Applying IFRS in Software and Cloud Services

The new revenue recognition standard - software and cloud services

January 2015
Overview

Software entities may need to change their revenue recognition policies and practices as a result of IFRS 15 Revenue from Contracts with Customers: a new standard jointly issued by the International Accounting Standards Board (the IASB) and the Financial Accounting Standards Board (the FASB) (collectively, the Boards). The new standard will supersede virtually all revenue recognition requirements in IFRS and US GAAP.

IFRS 15 specifies the accounting treatment for all revenue arising from contracts with customers. It affects all entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other IFRS, such as IAS 17 Leases). The new standard also provides a model for the recognition and measurement of gains and losses on the sale of certain non-financial assets, such as property and equipment and intangible assets.

The new standard will likely require software entities to use more judgement than they do today. The new model in IFRS 15 represents a significant change from the current ‘transfer of risks and rewards’ model in IAS 18 Revenue. Today, some entities may recognise fees from the development of their software by reference to the stage of completion of the development, which includes the completion of post-delivery service support services. In effect, software entities may treat the development of software and post-delivery service support as a single component. However, software entities may reach different conclusions under IFRS 15 about which goods or services can be accounted for separately and the consideration that needs to be allocated to them.

IFRS 15 could also change practice for software entities that sell their products through distributors or resellers. Under IAS 18, when the sales price charged to the distributor or reseller is not finalised until the product is sold to the end-customer, entities may wait until the product is sold to the end-customer to recognise revenue. Under IFRS 15, software entities could reach different conclusions than they do today and recognise revenue earlier because they will be required to estimate variable consideration and include these amounts in the transaction price (subject to the constraint on variable consideration). Applying the constraint on variable consideration introduces a threshold for recognition and measurement that differs from IAS 18.

The requirement to capitalise the incremental costs of obtaining a contract (e.g., sales commissions) if the entity expects to recover such costs, may also be a significant change for entities that expense these costs. Practice is generally divided today. Some software entities may already capitalise these costs under current IFRS. However, entities will need to evaluate whether there will be any changes to the costs that can be capitalised under IFRS 15.
This publication considers the key implications of IFRS 15 for software entities. It provides an overview of the revenue recognition model in IFRS 15 and highlights key considerations for the software industry. It also discusses accounting for licences of intellectual property, licence arrangements that include sales or usage-based royalties and cloud arrangements, amongst other issues. This publication supplements our Applying IFRS, A closer look at the new revenue recognition standard (June 2014)¹ (general publication) and should be read in conjunction with that publication.

For a discussion of the key considerations for technology entities that do not currently apply software guidance, refer to our Applying IFRS, The new revenue recognition standard - technology (January 2015) (technology publication).

To support stakeholders in the implementation of IFRS 15, the Boards have established a Joint Transition Resource Group for Revenue Recognition (TRG). The Boards created the TRG to help them determine whether additional interpretation, application guidance or education is needed on implementation issues and other matters submitted by stakeholders. The TRG will not make formal recommendations to the Boards or issue guidance. Issues highlighted in this publication have been, and continue to be, discussed by the TRG. Software entities should closely follow the TRG’s discussions and possible subsequent discussions by the Boards.

The American Institute of Certified Public Accountants (AICPA) established a software industry task force that is one of 16 industry task forces the AICPA has formed to help develop a new Accounting Guide on revenue recognition under US GAAP and to aid industry stakeholders in implementing the standard. Any views discussed by the TRG or guidance produced by the AICPA are non-authoritative.

The views we express in this publication are preliminary. We may identify additional issues as we analyse the standard and as entities begin to apply it and our views may evolve during that process.

¹ Available on www.ey.com/ifrs
## Contents

Overview ................................................................................................................. 1

1. Summary of the new standard ................................................................. 5

2. Effective date and transition .................................................................. 5

3. Scope ................................................................................................. 6

4. Identify the contract with the customer ............................................. 6
   4.1 Contract modifications ................................................................. 8

5. Identify the performance obligations in the contract ....................... 10
   5.1 Licences of intellectual property .............................................. 11
   5.2 Post-contract support services ............................................... 12
   5.3 Specified upgrades ................................................................. 13
   5.4 Unspecified additional software products ............................... 13
   5.5 Customer options for additional goods or services ............ 16
   5.6 Considerations for cloud arrangements .................................. 16
   5.7 Non-refundable upfront fees .................................................... 17

6. Determine the transaction price ............................................................ 18
   6.1 Variable consideration ............................................................. 18
   6.2 Significant financing component ............................................. 22
   6.3 Consideration paid or payable to a customer ............................ 22

7. Allocate the transaction price to the performance obligations ...... 23

8. Satisfaction of performance obligations ............................................... 26
   8.1 Transfer of control for distinct software licences ................. 26
   8.2 Transfer of control for performance obligations
      excluding distinct licences ..................................................... 29

9. Reseller and distributor arrangements .................................................... 30

10. Contract costs ...................................................................................... 31
    10.1 Costs of obtaining a contract ............................................... 32
    10.2 Costs of fulfilling a contract ................................................ 32
    10.3 Amortisation and impairment ................................................. 33

11. Warranties .......................................................................................... 33

12. Next steps ............................................................................................ 34
What you need to know

• IFRS 15 creates a single source of revenue requirements for all entities in all industries. Although principles-based like the current IFRS, the new standard may result in a significant change and will require software entities to exercise more judgement.

• The new standard applies to revenue from contracts with customers and replaces all of the revenue standards and interpretations in IFRS, including IAS 11 Construction Contracts, IAS 18 Revenue and related Interpretations. IFRS 15 could change practice for software entities that sell their products through distributors or resellers, potentially accelerating the recognition of revenue.

• Entities will need to evaluate whether services that are now considered post-contract customer support (and sometimes treated as a separate component under current IFRS) will be considered a separate performance obligation under IFRS 15.

• Entities will be required to capitalise incremental costs of obtaining a contract (e.g., sales commissions) that meet certain criteria. This may change practice for entities that currently expense such costs.

• The recognition and measurement requirements in IFRS 15 also apply to the sale of certain non-financial assets.

• The standard is effective for annual periods beginning on or after 1 January 2017, with early adoption permitted.
1. Summary of the new standard

IFRS 15 specifies the requirements an entity must apply to recognise and measure revenue and the related cash flows. The core principle of the standard is that an entity will recognise revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring promised goods or services to a customer.

