KPMG

Revenue for the software and SaaS industry

The new standard's effective date is coming.

US GAAP

November 2016

kpmg.com/us/frn

Revenue viewed through a new lens

Again and again, we are asked what's changed under the new standard: what do I need to tweak in my existing accounting policies for revenue? It's just not that simple.

The new standard introduces a core principle that requires companies to evaluate their transactions in a new way. It requires more judgment and estimation than today's accounting and provides new guidance to determine the units of account in a customer contract. The transfer of control of the goods or services to the customer drives the amount and pattern of revenue recognition; this is a change from the existing risks and rewards model. As a result, there will be circumstances in which there will be a change in the amount and timing of revenue recognition.

Less has been said about disclosures, but the new standard requires extensive new disclosures.

Read this to understand, at a summary level, *some* of the most significant issues for the software and software-as-a-service (SaaS) industry – the issues that you should be considering now.

Stay tuned for our forthcoming detailed guidance on the accounting for software and SaaS arrangements under the new standard.

What's inside

Is there a software license?

Whether the customer obtains a software license affects the guidance that the entity will apply in accounting for the arrangement.

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 through a cloud computing arrangement.

Under current US GAAP, a software license is present in a cloud computing arrangement only if the following criteria are met:

— the customer has the contractual right to take possession of the software from the entity at any time without significant penalty; and

— it is feasible for the customer to host the software independent of the software entity – e.g. to host the software themselves or in a third party's environment.

If not, the entire arrangement is a service arrangement. In our experience, most cloud computing arrangements are accounted for as service contracts today.

The new standard applies the same tests as current US GAAP to determine if a contract with a customer includes a software license. As a result, entities will likely reach similar conclusions for cloud computing arrangements about whether the contract includes a software license.

Under the new standard, whether the customer obtains a software license affects the guidance that the entity will apply in accounting for the arrangement. If a software license is not granted (i.e. the arrangement is for SaaS), the licensing implementation guidance does not apply, including the specific guidance on sales- or usage-based royalties promised in exchange for a license.

Instead, the entity applies the general revenue model to determine the recognition of revenue for SaaS arrangements. Application of the general revenue model will result in a time-based, ratable recognition of fixed fees in those arrangements. The accounting for variable consideration (e.g. transaction-based fees) is discussed under **Sales- or usage-based royalties**.

Some contracts will include both software licensing elements subject to the licensing implementation guidance and SaaS elements subject to the general revenue model.

Performance obligations

A software company's determination of the performance obligations in the contract may accelerate software license revenue recognition compared with current US GAAP.

Under the new standard, an entity accounts for the performance obligations in the contract – i.e. the performance obligation is the unit of account for revenue recognition.

To determine the performance obligations in a contract, an entity first identifies the promised goods or services – e.g. a software license, SaaS, professional services, post-contract customer support (PCS), or specified upgrade or additional product rights. These may be promised to the customer explicitly or implicitly (e.g. by the entity's customary business practices), and/or promised to the customer's customers (e.g. a promise to provide technical support or unspecified upgrades to customers that purchase the entity's software from a reseller).

Promised goods or services do not include administrative or other activities that an entity undertakes to set up a contract; for example, certain SaaS installation or activation activities or a promise to provide additional copies of a delivered software application that is not a promise to deliver additional licenses might not transfer a promised good or service to the customer. Judgment will be required in some cases to distinguish promised goods or services from administrative tasks or set-up activities. However, an entity's identification of the promised goods or services in a software or a SaaS arrangement is likely to be similar to that under current US GAAP in most cases.

Once an entity identifies the promised goods or services, it then determines whether they are distinct from each other. Under the new standard, two or more goods or services (e.g. a software license and professional services or PCS, or SaaS and professional services) are distinct from each other, and therefore separate performance obligations, when they are *not* in effect inputs to a single combined item that is the object of the contract.

In making this determination, an entity considers factors such as whether:

— it is providing a significant integration service (using its expertise to create a combined output using the promised goods or services as inputs);

— one good or service significantly modifies or customizes the other;

— the goods or services are highly dependent on, or highly interrelated with, each other.

Unlike current US GAAP for software licensing arrangements, vendor-specific objective evidence of fair value (VSOE) does *not* factor into an entity's determination of the performance obligations in the contract. In many cases, this difference will accelerate software license revenue recognition compared with current US GAAP. For example, a software license is separable from PCS under current US GAAP only if the entity has VSOE for the PCS (as well as for any other undelivered elements in the contract). VSOE is established for PCS based on stand-alone sales (e.g. stand-alone PCS renewals).

Software/SaaS and professional services

Consistent with current US GAAP, an on-premise software license and significant customization 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, but not exclusively, the case if the services can be performed by alternative providers.

However, judgment may be required in assessing whether a software license and professional services are separate performance obligations in other circumstances. The new standard may result in combining a software license and services even when the services are not essential to the software's functionality. For example, some entities may conclude that services are not distinct from the software license when they do not customize or modify the software, but nonetheless are more complex in nature (e.g. complex interfacing), proprietary and integral to the customer's ability to derive substantive benefit from the software.

