the customer access to the software on an as-needed basis over the Internet or via a dedicated line.

Hosting arrangement revenues are derived from the use of the software and the related implementation, maintenance, and consulting services that the host provides to the customer. A hosting arrangement usually requires a smaller up-front investment by the customer, which can benefit the ASP by (1) expanding its ability to market to smaller customers and (2) shortening the normal sales cycle for the software. Additionally, a hosting arrangement may allow the customer to use the software on a trial basis before purchasing and installing it. The service element of a software hosting model can provide the ASP with a more consistent and predictable revenue stream, which may be viewed favorably by the investment community.

Although the terms of hosting arrangements vary, a typical hosting arrangement includes the customer’s license to use the software; implementation services that allow the customer to integrate applications with its own software, maintenance and support services during the hosting term; and other consulting services—a so-called multiple-element arrangement. The accounting issues surrounding the recognition of revenue from multiple-element arrangements are discussed at length in Section Two of this publication. However, the recognition of revenue from software hosting arrangements may be subject to special and more restrictive rules set forth in AICPA Statement of Position 97-2, Software Revenue Recognition (SOP No. 97-2). The remainder of this section is devoted to a discussion of the application of SOP No. 97-2 to these arrangements.

Software or Service?
The fundamental accounting question that management needs to resolve is whether revenue from the software element of the arrangement should be recorded separately or whether the software simply is part of a service arrangement. If the software is considered to be a separate element, the revenue from the sale of software generally can be recorded at the outset of the arrangement if all other criteria are met for revenue recognition under SOP No. 97-2. If the software component does not qualify for separate accounting, SOP No. 97-2 generally requires that all of the revenue be recorded ratably over the service period.

Arrangements that Include a Separate Software Element
EITF Issue No. 00-03 addresses when a software hosting arrangement includes a software element that could qualify for separate revenue recognition. This Issue provides guidance to help differentiate between arrangements that include a sale of software and those that are more akin to outsourcing computing to a traditional computer service center. The EITF concluded that for there to be a separate software element, a software hosting arrangement must satisfy two criteria:

- The customer must have the contractual right to take possession of the software at any time during the hosting period without significant penalty; and
It must be feasible for the customer either to run the software on its own hardware or to host the software with another third party.

A customer does not have a significant penalty if it has the ability to take delivery of the software without bearing significant cost and the ability to use the software separately without significantly reducing the utility or value of the software. Significant costs include the cost to install the software on its own or on a third party’s hardware. It may not be feasible for the customer to use the software separately if the software requires special expertise or hardware, or if the software is not written in a universal language.

The evaluation of significant penalty and feasibility requires the application of judgment to the specific facts and circumstances of each arrangement and customer. For example:

Host Company is an enterprise applications software vendor that enters into a hosting arrangement with Customer. The arrangement includes an up-front fee for the software license and a monthly service fee for the hosting. Customer has the contractual right to take possession of the software if the hosting arrangement expires or is terminated for any reason. Although no third parties currently host the software, Customer maintains an internal information systems department that could integrate Host Company’s software into its own fairly quickly and at a cost that is not significant to Customer.

Under these circumstances, we believe Customer has the ability to take possession of the software without significant penalty. Therefore, Host Company should account for the substance of this hosting arrangement as a software arrangement.

In reaching its consensus on Issue No. 00-03, the EITF relied heavily on the guidance in SOP No. 97-2, concerning how companies should record revenue for licensing, selling, leasing, and otherwise marketing computer software that does not require significant production, modification, or customization. Under SOP No. 97-2, a vendor would record revenue immediately on a license for that type of software that meets all of the following criteria:\(^1\)

1. Persuasive evidence of an arrangement exists;
2. Delivery has occurred;
3. The vendor’s fee is fixed or determinable; and
4. Collectibility is probable.

SOP No. 97-2 also addresses contracts under which a software vendor must deliver multiple elements, for example, software products and services. If a vendor must deliver multiple elements, the vendor allocates the total revenue to the various elements based on whether there is vendor-specific objective evidence (VSOE) of the fair value of those elements, and whether the contract meets the criteria listed above. If a multiple-element arrangement includes both software and services, the portion of the fee that is allocable to the services may be recorded separately as the services are performed, if certain criteria are met.

\(^1\) Refer to KPMG’s publication, *Software Revenue Recognition: An Analysis of Statement of Position 97-2*, for definitions and detailed analysis of these criteria.
In our earlier example, Host Company would apply the provisions of SOP No. 97-2 to each element of the hosting arrangement, including implementation, maintenance, support and consulting services, if any. At a minimum, Host Company must have VSOE for each element of the hosting arrangement in order to determine the portion of the fee that should be deferred and recognized over the service period. The residual amount (that is, amounts not allocated to undelivered elements of the arrangement) generally would be recorded on delivery of the software. The software is considered delivered when it becomes available for delivery and the customer has the ability to take immediate possession, generally on the date the hosting arrangement begins. However, the SEC staff has indicated in SAB No. 101 that revenue is not earned (and, therefore, cannot be recorded) under a software or other licensing arrangement until the commencement date specified in the license agreement even when all other criteria evidencing delivery have been satisfied.

**Arrangements that Are in Substance a Service Contract**

If the customer does not have the ability to take possession of the software, or if the customer does have the ability but only with a significant penalty, the hosting arrangement is considered a service contract and, in general, the host would record revenue over the period in which it provides the services. For example:

ASP offers a suite of enterprise software applications to small to medium companies through hosting arrangements whereby the customers have unlimited access to the software but do not have the ability to take possession of the software.

Because the customers are not entitled to take possession of the software, ASP is functioning more like a traditional service center and, therefore, it should account for its hosting arrangement as a service contract. Assuming that ASP provides the services in the hosting arrangement continuously over the contractual term, ASP would record revenue from the arrangement on a straight-line basis over the expected service period. The SEC staff has indicated that companies should follow the relative fair value approach in allocating the total fee among the elements. The SEC staff believes that fair value should be reliable, verifiable, and objectively determinable. A relative fair value allocation approach applicable to this arrangement is not as restrictive as the VSOE standard that must be applied to arrangements that include the sale of software. However, companies need to be able to demonstrate that amounts used represent an objectively verifiable measure of the fair value.
Section Four – Capitalization

Contractual Arrangements – Payments for Assets?

Many contracts entail an exchange of consideration for the right to receive goods or services, or access rights to an intangible asset, over an extended period of time. These arrangements commonly are referred to as **firmly committed executory contracts** because some portion of the contract remains undelivered; that is, further performance is required of one or both parties in future periods. Examples of these latter contracts, which are common to old and new economy companies alike, include operating leases of office space, software license arrangements, and agreements to maintain office or computer equipment for an extended period of time.

E-business companies often enter into significant firmly committed executory contracts with other companies, hoping to increase traffic to their Web site; to associate their name with a more recognizable brand name or trademark; to improve their access to new members, new customers, or prime advertising space; or to obtain exclusive distribution, marketing, or other rights. Frequently, these contracts require the company seeking to associate itself with a strategic partner to make substantial cash and/or equity payments, either up-front or periodically over the term of the agreement. Companies participating in such firmly committed executory contracts must address a number of contract-related accounting issues, including:

- Whether payments required under the contract should be capitalized or charged to expense when paid;
- How and when payments capitalized as assets should be amortized to expense;
- When payments capitalized as assets should be tested for impairment and, if impaired, how the impairment should be measured; and
- Whether or when an obligation to make payments gives rise to a liability that must be accrued in advance of performance by the other party under the contract.

Contracts Requiring Up-Front Payments

When a company enters into a firmly committed executory contract, management expects that the company will realize significant benefits from the contract. For example, an e-business retailer may believe that the value that it expects to realize from having a sponsorship button or hyperlink prominently displayed on the Web site of an Internet portal far exceeds its cost to obtain the right to display that sponsorship button or hyperlink. Nevertheless, it may be difficult to identify sufficient cash flows resulting directly from the purchased service to demonstrate that amounts paid under a contract are recoverable. As a result, in practice, companies have followed different approaches to accounting for the up-front payments associated with these contracts.

Asset or Expense?

Some companies have proposed to record up-front consideration paid under executory contracts as an expense of the period when paid, based on management’s belief that it could not demonstrate that the payment would be recovered out of future cash flows over the contract period. However, the SEC staff has become increasingly
uncomfortable with this accounting, and in a speech delivered at the annual AICPA/SEC Accounting Conference in December 1998, a representative from the Office of the Chief Accountant stated, “The staff is skeptical of arrangements where the accounting indicates that the company has given away value…” [emphasis added]. Since that time, the SEC staff generally has objected to immediate expense recognition for up-front payments because it believes that payments for these kinds of long-term contractual rights represent an asset that a company should capitalize and amortize to expense over the life of the contract as benefits are realized.

Generally accepted accounting principles define assets as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” Using this definition, the SEC staff would view cash paid in exchange for placing a hyperlink on another company’s Web site to be prepaid advertising costs that should be capitalized and amortized ratably over the contract period. Since its 1998 speech, the SEC staff has required some public companies to restate previously issued financial statements by capitalizing up-front payments that they originally had charged to expense.

In general, we have agreed with the SEC staff’s position that up-front payments made under executory arrangements usually represent the purchase of an asset, either a prepaid expense or an intangible right. However, there may be exceptions. The following examples illustrate both situations:

Internet Service Company (ISC) offers various services including online chat rooms and shopping. ISC enters into a contract with Broadcasting Company (BC), under which it becomes a premier partner, providing chat services on BC’s Web site for a period of three years. In addition, BC’s Web site will include a link to ISC’s Web site. As part of the agreement, ISC is required to make a significant up-front payment to BC.

ISC estimates that while the contract will create indirect advertising and product revenue from traffic that is routed to its Web site, the incremental advertising and product revenues that it receives over the life of the contract will be less than the sum of the required up-front payment, its estimated direct selling expenses and its costs of sales. Nevertheless, ISC believes that the contract with BC, tantamount to a marketing arrangement, will provide intangible benefits such as increased market access and ultimately a higher market capitalization.

Even though ISC management may not be able to identify expected incremental net cash flows sufficient to recover the full amount of its up-front payment, the company has purchased rights that it will receive over a three-year period. The contract entitles ISC to receive future economic benefits (in the form of a link from BC’s Web site) that ISC management expects will provide increased customer traffic to its own Web site. Ultimately, ISC management believes these benefits will translate into a higher market share. Furthermore, the value of these benefits was established in an arm’s-length negotiation between unrelated parties. Under these circumstances, we believe that ISC should capitalize the up-front payment as a prepaid asset and amortize it to expense over the contract period as ISC receives access to BC’s Web site to promote its own Web site.

LittleCo entered into an agreement with BigCo granting LittleCo the right to make a proposal to be the exclusive Internet service provider (ISP) for BigCo at some point in the future. LittleCo is required to make an up-front payment to BigCo in connection with this agreement. LittleCo does not receive a commitment or promise that it will become the exclusive ISP for BigCo; that is, BigCo reserves the right to reject LittleCo’s proposal.
In analyzing arrangements such as the LittleCo example, the SEC staff has concluded that an executory contract does not exist because companies such as LittleCo have no rights that they could seek to enforce in a court. Therefore, LittleCo’s payment does not create an asset because it does not have a future economic benefit that it controls (that is, it cannot control BigCo’s decision to accept or reject its proposal). LittleCo should charge its payment to expense immediately. We believe the instances in which an entity should charge an up-front payment to expense immediately will continue to be rare in practice, because generally companies are unwilling to exchange valuable assets for no consideration.

