Revenue recognition: an IFRS 15 guide for software and SaaS sellers

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Foreword

The guide for recognising revenue in the software industry is our collected insight on the application of International Financial Reporting Standards (IFRS) in this industry. This industry continues to be an area of rapid development in terms of products and sales strategies, and recent guidance from the IFRS Interpretations Committee shows that the accounting for this industry is also developing at pace. These new developments continue to introduce new complexities in accounting for software sales, in particular as it relates to cloud-based solutions, sales by intermediaries and renewals and modifications.

We hope that you find this publication useful in understanding the accounting for common transactions. Each solution is based on a specified set of circumstances. Entities must evaluate their own facts and circumstances which might differ from those in these solutions. The ongoing transformation of the industry will lead to variations in circumstances, requiring an individual case-by-case assessment of the accounting implications.

Acknowledgements

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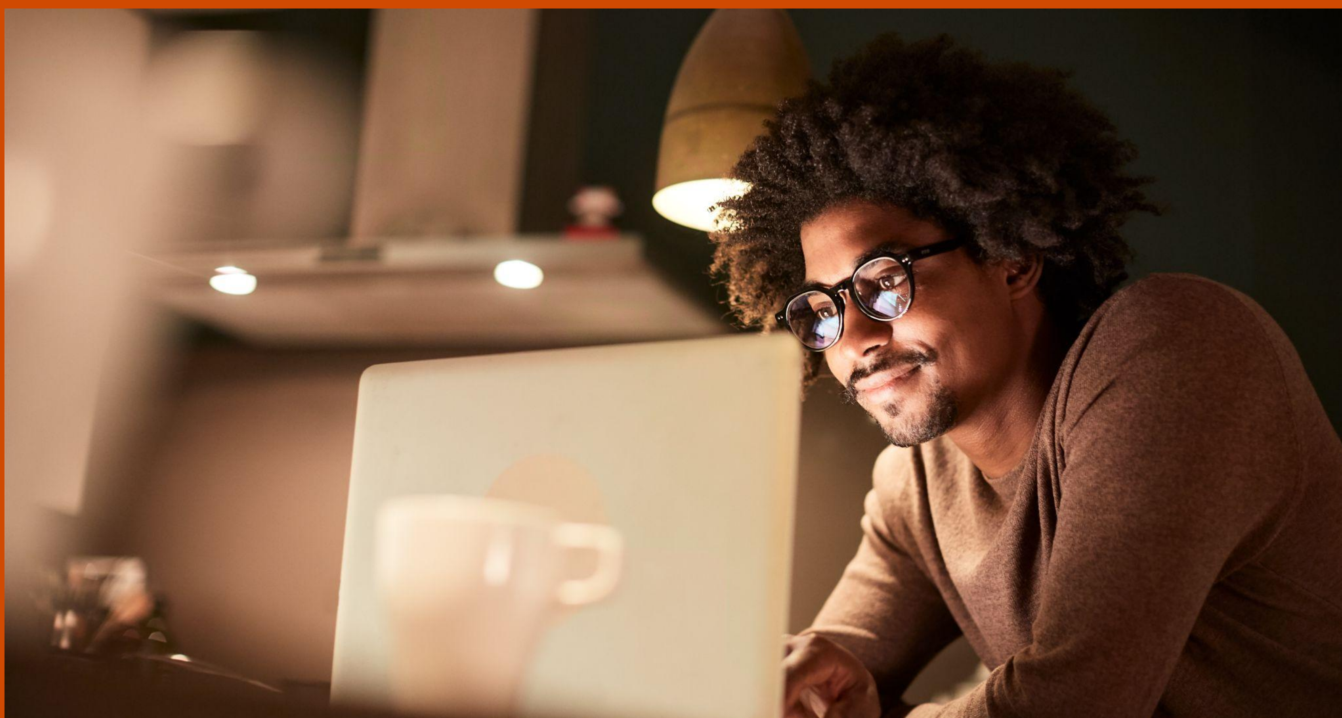
List of abbreviations

- IP – Intellectual Property
- SaaS – Software-as-a-Service
- SSP – Stand-alone Selling Price
- PCS – Post-contract Customer Support



Contents

1. Contract term and modifications **5**

1.1 What is the contract term for a software licence when the customer has a termination option and a right to refund? 6

1.2 What is the contract term in a SaaS arrangement if a customer has a termination option? 7

1.3 How should an entity account for the modification of a SaaS arrangement that extends the term and revises the pricing of the remaining term? 8

1.4 How should a software vendor account for the renewal of term licences? 9

1.5 How should an entity account for the modification of a contract that revokes the rights previously transferred to a customer (for example, transition from on-premises to SaaS)? 10

2. Identifying performance obligations **12**

2.1 How many performance obligations are in the contract that includes both software and services? 13

2.2 How many performance obligations are in a contract that requires use of the vendor's service? 14

2.3 Is a software licence distinct from installation services? 15

2.4 Is a software licence distinct from data storage services? 16

2.5 Are setup or implementation activities performed by a vendor in a software or SaaS arrangement considered a separate performance obligation? 17

2.6 What factors should be considered in determining whether a software licence and cloud-based services should be combined into a single performance obligation? 19

2.7 What factors should be considered in determining whether a software licence and promise to provide updates to the software should be combined into a single performance obligation? 20

2.8 When does a hosting arrangement (in connection with licensing software products) include a software licence? 21

3. Determining and allocating the transaction price **22**

3.1 What is the transaction price where an entity includes a service level agreement in the contract? 23

3.2 What factors should be considered in distinguishing between usage-based royalties and additional rights? 24

3.3 What factors should be considered in estimating SSP in a bundle of software and services? 26

3.4 How should an entity estimate SSP where the residual approach is not appropriate? 28

3.5 Allocating variable consideration to a series: how should variable consideration in an arrangement where pricing varies based on usage be accounted for? 29

3.6 Allocating variable consideration to a series: how should revenue be recognised for a contract with an upfront fee? 30

3.7 Allocating variable consideration to a series: how should an entity assess whether it is appropriate to allocate variable consideration received in a SaaS contract to distinct services within a series? 31

4. Recognising revenue **32**

4.1 When is the nature of a licence to provide a right to use IP? 33

4.2 Does the timing of revenue recognition differ for a distinct perpetual software licence and a term software licence? 34

4.3 Does an entity have to deliver a software key or access code to conclude control has transferred to the customer? 35

4.4 What factors should be considered in determining whether an arrangement is a stand-ready obligation versus a promise to deliver specific goods or services? 36

4.5 How should an entity recognise revenue for a stand ready obligation to provide unlimited support services? 37

4.6 How should an entity recognise revenue for a specified quantity of services? 38

4.7 How should an entity recognise revenue allocated to a promise to provide PCS? 39

4.8 How should an entity determine the appropriate measure of progress for a SaaS arrangement? 40

4.9 How should revenue be recognised for an arrangement to provide access to SaaS where the contract includes scheduled increases in the fee on an annual basis? 41

5. Other considerations: principal vs agent, costs **42**

5.1 Which party is the entity's customer for sales of its software product through the online marketplace? 43

5.2 How to determine when software is sold through an intermediary with an obligation for PCS? 44

5.3 If a vendor distributes its software or SaaS offering through an intermediary, is the reseller or the end consumer the vendor's customer? 45

5.4 How should an asset recognised for commission expense be amortised if it is related to a point in time licence of IP for which revenue from sales-based royalties is recognised over time? 47

1

Contract term and modifications

1.1 What is the contract term for a software licence when the customer has a termination option and a right to refund?

Entity A provides a four-year software licence to entity B. The arrangement terms allow entity B to cancel at the end of year one and receive a pro-rata refund of the licence fee.

Question

What is the contract term for purposes of applying the revenue standard?

Answer

The contract term is the period during which the parties to the contract have present and enforceable rights and obligations. It impacts the determination and allocation of the transaction price, and recognition of revenue. Entities should consider termination clauses when assessing contract duration. If a contract can be terminated early for no compensation, enforceable rights and obligations would likely not exist for the entire stated term. The contract could, in substance, be a shorter-term contract with a right to renew. In contrast, a contract that can be terminated early, but requires payment of a substantive termination penalty, is likely to have a contract term equal to the stated term. This is because enforceable rights and obligations exist throughout the stated contract period.

Determining the contract term for a software licence when the customer has termination rights can require significant judgement. The objective is to determine the period over which the parties have enforceable rights and obligations.

Entity A would likely conclude that the contract term is one year because there are enforceable rights and obligations for one year only. Entity B effectively has the option to "renew", or enter into a new licence, after one year. The likelihood of the customer exercising the termination right is not considered in the determination of the contract term. Even if entity B is not expected to cancel the licence at the end of year one, enforceable rights and obligations do not extend beyond the first year.

Termination rights that are non-substantive should not impact the accounting for the contract, similar to other non-substantive contract terms. If in the fact pattern above entity B was not entitled to any refund upon cancellation and therefore was still obligated to pay the entire licence fee even if the contract is cancelled, then entity B's termination right likely lacks substance. Thus, there are enforceable rights and obligations for the duration of the four-year contract. Similarly, if the customer is required to pay a substantive penalty to cancel the contract, the termination right is generally disregarded for purposes of determining the contract term.

Entities should also consider whether the option to renew is a material right that should be accounted for as a separate performance obligation.

1.2 What is the contract term in a SaaS arrangement if a customer has a termination option?

Vendor A provides a customer with access to its SaaS platform for three years, for a total fee of C90,000. The customer can terminate the contract for convenience with 30 days notice and is only required to pay for the period over which the customer received services.

Question

What is the contract term for purposes of applying the revenue standard?

Answer

Because revenue from a SaaS arrangement is generally recognised over the contract term, the recognition of revenue might not be impacted by a termination right. The contract between vendor A and the customer would be treated as a month-to-month service contract despite the three-year stated term. The parties do not have enforceable rights and obligations beyond the 30-day notice period. From a revenue recognition perspective, if the vendor determines that straight-line revenue recognition is appropriate, it would recognise C2,500 (C90,000/36 months) per month regardless of whether the contract term is one month or three years.

There are certain scenarios where the contract term determination could impact revenue recognition for a SaaS arrangement. For example, if the contract has other performance obligations in addition to the SaaS, only the non-cancellable SaaS term and related fee (that is, C2,500 for one month of SaaS) should be included when allocating the transaction price to the performance obligations.

Additionally, if the price of the SaaS increases over the stated term, the transaction price is limited to the fee for the non-cancellable SaaS term. In contrast, if the price of the SaaS decreases over the stated term, the vendor should assess whether the future discounts provide the customer with a material right.

