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Technology Spotlight

Recognizing Revenue From SaaS Arrangements

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The Bottom Line

The software revenue recognition guidance in ASC 985-605 is often inapplicable to SaaS arrangements since customers seldom have the ability to take possession of the software at “any time” during the hosting arrangement.

- Cloud computing is a growing sector in the technology industry that offers customers online access to a multitude of Web-based hardware and software solutions.
- Vendors that offer customers access to software in a cloud environment, known as software-as-a-service (SaaS), face challenges in developing an appropriate revenue recognition accounting policy under existing GAAP. While access to SaaS arrangements is generally provided to customers on a subscription basis, additional implementation, training, and other consulting services are often provided to customers in bundled arrangements, which can further complicate the recognition of revenue arising from such arrangements.
- When developing revenue recognition accounting policies for such arrangements, SaaS vendors may need to consider the guidance in SAB Topic 13.A[1] (especially SAB Topic 13.A.3(f) on up-front fees) and the multiple-element revenue recognition guidance in ASC 605-25.[2]
- The software revenue recognition guidance in ASC 985-605 is often inapplicable to SaaS arrangements since customers seldom have the ability to take possession of the software at “any time” during the hosting arrangement.
- Up-front fees related to services that do not have stand-alone value are typically deferred and recognized over the period in which they are earned. Such fees are generally earned over the estimated customer relationship period, which may extend beyond the initial contract term.
- Usage-based fees are generally not considered to be fixed or determinable for purposes of SAB Topic 13.A. Arrangements that have usage-based fees within the scope of TPA 5100.76[3] are generally recognized as earned.

1 SEC Staff Accounting Bulletin Topic 13, “Revenue Recognition” (SAB 101 and SAB 104).

2 For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte’s “Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*.”

3 AICPA Technical Practice Aid 5100.76, *Fair Value in Multiple-Element Arrangements That Include Contingent Usage-Based Fees and Software Revenue Recognition*.

Beyond the Bottom Line

This *Technology Spotlight* highlights certain accounting issues and challenges that entities may need to consider when developing a revenue recognition accounting policy for sales involving a SaaS arrangement.

Background

Cloud computing is a growing sector in the technology industry that encompasses a variety of offerings, including SaaS, platform-as-a-service (PaaS), infrastructure-as-a-service (IaaS), backend-as-a-service (BaaS), and desktop-as-a-service (DaaS). SaaS, PaaS, and IaaS are three of the predominant cloud-based services in the market today. In general, IaaS offers customers access to virtual computer hardware, PaaS delivers a computing platform and network that customers can use to run their own software applications, and SaaS offers customers the use of cloud-based application software and databases.[4]

Customer set-up under SaaS arrangements can generally be established quickly, and billing typically operates on a subscription basis for the duration of the contract.

Because the cloud computing industry is relatively new and rapidly evolving, questions about how to account for SaaS arrangements often arise. Existing accounting standards do not provide revenue recognition guidance that applies specifically to SaaS arrangements. As a result, vendors may need to consider a variety of guidance when developing a revenue recognition accounting policy for a specific SaaS arrangement. The appropriateness of such guidance may depend on factors such as the arrangement's price structure and the deliverables provided.

Existing accounting standards do not provide revenue recognition guidance that applies specifically to SaaS arrangements.

Key Accounting Issues

Determining the Appropriate U.S. GAAP to Apply When Recognizing Revenue From SaaS Arrangements

ASC 985-605-55-121 states that for a software element in a hosting arrangement to be subject to the software revenue recognition guidance in ASC 985-605, the following criteria must be satisfied:

a. The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.

b. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

SaaS arrangements typically provide hosted access to software applications for a subscription-based fee. Although certain aspects of the hosted software can sometimes be configured or customized at the SaaS arrangement's inception, customers seldom can take possession of the software at any time during the hosting period. Therefore, SaaS vendors are often precluded from applying the software revenue recognition guidance in ASC 985-605.[5]

In the absence of other specific guidance, SaaS vendors generally look to SAB Topic 13.A (codified in ASC 605-10-S99-1) when developing accounting policies for their arrangements. SAB Topic 13.A states that revenue should not be recognized until:

- "Persuasive evidence of an arrangement exists."
- "Delivery has occurred or services have been rendered."