**Asset or Contra-Equity?**

When executory contracts require an up-front payment in the form of fully-vested, nonforfeitable warrants or other equity instruments in exchange for services that will be received over the life of the agreement, an additional question arises concerning how the capitalized amount should be presented in the company’s balance sheet. Generally accepted accounting principles require that a company issuing equity in exchange for a note receivable classify the note as an item of contra-equity in the issuing company’s balance sheet (that is, as a debit balance in shareholders’ equity or partners’ capital) until the note is collected in cash.

We believe that a promise to deliver goods or services in the future is similar to a promise to pay cash in the future. When a company exchanges its equity for either type of promise we would expect the accounting to be similar as well. Therefore, we believe the preferable approach would be to report amounts capitalized in connection with issuing fully-vested, nonforfeitable equity instruments, at the inception of an uncompleted service contract, as contra-equity in the issuing company’s balance sheet until the contracted services are delivered. However, we are aware that the SEC staff also has accepted presenting the capitalized amount as an asset in recent filings and, accordingly, we would not object to either approach as long as a company discloses its accounting policy and applies it consistently to all similar transactions.

At the July 2000 EITF meeting, the SEC staff announced (in Topic D-90) that it no longer would accept the practice of recording an asset and related equity upon issuance of nonvested, forfeitable equity instruments to nonemployees at the beginning of an arrangement (that is, before any services have been received). The staff believes that those instruments should be treated as unissued for accounting purposes until the future services are received. The SEC staff announcement does not comment on the accounting for situations in which services are received throughout the period, even though the contract states that the equity is not vested until all services are received.

We believe that if forfeitable equity instruments that a company exchanges for goods or services vest only when all contracted goods or services have been received, a company still should account for goods or services as they are received. In our view, all credit balances that result from this accounting should be recorded in equity to the extent that the company’s obligation to pay for goods and services will be satisfied only with equity instruments. (See “Using Equity Instruments as Currency” on page 51 for a discussion of related issues.)
Amortization of Assets Capitalized

Payments required by executory contracts may or may not coincide with performance by the other party to the contract. When such payments precede the receipt of benefits or services, they should be capitalized as discussed above. Whether the capitalized asset represents a prepaid expense or an intangible right, it will need to be amortized to expense in a rational and systematic manner over the period of benefit.

When a company makes a substantial payment at the beginning of an agreement to obtain services such as advertising or insurance coverage, the service contracted for is received ratably throughout the term of the contract. A prepaid asset associated with such services (for example, displaying a sponsorship button or hyperlink on another company’s Web site for five years) should be amortized to expense ratably over the benefit period. The company would not begin to amortize the prepaid expense until it begins to receive the benefit. For example, if a Web site including a hyperlink is not launched until six months after the up-front payment is made, amortization would not commence until the launch date. On the other hand, when service is delivered in discrete increments (for example, thirty-second advertising spots at each of the next three Super Bowls), an appropriate portion of the prepaid asset should be charged to expense during each period in which a benefit is received.

In contrast with a payment for services, when a company makes a substantial payment at the beginning of an agreement to obtain a right, the resulting intangible asset should be amortized to expense over the period of expected benefit. We believe the straight-line method should be used unless another pattern more closely approximates the use-benefit pattern for the asset. Although the amortization period usually would be the entire term of the contract, occasionally it may be appropriate to use a shorter period if the expected useful life of the acquired intangible asset is less than the term of the contract.

Impairment of Assets Capitalized

Some amounts capitalized under firmly committed executory contracts represent prepayments for services not yet delivered. As noted above, even if a company had agreed to pay more than fair value for a service to be delivered in a future period, the cost of the service would be reported at the agreed-upon amount in the period in which the service is received. As a result, assets comprising prepaid expenses are not subjected to impairment testing under generally accepted accounting principles because they represent payments for services not yet received. Therefore, before the company receives the services, we do not believe it would be appropriate to write off as expense a portion of a prepayment deemed to represent an overpayment for services to be received in the future. In those rare instances in which the service provider is unwilling or unable to perform its future obligations under the agreement, and the company has no viable alternatives available to recover amounts previously paid, a write-off of a prepaid asset would be appropriate. However, such write-offs would be more in the nature of a bad debt loss than an impairment loss in any case.

Other amounts capitalized under firmly committed executory contracts represent intangible assets. Such assets might include agreements granting exclusivity rights and agreements providing access to patents or technology. Assets of this type generally would qualify as identifiable intangible assets and, therefore, would be subject to impairment testing under FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.
Statement 121 requires that a company test its long-lived and identifiable intangible assets for impairment whenever events or changes in circumstances suggest that the carrying amount of the asset may not be recoverable. A long-lived or intangible asset used in a company’s operations is deemed to be impaired if undiscounted net cash flows expected to be realized from using the asset over its remaining estimated useful life are less than the unrecovered cost or carrying value of the asset. A company is required to write an impaired asset down to its current fair value and report an impairment charge in its income statement in the period in which it is first determined to be impaired.

When testing for impairment, Statement 121 requires that a company project undiscounted cash flows at the lowest level at which cash flows associated with the asset being tested for impairment can be identified separately from the cash flows associated with other groups of assets. When it is not possible to identify cash flows at a lower level, a company is required to consider cash flows other than interest charges at the entire enterprise level in its impairment analysis.

In many instances, e-business companies have been unable to identify cash flows associated with capitalized intangible assets at any level below that of the entire company because the benefits management expects to be realized from the asset are not limited to the direct, incremental advertising revenue or sales generated from the relationship. Often, an estimate of direct cash flows from these sources alone would have led to a conclusion that the asset was impaired at the inception of the contract. However, the SEC staff has indicated that management should not record an impairment loss on a capitalized up-front payment unless it can demonstrate that conditions have clearly changed since management executed the contract. As a result, we have seen relatively few impairment charges relating to these assets.

Some agreements requiring an up-front payment also obligate a company to provide additional services over the term of the contract in order to be entitled to the benefits of the arrangement. For example:

Entertainment Company is seeking to increase traffic to its Web site. Therefore, in addition to an up-front payment, Entertainment Company agrees to provide specified entertainment news content to TV News Station’s Web site. TV News Station agrees to provide a hotlink from the content back to a specific Web page on Entertainment Company’s Web site.

If the additional traffic generated from this relationship does not produce sufficient incremental revenue to cover the cost of providing and maintaining the required content, management may negotiate to modify or terminate the contract. When a contract that gave rise to a capitalized up-front payment is terminated early, any unamortized balance remaining at the date of termination should be written off to expense. Likewise, when such a contract is modified, management should consider the effect of the modification on the expected future benefits to be derived from the contract and the need to write off some or all of the remaining unamortized balance if those benefits have been reduced significantly as a result of the changes.

Continuing with the above example, even if Entertainment Company had no ongoing obligations related to the contract, if traffic coming to Entertainment Company’s Web site as a result of its arrangement with TV News Station is not sufficient to recover its costs, Entertainment Company may decide to close that Web page, thereby effectively abandoning the benefits to be received under the contract. Although, technically, TV
News Station could continue to provide the services contracted for throughout the remaining term of the agreement (maintain hotlink), we believe that Entertainment Company should write off the remaining unamortized balance of any up-front payments capitalized with respect to such a contract in the period it actually abandons the specific Web page. However, if management of Entertainment Company chose to continue to maintain the Web page, thereby making it possible for traffic to come to its own Web site from TV News Station, we do not believe that it ordinarily would be appropriate to report an impairment charge relating to this asset.

**Contracts Without Up-Front Payments**

Certain executory contracts, such as operating leases and royalty agreements, may obligate a company to make a series of payments over the term of the agreement. Under generally accepted accounting principles, companies typically do not record obligations to make future payments under executory contracts as long as they remain equally unexecuted by both parties—that is, as long as both parties have future obligations to perform that are of approximately equal value. For example, when rents due under an operating lease are equal for all periods, neither lessee nor lessor records an asset or liability related to the lessee’s obligation to pay rent unless the lessee is early or late in making a payment. This is true even when the contract is something other than a lease and the timing and amount of payments due under the contract are fixed and firmly committed.

However, when contracts of this type do not generate the incremental benefits management expected when it negotiated the agreement, or when the market value of the purchased benefit declines below the level of the payments required under the contract, some companies have proposed to accrue a liability for some or all of the remaining future payments and report an equal amount of loss in their income statement. Consider the following example:

SportsNews Internet Company (SIC) enters into a Web site content licensing agreement with Athletic Shoe Company (ASC). ASC agrees to allow SIC to place its logo and a hotlink to SIC’s Web site on ASC’s Web site in exchange for minimum royalties to be paid by SIC over a period of two years. ASC’s market share declines steadily during the first year. As a result, the number of hits received by SIC’s Web site has been far below the original estimates.

By the end of the first year of the agreement, it would be clear to management of SIC that the benefits it can expect to receive during the remaining term of this contract are likely to be significantly less than it expected when it agreed to a minimum level of royalties. Nevertheless, we believe that the SEC staff would object to SIC’s accruing a liability and reporting a loss at the end of year one for all or a portion of the minimum royalty payments required during year two unless SIC management chooses to abandon the arrangement and remove its logo and hotlink from ASC’s Web site.

The issue of accounting for expected future losses on executory contracts has been on the EITF’s agenda for more than a year in the form of Issue No. 99-14. We support the view articulated in the Issue No. 99-14 Issue Summary that estimated losses on firmly committed executory contracts to deliver goods or services in the future meet the definition of a liability under generally accepted accounting principles and that such losses should be recognized when changes in circumstances indicate that future revenues expected under the contract will not be sufficient to recover estimated costs to be incurred under the contract. However, we believe the SEC staff supports the view...
that it is permissible to recognize a loss on a firmly committed executory contract only when specific authoritative accounting literature requires such accounting. Until this matter is resolved by the EITF, we believe that recognizing a loss (and accruing a corresponding liability) related to executory contracts will continue to be rare except when a company abandons its rights under the contract, or effectively abandons a portion of its right as a result of a significant contract modification.
Web Site Development Costs – Can I Capitalize Them?

Web sites have become vital to many companies’ operations or future business direction. Companies continue to build and enhance their Web sites, and as hardware and software technology continues to advance, the costs to develop and support a Web site can escalate quickly. We believe that the amount of internal-use software that is developed and capitalized as a result of Web site development efforts will increase substantially over the next few years. Increasingly, companies are using outside consultants either to develop or maintain their sites. Historically, many companies have not tracked the nature and amount of the Web site development costs that they incur, and they may need to implement procedures to ensure appropriate reporting of such costs in the future.

Web site development activities generally fall into three stages:

1. **Planning stage activities** include developing a project or business plan that outlines the goals for the Web site; determining the functionality (for example, order placement, search engines, and chat rooms); identifying hardware and software applications that will achieve functionality, security, and traffic flows; and selecting external vendors.

2. **Application and infrastructure development stage activities** focus on acquiring or developing hardware and software to operate a Web site.

3. **Operating stage activities** address training, administration, maintenance, and all other activities to operate an existing Web site.

Depending on the stage of the Web site development project and, in some cases, the nature of the costs, certain items may either be capitalized or recorded as an expense. Management will need an in-depth knowledge of the Web site development process before it can determine the appropriate accounting for these expenditures.