Customer termination rights might impact an entity's required disclosures. Paragraph 120 of IFRS 15 requires disclosure of information about the transaction price allocated to remaining performance obligations. This disclosure should only include the non-cancellable term of the SaaS. In this example, vendor A would include C2,500 in the disclosure required by IFRS 15 paragraph 120 for the SaaS arrangement. This is because it is a month-to-month contract with a 30-day notice period (that is, at year end if no notice has been given, the non-cancellable term is 30 days) even though the stated term is three years.

1.3 How should an entity account for the modification of a SaaS arrangement that extends the term and revises the pricing of the remaining term?

A SaaS vendor enters into a three-year non-cancellable SaaS contract for C900,000 per year. At the end of the second year, the parties agree to modify the contract to: 1) extend the service contract for an additional year and 2) lower the price to a "blended" rate of C850,000 per year for the remaining two years.

Question

How should the SaaS vendor account for the modification?

Answer

The parties in a SaaS arrangement agree to modify a contract prior to the end of the initial contract term to 1) extend the contract term and 2) revise the contract pricing for the remaining term (that is, a 'blend-and-extend' modification). Generally, in a 'blend-and-extend' modification, the customer immediately takes advantage of a lower price.

A promise to provide access to SaaS is typically a series of distinct goods or services accounted for as a single performance obligation. This is because each distinct period is substantially the same, and has the same pattern of transfer to the customer. An entity will account for a contract modification prospectively, because the remaining goods and services to be provided in the future are distinct, even if the series of distinct goods or services is accounted for as a single performance obligation. The accounting of such a modification depends on whether the additional consideration reflects the SSP of the additional services added to the contract. Therefore, the modification of a SaaS arrangement is generally accounted for as either (a) a separate contract in accordance with IFRS 15 paragraph 20, if the additional services are priced at SSP; or (b) as if it were the termination of the existing contract and the creation of a new contract in accordance with IFRS 15 paragraph 21(a), if the additional services are not priced at SSP.

In this example, the SaaS vendor agreed to add distinct services for additional consideration that reflects C800,000 for year 4 (C850,000 for the extension term, less C50,000 decrease in price for the original remaining term).

If C800,000 for the additional year of services reflects the current SSP, the SaaS vendor would account for the modification as a separate contract. In this case, the SaaS vendor would continue to recognise revenue of C900,000 in the third year of the original contract and recognise C800,000 in the fourth year. This would result in a contract asset balance built up over the third year, which will unwind over the fourth year.

If C800,000 for the additional year of services does not reflect the current SSP, the SaaS vendor would account for the modification as the termination of the existing contract and creation of a new contract. In this case, the SaaS vendor would recognise revenue based on the blended price (C850,000 per year) for the third and fourth years.

1.4 How should a software vendor account for the renewal of term licences?

Entity A sells a three-year term software licence with a term from 1 January 20X1 to 31 December 20X3 for C3m. This is assessed to be a 'right to use' licence, and so control of the licence transfers at a point in time. Entity A recognises C3m of revenue on 1 January 20X1, which is the beginning of the period during which the customer is able to use and benefit from the licence.

Entity A and the customer agree to renew the licence for an additional year on 1 December 20X3 for C1m. The renewal is irrevocable and is priced at a stand-alone selling price.

Question

How should entity A recognise revenue for the renewal?

Answer

Paragraph B61 of IFRS 15 states that revenue cannot be recognised for a licence that provides a right to use the entity's intellectual property before the beginning of the period during which the customer is able to use and benefit from the licence. However, there is no specific guidance on licence renewals. Entities will need to assess whether a renewal or extension agreed to after the initial licence is transferred should be accounted for as a new licence or a change in the attributes of an existing licence. This assessment might result in recognition of revenue from renewals as illustrated below:

- *New licence* – Entity A might conclude that the extension results in a new licence. Paragraph B61 of IFRS 15 prohibits recognition of revenue before the beginning of the period during which the customer is able to use and benefit from the licence. In this case, entity A recognises C1m of revenue on 1 January 20X4, because this is when the customer can use and benefit from the new licence.

- *Change in attribute of an existing licence* – Entity A might alternatively conclude that the one-year extension results in a change in an attribute of an existing licence. That is, the restriction of time is an attribute of the existing licence and, therefore, the extension is a change in an attribute of the licence that has already been transferred to the customer. In this case, entity A recognises C1m of revenue on the date when the renewal option is exercised, 1 December 20X3, because the customer is already able to use and benefit from the licence on that date.

In many cases, a number of factors will need to be considered in making the assessment of whether the renewal is a new licence or a change in an attribute of an existing licence. Such factors would include whether additional functionality is added, whether that functionality is a separate performance obligation, and the pricing of the renewal.

In this simple scenario (that is, renewal at a stand-alone selling price with no additional rights), either judgement might be acceptable. However, the approach taken should be applied consistently to similar transactions.

Renewals might be structured as either (1) an amendment to the original agreement or (2) a cancellation of the original agreement and execution of a new agreement. The accounting should be based on the substance of the arrangement and not solely on the contractual form.

Entities should also consider whether a renewal right offered at the contract inception provides a material right and, therefore, a portion of the transaction price should be deferred.

ASC 606 has specific guidance on accounting for renewals that specifically requires revenue to be deferred until the renewal period begins; as a result, the accounting might be different under US GAAP.

1.5 How should an entity account for the modification of a contract that revokes the rights previously transferred to a customer (for example, transition from on-premises to SaaS)?

An emerging trend in the software industry is to transition customers from on-premises software to a SaaS solution. This might be achieved by modifying an existing software agreement to revoke the rights to the on-premises licence and converting the arrangement to a SaaS. Revenue from a software licence is typically recognised at a point in time (that is, at contract inception), while revenue from a SaaS arrangement is typically recognised over time. Therefore, questions have arisen on accounting for the conversion of a point-in-time licence to a service provided over time. Often, as part of the conversion, the customer receives a 'credit' towards the purchase of the SaaS equal to the 'unused' portion of the licence term.

Consider the following example:

On 1 January 20X0, entity A enters into a three-year non-cancellable contract with its customer, for a total up-front fee of C3 million, to provide a non-exclusive on-premises data analytics software licence for 100 users. The on-premises software utilises the customer's data stored on the cloud to provide data analysis services. The on-premises software can also utilise data stored on the customer's premises or data stored by other vendors.

On 1 January 20X1, entity A renegotiates the contract with the customer to convert all 100 user rights of the licence to a SaaS arrangement for the remaining two-year term. The SaaS has the same functionality as the licensed software, but it would be hosted by entity A. The customer is required to forfeit the on-premises software licence. The conversion of the licence to a SaaS arrangement is irrevocable. As per the modified terms, the customer is required to pay an incremental fee of C2,000 per user licence, which is adjusted for the credit of the pro-rata portion of the 'unused' term-based licence.

SSPs of entity A's individual performance obligations are as follows:

- on-premises software licence: C10,000 per user per year; and
- SaaS service: C12,000 per user per year

Question

How should the renegotiation of the arrangement be accounted for?

Answer

The contract has been modified, so entity A applies the modification guidance in paragraphs 18-21 of IFRS 15. In this case, the modification in the contract adds a distinct service (that is, the SaaS service), but not at its SSP. Therefore the contract modification is accounted for as a termination of the existing contract and the creation of a new contract in accordance with paragraph 21(a) of IFRS 15. The 'credit' received on the cancellation of the on-premises licence is accounted for as an incentive to the customer to purchase the SaaS (that is, a discount on the SaaS purchase).

Accordingly, entity A will recognise the following:

On 1 January 20X0, entity A recognises revenue for the on-premises licence of C3,000,000 (C10,000 on-premises software licence SSP × 100 users × 3 years):

Dr Cash C3,000,000

Cr Revenue C3,000,000

On 1 January 20X1, when the contract is modified, entity A will receive incremental consideration of C400,000 (C2,000 incremental fee × 100 users × 2 years):

Dr Cash C400,000

Cr Deferred revenue C400,000

Entity A will recognise revenue of C400,000 for the SaaS over the remaining two-year term:

Dr Deferred revenue C400,000

Cr Revenue C400,000

Another option is to account for the 'credit' received on cancellation of the on-premises licence as a refund for the return of the licence in accordance with right-of-return guidance (that is, as variable consideration). This reflects that the customer is returning the original good/service that was provided (that is, possession or control of the on-premises software licence). Under this option, the credit is reflected as a refund and reversed against revenue.

The customer then utilises the credit, together with the incremental cash paid, as consideration for the SaaS that is provided over the remaining term.

Accordingly, entity A will recognise the following:

On 1 January 20X0, entity A recognises revenue for the on-premises licence of C3,000,000 (C10,000 on-premises software licence SSP × 100 users × 3 years):

Dr Cash C3,000,000

Cr Revenue C3,000,000

On 1 January 20X1, when the contract is modified, entity A will reverse revenue of C2,000,000 (C10,000 saving per user[1] × 100 users × 2 remaining years) for the implicit value of the returned portion of the on-premises software licence:

Dr Cash C400,000

Dr Revenue C2,000,000

Cr Deferred revenue C2,400,000

Entity A will therefore recognise revenue of C1,200,000 ((C2,000,000 + C400,000) / 2) per year for the SaaS over the remaining two-year term:

Dr Deferred revenue C1,200,000

Cr Revenue C1,200,000

Entities should apply judgement when determining which approach is more appropriate, based on the facts and circumstances. For example, the latter approach would not be appropriate if either (a) the software vendor does not enforce the revocation of the on-premises licence, or (b) the cancellation of the licence does not have substance. The latter approach might also be difficult to apply in cases where the SSP of the SaaS is not readily observable

Software vendors should consider whether there is an explicit right or an implicit right to convert the software licence, based on past business practices. Where this right exists at contract inception, the entity would need to account[1] for it as either a material right or a right of return, based on the facts and circumstance.

[1] The saving per user is calculated by deducting the SSP of the SaaS (C12,000 per user) from the actual price that will be charged by the entity (C2,000 per user).

2

Identifying performance obligations

2.1 How many performance obligations are in the contract that includes both software and services?

Entity G enters into a contract with a customer to provide a perpetual licence to on-premise software (right to use licence), installation services and three years of PCS. PCS includes unspecified future upgrades and telephone support.

Scenario A

Under scenario A, the installation services require entity G to configure certain aspects of the software, but do not significantly modify the software. These services do not require specialised knowledge, and other sophisticated software technicians could perform similar services. The upgrades and telephone support do not significantly affect the customer's ability to use and benefit from the software licence.

Scenario B

Under scenario B, the installation services require entity G to substantially modify and customise the software to change its functionality by adding significant new functionality, thereby enabling the software to function with other computer systems owned by the customer. The upgrades and telephone support do not significantly affect the customer's ability to use and benefit from the software licence.

Question

How many performance obligations are in the contract?

