

**Case 07-3**

**Columbia On-Line Networks**

**TOPIC 1: Revenue Recognition**

In conjunction with interim audit procedures for our client, Columbia On-Line Networks (the Company), the Company's controller provided the audit engagement team with the following information regarding a significant sales contract.

**MEMO**

To: Audit Engagement Team  
From: Controller, Columbia On-Line Networks  
Subject: Contractual Sales Arrangement with CheapTalk  
Date: October 31, 2009

Columbia On-Line Networks has developed and patented next-generation technology (Technology) related to transmitting wireless communication and data signals. The Technology consists of a license and a method, or blueprint, that documents the physics involved with such Technology. On October 15, 2009, the Company entered into a contractual arrangement with CheapTalk (the Customer), a telecommunications company.

The contractual arrangement with CheapTalk has been structured to include the following two phases:

**1. Evaluation Phase**

The Company will receive consideration of \$200,000 during the evaluation phase in exchange for professional services that will allow the Customer to assess the feasibility of the Technology before it invests additional amounts. If the Customer elects not to execute the option phase within 90 days, the Company is entitled to keep the full amount of this consideration and the option expires.

**2. Option Phase**

The Company will receive additional consideration under the option phase of the contract totaling \$10 million, which is due and payable upon execution of the option phase of the contract.

At the beginning of the option phase, the Company will provide the Customer with the Technology, which includes a perpetual license and related documentation (i.e., the method, or blueprint, that documents the physics involved with such Technology). These documents will provide the Customer with the means to update and enhance the existing

Technology. Note that the Technology does not include services or hardware. The Company does not have objective and reliable evidence of fair value of the Technology since there is limited history of selling the Technology. The Company also does not have third-party evidence of selling price for the Technology.

In addition, at the Customer's request, the Company will provide an oral presentation (Presentation) to certain executives and the Customer's other designated senior management within the 12 months following the delivery of the Technology. The Presentation will include, at a minimum, an overview of the Technology and any updates resulting from the Company's research and development efforts.<sup>1</sup> Although the Company does not have a demonstrated history of providing such Presentations for its customers, it believes that the cost to complete this obligation is insignificant. Further, the Presentation is not essential to the functionality of the Technology.

Upon delivery of the Technology, the Customer does not have a right to a full or partial refund.

The professional service rates in the contract for the evaluation phase are at prices consistent with the Company's standard hourly rates charged to other customers.

While a portion of the Technology is included in a software configuration, the software is only used to demonstrate the use of the Technology and does not incorporate the full potential of the Technology. The Company's management believes that the software is incidental to the Technology, as a result, the Technology is not considered a software deliverable as defined within ASC 985-605 (AICPA Statement of Position No. 97-2, *Software Revenue Recognition*).

The Company adopted ASU 2009-13, *Revenue Recognition: Multiple Deliverable Revenue Arrangements* as of the beginning of the current fiscal year.

**Required:**

- Should the Company recognize any revenue during the evaluation phase of the contract?
- Upon execution of the option phase of the contract, how should the Company account for revenue under the arrangement?

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<sup>1</sup> Note that the Company is not obligated to provide any specific deliverables from its research and development efforts.