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INSIGHTS FROM THE BDO TECHNOLOGY PRACTICE

A REVENUE RECOGNITION PRIMER FOR SAAS PROVIDERS:

Finding insights in recognizing revenues under ASC 606

The software as a service (SaaS) delivery model has been on a tear and shows no signs of slowing down. Indeed, according to Gartner, 2020 revenues will reach $110.5 billion, up from a projected $94.8 billion in 2019.

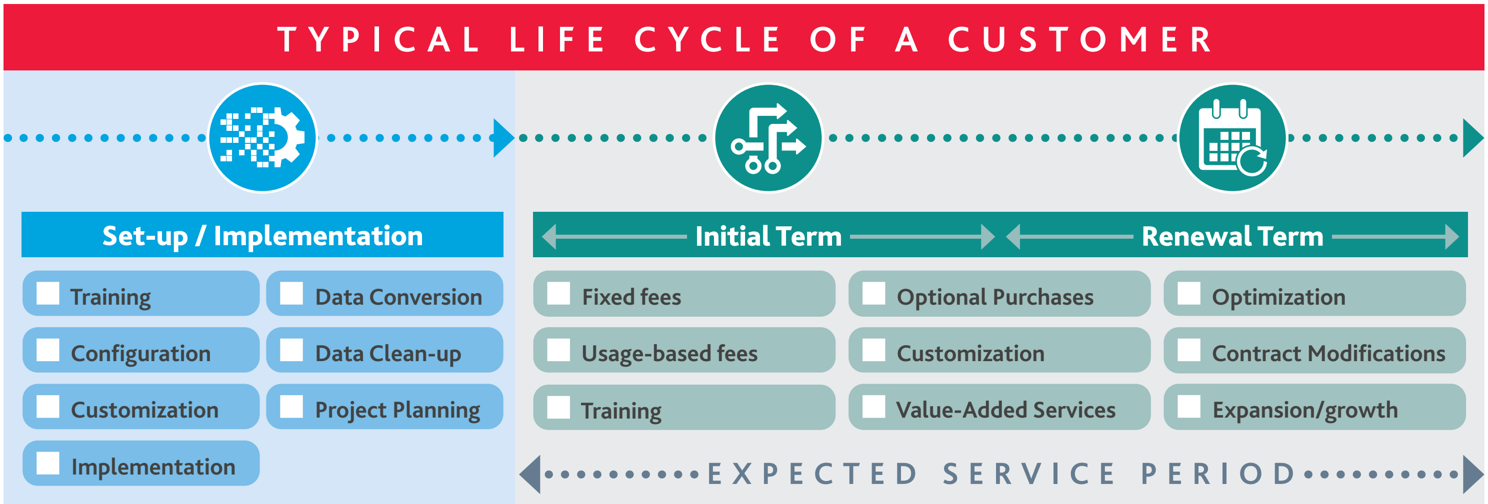
In a high growth industry, companies are moving fast to stay competitive—introducing new offerings, adjusting their services to improve customer retention, and finding new revenue streams.

THE EVOLVING SAAS MODEL

As the SaaS delivery model matures so does its business model in order to satisfy customer demands as well as retain profitability. For example, a typical scenario for a growing SaaS provider is to provide an enhanced service offering for customers up-front that would include individualized professional services and other customized solutions in order to gain a better understanding of customers' needs. Eventually the SaaS providers can standardize these offerings, thus reducing the level of individual professional services performed by themselves or partners they have engaged.

The lifecycle of a SaaS contract

The lifecycle of a typical SaaS customer, along with typical events that may require accounting considerations, is illustrated in the following diagram:



SaaS arrangements can include various services during the set-up and implementation period, and after go-live. Usually there is an initial term—for instance, one year or one month—and successive renewal periods until the customer ceases to use the service or migrates to a different version of the service.

As a result, this changing nature of the SaaS model can make it difficult to apply the revenue recognition guidance in Accounting Standards Codification Topic 606, *Revenue from Contracts with Customers* (ASC 606).

As the industry evolves, so too must SaaS companies' approach to revenue recognition.

To that end, BDO has identified the following insights that SaaS providers may find helpful related to revenue recognition along the customer lifecycle. Through a series of examples, this primer demonstrates the application of these insights.

