# Working Draft:

## Software Revenue Recognition Implementation Issue

### **Issue #14-11:** Considerations in Estimating Standalone Selling Prices

### Expected Overall Level of Impact to Industry Accounting: Significant

### Wording to be Included in the Revenue Recognition Guide:

*General Consideration for Establishing Standalone Selling Price*

1. Software vendors commonly sell their software products bundled with other products and services. FASB ASC 606 requires an entity to allocate the transaction price to the distinct performance obligations in a contract on a relative SSP basis. Under FASB ASC 606-10-32-31, *"…*an entity shall determine the standalone selling price at contract inception of the distinct good or service underlying each performance obligation in the contract and allocate the transaction price in proportion to those standalone selling prices.*"* SSP is defined as the price at which an entity would sell a promised good or service separately to a customer.

2. As explained in FASB ASC 606-10-32-32, the objective of estimating SSP for a performance obligation is to determine the price that an entity would charge for the good(s) or service(s) if they were sold separately. There is no hierarchy for how to estimate or otherwise determine the SSP for goods or services that do not have an observable SSP. Vendors should consider all reasonably available, relevant information when determining this estimate. A vendor should not presume that contractually stated prices or a list price for a good or service represents the SSP for that performance obligation.

3. Per FASB ASC 606- 10-32-32, "The best evidence of standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers." Software entities may have observable evidence of the SSP for certain promised goods and services. For example, an entity may have a history of selling maintenance renewals or professional services on a standalone basis.

4. If a vendor had previously established VSOE of fair value for a good or service under FASB ASC 985-605 using standalone sales, then FinREC generally believes the amount established as VSOE (whether reflected as a fixed dollar amount versus as a percentage of the license or as a single value versus range of values) could be used as the SSP for that good or service upon initial adoption of the new standard, in many cases, assuming that the entity maintains the same pricing and sales practices upon adoption of this new standard. However, in

certain circumstances, an entity may conclude that the process used to determine VSOE (generally based on the historical standalone pricing over a 12-month period) under FASB ASC 985-605 is not the best process for determining SSP under FASB ASC 606. For example, if an entity changes its pricing practices, it is unlikely that the pricing used prior to the change would be representative of the current SSP.

5. In circumstances where a vendor previously established VSOE using an approach other than standalone sales (e.g., substantive renewal rate approach), careful consideration should be given as to whether this would represent the best evidence of SSP. Depending on how an entity previously established VSOE (the entity used an approach other than standalone sales), it may not be sufficient to establish SSP under FASB ASC 606. One common interpretation of establishing VSOE using an approach other than standalone sales was that the renewal rate based pricing need only be substantive to satisfy the requirements of VSOE of maintenance while another common interpretation was that the renewal rate was both substantive and fairly consistent from transaction to transaction. However, the notion of being substantive, alone does not meet the SSP objectives in FASB ASC 606-10-32-32. FinREC believes that use of the stated renewal rate approach to establish SSP of maintenance may result in prices that are too varied to meet the allocation objectives of FASB ASC 606-10-32-32.

6. Regardless of the method used to determine SSP at adoption, the SSP could change over time based on the entity's pricing practices. The evaluation is made prospectively maximizing observable inputs.

7. As mentioned in paragraph 3 above, the best evidence of standalone selling price is an observable standalone selling price and entities are required to maximize the use of observable evidence in estimating SSP. Therefore, even in situations where an entity historically was unable to establish VSOE based on its observable standalone transactions, an entity may conclude it has sufficient observable evidence to form a basis for its estimate of SSP. However, regardless of the amount of observable data available, in all situations an entity must estimate SSP.