[4] This *Spotlight* focuses on the revenue recognition issues associated with SaaS arrangements. Although the principles it discusses may also apply to many other cloud-based arrangements, it may not address all issues related to those services. Cloud computing vendors are encouraged to consult with their accounting advisers to determine the appropriate guidance to apply to their specific arrangements.

[5] Although this publication focuses on the challenges associated with developing accounting policies for arrangements that are outside the scope of the software revenue recognition guidance in ASC 985-605, certain arrangements may still be within the scope of ASC 985-605 and thus could be subject to different accounting treatment under such guidance.

- "The seller's price to the buyer is fixed or determinable."
- "Collectibility is reasonably assured."

The terms and conditions of the subscription arrangement that customers enter into as part of the SaaS arrangement generally serve as evidence of the existence of an arrangement. The price of the SaaS arrangement is often a fixed periodic charge, and collectibility is usually "reasonably assured" since fees are typically paid up front. However, since delivery of the service (i.e., customer access to the software application) takes place over the period of the agreement, revenue is generally recognized over the service period or, in cases involving certain up-front fees, over the customer relationship period (see Accounting for Nonrefundable Up-Front Fees in SaaS Arrangements below).

> Before SaaS vendors begin to recognize revenue, they need to consider the terms and conditions of each of their hosting arrangements and evaluate the revenue recognition criteria in SAB Topic 13.A. Complications may arise in applying these criteria when the consideration is variable or there are doubts about whether the consideration is collectible. The implications of variable or usage-based fees are further discussed in SaaS Services Billed on a Usage Basis below.

Accounting for Multiple-Element SaaS Arrangements

Although the predominant deliverable in SaaS arrangements is generally hosted access to a software application, additional products or services (hereinafter referred to as "services") are often provided as part of those arrangements. The provision of additional services requires SaaS vendors to consider how their accounting for such arrangements could be affected by the guidance in ASC 605-25 on revenue recognition related to multiple-element arrangements. The services provided may include initial set-up to connect a customer to a hosted software application, data conversion or clean-up, training, and software configuration.

The provision of additional services requires SaaS vendors to consider how their accounting for such arrangements could be affected by the guidance in ASC 605-25 on revenue recognition related to multiple-element arrangements.

Identifying Each Separate Unit of Accounting

The first step in accounting for a multiple-element SaaS arrangement is to identify the deliverables in the arrangement and determine whether each of them qualifies as a separate unit of accounting under ASC 605-25-25-5 (in which case, revenue would be allocated to each identified unit of accounting and be recognized separately).

> The term "deliverable" is not defined in ASC 605-25. Therefore, SaaS vendors may need to exercise judgment in identifying elements of a multiple-element arrangement that represent deliverables (whose eligibility for treatment as separate units of accounting under ASC 605-25 can then be assessed). Factors to consider in identifying deliverables in a SaaS arrangement could include whether (1) an item in an arrangement requires a distinct action from the vendor; (2) excluding an item from, or including an item in, the arrangement would cause the arrangement fee to vary by more than an insignificant amount; or (3) the customer considers an item significant or of value separately from other deliverables. SaaS vendors may need to consider these and other factors before reaching a conclusion about the existence of multiple deliverables.

ASC 605-25-25-5 provides that for a deliverable to qualify as a separate unit of accounting, the following criteria must be satisfied:

- "The delivered item or items have value to the customer on a standalone basis. The item or items have value on a standalone basis if they are sold separately by any vendor or the customer could resell the delivered item(s) on a standalone basis. In the context of a customer's ability to resell the delivered item(s), this criterion does not require the existence of an observable market for the deliverable(s)."

- "If the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item or items is considered probable and substantially in the control of the vendor."

In applying these criteria, vendors may need to use judgment to determine whether a delivered item in a SaaS arrangement has stand-alone value. As noted above, stand-alone value exists only if the deliverables "are sold separately by any vendor or the customer could resell the delivered item(s) on a standalone basis."