The principles in IFRS 15 are applied using the following five steps:

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

Software entities will need to exercise judgement when considering the terms of the contract(s) and all relevant facts and circumstances, including implied contract terms. An entity also will have to apply the requirements of IFRS 15 consistently to contracts with similar characteristics and in similar circumstances. On both an interim and annual basis, an entity will generally need to disclose more information than it does under current IFRS. Annual disclosures will include qualitative and quantitative information about the entity’s contracts with customers, significant judgements made (and changes in those judgements) and contract cost assets.

2. Effective date and transition

IFRS 15 is effective for annual periods beginning on or after 1 January 2017. Early adoption is permitted for IFRS preparers and for first-time adopters of IFRS.

The effective date of the standard for public entities applying US GAAP is for fiscal years beginning after 15 December 2016, which is essentially the same as for IFRS preparers. However, US public entities will not be permitted to early adopt the standard.

All entities will be required to apply the standard retrospectively, either using a full retrospective or a modified retrospective approach. The Boards provided certain practical expedients to make it easier for entities to use a full retrospective approach.

Under the modified retrospective approach, financial statements will be prepared in the year of adoption using IFRS 15, but prior periods would not be adjusted (i.e., continue to be presented in accordance with prior revenue standards). Instead, an entity will recognise a cumulative catch-up adjustment to the opening retained earnings (or other appropriate component of equity) at the date of initial application for contracts that still require performance by the entity (i.e., contracts that are not completed). In addition, an entity will have to disclose the amount by which each financial statement line item was affected as a result of applying IFRS 15 and an explanation of significant changes.

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2 US non-public entities will be required to apply the new standard to reporting periods beginning after 15 December 2017. Early adoption is permitted, but not prior to reporting periods beginning after 15 December 2016.

3 For more information about the effective date and transition options, see Applying IFRS, A closer look at the new revenue recognition standard available on ey.com/ifrs.
3. Scope

IFRS 15 applies to all contracts with customers to provide goods or services in the ordinary course of business, except for the following contracts, which are specifically excluded from the scope:

- Lease contracts within the scope of IAS 17
- Insurance contracts within the scope of IFRS 4 Insurance Contracts
- Financial instruments and other contractual rights or obligations within the scope of IFRS 9 Financial Instruments or IAS 39 Financial Instruments: Recognition and Measurement, IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements, IAS 27 Separate Financial Statements and IAS 28 Investments in Associates and Joint Ventures
- Non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers

4. Identify the contract with the customer

The model in IFRS 15 applies to each contract with a customer. Contracts may be written, oral or implied by an entity’s customary business practices, but must be legally enforceable and meet specific criteria.

The Boards acknowledged that the determination of whether an arrangement has created enforceable rights is a matter of law and the factors that determine enforceability may differ by jurisdiction. In addition, the Boards identified certain criteria that must be present in order for an arrangement to meet the definition of a contract within the scope of the model in IFRS 15. These criteria include: approval of the contract by all parties; identification of each party’s rights in respect of goods and services to be transferred and the associated payment terms; and determination that the contract has commercial substance. In addition, an entity must conclude that it is probable that it will collect the consideration to which it expects to be entitled in exchange for the goods or services that will be transferred to the customer. These criteria are assessed at contract inception. If met, they are not reassessed, unless there is a significant change in facts and circumstances. An entity is also required to combine two or more contracts that it enters into at, or near, the same time with the same customer and account for them as a single contract, if they meet specified criteria.

Under current IFRS, entities are required to consider the underlying substance and economics of an arrangement, not merely its legal form. The Conceptual Framework for Financial Reporting states that “representing a legal form that differs from the economic substance of the underlying economic phenomenon may not result in a faithful representation.”

For example, a customer may sign and return a contract that the entity has not yet signed or an entity may deliver a software licence to the customer before both parties sign the contract. In these cases, an entity may conclude, under current IFRS, that an arrangement exists at that point in time based on an assessment of substance over form. Others may conclude the contract does not exist until a later date.

4 Conceptual Framework BC3.26
An entity may or may not reach a similar conclusion under IFRS 15. In assessing whether enforceable rights and obligations have been created between the parties in the arrangement, entities will have to exercise judgement.

**How we see it**

The new standard could change practice for some software entities. Some software entities may determine that enforceable rights and obligations exist as soon as performance begins, rather than at a later date, such as when the contract is signed by both parties. Careful consideration of the facts and circumstances of an arrangement will be required to determine when enforceable rights and obligations exist.

This evaluation will be affected by laws and legal precedent involving enforceability in the relevant jurisdiction and will require significant judgement.

Software entities will need robust documentation to demonstrate that a contract is legally enforceable. They may also need to develop or update processes to reflect the change in the accounting requirements.

Under IFRS 15, an assessment of collectability is included as one of the criteria for determining whether a contract with a customer exists. That is, an entity must conclude that it is probable that it will collect the consideration to which it expects to be entitled (i.e., the transaction price). The transaction price may differ from the stated contract price (e.g., if an entity intends to offer a concession and accept an amount less than the contractual amount). When performing the collectability assessment, an entity only considers the customer’s ability and intention to pay the expected consideration when due. This criterion essentially acts as a collectability threshold, similar to current IFRS, which requires that revenue only be recognised if it is probable that the economic benefits associated with the transaction will flow to the entity (assuming the other revenue recognition criteria have been met).  

However, the Boards acknowledged that an entity may enter into an arrangement not expecting to collect the full contractual amount (e.g., the contract contains an implied price concession). Therefore, the entity needs to assess collectability of the amount to which it expects to be entitled, rather than the stated contractual amount. This difference could result in the earlier recognition of revenue for arrangements in which a portion, but not the entire amount, of the contract price is considered to be at risk. Refer to Section 6 below.

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5 IAS 18.14(d)
**Illustration 4-1 – Collectability is probable**

Software Co. decides to enter a new region that is currently experiencing economic difficulty. Software Co. expects the economy to recover over the next two to three years and determines that building a relationship in the current environment could result in potential growth in future years. Software Co. enters into an arrangement with a customer in the new region for a software licence for promised consideration of CU1 million. At contract inception, Software Co. expects that it may not be able to collect the full amount from the customer.

