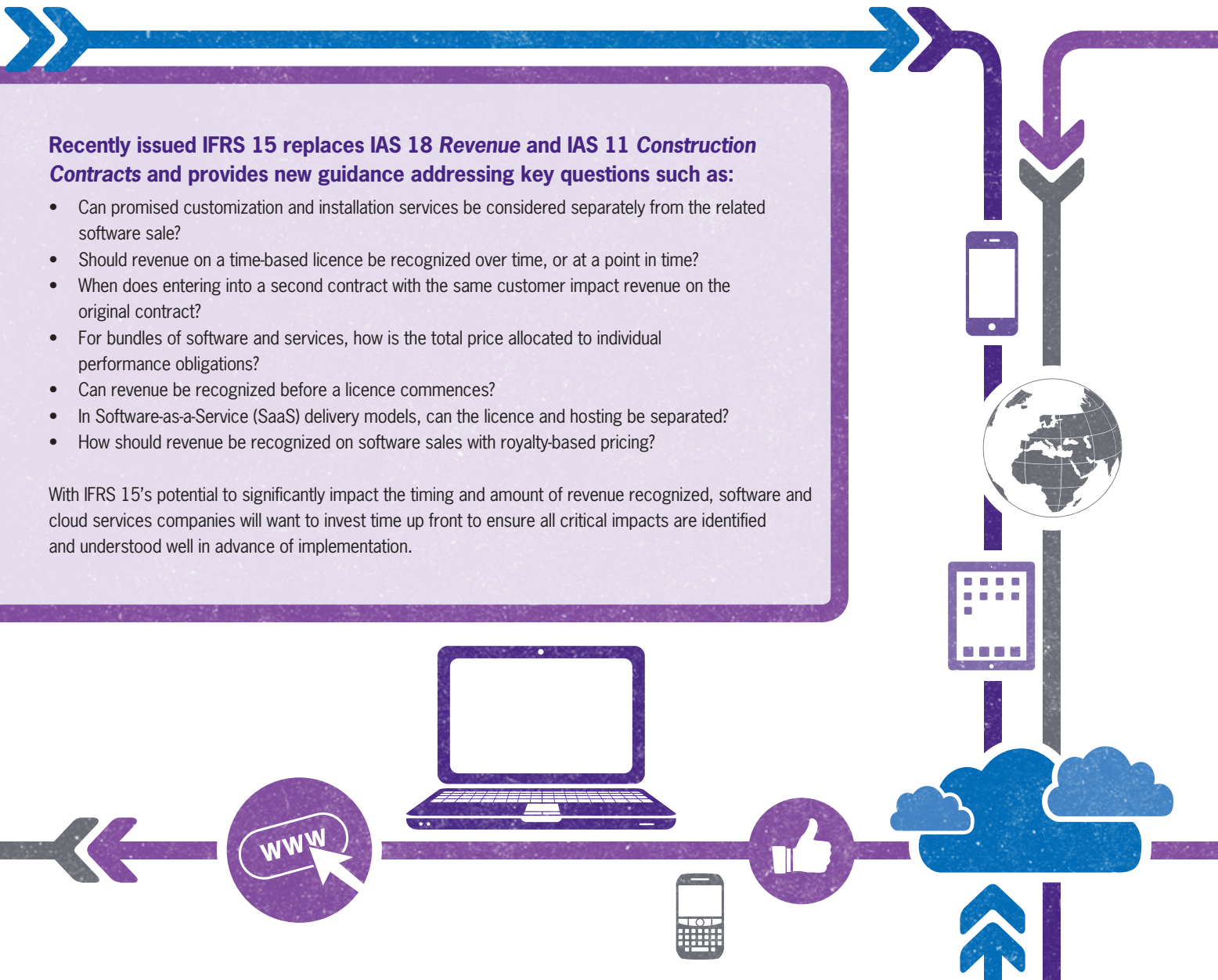


A new global standard on revenue

What this means for the software and cloud services industries

November 2014

The International Accounting Standards Board (IASB) and U.S. Financial Accounting Standards Board have finally issued their new Standard on revenue – IFRS 15 *Revenue from Contracts with Customers* (ASU 2014-09 or Topic 606 in the U.S.). This bulletin summarizes the new requirements and what they will mean for entities that apply International Financial Reporting Standards (IFRS) in the software and cloud services industries.