8. An entity's estimate of the SSP will require judgment and the consideration of a number of different factors. As stated in FASB ASC 606-10-32-33, an "entity shall consider all information (including market conditions, entity-specific factors, and information about the customer or class of customer) that is reasonably available to the entity" when estimating SSP. A vendor may consider the following information when estimating the SSP of the distinct goods or services included in a contract:
    a. Historical selling prices for any standalone sales of the good or service (e.g., standalone maintenance renewals), even if limited standalone sales exist. An entity will have to consider its facts and circumstances to determine how relevant historical pricing is to the determination of current SSP. For example, if an entity recently changed its pricing strategy, historical pricing data is likely less relevant for the current determination of SSP.
    b. Historical selling prices for non-standalone sales / bundled sales
    c. Competitor pricing for a similar product, especially in a competitive market or in situations where the entities directly compete for customers.
    d. Industry pricing practices for similar products
    e. Profit and pricing objectives of the entity, including pricing practices used to price bundled products
    f. Effect of proposed transaction on pricing and the class of the customer (e.g., the size of the deal, the characteristics of the targeted customer, the geography of the customer, the attractiveness of the market in which the customer resides)
    g. Published price lists
    h. The costs incurred to manufacture or provide the good or service plus a reasonable profit margin

9. The quantity and type of reasonably available data points used in determining SSP will not only vary among software vendors but may differ for products or services offered by the same vendor. Furthermore, with respect to software licenses, reasonably available data points may vary for the same software product that has differing attributes / licensing rights (i.e. perpetual vs. term license, exclusive vs. non-exclusive). For example, a vendor may have standalone observable sales of the maintenance services in its perpetual software license, (i.e., maintenance renewals). These observable sales may be a useful data point for similar maintenance services bundled with other types of software licenses (e.g., term licenses).

10. Although all reasonably available data points should be considered, management should place more weight on those data points that are used by management when making pricing decisions. For example, it may be appropriate for a software vendor to consider the costs associated with providing professional services as there is often a direct labor cost associated with those services included in the contract, assuming that these direct labor costs are important in the management decision making process. However, management may conclude that the costs associated with software licenses or maintenance services are not directly observable and may not be a data point that management uses in making pricing decisions and therefore would be less relevant to management's estimate of SSP for license and maintenance services. If a vendor has a history of providing

discounts off a published list price, the vendor should consider consistently discounted prices as a data point when estimating SSP, as the published list price by itself likely does not represent the standalone selling price.

**11.** Depending on the inherent uniqueness of a license to proprietary software and the related vendor maintenance, third party or industry pricing may or may not be useful for determining SSP of distinct goods or services included in these arrangements. When evaluating whether third party or industry pricing is a relevant and reliable basis for establishing the SSP, the data points should be based on information of comparable items sold on a standalone basis to similar types of customers. Products or services are generally similar if they are largely interchangeable and can be used in similar situations by similar customers. For these reasons, third party or industry pricing for software licenses may not be a relevant data point. However, third party or industry pricing may be a relevant data point for estimating SSP for maintenance, hosting or professional services if other vendors sell similar services on a standalone basis and their pricing is known by the vendor. For example, third party pricing may be a relevant data point if other vendors provide implementation services or host the vendor's software products. Furthermore, industry standard pricing practices may also provide relevant data points in estimating SSP. For example, over time the software industry has developed a common practice of pricing maintenance services as a percentage of the net license fee for related software products, indicating there may be a consistent value relationship between those two items. (See "Determining SSP of goods or services not sold on a standalone basis**"** below for further discussion.)

12. The guidance in paragraphs 32 – 33 of FASB ASC 606-10-32 indicate that observable prices are the standalone selling prices in similar circumstances for similar customers and that an entity should consider information about the class of customer. As a result, FinREC believes that pricing practices in the industry may often result in a vendor having more than one SSP for a single good or service. That is, the entity may be willing to sell goods or services at different prices to different classes of customers. Further, an entity may use different prices in different geographies or in markets where it uses different methods to distribute its products (e.g., use of a distributor or reseller versus selling directly to the end customer). Accordingly, an entity may need to stratify its analysis to determine its SSP for a particular distinct good or service.

