TAXPAYER EXHIBIT
B6
February 24, 2015
Millennium Dental Technologies, Inc.
747501

MILLENNIUM DENTAL TECHNOLOGIES, INC.

APPEAL CASE ID NO: 747501

FEBRUARY 24, 2015

EXHIBITS

STATE BOARD OF EQUALIZATION

Appeal Name: Millennium Dental Tech, Inc.
Case ID: 747501 ITEM #. B6
Date: 2/24/15 Exhibit No: 2.10
TP FTB DEPT PUBLIC COMMENT

A

Tax Research Consultant, ACCTNG: 9,050, Accrual of Income: All-Events Test

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New Developments

An item of income is includible in gross income when all event have occurred that fix the taxpayer's right to receive the income and allow the amount of income to be determined with reasonable accuracy. Accrual is deferred if the right to receive the income or the amount of the income is subject to contingency or is disputed, or if it is reasonably certain that the income is uncollectible.

Under the accrual of income method of accounting, an item of income is includible in gross income when it satisfies the all-events test. [1] Under the all-events test, income is includible in gross income when all the events have occurred that fix the taxpayer's right to receive the income and allow the amount of income to be determined with reasonable accuracy. [2] Thus, there are two essential elements to the accrual of income under the all-events test:

- The taxpayer's right to receive income must be fixed (see ACCTNG: 9,052); and
- The amount of income must be ascertainable with reasonable accuracy (see ACCTNG: 9,054). [3]

COMMENT

For purposes of deducting an accrual-basis taxpayer's expenses, the all-events test also requires economic performance. See ACCTNG: 12,100.

The courts have not developed a formula that can be mechanically applied to any given fact situation to determine whether accrual is proper. Rather, they have attempted to apply the all-events test in a manner that recognizes the realities of a given transaction, focusing on a practical examination of whether a right is fixed and the amount ascertainable. [4] The form in which income is received is generally irrelevant because, under the accrual method of accounting, income is reported when the right to it arises and not when it is paid. [5] However, the mode of payment may be relevant if there is sufficient doubt as to the validity or reliability of the check as to cast doubt on the reasonable likelihood of collection. When the accrual is generated by the receipt, both cash and checks are considered payment. [6] See ACCTNG: 6,104 for discussion of cash equivalents under the cash method of accounting.

For the first prong of the test, a fixed right to receive income is established when there is a reasonable expectation, at the time the debt is incurred, that the debt will be paid and the income received. See ACCTNG: 9,052.

The second prong of the test—the ascertainment of the amount of income with reasonable accuracy—has received less judicial and administrative attention than the first. It is applied with substantial flexibility, and can be satisfied based on approximations and estimate. See ACCTNG: 9,054.

Income subject to a contingency ordinarily does not accrue until the contingency is satisfied. If the taxpayer's right to receive the income depends on a contingency, the right-to-receive-income prong of the all-events test is not satisfied. If the amount of income depends on a contingency, the ascertainment prong is not satisfied. See ACCTNG: 9,056

A narrow exception to the all-events test permits an accrual basis taxpayer to defer income that unlikely to be collected. Qualified taxpayers can use a nonaccrual experience method to omit uncollectible income arising from the provision of certain services. See ACCTNG: 9,058.

A special rule requires public utilities that compute taxable income under the accrual method to include income attributable to the sale or furnishing of utility services to customers in gross income no later than the tax year in which the services are provided. [7] See ACCTNG: 9,422.

The all-events test generally applies to prepaid income (see ACCTNG: 9,100). However, special rules or accounting methods may apply to advance payments for certain goods and services (see ACCTNG: 9,150), and certain sales and long-term contracts (see ACCTNG: 9,200), as well as prepaid subscription income (see ACCTNG: 9,250), and prepaid membership dues (see ACCTNG: 9,300).

See ACCTNG: 9,350 for discussion of correcting erroneous accruals. See ACCTNG: 9,400 for discussion of accrual for particular types of taxpayers. See ACCTNG: 9,450 for discussion of accruing particular types of income.

NEW DEVELOPMENTS

Income Accrual Not Postponed by Right to Withhold Deferred Payments Under Contract

An accrual based parent corporation was required to include in its consolidated income deferred payments from the sale of barges manufactured by its subsidiary. Under the contract to sell the barges, a portion of the payments were due 18 months after the delivery of each barge. The deferred payments were excluded by the parent because they were withheld by customers in order to offset agreed-upon damages incurred under a previous barge sale contract.

As an accrual basis taxpayer, the parent was required to accrue the deferred payments for the barges in the year that all of the events occurred to fix the right to the income. The delivery of the barges unconditionally fixed the right to receive the full contract price, including the deferred payments, in the year of delivery. The customers' offset claim did not prevent the accrual of the income. The customers did not dispute the fact or the amount of the obligation under the contract and there was no question as to whether the right to receive income was vitiated by a contractual provision for withholding a portion of the sales price. The offset claims affected only the timing of the receipt of the income under the contract and not the right to receive the income. Moreover, the deferred payments did not fall within the income-accrual exception because there was no evidence that the deferred payments were uncollectible as a result of insolvency, bankruptcy or other financial conditions of the customers. It was only in the tax year after the barges had been delivered and the right to income had been fixed that the customers asserted their right to an offset for the damages from the previous contract.

Additionally, the withheld deferred payments could not be deducted in the year as an amount transferred to satisfy a contested liability in the tax year the income accrued. The withholding of the deferred payments did not constitute a transfer of property in the same tax year in satisfaction of a liability. In the year the barges were delivered and the income accrued, the deferred payments were not yet due and so could not have been withheld. Additionally, the withholding of the deferred payments did not constitute a transfer. The deferred payments withheld by the customers were not in the control of the subsidiary. In the year the income accrued, there was no order of any competent legal authority to force the subsidiary to transfer the funds that were owed.

Trinity Industries, Inc. v Commr, 132 TC __, No. 2, Dec. 57,718.

Footnotes

1 *US v P.C. Anderson*, SCt, 1 USTC ¶155, 269 US 422, 46 SCt 131.

2 Reg. §1.451-1(a); *Flamingo Resort, Inc. v US*, CA-9, 82-1 USTC ¶9136, 664 F2d 1387, cert. denied, 459 US 1036.

3 Reg. §§1.446-1(c)(1)(ii), 1.451-1(a); Rev. Rul. 83-106, 1983-2 CB 77.

4 *Flamingo Resort, Inc. v US*, CA-9, 82-1 USTC ¶9136, 664 F2d 1387, cert. denied, 459 US 1036.

5 *Spring City Foundry Co. v Commr*, SCt, 4 USTC ¶1276, 292 US 182, 54 SCt 644, reh. denied, 292 US 613.

6 *M.E. Schlude v Commr*, SCt, 63-1 USTC ¶9284, 372 US 128, 83 SCt 601.

7 Code Sec. 451(f)(1).

B

Internal Revenue Code

§461 General rule for taxable year of deduction.

(h) Certain liabilities not incurred before economic performance.

(4) All events test.

For purposes of **this subsection** , the all events test is met with respect to any item if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy.

Federal Regulations

Reg § 1 .451-1. General rule for taxable year of inclusion.

(a)General rule. Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. To the extent that income is attributable to the recovery of bad debts for accounts charged off in prior years, it is includible in the year of recovery in accordance with the taxpayer's method of accounting, regardless of the date when the amounts were charged off. For treatment of bad debts and bad debt recoveries, see sections 166 and 111 and the regulations thereunder. For rules relating to the treatment of amounts received in crop shares, see section 61 and the regulations thereunder. For the year in which a partner must include his distributive share of partnership income, see section 706(a) and paragraph (a) of §1.706-1. If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation, file claim for credit or refund of any overpayment of tax arising therefrom.

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Interpretations and Examples\18. Revenue Recognition
Revenue Recognition Guide
Chapter 5: Product Deliverables
Post-Delivery Product-Related Obligations

POST-DELIVERY PRODUCT-RELATED OBLIGATIONS

Customer Acceptance Provisions

Customer acceptance provisions allow the customer to cancel an arrangement when the product delivered does not meet the customer's needs or desires. The existence of such provisions raises questions as to whether the earnings process is complete at the time of shipment or only after customer acceptance has been obtained. When products are sold subject to these provisions, the nature of the provisions should be analyzed to determine which accounting model applies to the transaction. Generally, customer acceptance provisions and the related accounting take one of the four forms discussed below.

Product Shipped for Trial or Evaluation Purposes

In these arrangements, the seller delivers a product (before finalizing a sales agreement) and allows the customer to evaluate it prior to acceptance. When products are shipped on this basis, a purchase is consummated only upon customer acceptance. In some cases, acceptance occurs as long as the customer does not reject the product within a specified period of time. For example, a book club may ship its members a book every month for a 14-day trial period. If the member does not return the book within the trial period, the member is deemed to have accepted the book and is obligated to pay for it.

In other cases, an affirmative acceptance from the customer is necessary to trigger a purchase obligation. This is more common if the product is equipment that is intended for a specific use.

Regardless of whether title passes upon shipment, these arrangements do not constitute a sale until acceptance occurs. This is because until acceptance, there is no persuasive evidence of an arrangement. Accordingly, in arrangements where products are delivered for trial or evaluation purposes, revenue should not be recognized until acceptance occurs, either by notification from the customer or by passage of time without rejection, provided the other conditions for revenue recognition have been met (ASC 605-10-S99, A3b, ques. 1) (SAB Topic 13A3b, ques. 1).

PRACTICE POINTER: The reason shipment on a trial basis or for evaluation purposes does not trigger revenue recognition is because the arrangement does not even purport to be a sale until acceptance occurs. Therefore, historical experience at estimating how many of these shipments will ultimately result in sales, no matter how accurate, cannot be used to justify revenue recognition prior to acceptance. By contrast, subjective customer acceptance clauses and rights of return (discussed later in this chapter) do not absolutely preclude revenue recognition during the return period because a sale agreement is in place before the products are delivered. Since rights of return provide many of the same protections as an arrangement with a trial or evaluation period, companies may wish to change their sales contracts accordingly. This may allow a company to recognize revenue at an earlier point in time.

Subjective Right of Return

Certain customer acceptance provisions give the buyer a right to reject the product if he or she is dissatisfied for any reason. An example of such a provision is one that allows the customer to return a product with "no questions asked." Acceptance provisions based on wholly subjective terms are, in substance, general rights of return. Thus, this class of acceptance provisions should be accounted for in accordance with ASC 605-15-25 and related interpretations. (See ASC 605-10-S99, A3b, ques. 1 (SAB Topic 13A3b, ques. 1) and "Rights of Return" in this chapter.)

Customer Acceptance Based on Meeting Standard Seller-Specified Performance Criteria

These provisions give the customer a right of return or replacement if the delivered product is defective, fails to meet advertising claims, or does not meet the *vendor's* published specifications for the product. In some cases, the seller may have the right to refund the purchaser's money or repair the product rather than provide a replacement. This type of acceptance provision is generally used in a situation where identical rights are granted to every customer of a particular class and involves seller-specified performance criteria that the seller is reasonably certain the product will meet. If the seller has previously demonstrated that the product meets these criteria, the customer acceptance provision is no different from a product warranty. Under these circumstances, the customer acceptance provision should be accounted for as a warranty (see "Product Warranties" in this chapter).

However, if the seller has not previously demonstrated that the delivered product meets the stated specifications, warranty accounting is not appropriate, because it is uncertain whether the company has delivered the product specified in the arrangement. Therefore, revenue should be deferred until the specifications have been achieved or the customer has accepted the product (ASC 605-10-S99, A3b, ques. 1 and 2) (SAB Topic 13A3b, ques. 1 and 2).