Because the services provided under most SaaS arrangements take place in a hosted environment and are consumed as delivered, customers are unable to resell such services on a stand-alone basis. In addition, given the intangible nature of the services received, customers do not have a right of return, although they may have the ability to cancel their SaaS subscription under certain circumstances. As a result, vendors typically focus on whether a service provided to a customer can be sold separately in determining whether it has stand-alone value. Determining whether a deliverable has stand-alone value is a critical component in the development of revenue recognition policies for SaaS arrangements. Such a determination could significantly influence the recognition of revenue related to the arrangement and often requires revenue deferral when stand-alone value does not exist.

If a vendor does not sell a particular service separately, it may need to consider the ability of other vendors to do so. Vendors may need to apply significant judgment in assessing whether services sold separately by other vendors could be used in place of their own services. Factors to be considered in evaluating whether other vendors can realistically offer a replacement service include the nature of the services sold, the price charged, the method of delivery, and target customers.

Under ASC 605-25-25-5, stand-alone value exists only if the deliverables "are sold separately by any vendor or the customer could resell the delivered item(s) on a standalone basis."

SaaS vendors may also need to determine whether a service provided affects the customer's ability to access the hosted software application (e.g., when configuration services are required to access a hosted software application). When a hosted software application cannot be used without the fulfillment of a particular service, entities may need to consider whether the service has stand-alone value even though the service and the hosted software application are interdependent. When an entity cannot recover the value of the service independently from the use of the hosted software application, it is often inappropriate to conclude that the service has stand-alone value.

Many SaaS arrangements also involve set-up or "activation" fees, which typically are charged in addition to the subscription fee for the related hosting service. Activation fees generally do not involve the provision of a service other than simply "activating," or permitting a customer to access the hosted software application. Other set-up services may require incremental work before a customer can access the software application. However, vendors need to consider whether the set-up services involved are essential to the functionality of the hosted software application. In many cases, a customer may be unable to access or use the software until the set-up services have been completed. As a result, activation or set-up services are generally not considered to have stand-alone value under ASC 605-25. However, vendors that charge set-up or activation fees should evaluate all of the specific facts and circumstances before concluding whether such services have stand-alone value.

Allocating Consideration to Each Deliverable

Once all units of accounting in a multiple-element arrangement have been identified, the consideration received is allocated to each of those units. ASC 605-25-30-2 requires vendors to allocate the arrangement consideration to each unit on the basis of the units' relative selling price. To determine the selling price of each unit, vendors apply a hierarchy that requires them to use vendor-specific objective evidence (VSOE) if available, third-party evidence (TPE) if VSOE is not available, or their best estimate of the selling price (BESP) if neither VSOE nor TPE is available.

The guidance in ASC 605-25 on allocating consideration to each unit of accounting on the basis of VSOE, TPE, or BESP is broader than previous guidance under U.S. GAAP, which allowed vendors to treat deliverables as separate units of accounting only by using VSOE or TPE of the fair value of each deliverable. The lack of VSOE or TPE of fair value for each deliverable often resulted in combining several deliverables into a single unit of accounting and deferring revenue. The introduction of the requirements that are now codified in ASC 605-25 has allowed many SaaS vendors to recognize revenue for units of accounting that previously would not have been permitted in the absence of VSOE or TPE of the fair value of each unit.

However, while many SaaS vendors have viewed this development favorably, the current guidance may be more challenging to apply. In particular, the determination of BESP (when VSOE and TPE do not exist) may involve the use of significant judgment and estimates. Vendors should consider reviewing all information at their disposal in developing a method for determining BESP (should its determination be required) and ensure that they apply the method consistently. Methods for determining BESP may include applying (1) a margin to estimated costs or (2) valuation techniques that consider market-specific factors. Further, VSOE, TPE, or BESP is determined for each unit of accounting at the commencement of an arrangement and is not revised if changes to those amounts subsequently occur.