13. There may be instances when a vendor's pricing practices, even after stratifying available data (i.e. by geographic location, customer class, contract value, or by product) are highly variable for some or all of the goods and services within the arrangement due to many factors including the uniqueness of each customer's specific needs and the software license portfolio being licensed at any given time. If the pricing is observable and not highly variable for some goods or services and highly variable or not observable for other goods or services, it may be appropriate for the entity to use a residual approach when estimating SSP of the items with highly variably prices. See issue paper #14-6: Estimating the Standalone Selling Price – Use of the Residual Approach, for a discussion of applying the residual approach when pricing is highly variable for some goods or services in an arrangement. It is not appropriate for a vendor to conclude that they are unable to estimate SSP for a performance obligation under FASB ASC 606. FASB ASC 606-10-32-32 explains the best evidence of SSP is the observable price, but FASB ASC 606-10-32-34 provides other suitable methods for estimating the SSP.

*Establishing SSP as a Range*

14. Based on the pricing practices a vendor has for its software licenses or other performance obligations, it may be appropriate, depending on the facts and circumstances, for an entity to develop a reasonable range for its estimated SSP for these goods and services rather than a single point.

15. The range should represent prices for which management would be willing to sell a given distinct good or service, on a standalone basis and should be consistent with the vendor's pricing strategies. For example, required additional management approvals for certain levels of pricing may suggest that such pricing is not consistent with the vendor's pricing strategies.

16. Furthermore, certain evidence or data points may be more relevant than others when determining the estimated SSP. For example, a standalone transaction generally provides better evidence for SSP than a multiple element transaction with line item pricing or an internal pricing sheet. The relevance of the data points will likely affect the weight that should be placed on these data points when estimating SSP. For example, assume that an entity has observable data showing that recent *standalone sales* of installation services were priced at a 60 to 70% discount from the entity's list price and in *bundled transactions* the majority (over 50%) of its recent transactions including installation services were priced at a 40 to 60% discount from the entity's list price. In accordance with the objective of FASB ASC 606-10-32-32, it likely would not be appropriate for the entity to conclude that its SSP is a range of 40-70% discount from list price. Instead, the entity would have to consider both sources of data, likely giving more weight to the standalone sales data, and determine a reasonable range. To continue that example, the entity noted that while over 50% of its transactions were priced at 60-70% discount from the list price, if the range were expanded to a 40-80% discount from the list price, over 75% of its

transactions would fall within the range. However, entities should avoid simply expanding the range to encompass a higher percentage of historical transactions as that likely reduces the relevancy of the range in terms of providing a useful data point for determining SSP. That is, in order for the use of a range to comply with the objective of ASC 606-10-32-28, the width of the range must be reasonable.

17. When all distinct performance obligations in an arrangement are priced at their SSP or within the identified SSP range, FinREC believes it would be appropriate for the vendor to conclude no reallocation of transaction price under the relative selling price methodology is required from the stated amounts for each performance obligation (that is, where a relative selling price allocation be performed, no pricing would change as all elements are priced at their SSP).

18. However, in situations where an entity uses a range to estimate SSP, and the stated contractual price for a distinct good or service is outside of that range, the vendor should consistently use a reasonable and systematic approach when allocating the transaction price between the distinct performance obligations's included in an arrangement. FinREC believes the use of a consistent point in the range, such as the midpoint of the range, for purposes of identifying a specific SSP for the relative selling price allocation calculation, would be acceptable. Note, however, an entity should verify that the overall allocation objective in FASB ASC 606-10-32-28 is still met after the application of this accounting convention. If it is not, the entity should re-challenge the appropriateness of the calculated range for SSP.