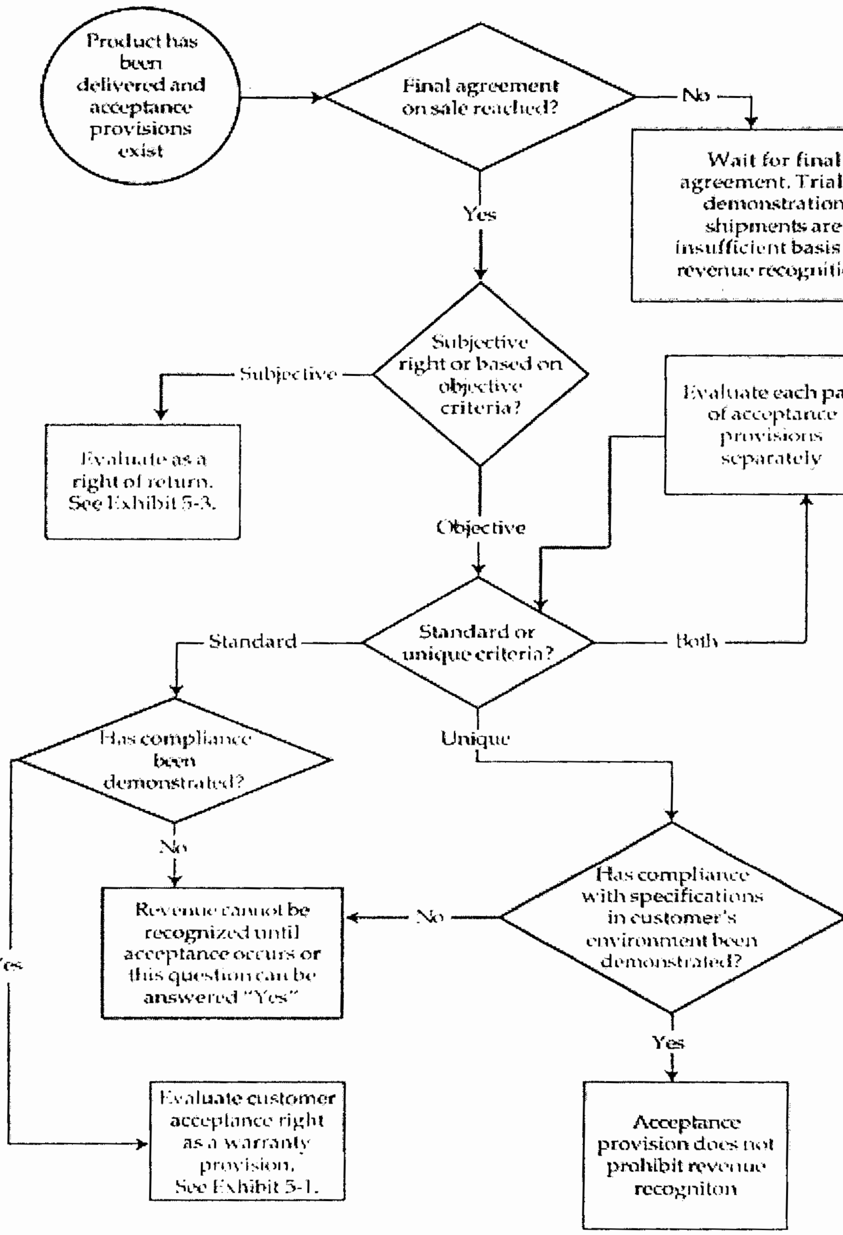
Customer Acceptance Based on Customer-Specified or Negotiated Criteria

This type of customer acceptance provision is the most difficult to analyze. Provisions like these are common in sales of equipment to be used in manufacturing, and in sales of industrial goods designed for a specific location, such as an air conditioning system designed for a particular building. Prior to installation and product testing at the customer's location, it is often unclear whether the product meets the specified criteria. This is because, no matter how much testing is done before shipment, it may not be possible to replicate the conditions of the customer's environment. These types of arrangements usually allow the seller a period of time after installation and testing to resolve any problems that might exist in meeting the criteria. As a result, the seller may need to perform additional work after installation in order to meet the specifications. If a substantive amount of additional work is likely to be required, revenue recognition upon shipment is inappropriate because the seller has not met its obligations.

Therefore, when an arrangement has customer-specified acceptance provisions, the seller must be able to reliably demonstrate that the delivered product meets these specified criteria before revenue can be recognized. If the criteria are sufficiently objective and the seller can replicate conditions under which the customer will operate the product, it may be possible to objectively demonstrate compliance with the acceptance provisions prior to shipment. In this case, revenue may be recognized upon delivery, provided that all other revenue recognition conditions have been met.

However, if unique aspects of the customer's environment could affect the assessment of whether the product meets the criteria or if other circumstances exist that prohibit the seller from verifying compliance with the acceptance provisions until delivery or installation, revenue should not be recognized until compliance can be verified. Verification often consists of a formal customer sign-off to indicate that the acceptance provisions have been met. However, if the seller can verify that the product meets the acceptance criteria and, thereby, believes it would be able to enforce a claim for payment even though formal customer sign-off has not occurred, revenue may be recognized because the seller has fulfilled all terms of the contract. As with other accounting that is based on a legal interpretation, consultation with legal experts may be necessary to determine the appropriate treatment (ASC 605-10-S99, A3b, ques. 1) (SAB Topic 13A3b, ques. 1).

Exhibit 5-2: Customer Acceptance Provisions



Example: Customer Acceptance Provisions

GT Advanced Technologies, Inc. Form 10-K—Fiscal Year Ended December 31, 2013

Revenue Recognition

The majority of the Company's contracts involve the sale of equipment or materials and services under multiple element arrangements. The Company recognizes revenue when persuasive evidence of an arrangement exists, the sale price is fixed or determinable, collectability is reasonably assured through historical collection results and regular credit evaluations, and delivery has occurred and there are no uncertainties regarding customer acceptance.

* * * * * * *

The Company's ASF and DSS equipment contracts contain customer-specified acceptance provisions. Polysilicon reactors contracts do not contain customer-specified acceptance provisions, and are generally deemed to be contractually accepted at the time the reactor is initially delivered to the customer's facility. For arrangements containing products that the Company considers to be "established," revenue is recognized for the product deliverable upon delivery, assuming all other revenue recognition criteria are met. For arrangements containing products considered to be "new" or containing customer acceptance provisions that are deemed to be more than perfunctory, product revenue is recorded upon customer acceptance or at the time the product is determined to be "established".

Products are classified as "established" products if post-delivery acceptance provisions and the installation process have been determined to be routine and there is a demonstrated history of achieving the predetermined contractual objective specifications.

In determining when a "new" product is considered "established", the Company considers the following factors: (i) the stability of the product's technology, (ii) the test results of products prior to shipment, (iii) successful installations at customer's sites and (iv) the performance results once installed. The Company generally believes that the satisfaction of the first two criteria, coupled with the satisfaction of final two criteria for multiple product units in the facilities of at least three to five separate customers that, in each case, results in acceptance in accordance with the standard contract terms are necessary to support the conclusion that there are no uncertainties regarding customer acceptances of the standard objective specifications and therefore the installation process can be considered perfunctory.

SDR-400™

During the three months ended June 29, 2013, the Company determined that it had obtained sufficient evidence that the SDR-400™, a product within the Polysilicon business unit, is an established product in accordance with the Company's revenue recognition policy, and accordingly, there is no longer uncertainty around meeting the requirements of customer acceptance conditions in agreements that contain the standard or demonstrated specifications of the SDR-400™. In concluding that the SDR-400™ is now an established product, the Company considered the stability of the product's technology, the ability to test the product prior to shipment, and the historical performance results of over 30 product installations at one of our customers' facilities. As a result of classifying the SDR-400™ an established product, the Company recognized revenue and gross profit of $148,935 and $58,907, in the twelve months ended December 31, 2013, from two customer arrangements that included SDR-400™'s, prior to formal customer acceptance of the products. Non-refundable payments received under these customer arrangements exceed the recognized revenue and were previously recorded as deferred revenue. The Company continues to report deferred revenue related to these arrangements for advance payments on other deliverables included in the arrangements.

OBSERVATION: Acceptance provisions based on specific criteria must be evaluated on a contract-by-contract basis. As a result, the timing of revenue recognition may differ for otherwise similar contracts. For example, in an arrangement to deliver multiple machines, each of which operate to identical specifications, it may not be possible to determine whether the first machine meets the specifications until it is tested in the customer's plant. Therefore, revenue recognition would need to be deferred on the first machine until after installation and testing. However, if the other machines in the order are identical to the first and any modifications that were necessary on the first machine are made to the others before shipment, revenue recognition on these machines may be appropriate upon shipment. If the contract specified unique acceptance provisions for each machine delivered, the analysis of the timing of revenue recognition would be different for each machine.

DISCLOSURE ALERT: See Chapter 12, "Disclosures," for information about disclosures that may be required.

SEC REGISTRANT ALERT: In early 2003 the SEC staff issued the Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies (Fortune 500 Report). This report resulted from the SEC's Division of Corporation Finance's (Corp Fin) review of all annual reports filed by Fortune 500 companies. The report provides insight into areas commonly questioned by Corp Fin during its reviews of annual reports. One area specifically mentioned in this report relates to customer acceptance clauses. Corp Fin noted that the quality of disclosures on these provisions requires improvement, particularly in the capital goods, semiconductor, and electronic instruments and controls industries.

Illustration: Effects of Customer Acceptance Provisions on Revenue Recognition

(Adapted from ASC 605-10-S99, A3b, ques. 3 through 5 (SAB Topic 13A3b, ques. 3 through 5))

Facts: Company E is an equipment manufacturer whose main product is generally sold in a standard model. The contracts for sale of that model provide for customer acceptance to occur after the equipment is received and tested by the customer. The acceptance provisions state that if the equipment does not perform to Company E's published specifications, the customer may return the equipment for a full refund or a replacement unit, or may require Company E to repair the equipment so that it performs up to published specifications. Customer acceptance is indicated by either a formal sign-off by the customer or by the passage of 90 days without a claim under the acceptance provisions. Title to the equipment passes upon delivery to the customer. Company E does not perform any installation or other services on the equipment it sells and tests each piece of equipment against its specifications before shipment. Payment is due under Company E's normal payment terms for that product—30 days after customer acceptance.

Example 1

Additional Facts: Company E receives an order from a new customer for a standard model of its main product. Based on the customer's intended use of the product, location, and other factors, there is no reason that the equipment would operate differently in the customer's environment than it does in Company E's facility.

Discussion: Although the arrangement includes a customer acceptance provision, acceptance is based on meeting Company E's published specifications for a standard model. Because Company E demonstrates that the equipment shipped meets the specifications before shipment, and the equipment is expected to operate the same in the customer's environment as it does in Company E's, Company E should evaluate the customer acceptance provision as a warranty under ASC 460. If Company E can reasonably and reliably estimate the amount of warranty obligations, Company E should recognize revenue upon delivery of the equipment (provided the other criteria for recognition are met) with an appropriate liability for probable warranty obligations.

Example 2

Additional Facts: Company E enters into an arrangement with a new customer to deliver a version of its standard product modified as necessary to fit into a space of specific dimensions while still meeting all of the published vendor specifications with regard to performance. In addition to the customer acceptance provisions relating to the standard performance specifications, the customer may reject the equipment if it does not conform to the specified dimensions. Company E creates a testing chamber of the exact same dimensions as specified by the customer and makes simple design changes to the product so that it fits into the testing chamber. The equipment still meets all of the standard performance specifications.

Discussion: The contract effectively includes two customer acceptance clauses—one based on a customer-specific criterion and one based on standard performance specifications. For the customer acceptance clause based on the customer-specific criterion, Company E demonstrates that the equipment shipped meets that objective criterion before shipment. As such, there are no uncertainties related to that customer acceptance clause that affect revenue recognition. For the customer acceptance clause based on the standard performance specifications, Company E demonstrates that the equipment shipped meets those specifications before shipment as well. This customer acceptance clause should be evaluated under ASC 460 as a warranty obligation. If Company E can reasonably and reliably estimate the amount of warranty obligations, it should recognize revenue upon delivery of the equipment with an appropriate liability for probable warranty obligations (provided the other criteria for recognition are met).

Example 3

Additional Facts: Company E enters into an arrangement with a new customer to deliver a version of its standard product modified as necessary to be integrated into the customer's new assembly line while still meeting all of the standard published vendor specifications with regard to performance. The customer may reject the equipment if it fails to meet the standard published performance specifications or cannot be satisfactorily integrated into the new line. Company E has never modified its equipment to work on an integrated basis in the type of assembly line the customer has proposed. In response to the request, Company E designs a version of its standard equipment that is modified as believed necessary to operate in the new assembly line. The modified equipment still meets all of the standard published performance specifications, and Company E believes the equipment will meet the requested specifications when integrated into the new assembly line. However, Company E is unable to replicate the new assembly line conditions in its pre-shipment testing.

Discussion: This contract includes a customer acceptance clause based, in part, on a customer-specific criterion and Company E cannot demonstrate that the equipment shipped meets that criterion before shipment. Accordingly, Company E may not recognize revenue before the product is successfully integrated at its customer's location and meets the customer-specific criterion.