Assuming the contract meets the other criteria to be within the scope of the model in IFRS 15, Software Co. assesses whether collectability is probable. In making this assessment, Software Co. considers whether the customer has the ability and intent to pay the estimated transaction price, which may be an amount less than the contract price (e.g., the entity may offer a price concession to the customer). For the purpose of this example, assume Software Co. determined at contract inception that it may be forced to grant the customer a price concession and it is willing to do so, up to CU200,000, if necessary. As a result, Software Co. determines that the amount to which it expects to be entitled is CU800,000. It performs the collectability assessment based on that amount, rather than the contractual price of CU1 million.

Refer to our discussion of implied price concessions in variable consideration in Section 6.1.1 below.

**How we see it**

Software entities may struggle with applying the collectability criterion. Under current IFRS, when software entities have significant concerns about whether they will collect the stated contractual amount (i.e., they are unable to conclude that it is probable that the economic benefits will flow to the entity), they may defer the recognition of revenue until cash is collected.

Under IFRS 15, software entities will need to carefully evaluate the customer’s ability and intent to pay the amount to which they expect to be entitled, which may not necessarily be the stated contractual price. As a result, entities may reach different conclusions than they do today and may recognise revenue earlier in some cases.

4.1 Contract modifications

A contract modification is a change in the scope or price (or both) of a contract. Changes to existing contracts, such as extensions or renewals of software licences, are examples of contract modifications that may occur in software arrangements.

An entity must determine whether the modification creates a separate contract or whether it will be accounted for as part of the existing contract. Two criteria must be met for a modification to be treated as a separate contract: (1) the additional goods and services are distinct from the goods and services in the original arrangement (see Section 5); and (2) the amount of consideration expected for the added goods and services reflects the stand-alone selling price of those goods or services (see Section 7). Only modifications that meet these criteria can be treated as separate contracts. In determining the stand-alone selling price, entities have some flexibility, depending on the facts and circumstances. For example, an entity may conclude that, with additional purchases, a customer qualifies for a volume-based discount.
A contract modification that does not meet the criteria to be accounted for as a separate contract is considered a change to the original contract. It is treated as either the termination of the original contract and creation of a new contract, or as a continuation of the original contract (or a combination of the two) depending on whether the remaining goods or services to be provided after the contract modification are distinct. Such modifications are accounted for as follows:

- A termination of the original contract and creation of a new contract (i.e., on a prospective basis), if the goods and services subject to the modification are distinct from the other goods and services provided within the original contract, but the consideration does not reflect the stand-alone selling price of those goods or services

- A continuation of the original contract if the goods or services added or removed are not distinct from the goods and services already provided. Such modifications are accounted for on a cumulative catch-up basis

**Illustration 4-2 – Contract modification is not a separate contract**

Software Co. enters into an arrangement with a customer to significantly customise a financial reporting application for CU30,000. Based on its experience, Software Co. determines that customising the application will take two technicians approximately 150 hours in total to complete the project. This will be charged at a rate of CU200 per hour. Assume Software Co. accounts for the services as a single performance obligation and satisfies the performance obligation over time because the customer simultaneously receives and consumes the benefits provided as Software Co. performs.

After incurring 30 hours of time (satisfying 20% of the performance obligation), Software Co. and the customer agree to change an aspect of the project that increases the estimate of labour hours by 50 hours, which will be charged at a rate of CU100 per hour. The contract is modified to reflect a total price of CU35,000 for a total of 200 hours.

Software Co. accounts for the contract modification as part of the original contract because the service is not distinct. Rather, it is part of the single performance obligation that is partially satisfied at the date of the contract modification. Software Co. updates its measure of progress and estimates that it has satisfied 15% of its performance obligation (30 hours incurred at the time the contract was modified ÷ 200 total hours expected to complete the project). Consequently, Software Co. recognises a reduction in revenue of CU750 at the date of the modification as a cumulative catch-up adjustment (CU6,000 revenue recognised to date (15% complete × CU35,000 modified transaction price)).
5. Identify the performance obligations in the contract

Once an entity has identified the contract with a customer, it evaluates the contractual terms and its customary business practices to identify all the promised goods or services within the contract and determine which of those promised goods or services (or bundles of promised goods or services) will be treated as separate performance obligations.

Promised goods and services represent separate performance obligations if they are:

- Distinct (by themselves or as part of a bundle of goods and services)

Or

- Part of a series of distinct goods and services that are substantially the same and have the same pattern of transfer to the customer

A good or service (or bundle of goods and services) is distinct if the customer can benefit from the good or service on its own or together with other readily available resources (i.e., the good or service is capable of being distinct) and the good or service is separately identifiable from other promises in the contract (i.e., the good or service is distinct within the context of the contract). A promised good or service that an entity determines is not distinct is combined with other goods or services until a distinct performance obligation is formed.

Software arrangements commonly involve the delivery of multiple goods and services, such as a software licence, unspecified or specified future upgrades and enhancements, maintenance and other professional services. Goods or services promised in a contract with a customer can either be explicitly stated in the contract or implied by an entity's customary business practice. IFRS 15 requires entities to consider whether the customer has a valid expectation that the entity will provide a good or service when it is not explicitly stated. If the customer has a valid expectation, the customer would view those promises as part of the goods or services in the contract.

The new requirements for identifying separate performance obligations will be a significant change for software entities. Current IFRS does not specifically address contracts with multiple components. IAS 18 indicates that an entity may need to apply its recognition criteria to separately identifiable components in order to reflect the substance of the transaction. However, it does not provide additional application guidance for determining those separate elements.

Some software entities may currently recognise fees from the development of their software by reference to the stage of completion of the development, which includes the completion of post-delivery service support services. In effect, the software entities treat the development of software and post-delivery service support as a single component under current IFRS. However, software entities may reach different conclusions under IFRS 15 about which goods and services can be accounted for separately and the consideration that is allocated to them. This may be a change in practice.

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6 IAS 18.13, IE19
Other IFRS preparers may currently identify separate components to reflect the substance of the transaction.7 Furthermore, given the limited application guidance in IFRS, some entities may develop their accounting policies by reference to the applicable US GAAP requirements (e.g., Accounting Standards Codification (ASC) 985-605 - Software Revenue Recognition). US GAAP’s software accounting under ASC 985-605 currently allows an entity to separately account for elements in a software licensing arrangement only if vendor-specific objective evidence (VSOE) of fair value exists for the undelivered element(s). An entity that does not have VSOE of fair value for the undelivered element(s) generally must combine multiple elements in a single unit of account and recognise revenue as the delivery of the last element takes place. For those entities that look to this literature (and separately accounted for elements only when VSOE of fair value exists), this will no longer be a requirement of the new model under IFRS 15.