Answer

Scenario A

There are four performance obligations: (1) software licence; (2) installation services; (3) unspecified future upgrades; and (4) telephone support.

The software is capable of being distinct because the customer could benefit from it without the other promises in the contract. The other promises (the installation services, unspecified future upgrades or telephone support) are also capable of being distinct because they could be provided separately after the software has been delivered.

Entity G concludes that each good and service is separately identifiable, because the software licence, installation services, unspecified future upgrades and telephone support are not inputs into a combined item the customer has contracted to receive. Entity G can fulfil its promise to transfer each of the goods or services separately and does not provide any significant integration, modification or customisation services.

Scenario B

There are three performance obligations in the contract: (1) licence to customised software/installation including the software licence; (2) unspecified future upgrades; and (3) telephone support. This is because the installation services substantially customise the software by adding significant new functionality, thereby enabling the software to function with other computer systems owned by the customer. In this case the software and customisation services are inputs into the combined item for which the customer has contracted. As a result, the software licence and installation services are not separately identifiable.

Under both scenarios, the components of PCS (when-and-if available updates and upgrades and phone support) are stand-ready obligations that are delivered to the customer concurrently. A stand-ready obligation will usually meet the criteria to be accounted for as a series of distinct goods or services and, therefore, a single performance obligation.

If PCS is accounted for as a single performance obligation, the outcome will be similar to accounting for the PCS components as separate performance obligations, providing the components are delivered to the customer concurrently.

2.2 How many performance obligations are in a contract that requires use of the vendor's service?

Entity G enters into a contract with a customer to provide a perpetual software licence, installation services, and three years of PCS (unspecified future upgrades and telephone support). The installation services require the entity to configure certain aspects of the software, but they do not significantly modify the software. These services do not require specialised knowledge, and other sophisticated software technicians could perform similar services. The upgrades and telephone support do not significantly affect the software's benefit or value to the customer. The customer is contractually required to use entity G's installation services.

Question

How many performance obligations are in the contract?

Answer

The contractual requirement to use entity G's installation services does not change the evaluation of whether the goods and services are distinct. Entity G concludes that there are four performance obligations; (1) software licence; (2) installation services; (3) unspecified future upgrades; and (4) telephone support.

The customer can benefit from the software (delivered first), because it is functional without the installation services, unspecified future upgrades or telephone support. The customer can benefit from the subsequent installation services, unspecified future upgrades and telephone support together with the software, which it has already obtained.

Entity G concludes that each good and service is separately identifiable, because the software licence, installation services, unspecified future upgrades and telephone support are not inputs into a combined item that the customer has contracted to receive. Entity G can fulfil its promise to transfer each of the goods or services separately, and it does not provide any significant integration, modification or customisation services.

2.3 Is a software licence distinct from installation services?

Entity B provides a perpetual software licence to an engineer. Entity B will also install the software as part of the arrangement. Entity B offers the software licence to its customers with or without installation services, and the engineer could select a different vendor for installation. The installation does not result in significant customisation or modification of the software.

Question

Is the licence in this arrangement distinct?

Answer

The software licence is distinct, because the engineer can benefit from the licence on its own, and the licence is separable from other promises in the contract. This conclusion is supported by the fact that entity B licenses the software separately (without installation services) and other vendors are able to install the software. The licence is separately identifiable, because the installation services do not significantly modify the software. The licence is therefore a separate performance obligation that should be accounted for in accordance with the guidance in IFRS 15 Appendix B paragraph B52 onwards.

2.4 Is a software licence distinct from data storage services?

'Hybrid cloud' arrangements typically include both a licence to on-premise software and access to SaaS. Assessing whether the licence to the on-premise software is distinct or should be combined with the service will require an understanding of the stand-alone functionality of each and the degree to which the licence and the service affect each other.

A software company enters into a contract with its customer for on-premise data analytics software and cloud data storage. The on-premise software utilises the customer's data stored on the cloud to provide data analysis. The on-premise software can also utilise data stored on the customer's premises or data stored by other vendors.

Question

Is the licence in this arrangement distinct?

Answer

It is likely that the software company would conclude that the on-premise software licence is distinct from the cloud data storage service. The cloud data storage could be provided by other vendors and is capable of being distinct. The software licence and cloud data storage service are separately identifiable because a customer could gain substantially all of the benefits of the on-premise software when data is stored on the customer's premises or with another vendor.

Alternatively, if the software company's on-premise software and cloud data storage are used together in such a manner that the customer gains significant functionality that would not be available without the cloud data storage service, the software company might conclude that the licence is not distinct from the storage service.

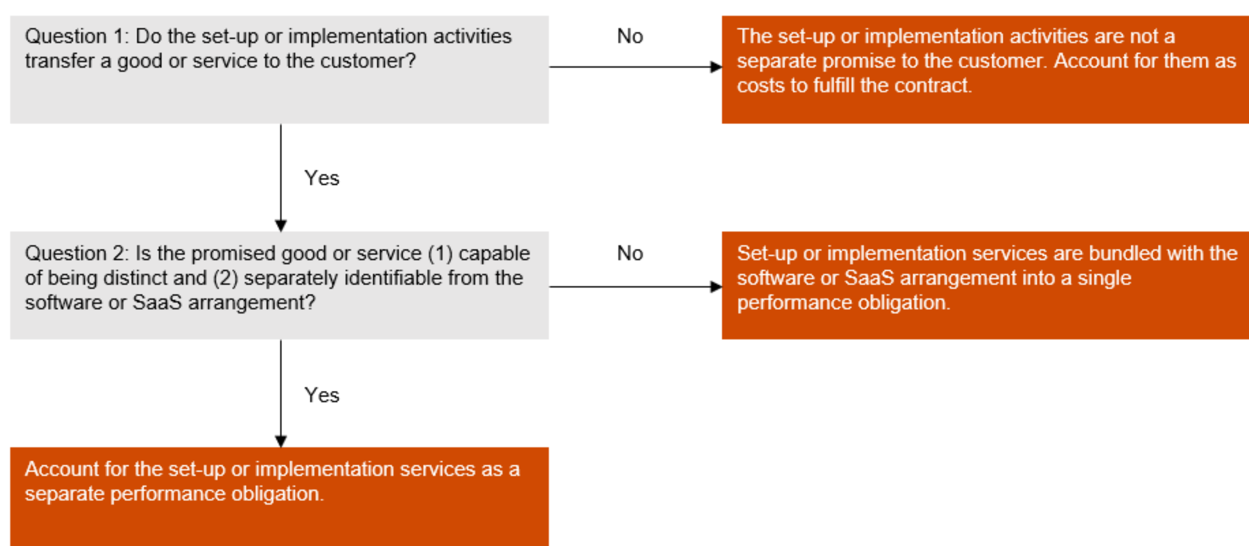
2.5 Are setup or implementation activities performed by a vendor in a software or SaaS arrangement considered a separate performance obligation?

Question

Are setup or implementation activities performed by a vendor in a software or SaaS arrangement considered a separate performance obligation?

Answer

The conclusion will depend on whether the set-up or implementation activities transfer a good or service to the customer and, if so, whether the good or service transferred is distinct from the software or SaaS arrangement. The following flowchart illustrates this concept.



The first question is whether the setup or implementation activities transfer a good or service to the customer, either as an explicit or implicit promise to the customer. This will depend on the nature of the activities performed. Set-up or implementation activities that modify the vendor's own infrastructure or assets (such as systems or platforms), or involve training the vendor's own personnel in preparation to provide services to the customer, represent activities that the vendor undertakes to fulfil a contract with a customer. These activities do not transfer goods or services to the customer, and so they are not performance obligations. The vendor should consider, however, whether the costs should be capitalised in line with the guidance on cost to fulfil a contract. In contrast, setup or implementation activities that modify the customer's infrastructure or assets, or involve providing training or consulting services to the customer's personnel, are likely to be promises to transfer a good or service to the customer.

If the activities transfer a good or service to the customer, the second question is whether those goods or services are distinct from the software or SaaS arrangement, based on the guidance in paragraph 27 of IFRS 15. Factors indicating that the set-up or implementation is distinct, and therefore a separate performance obligation, could include:

- The customer's own employees or another vendor could perform the activities (for example, there is a bidding process for the set-up/implementation phase).
- The customer receives a benefit from the goods or services separate from the software/SaaS (for example, an improved business process or hardware/software asset that can be used for other purposes).

- The customer's purchase of the goods or services is optional (for example, optional training or consulting services).
- The vendor has historically offered the SaaS without set-up or implementation services to other customers.
- The set-up or implementation services do not significantly alter any functionality of the SaaS and are not significantly integrated, or highly interdependent or highly interrelated with the SaaS.
- Providing the set-up or implementation services does not require a highly specialised or complex skill set.

None of the above factors is individually determinative, and there might be other relevant facts and circumstances to consider.

2.6 What factors should be considered in determining whether a software licence and cloud-based services should be combined into a single performance obligation?

Question

What factors should be considered in determining whether a software licence and cloud-based services should be combined into a single performance obligation?

Answer

An arrangement that includes both a licence to on-premises software and cloud-based services (such as SaaS) is sometimes referred to as a 'hybrid cloud' offering. If a customer can only benefit from a licence in conjunction with a related service (for example, the software is used solely to access an online service), the licence is not distinct. If the on-premises software has stand-alone functionality (that is, it is capable of being distinct), the software and cloud-based services would generally only be combined if the vendor can demonstrate that the components are highly interdependent or highly interrelated. This assessment requires a thorough understanding of the functionality provided by each of the components and how they interact with each other.

Significant judgement is often required to determine whether the on-premises software is distinct from the cloud-based services.

Some factors that might indicate that the software licence and cloud-based services are highly interdependent or highly interrelated, and should therefore be combined into a single performance obligation, include:

- Significant and regular two-way interaction between the on-premises software and the SaaS, as opposed to a one-way hand-off between the elements.
- The interaction between the elements is critical for the user to obtain the intended benefit from the arrangement.
- The two elements together provide new or different functionality; in other words, the SaaS functionality is transformative rather than additive. Note that obtaining increased efficiencies by using the two elements together is generally not considered transformative on its own. The value of the SaaS to the customer, and its influence on the customer's decision to purchase the offering, does not dictate whether the functionality is 'additive' or 'transformative'.
- The customer cannot practically obtain similar benefits provided via the SaaS from other sources.
- Contracts, marketing materials, and other customer communications describe the offering on a combined basis rather than as two separate elements. This factor is not conclusive on its own, and it should only be used as supporting evidence.

2.7 What factors should be considered in determining whether a software licence and promise to provide updates to the software should be combined into a single performance obligation?

Question

What factors should be considered in determining whether a software licence and promise to provide updates to the software should be combined into a single performance obligation?