Product Warranties

Many product sale arrangements include a warranty provision that provides the purchaser with some protection in the event the product does not perform as expected or requires post-sale servicing. Under a basic warranty, the seller assumes an obligation to repair or replace the product if it fails to perform as advertised or according to published specifications. However, not all warranty provisions involve the same type of obligation and it is important to understand the substance of these obligations to facilitate the proper accounting. For example, if the seller commits to ensure that the product will meet certain specifications that have not yet been demonstrated, revenue should not be recognized until compliance with these specifications is achieved. Furthermore, if the warranty is based on meeting criteria specific to a particular customer or product sale, the warranty obligation should be evaluated as a customer acceptance provision based on customer-specified criteria (see "Customer Acceptance Provisions" above).

In addition, certain warranties may include obligations other than ensuring that the product continues to operate according to specifications. For example, a warranty provision in a software arrangement may include the right to upgrades or updates to the product or a warranty on an automobile may include oil changes and other preventative maintenance during the warranty term. Neither of these specific provisions should be accounted for as part of the warranty. Rather, the sale of a product, along with a promise to provide upgrades or services after the sale, should be treated as a multiple-deliverable arrangement (see Chapter 4, "Multiple-Deliverable Revenue Arrangements"). Therefore, a portion of the sales prices in these situations generally should be allocated to the additional deliverables and deferred until the seller fulfills its obligations to provide the other products or services.

Most warranty provisions, however, merely require that the seller repair or replace the item if it fails to perform in the way it was designed and manufactured to perform. These provisions are usually explicitly identified in the documentation that comes with the product, but warranties may also be implied or required by laws or regulations (e.g., the "lemon laws" that cover automobiles in many states are a type of warranty). Because of a warranty commitment, the seller's involvement with the product may not end after delivery. At a minimum, the seller must be prepared to honor the warranty for whatever period of time it is in force.

One method of accounting for a product sale with a warranty would be to treat it as a multiple-deliverable arrangement; the product would be one deliverable and the warranty another. Revenue would be allocated between the product and the warranty, with the amount allocated to the warranty recognized as revenue over the warranty period, consistent with other service transactions. Another possible method of accounting for a warranty would be to treat it as a part of the product and not account for it separately. If analyzed this way, a question arises as to whether the warranty obligation is significant enough to prevent revenue recognition on the product. If the obligation is significant, revenue would not be recognized until the warranty expires. Conversely, if the warranty obligation were deemed insignificant, all revenue would be attributed to the product and recognized upon delivery (or when all revenue recognition criteria are met). U.S. GAAP recognizes both accounting approaches, depending on the facts and circumstances.

OBSERVATION: Although warranties are conceptually within the scope of ASC 460, they are exempted from its accounting requirements.

Standard Warranties

In many cases, a sale of goods in the normal course of business includes a standard warranty for all buyers of the product. This warranty is not treated as a separate service; rather, it is considered an integral part of the product sale. Revenue may be recognized upon product delivery when a standard warranty is included in the transaction, provided that the costs of honoring the warranty can be reliably estimated and that the other conditions for revenue recognition have been met. The estimated costs of honoring the warranty must be accrued to cost of sales when revenue is recognized, and these costs should be updated as estimates change.

However, if the costs of honoring the warranty cannot be reliably estimated and the potential range of loss is wide, revenue should be deferred until either a reliable estimate of the costs can be made or the warranty period expires (ASC 460-10-25-6). Indicators that costs may not be reliably estimable include (a) the introduction of new products or significant modifications that have been made to old products, (b) the extension of the scope of a warranty beyond what has normally been given in the ordinary course of business, and (c) undertaking new obligations.

DISCLOSURE ALERT: See Chapter 12, "Disclosures" for information about required disclosures.

Separately Priced Extended Warranty and Product Maintenance Contracts

The preceding discussion applies only to standard warranties offered to all purchasers of a product without an extra charge. Revenue from separately priced extended warranty and product maintenance contracts should be deferred and recognized in income over the contract period. A warranty is priced separately any time a customer may purchase the product with or without the warranty. For example, assume that all purchasers of a particular model of television receive a one-year warranty and can purchase a three-year warranty for an added charge. The arrangement should be accounted for as having a one-year standard warranty and a two-year separately priced extension. As such, the fee paid for the two-year extension should be deferred and recognized as revenue after the television is delivered in years two and three. The purchase price of the television with the standard one-year warranty should be recognized as revenue upon delivery as long as all other revenue recognition conditions are met and the costs of honoring the one-year warranty can be reliably estimated.

The recognition pattern for revenue attributable to a separately priced extended warranty contract should be on a straight-line basis, unless historical evidence indicates that the costs of performing services under the contract are incurred on other than a straight-line basis. If costs are incurred on other than a straight-line basis, revenue should be recognized over the contract period in proportion to the costs expected to be incurred in performing services under the contract (ASC 605-20-25-1 through 25-6).

DISCLOSURE ALERT: See Chapter 12, "Disclosures" for information about required disclosures.

Examples: Warranties

Dell, Inc. Form 10-K—Fiscal Year Ended February 1, 2013

Warranty Liability and Related Deferred Service Revenue

Note 9: Warranty and Deferred Extended Warranty Revenue

Dell records liabilities for its standard limited warranties at the time of sale for the estimated costs that may be incurred. The liability for standard warranties is included in accrued and other current liabilities and other non-current liabilities on the Consolidated Statements of Financial Position. Revenue from the sale of extended warranties is recognized over the term of the contract or when the service is completed, and the costs associated with these contracts are recognized as incurred. Deferred extended warranty revenue is included in deferred revenue on the Consolidated Statements of Financial Position. Changes in Dell's liabilities for standard limited warranties and deferred services revenue related to extended warranties are presented in the following tables for the periods indicated:

	Fiscal Year Ended		
	February 1, 2013	February 3, 2012	January 28, 2011
Warranty liability:			
Warranty liability at beginning of period	$888	$895	$912
Costs accrued for new warranty contracts and changes in estimates for pre-existing warranties[(a)] [(b)]	992	1,025	1,046
Service obligations honored	(1,118)	(1,132)	(1,063)
Warranty liability at end of period	$762 =====	$888 =====	$895 =====
Current portion	$492	$572	$575
Non-current portion	270	316	320
Warranty liability at end of period	$762 =====	$888 =====	$895 ======

	Fiscal Year Ended		
	February 1, 2013	February 3, 2012	January 28, 2011
		(in millions)	
Deferred extended warranty revenue:			
Deferred extended warranty revenue at beginning of period	$7,002	$6,416	$5,910
	4,130	4,301	3,877

Revenue deferred for new extended warranties[b]			
Revenue recognized	(4,029)	(3,715)	(3,371)
Deferred extended warranty revenue at end of period	$7,103 =====	$7,002 ====	$6,416 ====
Current portion	$3,400	$3,265	$2,959
Non-current portion	3,703	3,737	3,457
Deferred extended warranty revenue at end of period	$7,103 =====	$7,002 ====	$6,416 ====

[a] Changes in cost estimates related to pre-existing warranties are aggregated with accruals for new standard warranty contracts. Dell's warranty liability process does not differentiate between estimates made for pre-existing warranties and new warranty obligations.

[b] Includes the impact of foreign currency exchange rate fluctuations.

Products Shipped Subject to Other Conditions

Product sales can include various other conditions. For example, products may be sold subject to installation or performance of other services. When a product is sold together with post-delivery services, the arrangement should be accounted for as a multiple-deliverable arrangement. If the product and service deliverables meet the requirements for separate accounting treatment, the revenue allocated to the product deliverable should be recognized at the appropriate time, without regard to the service deliverable. However, if the deliverables do not meet the requirements for separate accounting treatment, no revenue should be recognized until the product is delivered *and* the service has been performed. See Chapter 4, "Multiple-Deliverable Revenue Arrangements," for further discussion.

RIGHTS OF RETURN

Return rights are very common in product transactions. For example, almost any retail purchase can be returned for a limited period of time. Resellers and distributors are often granted rights of return to reduce their risk of loss if the product is difficult to resell. Similarly, sales of commercial products may have rights of return related to quality, performance testing, or other factors.

PRACTICE POINTER: Return rights are often documented in the sales contract. However, such rights may also exist due to industry practice, company policy, or laws and regulations. In addition, the relationship between the buyer and seller should be evaluated in full to determine whether unstated rights of return might exist. For example, a large customer of a company may have enough leverage to return goods beyond the limited period stated in the contract. Although the seller may be within its rights to deny such returns, it is common for a seller to accept such a return from an important customer. Therefore, all rights of return, whether or not explicitly stated in a contract, must be considered.

General Rights of Return

ASC 605-15 provides accounting guidance for a subjective right of return, such as a "100% satisfaction guarantee," that may be exercised at will by the purchaser. This guidance prohibits recognition of revenue if there is significant uncertainty as to whether, or to what extent, the return right will be exercised.

Rights of Return vs. Rights of Exchange

The guidance regarding rights of return does not apply to rights given to ultimate customers (i.e., end users) to exchange one item for another of the same kind, quality, and price. These "like-kind" exchange rights are not treated as returns for accounting purposes and generally should have no effect on revenue recognition (ASC 605-15-15-2). Instead, the estimated costs of fulfilling those exchange rights expected to be exercised should be accrued at the time of sale.

This exception applies only to sales to end-users, not resellers. Therefore, if a manufacturer of a product provides "stock rotation rights" to distributors or retailers that allow the reseller-customer to return products for credits towards other purchases, that right must be evaluated as a right of return, no matter how similar the products the credit can be used towards are to the original products.

In addition, the evaluation of whether the exchange represents an exchange of a product for one of the same kind-quality, and price must be made considering the condition of the product to be returned. For example, a right to exchange product that is accidentally damaged by the customer for an undamaged product would not represent a like-kind exchange. Such a right would be considered a right of return.

Similarly, a right offered by a drug manufacturer to allow its customer to return product that gets close to its expiration date for "fresh" product is not a like-kind exchange, as the fresh product is clearly more useful than the product close to its expiration date. In addition, such rights, when offered, are almost invariably offered to distributors of the drug, not to patients who will take the drug, and therefore are not being offered to ultimate customers. For both reasons, this kind of right, even when limited to getting fresh inventory of the same drug, must be evaluated as a right of return.

Accounting for Rights of Return

Although a return right creates a question as to whether the transaction has been completed, the seller records revenue upon delivery if the terms of the arrangement make it clear that a sale has occurred, there are no other contingencies, and the likelihood of the customer exercising the right of return can be estimated.

Specifically, revenue should be recognized at the time of sale, net of estimated returns, only if all of the following conditions (and the remaining general conditions for revenue recognition) are met (ASC 605-15-25-1):

1. *The sales price to the buyer is fixed or determinable.* This shows that the return period is not just part of the transaction's pricing negotiations. If the arrangement does not meet this criterion, no revenue should be recognized because a fixed or determinable fee is one of the prerequisites to recognizing revenue.

2. *Payment is not contractually or otherwise excused until the product is resold.* If payment is not required until the product is resold, the transaction takes on characteristics of a consignment, for which no revenue should be recognized.

OBSERVATION: Although payment may contractually be due within a specified period of time, a company may have a business practice of not pursuing payment until the customer actually resells the products. If this is the case, the business practice must be considered in the evaluation, and revenue may not be recognized until the right of return expires or payment is received.

3. *The buyer holds the risks of destruction, damage, or theft of the property.* If the buyer does not hold these risks, then all of the risks and rewards of ownership have not passed, and revenue recognition is prohibited.

4. *The buyer has economic substance apart from the seller.* A sale with a right of return to a company with little substance raises significant questions about the buyer's ability to pay. In this case, the buyer would appear to be acting as a sales agent for the seller, rather than as a substantive purchaser. As a result, the seller should not record any sale to the nonsubstantive purchaser.

5. *The seller does not have significant obligations for future performance relating to the resale of the product by the buyer.* If the seller is required to assist the buyer in the product's resale, the seller has not completed its obligations under the arrangement until resale has occurred and should not recognize revenue until then, provided the other conditions for recognition have been met.

6. *The amount of future returns and costs expected in connection with any returns can be reasonably predicted.* This criterion requires the most judgment and is the one that most often cannot be met. See below for further discussion.