Accounting for Nonrefundable Up-Front Fees in SaaS Arrangements

In accounting for nonrefundable up-front fees charged for additional services, SaaS vendors may need to consider the guidance in SAB Topic 13.A.3(f).

Services provided under SaaS arrangements are often billed to the customer as nonrefundable up-front fees. Up-front fees are often charged for additional services delivered as part of multiple-element SaaS arrangements. In such situations, vendors should first assess whether each deliverable has stand-alone value and should be accounted for as a separate unit of accounting under ASC 605-25. Consideration allocated to deliverables that are deemed to have stand-alone value are generally recognized over the period delivered, while deliverables that do not have stand-alone value are combined with other deliverables into a single unit of accounting. In accounting for nonrefundable up-front fees charged for additional services, SaaS vendors may need to consider the guidance in SAB Topic 13.A.3(f), which reflects the SEC staff's view that these types of services often do not provide value to the customer on a stand-alone basis.

Footnote 36 of SAB Topic 13.A.3(f) expresses the SEC staff's belief "that the vendor activities associated with the up-front fee, even if considered a deliverable to be evaluated under FASB ASC Subtopic 605-25, will rarely provide value to the customer on a standalone basis." SEC registrants should bear this view in mind when assessing SaaS arrangements that involve up-front nonrefundable fees. SaaS vendors may need to consider providing additional disclosures, particularly when they consider the services rendered for an up-front fee to have stand-alone value.

When an up-front fee is charged and multiple deliverables in a SaaS arrangement are treated as a single unit of accounting under ASC 605-25, vendors should consider SAB Topic 13.A.3(f) in determining an appropriate accounting policy for the recognition of revenue related to the up-front fee. SAB Topic 13.A.3(f) states that "unless the up-front fee is in exchange for products delivered or services performed that represent the culmination of a separate earnings process," revenue is typically deferred and recognized over the period in which the up-front fees are earned, which may extend beyond the initial contract term. Footnote 39 of SAB Topic 13.A.3(f) indicates that the "revenue recognition period should extend beyond the initial contractual period if the relationship with the customer is expected to extend beyond the initial term and the customer continues to benefit from the payment of the up-front fee."

In certain SaaS arrangements, vendors may expect customers to extend the SaaS agreement beyond the initial contract term. This may be the case when significant customization and set-up services that do not have stand-alone value (in accordance with ASC 605-25) are provided at the beginning of a SaaS arrangement such that a customer is likely to extend the use of the hosted software beyond the initial contract period to justify any up-front investment. Under these circumstances, since the customer will benefit from the customization, set-up, or other services associated with the up-front fee beyond the initial contract period, revenue would be recognized over the estimated customer relationship period.

In estimating the customer relationship period, SaaS vendors should consider using all available information, including historical information on customer behavior or relationship periods for specific services. In certain instances, especially for newly formed entities, historical information may not be readily available. In those instances, entities may wish to consider other available information, including the length of the initial contract term relative to terms provided to other customers (e.g., if a vendor contracts with most customers for three years and then with a customer for one year, this may suggest that the customer relationship period is at least three years, in the absence of renewal history). Consideration of the customer relationship periods of competitors offering similar services may also be relevant to estimating the customer relationship period.

In estimating the customer relationship period, SaaS vendors should consider using all available information, including historical information on customer behavior or relationship periods for specific services.

Further, when an up-front fee is charged and the deliverables or services in a multiple-element SaaS arrangement are treated as separate units of accounting under ASC 605-25, consideration should be allocated to each unit in accordance with ASC 605-25-30-2 and recognized as revenue over the period in which the services are rendered.

Example 1

Vendor S enters into a SaaS arrangement with Customer X. Under the arrangement, Vendor S provides Customer X with access to a hosted customer relationship management (CRM) software application on a subscription basis. Customer X is charged an annual $100,000 fee for use of the CRM software over a five-year period. In addition, Customer X pays a one-time nonrefundable up-front fee of $50,000 for the following services:

(1) Application set-up services to be performed within the first few weeks of the arrangement. The set-up services are always provided together with access to the hosted CRM application (which cannot function without the set-up services), and other vendors are incapable of providing a similar replacement service.

