Working Draft:
Software Revenue Recognition Implementation Issue

Issue 14-4 (a): Defining and Identifying Potential Price Concessions

Expected Overall Level of Impact to Industry Accounting:
Moderate

Wording to be Included in the Revenue Recognition Guide:

Identification of Potential Price Concessions

1. An entity will need to apply judgment in determining whether it has implicitly offered a price concession or whether it has chosen to accept the risk of default by the customer of the contractually agreed-upon consideration (that is, customer credit risk). If an entity determines that it will collect less than the stated contract price due to a price concession (regardless of whether the price concession is implicit or explicit), then that amount is accounted for as a reduction of the transaction price. That is, the amount is considered to be variable consideration that is subject to the constraint on variable consideration in determining the transaction price (Step 3 of the new revenue standard) rather than an input into the collectibility assessment in Step 1. Conversely, if an entity concludes that there is a significant credit default risk, then the vendor may conclude that the arrangement does not meet the criteria to be accounted for as a contract. This distinction can therefore impact both the timing and the amount of revenue recognized.

2. FASB ASC 606-10-25-1(e) states "The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession (see paragraph 606-10-32-7)." Accordingly, an entity may need to consider whether an implied price concession exists at the outset of a contractual arrangement.

3. For purposes of this discussion, we will assume that the entity has concluded that the criteria in FASB ASC 606-10-25-1, including that collectibility is probable, have been met and the contract is within the scope of the five-step model in ASC 606. To determine if it is probable that the entity will collect substantially all of the consideration to which it will be entitled as required in FASB ASC 606-10-25-1(e), the entity will need to determine the transaction price as described in FASB ASC 606-10-32-2 that includes estimating variable consideration.

4. As noted in FASB ASC 606-10-32-7 (a), a price concession occurs when a vendor "accepts an amount of consideration that is less than the price stated in the contract." Software

vendors may have a higher likelihood than other industries of offering such price concessions due to the fact that there may be little to no incremental cost associated with the fulfillment of performance obligations such as the license of a software product.

5. Accordingly, as also noted in FASB ASC 606-10-32-7 (a), software vendors should consider whether a customer has a "valid expectation arising from an entity's customary business practices, published policies, or specific statements" that the entity will provide a payment concession, and should estimate the concessions at the outset of the contractual arrangement. In addition, the vendor should consider whether "Other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer", as noted in FASB ASC 606-10-32-7 (b).

6. Price concessions may arise from each of the factors stated in FASB ASC 606-10-32-7 and may take many forms. Indicators of potential price concessions include but are not limited to: price discounts; rebates; refunds; credits; or extensions of scheduled payment obligations. For example, a vendor may enter into a contract that includes 5 years of maintenance with committed annual payments of $100, and may subsequently agree to allow its customer to make reduced annual payments of $75 per year. Alternatively, a vendor may accept an amount of consideration that is less than the price stated in a contract in exchange for a reduction in the scope of the performance obligations for that contract, such as a reduced maintenance period. These situations may indicate either an implied price concession, a contract modification or both.

7. The determination of whether arrangements with customers include implied price concessions at the onset is one that requires significant judgment. Vendors may want to evaluate the different sources of information available to them in making this determination, which could include: their transaction history, public statements, or changing market conditions in order to estimate whether there are any implied price concessions. As noted in FASB ASC 606-10-32-9, "an entity shall consider all of the information (historical, current, and forecast) that is reasonably available to the entity and shall identify a reasonable number of possible consideration amounts. The information that an entity uses to estimate the amount of variable consideration typically would be similar to the information that the entity's management uses during the bid-and-proposal process and in establishing prices for promised goods and services." For contracts with financially stressed customers, determination of the customer's creditworthiness could include an assessment of prior price concessions to determine whether the concessions are indicative of a customer's inability to pay the amounts to which the entity was entitled, which may lead an entity to question whether collectability is probable for the contract.

Use of Portfolio Approach in Estimating Potential Price Concessions

8. Software vendors may want to consider whether it is possible to use a portfolio approach to estimate the value of potential price concessions. FASB ASC 606-10-10-4 allows an entity to apply the guidance in ASC 606 to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this guidance to the portfolio would not differ materially from applying this guidance to the individual contracts.

9. In grouping transactions with similar characteristics for the purpose of estimating a price concession, software vendors could consider all characteristics that may impact the estimation of a concession, which include: customer size, transaction size, market vertical, geographic location, product type, product stage (new vs existing), or other customary business practices. When grouping transactions with similar characteristics, software vendors could consider whether a sufficiently large, homogeneous pool of transactions exists for any identified group. A software vendor may generally conclude that it is appropriate to use the portfolio approach for a homogeneous pool of contracts while also concluding that some transactions cannot be grouped, and will need to be evaluated on a customer, or even transaction-specific basis.

Transition Guidance - Extended Payment Terms

10. The guidance on extended payment terms under the software revenue recognition guidance in FASB ASC 985-605 will be superseded. The following implementation guidance has been incorporated to assist in transition to FASB ASC 606.

11. Extended payment terms may be explicitly stated in a contract or they may be implied through a vendor's past actions or customer expectations. Software products are continually evolving and tend to have a limited useful life. Accordingly, extended payment terms may be particularly challenging for software arrangements as the underlying software product may become technologically obsolete by the time a customer is required to make payment to the software vendor. In accordance with FASB ASC 606-10-32-9, software vendors should consider all information (historical, current, and forecast) that is reasonably available to the entity to estimate variable consideration when determining the transaction price, that includes price concessions, whether the guidance in FASB ASC 606 is applied on a portfolio or contract by contract basis. This includes historical collection history for sales of similar software products when estimating the frequency, extent, and likelihood of potential price concessions for a group of contracts, or for a specific contract. In accordance with the discussion at the July 2015 TRG meeting on the portfolio practical expedient[1] , an entity is not required to apply the portfolio practical expedient when considering evidence from other, similar contracts to develop an estimate of variable consideration.

12. If a contract, or group of contracts, have payment terms that are longer than a software vendor typically offers for a given type of software product, then historical collection patterns may be a less useful predictive measure when estimating the likelihood and amount of potential price concessions. This may also be the case when a software vendor enters a new market with a product that may have a different technological useful life than the vendor's other products. The existence of extended payment terms, and the payment term length offered to different customers, could also be considered when applying a portfolio approach for purposes of estimating payment concessions.

13. In addition, the basis for granting longer than normal payment terms could be analyzed to determine whether additional factors should be considered when concluding whether potential price concessions exist. This analysis may include assessing the underlying reasons for providing extended payment terms, and whether there is a history of changing payment terms because of creditworthiness issues. For example, the willingness to grant extended payment terms to a financially stressed customer could be indicative of a willingness to provide price concessions in the future even if the software vendor has not historically provided concessions. Alternatively, an entity might decide to grant extended payment terms to respond to market demands, and may conclude that such an action is not an indicator of an implied price concession.

14. Additionally, if the contract has payment terms that extend significantly beyond the expected timing of fulfillment for the contractual performance obligations, the software vendor should consider whether the transaction includes a significant financing component.

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.

[1] As noted in paragraph 25 of Agenda Ref 44, July 2015 Meeting – Summary of Issues Discussed and Next Steps:

> In some circumstances, an entity will develop estimates using a portfolio of data to account for a specific contract with a customer. For example, to account for a specific contract with a customer, an entity might consider historical experience with similar contracts to make estimates and judgments about variable consideration and the constraint on variable consideration for that specific contract. On question 1, TRG members agreed with the staff's view that the use of a portfolio of data is not the same as applying the portfolio practical expedient.