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SaaS CXO Highlights

Common Themes Related to Applying the New Revenue Standard

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The FASB's new standard on revenue recognition is effective for annual reporting periods beginning after December 15, 2017, for public entities. For all other entities, it is effective for annual reporting periods beginning after December 15, 2018. Early adoption is permitted for annual reporting periods beginning after December 15, 2016.

While the new standard will affect entities differently depending on their facts and circumstances, we have briefly summarized for corporate executives (CXOs) some of the common significant themes associated with its application by entities in the software-as-a-service[1] sector.

Contract Cost

Under current U.S. GAAP, the decision to capitalize commissions (and similar costs) is a policy election that can be made only if such costs are direct and incremental to obtaining the contract. Under the new standard, **direct and indirect** incremental costs attributable to the acquisition of a contract **must** be capitalized unless the amortization period is one year or less. An organization must also use judgment to determine the costs associated with renewals and an appropriate amortization period.

Limitation of Revenue (Contingent Revenue Guidance)

Revenue on delivered items is limited under current U.S. GAAP if it is subject to refund for failure to provide future deliverables (referred to as "contingent revenue"). While the new standard does not require the deferral of contingent revenue, it introduces a new requirement to limit revenue (referred to as the "constraint") to the amount for which sufficient confidence exists that no reversal will be made at a later date. This change could result in earlier revenue recognition for certain contracts.

Contract Modifications

The new standard establishes a framework for accounting for contract modifications that does not exist under current U.S. GAAP. An organization must use judgment to determine whether the modification, including changes to the transaction price, should be accounted for as a separate contract, as a modification with a prospective adjustment, as a modification with a retrospective adjustment (cumulative catch-up), or under a combination of these methods.

Billings

Current guidance generally limits the amount of revenue to be recognized under extended payment term arrangements, including in those contracts with increasing annual billings. There is no such limitation under the new standard. As a result, revenue can exceed

[1] Under software-as-a-service (SaaS) contracts, customers do not have the right to take possession of the provided software without incurring a significant penalty.

Termination Provisions

Certain SaaS arrangements include provisions that allow the customer to terminate the contract before it expires. The treatment of termination provisions under the new standard can be complex. Such provisions may affect the transaction price allocated to the various elements in a contract (and in some cases, could result in the inclusion of expected termination fees in the transaction price) as well as the financial statement disclosures. For example, disclosure of remaining performance obligations (discussed below) may only include amounts not subject to certain termination provisions.

Minimum Guarantees, Volume-Based Pricing, and Usage-Based Fees

SaaS arrangements sometimes include minimum guarantees, volume-based pricing or rebates, or other usage-based fees. An organization must use judgment when accounting for these arrangements. The new standard may require the organization to estimate usage, defer a portion of the transaction for future changes in price, recognize amounts earlier than it does under current U.S. GAAP, or change the measure of recognizing revenue (e.g., units delivered, time lapsed), depending on the facts and circumstances.

Set-Up or Activation Fees

Many SaaS arrangements require set-up or "activation" fees, which typically are charged in addition to the SaaS subscription fee. Under current U.S. GAAP, the consideration allocated to such activities is recognized over the initial contract period or over the estimated customer relationship period if longer. The new standard requires SaaS vendors to recognize up-front fees that are not related to the transfer of a distinct good or service over a period extending beyond the initial contract period only if the customer has the option to renew the SaaS contract and the renewal option gives the customer a material right.

Concessions

Price concessions give customers an incentive to renew or upgrade and can be common in software arrangements. Under current U.S. GAAP, a history of price concession can lead to a significant deferral of revenue. The new standard requires such concessions to be estimated at the onset of the arrangement, which will generally result in revenue deferral that is less significant.

Separation Criteria

The evaluation process under the new standard for determining whether elements in a contract should be accounted for separately from one another is different from that under current U.S. GAAP. As a result, the conclusions an organization reaches under the new standard related to items such as implementation services may be different from those it reached under current guidance.

Disclosures

The new standard requires entities to disclose much more information about revenue activities and related transactions than they do under current U.S. GAAP. For example, under the standard's new quantitative and qualitative disclosure requirements, SaaS companies will need to provide information about (1) performance obligations (including disclosures commonly referred to as "backlog disclosures"), (2) significant judgments and estimates, (3) contract assets and liabilities (including rollforwards of these balances), and (4) revenue disaggregated to a degree that will be partially, if not entirely, new for many entities.

Internal Control

Because of the many changes made by the new standard as well as its complexity and requirements to use judgment, organizations will generally need to make significant revisions to their internal controls and add new controls.

Exit Considerations for Private Companies

As a result of initial public offerings and other SEC filings, a private company may be required to adopt the new standard in accordance with the adoption timeline for public companies or to present an additional year of recasted results because of the new standard's scope requirements related to recasting financial information.

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