The considerations for a SaaS arrangement that includes professional services will be similar to those for on-premise software licensing arrangements. SaaS entities will also need to evaluate whether up-front activities are a promised service to the customer or merely set-up activities. Set-up activities, which can range from simply 'activating' the customer to other activities performed by the SaaS provider that enable the customer to access the SaaS from its IT platform, are activities that do not provide incremental benefit to the customer beyond that which the customer receives from access to the hosted application.

Software and PCS

Software licensing arrangements often include PCS. This includes the right to receive technical support services and/or unspecified upgrades and enhancements. Current US GAAP treats PCS as a single element.

Under the new standard, the components of PCS (e.g. technical support and rights to unspecified updates or upgrades/enhancements) will typically be distinct from each other, and therefore separate performance obligations. However, if they are provided over the same period and have the same pattern of transfer to the customer – e.g. if they are both stand-ready obligations satisfied ratably over the PCS period – a software entity could account for both elements as if they were a single performance obligation.

In most cases, software, technical support, and rights to unspecified updates or upgrades/enhancements (or rights to unspecified additional software products) will be distinct from each other, even if the technical support and the right to unspecified updates or upgrades/enhancements is mandatory. However, the new standard illustrates that, in *limited* fact patterns, a software license may not be distinct from a right to unspecified updates or upgrades/enhancements (or unspecified additional software products) if those updates are critical to the customer's ability to derive benefit and value from the license (e.g. in an anti-virus scenario). In those limited cases, the software and the right to the unspecified items would be a single performance obligation.

Specified upgrades or additional software products

What constitutes a specified upgrade or an additional software product is not expected to change substantively from current US GAAP, including the effect of product roadmaps on determining whether a specified upgrade or enhancement has been implicitly promised to the customer.

However, the elimination of the current VSOE requirement for undelivered items in a contract means that entities will no longer be required to defer substantially all of the revenue in the contract until any specified upgrades or additional software products are transferred to the customer, as is typical under current US GAAP. This is because specified upgrades and specified additional product rights will generally be distinct from the original software license and other elements (e.g. technical support or unspecified upgrade/additional product rights) in a software licensing arrangement.

In SaaS arrangements, judgment 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 judgment might be whether the promised functionalities are significantly different, significantly improved and/or independent from the original functionalities.

Hybrid SaaS/Cloud arrangements

It is increasingly common for arrangements to include both an on-premise software element and a SaaS element – e.g. an on-premise software application and a SaaS application or a SaaS application with an 'offline' mode. In many cases, those two elements will be distinct, but in others they will not.

If the customer cannot derive benefit from its right to use the on-premise software without the SaaS element, or can only derive an insignificant portion of the benefit the customer would be able to obtain from using the on-premise software together with the SaaS element, the on-premise software license is not distinct from the SaaS element.

When the on-premise software and the SaaS element each have substantive functionality, a key consideration in deciding whether the two elements are distinct may be whether the two elements are *transformative* to each other rather than merely *additive* to each other.

Transformative means that the two elements together provide a combined functionality, or utility that is greater than or different from the aggregate functionality or utility of the elements independently. For example, if the customer obtains a license to a software product and access to a SaaS element, the two elements would generally be distinct from one another if the combined functionality is merely the aggregate of the two elements' individual functionalities. Alternatively, the software and SaaS elements would generally not be distinct if the combination of the two elements results in incremental or changed functionalities that don't exist in either the software or the SaaS element separately, or if the combination of the elements produces a significantly enhanced level of functionality that is greater than the aggregate of the two elements' individual functionalities.

If the on-premise software and the SaaS element are transformative to each other, rather than merely additive, we would generally conclude that the two elements are not distinct from each other and account for the combined item as a service arrangement, rather than as a license.

Determining stand-alone selling price

VSOE is no longer the only basis for allocating contract revenue.

Software entities often agree to provide more than one software license or a combination of software licenses and services to a customer in an arrangement. Multiple-element arrangements may include licenses to additional software products, specified upgrades or enhancements, PCS or other services. Under current US GAAP for software licensing arrangements, revenue is allocated between contract elements on the basis of VSOE; and typically to separate license elements on a residual basis.

Under the new standard, the transaction price is allocated to the performance obligations based on the stand-alone selling price of the goods or services underlying each performance obligation. If VSOE (or another observable stand-alone selling price) does not exist for a performance obligation, the entity estimates the stand-alone selling price.

For many software entities that have VSOE for their software-related elements (e.g. PCS or professional services), this may not result in a significant change; this is principally because the new standard permits use of a residual approach to determine the stand-alone selling price for performance obligations (or bundles of performance obligations) that are sold at widely varying or uncertain prices (e.g. enterprise software licenses) when the other elements of the contract have observable prices.

However, the requirement to determine estimated stand-alone selling prices for each performance obligation in the contract will be challenging for many other entities that either:

— do not sell their software-related elements on a stand-alone basis – e.g. their PCS is co-terminus with their term software licenses; or

— have multiple software licenses – e.g. licenses to multiple software products or a license and one or more specified upgrades – in their contracts that are not transferred to the customer at the same time.

Customer options

A customer option may be an additional performance obligation. However, distinguishing a contractual option from a usage-based fee will require judgment.