How we see it
Software entities may reach different conclusions about separate performance obligations under IFRS 15 than they do under current IFRS. Software entities will need to carefully consider whether the good or service is separable from other promises in the contract, which may be challenging and will require significant judgement.

5.1 Licences of intellectual property
The determination of whether a licence is distinct may require judgement. In some software arrangements, a software licence will be distinct because it is the only promise in the contract. In other arrangements, the customer will be able to benefit from the licence on its own or with readily available resources and it will be separately identifiable from the other goods or services in the contract (i.e., the other goods or services are also distinct). An example of a distinct licence is a software package that can be used on its own without customisation or modification and future upgrades are not necessary for the customer to retain continued functionality of the software for a reasonable period of time after the initial free maintenance period.

Licences that an entity determines are not distinct are combined with other promised goods or services in the contract until a separate performance obligation is identified. In some contracts, the customer can benefit from the licence only with another good or service that is promised (explicitly or implicitly) in the contract. For example, a software licence may be embedded in a software-enabled tangible good and the software significantly influences the features and functionality of the tangible good. The customer cannot benefit from the software licence on its own, nor is it separable from the tangible good.

Certain types of software, such as antivirus software, require frequent upgrades to keep the software current in order for it to be beneficial to the customer. Under IFRS 15, an entity may conclude that such software licences are not capable of being distinct because the customer cannot obtain the benefit from the software without also obtaining the subsequent upgrades. In these situations, the software licence, together with the unspecified upgrades, will form a single distinct performance obligation.

7 IAS 18.13
Entities may also enter into arrangements with customers that involve significant production, modification or customisation of licenced software. Under IFRS 15, entities may conclude that the software licence is not distinct within the context of the contract. That is, the software licence and professional services are generally highly interrelated and significant integration and modification is required. Therefore, the licence and services together are a single performance obligation.

5.2 Post-contract support services

Most arrangements involving software also include promises for the right to receive services or unspecified upgrades and enhancements (or both) after the licence period begins. Generally, these services include telephone support and correction of errors (bug fixes or debugging), as well as unspecified upgrades or enhancements. These activities are commonly known as post-contract support (PCS). Entities may combine PCS with the software as a single component under current IFRS by reference to IAS 18.IE19. While other entities may separate PCS as a separate component from the software or even into multiple separate components.

PCS is not a unique service contemplated or defined in IFRS 15. As a result, entities will need to evaluate whether the individual services that comprise what is considered PCS today will be separate performance obligations. For example, a software entity may conclude that the promise to provide unspecified future upgrades and enhancements is a distinct promised good or service in the contract and, therefore, is a separate performance obligation. The entity may also determine that bug fixes and telephone support are provided to ensure that the software is functioning as promised. As a result, those services would be part of the assurance warranty coverage for the software and not a revenue element (such warranties will be accounted for under IAS 37 Provisions, Contingent Liabilities and Contingent Assets).

However, other entities may conclude that the promise to provide telephone support and bug fixes contains both an assurance-type warranty (non-revenue element) and service-type warranty (revenue element), as discussed further in Section 11 below.

Furthermore, when the contract includes a promise to provide unspecified future upgrades and enhancements, the entity must determine the nature of that promise. For example, an entity may conclude that it has established a clear pattern of providing only one significant upgrade or enhancement per year. Therefore, the obligation to provide ‘future upgrades and enhancements’ actually is an obligation to provide this single upgrade or enhancement. Alternatively, if the entity has a history of providing multiple upgrades each year, with no discernible pattern of when those upgrades are provided, the entity may conclude that the service is more consistent with a ‘stand-ready’ obligation.

How we see it

Software entities will need to carefully assess whether the services they now account for as PCS are separate performance obligations. Software entities may need to adjust their systems or create new ones to track and account for any additional performance obligations they may identify.

The TRG included stand-ready performance obligations on its agenda for discussions. Software entities should monitor those discussions at the TRG and any subsequent developments.
5.3 Specified upgrades
Entities may provide customers with the right to specified upgrades or enhancements as part of a software arrangement. Under IFRS 15, entities will need to evaluate whether the rights to receive specified upgrades or enhancements are promised goods or services and potentially separate performance obligations. If the specified upgrade is a separate performance obligation, a portion of the transaction price is allocated to it and revenue recognition is deferred until the specified upgrade is provided.

Some entities may account for a specified upgrade or enhancement as a separate identifiable component under current IFRS and allocate revenue to it, while others may account for it together with other components. Current IFRS does not restrict the methods that may be used to allocate consideration between components. If the specified upgrades are accounted for as a separate identifiable component, entities may use methods, such as relative fair value or a residual approach, to allocate consideration.

Other IFRS preparers may look to US GAAP in developing their accounting policies. The requirements in IFRS 15 represent a significant change from ASC 985-605 for specified upgrades and enhancements. Under ASC 985-605, because VSOE of fair value is generally unavailable for a yet-to-be-provided upgrade, an entity that includes such a promise in an arrangement is unable to separate the delivered elements from the upgrade. As a result, the upgrade is combined with the delivered elements as a single component, and the recognition of the entire arrangement consideration is typically deferred until the specified upgrade is provided.

5.4 Unspecified additional software products
As part of a contract with a customer, a software entity may license software today and promise to deliver unspecified additional software products in the future. For example, the software entity may agree to deliver all new products to be introduced in a family of products over the next two years.

Unspecified additional software products may be treated as a separately identifiable component under current IFRS by some entities. If so, the amount allocated to the component is recognised as revenue over the period that the products are provided. Other entities may account for the unspecified additional software products together with the related licence as a single component. The timing of revenue recognition, in those situations, may be affected by the licence.

Alternatively, since current IFRS does not provide detailed application guidance, some entities may look to US GAAP in developing their accounting policies. Under current US GAAP requirements, unspecified additional software products are distinguished from PCS because the future components are products, rather than unspecified upgrades or enhancements. The software elements of these arrangements are often accounted for as subscriptions. Revenue is not allocated to any of the individual software products. Instead, all software product-related revenue from the arrangement is recognised rateably over the term of the arrangement, beginning with delivery of the first product.

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8 ASC 985-605
Under IFRS 15, software entities will be required to determine whether the promise to deliver unspecified additional software products is a performance obligation separate from the licence that it delivers. Software entities will also need to evaluate whether the promise to deliver unspecified additional software products is a stand-ready obligation to provide future products on a when-and-if available basis or individual promises to deliver specified future products.