Estimating Returns

Determining whether a reasonable estimate of returns can be made is sometimes quite easy. For example, a product that has been sold to the same group of customers and has generated a consistent rate of return for many years can probably be expected to have the same level of returns in the future, as long as there are no external changes that might affect customers' return habits. On the other hand, a start-up company selling a newly invented product that is not similar to any other product on the market may quickly conclude that it cannot estimate the level of returns that will occur (ASC 605-10-S99, A4a, ques. 4) (SAB Topic 13A4a, ques. 4).

OBSERVATION: There is no specific level of returns that would prohibit recognition of revenue on sales with a right of return. The accounting literature focuses entirely on the ability of a company to estimate returns in determining whether revenue may be recognized upon delivery. When the percentage of customers exercising return rights is high, it may be more difficult to estimate the rate of returns, but this is just one of many factors a company would take into account in determining whether it can make a reliable estimate of returns (ASC 605-10-S99, A4a, ques. 5) (SAB Topic 13A4a, ques. 5).

When evaluating whether a reasonable estimate of returns can be made, all available information should be considered. The following factors, the existence of any of which may cause the seller to conclude that returns cannot be reasonably predicted, should be considered by a seller when estimating the amount of returns:

1. *The product is susceptible to significant external factors, such as technological obsolescence or changes in demand* (ASC 605-15-25-3). When the return period is lengthy, it may be difficult to predict the economic and technological life of (i.e., demand for) the product. It may also be harder to forecast competitors' actions and customers' responses to market factors.

2. *The return period is long* (ASC 605-15-25-3). The longer the return period, the more difficult it becomes to predict the level of returns. Whether a return period is long should be determined based on the nature of the product, industry practice, and the type of customer.

3. *The absence of relevant historical experience* (ASC 605-15-25-3). Without historical experience to reference, predicting customer actions is virtually impossible. However, in the absence of company-specific experience, industry experience may be relevant.

4. *The absence of a large volume of relatively homogeneous transactions* (ASC 605-15-25-3). It is generally difficult to predict the actions of a particular customer. However, it is much easier to predict, on average, the actions of a large number of similar customers.

5. *Increases in or excess levels of inventory at distributors, or a lack of information about the levels of inventory at distributors* (ASC 605-10-S99, A4b, ques. 1) (SAB Topic 13A4b, ques. 1). Either of these situations indicates that historical experience is less likely to have sufficient predictive ability to guide future actions given the problems with inventory management.

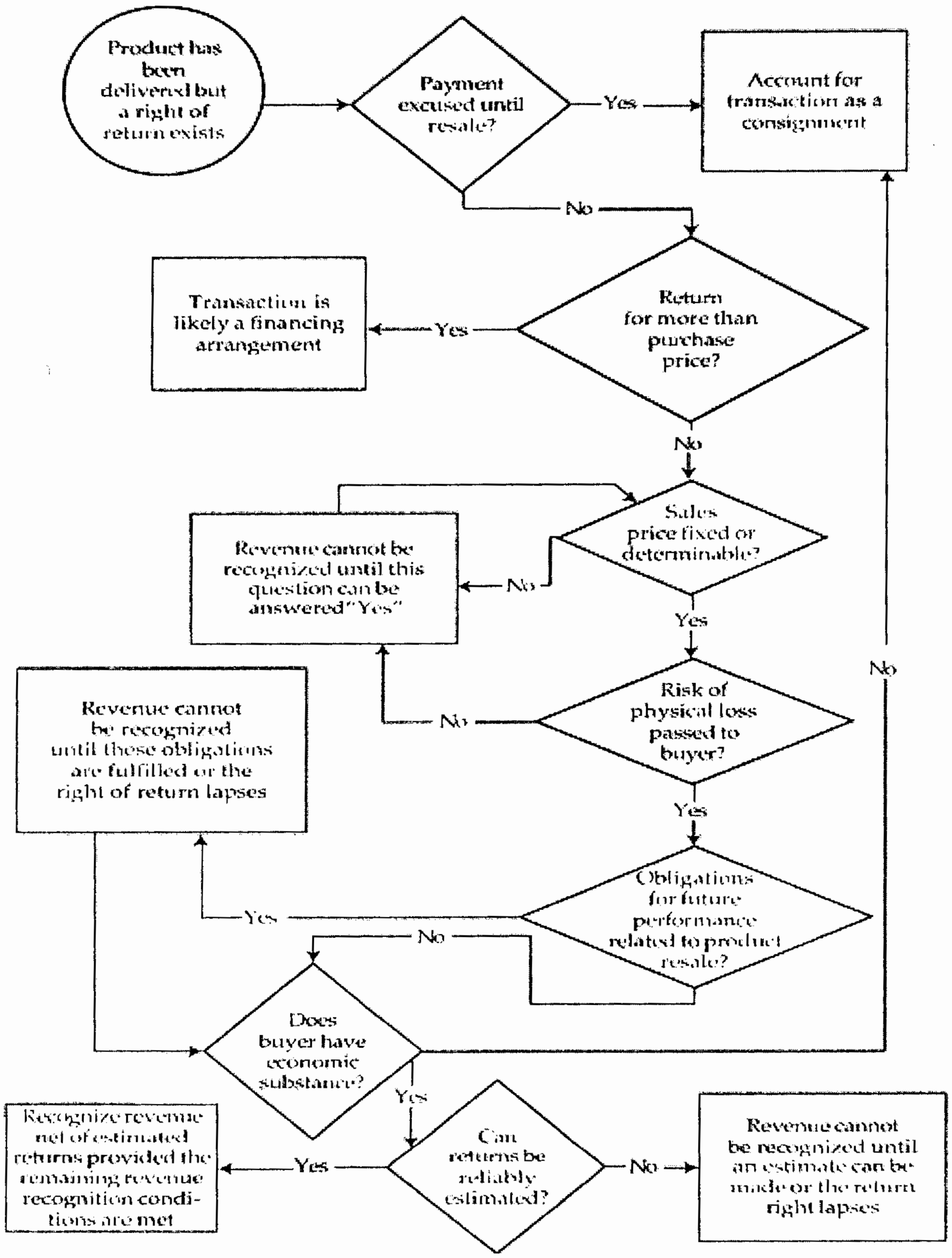
6. *Importance of sales by and to a particular distributor to the reporting entity (overall or to a specific reportable segment)* (ASC 605-10-S99, A4b, ques. 1) (SAB Topic 13A4b, ques. 1). Trends in sales by and to an important distributor or significant changes in inventory levels at a new distributor may have implications for the vendor's ability to estimate returns.

7. *Expected introductions of new products* (ASC 605-10-S99, A4b, ques. 1) (SAB Topic 13A4b, ques. 1). If the product subject to the return right is near the end of its life due to the planned introduction of a new or upgraded version, it is possible that more returns will occur as customers opt for the new or upgraded version.

8. *The product is new* (ASC 605-10-S99, A4b, ques. 1) (SAB Topic 13A4b, ques. 1). The newer the product, the less likely it is that relevant return experience exists. Depending upon the circumstances, return experience with other, similar, products may be useful.

OBSERVATION: The ability to estimate returns could vary from product to product, location to location, customer to customer, and arrangement to arrangement. In addition, it may be possible for a company to estimate returns for certain transactions but not others. Thus, a company that sells various products or serves different market segments whose return rates are expected to vary should develop different return estimates for each type of product or market segment.

Exhibit 5-3: Rights of Return



PRACTICE POINTER: U.S. GAAP requires a reliable estimate of returns before any revenue can be recognized. Some have suggested that, even in the absence of a good estimate, revenue recognition should be allowed if a company assumes an unusually conservative (i.e., high) level of returns that is unlikely to be exceeded. However, this treatment is not consistent with the accounting literature. Therefore, it is critical that the company develop and sustain the ability to reliably estimate returns to recognize any revenue at delivery (ASC 605-10-S99, A4b, ques. 5) (SAB Topic 13A4b, ques. 5).

In some arrangements, however, a company may sell a large number of products to a single customer with a capped right of return. For example, if the customer is only permitted to return up to 20% of the products shipped, revenue may be recognized upon delivery for the 80% to which the return rights do not apply, assuming all other revenue recognition criteria are met. The 20% of products to which the rights of return do apply should be evaluated to determine whether revenue may be recognized upon delivery.

Example: Inability to Estimate Returns

Acura Pharmaceuticals, Inc. Form 10-K—Fiscal Year Ended December 31, 2012

Nexafed was launched in the fourth quarter of 2012. The Company sells Nexafed in the United States to wholesale pharmaceutical distributors subject to the right of return for a period of up to six months after the product expiration. Nexafed currently has a shelf life of twenty-four months from the date of manufacture. Given the limited sales history of Nexafed, the Company currently cannot reliably estimate expected returns of the product at the time of shipment. Accordingly, the Company defers recognition of revenue on the product shipments of Nexafed until the right of return no longer exists or adequate history and information is available to estimate product returns.

Accounting for Rights of Return

When revenue is not recognized at the time of sale because an estimate of returns cannot be made, the seller should delay recognition until the earlier of when the return privilege has expired or information allowing the company to make a reasonable estimate of returns becomes available, provided the other conditions for revenue recognition have been met (ASC 605-15-25-1). In this situation, the inventory "sold" should remain on the company's books, and any cash collected should be reflected as a liability, rather than as revenue. The inventory should be evaluated for impairment under the assumption that the customer will return the products to the company and consider any anticipated repackaging or other costs to put the merchandise in saleable condition. If returned products cannot be resold or reused, the inventory balance related to products expected to be returned should be written down to scrap value.

OBSERVATION: U.S. GAAP is clear that when an estimate of returns cannot be made, no revenue can be recognized. To be consistent with this approach, no cost of sales should be recognized. It is not appropriate in such a situation to merely defer the margin on the sale by recognizing revenue equal to cost of sales. While deferring only the gross margin ensures that net income is not overstated, it results in the recognition of revenue for a transaction that is, essentially, incomplete (ASC 605-10-S99, A4b, ques. 1) (SAB Topic 13A4b, ques. 1). It also misrepresents various balance sheet components.

When a transaction meets all of the criteria for revenue recognition upon delivery despite the existence of a return right, revenue and cost of sales should be recognized net of the expected returns. Any inventory expected as a return should be evaluated for impairment and this evaluation should consider any anticipated repackaging or other costs to put the merchandise in saleable condition. As estimates of returns change, the anticipated refund liability should be adjusted to reflect this new information.

DISCLOSURE ALERT: See Chapter 12, "Disclosures," for information about disclosures that may be required.

SEC REGISTRANT ALERT: In early 2003 the SEC staff issued the Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies (Fortune 500 Report). This report resulted from the SEC's Division of

Corporation Finance's (Corp Fin) review of all annual reports filed by Fortune 500 companies. The report provides insight into areas commonly questioned by Corp Fin during its reviews of annual reports. One area specifically mentioned in this report relates to rights of return. Corp Fin noted that the quality of disclosures on rights of return requires improvement, particularly in the capital goods, semiconductor, electronic instruments and controls, and pharmaceutical industries.

Illustration: Product Sold with Right of Return

Facts: Example Company sells 100 units of Product A at $100 per unit. Product A has an inventory cost of $87 per unit, and repackaging any returned units for resale will cost $15 per unit. Customers get a 30-day right of return on Product A and, ultimately, 5 of the 100 units are returned. The right of return is the only issue that can affect when revenue should be recognized.

Example 1

Additional Facts: Example Company determines at the time of sale that it cannot estimate the amount of returns it will receive.

Accounting:

Upon delivery:

- No revenue is recognized and the inventory remains on the company's books.

- The inventory is evaluated for impairment, under the assumption it will be returned. As the inventory cost plus anticipated repackaging costs ($87 + $15 = $102/unit) exceeds the anticipated sales price of the products ($100/unit), an impairment of $2 per unit, or $200 total, is recorded.

Cost of Sales(Impairment)	$200	
Inventory		$200

- Payment is received.

Cash	$10,000	
Deposit Liability		$10,000

At the end of the return period:

- Revenue for products not returned is recognized.

Deposit Liability	$9,500	

Revenue		$9,500

- Inventory is reduced and cost of sales recorded for products not returned.

Cost of Sales	$8,075	
Inventory ($85 × 95 units)		$8,075

- Cash is refunded on the returned products.

Deposit Liability	$500	
Cash		$500

- Repackaging costs are incurred on the returned products.

Inventory	$75	
Cash		$75

Example 2

Additional Facts: Example Company determines that it can estimate the amount of returns and this estimate is initially determined to be 6% of sales.

