

IFRS INDUSTRY ISSUES

SOFTWARE

IFRS 15: REVENUE FROM CONTRACTS WITH CUSTOMERS



The headlines

In May 2014, the International Accounting Standards Board published IFRS 15 *Revenue from Contracts with Customers*. IFRS 15 contains comprehensive guidance for accounting for revenue and will replace existing requirements which are currently set out in a number of Standards and Interpretations.

IFRS 15 is fully converged with equivalent new US GAAP guidance (although, unlike IFRS, US GAAP does not permit adoption before 2017), and contains significantly more prescriptive and precise requirements in comparison with existing IFRS. This means that for many entities, the timing and profile of revenue recognition will change. In some areas, the changes will be very significant and will require careful planning, including for commercial effects.

For entities in the software sector, BDO's initial analysis of IFRS 15 indicates that the following areas may be of particular significance:

- Is revenue recognised at a point in time, or over a period of time?
- How will licences be dealt with?
- If revenue is recognised over time, how should progress towards completion be measured and recognised?
- Will a contract need to be 'unbundled' into two or more components? Alternatively, will two or more contracts need to be 'bundled' into a single overall obligation?
- How should contracts which include variable amounts of consideration be dealt with?
- How should contracts which include a right of return be dealt with?
- How should modifications to contracts be dealt with?
- Should costs associated with obtaining a contract be capitalised, or expensed immediately?
- What adjustments are required for the effects of the time value of money (a 'financing component')?

IFRS 15 also introduces significantly more disclosures about revenue recognition. It is possible that new and/or modified internal processes will be needed in order to obtain the necessary information.

IFRS 15 is applicable for annual periods beginning on or after 1 January 2017. Earlier application is permitted. For entities that report in accordance with EU-endorsed IFRS, endorsement is currently scheduled for quarter 2 of 2015.

EFFECTIVE DATE

Annual periods beginning on or after 1 January 2017. Earlier application permitted.

ACCOUNTING IMPACT

Wide and potentially very significant effects on the timing and profile of revenue and profit recognition in comparison with current guidance. Significant enhancements to disclosure requirements.

The commercial effects

The adoption of IFRS 15 may lead to significant changes in the pattern of revenue and profit recognition. Careful consideration and planning will be needed for a wide range of issues, including the effect on:

- Compliance with bank covenants
- Performance based compensation (including share-based payments)
- Internal budgeting processes
- Corporate tax obligations
- Market and investor communications, including compliance with regulatory requirements (which might arise from significant expected future changes to an entity's reported financial position or performance).

A review of the terms and conditions of existing contracts will be needed (in particular long term contracts which extend into periods covered by financial statements affected by the adoption of IFRS 15) as well as those which are to be entered into in future. In some cases, entities may wish to consider whether changes should be made to contracts.

It is also likely that sales departments will need to liaise more closely with the accounting department in future, in order that the effects of any proposed contractual terms on the related financial statements can be understood in advance.

Is revenue recognised at a point in time, or over a period of time?

Certain software packages are designed and written specifically for a particular customer. The question which then arises is whether the revenue attributable to the 'design and build' of the software should be recognised during a period, or at the point at which the finished product is supplied to the customer.

IFRS 15 contains specific, and more precise, guidance to be applied in determining whether revenue is recognised over time (often referred to 'percentage of completion' under existing standards) or at a point in time.

There are three criteria, each of which would result in recognition over time. These are:

- The customer simultaneously receives and consumes the benefits provided by the vendor's performance as the vendor performs
- The vendor's performance creates or

enhances an asset (for example, work in progress) that is controlled by the customer as work progresses

- The vendor's performance creates an asset which does not have an alternative use to the vendor, and the vendor has an enforceable right to be paid for work completed to date.

In some cases, bespoke 'design and build' software contracts are built into hardware which is already owned by the customer and installed at its premises. In those cases, the second criterion may be relevant, because the customer is likely to have control over the software as it is written and installed.

In other cases, where the vendor builds the software on its own systems and releases it to the customer when it is complete, the third criterion is likely to be relevant. Because the software is being designed and built to a customer's own needs and specifications, it will often be the case that the vendor does not have an alternative use for the software. This is because it cannot readily be sold to another customer and, even if it could, the vendor would typically incur significant costs in modifying the software to be suitable for another customer.