The standard includes the following example to illustrate the determination of whether goods and services in a software arrangement are distinct:

**Extract from IFRS 15**

**Example 11 – Determining whether goods or services are distinct** (IFRS 15.IE49-IE58)

**Case A—Distinct goods or services**

An entity, a software developer, enters into a contract with a customer to transfer a software licence, perform an installation service and provide unspecified software updates and technical support (online and telephone) for a two-year period. The entity sells the licence, installation service and technical support separately. The installation service includes changing the web screen for each type of user (for example, marketing, inventory management and information technology). The installation service is routinely performed by other entities and does not significantly modify the software. The software remains functional without the updates and the technical support.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 27 of IFRS 15. The entity observes that the software is delivered before the other goods and services and remains functional without the updates and the technical support. Thus, the entity concludes that the customer can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available and the criterion in paragraph 27(a) of IFRS 15 is met.

The entity also considers the factors in paragraph 29 of IFRS 15 and determines that the promise to transfer each good and service to the customer is separately identifiable from each of the other promises (thus the criterion in paragraph 27(b) of IFRS 15 is met). In particular, the entity observes that the installation service does not significantly modify or customise the software itself and, as such, the software and the installation service are separate outputs promised by the entity instead of inputs used to produce a combined output.

On the basis of this assessment, the entity identifies four performance obligations in the contract for the following goods or services:

(a) the software licence;
(b) an installation service;
(c) software updates; and
(d) technical support.

The entity applies paragraphs 31–38 of IFRS 15 to determine whether each of the performance obligations for the installation service, software updates and technical support are satisfied at a point in time or over time. The entity also assesses the nature of the entity’s promise to transfer the software licence in accordance with paragraph B58 of IFRS 15 (see Example 54 in paragraphs IE276-IE277).
Extract from IFRS 15 (cont’d)

Case B—Significant customisation

The promised goods and services are the same as in Case A, except that the contract specifies that, as part of the installation service, the software is to be substantially customised to add significant new functionality to enable the software to interface with other customised software applications used by the customer. The customised installation service can be provided by other entities.

The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 27 of IFRS 15. The entity observes that the terms of the contract result in a promise to provide a significant service of integrating the licenced software into the existing software system by performing a customised installation service as specified in the contract. In other words, the entity is using the licence and the customised installation service as inputs to produce the combined output (ie a functional and integrated software system) specified in the contract (see paragraph 29(a) of IFRS 15). In addition, the software is significantly modified and customised by the service (see paragraph 29(b) of IFRS 15). Although the customised installation service can be provided by other entities, the entity determines that within the context of the contract, the promise to transfer the licence is not separately identifiable from the customised installation service and, therefore, the criterion in paragraph 27(b) of IFRS 15 (on the basis of the factors in paragraph 29 of IFRS 15) is not met. Thus, the software licence and the customised installation service are not distinct.

As in Case A, the entity concludes that the software updates and technical support are distinct from the other promises in the contract. This is because the customer can benefit from the updates and technical support either on their own or together with the other goods and services that are readily available and because the promise to transfer the software updates and the technical support to the customer are separately identifiable from each of the other promises.

On the basis of this assessment, the entity identifies three performance obligations in the contract for the following goods or services:

(a) customised installation service (that includes the software licence);
(b) software updates; and
(c) technical support.

The entity applies paragraphs 31–38 of IFRS 15 to determine whether each performance obligation is satisfied at a point in time or over time.

How we see it

Identifying performance obligations under IFRS 15 will require software entities to exercise greater judgement. The performance obligations identified under IFRS 15 may differ from the components identified under current IFRS (whether the software entity looked to US GAAP or not) and this may mean a change to how revenue is being recognised for some software entities.
5.5 Customer options for additional goods or services
Under some contracts, entities provide the customer with the right to future purchases of additional products or services for an amount below fair value. Under IFRS 15, such options are separate performance obligations if they provide a material right to the customer that it would not receive without entering into that contract. For example, the option may convey a material right if the discount exceeds the range of discounts typically given for those goods or services to that class of customer in that geographical area or market. If an option is a separate performance obligation, a portion of the transaction price is allocated to the option (see Section 7 below), and the allocated amount will be deferred until the option is exercised or until the right expires.

How we see it
Software arrangements often include options to purchase additional goods or services that may be priced at a discount, such as sales incentives, contract renewal options (e.g., waiver of certain fees, reduced future rates) or other discounts on future goods or services. Current IFRS does not provide application guidance on how to distinguish between an option and a marketing offer. Nor does it address how to account for options that provide a material right. As a result, some entities may effectively account for such options as marketing offers, even if the option is substantive (i.e., the customer makes a separate buying decision and has the ability to exercise or not exercise its right). Careful assessment of contractual terms will be important to distinguish between options that are accounted for as separate performance obligations under IFRS 15 and marketing offers. See also Section 11 for a discussion on warranties.

5.6 Considerations for cloud arrangements
Cloud services arrangements may include the cloud services (such as software-as-a-service (SaaS)) or other products or services. These arrangements also frequently include a licence of the software, for which the customer may (or may not) have the right to take possession. Cloud services entities also frequently offer professional services, such as implementation, data migration, business process mapping, training and project management services, in addition to the cloud service itself. These professional services may be required for a customer to begin using the cloud services in the manner described in the contract.

IFRS 15 provides a framework for identifying the performance obligations in a contract. When an entity determines that the promised goods or services are distinct, it will need to determine whether it is providing a software licence (as a separate performance obligation from the hosting service) or a service (a licence and hosting services that, together, are a single performance obligation because the two promises are not distinct from one another).

In some contracts, the assessment of whether the licence is distinct will be relatively straight-forward. For example, an entity may provide a customer with a software licence, but only in conjunction with a hosting service. In addition, the customer cannot take control of the licence or use the software without the hosting service. In this example, the customer cannot benefit from the licence on its own and the licence is not separable from the hosting services. Therefore, the licence is not distinct and would be combined with the hosting service.
However, many arrangements are more complex. For example, in some contracts, some of the software (enabling certain functionality) resides on the customer’s premises, and the customer has the ability to take control of that software. However, other functionality is provided by the hosting service and the customer cannot take control of that software. As a result, this determination may require significant judgement, depending on the terms of the contract.