As Web sites become more complex, companies are turning to highly skilled outside consultants to design, develop, or maintain their sites. This trend towards more outsourcing indicates a need to monitor carefully the components of invoices from third-party vendors to ensure that Web site development costs are properly capitalized or charged to expense, as appropriate, based on the nature of the expenditures.

**New Accounting Guidance**

The EITF considered the accounting for certain Web site development costs in Issue No. 00-02. The accounting for planning stage costs is relatively straightforward—a company should record all costs as expense as the company incurs the costs. Similarly, a company will record as expense *most* of the costs of operating a Web site as they are incurred. The exception will be costs that a company incurs to upgrade or enhance the Web site, that is, to provide additional functionality or features. A company must capitalize costs to enhance or upgrade the site in accordance with the requirements of SOP No. 98-1, if applicable. Determining whether a change upgrades or enhances, rather than maintains, the Web site may require that management apply significant judgment based on the specific facts and circumstances.

Accounting for application and infrastructure development stage costs is more complex, at least in part because the software tools that are used to create Web pages continue to expand and change rapidly. Companies must understand the nature of these tools and must be able to distinguish between the creation of content and the creation of graphics.
Some of the rules for application and infrastructure development costs seem intuitive. A company generally should capitalize the following items:

- The costs to acquire and install hardware to operate a Web site (including Web, application and staging servers; and networking routers and switches);
- Costs to obtain and register an Internet domain name;
- Up-front payments for software that it licenses from a vendor to operate its Web site, including the server operating system, Internet server, Web browser, database, middleware, predesigned storefronts, and security software; and
- Costs to develop internally or to customize licensed software. Internally developed software or customized software may include site search engines, customized database software, shopping cart programs, software to integrate distributed applications, interfaces to corporate databases or accounting systems, and certain graphics.

A company generally should charge to expense application and infrastructure costs paid to third parties for hosting arrangements. In addition, costs that a company incurs to restructure operations to integrate the Web site with existing operations are outside the scope of EITF Issue No. 00-02, but generally should be charged to expense in accordance with EITF Issue No. 97-13, which addresses business process reengineering and information technology transformation.

Application and Infrastructure Development Costs – Distinguishing Between Graphics and Content

In contrast to the specific types of application and infrastructure development costs discussed above, applying the rules related to capitalization of costs incurred for other types of application and infrastructure development costs such as graphics and content is complex. Graphics and content are distinguished as follows:

**Graphics** — Graphics involve the overall design of the Web page (including borders, background and text colors, fonts, frames, and buttons) that affect the *look and feel* of the Web page and generally remain consistent regardless of changes made to the content.

**Content** — Content refers to information that is included on the Web site; for example, articles, product photos, maps, stock quotes, and charts.

While it is not possible to distinguish definitively between Web site graphics and content without a detailed knowledge of a specific Web site, we have identified a few key attributes to assist companies in making the distinction:

- Content often resides in a database rather than being part of the software code.
- Graphics generally are more permanent than content (graphics should have a life greater than six months) and comprise the unique look and feel of a company’s Web site.
- Digitized photographs are not created using software and thus are excluded from the EITF’s definition of graphics.

In general, a company is required to capitalize graphics because the Web page design is created using software code (HTML or XML) either directly or through the use of an HTML editor. Existing accounting rules require a company to capitalize the costs
associated with internal-use software projects. In practice, companies may not be capturing and capitalizing the costs of graphics, either because the costs are not material or the Web site graphics change frequently (thus, the cost of capitalizing and amortizing may exceed the benefit).

**Content**

In contrast to graphics, content such as images, video, or sound often resides in a database that is integrated into (or linked to) the Web page through Web server and database software, or is coded directly into the Web page. Content includes information like charts or stock quotes that can be viewed through the Web site in real time. A company must update content frequently to keep viewers coming back to the site, although some content can have an extended useful life.

Web site content may not be used solely on the site. For instance, an eye-popping graphic (which is not part of the look and feel of a Web site) may appear on a Web page and also may be used in a company’s advertisements and brochures. EITF Issue No. 00-20 will address the accounting for database content and other collections of information. However, the scope of the discussion is expected to exclude certain collections of information, such as content used for advertising or administrative purposes.

In the pre-Internet world, a company’s databases enabled management to perform trend analysis of historical data, but the information often did not have a ready market or use outside of the company. Database content traditionally has not been viewed as an asset. With the evolution of the Internet and improvements in database technologies, enterprises increasingly generate revenues by selling or leasing access to vast collections of database content and other collections of information. A database may contain a wide variety of content, including, but not limited to, financial data, words (for example, articles and books), digitized photographs, maps, videos, music (MP3), Java™ applets, charts, graphs, software applications or graphics. Examples of collections of information might include a doctor’s patient files and an employee phone listing that is updated in hard copy each year.

Companies are addressing whether the costs they incur to acquire or originate information for database content should be capitalized as an asset and amortized or simply recorded as an expense when incurred. If the database content has a very short useful life, for example, one month, it may not be worth the effort to capitalize and amortize an asset. EITF Issue No. 00-20 also is addressing how a company should account for subsequent costs to maintain and refresh information, if a company capitalized the costs to acquire or originate the database.
Development Costs for Software Hosting Arrangements – Asset or Expense?

(Refer to page 35 of this publication for a detailed discussion of software hosting arrangements.)

If a vendor’s hosting arrangement is deemed to be, in substance, a software agreement, the host should record as research and development expense the cost to develop or purchase the software, until it establishes technological feasibility of the product. Management of a company achieves technological feasibility for a product when it completes a detail program design or a working model. After that point, it should capitalize all software development costs incurred until the product is available for general release. Capitalized costs should be amortized over the useful life of the software.

If the hosting arrangement is deemed to be, in substance, a service contract it is presumed to be software developed or obtained for internal use. The company should capitalize as an asset the cost related to that software in accordance with SOP No. 98-1. The company should begin to amortize the software asset when the software is ready for its intended use, regardless of whether the software has been placed into service. Thus, it is possible that a vendor providing software hosting that is, in substance, a service contract may begin to amortize the cost of the software before it records revenue from hosting the software. For example:

In September 2000, ASP purchases an enterprise software package from Software Manufacturer. ASP plans to offer the software to its customers via a hosting service beginning in January 2001 whereby customers have unlimited access to the software but do not have the ability to take possession of the software. It is not necessary for ASP to customize or modify the enterprise software package before it offers its product to its customers.

ASP should capitalize the cost of the enterprise software and amortize it beginning in September 2000. At that point the software is ready for use, even though the service contracts with customers do not commence until January 2001.
Section Five – Transactions in an Entity’s Own Stock

Using Equity Instruments as Currency – What Do They Cost?

In today’s marketplace, companies often issue equity instruments to nonemployees in exchange for goods or services. This practice is especially common among e-business start-ups, which view the use of equity as a logical alternative to more traditional forms of consideration. In fact, for those with limited cash flow, equity instruments often are the only currency available to obtain vital goods and services. On occasion, vendors and service providers will request equity participation from emerging businesses. In this environment, companies may, for example, issue shares of their stock or warrants instead of paying cash to a(n):

- Landlord for a facilities lease;
- Law firm for legal services;
- Search firm for placement of employees;
- Software vendor for a license to an enterprise software system;
- Customer or reseller as a reward for achieving a specified volume of transactions;
- Public relations firm at the completion of each milestone in a specified campaign;
- Internet company in exchange for a one-year banner advertisement on its Web site;
- Technology systems consulting firm in exchange for customer referrals for a particular software package; or
- Construction firm after timely completion of a project.

Although these transactions do not require the company to make a cash outlay, they do have an inherent cost and, unlike the cost of many employee stock compensation plans, these costs must be measured and reported in the issuer’s financial statements.

The accounting standards in this area are extremely complex. If management of a growing company is to avoid unexpected volatility in future income statements, it needs to understand and consider the rules when negotiating agreements that involve issuing equity instruments to its vendors or customers. To determine the accounting consequence of using equity instruments as consideration for goods or services, management needs to understand the following:

- How the cost associated with an issuance of equity is measured for accounting purposes;
- When that cost is recorded; and
- How that cost is reported in the financial statements.

These issues arise in all situations in which a company provides equity instruments to nonemployees (referred to herein as recipients), whether to acquire goods or services or to encourage customers to generate increased sales.
Generally, companies record these equity transactions the same as if they had paid cash for the goods or services or used cash rebates as a sales incentive. Because the business purpose of these arrangements usually is to compensate or to provide performance incentives to the recipient, the equity instruments often are structured to vest as the recipient performs on its side of the arrangement. The accounting standards generally require that these transactions be recorded as expense in the financial statements based on the fair value of the equity instruments measured at the date or dates they vest, not on the dates they are issued. For example, if a recipient becomes entitled to an award of equity instruments upon completion of performance on the last day of a contract, the expense is measured on that day. Alternatively, if a recipient becomes entitled to portions of an award at the end of each year, as services are rendered under a multi-year contract, the company measures corresponding portions of that expense each year at the respective vesting dates.

Therefore, unlike payments made in cash, the ultimate cost of issuing equity instruments to nonemployees for these transactions may not be known until the recipient’s performance is complete. For a company whose stock price rises during the term of the arrangement, the costs of the goods or services may be much higher than originally anticipated. This effect may be of particular concern to a company that completes an initial public offering before the equity instruments vest.

**How the Cost Associated with an Issuance of Equity Is Measured for Accounting Purposes**

Under generally accepted accounting principles, a company that grants equity awards to nonemployees for goods and services should measure those instruments at the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably determinable. Generally, companies are required to use the value of the equity instruments that they issue, because that value can be determined more reliably than the value of the goods or services they receive. A company should determine the fair value of equity instruments, including grants of common stock, restricted stock, stock options, and stock purchase warrants, using:

- The market price, if the equity instruments are publicly traded;
- Valuation techniques, if the equity instruments are privately-held or are non-listed securities of a public company;
- An option-pricing model (as described below), if the equity instruments are warrants or options.

An option-pricing model employs a mathematical formula to estimate fair value of a stock option or warrant. The most commonly used option-pricing model is the Black-Scholes Model, which computes the value of an option based on the exercise price, the current stock price and expected volatility (price fluctuation) of the underlying stock, the expected term of the option (which in almost all cases is the contractual term for a warrant granted to a nonemployee option), the risk-free interest rate based on the expected expiration date, and the expected dividend rate on the underlying stock. A company is not required to use the Black-Scholes Model; it can choose from other similar models. However, it may not use the intrinsic value method or the minimum value method to value options or warrants that it issues to nonemployees in exchange for products and services, because those methods do not consider the effect of volatility, among other things and, therefore, do not measure fair value.
When that Cost Is Recorded

EITF Issue No. 96-18 provides guidance concerning the appropriate date on which to measure and record the cost of these transactions. A company should measure the fair value of the equity instruments at the earlier of the date on which the recipient completes performance or the date on which a performance commitment is reached. A performance commitment exists if it is probable that the recipient will perform under the contract, because the recipient is subject to disincentives in the event of nonperformance that are sufficiently large to make performance appear probable at the outset of the arrangement. Unless a contract contains a performance commitment, the total cost of the transaction ultimately will equal the fair value of the equity instruments at the date or dates on which the recipient has completed the performance necessary to earn the instruments. Usually, that date will coincide with the date on which the equity instruments vest and are no longer forfeitable.

