THE STANDARD STANCE

Software Industry: Decoding Top Challenges in Revenue Recognition

Volume 6
January 2024

BDO

SOFTWARE INDUSTRY: DECODING TOP CHALLENGES IN REVENUE RECOGNITION

A software entity applies Ind AS 115 Revenue from Contracts with Customers to recognise revenue from a contract with a customer. The revenue recognition guidance under Ind AS 115 is industry agnostic. However, software entities face unique challenges in applying certain aspects of the guidance because of the judgements inherent in applying the guidance, the unique nature of software products and the continuous evolution of the software industry in terms of software products or pricing practices.

This publication summarises ten common challenges a software entity has to deal with for appropriate revenue recognition. The management would need to apply professional judgement based on facts and circumstances as they apply the accounting guidance in accordance with Ind AS 115.

Whether licensing or SaaS?

Instead of selling a software license and related services to the customer, a software entity might make the same software functionality available to the customer as a software-as-a-service (SaaS) arrangement. Nowadays, it is also quite common for software entities to enter into 'hybrid cloud' arrangements, whereby they offer both a license to on-premises software and cloud-based services (such as SaaS) to their customers.

A software entity must determine whether it has granted a software license (if it is distinct) or is just providing SaaS to its customers. A software license establishes a customer's rights over the intellectual property (IP) of a software entity. Hybrid cloud arrangements will require an understanding of the standalone functionality of each of the promised goods or services in the arrangement and the degree to which one affects the other in determining whether a license is distinct.

Examples of licenses that are not distinct from other goods or services promised in the contract could be (a) a license that forms a component of tangible goods and is integral to the functionality of the goods, or (b) a license that the customer can benefit from only in conjunction with a related service, for example, an online service provided by the software entity that enables, by granting a license, the customer to access content.

A software entity recognises revenue from licenses of IP in accordance with the licensing guidance, which is incremental to the general five-step revenue recognition model. The licensing guidance does not apply to SaaS, and a software entity recognises revenue from SaaS arrangements in the same manner as revenue from any other services under the five-step revenue recognition model.

Free trials — Does a contract exist?

A software entity may offer certain free services (e.g., SaaS) for a limited period during which a customer can try the services and decide whether to purchase them for a longer term. During the trial period, the customer can opt out of the free trial at any time or decide to accept the offer and purchase the services for a longer term.

Accounting for the services provided during the free trial period depends on whether and when the customer accepts the software entity's offer and purchases the services for a longer term. A contract with a customer does not exist until the customer accepts the software entity's offer to provide services after the free trial period in exchange for consideration.

For example, a software entity provides SaaS services and offers a free trial period of three months. The customer can decide to obtain the entity's SaaS services for 12 months (after the free trial period) at a price of Rs. 10 lakh at any time during the trial period. If the customer contracts for the SaaS services for 12 months during the trial period (say, the beginning of the third month), then the services provided during the remainder of the free trial period (i.e., one month in this case) and the term beginning after the end of the free trial period (i.e., 12 months) are considered in determining the performance obligations in that contract. Therefore, in this case, the entity's performance obligation is to provide SaaS services for Rs. 10 lakhs over a period of 13 months. The services provided in the free trial period before the customer accepts the offer (i.e., two months in this case) are accounted for as sales incentives.

What is the contract term?

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.

A software entity must carefully evaluate substantive termination provisions (termination rights, termination penalties, or other payments) in a contract with a customer and its customary business practices to determine whether the duration for which enforceable rights and obligations exist is shorter or longer than the contractually stated term. Determining what constitutes a termination penalty and whether the termination penalty is substantive requires the application of professional judgement, based on the facts and circumstances.

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.

For example, a software entity enters into a contract to provide SaaS to one of its customers at a monthly price (payable at the beginning of the month), which increases every month based on changes in the consumer price index. The contract may be terminated at the end of each month by either party without any penalty. In this case, the contract term would be limited to one month (and the transaction price will be determined for one month only) and a new contract will arise once each party forgoes its termination right for that period.

What are the performance obligations in the contract?

It is crucial for a software entity to appropriately identify the performance obligations to correctly recognise revenue from a contract with a customer because each performance obligation is a separate unit of account for determining when and how much revenue to recognise.