(2) Customization services that configure certain aspects of the software to perform tasks that are necessary to meet the specific needs of Customer X. Such services are performed only in accordance with a customer’s specific request. Customers can use the standard version of the CRM software without customization should they wish to do so. Customization services are always provided together with access to the hosted CRM application, and other vendors are unable to provide similar services.

(3) Consulting services comprising data aggregation and trend analysis services provided to Customer X on the basis of the information processed through the CRM application. These services are to be provided on a monthly basis for the first nine months of the arrangement and are not sold separately from the hosted CRM application. However, other vendors in the market provide identical data aggregation and trend analysis services that could serve as a replacement for the services offered by Vendor S. These services are not necessary for Customer X to begin using the CRM application.

Vendors should consider all relevant facts and circumstances when evaluating the existence of separate deliverables.

Vendors S believes that on the basis of historical evidence, Customer X is likely to renew its contract to use the CRM application for an additional three years after completing its initial contract term in order to fully benefit from its initial up-front investment.

Question 1

Assume that Vendor S considers each service to be a separate deliverable.[6] Which of these deliverables have stand-alone value and may be treated as separate units of accounting under ASC 605-25?

Since the services described in (1) and (2) above are not sold separately by any vendor and are always provided together with access to the hosted CRM application, they would not be considered to have stand-alone value and would be combined with the hosted CRM application and treated as a single unit of accounting under ASC 605-25.

The consulting services described in (3) above would be considered to have stand-alone value since they are sold separately by other vendors and the services provided are not necessary for Customer X to begin using the CRM application. Consequently, the consulting services would be regarded as a separate unit of accounting.

Question 2

Vendor S determines that the BESP for the unit of accounting comprising the hosted CRM application, set-up, and customization services is $535,000, and TPE indicates that the stand-alone selling price of the consulting services is $25,000. How should Vendor S recognize revenue from the $500,000 fee related to the hosted CRM application and the $50,000 up-front fee charged for services (1), (2), and (3)?

In accordance with the allocation requirements of ASC 605-25-30-2, the total fixed and determinable consideration of $550,000 is allocated to each unit of accounting as follows:

Unit of Accounting	Selling Price (VSOE, TPE, or BESP)	Relative Percentage	Allocated Amount
Hosted CRM, set-up, and customization services	$ 535,000	95.5%	$ 525,250
Consulting services	25,000	4.4%	24,750
Total	$ 560,000	100%	$ 550,000

Revenue would be recognized in the following manner:

- *Hosted CRM, set-up, and customization services* — SAB Topic 13.A.3(f) requires revenue from up-front fees related to deliverables that do not have stand-alone value to be recognized over the period in which the customer is expected to benefit from such deliverables. The set-up and customization services do not have stand-alone value and are billed under an up-front fee arrangement (which also includes the consulting services). Customer X is expected to renew its subscription for an additional three years; therefore, the period over which Customer X is expected to benefit from such services is eight years.

[6] In practice, some SaaS vendors may argue that the set-up and customization services described in (1) and (2) are not separate deliverables since the customer does not receive a service that is distinct from the use of the hosted software application. Vendors should consider all relevant facts and circumstances when evaluating the existence of separate deliverables. See Identifying Each Separate Unit of Accounting above for more information about the identification of deliverables.

However, these services are included in a single unit of accounting that also includes the hosted CRM application. The $525,250 allocated to the unit of accounting that comprises the hosted CRM application, set-up, and customization services thus represents both revenue related to the hosted CRM application and revenue attributable to the up-front fee charged for the set-up and customization services. The hosted CRM application is provided for an annual fee of $100,000 over the initial contract period of five years. As a result, revenue of $100,000 should be recognized in each year of the contract in relation to the hosted CRM application (i.e., $500,000 in total over the five-year period). The remaining $25,250 ($525,250 – $500,000) is considered to be related to the set-up and customization services. Under SAB Topic 13.A.3(f), the $25,250 in revenue should be recognized over the eight-year customer relationship period (i.e., $3,156 per year). This results in revenue of $103,156 recognized in year 1 through year 5. It would also result in the same amount of revenue recognized in year 6 through year 8, assuming that Customer X renews its subscription to the hosted CRM application at the same annual rate during that period.