Answer

A software licence should be combined with a promise to provide updates if the updates significantly modify the software or if the software and updates are determined to be highly interdependent or highly interrelated. A key consideration is whether the updates are critical to maintaining the utility of the software. This assessment will often require significant judgement.

Some factors that might indicate that the software licence and promise to provide updates should be combined into a single performance obligation include:

- Providing updates is essential to fulfilling the promise in the contract and the intended purpose of the software.
- The updates relate to the core functionality of the software; utility of the software declines quickly and significantly (relative to the contract term) without the updates.
- The updates are related to changes caused by external factors outside the company's control that impact on the software's ability to function as intended.
- The company has more than insignificant resources dedicated to monitoring external factors, identifying the need for updates, and developing and releasing the necessary updates.
- The updates are expected to be frequent relative to the contract term. There is not a minimum number of updates needed to qualify as 'frequent'; however, updates should be frequent enough that the utility of the software would decline quickly without the updates. Only critical updates should be included when assessing frequency of updates.
- Evidence supports that customers download/accept updates when they are made available.
- The customer cannot practically obtain the updates from another source.

None of the above factors is individually determinative, and there might be other relevant facts and circumstances to consider.

If a licence and updates are combined, the outcome is generally a performance obligation that is delivered over time. IFRS 15 Example 55 illustrates a fact pattern where a software licence is combined with a promise to provide updates. There might be other performance obligations that require separate identification. However, they are often delivered over time and over a similar period as the combined service of software and updates; and, in practice, any allocation of transaction price would not have a significant effect on the timing and amount of revenue recognised.

2.8 When does a hosting arrangement (in connection with licensing software products) include a software licence?

Question

When does a hosting arrangement (in connection with licensing software products) include a software licence?

Answer

In a hosting arrangement, the end user does not take possession of the software being licensed by the vendor; instead, the hosted software resides on the vendor's or a third party's hardware, with the customer accessing the software remotely.

Management is required to assess whether the licence is distinct from the hosting service and is therefore a separate performance obligation. In making this assessment, the entity should consider the guidance in paragraph 27 of IFRS 15 on identifying separate performance obligations. The assessment of whether the licence is distinct has two elements: the licence must be both capable of being distinct and separately identifiable in the context of the contract.

In terms of assessing whether the licence is distinct in a hosting arrangement, if the customer has the contractual right to take possession of the software at any time during the hosting period and that right is substantive, the licence is considered distinct. This is because:

(a) the licence is capable of being distinct [IFRS 15 para 27(a)] because, through the substantive right to take possession, the customer is able to benefit from the licence without the hosting; and

(b) the hosting is separately identifiable from the licence. [IFRS 15 para 27 (b)]. In particular, the substantive right to take possession indicates that the entity does not provide a significant service of integrating the hosting, the hosting does not significantly modify or customise the underlying software licence, and the entity is able to deliver each promise independently.

A right to take possession of software at any time during the hosting period would be substantive if, for example, the customer has the ability to take possession without significant penalty, and it is feasible for the customer to run the software on its own or by contracting with an unrelated third party for the hosting service. A significant penalty could be either a significant cost to take delivery of the software or a significant diminution in utility or value of the software if it is used separately.

If the licence is not both capable of being distinct and separately identifiable, it should be accounted for solely as a service contract.

3

Determining and allocating the transaction price

3.1 What is the transaction price where an entity includes a service level agreement in the contract?

Entity A enters into a one-year contract (which is coterminous with entity A's financial reporting period) with a customer to provide access to its SaaS platform for a C1 million annual fee. The contract includes a service level agreement (SLA) that the SaaS platform will maintain a 99.99% uptime during the year, or the customer will be entitled to a partial refund of the annual fee. Based on its experience, entity A refunds on average approximately 5% of the annual fee under this guarantee.

Question

What is the transaction price in this arrangement?

Answer

The platform availability guarantee in the contract results in variable consideration.

Therefore, entity A should estimate the expected refund using either the expected value or most likely amount approach. Entity A should also consider whether the transaction price should be constrained; that is, amounts should only be included in the transaction price to the extent that it is highly probable that a significant reversal of the revenue recognised will not occur once the uncertainty is resolved.

Entity A estimates the variable consideration based on the expected refund value of 5% and in making that estimate, determines that it is highly probable that a significant reversal of the revenue recognised will not occur once the uncertainty is resolved. The transaction price in this arrangement is C950,000 (C1 million annual fee less 5% estimated refund).

In this case, the estimation uncertainty is resolved within the reporting period. However, there might be instances in practice where the uncertainty is not resolved within the reporting period. In such cases, entities will need to update their estimate of the refund at each reporting date until the uncertainty is resolved.

3.2 What factors should be considered in distinguishing between usage-based royalties and additional rights?

Many software licence arrangements include a variable fee linked to usage of the software. It might not be clear whether this fee is a usage-based royalty or a fee received in exchange for the purchase of additional rights by the customer. If a software vendor is entitled to additional consideration based on the usage of software to which the customer already has rights, without providing any additional or incremental rights, the fee is generally a usage-based royalty. In contrast, if a software vendor provides additional or incremental rights that the customer did not previously control for an incremental fee, the customer is likely exercising an option to acquire additional rights.

Judgement might be required to distinguish between a usage-based royalty (a form of variable consideration) and an option to acquire additional rights. A usage-based royalty is recognised when the usage occurs or the performance obligation is satisfied, whichever is later. Fees received when an option to acquire additional rights is exercised are recognised when the additional rights are transferred; however, at contract inception, the software vendor would need to assess whether the option provides a material right. [IFRS 15 App B para B39].

Factors indicating that a variable fee is an option to purchase additional rights could include:

- The customer is making a separate purchasing decision (within its control) to obtain additional rights.
- The customer is obtaining either (a) additional and incremental rights to use the same software (such as additional seats or users) or (b) incremental functionality.
- The customer benefits from the additional rights concurrently with existing rights; that is, in exchange for the variable fee the customer receives an incremental benefit as opposed to replacing usage that has been consumed.

Factors indicating that a variable fee is a usage-based fee could include:

- The fee is incurred as a result of usage of the software that is not solely within the customer's control (for example, processing of transactions initiated by end users).
- The fee is incurred as a result of the customer's use of the software to perform a function or obtain an output.

None of the above factors is individually determinative, and there might be other relevant facts and circumstances to consider.

The following examples illustrate the assessment of whether variable fees represent a usage-based royalty or an option to acquire additional rights.

Example 1: Usage-based royalty

A software company licenses software to a customer that will be used by the customer to process transactions. The licence permits the customer to grant an unlimited number of users access to the software for no additional fee. The contract consideration includes a fixed upfront fee and a variable fee for each transaction processed using the software.

Question

How should the software company account for the variable fee?

Answer

The software company should account for the variable fee as a usage-based royalty. The incremental fees that the software company receives are based on the usage of the software rights previously transferred to the customer. There are no additional rights transferred to the customer; therefore, the software company should recognise the usage-based royalty in the period the usage occurs.

Example 2: Option to acquire additional rights

On 1 January 20X7, a software company licenses to a customer the right to use its software for five years for a fixed price of C1 million for 1,000 users (or 'seats'). C1,000 per user is the current SSP for the software. The contract also provides that the customer can add additional users during the term of the contract at a price of C800 per user. Management has concluded that each 'seat' is a separate performance obligation and, in substance, the customer obtains an additional right when a new user is added.

On 1 January 20X8, the customer adds 20 users and pays the software company an additional C16,000.

Question

How should the software company account for the variable fee?

Answer

The variable fee in this arrangement is an option to purchase additional rights to use the software, because the rights for the additional users are incremental to the rights transferred to the customer on 1 January 20X7. The software company will need to assess whether the option provides a material right and, if so, allocate a portion of the C1 million transaction price to the option. The amount allocated to the option would be deferred until the option is exercised or expires. In this fact pattern, the discounted pricing of C800 per user, compared to the current pricing of C1,000 per user, might indicate that the option provides a material right if the customer would not have received the discount without entering into the current contract.

The software company would recognise the C16,000 fee for the additional rights when it transfers control of the additional licences. The software company would also recognise amounts allocated to the related material right, if any, at the time the right is exercised.

3.3 What factors should be considered in estimating SSP in a bundle of software and services?

Entity A sells software licences bundled with other goods or services, such as PCS. IFRS 15 requires an entity to allocate the transaction price to the performance obligations based on their relative SSPs. However, entity A has no stand-alone sales of a software licence.

Question

How should entity A estimate the SSP in the case of a software bundle?

Answer

IFRS 15 does not prescribe or prohibit any particular method for estimating SSP as long as the method results in an estimate that faithfully represents the price a reporting entity would charge for the goods or services if they were sold separately.

Software vendors often sell software licences bundled with other goods or services, such as PCS. IFRS 15 requires an entity to allocate the transaction price to the performance obligations based on their relative SSPs. SSP is the price at which an entity would sell a promised good or service separately. The best evidence of SSP is an observable price when the good or service is sold on a stand-alone basis. There may be observable prices for PCS based on stand-alone renewal transactions. An entity should consider its pricing policies and practices, and data used in making the pricing decisions, maximising the use of observable inputs. However, a software vendor often has limited, if any, stand-alone sales of a software licence. Often, an entity may conclude that a market-based approach or expected cost plus a reasonable margin approach do not provide reliable information for determining SSP in a licence and PCS bundle. In this case, alternative approaches to estimating the SSP may be used.

Percentage relationship approach

One way of estimating the SSP of the PCS in a software bundle would be to consider the relationship between the prices of the licence and the PCS. It might be reasonable for an entity to conclude that there is a value relationship between the licence and PCS that could be used to establish SSPif the entity has historically and consistently priced PCS as a percentage of the licence fee for both the initial purchase and renewals. For example, an entity may determine that PCS is historically and consistently priced at 20% of the licence fee.

Residual approach

A software vendor may estimate the SSP of a good or service using the “residual approach” when the SSP of a promised good or service is highly variable or uncertain. The residual approach should only be used when the entity sells the same good or service to different customers for a broad range of prices, making them highly variable, or when the entity has not yet established a price for a good or service because it has not been previously sold. Before concluding that SSP for a software licence will be estimated using the residual approach, the entity should first consider whether another method can be used to estimate SSP by maximising the use of observable inputs, if any. An entity that does not licence software separately should consider whether the pricing of its bundled arrangements (for example, software licences and PCS) is highly variable. There are no bright lines for assessing whether pricing is highly variable; therefore this analysis will require judgement and could include both qualitative and quantitative data. An entity should document its methodology for evaluating pricing variability and apply that methodology consistently.

In applying the residual approach, an entity would calculate the estimated SSP of the software licence by subtracting the sum of observable SSPs of other goods or services in the arrangement (for example, PCS). The entity would then use the estimated SSP of the software licence in the relative SSP allocation.

