Determining the best estimate of selling price

Implementation considerations of amended guidance in FASB ASU 2009-13

Summary

In October 2009, the FASB issued Accounting Standards Update (ASU) 2009-13, Multiple-Deliverable Revenue Arrangements, to amend FASB Accounting Standards Codification™ (ASC) 605-25, Revenue Recognition: Multiple-Element Arrangements. The revisions to the multiple-element arrangement guidance introduced by ASU 2009-13 include a provision that in certain circumstances allows for management to use “best estimate of selling price” in determining how much revenue to allocate to each unit of accounting.

Entities adopting the amended guidance have found applying this concept of “best estimate of selling price” challenging. This bulletin provides guidance on determining a selling price under the amended guidance and also addresses several implementation issues reported by early adopters.

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A. Introduction

In October 2009, the FASB issued Accounting Standards Update (ASU) 2009-13, Multiple-Deliverable Revenue Arrangements, to amend FASB Accounting Standards Codification™ (ASC) 605-25, Revenue
Recognition: Multiple-Element Arrangements. The revisions to the multiple-element arrangement guidance introduced by ASU 2009-13:

- Modify the criteria used to separate elements in a multiple-element arrangement
- Introduce the concept of “best estimate of selling price” for determining the selling price of a deliverable
- Establish a hierarchy of evidence for determining a selling price
- Require the use of the relative selling price method, and prohibit use of the residual method, to allocate arrangement consideration among units of accounting
- Allow for management’s estimate of selling price

The amendments in ASU 2009-13 are effective prospectively for new or materially modified arrangements in fiscal years beginning on or after June 15, 2010. Early adoption is permitted. However, few entities elected to adopt the guidance early; as a result, many entities will be required to adopt the guidance in 2011.

One of the challenges faced by early adopters and entities preparing for adoption is applying the concept of “best estimate of selling price.” While management estimates have always been required in preparing financial statements, the concept of estimating a selling price is new to both preparers and auditors. This bulletin provides guidance on determining a selling price under the amended guidance, including lessons learned from early adopters.

B. Allocating consideration

Among the amendments in ASU 2009-13 is a requirement to use the relative selling price method to allocate consideration to the separate units of accounting in a multiple-element arrangement. (Frequently the units of accounting are referred to without distinction as “elements,” “items,” or “deliverables”). Use of the residual method is no longer permitted.

Under the prior guidance, an entity with objective and reliable evidence of fair value for each unit of accounting allocates the arrangement consideration based on the relative fair value of each unit of accounting to the total transaction price. If objective and reliable evidence of fair value exists for the undelivered items, but not for the delivered items, arrangement consideration is allocated based on the residual method. Under the residual method, an amount equal to the fair value of the undelivered items is deferred, and the remaining consideration is allocated to the delivered items. Many entities do not have objective and reliable evidence of fair value for the delivered items in their multiple-element arrangements and have therefore used the residual method.

As a result of the amendment prohibiting the residual method, an entity must determine a selling price for each unit of accounting. The amended guidance in ASC 605-25 contains the following hierarchy of evidence for determining a selling price:

- Vendor-specific objective evidence (VSOE) of selling price should be used if it exists.
- If VSOE of selling price does not exist, an entity should determine if third-party evidence (TPE) of selling price is available.
- If neither VSOE nor TPE of selling price exists, management should use its best estimate of selling price.
The requirement to use the relative selling price method and to estimate a selling price when neither VSOE nor TPE exists represents a significant change for many entities. The guidance in ASC 605-25 for determining best estimate of selling price is principles-based, and applying the principles is resulting in many questions from preparers and auditors.

C. Determining the selling price

At the arrangement inception, an entity must evaluate the separation criteria in ASC 605-25 to identify the separate units of accounting. A selling price must be determined for each identified unit of accounting using the hierarchy in ASC 605-25-30-2. This might result in using different methods for determining a selling price for the separate units even though they are within a single arrangement. If VSOE or TPE exists, it must be used in determining the selling price for an item. Management cannot default to estimating a selling price and ignore evidence that is reasonably available without undue cost and effort.

