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Priced to sell

Valuing bundled products and services under the new rev rec rules

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By Kelley Wall

RoseRyan Technical Accounting Group

New Financial Accounting Standards Board (FASB) guidelines will change the way many companies recognize revenue. For most companies, determining the selling price for deliverables in multiple-element arrangements will be the most challenging compliance step. This guide provides a framework.

Use the right strategies, in the right order—get the right price

Like puzzles and brain teasers? If so, the pricing aspect of the revenue recognition rules approved by the Financial Accounting Standards Board (FASB) in September 2009 is for you.

The rules will change revenue recognition for many nonsoftware companies that sell bundles of products and/or services (a.k.a. "multiple-element arrangements"). They may also affect companies that sell products containing software and have been required to comply with software rev rec rules. Adoption is mandatory for fiscal years beginning on or after June 15, 2010.

For most companies, the most challenging compliance step will be estimating the selling price of each deliverable within a multiple-element arrangement in accordance with EITF 08-1 (ASU 2009-13). Pricing a product that may never be sold on a stand-alone basis is tricky. That's why our overview guide, *OMG! Rev rec is coming!*, recommends forming a cross-functional task force to calculate element prices. Pinning down those elusive numbers requires significant analysis and will likely involve sales, marketing, several areas of your finance organization, and possibly other departments.

Our process (four to six steps, depending on how lucky you are) illustrates what's involved.

Do I really have to do this?

Step 1: Determine whether the individual deliverables have stand-alone value to customers. A deliverable is considered to have stand-alone value if any vendor sells that item separately or the customer could resell it separately. Most companies meet the requirement for stand-alone value, as there are competitive stand-alone products or services on the market. But in some situations stand-alone value may be unclear—multi-collaboration revenue arrangements in the biotech industry, for example—and you'll need to consult your auditors.

Where do I start?

Step 2: Determine the level within your product groups where you need to establish a selling price. For companies with a few products, this isn't an issue, but for companies with thousands of SKUs, it's essential to determine the appropriate product groups or families to price. Consider areas of product similarity, such as function, markets, customers, and sales territories. If you assess the selling price at too high a level, you may not meet the requirements, and your revenue recognition will be inappropriate. If you assess it at too low a level, you could create an administrative nightmare.

So how do I find the price?

Step 3: Use a three-level hierarchy of measures to estimate selling prices. The best measure of a deliverable's selling price is vendor-specific objective evidence (VSOE) of fair value. VSOE is the price charged for a deliverable when it is sold separately. If VSOE does not exist, consider third-party evidence (TPE). TPE is the price of any third-party company's interchangeable products or services sold on a stand-alone basis to similar customers. When neither VSOE nor TPE is available, companies must use their best estimate of the selling price, considering all relevant, available information.

The rules make it clear that contractually stated prices for individual deliverables are not presumed to be representative of VSOE, TPE, or a best estimate of selling price. So stating the prices of each element in a contract isn't a viable shortcut. (Sorry.)

No, really—how do I find the price?

Step 4: VSOE should always be your starting point. If you sell the deliverable on a stand-alone basis, you will be expected to use this method, assuming most of your sales fall within a narrow price range. In general, VSOE is established when a company sells a deliverable on a stand-alone basis and can demonstrate that 80 percent of the time, the price falls within a range of 15 percent of the midpoint. If you don't meet the parameters for substantiating VSOE, don't be depressed—the failed VSOE model may be useful in developing a best estimate of selling price. If you have already established VSOE for some of your deliverables, you should continue to use those values as long as they continue to meet the parameters.

I don't have VSOE—now what?

Step 5: Evaluate and document TPE. TPE may be difficult to obtain, but you have to try. Assuming competitor pricing information is available, there are several factors to consider. The rule documentation cites two: Are the competitor's products sold on a stand-alone basis? Are the competitor's products interchangeable with yours? Auditors recommend three others:

- Is there limited or no customization of the products?
- Is the price range in the marketplace small?
- Is the customer base or geographic sales region similar?

If you answer no to any of these questions, your comparisons to competitors may not be considered valid. If you believe you have enough data to support TPE, consult with your auditors. If you believe you don't have enough information to support TPE, document the information considered and the basis for your conclusion.

What's behind door number 3?

Step 6: Develop a best estimate of selling price. So you've determined that you don't have VSOE or TPE—there's some good news and bad news. The best estimate of selling price is the least constricting measure; it can also be the most challenging to develop. This is a company-specific analysis and that requires collaboration among various departments—sales, marketing, R&D, and possibly others—and will be subject to greater scrutiny by auditors because of the subjective nature of the inputs and assumptions that make up the analysis.

We recommend using multiple methods to derive the best estimate of selling price. The example cited in the rules uses a cost-plus-reasonable-margin approach. But that may not be suitable for technology companies whose product value includes home-grown intellectual property, as it wouldn't account for the value of that property. Other approaches auditors have suggested include pricing committee models, discounted price lists, failed VSOE models, and available TPE. Your analysis should consider not only market data but also information specific to your company and its products. To obtain the necessary information, you may need to tap all groups at your company involved with the product from the development phase through the sales process.

Once you've established the estimated selling price for your individual deliverables, be sure to document your process and methodology and update your estimates when circumstances suggest the selling prices would change.

Not a puzzle fan?

Get help! RoseRyan can help you establish your selling prices, address key issues in your rev rec implementation, or manage the entire process from start to finish. We can assess revenue impact, scope your implementation needs, reinvent your revenue accounting processes, help update your accounting systems, and more.

And we've got more rev rec advice in store: check your in-box over the next couple of months for in-depth looks at getting your accounting system to cooperate and dealing with comparative data. If you missed our overview guide, *OMG! Rev rec is coming!*, get it on the RoseRyan website.

About Kelley Wall: Kelley Wall, a CPA with more than 15 years' experience in finance and accounting, regularly advises clients on the interpretation and implementation of new accounting pronouncements. She joined RoseRyan in 2005 and helps lead the firm's growing technical accounting group.