As a result, there may be significant focus on whether the vendor has, at all stages of the contract, an enforceable right to be paid for the work which has been completed to date. This will require careful analysis of the precise terms of each contract, including in particular the effect of any terms that permit the customer to cancel, curtail or significantly modify the existing contract. This analysis may also require consideration of the general (or common) law in each jurisdiction. The focus is on whether in all circumstances, other than the vendor's failure to fulfil its obligations under the contract, the customer will be required to pay for performance to date. This needs to be an amount that approximates the selling price of the goods or services that have been provided; compensation for loss of profit does not satisfy this condition. Alternatively, the vendor may have the legal right and practical ability to require completion of the contract and payment by its customer.

Vendors which provide Software as a Service (SaaS) under which, for example, a customer purchases an externally hosted service based on proprietary software, will need to give careful consideration to both the guidance for the timing of revenue

recognition for the services provided and, depending on the contractual terms, to the question of whether a contract with a customer gives rise to a licencing arrangement.

How will licences be dealt with?

Sales of software are frequently in the form of a licence to use the software. IFRS 15 includes specific guidance for licensing arrangements. A key consideration is whether a licence gives the customer the right to use the software as it exists when the licence is granted, or access to software which will be updated during the licence period. If it is the former, revenue will often be recognised at the point at which the customer is able to access the software; this might be later than the start of the licence period if the customer has not yet been provided with an access code. If the software will be updated during the licence period then revenue is likely to be recognised over the period during which the software is made available.

In practice, a range of linked services can be made available by a software vendor during a licence period, such as maintenance, hosting and updating. The extent to which the licensed software is functional when it is transferred to the customer, and the extent to which its continued functionality is linked to and dependent on the additional services to be provided by the software vendor, will need to be considered carefully. This will affect whether, and the extent to which, the licence and linked services are regarded as being interrelated and, in consequence, whether revenue relating to the licence is recognised at a point in time (at the start of the licence period) or is recognised over time (during the licence period).

If revenue is recognised over time, how should progress towards completion be measured and recognised?

If revenue is recognised over time, the overall principle is that revenue is recognised to the extent that each of the vendor's performance obligations has been satisfied.

IFRS 15 permits either output or input methods to be used to calculate the amount of revenue to be recognised. An output method results in revenue being recognised on the basis of direct measurement of the value of goods or services transferred to date, while input methods result in revenue being recognised based on measures such as resources consumed, costs incurred or machine hours.

It is noted explicitly that when input methods are used, there may not be a direct relationship between the inputs being used, and the transfer of goods or services to a customer. Consequently, any inputs that do not relate directly to the vendor's performance in transferring those goods and services are excluded when measuring progress to date.

Certain contracts require administrative or other set-up activities to be carried out in order that an entity is in a position to carry out the services specified in a contract. Under IFRS 15, these activities do not give rise to revenue. Instead, consideration is given to whether the costs incurred in setting up a contract meet the criteria to be capitalised as a contract asset.

In addition, the guidance extends to cover not only revenue recognition, but also profit recognition. For example, a contract for the design and implementation of a new software package might involve the vendor procuring high value items for installation, such as servers and other IT equipment. IFRS 15 takes the view that although it is appropriate to recognise revenue from the sale of the equipment at the point at which control is transferred to the customer, it is not appropriate to recognise profit. This is because the vendor's performance obligations are in connection with the design and implementation of the new software package and not the supply of items such as servers and other IT equipment; this supply does not result in any part of the design and implementation services being provided. Consequently, in many cases the vendor would recognise an equal amount of revenue and cost of sales for the servers and IT equipment, with profit margin only being recognised on the design and implementation services.

Will a contract need to be 'unbundled' into two or more components? Alternatively, will two or more contracts need to be 'bundled' into a single overall obligation?

Previously, IFRS had little specific guidance for 'unbundling' contracts into components. In contrast, IFRS 15 contains detailed guidance and it is likely that many entities will need to amend their current accounting policies and approaches. This may have a significant effect on the pattern of revenue and profit recognition.

The lack of existing guidance in IFRSs has led many entities in the software sector to consider the requirements of US GAAP. Although IFRS 15 contains substantially more guidance than has existed in IFRS to date, it does not contain some of

the most prescriptive aspects of current US GAAP, where software is a fundamental part of the contract, such as the need to obtain explicit vendor specific objective evidence of selling prices when allocating sales consideration to multiple element arrangements. Instead, in many cases, the consideration receivable is allocated to each component on a relative stand-alone selling price basis. Consequently, and regardless of whether guidance in US GAAP is currently being followed, entities may see a significant change in the timing and profile of revenue recognition for those types of sales.

As with many other goods and services, hardware and software is frequently sold with a warranty that it will operate satisfactorily for a specified period of time. The accounting treatment depends on

- whether customers have an option to purchase the warranty separately and,
- whether the warranty is part of the overall package of goods and services sold to the customer and, if so, whether the warranty simply provides assurance that the hardware and software is in compliance with the agreed upon specifications in the contract.