The matters addressed in this publication are as follows:

- Determining the contract term
- Evaluating professional services with the SaaS arrangements
- Applying the series guidance
- Usage-based pricing
- Evaluating optional purchases
- Accounting for commissions and other similar costs of obtaining a customer contract

BRIEF REFRESHER – THE MAIN PRINCIPLES OF ASC 606

Under ASC 606, a SaaS provider recognizes revenue when it transfers a service to the customer. The amount of revenue recognized is based on the consideration the SaaS provider expects to be entitled to in exchange for those services.

To apply these principles, ASC 606 requires entities to employ the following five-step process:

1. Identify the contract with the customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations in the contract using Stand Alone Selling Price (SSP)
5. Recognize revenue when (or as) the entity satisfies a performance obligation

EXAMPLE 1: Web-based Sales Platform (A Basic Example)

Wind in Your Sales, Inc. (WINS) has developed a sales platform that allows customers to track customer leads, develop sales proposals, and warehouse contracts. The sales platform is accessed through the cloud, and WINS does not allow its customers to license the underlying software on premise.

WINS enters into a contract with a customer on October 1, 20X1. The contract permits the customer to utilize all of the features of the sales platform and store an unlimited amount of data on WINS's secure servers. The contract duration is for one year. The customer will pay the $100,000 subscription fee, in four quarterly installments starting at contract inception.

Even in this relatively straightforward example, there are many aspects of applying the five-step revenue recognition process to consider:

1. **Identify the contract with the customer.** The customer contract would need to be evaluated to ensure that it is enforceable—both from a legal and accounting perspective based on the guidance in ASC 606. For instance, WINS would need to consider whether both parties are committed to perform their respective obligations under the contract. Moreover, WINS would need to consider whether a portion of the contract may actually contain a lease for the right to use the company's server space. If so, that portion of the contract would be accounted for outside of ASC 606.

   For the remainder of this example, we'll assume that the contract is enforceable under ASC 606 and does not contain a lease.

2. **Identify the performance obligations in the contract.** WINS would evaluate whether the promises to allow the customer to use its platform and to store an unlimited amount of data are separate or distinct performance obligations (accounting units). The two promises would be distinct if they meet the following criteria:

   - The customer can benefit from the good/service on its own (i.e., each promise is capable of being distinct.)
   - Each good or service is "separately identifiable." This means that each promise is distinct within the context of the contract. For instance, the promises are not significantly interdependent or interrelated, or one promise is not an input necessary to deliver a combined output to the customer.

   Let's assume, though, that WINS concludes that these two undertakings are <u>not</u> distinct—that they are actually inputs to fulfilling a combined promise of providing customers with a cloud-based solution. Next, the company would then consider whether the single combined promise actually provides the customer with a distinct daily service of standing ready to allow access to its cloud-based platform. If so, WINS would account for the customer contract as a single performance obligation using the so-called "series guidance" in ASC 606. The series guidance is explained in more detail later in this publication.

3. **Determine the transaction price.** The transaction price seems to be fixed at $100,000. Nevertheless, WINS should consider whether its customary business practices or intent might involve granting concessions, discounts, rebates, or other credits that could vary this transaction price. This evaluation should be performed even if the contract itself is silent as to whether the customer might be entitled to or will receive these credits.

4. **Allocate the transaction price to the performance obligations in the contract.** Assuming that the customer contract either contains a single performance obligation or a series of distinct services that will be accounted for as a single performance obligation, there would be no need for WINS to perform this step in accounting for the contract.

5. **Recognize revenue when (or as) the entity satisfies a performance obligation.** WINS is fulfilling its promise under the contract each day the sales platform is made available for the customer's use. Accordingly, as WINS is fulfilling its performance obligation, the customer is simultaneously receiving and consuming the benefits of WINS's performance. This means that WINS would recognize revenue from the customer contract over the one-year contract term, likely on a straight-line basis. Sometimes, however, it will be more appropriate to recognize revenue in proportion to customer usage of the sales platform—this determination will be covered in more depth later in this publication.