Software entities may provide a customer option to acquire additional goods or services (including new software licenses or additional licenses of previously delivered software). Under current US GAAP, a customer option to purchase additional copies (or seats, users, etc.) of products licensed by and delivered to the customer under the same arrangement is not subject to the guidance for a significant, incremental discount.

In contrast, under the new standard, a customer option is an additional performance obligation if it provides the customer with a 'material right' that the customer would not have received without entering into the contract – e.g. a discount unavailable to customers that had not entered into a similar contract with the entity.

Distinguishing a contractual option to acquire additional licenses of a previously delivered software product from a usage-based fee will require judgment in many cases. The following should be distinguished:

— an option to acquire additional rights to use the software (e.g. increased capabilities), the acquisition of which constitutes an additional purchasing decision by the customer and requires the entity to grant those additional rights; versus

— a customer's exercise of rights that it already controls (e.g. processing transactions using the licensed software) for which the consideration is variable (i.e. in the form of a usage-based fee).

Timing of revenue

Revenue from licenses

A software license is subject to the new licensing guidance. If a license is not distinct, an entity considers the licensing guidance in applying the general revenue recognition model to the performance obligation that includes the license.

The new standard divides intellectual property (IP) into two categories.

— ***Functional IP*** has significant stand-alone functionality – e.g. the ability to process a transaction, perform a function or task, or be played or aired. Functional IP derives a substantial portion of its utility (i.e. its ability to provide benefit or value) from its significant stand-alone functionality. The new standard states that software is functional IP, along with biological compounds or drug formulas, completed media content (e.g. films, television shows or music) and patents underlying highly functional items.

— ***Symbolic IP*** does not have significant stand-alone functionality, and therefore substantially all of the utility of symbolic IP is derived from its association with the licensor's past or ongoing activities. Symbolic IP includes brands, trade names such as a sports team name, logos and franchise rights.

Revenue attributable to a software license *that is a separate performance obligation* is recognized at the point in time that the customer obtains control of the license. A customer does not obtain control of a software license before the later of (1) the point in time the customer is provided a copy of the software (or one is made available) and (2) the beginning of the license period.

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

Electronic delivery

A copy of the software has been provided (or otherwise made available) to the customer when the customer:

— takes possession of the software via download;

— has been provided with the access code (or key) that allows the customer to take immediate possession of the software; or

— has the right to request such access code (or key) at any time and the transfer of such key is effectively administrative or perfunctory.

In a hosting arrangement that includes a software license, control of the license will generally be considered to have been transferred to the customer at the point in time that the hosting services commence.

License renewals

Consistent with revenue attributable to an initial software license, revenue attributable to a software license renewal cannot be recognized before the beginning of the renewal period. This is a change from current US GAAP under which revenue attributable to a software license renewal is recognized when the renewal is agreed to by the parties (as long as the other revenue recognition requirements are met).

The timing of revenue recognition for unspecified software updates or upgrades/enhancements and professional services will be similar to today.

Rights to unspecified software updates or upgrades/enhancements

Software entities often provide unspecified upgrades/enhancements to customers on a when-and-if available basis as long as the customers have purchased PCS.

Under current US GAAP, the unspecified upgrade/enhancement right is not considered to be a separate element of the arrangement; instead, it is deemed to be part of the PCS. The portion of the fee allocated to PCS is generally recognized ratably over the term of the PCS arrangement.

Under the new standard, a promise to provide unspecified updates or upgrades/enhancements (or unspecified additional software products) is generally a stand-ready obligation to provide those items on a when-and-if available basis that is satisfied ratably over the PCS period. However, an entity's customary business practice of fulfilling its promise to provide updates or upgrades/enhancements at specific points in time during the PCS period (e.g. regularly providing one updated release each year) might suggest the underlying nature of the entity's promise is not a stand-ready obligation satisfied over time, but rather a promise to deliver an implied number of updates or upgrades/enhancements at discrete points in time during the contract period.

Professional services

Software arrangements often include both software and service elements (other than PCS-related services). The services may include training, installation and/or consulting. Consulting services often include implementation support, software design or development, or the customization or modification of the licensed software.

Under current US GAAP, revenue allocated to a service element that qualifies for separate accounting is recognized as services are performed; or, if no pattern of performance is discernible, on a straight-line basis over the period during which the services are performed.

Under the new standard, entities must meet one of three criteria to recognize revenue over time; if none of those criteria are met, recognition occurs at a point in time. Entities providing professional services in SaaS or software licensing arrangements, either as a separate performance obligation or part of a combined performance obligation, will find in most cases that professional services meet at least one of the over-time recognition criteria.

Sales- or usage-based royalties

Sales- or usage-based fees promised in exchange for a software license will typically not be subject to the general guidance on variable consideration. However, exceptions may arise if the royalty is also promised in exchange for other goods or services.

Sales- and usage-based royalties in a software licensing arrangement

The new standard contains an exception to the general guidance on variable consideration for sales- or usage-based royalties that are (1) promised solely in exchange for a license of IP, or (2) promised in exchange for a license of IP and other goods or services when the license is the *predominant* item to which the royalty relates. The new standard states that the license may be the predominant item "when the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates".