- *Consulting services* — The $24,750 allocated to the consulting services provided would be recognized on a straight-line basis over the nine-month period in which the services are provided unless another pattern better reflects the delivery of the services.

If the realization of the revenue allocated under ASC 605-25-30 to services provided in addition to a SaaS service depends on the future delivery of the SaaS services, it may be necessary to defer a portion of the revenue until such future SaaS services are provided.

Identifying Contingent Revenue in Multiple-Element SaaS Arrangements

Arrangements that permit partial or full refunds of amounts received in the event that a vendor fails to deliver future deliverables may give rise to contingent revenue and could affect how revenue is allocated to each unit of accounting. Further, as illustrated in Example 2 below, if the realization of the revenue allocated under ASC 605-25-30 to services provided in addition to a SaaS service depends on the future delivery of the SaaS services, it may be necessary to defer a portion of the revenue until such future SaaS services are provided. Under these circumstances, a vendor may need to reallocate some or all of the revenue that is contingent on delivery of the SaaS services (and allocated to such other services) back to the SaaS service unit of accounting through recognition of deferred revenue. Entities encountering a situation that involves contingent revenue should consider the guidance in ASC 605-25-30-5.

Example 2

Assume the same facts in relation to the CRM SaaS service as described in Example 1 above except:

- The set-up services are not always provided together with access to the hosted CRM application, which can function without these services, and other vendors are capable of providing a similar replacement service.
- Vendor S separately sells the customization services offered to Customer X (described in (2) of Example 1 above). Vendor S offers customization services for a variety of applications. These services are not required for Customer X to begin accessing the CRM software.

Given these facts, Vendor S concludes that the set-up, customization, and consulting services have stand-alone value since they can be sold separately and are not required for Customer X to begin accessing the hosted CRM application. VSOE indicates that the stand-alone selling price of a five-year contract for the hosted CRM application is $500,000. The BESP of the set-up services is $15,000, and the BESP of the customization services is $20,000. As stated in Example 1 above, TPE indicates that the consulting services have a stand-alone selling price of $25,000. None of the amounts charged under the arrangement are refundable under any circumstances.

Usage-based fees charged under a SaaS arrangement are generally not considered to be fixed or determinable (as required under SAB Topic 13.A) until the customer uses the software.

How should Vendor S recognize revenue from the $500,000 fee related to the hosted CRM software and the $50,000 up-front fee charged for services (1), (2), and (3) in Example 1 above?

The total fixed and determinable consideration of $550,000 is allocated to each unit of accounting as follows:

Unit of Accounting	Selling Price (VSOE, TPE, or BESP)	Relative Percentage	Allocated Amount
Hosted CRM service	$ 500,000	89.3%	$ 491,150
Set-up services	15,000	2.7%	14,850
Customization services	20,000	3.6%	19,800
Consulting services	25,000	4.4%	24,200
Total	$ 560,000	100%	$ 550,000

Revenue would be recognized in the following manner:

- *Hosted CRM service* — The $491,150 allocated to the hosted CRM software service should be recognized over the period in which Customer X can use the software during the contract term (i.e., $98,230 per year). Revenue would typically be recognized on a straight-line basis unless another pattern better reflects Customer X's use of the software.
- *Set-up services* — The $14,850 allocation to the set-up services should be recognized over the period in which the services are performed (i.e., over the first few weeks of the arrangement). The revenue would generally be recognized on a straight-line basis unless another method better reflects the performance of the set-up services.
- *Customization services* — The $19,800 allocated to customization services should be recognized over the period in which the services are performed, typically before or at the time Customer X begins to use the hosted CRM service.
- *Consulting services* — The $24,200 allocated to the consulting services should be recognized on a straight-line basis over the nine-month period in which the services are provided. A method other than straight-line may be used only when it better reflects the performance of the consulting services.
- *Deferred revenue* — In year 1, revenue of $98,230 ($491,150 ÷ 5) would be recognized in relation to the hosted CRM service. In addition, since the other services are delivered within year 1, the total revenue of $58,850 allocated to such services would also be recognized in full during that year. Thus, total revenue recognized in year 1 would be $157,080. However, Vendor S receives only $150,000 during that period. As a result, the realization of the excess $7,080 ($157,080 – $150,000) in revenue to be recognized in year 1 is effectively contingent on the continued delivery of the hosted CRM service in the future. Accordingly, the $7,080 in revenue would be deferred and recognized over the remainder of the contract as the contingency is resolved (i.e., $1,770 ($7,080 ÷ 4) per year for the remaining four years). This will result in the recognition of $100,000 ($98,230 + $1,770) in revenue for year 2 through year 5.

SaaS Services Billed on a Usage Basis

Although consideration paid for the use of software in many SaaS arrangements is typically a fixed monthly, quarterly, or annual subscription, certain arrangements can be usage-based (e.g., fees are charged per transaction processed though a software application). Certain billing structures may also contain a combination of fixed and usage-based fees. Usage-based fees charged under a SaaS arrangement are generally not considered to be fixed or determinable (as required under SAB Topic 13.A) until the customer uses the software. In a multiple-element SaaS arrangement, revenue must be fixed and determinable in accordance with ASC 605-25-30-1 before it is allocated to each identified unit of accounting. As a result, revenue from SaaS arrangements that charge the customer on a usage basis is generally not allocated to each unit of accounting until it is realized and considered fixed or determinable.

Usage-based fees are generally recognized as they are earned if they are within the scope of TPA 5100.76. For a usage-based arrangement to be within the scope of this TPA, the following requirements need to be met:

- The usage-based fees must be "determined based on applying a constant multiplier to the frequency that the licensee uses the software" (e.g., $1 per transaction processed through the software). This differs from "fees that are determined based on the number of individuals or workstations that use or employ the software (that is, user-based fees)."
- Customers use the software functionality "only in [processing] the activity that underlies the measurement of the usage-based fee, that is, the software provides the licensee with no internal-use functionality for which a usage-based fee would not be charged."

Fees related to arrangements outside the scope of this TPA should be carefully evaluated in the determination of an appropriate method of recognizing revenue, which may not result in revenue recognition as the fees are earned.

Revenue from SaaS arrangements that charge the customer on a usage basis is generally not allocated to each unit of accounting until it is realized and considered fixed or determinable.

Example 3

Assume the same facts as Example 2 above except that the contracted cost of the hosted CRM service is now determined as $1 per customer transaction processed through the CRM software rather than a fixed annual fee of $100,000. When allocating consideration to each unit of accounting, the usage-based fees would not be included and instead would be recognized as incurred since the fee is not considered fixed or determinable. However, the $50,000 up-front fee, which is fixed and determinable, would be allocated as follows:

Unit of Accounting	Selling Price (VSOE, TPE, or BESP)	Relative Percentage	Allocated Amount
Hosted CRM service	$ 500,000	89.3%	$ 44,650
Set-up services	15,000	2.7%	1,350
Customization services	20,000	3.6%	1,800
Consulting services	25,000	4.4%	2,200
Total	$ 560,000	100%	$ 50,000

As illustrated above, the initial allocation of the up-front fee to each unit of accounting is significantly affected when the fees for the hosted CRM service are usage-based and not deemed fixed or determinable. As a result, a large portion of the fixed consideration is allocated to the hosted CRM service even though the up-front fee of $50,000 is intended to cover the other services. This may also affect the margins realized on the customization and consulting services. Over time, however, the usage-based transaction fees realized would be allocated to each element in the arrangement when they become fixed or determinable and ultimately correct any impact on margins over the course of the arrangement. SaaS vendors that encounter situations in which the consideration is neither fixed nor determinable are encouraged to consider the accounting ramifications before entering into such an arrangement.