19. The following examples illustrate the allocations for three typical software transactions, the actual determination of the allocation should be based on the facts and circumstances of an entity's specific situation

    Example 1:

    Assume a contract for a perpetual license and one year of maintenance for a contractual amount of $1 million for the license and 13% for the maintenance (total consideration of $1,130,000). The customer has the contractual right to renew maintenance annually at 13% of the license fee. The entity's SSP range for the software license is $950,000 to $1,050,000 and the SSP range for maintenance is 12-16% of the license fee. In this example, both the license and the maintenance are within the company's SSP ranges. As described in paragraph 17, the entity would not need to reallocate consideration beyond the amounts stated in the contract. The Company would allocate $1,000,000 to the license and $130,000 (13%) to the maintenance. Further, since the renewal rate is within the company's SSP range for maintenance, the company concludes that no material right related to the option to renew maintenance exists.

    Example 2:

    Assume the same facts as Example 1, except the contractual price for maintenance is 10% of the license fee for both the initial year and any renewals. The entity's SSP range for the software license is $950,000 to $1,050,000 and the SSP range for maintenance is 12-16% of the license fee. In this example, the license fee of $1 million is within the SSP range, however the 10% maintenance fee (both the initial year and any renewals) is not. As such, the entity must allocate the consideration in an amount different from the stated contractual amounts as the contractual amounts are not both within the SSP range. The entity would have to determine what percentage to use as the SSP in order to calculate the relative selling price of the maintenance. For this illustration, assume the entity's policy is to use the mid-point of its identified range. Further, the company has concluded that the contract contains a material right related to the right to renew maintenance. The company anticipates the customer will renew the maintenance four times. Therefore, the company concluded that the discount on future maintenance from SSP of $80,000 (the difference between the maintenance at the mid-point of the SSP range of 14% ($140,000) and the contractual renewal rate of 10% ($100,000) for the number of years the company expects the customer to renew) is material to the contract (over 14% of the contract value). (Note that for purposes of this example, the materiality of the right is assumed and the qualitative and quantitative evaluation of materiality is not included in the example. Further, for purposes of this example, assume that in determining the SSP of the option, the entity has concluded that there is a 100% likelihood that the customer will exercise the option.) The allocation calculation would be as follows (note, the allocation is based on the estimated fair value of the material right versus using the alternative practical expedient allowed for options in ASC 606-10-55-44):

| Performance obligation | SSP | Allocated arrangement consideration |
|---|---|---|
| License | $1,000,000 | $846,000 |
| Maintenance (12%) | 140,000 | 119,000 |
| Material Right | 160,000 | 135,000 |
| | $1,300,000 | $1,100,000 |

Example 3:

Assume a contract for a perpetual license and one year of maintenance for a contractual amount of $1 million for the license and 18% for the maintenance. The entity's SSP range for the software license is $950,000 to $1,050,000 and the SSP range for maintenance is 12-16% of the license fee. In this example, the license fee of $1 million is within the SSP range, however the 18% maintenance fee is not. As such, the entity must allocate the consideration in an amount different from the stated contractual amounts as the contractual amounts are not both within the SSP range. The entity in case B established a policy of using the mid-point (14%) for the allocation calculation. Further, since the renewal rate is in excess of the entity's SSP range for maintenance, the entity concludes that no material right exists related to the option to renew maintenance. The allocation calculation would be as follows:

| Performance obligation | SSP | Allocated arrangement consideration |
|---|---|---|
| License | $1,000,000 | $1,035,000 |
| Maintenance (12%) | 140,000 | 145,000 |
| | $1,140,000 | $1,180,000 |

*Determining SSP of Goods or Services Not Sold on a Standalone Basis*

20. Software vendors may commonly encounter situations where software products or other goods or services (e.g., maintenance) bundled in an arrangement are rarely or never sold on a standalone basis. For example, a software vendor that sells perpetual software licenses with the first year of maintenance will not have any history of standalone sales for the software product. Additionally, a vendor that sells term licenses bundled with maintenance may lack history of standalone sales for the software product, the maintenance or both.

21. This lack of history of selling goods or services on a standalone basis combined with minimal direct costs and a lack of third party or industry comparable pricing may result in some software vendors focusing on entity-specific and market factors when estimating SSP of both the license or the maintenance such as internal pricing strategies and practices. That is, based on its established pricing practices, an entity may conclude that it has established a value relationship between a software product and the maintenance that is helpful in determining SSP.