Accounting:

Upon delivery:

- Revenue is recognized for products not expected to be returned and a refund liability is recorded for products expected to be returned.

Cash	$10,000	
Revenue		$9,400
Deposit Liability		$600

- Cost of sales is recognized for products not expected to be returned.

Cost of Sales ($87 × 94 units)	$8,178	

Inventory		$8,178

- Units expected to be returned are evaluated for impairment, taking repackaging costs into account. An impairment of $2 per unit is calculated.

Cost of Sales	$12	
Inventory		$12

At the end of the return period:

- Additional revenue and cost of sales are recognized because returns were less than expected.

Deposit Liability	$100	
Revenue		$100
Cost of Sales	$85	
Inventory		$85

- Cash refunds are made for returned products.

Deposit Liability	$500	
Cash		$500

- Repackaging costs on returned products are incurred.

Inventory	$75	
Cash		$75

SALES WITH MARKET VALUE PROTECTION

Certain clauses in a product sales arrangement mitigate some of the buyer's risk of a decline in market value of the goods. However, when these clauses cause the seller to retain a substantial amount of the risks and rewards of ownership, sale accounting will be precluded.

Price Protection

A price protection clause provides the buyer a credit (either in cash or as a discount on future purchases) if there is a price decrease during a specified period of time or until the buyer resells the goods. Some price protection clauses (sometimes called "Most Favored Nation" clauses) require a payment only if the seller lowers its prices during the price protection period. Other terms result in a direct payment to the customer if a competitor offers the same or a similar product at a lower price. Retailers in competitive market segments, such as appliances and electronics, commonly offer the latter form of price protection.

The accounting for price protection depends on whether the seller can estimate the amount of refunds to be granted under the price protection terms. If the seller can develop a reasonable and reliable estimate, revenue should be recognized upon delivery (assuming all other revenue recognition criteria are met) net of a provision for estimated price protection refunds. If the seller cannot develop a reasonable and reliable estimate, revenue should not be recognized until either such an estimate can be made or the price protection period ends. When the price protection clause allows for refunds based on the actions of a competitor, it may be difficult to make a reasonable and reliable estimate because the payments can be triggered by a third party rather than the seller. At a minimum, the factors discussed under "Rights of Return" should be considered in these situations.

DISCLOSURE ALERT: See Chapter 12, "Disclosures," for information about disclosures that may be required.

SEC REGISTRANT ALERT: In a December 2001 speech, the SEC staff indicated that it would focus on the accounting for price protection clauses. Specifically, the staff suggested that it will be highly skeptical in a situation where a company has developed an estimate of payments to be granted without relevant historical experience. In addition, in early 2003, the SEC staff issued the Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies (Fortune 500 Report). This report resulted from the SEC's Division of Corporation Finance's (Corp Fin) review of all annual reports filed by Fortune 500 companies. The report provides insight into areas commonly questioned by Corp Fin during its reviews of annual reports. One area specifically mentioned in this report relates to price protection clauses. Corp Fin noted that the quality of disclosures on price protection clauses requires improvement, particularly in the capital goods, semiconductor, and electronic instruments and controls industries.

Examples: Product Returns and Price Protection

Intel Corporation Form 10-K—Fiscal Year Ended December 29, 2012

We recognize net product revenue when the earnings process is complete, as evidenced by an agreement with the customer, delivery has occurred, and acceptance, if applicable, as well as fixed pricing and probable collectibility. We record pricing allowances, including discounts based on contractual arrangements with customers, when we recognize revenue as a reduction to both accounts receivable and net revenue. Because of frequent sales price reductions and rapid technology obsolescence in the industry, we defer product revenue and related costs of sales from component sales made to distributors under agreements allowing price protection or right of return until the distributors sell the merchandise. The right of return granted generally consists of a stock rotation program in which distributors are able to exchange certain products based on the number of qualified purchases made by the distributor. Under the price protection program, we give distributors credits for the difference between the original price paid and the current price that we offer.

Activision Blizzard, Inc. Form 10-K—Fiscal Year Ended December 31, 2012

We may permit product returns from, or grant price protection to, our customers under certain conditions. In general, price protection refers to the circumstances in which we elect to decrease, on a short or longer term basis, the wholesale price of a product by a certain amount and, when granted and applicable, allow customers a credit against amounts owed by such customers to us with respect to open and/or future invoices. The conditions our customers must meet to be granted the right to return products or price protection include, among other things, compliance with applicable trading and payment terms, and consistent return of inventory and delivery of sell-through reports to us. We may also consider other factors, including the facilitation of slow-moving inventory and other market factors.

Significant management judgments and estimates must be made and used in connection with establishing the allowance for returns and price protection in any accounting period based on estimates of potential future product returns and price protection related to current period product revenue. We estimate the amount of future returns and price protection for current period product revenue utilizing historical experience and information regarding inventory levels and the demand and acceptance of our products by the end consumer. The following factors are used to estimate the amount of future returns and price protection for a particular title: historical performance of titles in similar genres; historical performance of the hardware platform; historical performance of the franchise; console hardware life cycle; sales force and retail customer feedback; industry pricing; future pricing assumptions; weeks of on-hand retail channel inventory; absolute quantity of on-hand retail channel inventory; our warehouse on-hand inventory levels; the title's recent sell-through history (if available); marketing trade programs; and performance of competing titles. The relative importance of these factors varies among titles depending upon, among other items, genre, platform, seasonality, and sales strategy.

Based upon historical experience, we believe that our estimates are reasonable. However, actual returns and price protection could vary materially from our allowance estimates due to a number of reasons including, among others, a lack of consumer acceptance of a title, the release in the same period of a similarly themed title by a competitor, or technological obsolescence due to the emergence of new hardware platforms. Material differences may result in the amount and timing of our revenue for any period if factors or market conditions change or if management makes different judgments or utilizes different estimates in determining the allowances for returns and price protection. For example, a 1% change in our December 31, 2012 allowance for sales returns, price protection and other allowances would have impacted net revenues by approximately $3 million.

Guaranteed Resale or Residual Value

To induce a purchaser to buy its product, a company may offer what amounts to a blanket guarantee on the value of the product for some period of time after delivery. Such guarantees can take several forms. For example, the company may agree to repurchase the product from its customer for a set price after several years of use. Alternatively, a company could agree to make up the difference between the actual selling price when its customer resells the product and the guaranteed price. These kinds of price guarantees must be evaluated as part of the original sale transaction, rather than as a separate purchase transaction or loss contingency.

The accounting for a resale price or residual value guarantee generally depends on whether the purchaser (i.e., the beneficiary of the guarantee) intends to use the products or resell them. If the purchaser is a reseller, the seller should account for the transaction as a product financing arrangement (see the discussion earlier in this chapter).

When the purchaser intends to use the products, the seller should account for the transaction as a lease. This is because the purchaser has essentially agreed to pay the difference between the initial purchase price and the guaranteed residual value for use of the product during the guarantee period.

Unless the residual value guarantee is less than 10% of the original sales price or the term of the guarantee is at least 75% of the useful life of the product, the lease accounting literature will classify this type of arrangement as an operating lease, rather than a sales-type lease. As a result, the asset will remain on the seller's books and be depreciated, the cash received will be recorded as a liability, and the difference between the initial sales price and the guaranteed residual value will be recognized as revenue over the guarantee period. If the guarantee can be exercised at various dates, with amounts declining over time, each decrease in guaranteed value should be considered rental income for the applicable period. If the residual value guarantee expires, any remaining liability should be recognized as revenue at that time, and the remaining asset value should be treated as cost of sales (ASC 840-10-55-12 through 55-25).

OBSERVATION: The residual value guarantee in a sales arrangement does not fall within the scope of ASC 460 because ASC 460 does not apply to a guarantee for which the underlying is related to an asset of the guarantor. For example, if a sales arrangement with a residual value guarantee is deemed an operating lease based on applying the guidance in ASC 840-10-55-12 through 55-25, the equipment (i.e., the underlying) will remain on the lessor's books, which exempts the guarantee from the scope of ASC 460. If a sales arrangement with a residual value guarantee is deemed a sales-type lease, the lessor continues to recognize the guaranteed equipment's (the underlying's) residual value as an asset through its net investment in the lease (ASC 460-10-55-17), which also exempts the guarantee from the scope of ASC 460.

Illustration: Residual Value Guarantee on Used Equipment

Facts: Equipment Co. sells Product X for $100,000. It also offers its customer a residual value guarantee on Product X that is exercisable three years after the original sale. The guaranteed value is $55,000 after three years. Product X has a cost basis of $60,000, and an estimated useful life of ten years. Equipment Co. generally uses straight-line depreciation. Since the residual value guarantee is more than 10% of the original sales price and the term of the guarantee is less than 75% of the useful life of the product, Equipment Co. concludes that the agreement should be treated as an operating lease.

Example 1

Additional Facts: The customer uses the equipment for three years, and then sells it to a third party for $50,000. Equipment Co. therefore makes a $5,000 payment related to the residual value guarantee.

Accounting:

Original Sale:

- Equipment Co. recognizes the receipt of payment, but no revenue.

Cash	$100,000	
Deposit Liability		$100,000

Each of the three years following the original sale:

- Equipment Co. recognizes the difference between the original sales price and the first residual value guarantee amount as lease income as follows:

Original sales price	$100,000
Residual value guarantee in three years	55,000
Income to recognize over three years	$45,000 ======
Income to recognize each year	$15,000 ======

Deposit Liability	$15,000	
Lease Revenue		$15,000

- Equipment Co. records depreciation expense on Product X based on Product X's carrying value of $60,000 and a ten-year life.

Depreciation Expense	$6,000	
Accum. Depreciation—Product X		$6,000

At the end of year three:

- Equipment Co. records its payment under the guarantee.

Deposit Liability	$5,000	
Cash		$5,000

- Equipment Co. records the remaining liability as revenue, along with cost of sales for the remaining carrying value of Product X.

Deposit Liability	$50,000	
Product Sale Revenue		$50,000

Cost of Sales	$42,000	
Accum. Depreciation—Product X	$18,000	
Historical Cost—Product X		$60,000

Example 2

Additional Facts: The customer keeps the equipment longer than three years. Equipment Co. therefore makes no payment on its residual value guarantee.

Accounting:

Original sale and each of the three years following the original sale:

- See Example 1.

At the end of year three:

- Equipment Co. records the remaining liability as revenue, along with cost of sales for the remaining carrying value of Product X.

Deposit Liability	$55,000	
Product Sale Revenue		$55,000
Cost of Sales	$42,000	
Accum. Depreciation—Product X	$18,000	
Historical Cost—Product X		$60,000

Sales with Fixed-Price Trade-In Rights

One variant on a guaranteed residual value is a fixed-price trade-in right, which allows the customer to exchange the purchased product for a specified credit toward another of the manufacturer's products after some period of time. This type of right is a guarantee under ASC 460. As a result, the fixed-price trade-in right should be initially recognized and measured at fair value provided that it does not prohibit revenue recognition on the arrangement in general. In effect, a sales contract that includes a fixed-price trade-in right is a multiple-deliverable arrangement; one deliverable is the sale of the product and the other is the trade-in right or guarantee. Multiple-deliverable arrangements and ASC 460 are discussed in more detail in Chapter 4, "Multiple-Deliverable Revenue Arrangements."

SELLER-PROVIDED FINANCING AND GUARANTEES

Sales with Extended Payment Terms

Some sellers elect to finance their customers' purchases by agreeing to receive fixed payments over an extended period of time, rather than receiving the purchase price per normal payment terms shortly after delivery. Except in the sale of software products (see Chapter 10, "Software—A Complete Model"), U.S. GAAP does not provide specific guidance about when extended payment terms should prevent revenue recognition. However, extended payment terms can affect two of the four basic conditions for revenue recognition—a fixed or determinable fee and that collectibility is reasonably assured.

Extended Payment Terms and Fixed or Determinable Fees

Extended payment terms raise the risk that the seller will agree to provide additional products or services or reduce the arrangement fee to ensure payment according to the stated terms, even for a creditworthy customer. Consider the example of a customer who is dissatisfied with the product but does not have a warranty or return right. The customer may instead elect to withhold payments and require the seller to negotiate to receive additional amounts that are due. Therefore, extended payment terms should be carefully considered along with warranty, return, customer acceptance, and other terms in the arrangement to determine whether they result in a conclusion that the arrangement fee is not fixed or determinable.