Fees earned from the royalty in either of these cases are recognized at the later of when the subsequent sales or usage occurs, and the satisfaction or partial satisfaction of the performance obligation to which the royalty relates.

In most cases, fees earned from a sales- or usage-based royalty promised in exchange for a software license that is a separate performance obligation will be recognized when the subsequent sales or usage occur. However, exceptions *may* arise if the royalty is also promised in exchange for other goods or services, regardless of whether the software license is distinct. In addition, any guaranteed royalties (e.g. a fixed minimum amount) are accounted for as fixed consideration and will be recognized in the same manner as any other fixed consideration in the contract.

Royalty reporting on a lag no longer permissible

Under current US GAAP, some software entities recognize sales- or usage-based royalties on a lag basis – i.e. they recognize revenue in the period subsequent to that in which the sales or usage occur because they do not receive reporting about the royalties that the customer owes until the subsequent period.

Under the new standard, lag reporting is not permitted. If subsequent sales or usage of the entity's software is not known, it is estimated using a most likely or expected value approach; that amount is recognized as revenue for the period. The entity will true-up the difference between the estimate and actual royalties earned in the subsequent period.

Usage-based fees in a SaaS arrangement

In a SaaS arrangement, the royalties exception does not apply because the arrangement does not contain a software license. Consequently, the general variable consideration guidance in the new standard applies. Unlike current US GAAP, the new standard neither limits fees that can be recognized to only those that are fixed or determinable, nor precludes the recognition of contingent revenue.

The new variable consideration guidance may require the SaaS provider to make an estimate of the total usage-based fees (e.g. per transaction fees) that it will earn over the course of the contract, subject to the variable consideration constraint, unless:

— the 'as-invoiced' practical expedient can be applied that permits an entity to recognize revenue in the amount to which it has a right to invoice the customer. This applies if that amount corresponds directly with the value to the customer of the entity's performance completed to date. A significant up-front fee or a usage-based fee rate that changes during the contract period in a manner that cannot be directly linked to a change in value of the entity's services to the customer may preclude use of this expedient; or

— the SaaS performance obligation is determined to be a series of distinct service periods (e.g. a series of distinct daily, monthly or annual periods of service), and allocation of the fees earned to each distinct service period based on the customer's usage each period would reasonably reflect the fees to which the entity expects to be entitled for providing the SaaS for that period. Consistent with the as-invoiced practical expedient, a usage-based fee rate that differs from period to period during the contract may prevent allocation of the fees earned in a single distinct service period to that period, as might a discount or rebate that is based on metrics that cross multiple distinct service periods. However, unlike the as-invoiced practical expedient, an up-front fee generally will not affect whether this condition is met.

Combination of contracts

Whether multiple contracts are combined for software and SaaS entities will be similar to current US GAAP in most cases.

Software entities may include multiple promised goods or services in separately executed contracts with the same customer. Under current US GAAP, a question arises as to whether the separate contracts should be accounted for individually as distinct arrangements or whether the separate contracts are, in substance, a multiple-element arrangement subject to the revenue allocation provisions.

Under the new standard, entities are required to combine contracts if (1) the contracts are entered into at or near the same time with the same customer (or related parties) and (2) any one of three criteria is met:

— the contracts are negotiated as a package with a single commercial objective;

— the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or

— the goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation.

Although this is similar to current US GAAP, it may result in some different conclusions about whether multiple contracts are combined for software and SaaS entities.

Comparison to current software revenue guidance

Current software revenue guidance evaluates whether two or more contracts between an entity and a customer should be combined and accounted for as a single arrangement based on six indicators. Some of the indicators are similar to the criteria under the new standard – e.g. one of the indicators is that the contracts are negotiated or executed within a short time frame of each other. However, none of the six indicators are determinative, which could lead to differences in practice under the new standard.

Comparison to current guidance applied by SaaS providers

General US GAAP revenue guidance applicable to SaaS providers contains a rebuttable presumption that contracts entered into at or near the same time should be combined. Because the new standard does not contain this presumption and additional criteria must be met, it is possible for entities to come to different conclusions.

Contract costs

Software and SaaS entities will no longer have the choice to expense commissions as incurred if certain criteria are met.

Capitalization of contract costs

Software entities frequently incur either or both:

— costs to obtain a customer contract, including renewal contracts and costs to obtain contract modifications, that are incremental (i.e. would not have been incurred but for obtaining the contract) – e.g. sales commissions and fringe benefits directly attributable to payment of that commission, such as additional 401(k) match or payroll taxes. Costs that are not incremental to obtaining a customer contract are expensed as incurred unless capitalized in accordance with other US GAAP. The following are not incremental costs (not exhaustive):

  - costs that are incurred regardless of whether the contract is obtained – e.g. costs incurred in negotiating or drafting a contract;
  - costs that depend on further performance by the commission recipient, such as continued employment at a future date when all or a portion of the commission will be paid; and
  - payments based on operating metrics like EBITDA or operating income that are not solely linked to obtaining one or more customer contracts.

— costs to fulfill a contract – e.g. costs associated with set-up activities that do not provide a service to the customer in a SaaS arrangement.

Under current SEC guidance, an entity can elect to capitalize direct and incremental contract acquisition costs (e.g. sales commissions) in certain circumstances, although many entities expense such costs as incurred.

