

CHAPTER 1

Software as a service – revenue recognition considerations

This article aims to:

- Provide step by step approach of revenue recognition of SAAS contracts under Ind AS 115 with the help of illustrative examples.



Software as a service – revenue recognition considerations

The software industry encompasses the distribution, sale, and development of software services and products. Common types of software include Operating Systems (OS), productivity software, business applications, and specialised industry-specific software. The industry is transitioning to cloud computing and the Software-as-a-Service (SaaS) model due to its cost-effectiveness, scalability, and flexibility, allowing users to access programs and data remotely via the internet.

Revenue recognition is a crucial aspect for SaaS-based companies, governed by principles laid down in Ind AS. It dictates how

and when a business should recognise its revenue. The process becomes even more complex with custom and mixed pricing plans for SaaS contracts, making revenue recognition a challenging task.

To ensure accurate revenue recognition for a SaaS business, the Ind AS framework, specifically 115, *Revenue from Contracts with Customers*, comes into play. This standard provides the necessary guidelines to navigate these complexities.

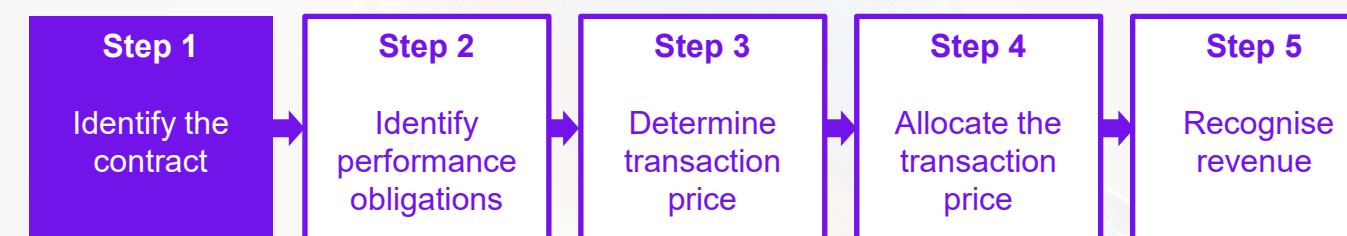
This article dives into the details to understand it thoroughly.

Ind AS 115 – Five-Step Model

The core principle of this accounting standard is that revenue is recognised in a manner that depicts the transfer of goods or services to the customer at the amount to which the entity expects to be entitled. An entity implements this core principle by applying a five-step, contract-based model to recognise and measure revenue from contracts with customers.

Following is a summary of the evaluation that needs to be performed for the purpose of revenue recognition.

Revenue Recognition- 5 Step model



Step 1: Identify the contract and combination of contracts

The first step in revenue recognition for a SaaS contract is to determine if a contract has been established. A 'contract' is an agreement between two or more parties that creates enforceable rights and obligations. Contracts can be written, oral, or implied by an entity's customary business practices.

One application area for SaaS contracts is identifying when an entity should combine two or more contracts and account for them as a single contract.

According to Ind AS 115, contracts entered into at or near the same time with the same customer (or related parties) are combined if one or more of the following criteria are met:

- The contracts are negotiated as a package with a single commercial objective.
- The consideration in one contract depends on the price or performance of the other contract.
- The goods or services promised in the contracts (or some of the goods or services promised in each of the contracts) are a single performance obligation.

Example on combining contracts

Software Company S enters into a contract to license its customer relationship management software to Customer B. Three days later, in a separate contract, S agrees to provide consulting services to significantly customise the licensed software to function in B's IT environment. B is unable to use the software until the customisation services are complete.

S determines that the two contracts should be combined because they were entered into at nearly the same time with the same customer, and the goods or services in the contracts constitute a single performance obligation.

Source: IFRS 15 Handbook Revenue, KPMG IFRG Ltd, November 2022

Step 2: Identify the performance obligation in the contract

Ind AS 115 distinguishes between obligations to provide goods or services to a customer and other obligations by defining those obligations as performance obligations. The determination of a performance obligation ensures that entities appropriately identify the unit of account for the goods and services promised in a contract with a customer.

A performance obligation could be either:

- A good or service (or a bundle of goods or services) that is distinct, or
- A series of distinct goods or services that are substantially the same and have the same pattern of transfer.

The standard provides several indicators to determine when distinct criteria are met. However, it does not include a hierarchy of these indicators. Whether a good or service is separately identifiable from other promised goods or services within the context of the contract requires an entity to evaluate the specific facts and circumstances of the contract to determine how much emphasis to place on each indicator.

Example – Performance obligation under the contract

Company V grants Customer C a three-year license for its anti-virus software. Under the contract, V promises to provide C with updates to the software on a when-and-if-available basis during the license period. These updates are critical for the continued use of the anti-virus software.

V determines that the license and the updates are capable of being distinct because the anti-virus software can still deliver its original functionality during the license period without the updates. Additionally, C can benefit from the updates together with the license transferred when the contract is signed.