22. For example, consider a vendor that sells perpetual licenses bundled with the first year of maintenance and subsequent maintenance renewals are sold on a standalone basis. This vendor may conclude that the established practice of pricing and selling maintenance as a percentage of the net fee for related software licenses indicates the entity has established a value relationship between the software and maintenance that provides insight into the SSP for each element on its own. In another example, a vendor may have a practice of selling renewals of maintenance at a slightly higher or slightly lower price than the initial bundle due to specific reasons related to the perceived value of the first year of maintenance compared to subsequent years. While the maintenance pricing on renewals in subsequent years is not the exact same as it was in the first year, it could still provide evidence of the value relationship that exists between the software product and the maintenance. Note, these two examples are not meant to represent the only ways an entity could establish a value relationship between the software product and the maintenance. An entity should consider its own facts and circumstances in making this determination.

23. Further, a vendor selling one year term licenses with bundled maintenance might not have standalone sales of the software product or the maintenance. In such situations, the vendor is likely to consider its pricing practices for other products where it may have observable standalone transactions as well as industry practice and may determine that it is reasonable to conclude that a value relationship exists between the software product and the maintenance that will help establish the SSP of each item. (See "Determining SSP of Maintenance for Term and Perpetual Software Licenses" below for further discussion.)

24. In either scenario described above, it is important the vendor give priority to any available observable data in estimating the value relationship between the software and the maintenance.

*Determining SSP of Maintenance for Term and Perpetual Software Licenses*

25. Certain software entities sell both perpetual and term licenses for the same software products, which provide customers with the right to use the license indefinitely or for a specified period of time, respectively. FASB ASC 606-10-55-64(a) explains that contractual restrictions of time, geographical region, or use are attributes of a license that define the scope of a customer's rights under the license and do not affect the identification of promised products or services. Therefore, a perpetual license and a term license to a particular software product are very similar as they are related to the same promised product albeit there are differences in the period of time for which the customer can use that product.

29. Licenses, whether perpetual or term, often are bundled with additional deliverables including maintenance, which is typically comprised of technical support and unspecified upgrades and enhancements to the underlying software functionality (see Issue #14-2: Determining whether components of Postcontract Customer Support ("PCS") are separate performance obligations distinct from one another, and the associated pattern in which an entity satisfies each performance obligation, for a further discussion of the elements included within maintenance). Consistent with the notion that perpetual licenses and term licenses for the same software product are very similar, the maintenance deliverables being provided for that software product are also similar.

30. As noted above, under FASB ASC 606-10-32-31, the arrangement transaction price is allocated to each performance obligation, generally on a relative standalone selling price basis.

31. As discussed in paragraph 21 above, a software vendor may have established a value relationship between the perpetual software license and the maintenance services for that license that influences the vendor's determination of SSP for each of those items. Given that the underlying products (software license) and services (technical support and unspecified upgrades and enhancements) are similar for both a perpetual and a term license arrangement, FinREC believes that the renewal pricing for the maintenance associated with one type of license (e.g., a percentage of the license fee for a perpetual license) would be a good starting point for establishing SSP for the maintenance associated with the license without renewal pricing. Entities would have to determine whether the SSP of the maintenance for one type of license would be different from the other type of license. Management would need to carefully analyze its particular facts and circumstances and the related market dynamics, but should consider any standalone renewal transaction data, adjusting as necessary for the type of license, in formulating its SSP. For example, some vendors may determine that the renewal rates would not differ based on market dynamics. Conversely, other vendors may determine that the ability to use the updates provided in maintenance associated with perpetual or longer-term licenses might cause that maintenance to have higher pricing.

Comments should be received by August 1, 2017, and sent by electronic mail to Kim Kushmerick at kim.kushmerick@aicpa-cima.com, or you can send them by mail to Kim Kushmerick, Accounting Standards, AICPA, 1211 Avenue of the Americas, NY 10036.