Vendor-specific objective evidence (VSOE)

ASC 605-25 defines “VSOE of selling price” as the price charged when the same element is sold separately or, for an element not yet sold separately, the price established by management with the relevant authority. An entity must sell, or plan to sell, an element separately to establish VSOE of selling price.

If an entity sells an element separately, it must perform an analysis to determine if VSOE exists. In addition, an entity with a history of establishing VSOE of selling price for an element should continue to perform this analysis, providing no significant change in facts and circumstances results in a change in pricing practices. This analysis should be performed even if the effort and cost of that analysis is considered greater than the effort and cost of developing a best estimate of selling price.

However, it is possible that separate sales prices for a single element are too disparate to represent VSOE. In those situations, management should consider the separate selling prices in determining its best estimate of selling price and should also consider whether TPE exists.

If an entity sells an element separately and neither VSOE nor TPE exists, the stand-alone transactions could provide information regarding (1) the pricing practices of the entity and (2) how much customers are willing to pay for the item on a stand-alone basis. However, the entity should consider the facts and circumstances of the stand-alone sales to determine how much emphasis should be placed on those selling prices and whether adjustments to the selling prices are necessary. For example, the selling price ordinarily would be adjusted if a stand-alone sale is at or below cost or to reflect geographical differences.

Third-party evidence (TPE)

TPE includes competitors’ sales prices for the same or largely interchangeable products or services to similar customers in stand-alone sales. Similar to evaluating whether VSOE exists, an entity that has a history of establishing TPE of selling price should continue to evaluate whether TPE exists if there has been no significant change in facts and circumstances that affect pricing.

Estimating a selling price

The guidance on estimating a selling price is principles-based, and as a result, management must exercise significant judgment in determining best estimate of selling price for an item when neither VSOE nor TPE exists. ASC 605-25-30-6C states:

The vendor’s best estimate of selling price shall be consistent with the objective of determining vendor-specific objective evidence of selling price for the deliverable; that is, the price at which
the vendor would transact if the deliverable were sold by the vendor regularly on a standalone basis. The vendor shall consider market conditions as well as entity-specific factors when estimating the selling price.

ASC 605-25 does not require any specific approach to estimate a selling price when VSOE or TPE of selling price does not exist. Guidance is provided in the form of examples that illustrate only one method an entity might use to estimate selling price: a cost-plus margin approach. However, there are many circumstances where using a cost-plus margin approach may not be appropriate, such as when direct fulfillment costs are not easily identifiable.

Therefore, the guidance provides management significant flexibility in determining which method to use to determine best estimate of selling price. We believe a best practice is for management to first consider the entity’s overall pricing model and objectives, including the various factors the entity considers in making pricing decisions. Management should then consider how the relevant market conditions and entity-specific factors impact those pricing objectives.

Entities applying a cost-plus margin approach to estimating a selling price have questioned which costs to include in the selling price analysis. We believe an entity should develop and consistently apply a methodology that considers direct and indirect costs, as well as other relevant costs considered in its normal pricing practices, such as research and development costs. Determining the margin to use when applying a cost-plus approach requires significant judgment, particularly when the entity does not have current plans to separately sell a product or service.

### Lessons from early adopters

In applying the provisions of ASU 2009-13, many entities have struggled with how to determine best estimate of selling price. Accounting personnel are comfortable calculating numbers and tend to gravitate to an approach of estimating a selling price that uses historical data that is available. They might, for example, take an average or weighted average of sales prices stated in bundled arrangements or use the amount that has historically been allocated using the residual method. ASC 605-25-30-6C states the principle that best estimate of selling price should be “the price at which the vendor would transact if the deliverable were sold by the vendor regularly on a standalone basis.” In addition, the guidance states that “contractually stated prices for individual products or services in an arrangement with multiple deliverables shall not be presumed to be representative of vendor-specific objective evidence, third-party evidence, or a vendor’s best estimate of selling price.” As a result, methods that are largely based on contract amounts or amounts determined under previous guidance are not appropriate because they tend to overly rely on historical data rather than applying the principle in ASC 605-25-30-6C to determine best estimate of selling price.