In certain instances, vendors offer additional services beyond those typically provided up front (e.g., Vendor S may offer Customer X a continuation of the consulting services at $0.02 per transaction analyzed). This may create an additional deliverable in the multiple-element arrangement. However, if Vendor S determines that the $0.02 rate charged per transaction represents a significant incremental discount on the rate that would typically be charged for the work involved, the discount offered would need to be allocated to each deliverable in the arrangement either by analogy to ASC 985-605 or by determining the fair value of the option to continue the consulting services. The specific facts and circumstances of an arrangement that offers a significant incremental discount on future services may need to be carefully analyzed to determine the appropriate method of recognizing revenue.

Classification and Presentation

A key focus of the SEC staff in reviewing SaaS vendors' financial statements has been the appropriate classification of revenue from products and services in the income statement. In particular, registrants need to ensure that the classification of revenue between products and services is supported by sufficient evidence and adequately disclosed in their financial statements. The SEC requires, among other things, that products and services revenues be displayed separately in the income statement when certain criteria are met. In certain SaaS arrangements, however, there may be instances in which elements in an arrangement that includes both software products and services cannot be separated for revenue recognition purposes. The challenge in these situations is determining how revenues from such arrangements should be presented in the income statement for SEC reporting purposes.

Registrants need to ensure that the classification of revenue between products and services is supported by sufficient evidence and adequately disclosed in their financial statements.

One acceptable method would be to present the revenues related to both the software products and the services on a combined basis in a separate income statement line item. Revenues from such arrangements would then be reported separately from other products and services revenues.

Another acceptable method would be to separate revenues earned from both software products and services and present them separately in the products and services income statement line items, respectively, if a reasonable basis for separation exists. Mark Barrysmith, a former professional accounting fellow in the SEC's Office of the Chief Accountant, supported this method at the 2007 AICPA National Conference on Current SEC and PCAOB Developments. Mr. Barrysmith indicated that these revenues could be separately presented "when a vendor has a reasonable basis for developing a separation methodology, so long as the method of separating is consistently applied, clearly disclosed and not misleading." However, Mr. Barrysmith cautioned preparers that a separation method for presentation purposes should be both systematic and based on rational methods.

Challenges and Other Considerations

Estimates and Judgments

As discussed throughout this *Spotlight*, the lack of SaaS-specific guidance in U.S. GAAP requires vendors to exercise significant judgment and determine a range of estimates in developing revenue recognition accounting policies (e.g., when considering stand-alone value, relative selling prices, and estimated customer relationship periods). SaaS vendors should consider adequately documenting all factors considered in reaching their conclusions and should provide robust disclosures in their financial statements to the extent necessary.

Systems, Processes, and Controls

The introduction of new and improved cloud-based services will require changes not only to SaaS vendors' accounting policies but also to their systems, processes, and internal controls. In many cases, the changes necessary to ensure the integrity and accuracy of financial reporting and internal control systems may be significant and could require the investment of substantial resources. Vendors that are developing new cloud-based offerings and assessing the impact of those offerings on their accounting may need to assess the consequent impacts on all controls, systems, and processes before their launch.

Thinking Ahead

The FASB and IASB are currently finalizing a new converged revenue recognition standard. The new standard is expected to be effective for reporting periods (fiscal and interim) beginning after December 15, 2016, for public companies. Nonpublic companies will most likely have the option to apply the standard at the same time or to defer adoption for an additional year.

The new standard currently proposes a five-step process to recognizing revenue, as follows:

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

The new standard will require entities to consider whether existing units of accounting in multiple-element SaaS arrangements represent separate performance obligations or whether changes in the identification of performance obligations are necessary. Entities may also be required to estimate and allocate consideration in a manner that differs from existing accounting policies. In addition, the new standard may require SaaS vendors to capitalize costs incurred in obtaining and fulfilling a contract under certain circumstances.

As a result, SaaS vendors will need to reconsider their current accounting policies to ensure compliance with the new standard.

SaaS vendors will need to reconsider their current accounting policies to ensure compliance with the new standard.

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