Agreed upon specifications often relate to an assurance that an item will function properly for a specified period, and may link to legal requirements in some jurisdictions.

If customers have an option to purchase a warranty separately from the hardware and software itself, this is accounted for separately. If the warranty is part of the overall package, then if it simply provides an assurance of compliance with agreed upon specifications, it is not accounted for separately. If it goes beyond compliance with agreed upon specifications, then it is accounted for separately regardless of whether it is identified as a separate component of the sales transaction.

Standard software packages may also be sold with a licence for a specified period (such as 12 months), with the customer being given the right to renew the contract (or take out a new 12 month licence over updated software) at a discount from the standard selling price. In these cases, the consideration received for the first 12 month licence may need to be split between the initial 12 month licence and the renewal right, with revenue relating to that renewal right being deferred and recognised in a future period.

IFRS 15 also requires two or more contracts to be

combined and accounted for a single contract (or 'bundled') if one or more of the following conditions 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; or
- The goods or services promised in the contracts (or some of them) are a single performance obligation.

The purpose of this guidance is to ensure that, for a particular good or service, regardless of the legal form of a contract (or contracts) with a customer, the accounting will be the same. Consequently, careful consideration will be required of the commercial objectives of, and item(s) covered by, one or more contract(s) with the same customer.

For example, software is often supplied with a maintenance agreement. This can be supplied separately at the option of the customer, or may be included as part of the overall package. A key consideration is whether the maintenance agreement is integral to the functionality of the software, meaning that it is necessary for the software to operate satisfactorily during the licence period. In such cases, the licence and maintenance contract would typically be regarded as being linked, and would be accounted for as a single obligation. This may represent a significant change for some entities in comparison with existing practice, with the effect of IFRS 15 being to defer revenue that is currently recognised on inception to later periods.

Consequently, many entities will need to give careful consideration to how IFRS 15 will change their timing and profile of revenue recognition, and to systems and process changes which will be required to identify which item(s) are required to be accounted for separately.

How should contracts which include variable amounts of consideration be dealt with?

Contracts for the design and/or installation of software may contain clauses which can give rise to variations in the amount of consideration receivable by the vendor. For example, a bonus payment might be receivable is an installation has been completed before a specified date, with penalties being deducted from the sales price if completion is late.

The clauses give rise to what IFRS 15 calls 'variable consideration'. This is significant, because when

consideration is variable IFRS 15 places a limit on the amount that can be recognised. This limit means that revenue is only recognised when it is highly probable that there will not be a significant reversal in the cumulative amount of revenue recognised to date (for example, because the criteria that were expected to be met for a bonus payment are not, in fact, satisfied). This may result in later recognition of revenue and profit in comparison with current accounting.

In assessing the amount of variable consideration which should be recognised, IFRS 15 permits two approaches. One, which applies to circumstances in which a large number of similar contracts exist, is to look at the expected value over the portfolio. The other, which would generally be applied when there are only two possible outcomes (for example, a bonus payment will or will not be received), is the most likely outcome - subject to the constraint over recognition.

How should contracts which include a right of return be dealt with?

Software, in particular standard packages sold in the retail market, often result in the customer having a right of return under which the customer may be entitled to a refund, a credit that can be applied against another purchase, or another product in exchange.

To the extent that the vendor expects customers to exercise the right of return, revenue is not recognised for the related goods or services, even though these may already have been transferred to the customer. Instead, a refund liability is recognised together with an asset for the right to recover the original asset (depending on whether the item recovered would have any value).

How should modifications to contracts be dealt with?

For larger, 'design and build' software supply contracts the scope and/or price may be modified, due to changes in the scope of work. IFRS currently has limited guidance for the accounting consequences of these changes. In contrast, IFRS 15 has detailed guidance to be applied in determining whether contract modifications result in changes to the existing contract or a new contract, and whether there is either an adjustment to the amount of revenue recognised to date (resulting in a 'true up' in the income statement) or to revenue to be recognised in future. These new requirements may result in significant changes to the pattern of revenue

recognition.

Should costs associated with obtaining a contract be capitalised or expensed immediately?

In addition to the substantially more detailed guidance for revenue recognition, IFRS 15 contains prescriptive criteria to be applied when determining whether costs associated with the acquisition of a contract should be recognised as an asset, or expensed as incurred. This extends to cover all contract acquisition costs, such as bid costs incurred prior to the award of a contract.