Please consider reading this publication in conjunction with ASC 606 itself, as well as our companion piece **BDO Knows FASB: Topic 606 Revenue from Contracts with Customers**, which describes the requirements of the standard in more detail.

DETERMINING THE CONTRACT TERM

Many SaaS arrangements contain a stated term of one year or longer. However the "accounting term" might be much shorter if the arrangement contains termination for convenience provisions. A termination for convenience clause allows one or both of the parties to cancel the contract without having to pay any type of substantive penalty.

A shorter accounting term might reduce the transaction price of the contract, potentially introduce new performance obligations (material rights), and/or change the period over which certain deferred costs are amortized, as summarized in the following table:

TABLE 1: Accounting Implications of Termination for Convenience Rights

Party Possessing the Rights	Accounting Implications
Both Parties	When both parties can opt out of the contract at any time for convenience, the contract effectively becomes a day-to-day contract for accounting purposes. This means that the SaaS provider should not consider any future variable consideration in determining the transaction price.
Customer Only	The term of the contract is limited to the notice period, if any, that the customer must provide when electing its right to opt out of the contract. Moreover, if the customer initially paid a nonrefundable fee at the commencement of the contract, the SaaS contract might contain a material right, since the customer can effectively opt to remain in the contract (i.e., by not exercising the termination right), and receive future periods of access to the SaaS solution without having to pay that same initial upfront payment. The concept of material rights is explained in more detail later in this publication.
SaaS Provider Only	No implications—the accounting term of the contract is presumed to be its stated term.

Practice Point. Recall that if the SaaS arrangement provides for a substantive penalty upon early termination, the termination for convenience right can be ignored when determining the accounting term of the contract as it is unlikely to be exercised. ASC 606 does not provide guidance on what constitutes a substantive penalty. Nonetheless, the mere requirement for a customer to pay for services rendered through the cancellation date is **not** considered a substantive penalty. Instead, the terminating party must incur some other sort of loss by opting out the contract. A substantive penalty can be nonmonetary (e.g., cancellation of the contract causes the customer to forfeit an exclusive license).

EVALUATING PROFESSIONAL SERVICES ASSOCIATED WITH THE SAAS AGREEMENT

Most SaaS arrangements involve more than just "hosting"—i.e., allowing customers access to a software solution through the web. Commonly, SaaS providers will also offer customers professional services (PS), which may include configuration of the SaaS solution, interfacing the SaaS solution with the customer's existing software, building customized reports, or many other types of value-added services.

When a customer contract includes PS, it may be challenging to determine whether these services are performance obligations under ASC 606 versus set-up activities that are necessary for the SaaS provider to fulfill its promise(s) in the contract. This distinction is important because it significantly affects the timing of revenue—and cost—recognition in the income statement, as shown in the following table:

TABLE 2: Performance Obligation vs. Set-up Activity for Professional Services

	Performance Obligation	Set-Up Activity and/or Non-Distinct Performance Obligation
Description/ Distinction	The PS will be evaluated as a potential performance obligation if it transfers a good or service to the customer. Moreover, the PS will be a **distinct** performance obligation—i.e., one that is accounted for separately from other promises in the contract—if the PS meets both of the following criteria: 1. The customer can benefit from the PS on its own, or together with resources that are readily available to the customer 2. The promise to provide PS is separately identifiable from other promises in the contract The first criterion is typically met when the SaaS provider or others regularly sell the PS separately, without also requiring the customer to purchase the hosting services. In some cases, this criterion can also be met even if the PS is only sold in conjunction with the hosted software, depending on facts and circumstances. For example, if the PS will be provided **after** the hosting services have commenced, the customer can benefit from PS together with resources readily available to the customer, namely the hosting services that have already been transferred. The objective of the second criterion is to assess whether the nature of the promise in the customer contract is to deliver PS and other goods and services individually or, instead, to transfer a combined item. Factors suggesting that the PS is not separately identifiable from the hosting and other services in the contract (and therefore not a separate performance obligation) include: a. The PS is an input necessary to fulfill a promise of delivering a combined output to the customer, i.e., they are integral and they can not be performed by someone else. b. The PS significantly modifies or customizes the hosting solution, or vice versa. c. The PS and other goods and services in the contract are highly interrelated or interdependent. This means that the SaaS provider would not be able to fulfill its contractual promise by transferring each of the goods or services independently. In practice, application of this second criterion involves significant judgment.	If the PS does not meet the criteria to be a separate performance obligation (i.e., is a non-distinct performance obligation), a SaaS provider should consider whether the activities are items that the entity must undertake to fulfill a contract—i.e., set-up activities. Set-up activities do not transfer a good or service to a customer. For example, a SaaS provider may need to perform various administrative tasks to configure a cloud-based platform for use by a customer. The SaaS provider may even charge the customer an “activation” or similar fee to recover the cost of performing the tasks. However, the performance of those tasks does not transfer a good or service to the customer. Therefore, those set-up activities cannot be considered performance obligations in the contract with the customer.
Accounting Guidance	See paragraphs 19-21 of ASC 606-10-25	See paragraph 17 of ASC 606-10-25