In contrast, under the new standard, incremental costs to obtain a customer contract and costs to fulfill a contract that meet specified criteria are required to be capitalized as contract cost assets if they are recoverable. Costs to obtain a contract are not required to be capitalized if the expected amortization period is 12 months or less. An entity electing not to capitalize costs to obtain a contract should apply this practical expedient consistently across all of its business units or segments.

The requirement to capitalize contract acquisition and fulfillment costs will be new to most software entities and some SaaS providers and may be complex to apply, especially for entities with many contracts and a variety of contract terms and commission and incentive structures. And for those SaaS providers that currently capitalize contract acquisition costs, they may find the types of costs that can be capitalized will differ because only costs that are incremental to obtaining the contract are capitalizable – allocable costs are not, unless they meet the criteria to be capitalized as fulfillment costs.

Those entities that have not previously tracked the costs of acquiring a contract may find it difficult to determine which costs to capitalize, both for the transition amounts on adoption (regardless of the transition method used) and in the ongoing application of the new standard.

Amortization and impairment of contract cost assets

Contract cost assets are amortized consistent with the transfer to the customer of the goods or services to which the asset relates, which means that:

— if a contract cost asset relates to two or more goods or services that have a different pattern of transfer to the customer (e.g. one transferred at a point in time and another provided over time), entities should either (1) allocate the contract cost asset to those multiple goods or services on a systematic and rational basis or (2) select a *single* measure that best reflects the *use* of the asset as the goods and services are transferred; and/or

— the entity amortizes a contract cost asset over more than the contract period when the asset relates to goods or services that will be provided under an anticipated contract that the entity can identify specifically. For example, an entity will amortize a commission paid for a service contract over the contract period plus any anticipated renewal periods unless the entity also pays commissions for renewals that are commensurate with the commission paid on initial service contracts. 'Commensurate' refers to the commission paid as compared to the margin the entity will earn.

For those SaaS providers that currently capitalize contract acquisition costs, they may find that the amortization period for those costs changes because of the new standard's requirement to amortize such costs over specifically anticipated renewal periods (in many cases), which precludes the current practice of amortizing such costs over only the non-cancellable contract period.

Contract cost assets are assessed for impairment in accordance with specific guidance in the new standard, which assesses the remaining balance of a contract cost asset against the remaining amount of consideration (including variable consideration) that the entity expects to *receive* from the customer less direct costs to fulfill the related goods or services.

Some other considerations

Extended or advance payment terms

Software entities often enter into arrangements where payment of a signification portion of the license fee is not due until after expiration of the license, or more than 12 months after delivery of the software.

Under current US GAAP, the arrangement fee is presumed not to be fixed or determinable for those arrangements. Unless sufficient evidence exists to overcome this presumption, revenue is generally not recognized until the payments become due and payable.

Under the new standard, extended payment terms do not preclude revenue recognition as long as collectibility of those payments is considered probable and a contract exists between the parties. Instead, such terms may indicate that there is a risk of a future price concession, which might lead to the conclusion that the transaction price is variable. In that case, the entity will need to consider whether it expects to provide a concession, and the transaction price would be subject to the new standard's variable consideration guidance, including the variable consideration constraint.

Where extended payment terms are granted, the entity needs to consider whether a significant financing component exists in the contract. Similarly, where a customer prepays in advance for PCS or a SaaS service (and that prepayment relates to a PCS or SaaS period greater than one year), the entity will also need to consider whether a significant financing component exists – i.e. 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 either situation affects the amount of revenue to be recognized by the entity under the contract, with an offsetting amount of interest income (deferred payment terms) or interest expense (advance payment terms). Whether a significant financing element exists is evaluated at the contract level; it is not assessed at the performance obligation level or in 'aggregate' for the entity.

Discounted or free services

SaaS providers frequently offer customers free or discounted services in return for entering into longer term SaaS contracts – e.g. the customer may receive three free or six discounted months of the SaaS service in return for entering into a three-year contract or may receive discounted implementation services.

Under current US GAAP, arrangement consideration is limited to only non-contingent amounts (often referred to as the 'contingent cash cap'). That means, in a SaaS contract that provides the customer with three free or six discounted months of service or discounted implementation services, revenue recognized as those free or discounted services are provided is limited to amounts that are not contingent on the provision of future services.

In contrast, the new standard does not have a contingent revenue prohibition. Therefore, SaaS providers will generally allocate additional revenue to free or discounted services provided at the outset of the arrangement than they do under current US GAAP, which will accelerate overall revenue recognition under the contract.

Concessions

Software entities may have a history of granting price or other concessions – e.g. free licenses or services. Under current US GAAP, a history of granting price or other concessions means that the arrangement fees are not fixed or determinable. Revenue under arrangements for these entities may be significantly deferred, even beyond the point at which cash is received, and is recognized only once the arrangement consideration is deemed to be fixed or determinable.

Under the new standard, because the fixed or determinable notion does not exist, a history of price or other concessions will not result in the complete deferral of revenue. Instead:

— An expectation, based on relevant history or otherwise, of a price concession creates variability in the transaction price for a contract. The existence of variable consideration does not affect the timing of revenue recognition; instead, it affects the amount of revenue that is recognized when (or as) the entity satisfies its performance obligation(s).