To identify performance obligations, a software entity first identifies, at contract inception, all the promised goods or services in a contract with a customer, e.g., a software license, SaaS, professional services, post-contract customer support (PCS), specified updates/ upgrades or additional product rights. Promised goods or services may be explicitly identified in the contract or implied by the entity's customary business practices.

After identifying the promised goods or services in the contract, a software entity determines which of those are 'distinct' and, hence, represent separate performance obligations. If any of those is not distinct, the entity must combine them with other promised goods or services until a bundle of goods or services that is distinct can be identified.

The above guidance can be illustrated with the following examples:

- **Software and professional installation services**

  A software license and professional services for significant customisation or modification of that software will generally not be distinct from each other; therefore, they will be accounted for as a single performance obligation. Conversely, a software license and non-complex implementation services will generally be distinct from each other and accounted for as separate performance obligations; this is especially true if alternative providers can perform the services.

- **Software and technical support**

  Software license, technical support and rights to unspecified updates, upgrades or enhancements are usually distinct from each other, even if the technical support and the right to unspecified updates, upgrades or enhancements are mandatory. However, in certain cases, a software license may not be distinct from a right to unspecified updates, upgrades or enhancements if those updates are critical to the customer's ability to derive benefit and value from the license (e.g., an anti-virus software license). In those cases, the software and the right to the unspecified items would likely be a single performance obligation.

- **Additional software products**

  In SaaS arrangements, judgement will be required to determine whether a promise to provide additional or upgraded functionalities is an additional promised service, or merely part of providing the ongoing SaaS – e.g., keeping the hosted application current and relevant. An important part of that judgement might be whether the promised functionalities are significantly different, significantly improved and/ or independent from the original functionalities.

- **Customer options (for example, a renewal right)**

  A software entity may grant its customer an option that allows the customer to purchase additional goods or services as part of or in conjunction with a contract. For example, a software entity may sell a one-year software license to a customer and give the customer the option for annual renewals. A customer option for future goods or services represents a material right to the customer and hence a performance obligation in the contract if the option gives a material right to the customer that it would not receive without entering that contract (e.g., an additional discount on renewals). Conversely, if the option allows the customer to acquire additional goods or services at a price that would reflect the standalone selling price for those goods or services, that option would not be expected to provide the customer with a material right.

  Thus, we can see that given the assortment of product offerings and pricing models in the software industry, identifying performance obligations for revenue recognition is often complex. Nuanced differences in the facts and circumstances of each arrangement could lead to different conclusions for arrangements that may appear similar on the surface.

Determining whether SaaS is a 'stand-ready' obligation.

A software entity must carefully assess the nature of its

promise to determine whether it has promised to deliver a specified volume of services (i.e., a series of distinct services or usage) or stand ready to perform as the customer requests (i.e., a series of distinct time increments). Determining whether a SaaS subscription is a stand-ready obligation requires the application of professional judgement, based on the facts and circumstances on a case-to-case basis.

To assess the nature of its promise, a software entity may consider the following factors:

- Whether the customer benefits from the right to access the SaaS platform in the amount and at the time as needed. In other words, whether the software entity stands ready to perform throughout the contract duration.

- Whether the software entity can pre-determine the timing and volume of transactions, and its performance is dependent upon events or circumstances that are outside its control (e.g., because the customer controls when and how much to use the service).

- Whether the software entity stands ready to process unlimited transactions or whether the software entity's obligation to the customer diminishes as the customer uses the services.

If the nature of the entity's promise is to provide a specific volume of services, revenue is typically recognised when (or as) those services are provided. On the other hand, if the nature of the entity's promise is to stand ready to provide the SaaS, there are additional considerations related to applying the series guidance, determining an appropriate measure of progress, and determining how variable consideration is to be recognised.

How are administrative or set-up activities accounted?