	Performance Obligation	Set-Up Activity and/or Non-Distinct Performance Obligation
Accounting implications	If the PS is considered to be a distinct performance obligation, a portion of the transaction price would be allocated to the PS (based on SSP) and recognized as revenue when or as the PS is transferred to the customer. If costs of fulfilling PS are incurred prior to the transfer of the PS to the customer, such costs will typically be deferred under ASC 340-40. Once transfer of control of the PS begins, any costs previously deferred as fulfillment costs should be recognized on a systematic basis that is consistent with the transfered goods and serivces to which the asset relates.	Any fees charged to the customer for the set-up activities are allocated to other performance obligations in the contract and recognized as revenue with those performance obligations. That is, no revenue is recognized upon completion of the set-up activities. The costs of performing the set-up activities are typically accounted for as a fulfillment cost; such costs are deferred and amortized in proportion to the revenue recognized under the contract, including consideration of any expected renewal periods.
Example	Hosting Co. (HC) enters into a one-year contract with a customer. The contract permits the customer to use HC's cloud-based platform to process an unlimited number of transactions each month. HC also agrees to migrate the customer's historical data onto the platform for comparative purposes only—such data is not required for the platform to operate. In addition, HC will provide training on how to use the platform to the customer's sales professionals. The customer will pay a fixed amount of $12,000 per month over the contract term. Assume that HC has separately sold data migration services to other customers. Accordingly, the data migration services meet the first criterion to be a separate performance obligation. However, further assume that HC never sells training separately. Nevertheless, the training services can still meet the first criterion to be a separate performance obligation because the customer can benefit from the training services with resources that are readily available to the customer. Simply, the training services would not be provided until after the customer has access to the transaction processing platform, making it a resource readily available to the customer at the time the training is delivered. The transaction processing platform can function without the training and data migration services. Accordingly, it does not appear that the items work in concert to deliver a combined output, or that they are significantly interdependent or interrelated. The items also do not significantly customize or modify one another. Accordingly, the training, data migration, and hosting services would all be separate performance obligations. The total transaction price of $144,000 ($12,000/month for one-year) would be allocated to the three items on a relative standalone selling price basis. The amount allocated to the hosting services would be recognized as revenue over time, while the amounts allocated to the training and data migration services would likely be recognized when those services are transferred to the customer.	Internet Provider Inc. (IPI) enters into a contract that allows a customer to process an unlimited number of sales transactions each month. IPI also agrees to modify the platform so that it calculates appropriate sales tax depending on where a customer resides and the tax laws in that state. The customer has engaged IPI to perform these modification activities for a fixed fee of $10,000. The modification services are necessary for the platform to operate as designed and to ensure that its customers comply with sales and use tax regulations. Assume that both the modification services and the SaaS offering are capable of being distinct. Therefore, these services would meet the first criterion to be a separate performance obligation under ASC 606. However, the modification services appear to be necessary for the transaction processing platform to properly operate. Accordingly, the modification services would be an input necessary to fulfill IPI's promise of delivering a functioning transaction processing platform. Therefore, IPI concludes that it has one combined performance obligation that includes both the modification services and the SaaS services. The $10,000 fee charged by IPI for modification would be added to the consideration for the hosting service, and the total amount recognized over the contract period as the services are provided. Any costs incurred in performing the modification services would be deferred under ASC 340-40 and recognized in proportion to revenues recognized. The amortization period may extend beyond the initial contract term if customer renewals are expected to occur.