Historical pricing is a data point that should be considered in developing an estimate of selling price; however, it should not be the starting point when VSOE or TPE does not exist. In addition, because the residual method results in allocating the entire discount to the delivered element, this residual amount may represent the low end of the estimated selling price range, which is discussed further under “Factors to consider in developing a best estimate of selling price.”
Factors to consider in developing a best estimate of selling price

ASC 605-25 requires an entity to consider market conditions in addition to entity-specific factors to determine its best estimate of selling price. The guidance does not identify specific market conditions or entity-specific factors to consider, but it does provide insight into some of the factors that an entity might consider through examples in the implementation guidance (in ASC 605-25-55-37 through 55-57).

Market conditions include, but are not limited to, the following:

- Overall economic conditions
- Customer demand for the element(s)
- Impact of competition for the element(s)
- Profit margins realized by entities in the industry
- Impact of product customization
- Expected technological life of the product and impact of expected industry advancements
- Impact of geographic factors

In addition, an entity may consider the following entity-specific factors, among others, in developing its best estimate of selling price:

- The entity’s pricing practices for the element(s), including discounts or pricing strategies, such as
  - Volume discounts
  - Price reductions to gain market share or lower inventory levels due to obsolescence or an improved model
- Costs incurred by the entity to provide the element(s)
- The entity’s profit objectives for the element(s)
- Expected life of the product and impact of entity-specific improvements
- Impact of product customization
- How the type or size of customer impacts pricing
- Market share goals for the element(s)
- Stand-alone sales of the element when VSOE of selling price is not achieved

Evaluating the evidence relating to selling price may require significant judgment. Management should consider all available evidence at contract inception in developing its best estimate of selling price for each element.

An entity should also establish policies and procedures for developing a best estimate of selling price and should apply those policies and procedures consistently to similar elements. As a best practice, management should document its evaluation of the market conditions and entity-specific factors considered in developing a best estimate of selling price, including those determined not to be relevant and the reasons why.
Lessons from early adopters

Early adopters have applied different approaches in different situations to determine best estimate of selling prices. Entities have varied both the factors considered and the relative weight given to each factor based on the facts and circumstances of particular arrangements. Some entities have found it challenging to determine a best estimate of selling price for items that are never sold on a stand-alone basis, such as licenses for software and other intangible assets. We believe that management should tailor the approach used to determine best estimate of selling price to the entity’s particular facts and circumstances and give consideration to the factors contemplated in negotiating the arrangement with the customer.

Utilizing a range of estimated selling prices

Under the amended guidance, the objective of determining best estimate of selling price is consistent with the objective of determining VSOE—that is, the price at which the vendor would transact if the item were sold regularly on a stand-alone basis. Entities sometimes establish VSOE using an appropriate range of stand-alone selling prices rather than a single price, especially entities using the widely accepted bell-shaped curve method. Consequently, we believe that establishing a range of estimated selling prices might also be acceptable if that range represents a reasonable price the entity would accept in stand-alone sales of the product or service. However, we also believe that the range used for estimated selling price should not be wider than the range used for VSOE, as described in the following paragraph, since estimated selling price, unlike VSOE, is not solely based on actual transactions.

Under the bell-shaped curve method used for establishing VSOE of fair value, the entire population of transactions is evaluated to determine whether the range of prices is sufficiently narrow to provide evidence of VSOE. Although judgment is required in assessing whether the range of prices is sufficiently narrow for establishing VSOE, we believe that at least 80 percent of the transactions in the population should fall within a range of $\pm 15$ percent of the midpoint of the range. In calculating the range for VSOE, the relative percent is applied to the change from the midpoint of the range. For example, if $100$ is the midpoint of the range, a range of $\pm 15$ percent would be $85$ to $115$.

If an entity believes a range represents its best estimate of selling price, the range should be sufficiently narrow such that any price within the range represents a price it would accept if the element were sold regularly on a stand-alone basis. It is not appropriate for an entity to establish a point estimate and then calculate a narrow range of prices on either side of the point estimate. An entity might conclude that multiple data points, adjusted for market and entity-specific factors, provide valid pricing points that are within a narrow range of one another, as in situations where the entity has stand-alone sales that do not constitute VSOE.