During reporting periods before the completion of performance, a company should estimate the cost of an unvested equity grant based on the fair value of the equity instruments at each interim date (using the valuation method applied in prior periods) and account for the portion of the services that the recipient has rendered to date using that estimate. Changes in a company’s share price will result in adjustments to the reported costs of goods and services each period until performance is complete.

The requirement to remeasure the cost of equity instruments periodically over the performance period often results in earnings volatility. That is, increases or decreases in share price result in changes in the fair value of the equity instruments and the corresponding expense, sales discount or other financial statement item that management must record. To avoid uncertainty caused by the potential for significant changes in the price of a company’s stock, and to fix the cost of goods and services obtained in exchange for equity instruments issued, some companies have structured transactions to measure the value of the equity instruments at the date of issuance. The most common structures include the following:

- Equity instruments that are fully-vested, nonforfeitable and:
  - exercisable at the grant date,
  - exercisable at some future date, or
  - exercisable at some future date unless a performance target is reached, at which time they become exercisable immediately;
- A significant penalty that is payable by the recipient in the event of nonperformance under the contract (that is, a performance commitment).

Issuing Fully-Vested, Nonforfeitable Equity Instruments

Some companies have elected to grant equity awards that are fully-vested, nonforfeitable and exercisable at the commencement of a contract. No performance is required for the recipient to be entitled to the equity instruments. If nonforfeitable equity instruments vest on the date they are issued without further condition, a company should measure their fair value on that date and record this fixed amount as an asset, expense or sales discount in the financial statements over the expected period of benefit. The terms of the contractual arrangement will dictate how the company recognizes the benefit over the contract period, which should be no different from the manner in which the company would recognize the benefit if the company had paid cash instead of issuing equity instruments. (For additional discussion of contracts with large up-front payments, see “Contractual Arrangements” on page 39.)
From a business perspective, granting fully-vested, nonforfeitable equity instruments to a recipient who has no future performance obligations may not be attractive to a company. In an attempt to alleviate concerns about whether a recipient performs while fixing the cost of the equity award at the time it is granted, some companies structure equity instruments such that, although they are fully vested and nonforfeitable at the date they are issued, they cannot be exercised until a future date. However, the delay in the recipient’s ability to exercise has limited value as a performance incentive. As an alternative, equity instruments may be structured to accelerate exercisability if certain performance targets are met. This approach still fixes the measurement of the cost of the award at the issuance date, while providing some performance incentive for the recipients through acceleration of exercisability if specific milestones are achieved.

For example:

Internet Search Company enters into an affiliation agreement with Travel Agency. The agreement provides for Travel Agency to grant Internet Search Company fully-vested, nonforfeitable warrants to purchase Travel Agency stock. In return, Internet Search Company agrees to refer customers to Travel Agency. If Internet Search Company refers an aggregate of 5,000 customers to Travel Agency, the warrants become exercisable immediately. Otherwise, the warrants are exercisable after three years.

Travel Agency fixes the cost of this transaction at the date the warrants are issued because it does not condition the ultimate receipt of the warrants on achieving a particular level of performance—that is, Internet Search Company may exercise the warrants at the end of three years, regardless of whether it refers customers to Travel Agency. In contrast, if the warrants granted to Internet Search Company cannot be exercised unless it refers at least 5,000 customers, the cost of this transaction would not be measured until performance was complete, in this case, when Internet Search Company referred its 5,000th customer.

The EITF currently is considering the need for further guidance on transactions with accelerated exercise dates, and has added Issue No. 00-18 to its agenda to address this subject. The outcome of this issue could cause the accounting for these arrangements to change.

The following scenarios illustrate the effects of accounting for equity instruments at different measurement dates (assume the following facts apply to each of the scenarios below):

Internet Company contracts with Marketing Company to run a media campaign for its new Web site. In exchange, Internet Company will grant Marketing Company 3,000 warrants to purchase Internet Company stock. The media campaign commences at the contract date and lasts for three months. The fair value of the warrants, calculated using a Black-Scholes option-pricing model, is as follows:

- $1.00 per share at the date that the contract is signed;
- $1.25 per share at the end of the first month;
- $1.50 per share at the end of the second month;
- $2.00 per share at the end of the third month.
**Scenario 1:** The contract states that Marketing Company’s performance is complete only at the conclusion of the campaign. Therefore, all of the warrants vest at the end of the three-month campaign. The contract does not contain a *performance commitment*.

Internet Company would record total marketing expense of $6,000.(1)

**Scenario 2:** The contract states that Marketing Company will perform in ratable monthly increments over its three-month term. Therefore, 1,000 warrants vest at the end of each month. The contract does not contain a *performance commitment*.

Internet Company would record total marketing expense of $4,750.(2)

**Scenario 3:** Marketing Company earns the warrants granted as consideration for entering into the contract. The warrants granted are fully vested and nonforfeitable at the date the contract is signed. No future performance is required to receive the warrants. Pursuant to the terms of the contract, Marketing Company also is required to run a media campaign.

Internet Company would record total marketing expense of $3,000.(3)

**Scenario 4:** Marketing Company earns the warrants granted as consideration for entering into the contract. The warrants granted are fully vested and nonforfeitable at the date the contract is signed. No future performance is required to receive the warrants. Pursuant to the terms of the contract, Marketing Company also is required to run a media campaign. The warrants cannot be exercised for three years. However, Marketing Company will be able to exercise the warrants immediately if Internet Company’s sales increase by more than 25 percent in any month during the campaign.

The accounting in this situation is the same as in Scenario 3—Internet Company would record total marketing expense of $3,000. Based on current practice, the three-year restriction on exercisability does not preclude Internet Company from measuring the cost of the warrants at the date they are issued. Likewise, the acceleration of the exercise date upon achievement of the 25 percent increase in sales would not result in a new measurement of cost.

As the above scenarios illustrate, the timing of performance and vesting of equity instruments can make a significant difference in the total cost that a company recognizes, especially if its stock price is volatile.

Some contracts specify that the terms of the equity instruments, such as the quantity to be granted or the contractual strike price, are contingent on the outcome of one or more future events. These events may include market conditions (for example, the company’s stock price attains a specified target) or performance conditions (for example, the company attains a specified increase in market share). The application of EITF Issue No. 96-18 to such instruments is even more complex than the situations described herein and beyond the scope of this publication. However, management that is considering including such provisions in an agreement may benefit from consulting with its accounting advisors before agreeing to final terms if it wants to avoid unintended accounting consequences.

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(1) $6,000 = $2.00 x 3,000.
(2) $4,750 = $1,250 ($1.25 x 1,000) + $1,500 ($1.50 x 1,000) + $2,000 ($2.00 x 1,000).
(3) $3,000 = $1.00 x 3,000.
Performance Commitments

Even if the recipient has to perform in the future either to earn (vest), or avoid forfeiting the instruments, EITF Issue No. 96-18 provides that the issuer can measure the cost of the instruments before performance is complete if the recipient has a performance commitment. As noted above, a performance commitment exists if it is probable that the recipient will perform under the contract, because the recipient is subject to sufficiently large disincentives in the event of nonperformance.

Whether disincentives in the event of nonperformance are sufficiently large to create a performance commitment is a matter of judgment that requires a careful analysis of the specific facts and circumstances of each situation. To determine that a disincentive is sufficiently large to deter nonperformance, an entity must make a quantitative and qualitative analysis of the terms of each arrangement relative to the probability of counterparty performance. Simply forfeiting the unvested equity instruments or future cash payments that the recipient is scheduled to receive for performing would not constitute a sufficiently large disincentive for purposes of measuring the cost of the equity instruments; neither would a recipient’s risk of being sued for nonperformance under the terms of the contract provide a sufficiently large disincentive. A requirement to pay a substantial penalty in addition to forfeiting the other consideration in the arrangement could qualify as a sufficiently large disincentive if it reasonably can be expected to cause the recipient to continue to perform under the contract regardless of changes in the value of the equity instruments. In assessing significance, the issuer generally should consider the amount of the penalty relative to the value of the overall transaction and relative to the overall size of the recipient. For example, even if a stated penalty is significant to the value of the transaction, it may not be sufficient to cause a large company to perform under the contract, but it may be sufficient to cause a smaller company with fewer resources and fewer alternative sources of revenue to perform.

Scenario 5 (continuing with the facts assumed above): The contract includes a provision stating that Marketing Company will forfeit all warrants if it fails to perform under the contract.

Marketing Company has no performance commitment. There is no disincentive for failure to perform because the only consequence of nonperformance is losing the warrants attributable to the remaining months of the campaign. Under these circumstances, Internet Company would measure the value of the equity instruments at the date that performance is complete.

Scenario 6 (continuing with the facts assumed above): The contract includes a provision stating that, in addition to forfeiting the warrants, Marketing Company also would be required to pay a $5,000 penalty if it fails to perform under the contract. Internet Company has evaluated the facts and circumstances and has determined that this penalty is a sufficiently large disincentive in the event of nonperformance to make performance probable.

Even if Marketing Company decides that the value of the warrants is not sufficient to compensate it for the time it is spending on the campaign, Marketing Company is considered to be likely to continue to perform under the contract because nonperformance will result in forfeiture of the warrants and an additional cash penalty. Because the penalty has been assumed to provide a sufficiently large disincentive in the event of nonperformance, the contract contains a performance commitment. Therefore, the cost attributable to these warrants can be measured and fixed at the date they are
issued under the contract even though Marketing Company must meet performance goals to earn the warrants. Companies may want to consider consulting with their accounting advisors for assistance in determining what constitutes a sufficiently large disincentive.

**Scenario 7:** The contract has no penalty clauses, but states that Internet Company will pursue breach of contract in accordance with the state laws if Marketing Company fails to perform under the agreement. Internet Company’s attorneys advise it that legal action will result in Marketing Company’s being required to perform under the contract or to forfeit the warrants. Internet Company intends to pursue litigation, if necessary.

Based on the attorney’s conclusions, this contract does not include a *performance commitment* because Marketing Company is not subject to a significantly large disincentive in the event of nonperformance—at worst, Marketing Company must continue to perform as originally contracted. Furthermore, a peripheral risk arising from the litigation, such as the potential for negative publicity for Marketing Company, is not considered to be a significant disincentive in most situations.

We believe it would be rare that a company will be able to satisfy the requirements for a *performance commitment* absent a substantial liquidated damages penalty for failing to perform. Most recipients are not willing to commit to contracts that contain significant actual and potential cash or near-cash penalties over and above the consideration that they must forego if they fail to perform. This is particularly true when the sole form of consideration they are receiving is equity instruments, which expose them to the full risk of future changes in the issuer’s stock price. We believe that the mere fact that the recipient contractually agreed to a penalty may indicate that the amount of the penalty would not be significant to the recipient.

Therefore, given the difficulty in structuring contracts to achieve a *performance commitment*, the final measure of expense for equity instruments subject to forfeiture for nonperformance most often will be based on the fair value of the equity instruments at the date the recipient completes performance.

**How that Cost Is Reported in the Financial Statements**

EITF Issue No. 96-18 states that an asset, expense or sales discount should be recognized in financial statements of the issuing company in the same period and in the same manner as if the company had paid cash for the goods or services or used cash rebates as a sales discount instead of issuing equity instruments. Thus, a company should consider the nature of what it received in the transaction to determine the appropriate period in which to recognize the cost and the appropriate line item in which to report it in its financial statements. For example:

A company issues equity instruments to a software vendor for a license to an enterprise software system to be used internally by the company.

