Working Draft:
Software Revenue Recognition Implementation Issue

Issue #14-6 – Estimating the Standalone Selling Price

Expected Overall Level of Impact to Industry Accounting:
Significant

Wording to be Included in the Revenue Recognition Guide:

Using the Residual Approach to Estimate the Standalone Selling Price of a Software License

1. Software vendors commonly sell their software licenses bundled with other products and services; for example, a software license bundled with maintenance services (generally for a stated period of time). Step 4 of the new revenue recognition standard requires an entity to allocate the transaction price to the performance obligations in the contract. 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.” FASB ASC 606-10-32-32 defines the standalone selling price (“SSP”) as the price at which an entity would sell a promised good or service separately to a customer.

2. The SSP of a good or service (or bundle of goods or services that make up a single performance obligation) may not be directly observable. This is especially common in many software transactions where the software vendors do not sell the software license on a standalone basis. Often the software license is always sold with maintenance services and/or other products and services (e.g. professional services or hosting).

3. Under FASB ASC 606-10-32-34(c), an entity may estimate the SSP of a good or service using the “residual approach” in certain circumstances, calculated as the total transaction price less the sum of the observable SSP of other goods or services promised in the contract. The use of the residual approach to estimate the SSP of a promised good or service is appropriate only when SSP of a promised good or service is highly variable or uncertain, as demonstrated by meeting one of the following conditions:
    a. The entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (that is, the selling price is highly variable because a representative standalone selling price is not discernible from past transactions or other observable evidence);

b. The entity has not yet established a price for that good or service, and the good or service has not previously been sold on a standalone basis (that is, the selling price is uncertain)."

4. Historically, many software vendors have sold their software bundles (i.e., software license bundled with maintenance services and/or other products and services) at prices that vary significantly from customer to customer. The lack of history of selling the software license on a standalone basis combined with the variable pricing on bundled arrangements may lead many software vendors to consider using the residual approach for determining the SSP of the software license.

5. In order to use the residual approach for the software license in the contract, an entity will first need to evaluate whether the software license sold to the customer is the "same" and whether the selling price of those same licenses has been highly variable or uncertain in those other transactions.

6. When considering whether the entity is licensing the "same" software, notwithstanding that the license is for the same underlying software product, FinREC believes that an entity would consider the particular attributes of the license – for example, whether the license is perpetual or time-based (and if time-based, the duration of the license term – for example, 3 years vs. 7 years), exclusive or non-exclusive, restricted as to permitted uses. This is consistent with both the notion that a license gives an entity rights related to intellectual property (that is, it is not the intellectual property itself) and with FASB ASC 606-10-55-64(a), which states that "restrictions of time, geographic region, or use… define the attributes of the promised license". Therefore, FinREC believes an entity should group software licenses with similar attributes for the purpose of the analysis.

7. The determination of whether the entity is licensing the same software from transaction to transaction may be straightforward. However, the determination of whether the pricing has been highly variable will often require judgment.

8. For the purposes of assessing whether condition 1 under FASB ASC 606-10-32-34(c) has been met (i.e., whether the selling price is highly variable), an entity would evaluate whether it licenses its software for a broad range of amounts. FinREC believes that an entity may employ different quantitative as well as qualitative approaches to determine whether its pricing is "highly variable". FinREC believes an entity should document its methodology for evaluating its pricing variability and apply the methodology consistently.

9. For example, an entity may bundle a software license with maintenance services. An entity may decide to quantitatively evaluate the pricing variability of its licenses to that software, grouped by similar types of licenses, by assessing the pricing variability of the bundle. This involves analyzing the different actual prices charged for the same software bundle. Such an analysis will produce a range of prices charged for the bundle, which the vendor can use to determine whether the pricing variations are deemed to be highly variable. If the vendor has consistently sold the same software license bundle at the same price (or in a range of prices that is not highly variable), the pricing for the bundle would not be deemed highly variable; and therefore the pricing of the software license component of the software bundle would not be considered highly variable.

10. If, after performing the analysis specified in paragraph 9 above, an entity concludes that the pricing of the bundle is highly variable, the entity will have to determine how to allocate the pricing for the bundle to each of the separate performance obligations within the bundle. Frequently, an entity will have standalone sales data for the maintenance (e.g., information gathered from renewals of the maintenance services), and will not have such data for its licenses. In such situations, an entity would typically determine the standalone selling price for the maintenance based on that observable data, and use the residual approach to determine the standalone selling price of the software license. However, this may not be the case in all situations and judgment may be required to determine how the transaction price of the bundle should be allocated to the identified performance obligations. This may particularly be the case if multiple elements of the bundle are not sold separately (e.g., if the entity sells its maintenance only together with renewals of term licenses). However, in the case of maintenance and some services, there may still be external data that provides a more observable basis for estimating the standalone selling price for those items than for the entity's software licenses. Ultimately, the objective of the analysis is to achieve an allocation of the portion of the transaction price allocated to the bundle that is consistent with the relative selling price principle underlying FASB ASC 606-10-32-31.

