U.S. Securities and Exchange Commission

Letter From the Chief Accountant: Accounting Issues Related to Internet Operations

October 18, 1999

Mr. Timothy S. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Lucas:

As we discussed at the EITF meeting on September 23, the SEC staff has been developing a list of issues that have arisen in internet businesses. We have finished preparing that list, and it is attached to this letter. The list includes those issues that we believe warrant consideration by the EITF (or another standard-setting body). As discussed at the EITF meeting, we have also suggested priority levels for addressing each of the issues (priority levels 1-3). It would be helpful if the level 1 items could be dealt with first. However, we believe that all of the issues should eventually be addressed.

As you may recall, at the EITF meeting I expressed support for setting up a working group to focus on internet issues. We hope to be able to discuss the issues in the attached list and the possible formation of a working group with the EITF Agenda Committee before the November EITF meeting. As you will note, there are several issues that we believe can best be addressed by staff announcements. If the working group (or the EITF Agenda Committee, if a decision is reached not to form a working group) agrees that staff announcements are an appropriate way to resolve these issues, we hope that such announcements can be made at the November EITF meeting. Other issues could be added to the EITF Agenda (or the agendas of other standard-setting bodies) for discussion at the November and subsequent meetings.

After you have had a chance to review the issues, please let us know your thoughts about setting up a working group. If you have any questions about the issues in the attached list, please contact Scott Taub in the Office of the Chief Accountant at 202-942-4409.

Sincerely,

Lynn E. Turner
Chief Accountant

Issues in Accounting for Internet Activities

This memo describes accounting issues the SEC staff is aware of that have arisen in companies with internet activities. The list has been compiled based upon a review of issues the SEC staff has dealt with in registrant filings, as well as issues identified through input from accounting firms. The issues discussed are all issues in which 1) there appears to be a diversity in practice, 2) the situation does not appear to be addressed in the accounting literature, and/or 3) the SEC staff is concerned that the developing practice may be inappropriate under generally accepted accounting principles.

Some of the issues arise due to the new business models used in internet operations, while others are issues that also exist in businesses with no internet operations. For example, advertising partnerships, coupon and rebate programs, and complex equity instruments, while perhaps more common in internet businesses, were in use long before the internet. As a general rule, the SEC staff believes that internet companies engaging in transactions that are similar to transactions entered into by traditional companies should follow the already established accounting models for those transactions.

We believe that all of the issues discussed warrant further consideration by the accounting and financial reporting community. Each issue represents an area in which investors would benefit from the improved financial information and consistency that would come out of providing additional guidance on the issue. In order to maximize the benefits of providing such guidance, we believe it is important that any guidance address not only recognition and measurement questions, but also classification and disclosures.

For each issue, we have added comments from the SEC staff regarding the issue, and an assessment of the priority of addressing the issue.

Gross vs. Net – Some of the more significant issues facing internet businesses surround whether to present grossed-up revenues and cost of sales, or merely report the net profit as revenues, similar to a commission. The significance is enhanced due to the importance often placed on the revenue line in the valuation of internet stocks.

1. The question of gross vs. net revenue and cost display has arisen several times in connection with an internet company that distributes or resells third party products or services. Because the internet is a new distribution model, and can be used in the distribution of tangible assets, intangible assets, and services, the existing practices used for making this determination are not always sufficient.

   SEC Staff Comments: **This seems to be a key issue.** Priority level 1.

2. Many internet companies enter into advertising barter transactions with each other, in which they exchange rights to place advertisements on each others' websites. There is diversity in practice in accounting for these transactions. The staff believes a prerequisite

staff believes registrants should be making transparent disclosure that will clearly convey to investors the accounting being used.

SEC Staff Comments: There have been a number of press articles on this issue, illustrating its importance. **Priority level 1.**

3. ISP's and PC retailers are currently offering a $400 rebate to purchasers of new PC's who contract for three years of internet service. It appears that most of the rebate cost is borne by the ISP while a portion is borne by the PC retailer, that the retailer provides advertising and marketing for the arrangement, and that the rebate, or a portion thereof, must be returned by the consumer to the ISP if the consumer breaks the contract with the ISP. Some ISPs and retailers believe their portion of the cost of the rebate should be a marketing expense, as opposed to a reduction of revenues. The SEC staff generally believes that such rebates should be considered a reduction of revenues.

   SEC Staff Comments: The SEC staff believes that a **staff announcement** indicating that discounts like these should be accounted for as reductions of revenue is appropriate.

4. Shipping and handling costs are a major expense for internet product sellers. Most sellers charge customers for shipping and handling in amounts that are not a direct pass-through of costs. Some display the charges to customers as revenues and the costs as selling expenses, while others net the costs and revenues. The staff believes that practice for non-internet mail-order companies is to net the revenues and expenses, although diversity may exist. In either situation, we note that companies generally do not provide any separate disclosure of shipping revenues and costs (e.g., by reporting shipping revenue and costs as separate line items, or by providing footnote disclosure of the gross shipping revenues and costs).