The company should capitalize internal-use software at the fair value of the equity instruments that it issued and should amortize the amount capitalized over the expected useful life of the software.

A company issues equity instruments to a public relations firm at the completion of each milestone in a specified campaign.
The company should record advertising expense equal to the fair value of the equity instruments. If the measurement date precedes performance, the cost should be established as a prepaid asset and recognized ratably as a charge to earnings throughout the period of service. If the measurement date is at the conclusion of performance, interim estimates of advertising expense should be recognized throughout the period of service and adjusted for changes in fair value until performance is complete.

A company issues equity instruments to a customer for every $50,000 in orders that the customer places.

The Company should record the fair value of the equity instruments as a sales discount, thereby reducing the revenue reported on the transaction.

The EITF also concluded in Issue No. 96-18 that the asset, expense or sales discount that the company recognized should not be reversed if an equity instrument that a recipient has the right to exercise expires unexercised.

**Accounting by the Recipient of the Equity Instruments**

The discussion above focuses on the accounting by the issuer of equity securities in exchange for goods or services. In Issue No. 00-08, the EITF addressed the accounting by the recipient of those equity instruments and, in general, determined that the accounting by the issuer and the recipient should be symmetrical. Similar to the accounting under EITF Issue No. 96-18, a company that receives equity instruments in exchange for goods or services should record that transaction at the fair value of the products or services provided or the fair value of the equity instruments received, whichever is more readily determinable.

Assuming for the remainder of this section that the fair value of the equity instruments received is more readily determinable, a recipient should determine the amount of revenue that it will record based on the fair value of the equity award at the earlier of (1) the date the parties come to a mutual understanding of the terms of the arrangement and a performance commitment is reached or (2) the date at which the recipient has performed as necessary to earn the equity instruments (that is, the vesting date). The earlier of these dates is referred to as the measurement date.

EITF Issue No. 00-08 does not address explicitly when the recipient should record revenue. The EITF did observe, however, that a recipient should record revenue or deferred revenue (a liability) in the same period and in the same manner as if it received cash instead of equity instruments for the products or services. The requirement to record a liability or deferred revenue implies that the recipient also would record a corresponding investment asset.

We believe that the recipient should estimate the fair value of the award at reporting dates between the date on which the instruments are granted and the measurement date. The amount of revenue to be recorded in a given reporting period would be based on the fair value of the equity instruments at the reporting date, multiplied by the percentage of the services rendered to date, less any revenue recognized in earlier periods. If the fair value of the equity instruments is volatile, there may be significant fluctuations in the revenue from period to period before the measurement date.
Arguably, this result may not produce the most useful information for financial statement users. For example:

Service Provider receives 100,000 warrants on January 1, 2000, in exchange for providing consulting services delivered evenly over a six-month period. The arrangement does not include a performance commitment. All warrants vest only upon completion of the engagement. The fair value of the award is $100,000 on January 1 (the grant date), $1 million on March 31, and $200,000 on June 30 (the measurement date). At March 31, half of the project is complete.

Service Provider records revenue based on the fair value of the warrants at the end of each reporting period until Service Provider completes its performance on June 30. At March 31, Service Provider records earned revenue of $500,000 based on completing 50 percent of the project to date. When the project is finished, Service Provider reduces earned revenue for the quarter ended June 30 by $300,000 to record total revenue year-to-date for this project of $200,000, which represents the fair value of the equity instruments at the time performance is complete. While some may find the volatility reflected in this example to provide results that are counterintuitive or of questionable value to users of the financial statements, we believe companies must follow the approach illustrated in the example above to comply with the EITF’s consensus.

Once an entity has recorded equity instruments received at their fair value, it should account for the resulting asset as an investment in an equity instrument using the cost method, the equity method or the fair value method as appropriate. Accounting for an investment under the cost and equity methods is discussed further in “Investments in Alliances” in Section Six. Accounting for the investment under the fair value method, which generally would be required only for publicly-traded equity securities, will result in fluctuations in equity or earnings each period.

Some contracts specify that the terms of the equity instruments, such as the quantity to be granted or the contractual exercise price, are contingent on the outcome of one or more future events. The application of EITF Issue Nos. 96-18 and 00-08 to such instruments by recipients is even more complex than the situations described herein and beyond the scope of this publication. Management may want to consider consulting with its accounting advisors when structuring these types of arrangements.
Transactions in Privately-Issued Equity Securities – How Do You Value the Securities?

To record purchase business combinations and certain stock-based compensation arrangements, a company is required to determine the fair value of the stock that it issues in those arrangements. In general, it is relatively easy for management of a publicly-held company to determine the value of its common stock, because it can rely on quoted prices derived from trading in an active market. In contrast, stock issued by a nonpublic company and certain restricted or preferred stock of a public company may not have a readily observable fair market value.

These valuation issues become particularly sensitive for a company that is about to undertake an IPO. The SEC staff likely will compare the estimated offering price per share with the price that the company assigned to equity transactions during periods before the IPO. In many instances, the SEC staff has asserted that a difference between the two prices indicates that the transactions before the IPO may not have been recorded at fair value. Discussions with the SEC staff on this matter can delay the filing process and may result in the company restating its financial statements for prior periods. If the SEC staff challenges management’s assertion that there are justifiable differences in the prices assigned to pre-IPO transactions and the estimated offering price, the company will be required to substantiate its assertion using objective evidence to support the values of the pre-IPO transactions.

If there is no market for a company’s stock, there are several valuation techniques that provide objective evidence of the value of equity securities:

- Cash transactions with a third party involving similar equity securities;
- An independent valuation of an entire company;
- Comparable transactions of other companies; and
- Valuations performed by the company.

We understand that, in general, the SEC staff assigns relatively less standing to the last two techniques in the list. Depending on the facts and circumstances, however, those techniques may be appropriate; for example, if they are used by a company that is relatively early in its life cycle.

Cash Transactions

A cash transaction with an independent third party involving similar equity securities is the strongest objective evidence of fair value. In contrast, an equity transaction with an existing stockholder, other related party, or strategic investor may not be at arm’s length. For that reason, those transactions generally provide only limited evidence to support the fair market value. In some cases, the cash that the stockholder, other related party, or strategic investor paid for the stock may include an element of compensation for work performed by the other party. The value of the services performed would have to be added back to the price that the other party paid for the stock to determine an appropriate stand-alone fair value for the stock.

Equity transactions with independent third parties which are consummated at or near the issuance date of the securities that are being valued generally provide credible, objective evidence of fair value. However, earlier equity transactions are not likely to be a good indicator of the stock’s current value if there have been significant changes in the
company’s business or in the industry in which the company operates. Management needs to take into account the effect of those significant changes on the fair value of the stock.

Individual facts and circumstances will determine whether securities are similar in nature. Despite differences in liquidation rights, preferences, or restrictions on transferability, the SEC staff has, on occasion, accepted the sale of convertible preferred stock to a third party as a reliable and acceptable proxy for pricing common stock, particularly if the company issues the convertible preferred stock within a reasonably short period of time before the IPO. Whether the convertible preferred stock is a reliable indicator of the fair value of the common stock depends on the terms of the preferred stock, including the conversion ratio, liquidation preferences, voluntary or involuntary conversion at IPO, voting rights, dividend rights, and the anticipated IPO date. The argument that the value of preferred stock is a good proxy for the value of common stock is more compelling when the liquidation preferences lack substance. For example, if there are essentially no assets available to satisfy the preferred shareholders in the event of liquidation, the fair value of the preferred stock likely would be deemed a reliable indicator of the fair value of the common stock. Likewise, a liquidation preference may have little value if a company is in the process of registering its common stock with the SEC and the preferred stock is mandatorily converted to common stock on a one-for-one basis at the IPO date. In the absence of other differences in terms, and subject to the timing of the issuance, if the liquidation preference has little value and the conversion ratio is one-for-one, the value of the common stock may well approximate the value of the convertible preferred stock.

Many companies and their investment bankers have asserted that the value of common stock is a specified percentage of the value of recently-issued convertible preferred stock. For example, management may assume that the value of the company’s common stock is always 10 percent of the value of its preferred stock. The SEC staff routinely rejects such rule of thumb assertions and instead believes that management must evaluate each factor to determine whether it is appropriate to use the value of convertible preferred stock in establishing the fair value of the common stock.

In a speech, the SEC staff is on record as challenging situations in which a company issued convertible preferred stock within 12 months of the IPO date at a conversion price below the expected initial offering price. The SEC staff stated that in those circumstances the convertible security was granted with an in-the-money conversion price. Consequently, the preferred shareholder receives an immediate benefit on conversion. To overcome that presumption of immediate benefit, management would have to provide sufficient, objective, and verifiable evidence to support the assertion that the conversion price represented fair value on the date that the company issued the security. If senior management or the board of directors had discussions with underwriters about the value of the company at the time it issued the convertible preferred security, it may be difficult for the company to assert that the conversion price should be lower than the expected offering price. If management is not able to overcome the presumption of a benefit associated with the fact that the conversion price was below the initial offering price, the company may need to account for the difference in prices as an embedded beneficial conversion feature using the guidance in EITF Issue No. 98-5 or Topic D-60.
In practice, we understand that the SEC staff has challenged valuations of issuances with beneficial conversions up to two years before the IPO date. We believe that the area of greatest concern to the SEC staff is recent transactions, that is, those transactions in the months immediately preceding an IPO. The SEC staff likely will challenge situations in which a conversion price of stock issued shortly before an IPO is below the expected initial offering price.

**Independent Valuation**

A valuation performed by an independent qualified valuation specialist may be the strongest evidence of fair value available when an entity has not sold similar securities in a recent transaction with an independent third party. However, the SEC staff tends to view appraisals with skepticism. A reliable valuation must reflect, among other things, the nature of the company’s business and its position in the industry. Many valuations lack sufficient support for the assumptions used; at times, valuation specialists rely on inappropriate comparables or industry rules of thumb. A sound valuation should include assumptions that are consistent with the company’s individual facts and circumstances. (For example, the assumption of the number of years over which an existing technology will provide cash flows should be consistent with the estimated useful life used to amortize any capitalized cost of acquiring that technology. Also, the discount rate applied to cash flows should be commensurate with the rate of return that is expected in the industry.) An independent valuation that is performed contemporaneously with the granting of an award or the issuance of securities generally is stronger evidence than a valuation that is performed at a different date.

When assessing the reasonableness of an independent valuation, management should consider:

- Discounts for lack of marketability; and
- Comparisons of the ultimate IPO price with the underwriter’s valuation and other earlier valuations.