When the residual approach is used, an entity still needs to compare the results obtained to all reasonably available observable evidence to ensure the method meets the objective of allocating the transaction price based on SSP. Allocating little or no consideration to a performance obligation suggests the method used might not be appropriate, because a good or service that is distinct is presumed to have value to the purchaser. Reasonable evidence for a software arrangement could include:

- the entity's pricing policies and strategy;
- pricing for similar products sold by the entity;
- pricing for competitor's products; or
- an assessment of whether the estimated SSP yields a reasonable margin.

3.4 How should an entity estimate SSP where the residual approach is not appropriate?

A software company enters into a contract with a customer to licence software and provide PCS for a total transaction price of C1.1 million. The software company regularly sells PCS for C1 million on a stand-alone basis. The software company also regularly licenses software on a stand-alone basis for a price that is highly variable, ranging from C500,000 to C5 million.

Question

Can the software company use the residual approach to determine the SSP of the software licence?

Answer

No. Since the seller has observable evidence that PCS sells for C1 million, the residual approach results in a nominal allocation of selling price to the software licence. As the software is typically sold separately for C500,000 to C5 million, this is not an estimate that faithfully represents the price of the software licence if it was sold separately. As such, the allocation objective of the standard is not met, and the software company should use another method to estimate the SSP of the licence.

3.5 Allocating variable consideration to a series: how should variable consideration in an arrangement where pricing varies based on usage be accounted for?

Entity B enters into a two-year contract with a customer whereby entity B will process all transactions on behalf of the customer. The customer is obligated to use entity B's system to process all of its transactions; however, the ultimate quantity of transactions is unknown. Entity B charges the customer a monthly fee calculated as C0.03 per transaction processed during the month.

Entity B concludes that the nature of its promise is a series of distinct monthly processing services and accounts for the two-year contract as a single performance obligation.

Question

How should entity B allocate the variable consideration in this arrangement?

Answer

Entity B should allocate the variable monthly fee to the distinct monthly service to which it relates, assuming the results are consistent with the allocation objective. Entity B would determine that the allocation objective is met because the fees are priced consistently throughout the contract and the rates are consistent with the entity's pricing practices with similar customers.

Assessing whether the allocation objective is met will require judgement. For example, if the rate per transaction processed was not consistent throughout the contract, entity B would have to evaluate the reasons for the varying rates to assess whether the results of allocating each month's fee to the monthly service are reasonable. Entity B should consider, among other factors, whether the rates are based on market terms and whether changes in the rate are substantive and linked to changes in value provided to the customer. For example, if the terms were structured to simply recognise more revenue earlier in the contract, this is a circumstance when the allocation objective would not be met. Management should also consider whether arrangements with declining prices include a future discount for which revenue should be deferred.

3.6 Allocating variable consideration to a series: how should revenue be recognised for a contract with an upfront fee?

Entity A enters into a contract to provide a customer with a cloud-based solution to process payroll over a one-year period. The customer cannot take possession of the software at any time during the hosting period; therefore, the contract does not include a licence. Entity A charges the customer an upfront fee of C1 million and a monthly fee of C2 for each employee's payroll processed through the cloud-based solution. If the customer renews the contract, it will have to pay a similar upfront fee.

Entity A concludes that the nature of its promise is a series of distinct monthly services, and it accounts for the one-year contract as a single performance obligation.

In the first quarter of the year, the monthly fees for payroll processed in January, February and March are C50,000, C51,000 and C52,000, respectively.

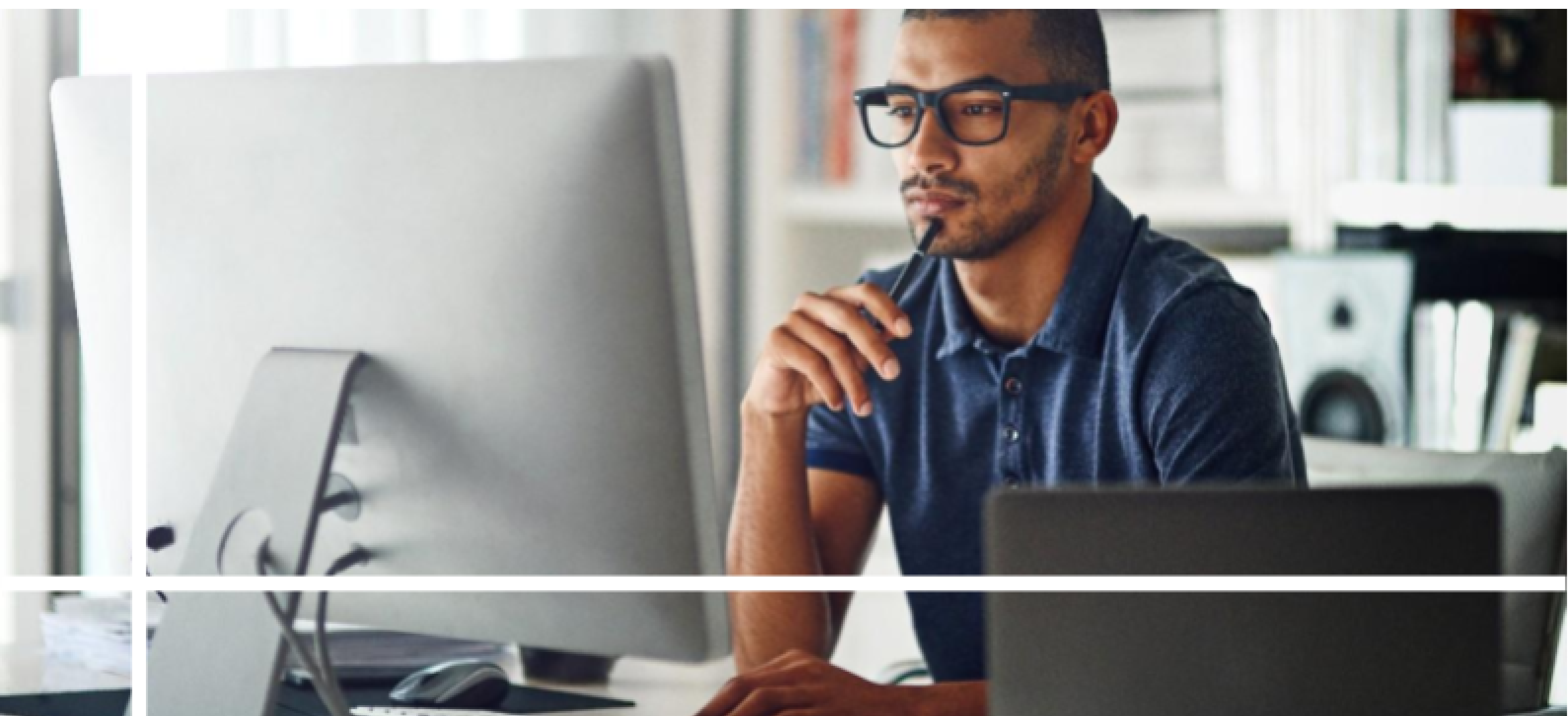
Question

How should Entity A recognise revenue from this arrangement?

Answer

Entity A should determine an appropriate measure of progress to recognise the C1 million upfront fee, which would likely be a time-based measure (that is, ratable recognition over the contract term). Entity A should allocate the variable monthly fees to the distinct monthly service to which they relate (that is, C50,000 to January, C51,000 to February, and C52,000 to March). The allocation objective is met, because the C2 monthly fee per employee is consistent throughout the contract and the variable consideration can be allocated to the distinct service to which it relates, which is the monthly payroll processing service in January, February and March.

The resulting accounting is that the upfront fee is spread ratably, but the variable fee is not. This does not mean that the entity is using multiple measures of progress. The single measure of progress for the contract is a time-based measure, but the variable fee is allocated to specific time periods in accordance with the allocation guidance in paragraph 85 of IFRS 15.



3.7 Allocating variable consideration to a series: how should an entity assess whether it is appropriate to allocate variable consideration received in a SaaS contract to distinct services within a series?

SaaS will typically meet the criteria to be accounted for as a series of distinct goods or services and therefore be considered a single performance obligation. To meet the criteria to be accounted for as a series pursuant to paragraph 23 of IFRS 15, the distinct goods or services provided must both (a) be substantially the same and (b) have the same pattern of transfer to the customer. These criteria are often met with a SaaS arrangement because each distinct service (for example, each day of service) is substantially the same, and have the same pattern of transfer to the customer.

Question

How should a SaaS vendor assess whether it is appropriate to allocate variable consideration received in a SaaS to distinct services within a series?

Answer

When the arrangement includes variable consideration (for example, a usage-based fee), the SaaS vendor should apply the guidance in paragraph 85 of IFRS 15 to determine whether the variable consideration should be allocated entirely to a distinct service within the series. A SaaS provider will need to determine whether the arrangement is (a) a promise to provide access to the SaaS, or (b) a promise to provide a specified amount of services. (See section 4.9 “How should revenue be recognised for an arrangement to provide access to SaaS where the contract includes scheduled increases in the fee on an annual basis?”)

A common example is a SaaS arrangement with a variable fee based on daily usage of the SaaS platform. The criteria in paragraph 85 of IFRS 15 are used to determine whether the daily fee (variable consideration) should be allocated to the day to which it relates (a distinct service within the series). If the criteria are met, the daily fee is recognised each day as the usage occurs (see section 3.6 “Allocating variable consideration to a series: how should revenue be recognised for a contract with an upfront fee?”).

The first requirement will often be met for usage-based fees because the terms of the variable fee relate to the period the customer is receiving benefit from the SaaS. More judgement may be required to assess whether allocation of the fee to the period of usage is consistent with the allocation objective. The allocation objective would likely be met if:

- the usage-based fee is consistent throughout the contract period (for example, a per-usage fee for each transaction processed), and
- a usage-based fee is incurred each reporting period.

If the usage-based fee is not consistent throughout the contract term (for example, the per-usage fee ranges significantly from period to period), allocating the fee to the period of usage may not be consistent with the allocation objective, depending on the reasons for the varying fee.

If the criteria are not met, the variable consideration is estimated and included in the total transaction price, which is recognised using the measure of progress determined for the SaaS arrangement (for example, ratably over the SaaS contract term if a time-based measure of progress is utilised).

4

Recognising revenue

4.1 When is the nature of a licence to provide a right to use IP?

Entity F provides a fixed-term software licence to entity G. The terms of the arrangement allow entity G to download the software by using a unique digital key provided by entity F. Entity G can use the software on its own server. The software is functional when it transfers to entity G. Entity G also purchases PCS with the software licence. There is no expectation for entity F to undertake any activities other than the PCS. The licence and PCS are distinct, as entity G can benefit from the licence on its own, and the licence is separable from the PCS.