Recently issued IFRS 15 replaces IAS 18 *Revenue* and IAS 11 *Construction Contracts* and provides new guidance addressing key questions such as:

- Can promised customization and installation services be considered separately from the related software sale?
- Should revenue on a time-based licence be recognized over time, or at a point in time?
- When does entering into a second contract with the same customer impact revenue on the original contract?
- For bundles of software and services, how is the total price allocated to individual performance obligations?
- Can revenue be recognized before a licence commences?
- In Software-as-a-Service (SaaS) delivery models, can the licence and hosting be separated?
- How should revenue be recognized on software sales with royalty-based pricing?

With IFRS 15's potential to significantly impact the timing and amount of revenue recognized, software and cloud services companies will want to invest time up front to ensure all critical impacts are identified and understood well in advance of implementation.

The new standard at a glance

The new standard replaces IAS 18, IAS 11 and some revenue-related interpretations with a control-based model centered around the following five steps:

Step 1: Identify the contract with a customer

Step 2: Identify the performance obligations

Step 3: Determine the transaction price

Step 4: Allocate the transaction price to the performance obligations

Step 5: Recognize revenue when or as performance obligations are satisfied

IFRS 15 changes the criteria for determining whether revenue is recognized at a point in time or over time. IFRS 15 also has more guidance in many areas where current IFRS are lacking such as:

- multiple-element arrangements;
- non-cash and variable consideration;
- rights of return and other customer options;
- seller repurchase options and agreements;
- warranties;
- principal versus agent (gross versus net);
- licensing intellectual property;
- breakage;
- non-refundable upfront fees;
- consignment and bill-and-hold arrangements.

IFRS 15 requires considerably more disclosure about revenue including information about contract balances, remaining performance obligations (backlog) and key judgements made.

Transition and effective date

IFRS 15 is effective for annual periods beginning on or after January 1, 2017. Transition is retrospective subject to some simplifications, including an option to not restate comparative periods. Early application is permitted.

Accounting for revenue in the software and cloud services industries is complex, with many arrangements characterized by multiple elements and a variety of features not found in many other industries such as specified and unspecified upgrade rights, installation services, customization, set-up costs and service renewal options. The emergence of SaaS business models and other unique features also present special challenges when determining how and when to recognize revenue under the limited guidance provided by IAS 18 and IAS 11.

What this means for the software and cloud services industries

As IFRS lack specific software and cloud services industry guidance on revenue recognition, many entities in these industries turn to much more detailed U.S. generally accepted accounting principles (GAAP) for guidance. With the release of ASU 2014-09 or Topic 606 in the U.S., most of the existing U.S. GAAP guidance on multiple element arrangements and software revenue recognition is superseded by the new standard. The new converged revenue guidance applies equally to all software and cloud services arrangements, eliminating the need to determine which U.S. GAAP guidance to analogize to – a challenge commonly faced by cloud services entities today.

Step 1: Identify the contract with a customer

Step 1 of the new model is to identify the contract. An entity is only able to proceed to the next steps in the model if:

- the contract has commercial substance;
- the parties have approved the contract;
- each party's rights and the payment terms can be clearly identified;
- it is probable the entity will collect the consideration.

Contract approval

Under IFRS 15, approval may be evidenced in writing, orally or in accordance with other customary business practices; therefore, there is latitude in how an entity demonstrates the parties have an agreement that creates enforceable rights and obligations. While current guidance in IAS 18 is not as detailed, most software entities are unlikely to see significant impacts in this area unless they had previously adopted an accounting policy requiring a signed contract to be in place before recognizing revenue.

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Criteria not met

In circumstances where an entity has not yet concluded that the criteria above have been met, IFRS 15 does not permit revenue to be recognized as partial cash payments are received. Instead, all revenue must be deferred until such time as the criteria are met, or until all consideration received to date is non-refundable and either performance is complete or the arrangement has been cancelled.