**Discounts for Lack of Marketability**

Restricted securities include stock that is not registered or is not transferable for a specified period. Restricted securities often are purchased at a discount from the market price of similar unrestricted securities that trade on an exchange. Management that computes a discount on the value of restricted securities from a quoted market price (or fair value if the security is not publicly traded) must demonstrate, using objective evidence, that the discount is justified by the severity and type of restriction imposed. In practice, we understand that the SEC staff will challenge a discount greater than 10 percent for lack of marketability. The SEC staff tends to reject the use of industry guidelines to support discount percentages, because the guidelines fail to incorporate company-specific factors such as the likelihood of registering securities in the near future (for example, if a shelf registration already exists); whether a market exists (even if certain restrictions are limited due to the stock’s being thinly traded); whether restrictions lapse at the IPO; and the likelihood of an IPO. The closer a company gets to an IPO, the less supportable a discount for illiquidity becomes if the restrictions lapse at the IPO. If the company has engaged an underwriter, the SEC staff assumes that a market for the stock will develop in the near future, and likely would not accept a discount for illiquidity.
Comparisons of the Ultimate IPO Price with the Underwriter’s Valuation and Other Earlier Valuations

During the registration process, the underwriter prepares a valuation to determine the estimated offering price. The SEC staff places more weight on the underwriter’s valuation than the valuation of an independent appraiser, in part because underwriters often are selected for their knowledge of the industry. In addition, the underwriter’s valuation will directly affect the price at which the company ultimately sells its securities to the public. Thus, the SEC staff may require a company to reconcile the values it has assigned to earlier transactions using an independent appraisal with the underwriter’s valuation and final IPO price. Management should evaluate the effect of the following factors when it prepares that reconciliation:

- Growth in sales or backlog;
- Introduction of new products or a new business direction;
- Changes in management;
- Changes in the industry, including the entrance or exit of competitors;
- Changes in the overall stock market and/or earnings or revenue multiples of comparable companies;
- New strategic alliances; and
- Technical product breakthroughs.

Furthermore, the SEC staff will compare the estimated offering price used during its review of the registration statement to the ultimate IPO price that is disclosed in the final registration statement. The staff generally does not challenge a price increase from the underwriter’s valuation to the ultimate IPO price of up to 20 percent. However, more dramatic price increases may cause the SEC staff to ask the registrant to resubmit the analysis of valuation differences. In certain cases, the SEC staff has required management to restate its financial statements to adjust equity transactions that a company recorded using a valuation that the SEC staff found to be insufficiently supported.
In the environment of rapidly emerging technologies, evolving business models, and constantly changing competitors that characterizes the e-business arena, successful companies are always on the lookout for opportunities to form strategic alliances that will enhance their competitive position. Companies form cooperative arrangements or strategic alliances with other enterprises for any number of strategic purposes, including the following:

- To gain access to complementary technology and skill sets as a cheaper or faster alternative to internal development;
- To outsource operations that may be less profitable and focus resources on core competencies;
- To isolate new activities from established operations to facilitate financing;
- To grow the business more rapidly to obtain critical mass;
- To share risks and resources to make a project more viable; and
- To penetrate new markets or expand foreign operations while sharing the risks with strategic partners.

Depending on the strategic objectives of the parties, such alliances can take a variety of forms, each designed to maximize the potential benefits to the alliance participants. Different structures may produce very different accounting consequences for the companies participating in a strategic alliance. Therefore, when negotiating the basic structure of an agreement, management needs to consider what impact an arrangement will have on its reported financial position and operating results.

For example, if a company purchases a controlling interest in the voting stock of a strategic partner, it most likely will have to consolidate that entity in its financial statements. Consolidation will increase the investor’s reported revenues if the investee is beyond the development stage and will increase reported profits if the investee is profitable. However, the investee’s indebtedness will be included in the investor’s consolidated financial statements and, if the investee is incurring losses during its start-up phase, the investor would be required to report those losses in its financial statements.

Alternatively, a company wishing to avoid consolidation might invest in convertible preferred stock or convertible debt that would enable it to obtain the desired level of voting interest and control at a later date. However, it would not be able to control the operating decisions of the investee until it converted its shares or debt into voting common stock.

Under current accounting standards, an investor is required to account for an equity investment in another entity using one of the following three methods:

- Consolidation;
- Equity Method; or
- Cost Method.
The selection of an appropriate accounting method is not a free choice; rather, it depends on the specific facts and circumstances of the investment and the extent to which the investor is able to participate in or influence significant operating and financing decisions of the investee company. Factors bearing on that selection are discussed below.

**Consolidation – Accounting for Majority Ownership and Voting Control**

Consolidated reporting presents the financial position, results of operations and cash flows of a consolidated group of companies as if they were a single company. Consolidated financial statements are assumed to present more meaningful information than separate financial statements and must be used in substantially all cases in which a parent directly or indirectly controls the majority voting interest of a subsidiary. For example:

On January 1, 2000, Telecom paid $1 million for a 51 percent share in Investee, and holds 51 percent of the voting rights. Investee had a net loss of $100,000 during the year ended December 31, 2000.

Because Telecom holds the majority of the voting rights, the financial statements of Investee generally would be consolidated with Telecom’s financial statements as of and for the year ended December 31, 2000. One hundred percent of each category of Investee’s assets, liabilities, revenues and expenses will be added to the corresponding items reflected in Telecom’s financial statements to arrive at consolidated totals for the combined companies. The consolidated company’s net income will be reduced by its share of the subsidiary’s loss, with the remainder allocated to the interests of the minority shareholders.

A company is required to consolidate another entity when it holds a controlling financial interest in that entity, unless control is expected to be temporary. Control is expected to be temporary, for example, if a company intends to sell a subsidiary acquired as part of a purchase business combination within a short time after acquisition, because the subsidiary’s operations do not complement the purchaser’s post-acquisition business plans. Also, when a subsidiary is in legal reorganization or bankruptcy it is controlled by a receiver or trustee rather than the parent company, and consolidation is not appropriate.

Absent persuasive evidence to the contrary, a company is presumed to hold a controlling financial interest in another entity if it holds a majority of the entity’s voting equity interests. There are circumstances in which a company may seek to obtain majority ownership in an investment to consolidate the investee (for example, to benefit from recording the investee’s revenue in its consolidated results). However, the alliance or investment agreement may grant certain rights to the minority shareholders that are more consistent with shared control, which is discussed later in this section. The presumption of a controlling financial interest can be overcome only if the minority shareholders have **substantive participating rights** (that is, rights that enable minority shareholders to participate in the operating and financing decisions made by the company in the ordinary course of business; for example, approving the annual operating and capital budget and establishing policies for management hiring and compensation). EITF Issue No. 96-16, which develops the notion of substantive participating rights, does not establish a model for determining when control does exist.
and consolidation is required. Rather, it establishes a model for determining when the presumption that control exists has been overcome. Substantive participating rights effectively permit the minority shareholders to prevent the majority shareholder from implementing operating strategies with which they do not agree. Such rights go beyond the level of protective rights typically granted by law or agreement to protect the interests of minority shareholders from abuse by holders of the majority voting interests, who ordinarily are in control of the significant operating and financing decisions of the entity. The application of these concepts can be illustrated with the following example:

Internet Company entered into an agreement with Broadcasting Company to develop and operate Web sites in 30 cities. Internet Company and Broadcasting Company formed C-corp, with Internet Company owning 50.1 percent and Broadcasting Company owning 49.9 percent of C-corp’s equity. Broadcasting Company is the manager of C-corp and has the ability throughout the term of the agreement to appoint a majority (three out of five) of the seats on C-corp’s Management Committee. Three out of five votes are required for operating decisions, and there are only limited matters (such as major changes to the corporate governance structure) for which Internet Company has veto rights. The Management Committee is responsible for the day-to-day operations of the business, including setting operating budgets and management compensation. Internet Company structures the agreement to give itself a 50.1 percent ownership interest because it wants to consolidate C-corp so that it can record the revenue.

Internet Company does not control C-corp and, therefore, should not consolidate it. On the other hand, Broadcasting Company should consolidate C-corp even though it holds less than 50 percent of the voting interests. As a result of its ability to select a majority of the members of the Management Committee who are empowered to operate the entity in the ordinary course of business, it has overcome the presumption that the majority owner controls the enterprise.

Under different circumstances, Broadcasting Company may be willing to accept a less than 50 percent economic interest, but may be unwilling to cede control to Internet Company. If Broadcasting Company retains substantive participating rights, neither Internet Company nor Broadcasting Company would control or consolidate C-corp, as follows:

Internet Company owns 50.1 percent of C-corp’s equity. Internet Company has the right to appoint three members of the five-member Management Committee of C-corp, but four affirmative votes are required to approve significant operating decisions in the normal course of business, including approving the annual operating and capital budget and establishing policies for management hiring and compensation.

Despite having structured the agreement to hold a 50.1 percent interest, Internet Company would not control C-corp. In this situation, Broadcasting Company’s substantive participating rights would overcome the presumption that Internet Company holds the controlling financial interest in C-corp. Therefore, each party would account for its investment using the equity method.
**Equity Method Investments – Accounting for Significant Influence**

Under current accounting standards, the equity method of accounting is required for investments in which an investor has the ability to exercise significant influence over the operating and financial policies of the investee. Ownership of 20 percent or more of the voting equity of an investee is presumed to give the owner that ability. A company holding less than 20 percent of the voting equity interest of an investee is presumed not to have the ability to exercise significant influence. Neither presumption should be considered to be a bright line in practice and either presumption may be overcome by persuasive evidence to the contrary. Therefore, an investor will need to consider the level of its involvement in the business affairs of an investee and the nature and extent of its rights to participate in those affairs in addition to the level of its voting interest to determine whether the equity method of accounting should be applied to a given voting equity investment.

It is essential to note that an investor that has the ability to exercise significant influence is required to use the equity method of accounting regardless of whether it chooses to exercise that influence. The following table presents factors that would indicate that an investor has the ability to exercise significant influence over an investee.

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<tr>
<th>Indicators of Significant Influence</th>
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<tbody>
<tr>
<td>Board Representation</td>
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<tr>
<td>Participation in Policy Making</td>
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<tr>
<td>Intercompany Transactions</td>
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<tr>
<td>Technological Dependence</td>
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<tr>
<th>Board representation that permits the investor to exercise influence</th>
<th>Shared management personnel</th>
<th>Significant intercompany transactions including administrative support, for example, human resources, business development, or finance</th>
<th>Sole source of technology that is significant to the entity's success</th>
</tr>
</thead>
<tbody>
<tr>
<td>Specific approval requirements for operating decisions, for example, policy, budgets, selection and compensation of management</td>
<td>Significant source of customers or suppliers</td>
<td>Economic dependence</td>
<td>Significant reliance on investor/investee for critical items based on lack of market availability</td>
</tr>
</tbody>
</table>

An investor accounting for an investment under the equity method of accounting is required to adjust its investment balance each period for its proportionate share of the investee’s net income or loss during the period and to reduce its investment balance for any dividends that it receives. For example:

On January 1, 2000, Telecom paid $1 million for a 30 percent share in Equity Investee. Equity Investee had a net loss of $100,000 during the year ended December 31, 2000, and has not declared or paid dividends during the year.

Telecom’s December 31, 2000, balance sheet would include an investment of $970,000\(^{(1)}\) accounted for by the equity method. Telecom’s income statement would reflect an equity interest in the losses of Equity Investee equal to 30 percent of the loss, or $30,000.

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\(^{(1)}\) $1 million original investment less $30,000 share of net loss in the year.
Determining the Amount of Equity Method Losses

In some situations, an investor would not limit the losses it records under the equity method to the amount of its equity investment. An investee is required to record its share of the investee’s losses up to the level of its entire investment, including loans and advances. Furthermore, if the investee incurs additional losses over and above the level of the investor’s equity investment and advances to the investee, an investor is required to record additional losses and a liability equal to its share of such additional losses to the extent that it has committed to provide additional funding to support the operations of the entity. The EITF has provided additional guidance concerning the application of the equity method of accounting to investments other than common stock investments in its consensus on EITF Issue Nos. 98-13 and 99-10.