11. In addition to analyzing the selling prices for a bundle that includes one or more software licenses, an entity may also qualitatively analyze its pricing practices and policies to determine how pricing decisions are made, the range of acceptable pricing based on policy as compared to actual prices, and whether such range is considered highly variable.

12. For the purposes of assessing whether condition 2 under FASB ASC 606-10-32-34(c) has been met (i.e., whether the selling price is uncertain), an entity should evaluate whether it has established a selling price for the license in accordance with FASB ASC 606-10-32-28 through 32-35. If a vendor has established a separate price for the license, the vendor should also consider whether it has or will be following such established price in evaluating the pricing's uncertainty. For example, if the license has only been sold on a standalone basis once, or was only sold separately on a limited basis and such transaction is not current, the pricing for the license could still be determined to be uncertain. If a vendor has not established a separate price for the software (e.g., by licensing the software separately), under this criterion, the residual approach could be appropriate if other observable inputs are not available for the software.

13. If the selling price is deemed to be highly variable or uncertain and the residual approach is applied, the resulting estimated SSP should be evaluated for reasonableness, consistent with BC273 of ASU 2014-09. In determining whether the standalone selling price is reasonable, consistent with BC269 of ASU 2014-09, the entity performs the analysis based on all reasonably available information, which may include the following:
    a. Consistency with the entity's pricing strategy;
    b. Comparison to similar products or services offered by the entity;
    c. Comparison to similar products or services offered by the competitors;
    d. Analyzing the cost to determine whether the estimated selling price yields an appropriate margin.

14. The resulting estimated SSP determined using a residual approach is reasonable if it is consistent with the internal and external information obtained under the preceding paragraph.

Transition guidance - Comparison to the superseded guidance under ASC 985-605

15. The following implementation guidance has been incorporated to assist in transition to FASB ASC 606. Assuming that the entity's contracting practices have not changed, paragraphs 16 - 18 compare the application of the residual approach under FASB ASC 606 to the residual method under the superseded software revenue recognition guidance in FASB ASC 985-605.

16. If an entity has previously established vendor-specific objective evidence ("VSOE") of fair value for the license under the previous software revenue recognition guidance (FASB ASC 985-605-25-6), an observable standalone selling price would exist for the license, therefore FinREC believes that it would be inappropriate to apply the residual approach to estimate the standalone selling price for the license, as an observable SSP exists absent a significant and sustained change to pricing practices that might render the SSP uncertain.

17. If an entity has previously sold the software separately but was unable to establish VSOE of fair value for such software under the previous software revenue recognition guidance, further evaluation is required on the appropriateness of the residual approach under FASB ASC 606. There were stricter requirements to establish VSOE under FASB ASC 985-605 than establishing SSP under ASC 606. In other words, FinREC believes a "failed" VSOE under FASB ASC 985-605 does not automatically indicate an entity does not have the ability to establish an observable SSP under FASB ASC 606. Further analysis would be required to determine whether it would be appropriate to use the residual approach. Implementation guidance discussed under paragraphs 1 – 14 should be considered.

18. If an entity did not sell nor intend to sell the software separately, it would not be able to establish VSOE of fair value under FASB ASC 985-605. It may have applied the residual method under ASC 985-605. In this fact pattern, further evaluation will be required to determine whether the residual approach will continue to be appropriate under FASB ASC 606.

Residual Method vs. Residual Approach

19. As discussed under BC273 of ASU 2014-09, the residual method under FASB ASC 985-605 was an allocation method. It was previously used when the entity had VSOE of fair value for the undelivered goods or services, but did not have VSOE of fair value for the delivered goods or services. It was most commonly used to account for bundled arrangements containing software license and maintenance services. This is because software vendors typically did not sell the software license on a standalone basis, and therefore VSOE of fair value for the software license did not exist. If the vendor had established VSOE of fair value for maintenance services, it could apply the residual method to allocate value to the software license based on the total arrangement fee less the VSOE of fair value of the maintenance services.

20. In contrast, the residual approach under FASB ASC 606 is an estimation method. It is used to estimate the SSP of a distinct good or service under ASC 606 and should not be used if the estimated standalone selling price is unreasonable (for example, zero). Under FASB ASC 606, the residual approach can be applied to the goods or services in an arrangement for which there is no observable SSP, regardless of whether the goods or services are delivered, if certain conditions are met. The SSP determined using the residual approach is then incorporated into the allocation of the transaction price based on the relative SSP of each performance obligation.

Comments should be received by December 5, 2016, and sent by electronic mail to Kim Kushmerick at kkushmerick@aicpa.org, or you can send them by mail to Kim Kushmerick, Accounting Standards, AICPA, 1211 Avenue of the Americas, NY 10036.