If the contract prices for the element(s) within the multiple-element arrangement are within the applicable range(s) established, then the contract prices are considered to approximate the entity’s best estimate of selling price. If the arrangement contains elements with contractually stated prices that are not within the range of estimated selling price, then the entity should not use the stated contract price as the estimated selling price, and should instead use a price within the range. The entity should establish a policy for using prices within a range and apply that policy consistently. Appropriate policies include using the midpoint of the range or using the endpoint of the range nearest the stated contract price. For example, if the contractually stated price for an element exceeds the established range of estimated selling price, then the entity should use the high end of the range as its estimated selling price for that element.
Example: Utilizing a range of estimated selling price

Entity A sells manufacturing equipment to entities in a variety of industries. Entity A enters into a contract to sell a conveyor system to its customer for total consideration of $1 million. The contract includes the following elements and stated contract prices: conveyor – $875,000, installation – $117,000, and eight days of training – $8,000. Each element meets the requirements for separation.

Entity A determines a narrow range of selling prices for each of the elements as follows:

<table>
<thead>
<tr>
<th>Element</th>
<th>Selling Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conveyor</td>
<td>$825,000 to $890,000</td>
</tr>
<tr>
<td>Installation</td>
<td>$100,000 to $125,000</td>
</tr>
<tr>
<td>Training</td>
<td>$975 to $1,000 per day</td>
</tr>
</tbody>
</table>

Because all of the stated contract prices fall within the selling price ranges established by Entity A, the stated contract prices are used to allocate arrangement consideration to the elements and no further allocation is required.

Assume the same facts, except that the stated contract prices for the elements are conveyor – $865,000, installation – $90,000, and training – $9,000, for total consideration of $964,000.

Because the stated contract prices for the installation and training are outside the respective selling price ranges established by Entity A, it would have to allocate the consideration on a relative selling price basis. Entity A’s policy is to allocate consideration using the endpoint of the range nearest the stated contract price, as shown below.

<table>
<thead>
<tr>
<th>Element</th>
<th>Selling Price</th>
<th>Ratio</th>
<th>Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conveyor</td>
<td>$865,000</td>
<td>88.9%</td>
<td>$857,000</td>
</tr>
<tr>
<td>Installation (low end)</td>
<td>100,000</td>
<td>10.3</td>
<td>99,075</td>
</tr>
<tr>
<td>Training (high end)</td>
<td>8,000</td>
<td>0.8</td>
<td>7,925</td>
</tr>
<tr>
<td></td>
<td>$973,000</td>
<td>100%</td>
<td>$964,000</td>
</tr>
</tbody>
</table>

As noted above, given that the objective of estimating a selling price is consistent with the objective of determining VSOE, we believe that the range of prices used to estimate the selling price should not be wider than the range used for determining VSOE. As such, the wider the range encompassing a high proportion of historical transactions, the less relevant that range is in estimating a selling price. If a wider
range exists, the entity may wish to consider whether its transactions could be stratified for purposes of developing an estimate of selling price.

**Multiple estimates of selling prices for a single deliverable**

While the guidance in ASC 605-25 does not directly address whether a single deliverable can have multiple estimates of selling price, we believe that the objective of determining a selling price at the price at which an entity would sell the deliverable on a stand-alone basis indicates that it may be appropriate in certain situations for an entity to identify multiple estimated selling prices. For a variety of reasons, an entity may be willing to sell a deliverable for different prices to different customers based on, for example, customer type or size. The entity may conclude that it is appropriate to stratify its customers by class and determine a best estimate of selling price for each class. In these situations, the entity should develop and consistently apply objective criteria for stratifying its customer population.

**Other considerations**

While an entity must apply judgment and consider the facts and circumstances in each situation when developing an estimate of selling price, there are some situations that make evaluating the elements and developing an estimate even more challenging. For example, an entity might enter into an arrangement that includes contingent deliverables, an option for additional products or services, or a product that has never been sold separately. Each of these potential scenarios is discussed below.