> **OBSERVATION:** The above discussion applies only to payment terms that are fixed at the time of delivery. Terms that are extended until the products are used or resold generally indicate the existence of a consignment arrangement, as previously discussed in this chapter.

Extended Payment Terms and Collectibility

The longer the payment terms, the more difficult it is to conclude that collection is reasonably assured. Significant judgment must be applied in these situations. If a seller concludes that collection is not reasonably assured, no revenue or receivable should be recorded. It is not acceptable in these instances to record revenue and a selling expense for the anticipated bad debt because the threshold criteria for revenue recognition were never met.

Discounting Long-Term Receivables

When products are sold on extended payment terms and it is acceptable to recognize revenue upon delivery, ASC 835-30-25-7 requires the long-term receivable and, therefore, the revenue, to be recorded at the present value of the payments, rather than at the nominal value. Interest income should then be accrued on the receivable until all payments are made. Therefore, when extended payment terms are stated at their nominal values, a portion of the payments will be attributed to interest income, as opposed to revenue (ASC 835-30-25-10).

Guaranteeing a Loan in Connection with a Sale of Products

Some companies agree to guarantee the loan a buyer uses to purchase the seller's products. Although the company has collected the purchase price in cash, the probability of ultimately realizing the purchase price is the same as if it had sold the product on extended payment terms per the loan terms. Therefore, before recognizing any revenue, the company should evaluate whether collectibility is reasonably assured as if it were the lender under the loan.

If the company still concludes that collection is reasonably assured and that all other revenue recognition criteria have been met, ASC 460 requires the transaction to be treated as a multiple-deliverable arrangement; one deliverable is the product sale and the other is the loan guarantee. This type of multiple-deliverable arrangement is discussed in more detail in Chapter 4, "Multiple-Deliverable Revenue Arrangements."

In other cases, the seller may agree to repurchase product from its customer in the event the customer defaults on a financing agreement for which the products in question serve as collateral. These arrangements, commonly called "floor plan" arrangements, should also be evaluated as guarantees provided to a third party lender. However, the terms of the arrangement would affect the estimation of any losses, as the resale of repurchased products would be taken into account in loss estimates.

Example: Guarantees

Winnebago Industries Form 10-K—Fiscal Year Ended August 25, 2012

It is customary practice for manufacturers in the RV industry to enter into repurchase agreements with financing institutions that provide financing to their dealers, upon their request. Our repurchase agreements generally provide that, in the event of a default by a dealer in its obligation to these lenders, we will repurchase vehicles sold to the dealer that have not been resold to retail customers. The terms of these agreements, which can last up to 18 months, provide that our liability will be the lesser of remaining principal owed by the dealer or dealer invoice less periodic reductions based on the time since the date of the original invoice. Our liability cannot exceed 100% of the dealer invoice. In certain instances, we also repurchase inventory from our dealers due to state law or regulatory requirements that govern voluntary or involuntary relationship terminations.

Based on these repurchase agreements, we establish an associated loss reserve which is disclosed separately in the balance sheets. Repurchased sales are not recorded as a revenue transaction, but the net difference between the original repurchase price and the resale price are recorded against the loss reserve, which is a deduction from gross revenue. Our loss reserve for repurchase commitments contains uncertainties because the calculation requires management to make assumptions and apply judgment regarding a number of factors. There are two significant assumptions associated with establishing our loss reserve for repurchase commitments: (1) the percentage of dealer inventory that we will be required to repurchase as a result of defaults by the dealer, and (2) the loss that will be incurred, if any, when repurchased inventory is resold. These key assumptions are affected by a number of factors, such as macro-market conditions, current retail demand for our product, age of product in dealer inventory, physical condition of the product, location of the dealer, financing source and independent third party credit rating of our dealers. To the extent that dealers are increasing or decreasing their inventories, our overall exposure under repurchase agreements is likewise impacted. The percentage of dealer inventory we estimate we will repurchase (which has ranged in recent years from 4 to 11% on a weighted average basis) and the associated estimated loss (which has ranged in recent years from 7 to 16% on a weighted average basis) is based on historical information, current trends and an analysis of dealer inventory aging for all dealers with inventory subject to this obligation. In periods where there is increasing retail demand for our product at our dealerships, the lower end of our estimated range of assumptions will be more appropriate and in periods of decreasing retail demand, the opposite will be true.

We do not believe there is a reasonable likelihood that there will be a material change in the future estimates or assumptions we use to calculate our loss reserve for repurchase commitments. A hypothetical change of a 10% increase or decrease in our significant repurchase commitment assumptions as of August 25, 2012 would have affected net income by approximately $255,000.

DISCLOSURE ALERT: See Chapter 12, "Disclosures," for information about required disclosures.

Sale/Repurchase/Lease Transactions

In certain situations, especially those involving a manufacturer that sells its products through a dealer network, the manufacturer will provide financing to the end users of the product. The manufacturer (or its finance affiliate) may accomplish this by (re)purchasing the product from the dealer and leasing it to the end user. If the manufacturer recognizes revenue on the original sale to the dealer and then also recognizes revenue from the lease to the end user, it will recognize revenue twice on the same physical product. In ASC 605-15-25-5, the EITF concluded that this is acceptable and that the manufacturer may recognize a sale at the time the product is transferred to the dealer, despite the possibility it will repurchase the product to lease it to an end user, if all of the following conditions exist:

1. The dealer is a substantive and independent enterprise that transacts business separately with the manufacturer and end users.

2. The manufacturer has delivered the product to the dealer and the risks and rewards of ownership, including responsibility for the ultimate sale of the product, insurability, theft, or damage, have passed to the dealer.

3. An end user's failure to enter into a lease with the finance affiliate (or manufacturer) would not allow the dealer to return the product to the manufacturer.

4. The finance affiliate (or manufacturer) has no legal obligation to provide a lease arrangement to a potential end user.

5. The end user may choose to obtain financing from parties unaffiliated with the manufacturer, and it is feasible for the end user to do so.

Tax Court Regulars (Archive), Hallmark Cards, Incorporated and Subsidiaries v. Commissioner, U.S. Tax Court, CCH Dec. 44,502, T.C. No. 44,502, 90 T.C. No. 26, 90 T.C. No. 2, (Jan. 4, 1988)

U.S. Tax Court, Docket No. 4237-86., 90 TC —, No. 2, 90 TC 26, Filed January 4, 1988

[Appealable, barring stipulation to the contrary, to CA-8.—CCH.]

[Code Sec. 446]

Accounting methods and periods: Accrual method: All events test.–

P, a calendar year and accrual basis taxpayer, is in the business of manufacturing and selling greeting cards and other "social expression" merchandise. For valid business reasons, P ships Valentine merchandise to customers in the year prior to that in which the holiday occurs. The terms of sale for this merchandise specify that title and risk of loss do not pass to the customer until January 1 of the following year. *Held,* since the "all events" test is not satisfied until the year following shipment, P is not required to accrue income from advance shipped Valentine merchandise in the year of shipment. *Held further,* P does not employ a "hybrid" method of accounting.

Jerome B. Libin, 1666 K St. N.W., Washington, D.C. 20006, and Bradley M. Seltzer, for the petitioner. Kendall C. Jones, for the respondent.

KEORNER, Judge:

Respondent determined the following deficiencies in petitioner's Federal income taxes:

Year	Deficiency
1975	$7,547,995
1976	422,704
1977	2,454,969
1978	1,521,251

After concessions, the sole issue for determination is whether income from the sale of Valentine merchandise is properly reported by petitioner, a calendar year taxpayer, in the year in which title and risk of loss pass to the purchaser, or, as respondent maintains, whether the income from such sales is accruable as of December 31 of the year in which the merchandise is shipped.

Findings of Fact

The facts of this case have been fully stipulated pursuant to Rule 122 [1] and, to the extent relevant and material to resolution of the issue to be decided, are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Petitioner is a privately-held Missouri corporation whose principal place of business was at Kansas City, Missouri, at the time the petition herein was filed.

Petitioner's primary business is the manufacture and sale of greeting cards, giftwrap, ribbon, stationery and related products. Within the industry, these products are collectively known as "social expression" merchandise. Petitioner maintains a leading position within this industry. Petitioner's customers are primarily card shops, department stores, drugstores, supermarket and other retail outlets. During the taxable years at issue, petitioner sold social expression merchandise to over 20,000 retailers at over 35,000 locations.

Petitioner sells social expression merchandise under two trademarks—Hallmark and Ambassador. The Hallmark label is reserved for merchandise to be sold at card shops, department stores and similar "upscale" retail outlets. The Ambassador trademark is used on merchandise to be sold in supermarkets, discount stores, and similar mass merchandising outlets. During the taxable years at issue, Hallmark sales accounted for approximately 85 percent of petitioner's total social expression sales volume, with Ambassador merchandise accounting for the remaining 15 percent.

Petitioner's social expression merchandise can be divided into two broad categories—everyday and seasonal. Everyday products are those which are normally purchased to commemorate birthdays, anniversaries, weddings and similar occasions which occur throughout the year. Seasonal products are those designed to be sold during specific holiday seasons such as Halloween, Christmas, Easter and St. Valentine's Day. During the taxable years at issue, everyday products accounted for approximately 60 percent of petitioner's total social expression sales volume. Seasonal products accounted for 40 percent of volume with Christmas and Valentine sales the largest components within this segment.

When petitioner was a much smaller operation, it was able to ship merchandise directly from the production line to its customers at the time the demand for the merchandise arose. For instance, Valentine merchandise could be shipped directly from petitioner's production line in early January to be on display in time for the Valentine season in early February. Petitioner would consummate the sale, pass title and report income from the sale all at the time of shipment.

However, as petitioner's volume of business increased, problems with this system began to develop, particularly as regards Christmas and Valentine merchandise. Petitioner was forced to resort to overtime schedules and expand production facilities in order to meet the seasonal demand for these products. Once these busy seasons had passed, petitioner had to lay off workers and bear the cost of idle plant capacity during relatively quiet parts of the year. Also as the volume of business grew, logistical problems developed in transporting merchandise to customers in time to meet the seasonal demand.

Petitioner sought to alleviate these problems by instituting a level production schedule throughout the year and establishing a regional warehousing system. Merchandise for the Christmas and Valentine seasons was produced throughout the year and shipped to the regional warehouses. As the holiday seasons approached, the merchandise was reshipped to customers as their orders were placed. Title to the merchandise passed and its sale was recorded at the time of shipment from the warehouse.

Although this warehouse system had its benefits, it soon became apparent that it had its weaknesses as well. The merchandise itself was ill-suited to warehousing since each customer's order was usually made up of many small packages. The costs of handling each piece of merchandise twice, renting warehouse facilities, and transportation made the warehouse system an expensive solution to petitioner's problems. In addition, proper coordination of the system proved elusive and missing and late shipments were a recurring problem. Also, questions were raised as to whether petitioner was doing business in the states in which the warehouses were located, thus exposing petitioner to potential state income and franchise tax liability.

As an alternative to the regional warehouse system, petitioner embarked on a policy of shipping seasonal merchandise to customers in advance of the period during which the merchandise would normally be displayed and sold. As to Christmas merchandise, customers were generally willing to accept this merchandise in advance. The summer and early fall are traditionally slow retail periods and acceptance of Christmas merchandise during this period posed no undue hardships. However, petitioner's customers were less disposed to receiving Valentine shipments in advance. St. Valentine's Day falls shortly after Christmas, the busiest retail season of the year. Merchants were unwilling to accept large shipments of Valentine merchandise while their stores were filled with Christmas merchandise. Additionally, many calendar year customers were concerned over the financial impact of inclusion of large amounts of Valentine merchandise in their year end inventories. There also was an unwillingness to bear the cost of personal property tax on Valentine merchandise included in year-end inventory. Thus, even though the regional warehouse system was eliminated in favor of advance shipment of most seasonal merchandise, customer intransigence forced that it be maintained for Valentine merchandise.