However, V concludes that the license and the updates are not separately identifiable because the software and the service are inputs into a combined item in the contract. Essentially, the nature of V's promise is to provide continuous anti-virus protection for the term of the contract. Therefore, V accounts for the license and the updates as a single performance obligation.

Source: IFRS 15 Handbook Revenue, KPMG IFRG Ltd, November 2022

Step 3: Determining the transaction price

Determining the transaction price is an important step in the revenue recognition model because the transaction price is the amount that an entity allocates to the performance obligations in a contract and ultimately recognises as revenue.

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange of transferring goods or services to a customer, excluding amounts collected on behalf of third parties – e.g. certain sales taxes. To determine this amount, an entity considers multiple factors.

Example – Determining the transaction price

Company E licenses Enterprise Resource Planning (ERP) software to its customers and provides post-contract support services throughout the license period. To retain its existing customers, E has developed a practice of frequently giving its customers a discount on the post-contract support fees stated in the original contract for the final year. This discount has ranged from 20 per cent to 60 per cent with no discernible pattern.

E enters into a contract with Customer C for a three-year license of its ERP software for 300,000 (paid up-front) and 180,000 in total for three years of post-contract support services, paid in three 60,000 installments at the beginning of

each year. The software license and the post-contract support services constitute two separate performance obligations. E transfers the software license to C at contract inception.

E concludes that its history of providing post-contract support fee discounts means that the transaction price is variable and therefore needs to be estimated. E uses an expected value method because there are many possible outcomes. It estimates that it will give C a discount of 42 per cent on the Year 3 post-contract support fees.

Consequently, E's estimate of the transaction price at contract inception – before applying the constraint – is 454,800. Assuming that the stand-alone selling prices of the license and the post-contract support services are 300,000 and 200,000 respectively, the relative stand-alone selling price allocation would be as follows. Discounts and variable consideration are allocated between all distinct goods or services in the contract unless specific criteria are met.

	Stand-alone Selling Price	Relative Stand-alone Selling Price
License	300,000	272,880 – 60% of 454,800
Post-contract Support	200,000	181,920 – 40% of 454,800

Because E has a history of granting price concessions of between 20 per cent and 60 per cent of the final year's contractual post-contract support fees, including any of the potential post-contract support discount less than the 60 per cent maximum in the transaction price carries the risk of a revenue reversal. However, E does not constrain its estimate of the transaction price below 454,800 because the revenue reversal that would result from the possible incremental discount of 18 per cent (60 per cent – 42 per cent) of 60,000 or 10,800 would not be significant to the cumulative revenue recognised to date under the contract. For example, an adjustment to the transaction price immediately after the transfer of control of the software license would result in a reversal of only 60% of 10,800 or 6,480 (compared with cumulative revenue recognised of 272,880). If E did not have a history of granting price concessions and it was not expected at contract inception, then it would account for any subsequent price concession as a contract modification.

Source: IFRS 15 Handbook Revenue, KPMG IFRG Ltd, November 2022

Step 4: Allocate the transaction price to the performance obligations in the contract

The transaction price is allocated to each performance obligation – generally each distinct good or service – to depict the amount of consideration to which an entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

An entity generally allocates the transaction price to each performance obligation in proportion to its stand-alone selling price. However, when specified criteria are met a discount or variable consideration is allocated to one or more but not all performance obligations. This step of the revenue model comprises two sub-steps that an entity performs at contract inception:

- Determine stand-alone selling prices
- Allocate the transaction price.

Example – Estimating Standalone selling Price – Residual Approach

Software Vendor M enters into a contract with Customer C to provide rights to use Licenses S and T for three years, along with PCS services for both licenses. The contract price is 100,000. The PCS services include telephone technical support for each license. M has identified four performance obligations in the contract: License S, PCS services for S, License T, and Post-contract Customer Service (PCS) for T.

The stand-alone observable price of 12,500 is available for the technical support for each of the licenses, based on renewals sold separately. However, the prices at which M has sold licenses similar to S and T have been highly variable and not directly observable. Additionally, the level of discounting in bundled arrangements varies based on negotiations with individual customers. M estimates the stand-alone selling prices of the performance obligations in the contract as follows:

Product	Stand-alone Selling Price	Approach
Licenses S and T	75,000	approach (100,000-12,500-12,500)
PCS services for S	12,500	Directly observable price
PCS services for T	12,500	Directly observable price
Total	100,000	

M uses the residual approach to estimate the stand-alone selling price for the bundle of products (S and T) with highly variable selling prices. Since the licenses will transfer to C at different points in time, M then estimates the stand-alone selling price of each license. It does this by allocating the 75,000 to S and T based on the average stand-alone selling

price determined using the residual approach over the past year, as follows:

Product	Average Residual Selling Price	Ratio	Price Allocation	Calculation
License S	40,000	40%	30,000	(75,000 * 40%)
License T	60,000	60%	45,000	(75,000 * 60%)
Total	100,000	100%	75,000	

Source: IFRS 15 Handbook Revenue, KPMG IFRG Ltd, November 2022



Step 5: Recognise revenue when the entity satisfies performance obligation

An entity recognises revenue when (or as) it satisfies a performance obligation by transferring a good or service to a customer. A good or service is considered 'transferred' when the customer obtains control of it. Control can be transferred either at a point in time or over time. The analysis of when control transfers is primarily performed from the customer's perspective.