APPLYING THE SERIES GUIDANCE

ASC 606 introduces a concept known as the "series guidance." The series guidance was intended to make it easier for companies that perform repetitive services to apply ASC 606. The guidance is neither optional nor an accounting policy election—instead, it must be applied by a SaaS provider for those contracts that meet the criteria to be accounted for as a series.

The series guidance applies when a SaaS provider transfers similar goods and services over the course of the contract. Specifically, those goods or services must be:

- Individually distinct - that is, each good or service is independent of the other goods and services transferred in the contract, and are not inputs to fulfilling a promise to deliver a combined output
- Substantially the same
- Transferred to the customer over time, using the same pattern of transfer

EXAMPLE 2: Example of a Series

Dashboard Inc. has created a SaaS platform that remotely monitors and diagnoses problems with a machine. Specifically, the machine is fitted with a sensor that feeds data real-time to Dashboard's platform. The platform's algorithms provide alerts when the machine needs replacement parts or is at risk of having a malfunction.

The nature of the promise Dashboard has made is to monitor the performance of a machine during the term of a contract. This promise is fulfilled every day through Dashboard's "stand-ready" obligation. That is, Dashboard has agreed to effectively provide a daily service of standing ready to alert the customer if the SaaS platform detects any issues with a machine. The daily service Dashboard provides on a given day is distinct from the other daily services it has provided in the past or will provide in the future. In other words, the outcome of the monitoring service on one day doesn't affect the outcome of that same service on any other days within the contract term.

If Dashboard were to enter into a one-year contract with a customer, it technically will make 365 distinct promises—to provide monitoring services each day of the contract. The FASB recognized that accounting for each separate promise would be burdensome. Accordingly, Dashboard's contract would be accounted for under the series guidance in ASC 606. Specifically, while each daily increment of monitoring services is distinct, the nature of Dashboard's stand-ready obligation each day is substantially the same (and each day's service is being transferred over time, using a time-based measure of progress).

As indicated in the following discussion, the series guidance will result in Dashboard combining the 365 distinct daily promises into a single performance obligation for purposes of applying ASC 606.

Again, the series guidance must be applied for those contracts that meet the criteria to be accounted for as a series. In contrast, the series guidance cannot be applied to contracts that do not otherwise meet the series guidelines—for instance, when:

- Each service in the contract is not similar in nature
- The pricing of the individual promises is inconsistent
- Each service is not distinct—perhaps because the service rendered one day influences the services performed in subsequent days
- The services are not transferred over time, but instead at discrete points in time

Contracts that do comprise a series of distinct goods and services are accounted for as though the entire series were a single performance obligation. While the series guidance can simplify the application of the revenue model in ASC 606, it also can introduce new challenges, such as the accounting for a modification or amendment of a contract containing a series.

USAGE-BASED PRICING

As discussed previously, some SaaS contracts contain usage-based pricing. ASC 606-10-55-65 provides a usage and sales-based royalty exception, which precludes a company from recognizing revenues from sales-based or usage-based fees associated with licenses of IP until the subsequent sale or usage occurs. However, this exception from the general guidance to recognize variable consideration does not apply to most SaaS arrangements because hosted software arrangements are typically scoped out of this guidance as noted in ASC 606-10-55-54(a).

As a result, SaaS providers could be required to estimate the variable consideration from usage-based pricing, subject to the general constraint in ASC 606, in determining the transaction price. Fortunately, though, many SaaS arrangements will qualify as a series, as mentioned earlier in this publication, which will likely provide relief from the need to estimate this variable consideration. This is because entities are required to allocate variable consideration solely to distinct goods or services promised in a series of distinct goods and services that forms a part of a single performance obligation if (1) it relates specifically to the entity's efforts to deliver that performance obligation and (2) allocating it only to that performance obligation wouldn't violate the overall allocation guidance. This means that generally the SaaS provider can simply recognize income based on the customer's usage during the reporting period, similar to the outcome that would have been obtained by applying the usage and sale-based royalty exception in ASC 606-10-55-65.