5.7 Non-refundable upfront fees

In many transactions, customers may pay an upfront fee at contract inception, which may relate to the initiation, activation or set-up of a good to be used or a service to be provided in the future. Under IFRS 15, entities must evaluate whether non-refundable upfront fees relate to the transfer of a good or service. In addition, the existence of such fees may indicate that there are other implied elements in the contract, such as the option to renew a service at a discounted rate because the upfront fee would not be charged for the renewal period. In such situations, the identified promised goods and services would also include those implied items.

Under IFRS 15, the non-refundable fee is allocated to the identified performance obligations in the contract (which may include some implied performance obligations) and it is recognised as revenue as the performance obligations are satisfied. By requiring allocation of the upfront fees to the future goods or services or renewal options, the adoption of IFRS 15 may result in a change in practice for some entities. See the illustrative example below:

<table>
<thead>
<tr>
<th>Illustration 5-1 — Non-refundable upfront fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cloud Co. enters into a contract with a customer for a licence of its software and a non-cancellable one-year subscription to access the licensed application (the cloud services). The contract amount for the software licence is an upfront, non-refundable fee of CU1 million. The fee for the cloud services is CU500,000 for one year. The customer has the right to renew the cloud services each year for CU500,000.</td>
</tr>
</tbody>
</table>

Assume that Cloud Co. determines the software licence and cloud services are a single performance obligation. There are no other promised goods and services in the contract. Therefore, the upfront fee is not associated with the transfer of any other good or service to the customer. However, Cloud Co. determines there is an implied performance obligation. That is, the right to renew the cloud services each year for CU500,000 is a material right to the customer because that renewal rate is significantly below the rate the customer paid for the first year of service (CU1.5 million in total).

Based on its experience, Cloud Co. determines that its average customer relationship is three years. As a result, Cloud Co. determines that the performance obligations in the contract include the right to a discounted annual contract renewal and that the customer is likely to exercise twice.

We discuss options further in Section 7 in relation to allocating the transaction price to performance obligations.
6. Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled. It includes an estimate of any variable consideration, the effect of a significant financing component (i.e., the time value of money), the fair value of any non-cash consideration and the effect of any consideration paid or payable to a customer.

The entitled amount is meant to reflect the amount to which the entity has rights under the present contract and may differ from the contractual price. For example, there may be variable consideration (if the entity expects to receive or accept an amount less than the stated contract amount) or the payment may be received before or after the entity provides goods or services.

6.1 Variable consideration

Entities enter into contracts in which a portion of the transaction price could vary because of the contract terms or the entity’s intention to act under the contract. For example, such terms could represent discounts or rebates offered or price concessions provided to customers in emerging markets.

IFRS 15 requires an entity to estimate, at contract inception, any variable consideration in the contract, but limits the amount of variable consideration an entity can include in the transaction price to the amount for which it is highly probable that a significant reversal in cumulative revenue recognised will not occur when the uncertainties related to the variability are resolved. That is, the standard requires an entity to apply a constraint on variable consideration. This determination includes considering both the likelihood and magnitude of a revenue reversal. The estimate of variable consideration, including the amounts subject to constraint, is updated at each reporting period.

Variable consideration will be estimated using either an ‘expected value’ or ‘most likely amount’ method, whichever better predicts the consideration to which the entity will be entitled. That is, the method selected is not meant to be a ‘free choice’. Rather, an entity needs to consider which method it expects to better predict the amount of consideration to which it will be entitled and apply that method consistently for similar types of contracts.

For a number of entities, the treatment of variable consideration under the new standard could represent a significant change from current practice. Under current IFRS, preparers often defer measurement of variable consideration until revenue is reliably measurable, which could be when the uncertainty is removed or when payment is received.

Furthermore, current IFRS permits recognition of contingent consideration, but only if it is probable that the economic benefits associated with the transaction will flow to the entity and the amount of revenue can be reliably measured. Some entities, therefore, defer recognition until the uncertainty is resolved.

In contrast, the constraint on variable consideration in IFRS 15 is an entirely new way of evaluating variable consideration and is applicable to all types of variable consideration in all transactions. As a result, depending on the accounting treatment entities currently apply, some entities may recognise revenue sooner under the new standard, while others may recognise revenue later. Greater judgement will also be required to measure revenue.
6.1.1 Implied price concessions

In certain situations, entities may enter into a contract anticipating that they will be unable to fully collect the stated contractual price. When the entity is aware of that risk and still chooses to transact with the customer, there may be an implied price concession in the contract. Under IFRS 15, any implied price concessions are components of variable consideration, and an entity must estimate these amounts at contract inception. For example, consider a software entity has a history of providing a price concession in a specific region that is 40% of the contract price. When determining the transaction price for an arrangement entered into in that region, the entity may determine that 60% of the contract price is the transaction price. That is, there is an implied price concession for the remaining 40% based on the entity's past practice.

Adjusting for implied price concessions could result in a significant change in practice for some entities. In some cases, entities currently recognise revenue from customers with these types of fact patterns on a cash basis due to the uncertainty in collectability. Although an entity may determine that the likelihood of an adjustment to the stated contract price is high (e.g., because price concessions will be granted), an entity must include its estimate of variable consideration in the transaction price, subject to the constraint, rather than deferring all revenue recognition until the uncertainty has been resolved.

How we see it

Software entities may find it challenging to distinguish between implied price concessions (i.e., reductions of revenue) and customer credit risk (i.e., bad debt) for collectability issues that were known at contract inception.

Software entities will need to carefully evaluate all facts and circumstances that were available at contract inception, as well as any subsequent events that may affect the customer's ability to pay. Significant judgement will be required when making this determination and documentation of the judgement should be retained. Software entities should develop clear policies and procedures for these evaluations to ensure consistent application across all transactions.

6.1.2 Licence arrangements that include sales or usage-based royalties

Entities commonly enter into arrangements that require the customer to pay consideration based on the sales or usage of a licence, such as a percentage of software sales generated by a distributor who has the right to distribute the software over a period of time.

IFRS 15 restricts when this type of variable consideration can be included in the transaction price. It requires that these amounts be recognised only at the later of: (a) when the sale or usage occurs; or (b) the performance obligation to which some or all of the sales or usage-based royalty has been allocated is satisfied (in whole or in part).