— An expectation of providing free goods or services creates additional performance obligations that are accounted for in the same manner as any other performance obligations in the contract. For example, a history of granting free technical support to customers in periods subsequent to the initial support period likely creates an additional performance obligation in the contract for the expected free support periods; therefore, a portion of the transaction price is allocated to this performance obligation and is recognized when (or as) this performance obligation is satisfied.

If an entity grants a concession that was not anticipated at contract inception, that concession will be accounted for as a contract modification.

Sales through distributors or resellers

Many software products are sold to end customers through distributors or resellers. In that case, the entity may grant price concessions through price protection, or accept returns if the distributor is unable to sell the products.

Under current US GAAP, some software entities that sell through distributors or resellers conclude that the fees for their software sales are not fixed or determinable because of the risk of granting price concessions or of accepting product returns. Those entities recognize revenue upon sell-through of the software to the end customer.

Under the new standard, either an expectation of price concessions or returns is accounted for as variable consideration. And because variable consideration does not affect the timing of revenue recognized from the satisfaction of a performance obligation (only the amount), software entities in distributor or reseller arrangements cannot default to a sell-through method under the new standard.

An entity is required to determine the total amount of consideration to which it expects to be entitled – e.g. the number of units it expects not to be returned and the amount it expects to be entitled to, after any price concessions, for those units – subject to the variable consideration constraint. The entity recognizes that amount at the time control of the good or service transfers to the distributor or reseller. Certain repurchase rights that exist in some distributor relationships – e.g. the right of the entity to buy back a good until the point in time it is sold to an end customer – will affect when control of the good or service transfers.

After control of the good or service transfers, the transaction price is updated each reporting period until the uncertainty for concessions and returns is resolved.

Applicable to all industries

Expanded disclosures

The new standard contains both qualitative and quantitative disclosure requirements for annual and interim periods. The objective of the disclosures is to provide sufficient information to enable users of the financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

Specifically, the new standard includes disclosure requirements for:

— disaggregation of revenue;

— contract balances, including changes during the period;

— performance obligations;

— significant judgments; and

— assets recognized to obtain or fulfill a contract, including changes during the period.

An entity should review these new disclosure requirements to evaluate whether data necessary to comply with the disclosure requirements are currently being captured and whether system modifications are needed to accumulate the data.

Internal controls necessary to ensure the completeness and accuracy of the new disclosures should be considered – especially if the required data was not previously collected or was collected for purposes other than financial reporting.

Also, SEC guidance requires registrants to disclose the potential effects that recently issued accounting standards will have on their financial statements when adopted[1]. The SEC expects the level and specificity of these transition disclosures to increase as registrants progress in their implementation plans. The SEC has also stated, when the effect is not known or reasonably estimated, that a registrant should describe its progress in implementing the new standard and the significant implementation matters that it still needs to address.

Transition

An entity can elect to adopt the new standard in a variety of ways, including retrospectively with or without optional practical expedients, or from the beginning of the year of initial application with no restatement of comparative periods (cumulative effect method).

Entities that elect the cumulative effect method, are required to disclose the changes between the reported results of the new standard and those that would have been reported under current US GAAP in the period of adoption.

For transition purposes, the new standard introduces a new term – completed contract. A completed contract is a contract for which an entity has recognized all or substantially all of the revenue under current US GAAP as of the date of adoption of the new standard. The concept of a completed contract is used when applying:

— certain practical expedients available during transition under the retrospective method; and

— the cumulative effect method coupled with the election to initially apply the guidance only to those contracts that are not complete.

This will require careful analysis particularly where there is trailing revenue after delivery has occurred (e.g. revenue was not fixed or determinable, collectibility was not reasonably assured, royalty arrangements). In those circumstances, the contract would not be considered complete if substantially all of the revenue had not been recognized before adoption. Applying the standard to these types of contracts at transition may result in revenue being pulled into the opening retained earnings adjustment.

Entities should consider the potential complexities involved with calculating the opening retained earnings adjustment and the recast of comparative periods (if any) when planning their implementation. It may be prudent for entities to perform transition calculations before the adoption date to ensure all potential complexities are identified.

Effective dates

Type of entity	Annual reporting periods after
Public business entities and not-for- profit entities that are conduit bond obligators	**December 15, 2017 including interim reporting periods within that reporting period.** Early adoption permitted for annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.
All other US GAAP entities, including SEC registrants that are Emerging Growth Companies	**December 15, 2018 and interim reporting periods within annual reporting periods beginning after December 15, 2019.** Early adoption permitted for annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period or interim reporting periods within the annual period subsequent to the initial application.

1 Staff Accounting Bulletin Topic 11.M.

Some basic reminders

Scope

The guidance applies to all contracts with customers unless the customer contract is specifically within the scope of other guidance – e.g. Topic 944 (insurance), Topic 460 (guarantees).

The new standard applies to contracts to deliver goods or services to a customer. A 'customer' is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

The new standard will be applied to part of a contract when only some elements are in the scope of other guidance.