Question

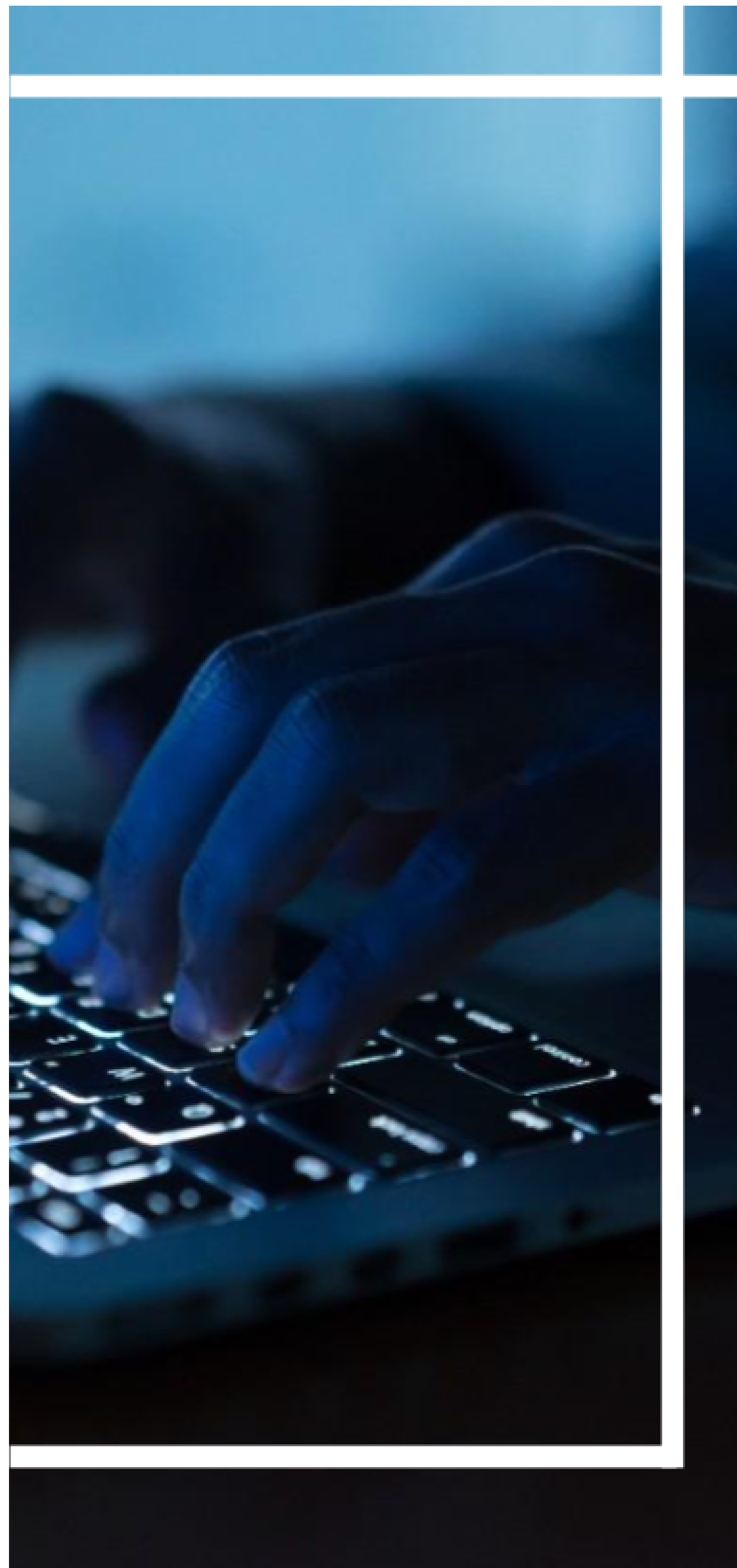
What is the nature of the licence in this arrangement?

Answer

A software licence is usually considered a licence that provides a right to use IP. This is because it has standalone functionality and the customer can use the IP as it exists at a point in time. This is consistent with Example 54 in IFRS 15, which cites software as an example of right to use IP.

PCS is not considered an 'activity' that affects the IP because it is a separate performance obligation. The IP has significant stand-alone functionality and entity F is not expected to perform any activities that affect that functionality. Therefore, entity F does not perform activities that significantly affect the IP to which the customer has rights. The three criteria required for a right to access IP over time are not met.

Entity F would recognise revenue at a point in time when entity G is able to use and benefit from the licence (no earlier than the beginning of the licence term). PCS is a separate performance obligation in this arrangement and does not impact the assessment of the nature of the licence.



4.2 Does the timing of revenue recognition differ for a distinct perpetual software licence and a term software licence?

Question

Is the timing of revenue recognition different for a perpetual software licence and a term software licence when those licences are separate performance obligations (that is, not bundled with other goods and services)?

Answer

No. Software is usually considered a right to use licence because it has stand-alone functionality and the customer can use the IP as it exists at a point in time. This is consistent with Example 54 in IFRS 15, which cites software as an example of right to use IP. As such, revenue allocated to a distinct software licence is usually recognised at the point in time control is transferred to the customer. In accordance with para B61 of IFRS 15, this is typically at the beginning of the licence term, regardless of whether the software licence has a stated term or is perpetual. The term of the licence could however affect the estimate of its SSP and therefore, the allocation of transaction price to the licence, and other performance obligations in the contract.

For licences that are not distinct and are bundled with other goods or services, an entity should apply judgement to assess the nature of the combined item and determine whether the combined performance obligation is satisfied at a point in time or over time.

4.3 Does an entity have to deliver a software key or access code to conclude control has transferred to the customer?

Question

Does an entity have to deliver a software key or access code to conclude control has transferred to the customer in a software arrangement?

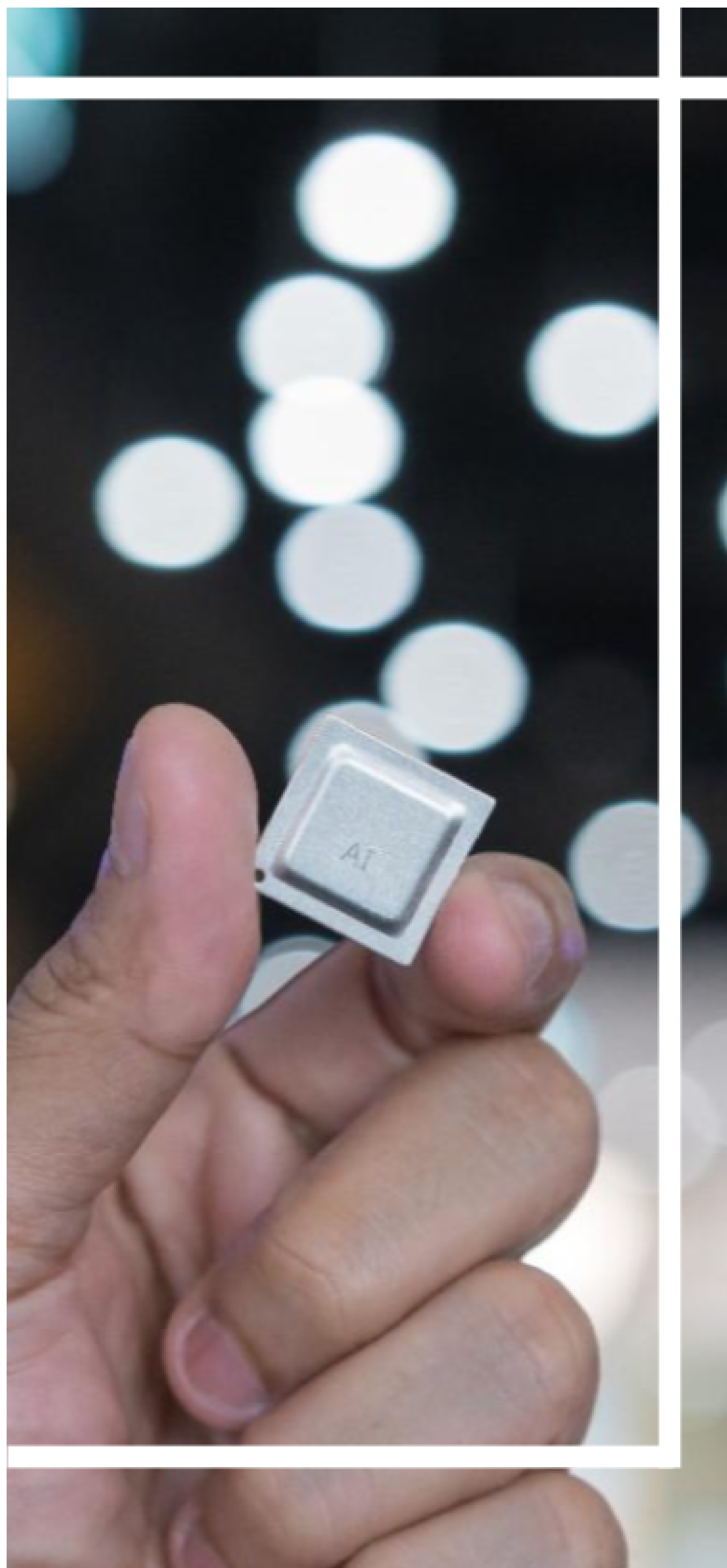
Answer

It depends. Appendix B paragraph B61 of IFRS 15 states that revenue cannot be recognised from a licence of IP before “the beginning of the period during which the customer is able to use and benefit from the licence”. This period usually begins when “an entity provides (or otherwise makes available)” the IP.

A software vendor might need to apply judgement to determine when it ‘makes available’ a copy of the software. This assessment should consider all of the indicators to determine the point in time control transfers in paragraph 38 of IFRS 15.

If delivery of a software key or access code is not substantive, it would not impact the assessment of control transfer. For example, delivery of a software key or access code would likely not be substantive in situations where (a) the customer already has access to the software (such as through a hosting arrangement or from a prior licence period or use of a temporary key) or (b) the vendor has made the software available for access by the customer upon demand and there is minimal to no effort required by the vendor to transfer the software (that is, providing a key or access code is an administrative task).

However, in other circumstances, the delivery of a software key or access code could be substantive, such as a situation where payment terms or acceptance clauses (that are not a formality) are tied to delivery.