In 1958, petitioner concluded that it could eliminate the regional warehousing of Valentine merchandise and satisfy customer concerns over its early shipment (other than physical storage) by changing its terms of sale as regards Valentine merchandise. Shipments of Valentine merchandise would be made during the later part of the year preceding Valentine's Day; however, the terms of sale were that title to the goods and risk of loss would not pass to the buyer until January 1 of the following year. Although customers were in physical possession of the merchandise at year end, they did not own it and therefore were not required to include it in year end inventory or pay personal property taxes on it. The terms of sale of all other merchandise remained the same (i.e., title and risk of loss passed at time of shipment). Petitioner revised its order forms, sales invoices and shipping documents to reflect this change in sales terms for Valentine merchandise and made substantial efforts to apprise its customers of the new policy. Customer reaction to the revised sales terms was generally favorable. Within petitioner, the practice of deferring title passage with respect to Valentine merchandise is referred to as the "Deferred Valentine Program." The Deferred Valentine Program has been followed by petitioner consistently from its adoption in 1958 through filing of the petition herein.

For certain years prior to the ones now before us, respondent on audit challenged petitioner's method of reporting income from Valentine sales under the new procedure. Such challenges were resolved administratively between the parties without the execution of any offer in compromise or closing agreement.

Respondent mailed notices of deficiency for the tax years 1975, 1976, 1977, and 1978 to petitioner on November 22, 1985. In those notices, respondent determined deficiencies in tax attributable to petitioner's allegedly improper deferral of income from Valentine sales until the calendar year following the year of shipment. The notices determined that this practice was inconsistent with petitioner's method of accounting for sales of other merchandise and resulted in a distortion of income.

Petitioner filed a petition with this Court seeking redetermination of the deficiencies on February 14, 1986.

Opinion

The determinations of respondent in his statutory notices of deficiency are presumptively correct and petitioner bears the burden of disproving the deficiency determined. *Welch v. Helvering* [3 USTC ¶1164], 290 U.S. 111, 115 (1933); Rule 142(a).

One of the most fundamental concepts of our system of taxation is that tax is imposed "on the basis of annual returns showing the net result of all of the taxpayer's transactions during a fixed accounting period." *Burnet v. Sanford & Brooks Co.* [2 USTC ¶636], 282 U.S. 359, 365 (1931). See also *United States v. Consolidated Edison Co.* [61-1 USTC ¶9462], 366 U.S. 380, 384-385 (1961). Taxable income for a particular accounting period is determined using the method of accounting used by the taxpayer in regularly maintaining his books. [2] Sec. 446(a); sec. 1.446-1(a)(1), Income Tax Regs. The Code does not mandate that a taxpayer utilize any particular method of accounting, and specifically authorizes the use of: (1) the cash receipts and disbursements method, (2) an accrual method, (3) any other method authorized in the Code, or (4) any combination of the above as permitted by regulations. Sec. 446(c); secs. 1.446-1(a)(2), 1.446-1(c), Income Tax Regs. Although a taxpayer enjoys a great deal of flexibility in initially adopting an accounting method, once a method has been selected, it cannot be changed without first securing respondent's consent to the change. Sec. 446(e); sec. 1.446-1(e)(2), Income Tax Regs.

Respondent may disregard the taxpayer's use of his accounting method to determine taxable income when he determines that the taxpayer's method does not result in a clear reflection of income. Sec. 446(b). Respondent possesses "broad powers in determining whether accounting methods used by a taxpayer clearly reflect income." *Commissioner v. Hansen* [59-2 USTC ¶9533], 360 U.S. 446, 467 (1959). See also *Thor Power Tool Co. v. Commissioner* [79-1 USTC ¶9139], 439 U.S. 522, 532 (1979); *Lucas & American Code Co. v. Commissioner* [2 USTC ¶483], 280 U.S. 445, 449 (1930), revg. 30 F.2d 222 (2d Cir. 1929). Ordinarily, a method of accounting which reflects a consistent application of generally accepted accounting principles will be regarded as clearly reflective of income. Sec. 1.446-1(a)(2), Income Tax Regs.; but see *Thor Power Tool Co. v. Commissioner, supra* at 539-540. Respondent's broad authority to determine whether a taxpayer's accounting method clearly reflects income is limited, in that he may not reject, as not providing a clear reflection of income, a method of accounting employed by the taxpayer which is specifically authorized in the Code or regulations and has been applied on a consistent basis. *Orange & Rockland Utilities v. Commissioner* [Dec. 42,884], 86 T.C. 199, 215 (1986).

We now examine the facts of this particular case in light of this statutory background. Petitioner utilizes the calendar year as its accounting period and has employed an accrual method of accounting for both tax and financial accounting purposes. [3] When an accrual method of accounting is utilized, an item of income is included in the taxpayer's gross income for the accounting period during which all the events have occurred which fix the taxpayer's right to receive the item of income and the amount thereof can be determined with reasonable accuracy. Sec. 1.451-1(a), sec. 1.446-1(c)(1) (ii), Income Tax Regs.; *Spring City Foundry Co. v. Commissioner* [4 USTC ¶1276], 292 U.S. 182, 184-185 (1934). Petitioner contends that, as regards Valentine merchandise shipped prior to year-end, this "all events" test is not satisfied until January 1 of the following year when title to the merchandise and risk of loss pass to the customer. Respondent argues that the all events test is satisfied, at the very latest, at midnight on December 31 of the year in which the merchandise was shipped. We agree with petitioner.

At what point in time a sale takes place is to be determined from the totality of the circumstances. While no single factor is controlling, passage of title is perhaps the most significant factor to be considered, although the transfer of possession is also significant. *Commissioner v. Segall* [40-2 USTC ¶9676], 114 F.2d 706, 709-710 (6th Cir. 1940), cert. denied 313 U.S. 562 (1941). The objective is to determine at what point in time the seller acquired an unconditional right to receive payment under the contract. *Lucas v. North Texas Lumber* [2 USTC ¶484], 281 U.S. 11, 13 (1930).

Based on the record before us, it is indisputable that petitioner's rights under the sales contracts for Valentine merchandise do not mature until January 1 of the new year. Not until this point in time did petitioner relinquish the benefits and burdens of ownership of the merchandise in exchange for a right to receive payment. Since petitioner had no right to income prior to January 1, the first prong of the all events test is not met until that date. [4] We cannot agree with respondent's characterization of the passage of title and risk of loss on January 1 as a mere "ministerial act" or "formality." Far from being a ministerial act, the passage of title and risk of loss to the buyer constitutes the very heart of the transaction and is the sine qua non to petitioner's right to receive payment. Until that moment in time when title passes, the potential buyer has mere possession of the merchandise and nothing more. Should it be destroyed while in his possession, the loss is suffered by petitioner. Should he decide that he does not wish to proceed with the transaction, he may return the merchandise to petitioner without penalty. [5] The fact that customers rarely exercised this right is of no consequence; it is existence of the right which controls.

Respondent's heavy reliance on *United States v. Hughes Properties, Inc.* [86-1 USTC ¶9440], 476 U.S. 593 (1986), is in our view misplaced. That case concerned the deductibility by the taxpayer, a casino operator, of properly accrued progressive slot machine jackpots which remained unpaid at year end. The Court allowed the deductions, holding that at the end of its taxable year, the taxpayer's liability for the accrued amounts was definite and fixed pursuant to Nevada law. The Court held that the remote possibility that the casino would cease operations—or the even more remote possibility that people would cease to gamble—went to whether the liability would eventually be paid—not to whether it had been incurred.

Respondent argues that since the Court in *Hughes* ignored these highly remote contingencies in allowing expense accruals, we should accrue Valentine income as of midnight, December 31 of the year of shipment since at that point of time there is no doubt that the sale will occur in the next instant.

Respondent misinterprets *Hughes*. In that case all the events necessary to make the taxpayer's liability for the accrued amounts fixed and definite had occurred by the end of its tax year. The remote contingencies in *Hughes* were found to go to whether the liability would be paid; as to the liability itself there were no contingencies. Here, in contrast, petitioner does not possess any fixed and definite rights to payment at year end. The fact that at the stroke of midnight petitioner knows with absolute certainty that in the next instant these rights will arise cannot compensate for the fact that as of the close of the old year they do not exist. The all events test is based on the existence or nonexistence of legal rights or obligations at the close of a particular accounting period, not on the probability—or even absolute certainty—that such right or obligation will arise at some point in the future. *United States v. General Dynamics Corp.* [87-1 USTC ¶9280], — U.S. —, —, 107 S.Ct. 1732, 1736 (1987);

Brown v. Helvering [4 USTC ¶1223], 291 U.S. 193, 200-201 (1934). We thus hold that as to merchandise sold by petitioner pursuant to its deferred Valentine program, the all events test is not satisfied until January 1, and that income from those sales is not accruable by petitioner until that date. [6] *Decision, Inc. v. Commissioner* [Dec. 28,146], 47 T.C. 58, 62-64 (1966); *Cox v. Commissioner* [Dec. 27,211], 43 T.C. 448, 456-457 (1965).

Respondent's argument that petitioner employs a "hybrid" method of accounting which does not clearly reflect income must also fail since the linchpin of such an argument is that Valentine sales income is properly accruable on December 31. See *Public Service Co. of New Hampshire v. Commissioner* [Dec. 38,865], 78 T.C. 445, 453 (1982). Since we hold that Valentine sales income is *not* properly accruable on December 31, petitioner's method of accounting is an accrual method and as such a "permissible method" pursuant to section 446(c)(2). As a permissible method of accounting which has been applied consistently, petitioner's method of accounting is deemed to clearly reflect income. *Orange & Rockland Utilities v. Commissioner,* 86 T.C. at 24. Respondent is without power to require a taxpayer to change from a method of accounting which clearly reflects income to any other method which respondent finds preferable. *Auburn Packing Co. v. Commissioner* [Dec. 32,103], 60 T.C. 794, 798-800 (1973); *Garth v. Commissioner* [Dec. 30,848], 56 T.C. 610, 623 (1971).

Respondent's theory that petitioner employs a hybrid accounting method is premised on a basic misunderstanding of section 1.446-1(c)(ii), Income Tax Regs. Respondent alleges that the "shipment method" is petitioner's predominant method of accounting which it uses for the sale of all merchandise with the exception of Valentine merchandise, income from the sale of which is accounted for using the "title method." However, the regulation reference to accounting for the sale of an item when shipped, delivered, accepted or when title to the merchandise passes does not refer to different accounting methods, but is merely illustrative of the different points in time at which an accrual method taxpayer may accrue an item of income. The touchstone for determining when an item may be accrued is the all events test. *United States v. Consolidated Edison Co., supra* at 385. For any given manufacturer, this test may be satisfied when merchandise is shipped, accepted, delivered or at some other point in time depending upon the particular circumstances. Petitioner's change in the point of time at which it recognizes income from Valentine sales was in recognition of a change in the contractual terms under which it sold Valentine merchandise. A change in treatment of an item of income resulting from a change in underlying facts does not constitute a change in method of accounting. Sec. 1.446-1(e)(2) (ii)(b), Income Tax Regs. To hold otherwise would effectively give respondent the right to dictate to petitioner the terms under which it may sell its merchandise, clearly "an odious propagation of the tentacles of the government anemone." *Decision, Inc. v. Commissioner,* 47 T.C. at 64. We therefore conclude that petitioner has consistently used an accrual method of accounting for all sales both before and after its 1958 adoption of revised terms of sale as to Valentine merchandise. [7] Since petitioner has consistently utilized a permissible method of accounting which is deemed to clearly reflect income, respondent abused his discretion in requiring petitioner to adopt a different method of accounting for Valentine sales.

To reflect the foregoing, as well as concessions by the parties,

Decision will be entered under Rule 155.

Footnotes

1 All statutory references are to the Internal Revenue Code of 1986, as in effect in the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

2 "Method of accounting" denotes not only the taxpayer's overall method of accounting, but also the accounting treatment of any item. Sec. 1.446-1(a)(1), Income Tax Regs.

3 Since the manufacture and sale of merchandise is an income-producing factor, petitioner is required to maintain inventories. Sec. 1.446-1(a)(4)(1), Income Tax Regs. When inventories are maintained, an accrual method of accounting is required for purchases and sales. Sec. 1.446-1(c)(2)(i), Income Tax Regs.

4 Since no right to receive income exists in the year of shipment, the second prong of the all events test—whether the value of that right can be reasonably estimated—is never reached.

5 Ambassador brand Valentine merchandise is sold pursuant to a "sale or return" policy under which the customer has the right to return any merchandise which he fails to sell. Even though such merchandise is subject to return, income therefrom is properly accruable at the point of sale. *J.J. Little & Ives Co. v. Commissioner* [Dec. 27,899(M)], T.C. Memo. 1966-68. We disagree with respondent's contention that, as regards Ambassador brand Valentine merchandise, the new sales contract terms adopted in 1958 did not alter rights the parties already possessed under the sale or return policy. Under the old sales terms, Ambassador merchandise which remained unsold after having been offered for sale could be returned to petitioner. Under the new sales terms, until passage of title and risk of loss on January 1, the sale may be canceled and the merchandise returned without its having been offered for sale.