At the inception of a contract, an entity first evaluates whether it transfers control of the good or service over time. If not, then control is transferred at a point in time.

Transfer of Control

A good or service is transferred to a customer when the customer obtains control of it. 'Control' refers to the customer's ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset. It also includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. Potential cash flows obtained either directly or indirectly – e.g., from the use, consumption, sale, or exchange of an asset – are considered benefits of an asset.

Performance Obligations Satisfied Over Time

For each performance obligation in a contract, an entity first determines whether the performance obligation is satisfied over time – i.e., control of the good or service transfers to the customer over time.

Example 1 – Time-Based Measure of Progress

Company S enters into a contract to license software to Customer C and provide technical support for the three-year license period. The terms of the support agreement specify that S's helpdesk and web support operators are available every day except Sundays. S concludes that the software license and the technical support services are distinct from each other and are separate performance obligations.

The distinct software license is satisfied at a point in time. S determines that the technical support services are satisfied over time because C consumes and benefits from having continuous access to S's support resources throughout the three-year period. This makes the technical support a 'stand-ready obligation.' S concludes that a time-elapsed measure of progress is appropriate.

However, if S's contractual obligation for technical support was to provide a specified number of support calls, then revenue would generally be recognised as C makes use of the specified calls.

Example 2 – Company U licenses software to Customer C and promises to provide unspecified updates for the full three-year license period. U concludes that the software license and the unspecified update rights are distinct from each other and are separate performance obligations. The distinct software license is satisfied at a point in time.

U has a history of providing unspecified items to customers regularly. However, the quantity and mix of items that a customer will receive (e.g., bug fixes and updates) and the timing of releases within a given period vary. Therefore, U concludes that:

- The nature of its performance obligation to provide unspecified updates, upgrades, and enhancements is a 'stand-ready obligation.'
- It expects to expend efforts to develop and transfer unspecified items to the customer on a generally even basis throughout the three-year term. U determines that a time-based measure of progress is appropriate, resulting in straight-line revenue recognition for the performance obligation.

Source: IFRS 15 Handbook Revenue, KPMG IFRG Ltd, November 2022



Revenue Recognition Criteria for License of Intellectual Property - (IP)

Ind AS 115 provides specific guidance on when to recognise revenue from a distinct license of intellectual property.

If the license is distinct from other goods or services, an entity assesses its nature to determine whether to recognise revenue allocated to the license at a point in time or over time.

Given the complexity of licensing intellectual property, the standard offers detailed guidance on the following aspects:

- Determination of the nature of a distinct license
- Principal vs. agent considerations
- Unit of account

Example – IP License in Combined Performance Obligation

Company X enters into a five-year patent license agreement with Customer Z for a fixed fee. Additionally, X provides essential consulting services for two years. X identifies two promises in the contract: the patent license and the consulting services. However, the

license is not distinct from the service component because the services are essential and highly interrelated.

Assuming the combined performance obligation is satisfied over time – for example, because the patent is being created specifically for Z and has no alternative use to X, and X has an enforceable right to payment for performance completed to date – X considers the nature of the license to determine the period over which the combined performance obligation will be satisfied and the appropriate measure of progress to apply.

If the license provides a right to use the IP, then the combined performance obligation is satisfied over the two-year consulting service period. In contrast, if the license provides a right to access X's IP, then the performance obligation will not be completely satisfied until the end of the license term, and revenue will be recognised over the five-year license period. In both cases, X must determine an appropriate measure of progress to apply over the two- or five-year performance period (e.g., time elapsed, costs incurred).

Source: IFRS 15 Handbook Revenue, KPMG IFRG Ltd, November 2022

Conclusion

The increasing use of smartphones, tablets, high-speed broadband networks, the emergence of 5G, remote work, and digital technologies has facilitated the rise of software that supports mobile platforms. The demand for software programs that facilitate remote work, video conferencing, and project management has increased. Organisations using cloud computing to support their remote operations have become very common. This technological advancement has made software licenses a necessity for all businesses.

We have highlighted the accounting challenges that arise from developments across the sector

and the emergence of newer offerings with technology. We have covered practical aspects such as the identification of distinct performance obligations, determining the transaction price of performance obligations, licensing for intellectual property, timing of revenue recognition, and principal/agent arrangements.

Our aim has been to stimulate thinking and enhance awareness among SaaS-based companies about revenue recognition issues. However, there can be multiple scenarios and practices that already exist and may arise in the future.