Step 1: Identify the contract

Contracts can be written, oral or implied by an entity's customary business practices, but must be enforceable by law. This may require legal analysis on a jurisdictional level to determine when a contract exists and the terms of that contract's enforceability.

A contract with a customer is in the scope of the new standard when the contract is legally enforceable and all of the following criteria are met:

— the contract has commercial substance;

— rights to goods or services can be identified;

— payment terms can be identified;

— the consideration the entity expects to be entitled to is probable of collection; and

— the contract is approved and the parties are committed to their obligations.

If the criteria are not met, any consideration received from the customer is generally recognized as a deposit (liability).

Step 2: Identify the performance obligations

Performance obligations do not have to be legally enforceable; they exist if the customer has a reasonable expectation that the good or service will be provided. A promise can be implied by customary business practices, policies or statements.

Performance obligations are the unit of account under the new standard and generally represent the distinct goods or services that are promised to the customer.

Promises to the customer are separated into performance obligations, and are accounted for separately if they are both (1) capable of being distinct and (2) distinct in the context of the contract.

An exception exists if the performance obligations represent a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer over time. A series is accounted for as a single performance obligation.

Step 3: Determine the transaction price

Estimating variable consideration will represent a significant departure from current accounting for many entities.

When determining the transaction price, an entity uses the legally enforceable contract term. It does not take into consideration the possibility of a contract being cancelled, renewed or modified.

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer, excluding amounts collected on behalf of third parties – e.g. some sales taxes. This consideration can include fixed and variable amounts, and is determined at inception of the contract and updated each reporting period for any changes in circumstances.

The transaction price determination also considers:

— **Variable consideration**, which is estimated at contract inception and is updated at each reporting date for any changes in circumstances. The amount of estimated variable consideration included in the transaction price is constrained to the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved.

— **Noncash consideration** received from a customer is measured at fair value at contract inception.

— **Consideration payable to a customer** represents a reduction of the transaction price unless it is a payment for distinct goods or services it receives from the customer.

— **Significant financing components** may exist in a contract when payment is received significantly before or after the transfer of goods or services. This could result in an adjustment to the transaction price to impute interest income/expense.

Step 4: Allocate the transaction price

A contractually stated price or list price is not presumed to be the stand-alone selling price of that good or service.

The transaction price is allocated at contract inception to each performance obligation to depict the amount of consideration to which an entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

An entity generally allocates the transaction price to each performance obligation in proportion to its stand-alone selling price. However, when specified criteria are met, a discount or variable consideration is allocated to one or more, but not all, performance obligations.

The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. Observable stand-alone prices are used when they are available. If not available, an entity is required to estimate the price using other techniques – even if the entity never sells the performance obligation separately.

Step 5: Recognize revenue

An entity must first determine whether a performance obligation meets the criteria to recognize revenue over time.

If none of the over-time criteria are met, revenue for the performance obligation is recognized at the point in time that the customer obtains control of the goods or services.

Control is the ability to direct the use of, and obtain substantially all of the remaining benefits from the goods or services – or prevent others from doing so.

An entity recognizes revenue when it satisfies its obligation by transferring control of the good or service to the customer.

A performance obligation is satisfied ***over time*** if one of the following criteria are met:

— the customer simultaneously receives and consumes the benefits as the entity performs;

— the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or

— the entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

If control transfers ***over time***, an entity selects a method to measure progress that is consistent with the objective of depicting its performance.

If control transfers at a ***point in time***, the following are some indicators that an entity considers to determine when control has passed. The customer has:

— a present obligation to pay;

— physical possession;

— legal title;

— risks and rewards or ownership; and

— accepted the asset.

Customer options

Customer options may be accounted for as performance obligations, resulting in more revenue deferral than under current GAAP.

Revenue is allocated to a customer option to acquire additional goods or services, and is deferred until (1) those future goods or services are transferred or (2) the option expires when it represents a material right. A material right exists if the customer is only able to obtain the option by entering into the sale agreement and the option provides the customer with the ability to obtain the additional goods or services at a price below stand-alone selling prices.

Warranties

Warranties do not have to be separately priced to be accounted for as performance obligations.

Assurance-type warranties will generally continue to be accounted for under existing guidance – i.e. Topic 450 (contingencies). However, a warranty is accounted for as a performance obligation if it includes a service beyond assuring that the good complies with agreed-upon specifications. This could require some warranties to be separated between a service element (deferral of revenue which is then recognized as the services are provided) and an assurance element (cost accrual at the time the good is transferred).

Principal vs. agent

The new standard changes the guidance used to evaluate whether an entity is a principal or an agent. Credit risk is no longer an indicator that an entity is a principal.	An entity identifies each specified good or service to be transferred to the customer, and determines whether it is acting as a principal or agent for each one. In a contract to transfer multiple goods or services, an entity may be a principal for some goods and services and an agent for others. An entity is a principal if it controls the specified good or service that is promised to the customer before it is transferred to the customer. Indicators that an entity has obtained control of a good or service before it is transferred to the customer are having primary responsibility to provide specified goods or services, assuming inventory risk, and having discretion to establish prices for the specified goods or services.