A software entity may perform certain initial administrative or set-up activities when selling a software license or SaaS to a customer. Activities performed to fulfil a contract that do not transfer goods or services to the customer are not considered promised goods or services in a contract, even though those activities are required to successfully transfer the goods or services for which the customer has contracted. Thus, no revenue should be recognised for fulfilling such activities (even if the contract allows such costs to be billed separately). Revenue will only be recognised when (or as and when) the control over the identified promised goods or services is transferred to the customer. However, the software entity should consider whether the costs incurred for such activities should be capitalised as per the guidance on costs to fulfil a contract.

For example, initial account set-up activities may be necessary for the customer to access the hosted software to derive the benefits of a SaaS subscription. In that case, these activities do not directly transfer additional services to the customer, and hence, are not separate promises. Conversely, a software entity may perform certain services upfront that provide incremental benefits to the customer (i.e., benefits beyond granting the software license or access to SaaS). For example, a software entity may provide data migration services to migrate historical data from a customer's existing systems to its SaaS platform.

Professional judgement will be required in some cases to distinguish promised goods or services from administrative tasks or set-up activities.

Whether a significant financing component exists?

A software entity needs to consider whether a significant financing component exists in the contract, especially where the contract includes extended payment terms. A significant financing component does not exist, however, when the difference between the promised consideration and the cash selling price arises for reasons other than financing.

Similarly, where a customer pays in advance for PCS or SaaS (and that prepayment relates to a service period greater than one year), the entity will also need to consider whether a significant financing component exists. In this regard, the entity considers whether there is a valid business reason for the advance payment other than the provision of financing and, if not, whether the financing component is 'significant' to the contract.

The presence of a significant financing component in both the above situations would affect the amount of revenue to be recognised by the entity under the contract, with an offsetting amount of interest income (deferred payment terms) or interest expense (advanced payment terms).

Determining principal or agent.

It is common for software entities to distribute software or SaaS through a reseller (intermediary). From the entities' perspective, they must assess whether the intermediary or the end customer is the entities' customer:

- If the intermediary is the entity's customer, the entity will recognise as revenue the amount it receives from the intermediary. The entity's revenue does not reflect any subsequent increase or decrease in the price the intermediary charges to the end customer.

- If the end consumer is the entity's customer, the entity 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 it is the principal or agent in transferring the goods or services to the end customer:

- If the intermediary is the principal in transferring the goods or services to the end customer, the intermediary will recognise as revenue 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, being the commission, they receive, in revenue.

Each of the distinct goods or services in the arrangement should be assessed separately. Ind AS 115 includes indicators and examples to assist with the analysis.

How is the transaction price allocated?

Software entities often sell software licenses bundled with other goods or services, such as PCS. Ind AS 115 requires an entity to allocate the transaction price to the performance obligations based on their relative standalone selling prices (SSP). SSP is the price at which an entity would sell the promised goods or services separately. The best evidence of SSP is an observable price when the goods or services are sold on a standalone basis. An entity should consider its pricing policies and practices, and data used in making the pricing decisions, maximising the use of observable inputs.

The requirement to determine estimated standalone selling prices for each performance obligation in the contract will be challenging for many entities that do not sell their software-related elements on a standalone basis.

When is the revenue recognised?

A performance obligation is satisfied, and revenue recognised, when control of the promised goods or services is transferred to the customer. A customer obtains control of the goods or services if it can (1) direct the use of and (2) obtain substantially all the remaining benefits from those goods or services.

Revenue attributable to a software license that is a separate performance obligation will be recognised either at a point in time, or over time, depending on whether the nature of the vendor's promise in transferring the license to the customer is to provide that customer with either:

- Right to use — A right to use the software entity's IP as it exists at the point in time at which the license is granted.
- Right to access — A right to access the software entity's IP throughout the license period or its remaining economic life, if shorter.

If a software license is not a separate performance obligation (e.g., the software license is combined with professional services), or in the case of SaaS arrangements, the entity will apply the general revenue recognition model to determine whether the performance obligation should be recognised over time or at a point in time; and, if recognised over time, what should be the appropriate measure of progress.

CONTACT US

For any content related queries, you may write in to accountingadvisory@bdo.in

For any other queries or feedback, kindly write to us at marketing@bdo.in

Ahmedabad | Bengaluru | Chandigarh | Chennai | Coimbatore | Delhi | Goa | Hyderabad | Kochi | Kolkata | Mumbai | Pune