Combining contracts

Current guidance requires the exercise of considerable judgement when determining whether contracts should be combined, offering only a series of indicators that might indicate when two or more contracts form part of the same economic arrangement.

In contrast, IFRS 15 explicitly requires an entity to combine contracts that are entered into at or near the same time with the same customer if one or more of the following criteria are 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;
- the goods or services promised in the contracts are a single performance obligation.

The existence of explicit criteria (and the fact that only one must be met) may change the accounting outcome for some arrangements.

Step 2: Identify the performance obligations

The cornerstone of the IFRS 15 model is the fact that revenue is recognized upon satisfaction of “distinct” performance obligations rather than the contract as a whole. A promised good or service is “distinct” if both:

- the customer benefits from the item on its own or along with other readily available resources;
- it is “separately identifiable”, e.g. the vendor does not provide a significant service integrating, modifying or customizing the various performance obligations.

Existing IFRS lack detailed guidance on “multiple element arrangements” and many software and cloud services entities look to U.S. GAAP’s more prescriptive guidance in this area. Unlike existing U.S. GAAP, under IFRS 15, the presence or absence of

“vendor-specific objective evidence” (VSOE) of fair value will not impact whether deliverables within an arrangement are separated (or combined) for accounting purposes. Instead, entities will be required to evaluate the separability of multiple elements based on the “distinct” criteria outlined above which may result in more or different elements (referred to as “performance obligations”) being separated. The subsequent allocation of arrangement consideration to the individual performance obligations identified is discussed in Step 4 below.

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Customer options for additional goods or services

Under IFRS 15, customer options must be evaluated as to whether they represent a “material right” and therefore a separate performance obligation. If a contract grants a customer an option to renew a software licence at a discount, that option represents a material right only if it provides something the customer would not have received without entering into the contract. Such a discount would be a material right only if it exceeds the range of discounts typically given for the licence. If a customer

has the option to acquire an additional good or service at a price that would reflect the standalone selling price for that good or service, that option does not provide the customer with a material right.

This is similar to the results that would be obtained by entities analogizing to existing U.S. GAAP as discounts on future sales are required to be evaluated as to whether they are considered to be “significant and incremental”. However, the amount allocated to the option under IFRS 15 (assuming it is a material right) may differ (see Steps 3 and 4).

Step 3: Determine the transaction price

Under IFRS 15, the transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. This consideration may include fixed or variable amounts or both.

Under IFRS 15, if customary business practices create a valid expectation on the part of the customer that the entity will enforce its rights to only a portion of the stated contract price (that is, the entity will provide a price concession), the transaction price equals the lower amount.

Variable consideration

Variable pricing arrangements (e.g. rebates, awards or incentive payments) of one type or another are commonplace in the software and cloud services industries, including in some reseller and distributor arrangements. An entity estimates and includes variable payment amounts in the contract price using either a probability-weighted or most likely amount approach. This amount is further subject to a revenue constraint such that estimated amounts are included in the contract price only to the extent that it is highly probable that a subsequent change in the estimate will not result in a significant reversal of cumulative contract revenue recognized.

An entity estimates and includes variable payment amounts in the contract price using either a probability-weighted or most likely amount approach, subject to a “constraint”.

One exception that will be very relevant for this industry relates to sales- or usage-based royalties on intellectual property — in this case, the transaction price does not include an estimate for expected royalty payments. Those amounts are included in the transaction price only as the subsequent sales or usage occurs.

Financing component

A software entity's payment terms may vary based on the type of business or class of customer. Under IFRS 15, the transaction price is adjusted if payment terms give rise to a "significant financing component". IFRS 15 provides indicators to help an entity determine if a significant financing component exists in a

contract, including (among other things) the relationship between the promised consideration and the cash selling price, and the length of time between delivery of the promised goods or services and when the customer pays. The effects of a significant financing component are accounted for separately from revenue.

Under IAS 18, the focus is on measuring the fair value of the consideration to be received, while under IFRS 15 the objective is to recognize revenue equal to the price the customer would have paid had they paid in cash.