**Contingent deliverables**

If an arrangement includes a deliverable that is contingent on a future event, an entity must evaluate whether the deliverable is included in the initial allocation of consideration. Unless the deliverable is contingent upon a future event that is exclusively in the customer’s control, the entity should exclude the deliverable from the initial allocation. For example, an entity enters into a research and development arrangement with a customer for the purpose of further developing a drug candidate that includes, among other deliverables, contract manufacturing that is contingent upon approval of the drug by the Food and Drug Administration. Because the contract manufacturing is contingent upon an event that is not exclusively in the customer’s control, the entity should exclude it from the initial allocation.

**Option to purchase additional products**

An entity must consider whether a customer option to purchase additional products or services in the future at a specified price is a deliverable in the original arrangement. The option must be “substantive,” in order for the entity to conclude that it is not a deliverable in the original arrangement. An option is deemed “substantive” if the customer’s exercise of that option represents a separate buying decision. The following factors might indicate that an option is substantive:

- The additional product or service is not essential to the functionality of another deliverable in the original arrangement.

- The additional product or service is essential to the functionality of another deliverable in the original arrangement and other vendors could provide the necessary product or service.

- The additional product or service is priced at fair value.

Even if the entity concludes that an option is substantive, it must evaluate whether the option is offered at a “more-than-insignificant” discount. According to ASC 985-650-15-3(d), *Software: Revenue Recognition*, a “more-than-insignificant” discount has all the following characteristics:

- It is incremental to the range of discounts reflected in the pricing of the other elements of the arrangement.
• It is incremental to the range of discounts typically given to other customers in comparable transactions.

• It is significant.

While judgment is required in evaluating the significance of a discount, significance should be measured in relation to the specific arrangement. For instance, a more-than-insignificant discount may be accounted for as another deliverable in the arrangement. To do so, an entity should develop a best estimate of selling price and include it in the relative selling price allocation. Alternatively, an entity may analogize to the software guidance on significant incremental discounts in ASC 985-605-55-82 through 55-85 to determine how to account for the discount.

**Product not yet sold separately**

If a product has not previously been sold separately, an entity must develop an estimate of selling price by evaluating all reasonably available evidence. The entity should consider its normal process of establishing selling prices for its products, as well as market conditions and entity-specific factors. Significant judgment is required and the approach used to develop an estimate of selling price for a new product depends on the specific facts and circumstances of each situation. The entity should establish a robust process that maximizes objective and verifiable data.

**D. Updating the selling price**

Current information should be used to determine a selling price at the inception of each arrangement as selling prices will likely change over time. As a result, an entity should establish policies and procedures to regularly update estimates of the selling prices of elements.

Questions have been raised from preparers regarding the frequency of the updates to best estimate of selling price. Because current information should be used to determine best estimate of selling price, the frequency of updates depends on the particular facts and circumstances of each deliverable. A reasonable policy might be for an entity to reassess the estimate of selling price when it reassesses the pricing for its products and services sold on a stand-alone basis. For example, a new product offering may require more frequent updates of selling price than an established product. In addition, the length of the expected product life cycle could impact the frequency of the evaluation.

If an entity determines that a change in selling price for an item is necessary, the new selling price should be applied prospectively to new or materially modified arrangements. The entity should not apply the revised selling price to reallocate consideration in existing arrangements. For example, if competitive pressures cause an entity to reduce its selling price for an item, the estimated selling price ordinarily is immediately revised to reflect the change in all new or modified arrangements that occur after the price reduction.

**E. Documentation**

As noted above, an entity should establish and consistently apply an approach that includes evaluating all reasonably available evidence to develop a selling price. The extent of documentation required will vary based on the specific facts and circumstances of each situation. For example, the documentation will likely be more extensive for an entity that does not have VSOE or TPE for all elements and therefore uses best estimate of selling price, for some or all of the elements, as a basis to allocate consideration.

An entity should document its approach and key controls, if applicable, including its process for ongoing monitoring and evaluation. It should also document the evidence it considered in developing a selling
price for each product or service. The documentation should provide evidence to support the entity’s conclusion about selling price, including the consideration of all reasonably available data points, adjustments that were made to those data points based on market conditions and entity-specific factors, and the weighting given to the available data points.

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