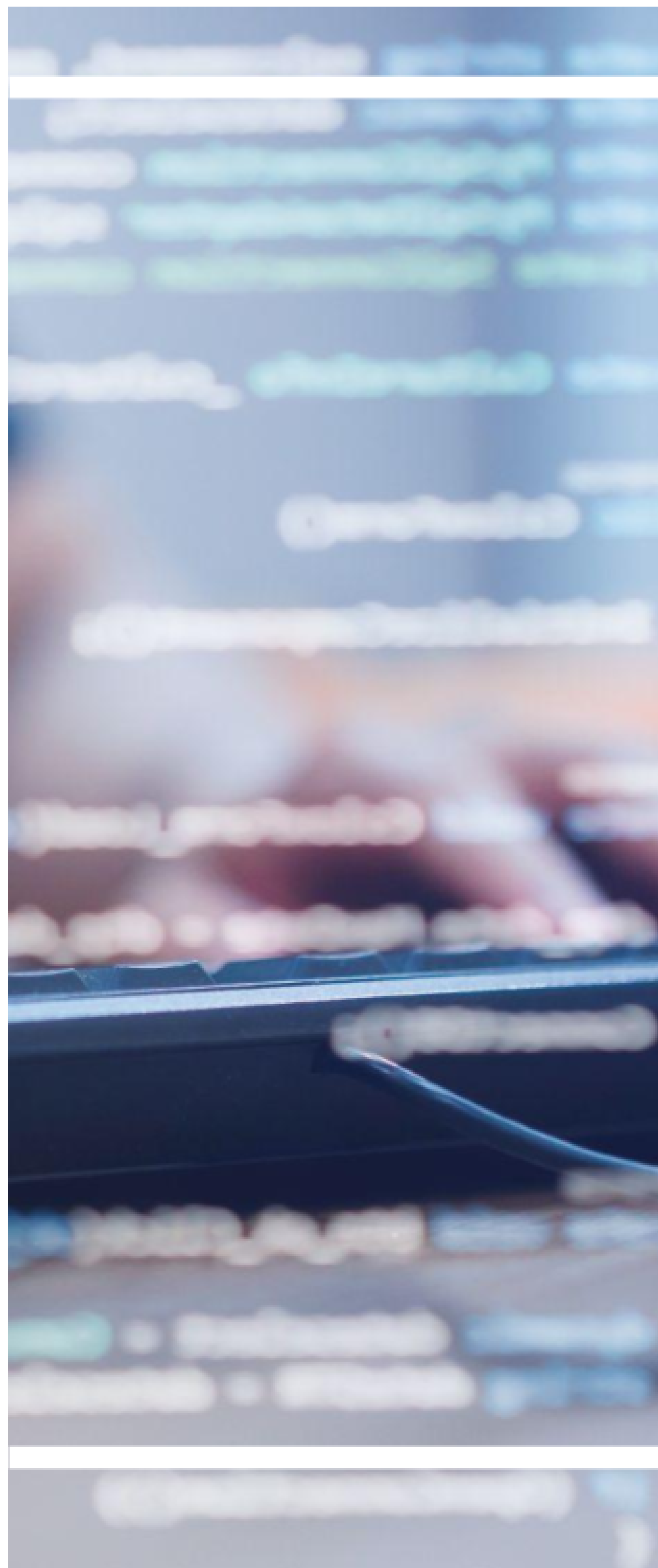
4.4 What factors should be considered in determining whether an arrangement is a stand ready obligation versus a promise to deliver specific goods or services?

Distinction between a promise to stand ready and a promise to deliver specific goods or services

Judgement is required. For example, a promise to provide one or more specified upgrades to a software licence is not a stand-ready performance obligation. A contract to deliver unspecified upgrades on a when-and-if-available basis, however, would typically be a stand-ready performance obligation. This is because the customer benefits evenly throughout the contract period from the guarantee that any updates or upgrades developed by the entity during the period will be made available. Refer to the Revenue Recognition Transition Resource Group ("TRG") memo no. 16 and the related meeting minutes in Revenue TRG memo no. 25 for further discussion of this topic.

Applicability of time-based method

A measure of progress based on delivery or usage (rather than a time-based method) will best reflect the entity's performance in some instances. For example, a promise to provide a fixed quantity of a good or service (when the quantity of remaining goods or services to be provided diminishes with customer usage) is typically a promise to deliver the underlying good or service rather than a promise to stand ready. In contrast, a contract that contains a promise to deliver an unlimited quantity of a good or service might be a stand-ready obligation for which a time-based measure of progress is appropriate.



4.5 How should an entity recognise revenue for a stand ready obligation to provide unlimited support services?

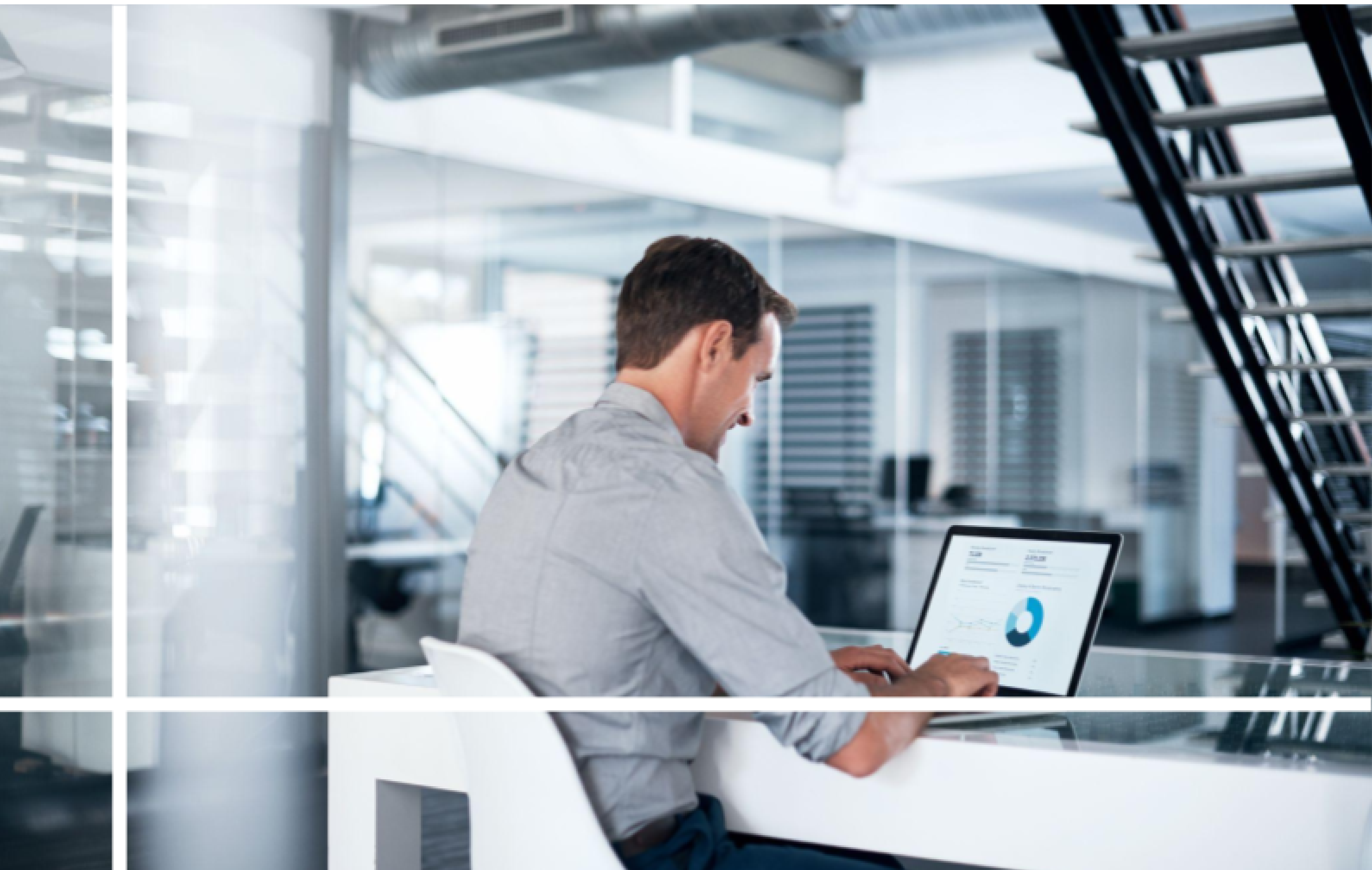
Entity H enters into a contract with a customer to provide a software licence and unlimited access to its call centre for a one-year period. Entity H determines that the software licence and support services are separate performance obligations. Customers typically utilise the call centre throughout the one-year term of the contract.

Question

How should entity H recognise revenue for the unlimited support services?

Answer

Entity H would conclude that its promise to the customer is a stand-ready obligation to provide unlimited access to its call centre. Entity H would then determine a measure of progress that best reflects its performance in satisfying this obligation. Assuming a time-based measure, entity H would recognise revenue for the support services on a straight-line basis over the one-year service period.



4.6 How should an entity recognise revenue for a specified quantity of services?

Entity H enters into a contract with a customer to provide a software licence and 100 hours of call centre support for a one-year period. Entity H determines that the software licence and support services are separate performance obligations. Entity H monitors customer usage of support hours to determine when the hours have been utilised. Customers are charged an additional fee for call centre usage beyond 100 hours. Customers frequently use more than 100 hours of support.

Question

How should entity H recognise revenue for the 100 hours of support services?

Answer

Entity H would conclude that its promise to the customer is to provide 100 hours of call centre support. Assuming a conclusion that hours of service provided best reflects its efforts in satisfying the performance obligation, revenue would be recognised based on the customer's usage of the support services.

4.7 How should an entity recognise revenue allocated to a promise to provide PCS?

Question

Should revenue allocated to a promise to provide PCS be recognised using a time-based measure of progress (that is, ratably) over the contract period?

Answer

For PCS arrangements that are a promise to stand ready to provide unspecified when-and-if available updates and upgrades once developed by the vendor, revenue is typically recognised using a time-based measure (that is, ratably) over the contract term. This is because the customer benefits evenly throughout the contract period from the guarantee that any updates or upgrades developed by the software vendor during the period will be made available. However, there might be some limited circumstances where judgement will be required to determine an appropriate measure of progress because the customer does not benefit evenly throughout the contract period.

In contrast, a promise to provide a specified update or upgrade is not a stand-ready obligation. For example, if the software vendor has provided a development roadmap to the customer, the vendor may have implicitly promised to provide the specified updates or upgrades on the roadmap. An implied promise exists if, at the time of entering into the contract, the customer has a valid expectation that the vendor will transfer a specified update or upgrade. Specified updates or upgrades are likely to be distinct from unspecified when-and-if available updates and upgrades even if both are provided pursuant to the same PCS arrangement. The entity therefore must determine the relative SSP of that specified update or upgrade and recognise the amount allocated to a specified update or upgrade as revenue as and when the update or upgrade is delivered.

4.8 How should an entity determine the appropriate measure of progress for a SaaS arrangement?

Question

What is the appropriate measure of progress for a SaaS arrangement?