IFRS 15 is restrictive, in that it permits only incremental costs of obtaining a contract to be considered. Consequently, only those costs which would not have been incurred if the contract had not been obtained are eligible to be considered. An example is a sales commission which is only payable in the event that a customer completes a sale. In contrast, ongoing costs of running the business are not eligible to be considered because these costs would have been incurred regardless of whether a specific contract had been obtained. Although it might be argued that certain costs might be lower if an entity was not involved in obtaining sales contracts, IFRS 15 does not permit contracts to be analysed on a portfolio basis. Instead, the focus is on whether costs attributable to each individual contract are incremental.

Once incremental costs have been identified, these are recognised as an asset if there is an expectation that they will be recovered, typically through profits to be generated from the related contract. This asset is then amortised on a basis that is consistent with the transfer of the goods or services specified in the contract. It will be necessary for judgement to be applied in determining an appropriate amortisation period and profile.

What adjustments are required for the effects of the time value of money (a 'financing component')?

Contracts in the software industry can involve cash receipts from customers which do not correspond to the timing of the recognition of revenue. If a financing component is significant, IFRS 15 requires an adjustment to be made for the effect of implicit financing.

As a practical expedient, adjustments for a financing component are not required when there is a period of less than one year between the transfer of goods or services and the receipt of payment from a customer.

In a major change from existing practice,

adjustments for a financing component are required for circumstances in which customers pay in advance, as well as in arrears. Payments in arrears will result in finance income and a reduction in revenue (because the vendor is providing finance to its customer), while payments in advance will result in a finance expense and an increase in (deferred) revenue (because the vendor is, in effect, borrowing funds from its customer).

The purpose of this approach is to reflect the 'cash selling price' of the underlying good or service at the point at which it is transferred to the customer. It also results in transactions which involve a significant financing component being split into two parts; one for the sale of the good or service and the other for the financing arrangement. However, the implications for the internal processes and systems that are needed in order to identify when a financing component is to be recognised, and to account for this, may be significant.

Disclosure requirements

Users of financial statements, and regulators, have criticised the existing disclosure requirements in IFRS as being inadequate and lacking cohesion with other disclosures made in financial statements. This has made it difficult to understand an entity's revenues, as well as the judgements and estimates that have been made in determining their recognition and measurement.

In consequence, comprehensive disclosure requirements have been included in IFRS 15. This means that, even if an entity concludes that the effect of the new standard on revenue recognition is not significant, changes to internal systems and processes may be required to enable the necessary information to be collected for disclosures.

In addition to the detailed guidance, an overall disclosure objective has been specified together with an explicit statement that immaterial information does not need to be disclosed and the disclosure requirements should not be used as a checklist. This is because some disclosures may be very relevant for certain entities or industries, but irrelevant for others. It is also intended to encourage entities to give careful consideration to the information that they will include in their financial statements in order to meet the disclosure objective. However, this again brings the need for careful planning, well in advance of adoption of the new requirements.

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Europe

Caroline Allouët	France	caroline.allouet@bdo.fr
Jens Freiberg	Germany	jens.freiberg@bdo.de
Teresa Morahan	Ireland	tmorahan@bdo.ie
Ehud Greenberg	Israel	ehudg@bdo.co.il
Ruud Vergoossen	Netherlands	ruud.vergoossen@bdo.nl
Reidar Jensen	Norway	reidar.jensen@bdo.no
Maria Sukonkina	Russia	m.sukonkina@bdo.ru
René Krügel	Switzerland	rene.kruegel@bdo.ch
Brian Creighton	United Kingdom	brian.creighton@bdo.co.uk

Asia Pacific

Wayne Basford	Australia	wayne.basford@bdo.com.au
Zheng Xian Hong	China	zheng.xianhong@bdo.com.cn
Fanny Hsiang	Hong Kong	fannyhsiang@bdo.com.hk
Khoon Yeow Tan	Malaysia	tanky@bdo.my

Latin America

Marcelo Canetti	Argentina	mcanetti@bdoargentina.com
Luis Pierrend	Peru	lpierrend@bdo.com.pe
Ernesto Bartesaghi	Uruguay	ebartesaghi@bdo.com.uy

North America & Caribbean

Armand Capisciolto	Canada	acapisciolto@bdo.ca
Wendy Hambleton	USA	whambleton@bdo.com

Middle East

Arshad Gadit	Bahrain	arshad.gadit@bdo.bh
Antoine Gholam	Lebanon	agholam@bdo-lb.com

Sub Saharan Africa

Nigel Griffith	South Africa	ngriffith@bdo.co.za
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