Cost Method Investments – Absence of Significant Influence (2)

As noted above, an investor that owns less than 20 percent of an investee’s voting equity securities is presumed not to have the ability to exercise significant influence over the operating and financing decisions of the investee. Assuming the presumption is not overcome by the attendant facts and circumstances, an investor would be required to account for such an investment using the cost method of accounting. Under the cost method, an investor records its investment in the equity of an investee at historical cost and records dividend income when the investee distributes dividends from its net accumulated earnings.

On January 1, 2000, Telecom paid $1 million for a 10 percent share of Cost Investee. Cost Investee had a net loss of $100,000 during the year ended December 31, 2000, and has not declared or paid dividends during the year.

Telecom would record its $1 million investment in Cost Investee as of December 31, 2000. Telecom would not record its 10 percent share of Cost Investee’s $100,000 net loss in its income statement for the year ended December 31, 2000.

An investor may overcome the presumption that it does not have the ability to exercise significant influence for an investment of less than 20 percent of an investee’s voting equity interest if it can demonstrate that it has obtained that ability through other means (for example, technological or economic dependency, or disproportionately higher board representation than the percentage ownership of voting stock). In those cases, the investor would be required to use the equity method rather than the cost method to account for its investment. For example:

On January 1, 2000, Telecom paid $1 million for a 15 percent share of Investee. Investee had a net loss of $100,000 during the year ended December 31, 2000, and has not declared or paid dividends during the year. Telecom appoints two of Investee’s five board members.

Because Telecom holds 40 percent of the board votes, which is disproportionate to its investment, we believe it has overcome the presumption that it does not have the ability to exercise significant influence and, accordingly, should use the equity method to account for its investment. Telecom’s balance sheet as of December 31, 2000, would

(2) Refer also to FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, which addresses the accounting for investments in equity securities with readily determinable fair values that are not consolidated or accounted for under the equity method.
reflect a $985,000\(^{(3)}\) investment in Investee under the equity method. Telecom’s income statement would report an equity interest in losses of Investee equal to 15 percent of the loss, or $15,000.

**Attributes of Ownership and Implications for Financial Reporting**

The following table summarizes the attributes of ownership and implications for financial reporting related to the alternative methods of accounting for an investment:

<table>
<thead>
<tr>
<th>Method of Accounting for an Investment</th>
<th>Voting Ownership Interests (^{(4)})</th>
<th>Attributes of Ownership</th>
<th>Implications for Financial Reporting</th>
</tr>
</thead>
</table>
| **Consolidation**                      | Greater than 50%                    | ■ Investor has the ability to exercise control over the operating and financing decisions of the investee, generally evidenced by majority ownership | ■ Line-by-line recording of assets and liabilities  
■ Gross presentation of revenues, expenses and net income or loss of all consolidated entities  
■ Investor records its share of Investee’s start-up losses as incurred  
■ Complete financial reporting disclosures relating to all entities included in the consolidated group |
| **Equity Method**                      | 20-50%                              | ■ Investor has the ability to exercise significant influence over the operating and financial policies of the investee. (Note that such ability is presumed not to exist, absent persuasive evidence to the contrary, if voting ownership interest is 20% or more.) | ■ One-line financial reporting presentation (In the balance sheet: Investment in equity method investee. In the income statement: Equity interest in income of investee)  
■ Investor records its share of investee start-up losses as incurred  
■ Recoverability of the investment must be assessed periodically and write-down or write-off is required when it is determined to be impaired |
| **Cost Method** \(^{(5)}\)             | Less than 20%                       | ■ Investor does not have the ability to exercise significant influence over the operating and financial policies of the investee. (Note that such ability is presumed not to exist, absent persuasive evidence to the contrary, if voting ownership interest is less than 20%.) | ■ One-line presentation in the balance sheet (Investments, at cost)  
■ No continuing financial reporting requirements unless dividends are paid or the investment becomes impaired  
■ Recoverability of the investment must be assessed periodically and write-down or write-off is required when it is determined to be impaired |

\(^{(3)}\) $1 million original investment less $15,000 share of net loss in the year.  
\(^{(4)}\) These ownership percentages are presented as general guidelines; they are not absolute. For example, as illustrated on page 69, an investor may account for an investment in 15 percent of the voting stock of an investee using the equity method of accounting if it has significant influence over the board of directors of the investee.  
\(^{(5)}\) Refer also to FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, which addresses the accounting for investments in equity securities with readily determinable fair values that are not consolidated or accounted for under the equity method.
Impairment – Is My Investment Still Worth What I Paid?

Regardless of the method a company applies to account for its investment in another entity, management of the investor must assess periodically whether the investment is recoverable out of expected future cash flows of the investee. Generally, whenever management determines that the book value of an investment is not recoverable, the company is required to report an impairment charge in its income statement and to write the investment down to its fair value.

A company that consolidates an investee must assess its ability to recover its investment at the level of the individual assets of its subsidiary, whereas companies holding equity and cost method investments would perform this assessment at the level of the investment itself. In the former instance, the focus of the analysis is on the subsidiary’s ability to generate operating cash flows (that is, cash flows exclusive of financing costs) in excess of the carrying value of its assets. In the latter two instances the focus is on the investor’s reasonable expectation that it will be able to recover its investment from future cash flows—either in the form of dividends or other distributions from the investee or from selling its investment to an unrelated third party.

Management is required to review the carrying value of an entity’s investments for impairment whenever events or changes in circumstances suggest that recoverability may be in doubt. For example, if an investee company has sustained substantial and recurring losses, experienced changes in technology or other developments that adversely affect the entity’s competitive position in the marketplace or become subject to litigation or changes in laws or regulations that cast doubts on its ability to pursue its business model in the future, management of an equity or cost method investor would be required to evaluate whether its investment is impaired.

In assessing whether an investment is impaired, management should consider available objective evidence concerning the value of the investment as well as estimated cash flows expected to be generated by the entity from future operations. Such evidence might include the investee’s business plan or forecast of future operations, an independent valuation by a qualified investment banker, the market value of the investment securities if traded in an active public market, or the offering price of a recent successfully completed private placement of equity. When no better objective evidence of the value of a cost method investment exists, management should consider whether the cumulative losses of the entity incurred subsequent to the time of its investment represent an objective measure of the extent to which that investment has been impaired by the investee’s ongoing losses. This latter approach is sometimes referred to as a modified equity method of accounting because it results in recording an impairment loss on the cost method investment equal to the investor’s proportionate share of the investee’s losses as its contributed capital is consumed to fund the operating losses of the investee, similar to the application of equity method accounting.

The consolidated subsidiaries of many new economy companies were acquired in business combinations accounted for by the purchase method using stock of the acquiror rather than cash as the primary consideration. Often the purchase price, based on the market value of the subsidiary immediately before acquisition, exceeds the fair value of its tangible and readily identifiable intangible assets by a substantial amount. This excess commonly is referred to as goodwill.
When changes in the marketplace adversely affect a subsidiary’s competitive position or its ability to pursue successfully its business plan, management should consider whether the carrying value of the subsidiary’s goodwill and other intangible assets is recoverable from its expected future cash flows. For example:

Assume that 15 months ago, Internet Company acquired Broadcasting Company using common stock that had a fair value of $500 million. The fair value of that stock today is $200 million.

Under these circumstances, management would need to assess whether the goodwill arising from Internet Company’s investment in Broadcasting Company is impaired. In assessing whether the goodwill or other assets of a subsidiary are impaired, management should consider all objective evidence available. For example, a substantial difference between projected and actual operating results may necessitate further analysis to determine whether the investment has suffered an other than temporary decline in value.

The analysis used to evaluate the need for and the amount of any impairment charge should be consistent with analyses such as operating budgets, profit plans and employee incentive compensation plan targets used within the company for strategic planning. The SEC staff likely will challenge impairment assumptions that are not consistent with these projections of future operating performance used by the company.

In SAB No. 100, the SEC staff stated that a company that reports a significant amount of goodwill on its balance sheet or that reports a significant amount of goodwill amortization should describe how management will determine that the value of the goodwill can be recovered, and how and when impairment would be measured.

The SEC staff believes that a company should adopt and disclose in its financial statements an explicit policy for assessing and measuring the impairment of goodwill. That policy should refer to objective, rather than discretionary, factors. SAB No. 100 states that the policy and the disclosure should address the following:

- Conditions that would trigger an impairment assessment of the carrying amount of goodwill;
- The method (market value, discounted or undiscounted cash flows) that the company would use to measure impairment; and
- How the method would be implemented, including how interest charges would be considered in the assessment, how the discount rate would be selected, and other significant aspects of the policy.

**Joint Ventures – Accounting for Shared Control**

A joint venture is a corporation or other entity owned and operated by two or more businesses. Generally, a joint venture arrangement includes an agreement granting each investor the right to participate directly or indirectly in the overall management of the venture. Operating and financing decisions that are essential to accomplishing the business purpose of the joint venture require the consent of all parties to the joint venture agreement. Therefore, a subsidiary, which by definition is controlled by one party, cannot be a joint venture. Joint ventures are accounted for as equity method
investments by all investors because each has the ability to exercise significant influence over the operating and financing policies of the venture. For example:

On January 1, 2000, Telecom paid $1 million for a 50 percent share in Joint Venture. Joint Venture had a net loss of $100,000 during the year ended December 31, 2000.

The December 31, 2000, balance sheet of Telecom would reflect a $950,000 investment in Joint Venture. Telecom’s income statement would report a charge equal to its equity interest in the losses of Joint Venture, that is, 50 percent of the loss, or $50,000.

Typically, when an entity contributes nonmonetary assets and operations to a joint venture in exchange for equity, it records its investment in the venture at historical net book value of the assets it contributed, often zero. Therefore, it generally is not possible for an investor to record a gain in its current income statement as a result of contributing its assets to a joint venture even when their fair value exceeds their historical cost or book value.

**Goodwill Amortization – What Is the Useful Life of Goodwill?**

Under current accounting standards, an entity is required to amortize goodwill to expense over its estimated useful life, not to exceed 40 years. One of the fundamental issues in accounting for a purchase business combination is determining the appropriate life for the goodwill that arises from the transaction. In the rapidly changing technological environment in which both new and old economy companies now operate, old rules of thumb such as a 40-year maximum life (or even 10 to 20-year maximum useful lives that are commonplace in many industries) no longer apply. Uncertainties about which of the many evolving and as yet unproven technologies or business models will survive in the Internet economy have contributed to the debate about the appropriate period over which to amortize goodwill.

By their very nature, these uncertainties dictate that determining the useful life of goodwill requires the application of significant judgment to the facts and circumstances of a specific situation. In some cases, based on the limited time during which a company has been in existence, the limited operating history of the industry in which an entity operates, or a review of other risk factors an entity typically identifies in its SEC filings, the SEC staff has required technology-related companies to amortize goodwill over periods as short as three to seven years.