Answer

To determine the appropriate measure of progress, the SaaS provider should assess whether the arrangement is (a) a promise to provide access to the SaaS, or (b) a promise to provide a specified amount of services. This assessment might require judgement.

Factors indicating that the promise is to provide access to the SaaS could include:

- The SaaS provider offers unlimited access to (or usage on) the SaaS platform during the contract term, or the contract includes a maximum usage that the customer is not expected to exceed (that is, a non-substantive 'cap').
- The customer primarily benefits from access to the SaaS platform over a contract term, rather than specific usage or outputs such as processing transactions or data.
- The SaaS provider provides support services related to access to the SaaS platform throughout the contract term.
- The SaaS provider does not separately sell services on a usage-only basis (that is, pay-as-you-go).

Factors indicating that the promise is to provide a specified amount of services could include:

- The contract with the customer specifies a fixed amount of usage/transactions and the customer needs to purchase more once the fixed amount is depleted.
- The customer can rollover unused pre-purchased amounts to subsequent periods.
- The customer does not benefit significantly from access to the SaaS platform alone without specific usage or outputs such as processing transactions or data.
- The SaaS provider separately sells services on a usage-only basis (that is, pay-as-you-go).

None of the above factors is individually determinative, and there might be other relevant facts and circumstances to consider.

For SaaS arrangements that are a promise to provide access to the SaaS platform for a period of time, the appropriate measure of progress is often a time-based measure.

For SaaS arrangements that are a promise to provide a specified amount of services, revenue is typically recognised as the services are provided (that is, as the customer utilises the SaaS platform).

If variable fees exist, the SaaS provider will also need to consider the guidance on allocating variable consideration in paragraphs 84–86 of IFRS 15.

4.9 How should revenue be recognised for an arrangement to provide access to SaaS where the contract includes scheduled increases in the fee on an annual basis?

Question

How should revenue be recognised for an arrangement to provide access to SaaS where the contract includes scheduled increases in the fee on an annual basis?

Answer

When an arrangement is a promise to provide access to the SaaS, the appropriate measure of progress is often a time-based measure. This is because the arrangement is a series of distinct goods or services. In an arrangement with scheduled increase in annual fees, management should consider the business reasons for the escalating fees and expected pricing of the services in future years when accounting for the arrangement. For example:

- Where a scheduled increase in the annual fee is only a mechanism to achieve deferred payment terms for the customer, revenue should be recognised ratably over the contract. The SaaS vendor should also assess whether the payment terms indicate that the arrangement includes a significant financing component.
- Where increases in the fee are indexed to inflation or similar terms, these would generally not be recognised ratably over the contract term as such price increases correspond directly with the value to the customer of the entity's performance.

In all cases, if the SaaS arrangement term is cancellable (for example, the customer can terminate for convenience after the first year), the SaaS vendor should only account for the non-cancellable term.

If the SaaS vendor is providing the customer with additional services each year (such as increased functionality or increased user access), straight-line recognition might not be appropriate. In this case, the SaaS vendor should assess whether the customer is receiving multiple distinct services that commence on different dates.

5

Other considerations: principal versus agent, costs

5.1 Which party is the entity's customer for sales of its software product through the online marketplace?

Entity A sells its software product offering through multiple channels, including an online marketplace owned and operated by entity B, an unrelated party. In arrangements with entity B, end consumers initiate a purchase of entity A's product through the online marketplace and are prompted to sign an agreement directly with entity A. Entity A determines the selling price paid by the end consumer, which is collected by entity B and remitted to entity A less a 20% fee for use of the marketplace. Entity A provides all customer service related to the use of its software product, while entity B provides customer service for use of the online marketplace.

Question

Which party is entity A's customer for sales of its software product through the online marketplace?

Answer

Entity A's customer for sales through the online marketplace is the end consumer because entity B does not obtain control of the software product and is therefore an agent providing services to entity A. Entity A should recognise revenue equal to the price paid by end consumers and an expense for the amount retained by entity B.

The specified good or service provided to the end consumer is the software product. Entity B does not obtain control of the software product before it is transferred to the end consumer; therefore, entity B is an agent arranging for entity A's sales to end consumers. This conclusion is supported by the following indicators of control:

- Entity B is only responsible for its online marketplace and is not primarily responsible for providing the software product to the end consumer. Also given that the end consumers are prompted to sign an agreement directly with entity A, end consumers will perceive entity A as the seller of the software product and not entity B.
- Entity B does not have inventory risk related to the software product.
- Entity B does not have discretion in establishing the selling price of the software product.

5.2 How to determine when software is sold through an intermediary with an obligation for PCS?

Question

When software is sold through an intermediary, but the software vendor has an obligation to the end consumer to provide PCS, is the end consumer the software vendor's customer for PCS?

Answer

When an intermediary (for example, a reseller) is involved in transferring goods or services to an end consumer, a vendor will need to assess whether the intermediary or the end consumer is the vendor's customer.

Each distinct good or service in the arrangement should be assessed separately.

Accordingly, if the software and PCS are distinct, the vendor should determine which party is its customer separately for the promises to licence software and provide PCS.

It is possible that a vendor could conclude the intermediary is the vendor's customer for the software licence, but the end consumer is the vendor's customer for PCS. However, the conclusion will depend on the specific facts and circumstances of the arrangement.

5.3 If a vendor distributes its software or SaaS offering through an intermediary, is the reseller or the end consumer the vendor's customer?

It is commonplace in the software industry for vendors to distribute software or SaaS through a reseller (intermediary). From the vendor's perspective, they must assess whether the intermediary or the end customer is the vendor's customer:

- If the intermediary is the vendor's customer, the vendor will recognise as revenue the amount it receives from the intermediary.
- If the end consumer is the vendor's customer, the vendor will recognise the price paid by the end consumer as revenue, with an expense recognised for the amount retained by the intermediary.

This assessment is also relevant to the intermediary, as the intermediary must assess whether they are principal or agent in transferring the goods or services to the end customer:

- If the intermediary is principal in transferring the goods or services to the end customer, the intermediary will recognise revenue at the gross amount paid by the end customer.
- If the intermediary is an agent in transferring the goods or services to the end customer, it will recognise a net amount in revenue, being the commission they receive.

Therefore the assessment of principal versus agent is relevant to both the vendor and the intermediary. The guidance below has been drafted from the vendor's perspective, but the same indicators can be used to make the assessment from the intermediary's perspective. In May 2022, IFRS IC issued an agenda decision considering the principal versus agent assessment for a software reseller and the guidance below incorporates the key principles of this agenda decision.

Question

If a vendor distributes its software or SaaS offering through a reseller or digital marketplace (that is, an intermediary), is the reseller or the end consumer the vendor's customer?

Answer

The principal versus agent assessment is a two-step process.

The first step is to identify the specified good or service to be provided to the end consumer. It is common in this industry for intermediaries to provide pre-sales advice to the customer (for example, advising them on which SaaS products to purchase). As this advice takes place prior to a contract with a customer for the sale of SaaS being in place, it is not considered as part of the assessment of whether the intermediary is acting as principal in the arrangement between the intermediary and the vendor to deliver SaaS to the end customer.

The second step is to assess whether the intermediary controls the specified good or service before it is transferred to the end consumer. The intermediary (for example, a reseller or digital marketplace) is the principal in the arrangement with the end consumer (and therefore, the vendor's customer) if it controls the software or SaaS offering before it is transferred to the end consumer. The principal versus agent assessment should be performed separately for each specified (distinct) good and service in a contract.

The assessment of whether the intermediary takes control of software or a SaaS offering is based on the definition of control in paragraph 33 of IFRS 15 and the explanation of how an entity obtains control outlined in paragraph B35A of IFRS 15. If additional evidence is needed to reach a conclusion, the vendor should evaluate the three indicators in paragraph B37 of IFRS 15.

Examples of evidence that the intermediary controls the software or SaaS could include:

1. Primary responsibility for fulfilment
    - Contractual terms and other communications (for example, marketing materials, website FAQs) indicate that the intermediary is responsible for providing the software or the SaaS.
    - The vendor does not have the right to refuse an arrangement with an end consumer (or the right is only protective in nature).
    - The vendor does not have a contractual relationship with the end consumer and/or has little to no interaction with the end consumer, with the intermediary being the party that engages with the customer before, after and as the software or SaaS is transferred to the customer. In many arrangements, the vendor will at a minimum have an end user agreement with the customer setting out the terms of the licence. Therefore, in assessing this indicator, the vendor should consider the substance of this agreement and in particular, whether it is indicative of control passing directly from the vendor to the customer or for example just provides information on using the licence.
    - The intermediary (a) has the ability to redirect the vendor to fulfil a different end consumer contract and/or (b) can prevent the vendor from providing software or SaaS services to a specific end consumer.
    - The intermediary is primarily responsible for customer service issues, including resolving complaints.
    - The intermediary provides service level agreements (SLA) or similar guarantees to the end consumer.
2. Inventory risk
    - The intermediary obtains a pool of software or rights to receive the SaaS before entering into a contract with the end customer, and can, for example, direct the goods to another customer should it so choose to or use it themselves.
    - The intermediary takes risk for software or SaaS that is not accepted by the customer as it cannot return the software or SaaS to the vendor or obtain a refund. However, inventory risk may be less relevant to the assessment of control if, for example, the type of software or offering is such that the reseller, in effect, has limited risk of return.
3. Pricing discretion.
    - The intermediary has discretion in establishing the price for the software or SaaS. However, pricing discretion may be less relevant to the assessment of control if, for example, the market is such that the reseller, in effect, has limited flexibility in establishing the price.

The above indicators should not be used as a checklist and there may be other facts and circumstances that are relevant to the assessment. Additional judgement may be required as the vendor may not have access to all the applicable contractual relationships between the intermediary and the end consumer.

5.4 How should an asset recognised for commission expense be amortised if it is related to a point in time licence of IP for which revenue from sales-based royalties is recognised over time?

Assets recorded for costs to obtain a contract should be amortised on a systematic basis consistent with the transfer of goods or services to the customer. In an arrangement that is a point in time licence of IP (for example, software), the licence is transferred at a point in time. Therefore, the asset recognised for commission expense related to the licence would be recognised as an expense at the point in time the licence is transferred.

The timing of amortisation of the asset is not impacted by the recognition of royalty revenue under the sales- and usage-based royalty exception.

Capitalised costs could also relate to anticipated contracts, such as renewals. If management anticipates that a customer will renew the licence, an entity should assess whether the commission paid on the initial licence relates only to the licence provided under the initial contract or to both the initial and renewal periods. If there is a commission paid for the renewal and the entity concludes that the renewal commission is commensurate with the commission paid on the initial contract, this would indicate that the initial commission relates only to the initial contract. If a portion of the commission paid relates to the renewal, the entity should recognise that portion when the control of the renewed licence transfers to the customer.

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