6 The business reasons for petitioner's adoption of the January 1 passage of title and risk of loss are sound and have not been disputed. Thus, this is not a case where a taxpayer has deliberately manipulated the terms of sale so as to prevent income from accruing that it would otherwise become entitled to prior to the end of its taxable year. We express no opinion as to the tax consequences of such a situation.

7 Since we find that petitioner has consistently employed an accrual method of accounting for all sales, we need not address petitioner's alternative argument that respondent effectively consented to petitioner's adoption of a hybrid method in 1958.

SOLD TO:			Shipping Address if Different:
Name:			Name:
Address:			Address:
City:	State:	Zip:	City:
Phone:	FAX:		
E-Mail:			State: Zip:

DATE OF ORDER:	FOB ORIGIN: ☐ UPS ☐ FEDEX ☐ Other:	
DEPOSIT PAYMENT METHOD (Check One): ☐ Check ☐ Credit Card		MDT REP:
CREDIT CARD NO:	TYPE:	EXP. DATE:
BALANCE OF ORDER PAYMENT METHOD (Check One): ☐ Check ☐ Financing ☐ Credit Card***		
CHOICE OF FINANCING (Please List):		
CUSTOMER WAS REFERRED BY:		

DENTIST(S) TO BE TRAINED AND LICENSED: (list specialty)	Laser BootCamp™ DATE/LOCATION

QUANTITY	ITEM #	DESCRIPTION	UNIT PRICE	TOTAL
	PL1	PerioLase® MVP-7 Periodontal Package™		
	N/A	Extended & Enhanced Warranty		

IMPORTANT: I agree to the TERMS & CONDITIONS on the attached/reverse side.

Name and Title (Print): ______________________

Signature: ______________________

*Deposit fully refundable.

**Balance due 30 days before training.

*** Balance payments on credit cards are subject to a 3.5% merchants transaction fee. Credit card transactions require MDT HQ approval (initials). ________ (initials)

SUB -TOTAL	
SALES TAX	
SHIPPING	
TOTAL	
LESS DEPOSIT*	
BALANCE**	

TAXPAYER EXHIBIT
B6
February 24, 2015
Millennium Dental Technologies, Inc.
747501

PerioLase® Periodontal Package

Satisfaction Guarantee*

Millennium Dental Technologies, Inc. wants to make your clinical decision to begin performing LANAP™ in your practice as risk-free as possible. That is why we offer you the *following guarantee*:

If, after taking the Laser Assisted New Attachment Procedure™ (LANAP™) training course and using the PerioLase® in your personal office for SIX (6) months, you are not able to reproduce the clinical results depicted in the training, upon return of all materials in the PerioLase® Periodontal Package in good working order, Millennium Dental Technologies, Inc. will refund your entire purchase price.

MILLENNIUM
DENTAL TECHNOLOGIES, INC.

* Leases and deferred payment plans are not eligible. Guarantee is valid with cash, personal loans, and credit card purchases only. Business and personal bankruptcy void guarantee, as does failure to complete Day 4 training. Applies to first time laser buyers only. Additional terms on Sales Order Form.

21-00-000 Rev. B 09/3/08

MILLENNIUM'S TERMS, CONDITIONS AND LICENSE AGREEMENT

All purchase contracts are subject to acceptance by Millennium Dental Technologies, Inc.
1. Payment of deposit secures the selected scheduled training date for the PerioLase® Periodontal Package™ training.
2. Balance of the PerioLase® Periodontal Package™ purchase price must be received 30 working days prior to the beginning of clinical training.
3. Training is conducted by The Institute for Advanced Laser Dentistry of Cerritos, California.
4. Any scheduled training canceled by Millennium Dental Technologies, Inc., is rescheduled to customer's choice of alternative training dates.
5. PerioLase delivery will be made to the customer's office as soon after completion of Laser BootCamp™ as possible.
6. The doctor purchasing the PerioLase® Periodontal Package™ will be licensed to use the Laser Periodontal Therapy™ protocols. After requisite training, this license (a copy of which is printed below) is issued to the purchasing dentist.
7. Six month Satisfaction Guarantee is conditioned upon: 1) The sale to first time laser buyers only, 2) Completion of Day 4 training, & 3) A good faith effort to communicate with MDT, implement and integrate the PerioLase® Periodontal Package™ into clinical use.

LICENSE AGREEMENT — IMPORTANT - READ VERY CAREFULLY: THIS IS A LEGAL AGREEMENT BETWEEN YOU (THE "TRAINEE" OR "YOU") AND MILLENNIUM DENTAL TECHNOLOGIES, INC., OF 10945 SOUTH STREET, SUITE 104-A, CERRITOS, CALIFORNIA 90703 ("MILLENNIUM"). IT IS IMPORTANT THAT YOU READ AND AFFIRMATIVELY AGREE TO BE BOUND BY THIS DOCUMENT BEFORE OPENING OR USING THE LASER PERIODONTAL THERAPY™ TRAINING MATERIALS, CLINICAL TRAINING PRESENTATIONS, OR CONFIDENTIAL AND PROPRIETARY INFORMATION AND INSTRUCTION ON MILLENNIUM'S PROPRIETARY TECHNIQUES AND PROCEDURES, INCLUDING WITHOUT LIMITATION THE "LASER EXCISIONAL NEW ATTACHMENT PROCEDURE," U.S. PATENT NO. 5,642,997 (COLLECTIVELY, THE "MILLENNIUM MATERIALS"). BY OPENING OR USING THE MILLENNIUM MATERIALS, YOU ACKNOWLEDGE THAT YOU HAVE READ THIS AGREEMENT AND THAT YOU AGREE TO BE BOUND BY ALL OF ITS TERMS. IF YOU DO NOT AGREE TO BE SO BOUND, IMMEDIATELY RETURN ALL MILLENNIUM MATERIALS TO MILLENNIUM UNOPENED AND UNUSED.

1. **License Grant:** Subject to, and contingent upon, Your successful completion of the Millennium 3-Day Basic Proficiency Training Course, "Laser BootCamp™," Millennium grants to You a LIMITED, NON-EXCLUSIVE, NON-SUBLICENSABLE, NON-TRANSFERABLE, PERSONAL license to use the Millennium Materials solely in connection with Your authorized practice of Laser Periodontal Therapy™. THIS AGREEMENT GIVES YOU NO OTHER RIGHTS IN OR TO THE MILLENNIUM MATERIALS OR OTHER PROPERTY OF MILLENNIUM, INCLUDING WITHOUT LIMITATION, NO RIGHTS TO (1) to teach or permit any other person to use the Millennium Materials or perform the Patented Procedure unless that other person is separately authorized under a current license agreement with Millennium, (2) use the Millennium Materials for any purpose other than the treatment of Your patients, or (3) to use any Millennium advertising materials or trademarks (e.g., "Laser Periodontal Therapy," "LaserENAP," "No Cut-No Sew," and the Millennium logo) other than in connection with Your authorized practice of Laser Periodontal Therapy™.

2. **Term:** This Agreement is effective upon the Commencement of Millennium's 3-Day Basic Proficiency Training Course "Laser BootCamp" and, unless terminated earlier pursuant to this paragraph 2, shall continue for the term of U.S. Patent No. 5,462,997. The license granted herein is personal to you and shall terminate immediately upon Your death or permanent disability. Furthermore, if You breach any of the terms, conditions or promises under this Agreement and continue in default for a period of thirty (30) days after receiving written notice of such default, Millennium shall have the right at the expiration of the notice period to terminate this Agreement and the licenses granted herein without further notice.

3. **FOB Origin – Cerritos, CA USA:** Customer (Buyer) shall determine the common carrier for delivery of products to the Buyer location; the Seller will choose a carrier on behalf of the Buyer if no preference is indicated. The Buyer shall be responsible for the payment of shipping, handling and insurance for the product, regardless of who selects the carrier. The Buyer takes title (ownership) of the merchandise at the time the Seller consigns the freight to the common carrier at the Seller's shipping dock. The Buyer retains ownership of the products in transit and at the destination, regardless of who selects the carrier. The Seller prepays the freight and insurance fees as a courtesy to the Buyer and then charges shipping, handling and insurance fees to the Buyer on the invoice. The Buyer is responsible to file any claims against the carrier for damage or loss of product.

4. **Return of Materials:** Upon termination or expiration of this Agreement, You shall immediately (1) cease using the Millennium Materials, and (2) upon request, return to Millennium all Millennium Materials (regardless of form) then in Your possession or in the possession of any third party to whom such materials were distributed, and You shall certify in writing that all original and copies thereof, regardless of form, have been returned. ***Sections 5 through 9 shall survive termination of this Agreement.*** All product returned to the Seller for any reason, including service, repair, replacement or refund, shall have a Seller issued Return Material Authorization (RMA) number marked on the outside of the shipping container. This RMA number may be issued by the Seller, at its sole option, when the Buyer contacts the Seller during normal business hours. Merchandise returned without a Seller issued RMA number shall be refused and sent back to the Buyer at the Buyers expense. The Buyer pays for shipping, handling and insurance for all shipments involving returned product unless prior arrangements or written offers dictate otherwise. The Buyer retains title (ownership) of the product during transit, at the destination and during service/repair or evaluation of the claims leading to the issuing of the RMA. The Seller will notify the Buyer, in writing, if and when the Seller takes title to the returned product and the terms of credit to be issued, if applicable. Buyer is responsible to file claims with the Buyers insurance company for damage or loss of product in transit or at the Seller's facility.

5. **Confidentiality:** You acknowledge and agree that the Millennium Materials are proprietary in nature and contain valuable confidential information developed or acquired by Millennium at great expense. Except as expressly allowed herein, You agree not to disclose Millennium Materials to third parties without the advance written consent of Millennium.

6. **No Warranty/Limitation of Remedies:** MILLENNIUM MAKES NO WARRANTIES, WHETHER EXPRESS OR IMPLIED, WRITTEN OR ORAL (INCLUDING ANY WARRANTY OF MERCHANTABILITY, NON-INFRINGEMENT, OR FITNESS FOR A PARTICULAR PURPOSE) AS TO THE MILLENNIUM MATERIALS OR THE PATENTED PROCEDURE. TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, MILLENNIUM SHALL NOT BE LIABLE TO YOU OR ANY OTHER PERSON OR ENTITY, INCLUDING WITHOUT LIMITATION YOUR PATIENTS, FOR SPECIAL, INCIDENTAL, INDIRECT OR CONSEQUENTIAL DAMAGES (INCLUDING, BUT NOT LIMITED TO, LOSS OF PROFITS OR LOSS OF USE DAMAGES) ARISING OUT OF THE USE OF THE MILLENNIUM MATERIALS OR THE PATENTED PROCEDURE, EVEN IF MILLENNIUM HAS BEEN ADVISED OF THE POSSIBILITY OF SUCH DAMAGES OR LOSSES AND WHETHER IN AN ACTION FOR OR ARISING OUT OF A BREACH OF CONTRACT, TORT, OR ANY OTHER CAUSE OF ACTION.

7. **Indemnity:** You assume sole responsibility for Your dental practice and Your use of the Millennium Materials. You agree to indemnify, defend and hold Millennium and its successors, and their respective shareholders, officers, employees and agents, harmless against, and to reimburse them for, all losses (including all liability, penalties, costs, damages, expenses, causes of action, claims, or judgments, including attorneys' fees and costs) arising out of Your treatment of patients and/or Your use of the Millennium Materials.

8. **Governing Law:** This Agreement shall be governed by the laws of the State of California, U.S.A., exclusive of its choice of law principles. The courts located in and serving Orange County, California shall have exclusive jurisdiction and venue over any dispute arising out of or relating to this Agreement, and You and Millennium hereby consent to such jurisdiction and venue.

9. **In General:** The failure of any provision of this Agreement by virtue of its being construed as invalid or otherwise unenforceable shall render the entire Agreement cancelable at the option of the party asserting the enforceability of said provision. Failure of a party to enforce any provision of this Agreement shall not constitute or be construed as a waiver of such provision or of the right to enforce such provision. This Agreement contains the parties' entire understanding and may only be modified by a written instrument signed by each party's duly authorized representative.

AS ORIGINALLY FILED