It is unclear whether this exception will apply to royalties that relate to both licensed intellectual property and other goods or services in a contract. An example would be a contract for a software licence that allows the customer to embed the licensor's software in its products, but also includes significant customisation services upfront that would require the goods and services to be bundled as one performance obligation. The TRG has discussed a number of views, including whether the exception would apply solely to a licence that is a separate performance obligation or whether it would apply regardless of whether the royalty also relates to a non-licence good or service. It is not yet clear whether the Boards will provide additional application guidance.
6.1.3 Right of return

A right of return, either explicitly stated in a contract or implied by an entity's customary business practice, is not a separate performance obligation. However, a right of return in a contract creates variability in the transaction price and, therefore, is a form of variable consideration. Under IFRS 15, an entity will estimate returns and include that estimate as a reduction of the transaction price (subject to the constraint). The entity will recognise the amount of expected returns as a refund liability, representing its obligation to return the customer's consideration. The entity will also recognise a return asset (and adjust cost of sales) for its right to recover the goods returned by the customer measured at the former carrying amount of the inventory, less any expected costs to recover those goods. For many software entities, this amount may be zero because there is no inventory to be returned.

The new standard's requirements are not significantly different from current IFRS. However, IFRS 15 specifies the presentation of a refund liability and the corresponding refund asset.

At each reporting date, an entity will remeasure the refund liability and update the measurement of the asset recorded, if any, for any revisions to its expected level of returns, as well as any potential decreases in the value of the products expected to be returned. That is, a returned item is recognised at the lower of the original cost, less the cost to recover the asset or the fair value of the asset at the time of recovery.

6.1.4 Extended payment terms

Under IFRS 15, when a contract provides the customer with extended payment terms, an entity will need to consider whether those terms create variability in the transaction price (i.e., are a form of variable consideration) and whether a significant financing component exists. Significant financing components are addressed in Section 6.2 below.

An entity will need to carefully evaluate contracts that include extended payment terms to determine whether the entity has an intention, or a valid expectation, that it will provide a price concession over the financing term. For example, a software entity may have a business practice of providing price concessions in contracts that include extended payment terms in order to negotiate a contract renewal with its customers. Such price concessions are a form of variable consideration, which are required to be estimated at contract inception and deducted from the transaction price.

As discussed in Section 6.1.1 on implied price concessions above, some entities may defer revenue recognition today if their contracts contain extended payment terms. Other IFRS preparers may take a different view, believing that the economic benefits will flow to the entity and the amount of revenue is reliably measurable and, therefore, recognise the revenue associated with the extended payment terms.

Depending on the accounting policy choices and judgements applied by an entity previously, some entities may recognise revenue earlier under IFRS 15, despite the extended payment terms, if they determine that the transaction price is not constrained. Others may recognise revenue later, if they had not previously deferred recognising any of the revenue, but will now have to do so when applying a constraint on variable consideration under IFRS 15.

The treatment of extended payment terms under IFRS 15 may be a significant change from current practice.
Illustration 6-1 — Extended payment terms

Software Entity X enters into a contract with a customer for a perpetual software licence on 30 December 20X3 for CU1.5 million. Payment terms are as follows:

- CU250,000 due 31 January 20X4
- CU250,000 due 30 April 20X4
- CU250,000 due 31 July 20X4
- CU250,000 due 31 October 20X4
- CU250,000 due 31 January 20X5
- CU250,000 due 30 April 20X5

Software Entity X’s standard payment terms for such arrangements are net 45 days and the entity has not provided this type of extended payment schedule to customers in the past.

Analysis

Under current IFRS, Software Entity X defers the recognition of revenue because it has no history of offering and collecting from customers with these types of extended terms. In this example, assuming all of the other revenue recognition criteria have been met, Software Entity X would then recognise revenue as the payments become due or when it becomes probable economic benefits will flow to the entity.

Under IFRS 15, if Software Entity X expects that it will be entitled to the entire transaction amount (i.e., it did not anticipate providing concessions or rebates to the customer), therefore the fixed arrangement fee of CU1.5 million will be recognised when control of the software licence is transferred.

In contrast, assume at contract inception, Software Entity X anticipates that it may provide some amount of concession or discount to the customer because of the extended payment terms. Under IFRS 15, the transaction includes variable consideration, and the entity will need to estimate the variable consideration to be included in the transaction price. Software Entity X will consider factors such as the customer’s current financial status in estimating the variable consideration. Using an expected value calculation, Software Entity X estimates a transaction price of CU1.3 million. It also concludes that it is probable that a significant revenue reversal of that amount will not occur. Therefore, in this case, the constraint does not further reduce the amount of variable consideration included in the estimated transaction price. The entity will need to update its estimate of the transaction price throughout the term of the arrangement to depict conditions that exist at the end of each reporting period.

This illustration does not consider whether a significant financing component exists. We discuss this concept further in Section 6.2.

How we see it

Under IFRS 15, while the existence of extended payment terms in a contract likely creates variability in the transaction price, it might not result in the full deferral of revenue. This will likely be a significant change for software entities that defer the recognition of revenue until cash is collected.
6.2 Significant financing component

Entities often enter into arrangements under which the timing of the payment from the customer does not match the timing of the entity’s transfer of the goods or services (i.e., the customer pays in advance or in arrears). For example, payments for maintenance are frequently made upfront while those services are provided over the contractual term. As previously discussed, contracts also may include extended payment terms.

An entity is required to adjust the transaction price for the time value of money if there is a significant financing component. It uses the same discount rate that it would use if it were to enter into a separate financing transaction with the customer. The assessment of significance is done at the individual contract level, but IFRS 15 does not specify how this assessment would be made. As a practical expedient, an entity is not required to assess whether the contract contains a significant financing component unless the period between the customer’s payment and the entity’s transfer of goods or services is greater than one year.

How we see it

Software entities will need to exercise judgement in assessing the significance of the financing component because the standard does not establish quantitative thresholds for significance. The treatment of the time value of money may have a significant effect on long-term contracts, such as multi-year maintenance arrangements with upfront payments.

Even entities that do not believe a financing component is significant will need to make a formal assessment. Software entities may be able to alleviate the burden of performing the significance assessment by using a practical expedient provided by the Boards.9

6.3 Consideration paid or payable to a customer

Software entities may agree to compensate a reseller or distributor up to a specified amount for shortfalls in the sales price or reimburse their customers for marketing activities related to certain software products. Consideration payable to a customer is treated as a reduction in the transaction price and, therefore, revenue, unless the payment to the customer is in exchange for a distinct good or service. The payment for distinct goods and services received is limited to their fair value, with any amount in excess of the fair value recognised as a reduction in the transaction price.