Contract modifications

A general accounting framework replaces specific contract modification guidance for long-term construction- and production-type contracts. However, outside of these arrangements, an entity will find more guidance in the new standard than under current GAAP.	The new standard requires an entity to account for modifications either on a cumulative catch-up basis (when the additional goods or services are not distinct) or a prospective basis (when the additional goods or services are distinct). If any additional distinct goods or services are not priced at their stand-alone selling prices, the remaining transaction price is required to be reallocated to all unsatisfied performance obligations, including those from the original contract.

Contract costs

More costs are expected to be capitalized under the new standard. An entity cannot elect to expense or capitalize. Capitalization is required when the criteria are met.	The new standard provides guidance on the following costs related to a contract with a customer that are in the scope of the new standard: — incremental costs to obtain a contract; and — costs incurred in fulfilling a contract that are not in the scope of other guidance. Incremental costs to obtain a contract with a customer (e.g. sales commissions) are required to be capitalized if an entity expects to recover those costs – unless the amortization period, which may include anticipated contracts or renewals, is less than 12 months. Fulfillment costs that are not in the scope of other guidance – e.g. inventory, intangibles, or property, plant, and equipment – are capitalized if the fulfillment costs: — relate directly to an existing contract or specific anticipated contract; — generate or enhance resources that will be used to satisfy performance obligations in the future; and — are expected to be recovered. An entity amortizes the assets recognized for the costs to obtain and fulfill a contract on a systematic basis, consistent with the pattern of transfer of the good or service to which the asset relates.

The impact on your organization

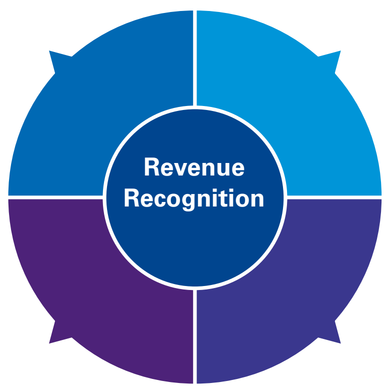
Implementation of the new standard is not just an accounting exercise.

New revenue recognition standard and corresponding accounting changes

- Impact of new revenue recognition standard and mapping to new accounting requirements
- New accounting policies – historical results and transition
- Reporting differences and disclosures
- Tax reporting/planning

Revenue recognition automation and ERP upgrades

- Automation and customization of ERP environment
- Impact on ERP systems
- General ledger, sub-ledgers and reporting packages
- Peripheral revenue systems and interfaces



Financial and operational process changes

- Revenue process allocation and management
- Budget and management reporting
- Communication with financial markets
- Covenant compliance
- Opportunity to rethink business practices
- Coordination with other strategic initiatives

Governance and change

- Governance organization and changes
- Impact on internal resources
- Project management
- Training (accounting, sales, etc.)
- Revenue change management team
- Multi-national locations

As noted in the chart, the new standard could have far-reaching effects. The standard may not only change the amount and timing of revenue, but potentially requires changes in the core systems and processes used to account for revenue and certain costs. Entities may need to design and implement new internal controls or modify existing controls to address risk points resulting from new processes, judgments, estimates and disclosures. The implementation of the new standard will involve a diverse group of parties (e.g. Tax, IT, Legal, Financial Planning, Investor Relations, etc.) and entities should have a governance structure in place to identify and manage the required change. For more information about implementation challenges and considerations, see chapter 14 of KPMG's **Revenue: Issues In-Depth**.

Keeping you informed

KPMG's Financial Reporting Network (FRN) provides a single source for the latest, executive-level financial reporting information, as well as news and activity from standard setters and industry sources – all organized by topic. It has been designed to help executives and accounting professionals stay in front of critical issues in today's evolving financial reporting environment. We not only keep a close watch on the latest financial reporting developments, we report on them and interpret what they might mean for you.

You can find the following and other insightful publications, webcasts, and in-person executive education on FRN.

Visit us at kpmg.com/us/frn

Revenue: Issues In-Depth	Provides you with an in-depth analysis of the new standard, including our additional insights and extensive examples. Additionally, chapter 14 provides implementation considerations. Our Issues In-Depth is supplemented by Defining Issues as new developments occur.
Revenue: Illustrative disclosures	We show how one fictitious company has navigated the complexities of the revenue disclosure requirements.
Revenue: Transition options	This publication will assist you in identifying the optimal transition method.

Contacts

KPMG is able to assist software and SaaS entities as they navigate the adoption of the new standard.

Jana Barsten
Partner – Global and U.S. Technology Audit Leader

3975 Freedom Circle Dr.
Mission Towers I, Suite 100
Santa Clara, CA 95054
Tel: 408-367-4913
jbarsten@kpmg.com

Prabhakar Kalavacherla ("PK")
Partner – Global Revenue Topic Team Leader

55 Second Street, Suite 1400
San Francisco, CA 94105
Tel: 415-963-8657
pkalavacherla@kpmg.com

Brian K Allen
Partner – U.S. Revenue Topic Team Leader

345 Park Avenue
New York, NY 10154
Tel: 212-954-3621
ballen@kpmg.com

Scott A Muir
Partner – Department of Professional Practice

345 Park Avenue
New York, NY 10154
Tel: 212-909-5073
smuir@kpmg.com

kpmg.com/socialmedia