   SEC Staff Comments: There is diversity in practice that should be eliminated. However, because the issue relates to a smaller portion of revenues and costs then some others in this section, it can be addressed after some of those issues. **Priority level 2.**

5. Some internet companies have concluded that a free or heavily discounted product or service, as is provided in introductory offers (e.g. free month of service, 6 CDs for a penny) should be accounted for as a sale at full price, with the recognition of marketing expense for the discount. The staff notes that an AICPA Technical Practice Aid (Section 5100.07, "One-Cent Sales") addresses this issue, concluding that "The practice of crediting sales and charging advertising expense for the difference between the normal sales price and the "bargain day" sales price of merchandise is not acceptable for financial reporting."

   SEC Staff Comments: The SEC staff believes that a **staff announcement** indicating that discounts like these should be accounted for as reductions of revenue is appropriate.

recently. Related costs may include refunds to customers/members, costs to correct the problem that caused the outage, and damage claims. Issues could include when to accrue the refunds and costs, whether refunds that are not required but are given as a gesture of goodwill are reductions of revenues or a marketing expense, etc.

SEC Staff Comments: The facts and circumstances surrounding these situations are likely to be very diverse, making the development of general guidance difficult. **Priority level 3.**

Definition of Software – We have noted several issues that relate to whether websites themselves and files or information available on websites should be considered software, and therefore be subject to the provisions of SOPs 97-2 and 98-1 and/or SFAS 86.

7. In EITF Issue 96-6, the SEC staff expressed its view that the costs of software products that include film elements should be accounted for under the provisions of SFAS 86. As such, revenue from the sale of such products should be accounted for under the provisions of SOP 97-2. By analogy, the staff believes that guidance should be applied to software with other embedded elements, such as music. However, EITF 96-6 did not discuss accounting for the costs of computer files that are essentially films (e.g., mpeg, realvideo), music (e.g., mp3), or other content. A number of questions may arise with relation to these files, including whether a company purchasing the rights to distribute music in the .mp3 format should account for those costs under SFAS 50 or 86. Similarly, it is not clear whether the revenue from the sales of .mp3 files falls under SOP 97-2.

   SEC Staff Comments: As the areas of software, film, music, etc continue to converge, it is important to be able to identify which accounting models apply to various transactions. In addition, resolving this issue may be necessary in order to resolve issue 8 below. **Priority level 2.**

8. Costs of developing a website including the costs of developing services that are offered to visitors (chat rooms, search engines, e-mail, calendars, etc.) are significant costs for many internet businesses. The SEC staff believes that a large portion of such costs should be accounted for in accordance with SOP 98-1, as software developed for internal use. The staff notes that SOP 98-1, paragraph 15 states that "If software is used by the vendor in providing the service but the customer does not acquire the software or the future right to use it, the software is covered by this SOP."

   SEC Staff Comments: This is a key issue, given that it is the largest cost for many internet businesses. **Priority level 1.**

Revenue Recognition – As with any new business model, issues exist regarding the recognition of revenue for various types of internet activities.

9. Auction sites usually charge both up-front (listing) fees and back-end (transaction-based) fees. The staff understands that the listing fees are being recognized as revenue when the item is originally listed, despite the requirement for the auction site to maintain the listing for duration of the auction. In addition, some auction sites recognize the back-end fees as revenue at the end of the auction despite the fact that the seller is entitled to a refund of the fee if the transaction between the buyer and seller doesn't close (Note: the auction house is merely a facilitator and takes no part in assisting in closing the transaction). Given that many popular sites have recently started up auction sites, this issue may become more prevalent.

   SEC Staff Comments on Front-end: The SEC staff believes that a **staff announcement** indicating that fees like this should be recognized over the listing period, which is the period of performance, is appropriate.

   SEC Staff Comments on Back-end: The facts and circumstances of the agreements between the auction site, the buyers, and the sellers may vary significantly, making it difficult to provide applicable guidance. **Priority level 3.**

10. Some purchasers of software do not actually receive the software. Rather, the software application resides on the vendor's or a third party's server, and the customer accesses the software on an as-needed basis over the internet. Thus, the customer is paying for two elements – the right to use the software and the storage of the software on someone else's hardware. The latter service is often referred to as "hosting." When the vendor also provides the hosting, several revenue recognition issues may arise. First, there may be transactions structured in the form of a service agreement providing internet access to the specified site, without a corresponding software license. In such instances, it may not be clear how to apply SOP 97-2. Second, when the transaction is viewed as a software license with a service element, it isn't clear how to evaluate the delivery requirement of SOP 97-2.

    SEC Staff Comments: This type of arrangement seems to be growing in popularity, although it is not all that common at this point. **Priority level 2.**

11. An internet business may provide customers with services that include access to a website, maintenance of a website, or publication of certain information on a website for a period of time. Certain companies have argued that because the incremental costs of maintaining the website and/or providing access to it are minimal (or even zero), this ongoing requirement should not preclude up-front revenue recognition. The staff has historically objected to up-front revenue recognition in these cases, even with an accrual of the related costs.

    SEC Staff Comments: The SEC staff believes that a **staff announcement** indicating that fees like this should be recognized over the performance period, which would be the period over which

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