Note that ASC 606-10-55-18 also provides a so-called "invoicing practical expedient." Under this practical expedient, an entity would simply recognize revenue equal to the amount that it has a right to invoice during a reporting period. This would allow the entity to avoid having to estimate the transaction price, or even determine the proper pattern in which the good or service is being transferred to the customer (e.g., straight-line or based on usage). To qualify for the practical expedient, an entity must have a right to receive consideration from the customer that corresponds directly with the value of the goods or services transferred to the customer for performance completed to date.

EXAMPLE 3: Usage-Based Pricing Series Guidance

Let's continue with Example 2. Recall that Dashboard Inc. has created a SaaS platform that monitors and diagnoses problems with a machine remotely. The contract is being accounted for under the series guidance.

Dashboard charges its customers $50 for every hour that the underlying machine operates and transmits data to Dashboard's platform.

- Absent the relief provided by the series guidance, Dashboard would have to estimate the transaction price over the term of the contract, which by necessity will involve estimating the manner and extent in which the customer will use the underlying machine.
- However, applying the series guidance permits Dashboard to avoid that highly judgmental process, and simply record revenue each day based on the customer's actual usage for that day. For instance, if the customer uses the machine for 8 hours one day and 10 hours the next, Dashboard would simply recognize daily revenues of $400 and $500, respectively.[1]

EVALUATING OPTIONAL PURCHASES[2]

Many SaaS contracts offer flexibility to customers. For instance, some contracts allow the customer to increase the number of users with access to the cloud platform for an additional fee. Other contracts may charge customers a fee for each transaction processed through the SaaS platform, where the number of transactions varies each day.

It is important for SaaS providers to ascertain whether certain contractual provisions represent variable consideration or optional purchases, as the accounting is very different for these two items:

- **Variable Consideration.** Unless subject to the series guidance (as discussed in the previous section), a SaaS provider would estimate the amount of variable consideration in a customer contract and include the estimate in the transaction price, subject to a constraint.[3]
- **Optional Purchases.**
  - The SaaS provider must first determine whether the optional purchase represents a material right. If so, then the material right would be a performance obligation, meaning that a portion of the transaction price would have to be allocated to the right. Revenue from the material right would be recognized at the earlier of when the purchase right expires or, if exercised, when the underlying good or service is transferred to the customer. The next section of this publication discusses the accounting for material rights in more depth.

1 Refer to Transition Resource Group Memo No. 39, *Application of the Series Provision and Allocation of Variable Consideration*.

2 Refer to Transition Resource Group Memo No. 48, *Customer Options for Additional Goods and Services*, Memo No. 39, *Application of the Series Provision and Allocation of Variable Consideration*, and Memo No. 6, *Customer Options for Additional Goods and Services and Nonrefundable Upfront Fees,* for further information and examples on this topic.

3 The estimate of variable consideration may be based on a most likely amount or an expected value, considering probability-weighted assumptions. The transaction price will then be constrained, or limited, to an estimate of variable consideration for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is subsequently resolved.

EXAMPLE 4: Variable Consideration

Under a contract, Stars Inc. allows astronomers to upload an unlimited number of telescopic images to Stars's proprietary cloud-based platform for a period of one-year. The platform will analyze the images and perform complex calculations to identify objects that might be newly discovered planets.

Assume that this contract does not fall within the series guidance because the precise services applied to each uploaded image will differ based on the quality of the image and its luminosity.

Stars Inc. charges $1,000 per GB of data processed. The amount of data processed—and the amount charged to the customer each month—varies depending on the number of images submitted by a customer and the quality of those images.

The nature of the promise in this contract is to evaluate the data submitted by the customer. Therefore, when a customer submits images for analysis, the customer is not making a separate purchasing decision. That is, the customer already made its purchasing decision by entering into the contract initially. This means that the fluctuations resulting from the customer's usage of the data analysis services is variable consideration that should be estimated and, subject to the constraint, included in the transaction price.

Stars would have to evaluate the appropriate pattern in which to recognize the transaction price as revenue. For example, Stars may conclude that it should recognize revenue based on the amount of computing processing time incurred during a period, relative to the total estimated amount of computing time it expects to incur in fulfilling its data analysis promise over the term of the contract.