Step 4: Allocate the transaction price to the performance obligations

When an entity determines that a contract contains more than one performance obligation, it is required to allocate the transaction price to each performance obligation based on relative stand-alone selling prices.

Estimating stand-alone selling price

IFRS 15 defines stand-alone selling price as "the price at which an entity would sell a promised good or service separately to a customer". The observable selling price charged by the entity, if available, provides

the best evidence of stand-alone selling price. If not available, the entity estimates the stand-alone selling price using all available information, maximizing the use of observable inputs. IFRS 15 suggests (but does not require) three possible methods: adjusted market assessment, expected cost plus margin or the residual approach.

The residual method may be used to estimate the stand-alone selling price under IFRS 15 only when the selling price of a good or service is highly variable (e.g. sold to different customers at prices adjusted for the strength of the existing relationship, volume of business, ability to pay or other factors) or the entity has not yet established a price for a good or service that has yet to be sold (e.g. new software). While IAS 18 provides very few details concerning the use of the residual method, it is a commonly held view that the method cannot be used to estimate the fair value of delivered

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elements (the so-called "reverse residual" approach). There is no such limitation under IFRS 15, although the use of the residual method generally is subject to some restrictions, as described above.

Under IAS 18, when stand-alone selling prices are not directly observable, an entity uses estimation techniques similar to those suggested in IFRS 15. However, cloud services entities analogizing to U.S. GAAP for additional guidance in this area will note that the hierarchy consisting of VSOE of fair value, third-party selling price and management's best estimate of selling price no longer exists.

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Allocation methodologies

As noted above, IFRS 15 requires the transaction price to be allocated to each performance obligation based on relative stand-alone selling prices. There is no prescriptive guidance in IAS 18 on when or how to allocate revenue to multiple deliverables within a contract, and practice varies.

IFRS 15's focus on "distinct" together with the variety of methods available to estimate the amount of consideration attributable to each separate

performance obligation should provide some relief to entities that previously looked to U.S. GAAP for guidance on dealing with special narrow-focus issues like specified software upgrade rights when performance is not yet complete and acceptable evidence of fair value is unavailable.

Allocation of discounts and variable consideration

It is common for customers to receive a discount when purchasing

a bundle of goods and services together. IFRS 15 provides detailed guidance on when and how it may be appropriate to allocate a discount to one or more (but not all) of the performance obligations present in an arrangement. Similar guidance is provided for the allocation of variable consideration. There is no equivalent guidance in IAS 18.

Step 5: Recognize revenue when or as performance obligations are satisfied

An entity determines at contract inception whether each performance obligation will be satisfied (that is, control will be transferred) over time or at a point in time. Broadly, control is transferred over time if any one of the following conditions applies:

- the customer receives and consumes the benefits as the entity performs;
- the customer controls the asset as it is created or enhanced;
- the asset has no alternative use to the seller and the seller is entitled to payment for performance-to-date.

If none of these conditions are satisfied, the entity recognizes revenue at a point in time.

When software is bundled together with significant customization, installation or integration services that are considered to be essential to the functionality of the software, many software entities today recognize revenue over time using a method similar to percentage-of-completion accounting as outlined in IAS 11. These entities will need to carefully analyze such performance obligations under IFRS 15's control-based model to determine whether revenue is still required to be recognized over time.

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Other guidance

Contract costs

IFRS 15 requires an entity to recognize an asset for contract fulfilment costs and the incremental costs of obtaining a contract (e.g. sales commissions) when certain criteria are met. However, as a practical expedient, an entity is allowed to expense the incremental costs of obtaining a contract as incurred if the amortization period of the asset that the entity would otherwise have recognized is one year or less.

Current practice in accounting for contract costs is mixed as some entities have made an accounting

policy election to defer certain contract acquisition costs by analogy to other guidance, while other entities expense those costs as incurred. In either case, entities may experience a change on adoption of IFRS 15.

Disclosures

IFRS 15 requires quantitative and qualitative disclosures that disaggregate revenue streams and identify contract assets/liabilities, among many other new disclosures that software and cloud services entities may not have previously reported. As a result, systems and

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processes will need to capture and summarize the incremental information necessary to comply with the new requirements.



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