**Financial Statements of Businesses that Are Acquired or to Be Acquired**

If a company plans to register securities with the SEC in connection with a stock-for-stock business combination, the company planning to issue new stock must provide, in its registration statement, audited financial statements for certain significant acquisitions (including potential acquisitions that are considered to be probable at the date that a registration statement is to be filed) in accordance with Rule 3-05 of Regulation S-X of the Securities Exchange Act of 1934. During a period of substantial growth, it is not uncommon for a company to acquire several businesses within a relatively short period of time.
Even though individual acquisitions may be below the Rule 3-05 significance threshold, an entity may be required to provide certain financial statements of those individually insignificant acquired businesses in its registration statement and proxy materials if, in aggregate, the total assets, investment, and income of the acquired businesses are significant when measured against the assets and income of the consolidated entity. The determination of significance depends on the facts and circumstances in each situation. If financial statements of an acquired business are required to be included in an SEC filing, those financial statements must be accompanied by an accountants’ report signed by the target’s auditors. To avoid delays when preparing to register securities with the SEC, companies need to evaluate whether acquisitions will trigger additional disclosure requirements under Rule 3-05 and, if so, plan accordingly.


Glossary

AcSEC – The Accounting Standards Executive Committee (AcSEC) is the senior technical committee at the AICPA; it is authorized to establish certain accounting standards, Statements of Position (SOPs) and to speak for the Institute in the areas of financial accounting and reporting. AcSEC works closely with the FASB to establish consistent accounting standards in the United States.

AICPA – The American Institute of Certified Public Accountants (AICPA) is the national professional organization for Certified Public Accountants. The AICPA provides technical advice and guidance to its members and such government bodies as the Securities and Exchange Commission.

APB – The Accounting Principles Board (APB) was the predecessor organization of the Financial Accounting Standards Board (FASB). It was established by the American Institute of Certified Public Accountants in 1959 and issued Opinions until 1973. Many of the 31 Opinions that the APB issued still form part of generally accepted accounting principles (GAAP).

Application Service Provider (ASP) – The vendor or third party in a software hosting arrangement that maintains the software application on its hardware and provides the customer with access to the software application over the Internet or via a dedicated line.


Content (as used in EITF Issue No. 00-02) – Information included on a Web site that may be textual or graphical in nature (such as a bar chart of company sales or a photograph of a museum piece), excluding graphics as defined later in this Glossary.

CPM – Cost per thousand is used by Internet marketers to price ad banners. Sites that sell advertising will guarantee an advertiser a certain number of impressions (number of times an ad banner is downloaded and presumably seen by visitors), then set a rate based on that guarantee times the CPM.

Digital Exchange – An Internet-based intermediary that enters supply chains in various vertical industries or across industries, introducing new efficiencies and ways of buying, selling and brokering products and services.

EITF – The Emerging Issues Task Force (EITF) was established by the FASB to assist in the early identification of (a) emerging issues that affect financial reporting and (b) problems in implementing authoritative pronouncements. The mission of the EITF is to assist the FASB in improving financial reporting through the timely identification, discussion, and resolution of financial issues within the framework of GAAP.

The Task Force comprises individuals who are both knowledgeable in accounting and financial reporting and are in positions to be aware of emerging problems as they develop. The Task Force’s 13 voting members include the senior technical partners of major national CPA firms as well as representatives of major associations of preparers.
of financial statements, such as the Financial Executives Institute, the Business Roundtable, and the Institute of Management Accountants. The FASB’s Director of Research and Technical Activities serves as Task Force Chairman. The SEC’s Chief Accountant and a member of the AICPA’s Accounting Standards Executive Committee participate in Task Force meetings as observers with the privilege of the floor.

**EITF Consensus** – Agreement among EITF members is recognized as a consensus if no more than 2 of the 13 members disagree with a position. A consensus position reached by the EITF becomes GAAP that must be followed unless a FASB Statement, Interpretation or Technical Bulletin, APB Opinion, Accounting Research Bulletin, SOP, or AICPA Industry Audit and Accounting Guide provides guidance that is more directly relevant to a given transaction or issue. EITF consensuses generally are effective upon issuance and are applied prospectively. The SEC will challenge accounting that is different from a consensus of the Task Force because the consensus position represents the best thinking in areas of accounting for which there are no other FASB standards.

**Executory Contract** – A contract that has not yet been fully completed or performed; a contract whereby the obligation (performance) relates to the future.

**Fair Value** – The amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between independent willing parties; that is, other than in a forced or liquidation sale.

**FASB** – The Financial Accounting Standards Board (FASB) was formed to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information. Since 1973, the Financial Accounting Standards Board has been the private sector organization responsible for establishing standards of financial accounting and reporting. Those standards govern the preparation of financial statements.

**Firmly Committed Executory Contract** – An agreement in which each party promises future performance of its obligations. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of delivery and payment.

**Goodwill** – The difference between the cost of an acquired company and the sum of the fair values of tangible and identifiable intangible assets less liabilities.

**Graphics (as used in EITF Issue No. 00-02)** – Graphics provide the overall design of a Web page (use of borders, background and text colors, fonts, frames, buttons, and so forth) that affect the look and feel of the Web page and generally remain consistent regardless of changes that a company makes to the content.

**IPO** – An Initial Public Offering (IPO) is accomplished when a company “goes public,” referring to a privately held company’s first interstate sale of securities to the general public. To go public, a company is required to file with the Securities and Exchange Commission (SEC) a registration statement that is in compliance with the Securities Act of 1933 as well as the Securities Exchange Act of 1934.

**Multiple-Element Arrangement** – A sales arrangement with a customer that involves the delivery of more than one product, service, or other right to use assets (deliverable). Performance of separate deliverables may occur at different times.
**Performance Commitment** *(as used in EITF Issue No. 96-18)* – A performance commitment is a commitment under which performance by the counterparty to earn the equity instruments is probable because of sufficiently large disincentives for nonperformance.

**Protective Rights** – The rights typically granted by law or agreement to protect the interests of minority shareholders from abuse by holders of the majority voting interests, who ordinarily are in control of the significant operating and financing decisions of the entity.

**SAB** – Staff Accounting Bulletins (SABs) are publications of the SEC’s Division of Corporation Finance (Division) and the Office of the Chief Accountant (Chief Accountant). SABs are not rules or interpretations of the Commission, nor are they published as bearing the Commission’s official approval. Even though SABs are not explicitly listed in the hierarchy of GAAP, they represent interpretations and practices followed by the Division and the Chief Accountant in administering the disclosure requirements of the federal securities laws. The staff’s purpose in issuing SABs is to disseminate guidance for application not only in the narrowly described circumstances, but also, unless authoritative accounting literature calls for different treatment, in other circumstances where events and transactions have similar accounting and/or disclosure implications.

**SEC** – The U.S. Securities and Exchange Commission (SEC) is an independent agency functioning as a quasi-judicial, quasi-legislative and administrative body that monitors and enforces corporate financial reporting, auditing practices, and trading activity in U.S. securities markets. The SEC has statutory authority to set accounting standards for public companies, but has relied on the accounting profession to establish GAAP in the United States. The SEC requires public companies to disclose meaningful financial and other information to the public.

**Significant Influence** – An entity’s ability to affect the operating and financing decisions of another entity to a significant degree. One entity may have the ability to influence another as a result of representation on the board of directors, direct participation in policy making, material intercompany transactions, change of management personnel, technological dependency and/or substantial ownership of voting interests in relation to the voting interests of other shareholders. Such influence is presumed to be *significant* when an entity holds a voting equity interest of 20 percent or more in another entity. An investor having the ability to exercise *significant influence* over the operating and financing decisions of another entity is required to account for its investment using the equity method of accounting.

**Software Hosting Arrangement** – An arrangement in which the software application resides on a vendor’s or third party’s hardware and the customer accesses and uses the software on an as-needed basis over the Internet or via a dedicated line.

**SOP** – Statements of Position (SOPs) of the Accounting Standards Division of the AICPA present the conclusions of AcSEC. SOPs are lower than FASB Statements in the hierarchy of GAAP.
Substantive Participating Rights – Rights that enable minority shareholders substantively to participate in the operating and financing decisions made by a company in the ordinary course of business, for example, approving the annual operating and capital budget and establishing policies for management hiring and compensation. Such rights effectively permit the minority shareholders to prevent the majority shareholder from implementing operating strategies with which they do not agree. Such rights go beyond the level of protective rights.

Technological Feasibility – The technological feasibility of a computer software product is established when a company has completed all planning, designing, coding and testing activities that are necessary to establish that the product can be produced to meet its design specifications including functions, features, and technical performance requirements. At a minimum, the company must have developed a detail program design or a working model that is tested to determine that it is consistent with the product design.

Vendor-Specific Objective Evidence (VSOE) – In the context of a multiple-element software arrangement, vendor-specific objective evidence is limited to:

- The price that a company charges when it sells the same element separately;
- For an element that is 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.

Vest – To become entitled to a right. An award of stock becomes vested on the date at which the recipient’s right to receive or retain shares of stock or cash under the award no longer is contingent on the achievement of a performance condition. Often, an option that is vested also is immediately exercisable.
References to Accounting Standards

FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed.*

FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities.*


APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock.*

APB Opinion No. 29, *Accounting for Nonmonetary Transactions.*


EITF Issue No. 93-11, *Accounting for Barter Transactions Involving Barter Credits.*

EITF Issue No. 96-16, *Investor’s Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights.*

EITF Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services.*


EITF Issue No. 98-5, *Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios.*

EITF Issue No. 98-6, *Investor’s Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Approval or Veto Rights.*

EITF Issue 98-13, *Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee.*

EITF Issue No. 99-10, *Percentage Used to Determine the Amount of Equity Method Losses.*


EITF Issue No. 99-17, *Accounting for Advertising Barter Transactions.*
EITF Issue No. 99-19, *Recording Revenue Gross as a Principal Versus Net as an Agent.*

EITF Issue No. 00-02, *Accounting for Web Site Development Costs.*

EITF Issue No. 00-03, *Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity’s Hardware.*

EITF Issue No. 00-08, *Accounting by a Grantee for an Equity Instrument to Be Received in Conjunction with Providing Goods or Services.*

EITF Issue No. 00-10, *Accounting for Shipping and Handling Fees and Costs.*

EITF Issue No. 00-14, *Accounting for Coupons, Rebates, and Discounts.*

EITF Issue No. 00-18, *Accounting Recognition for Certain Transactions Involving Equity Instruments Granted to Other than Employees.*

EITF Issue No. 00-20, *Accounting for Costs Incurred to Acquire or Originate Information for Database Content and Other Collections of Information.*

EITF Issue No. 00-21, *Accounting for Multiple-Element Revenue Arrangements.*

EITF Issue No. 00-22, *Accounting for “Points” and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future.*

EITF Issue No. 00-25, *Accounting for Consideration from a Vendor to a Retailer in Connection with the Purchase or Promotion of the Vendor’s Products.*

EITF Topic D-60, *Accounting for Issuance of Convertible Preferred Stock and Debt Securities with a Nondetachable Conversion Feature.*

EITF Topic D-90, *Grantor Balance Sheet Presentation of Unvested, Forfeitable Equity Instruments Granted to a Nonemployee.*

SAB No. 100, *Restructuring and Impairment Charges.*

SAB No. 101, *Revenue Recognition in Financial Statements.*


SOP 93-7, *Reporting on Advertising Costs.*

SOP 97-2, *Software Revenue Recognition.*

SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.*

AICPA Technical Practice Aid 5100.46, *Nonmonetary Exchanges of Software (Part I).*

AICPA Technical Practice Aid 5100.47, *Nonmonetary Exchanges of Software (Part II).*