EXAMPLE 5: Optional Purchase

Lab Inc. offers a collaboration platform that allows users to simultaneously work on and save documents in the cloud. Lab charges an annual fee of $1,000 per user.

A customer entered into a one-year contract with Lab, initially for three user licenses. Three months later, the customer requested that a fourth user be added to the contract and paid a pro-rata fee of $750 once the additional user credentials were provided by Lab.

In this fact pattern, the promise in the original contract was to provide the customer with three user licenses to the Lab collaboration platform. Lab is not obligated to provide collaboration services to more than three users unless the customer elected to expand the scope of the contract and pay an additional fee. Subsequently, the customer made a separate buying decision to add the additional user. At that time, the separate purchasing decision to add the fourth user would be accounted for under the contract modification framework, most likely as a new contract since the price of the contract appears to have changed by the standalone selling price of the additional seat license.

SaaS arrangements can be modified in many different ways, some of which may be significantly more complicated than simply adding additional user licenses at standalone selling prices. Practitioners are strongly encouraged to discuss any complex modifications with knowledgeable accounting advisors.

When a contract contains the right to make additional purchases, a SaaS provider must determine whether those purchases represent material rights. A material right results when the SaaS provider offers an optional benefit that the customer would not have received without entering into the contract.

For example, by entering into a contract, a customer might obtain the right to purchase a good or service at a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market.

Practice Point. Material rights commonly arise in SaaS arrangements when the contract includes a price list detailing other goods and services that the customer may purchase, and the pricing for those optional items are at a significant incremental discount. That is, the price list included in the contract provides the customer with discounts that are incremental to the range typically given for those goods or services when sold on a standalone basis to similar classes of customers.

A material right is a performance obligation under ASC 606. It must be allocated a portion of the transaction price based on its relative standalone selling price, although ASC 606 does provide an alternative that SaaS providers can use instead of estimating the standalone selling price of a material right.

Revenue from the material right would be recognized at the earlier of when the purchase right expires or, if exercised, when the underlying good or service is transferred to the customer.

EXAMPLE 6: Material Right

Recall our earlier Example 5, in which Lab Inc. offers a collaboration platform. A customer enters into a contract to purchase three user seats for $1,000 per license.

However, now assume that as part of the contract, Lab will allow the customer to purchase up to three additional user seats for a significantly discounted $600 per license. Lab does not offer this type of discount to similar classes of customers.

Accordingly, the option to purchase additional licenses is a material right. It would be a separate performance obligation and allocated a portion of the $3,000 transaction price (3 licenses x $1,000/license) based on relative standalone selling price. However, ASC 606 allows companies to use an alternative approach to allocating arrangement consideration to a material right. Rather than determining the stand alone selling price of the material right using sophisticated option pricing models, an entity can allocate the transaction price by referencing the goods or services expected to be provided, in this case the additional licenses.

Assume Lab estimates that there is a high likelihood that the customer will purchase three additional licenses. For simplicity, also assume that the discounted pricing is not offered in connection with any renewals of the for the platform seats purchased at discounted pricing. Accordingly, Lab would estimate the transaction price to be $4,800 (3 seats x $1,000 price per seat + 3 seats expected to be purchased upon exercise of the material right x $600). Lab would then allocate $800 to each seat ($4,00 divided by 6). That is, $2,400 would be allocated to the 3 seats purchased at inception and an additional $800 would be allocated to each seat purchased in the future as the options are exercised. If the customer decides not to exercise any of the options, Lab would recognize the revenue upon expiration of the options.

THE ACCOUNTING FOR COMMISSIONS AND OTHER SIMILAR COSTS OF OBTAINING A CUSTOMER CONTRACT

ASC 340-40 requires that incremental costs to obtain a contract be deferred and amortized on a systematic basis consistent with the pattern in which revenue related to the contract is being recognized. However, as a practical expedient, a company may recognize the incremental costs of obtaining a contract as a period expense if the amortization period would have been one year or less.

ASC 340-40 defines the incremental costs of obtaining a contract as those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained. A common example of a qualifying cost is a sales commission payable to a sales agent or employee upon contract signing.

In practice, SaaS providers may sometimes find it challenging to determine the period over which qualifying costs should be amortized and the pattern in which amortization should be recorded.

EXAMPLE 7: Sales Commissions[4]

Generous Provider Inc. (GP) enters into a one-year, $100,000 SaaS contract with a new customer. The contract is renewable on an annual basis for the same $100,000 annual fee.

GP has a single salesperson, who is entitled to a 5% commission on contract signing. The salesperson will also receive a smaller 1% commission if the contract is subsequently renewed. The difference in the commission rates stems from GP's belief that the level of effort necessary to obtain a renewal is far less than initially entering into a new contract.

In situations where commissions paid at inception of a customer contract exceed those paid upon contract renewal, careful consideration should be given as to whether GP may apply the practical expedient of immediately recording the incremental commission payments as a period expense. The FASB staff indicated that the "level of effort" to obtain a contract or renewal should not factor into determining

4 Refer to Transition Resource Group Memo No. 23, *Costs to Obtain a Contract,* and Memo No. 57, *Capitalization and Amortization of Incremental Costs of Obtaining a Contract,* for further information and examples.

whether the commission paid on a contract renewal is commensurate with the initial commission. Instead, a renewal commission is commensurate with an initial commission if the two commissions are reasonably proportionate to the respective contract values (e.g., both are 2% of the amounts invoiced to customers). If a contract does not contain commensurate commissions, the initial commission may relate to a contract period beyond the initial term of a customer contract.

In this example, the initial and renewal commissions are not commensurate. Accordingly, GP would not qualify for the practical expedient. Instead, GP would defer and amortize the initial commissions. The amortization period should consider both the initial contract term and any expected renewals. In practice, estimating future contractual renewals is highly judgmental and should consider factors such as historical renewal rates, expected obsolescence of the underlying software platform, and anticipated changes in technology, competition, and other economic factors. SaaS providers may find it appropriate to estimate the amortization period using a portfolio of similar contracts.

Practice Point. When determining the amortization period, preparers of financial statements should consider whether the customer relationship life, based on historical attrition, is longer than the technology life cycle for the underlying product. If the cumulative technology changes to the product being renewed are expected to be significant, the amortization period should be based on the shorter product life cycle, rather than the customer relationship period.

For purposes of this example, assume that GP determines that the contract will be renewed four times. The pattern in which amortization is recorded should be proportionate to the revenues recognized over that period. In this example, revenues from the contract will be recognized in a consistent amount of $100,000 per year, even during the renewal periods. Therefore, any deferred costs should be recognized on a similar straight-line basis.

In aggregate, GP anticipates paying commissions of $9,000 [$5,000 initial commission + (4 years x $1,000 renewal commissions)]. Accordingly, GP would record $1,800 of commission expense per annum ($9,000 / year anticipated amortization period). GP would record the initial $5,000 commission payment as a deferred cost, and would amortize $1,800 of that deferred cost in the first year of the contract. GP would then amortize $800 of the remaining balance each year for the next four years; that amount, added to the $1,000 of commissions paid in each renewal period, would result in a total $1,800 of commission expense each year.

Practice Point. Other approaches for amortizing the commission costs may be acceptable, provided they comply with the principles in ASC 340-40.

HOW BDO CAN HELP

BDO is well-equipped to help preparers navigate the myriad of complex accounting, SEC reporting, tax, and audit considerations needed to be addressed by SaaS providers as they determine the proper accounting for revenue. BDO professionals have a wealth of experience working with "best in class" SaaS providers. By leveraging our extensive experience with companies of all sizes across a wide range of industries, we have the ability to offer a comprehensive range of services to assist and complement your internal accounting functions through a collaborative and tailored approach.

For more information, contact one of the individuals listed on the next page.

People who know Technology, know BDO.

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ABOUT THE TECHNOLOGY PRACTICE AT BDO USA, LLP

BDO has been a valued business advisor to technology companies for over 100 years. The firm works with a wide variety of technology clients, ranging from multinational Fortune 500 corporations to more entrepreneurial businesses, on myriad accounting, tax and other financial issues.

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