Entities will need to carefully assess whether the consideration paid to the customer is actually a payment for a distinct good or service or whether it is a reduction in the transaction price for the goods and services the entity is transferring to the customer.
7. Allocate the transaction price to the performance obligations

Once the performance obligations have been identified and the transaction price has been determined, an entity is required to allocate the transaction price to the performance obligations, generally in proportion to their stand-alone selling prices (i.e., on a relative stand-alone selling price basis), with two exceptions. Firstly, the standard requires an entity to allocate variable consideration to one or more, but not all, performance obligations in some situations. Secondly, IFRS 15 contemplates the allocation of any discount in an arrangement to one or more, but not all, performance obligations, if specific criteria are met. The transaction price is not reallocated to reflect changes in stand-alone selling prices after contract inception.

The stand-alone selling price is the price at which an entity would sell a good or service on a stand-alone basis at contract inception. When determining stand-alone selling prices, an entity is required to use observable information, if available. If stand-alone selling prices are not directly observable, an entity will need to make estimates based on information that is reasonably available.

Possible estimation approaches include: (1) an adjusted market assessment approach; (2) an expected cost plus a margin approach; or (3) a residual approach. The use of one or a combination of the methods may be appropriate in estimating the stand-alone value of a good or service. Furthermore, these are not the only estimation methods permitted. IFRS 15 allows any reasonable estimation method, as long as it is consistent with the notion of a stand-alone selling price and maximises the use of observable inputs. An entity is required to apply estimation methods consistently in similar circumstances.

The new requirements for the allocation of the transaction price to performance obligations could result in a change in practice for many entities. IAS 18 does not prescribe an allocation method for multiple-element arrangements. IFRIC 13 Customer Loyalty Programmes mentions two allocation methodologies: allocation based on relative fair value; and allocation using the residual method. However, IFRIC 13 does not prescribe a hierarchy. Therefore, currently entities use judgement to select the most appropriate methodology, taking into consideration all relevant facts and circumstances and ensuring the resulting allocation is consistent with IAS 18’s objective to measure revenue at the fair value of the consideration.

Given the limited guidance in current IFRS on multiple-element arrangements, some entities may look to the software accounting literature in ASC 985-605 or the multiple-element arrangement literature in ASC 605-25 Revenue Recognition - Multiple-Element Arrangements to develop their accounting policies. The requirements in IFRS 15 are generally consistent with the estimation concepts in ASC 605-25, which set out a hierarchy starting with VSOE, then third-party evidence and then best estimate of selling price for determining selling price for each unit of account. IFRS 15, however, does not require an entity to follow the hierarchy.

Some entities may find it difficult to determine a stand-alone selling price, particularly for goods or services for which the historical selling price is highly variable (e.g., software licences) or for goods or services that have not yet been or are never sold separately (e.g., specified upgrade rights for software). IFRS 15 provides that an entity may be able to estimate the stand-alone selling price of a performance obligation using a residual approach if: (1) the entity sells the same good or service to different customers for a broad range of
amounts (i.e., the selling price is highly variable); or (2) the entity has not yet established a price for that good or service (i.e., the selling price is uncertain).

For example, software arrangements often include a software licence, professional services and maintenance services that are bundled together at prices that vary widely. The professional services and maintenance are also sold individually, often at relatively stable prices. The standard indicates that it may be appropriate to estimate the stand-alone selling price for the software licence as the difference between the total transaction price and the estimated selling price of the professional services and maintenance. In these instances, the results would likely be similar for entities that currently apply a residual approach.

Under IFRS 15, software entities are required to estimate the stand-alone selling price of options, included in software transactions, that provide the customer with a material right. Instead of estimating the stand-alone selling price of an option, entities may apply a practical alternative provided in IFRS 15 when the optional goods or services are both: (1) similar to the original goods and services in the contract; and (2) provided in accordance with the terms of the original contract (which may be common for contract renewals). Under this alternative, instead of valuing the option itself, the entity can assume the option is going to be exercised and include the additional goods and services (and related consideration) with the identified performance obligations when allocating the transaction price.

The following example demonstrates how the practical expedient could be applied:

| Illustration 7-1 – Allocation of the transaction price to an option to renew a contract |
| Assume the same facts as in Illustration 5-1. If Cloud Co. determines there is an implied performance obligation to renew the cloud services each year for CU500,000, the option would be a material right to the customer because that renewal rate is significantly below the rate the customer paid for the first year of service (CU1.5 million in total). Consequently, the renewal options would be separate performance obligations. Therefore, Cloud Co. would allocate the CU1.5 million transaction price to the identified performance obligations (i.e., the cloud services and the renewal options). The amount allocated to the renewal options would be recognised over the renewal periods. Note, the amount allocated to the renewal options will likely differ from the stated upfront fee because a portion will be allocated to the services performed in the first year. The remainder will be allocated to the renewal options. Assuming the criteria to use the practical expedient are met, Cloud Co. could value the renewal option by ‘looking through’ to the optional services. Cloud Co. would determine that the total transaction price is the sum of the upfront fee of CU1 million and the three years’ cloud service fees of CU1.5 million, which gives a total transaction price of CU2.5 million. Cloud Co. would then allocate the total transaction price to all of the services expected to be delivered, or three years of cloud services. Under current IFRS, entities often recognise non-refundable upfront fees systematically over the periods in which the related services are provided. Therefore, Cloud Co. would recognise the CU1 million upfront fee over the period of benefit (generally the longer of the contractual relationship or the contract period). |
Illustration 7-2 – Allocation of an option for additional software at a discount

Software vendor XYZ enters into a contract to licence software products A and B to a customer for a total of CU20,000. Software vendor XYZ agrees to provide a discount of CU3,000 if the customer licences products C, D or E within a year of entering the arrangement. The estimated selling price of both products A and B is CU10,000. The estimated selling prices of products C, D and E are CU10,000, CU20,000 and CU40,000, respectively. The Software vendor XYZ determines that the future discount provides a material right to the customer because it rarely discounts products C, D or E and it considers the discount percentage to be significant.

Analysis

Software vendor XYZ would allocate the transaction price to the individual performance obligations in the contract, including the option, in proportion to the stand-alone selling prices of goods underlying each performance obligation.

Assume Software vendor XYZ concludes that the stand-alone selling price for the option to purchase future products at a discount is CU1,500 based on the potential value of the discount and the likelihood the customer will take advantage of the discount.

As a result, the relative selling price allocation would be, as follows:

<table>
<thead>
<tr>
<th>Performance obligation</th>
<th>Estimated stand-alone selling price (CU)</th>
<th>Allocated transaction price (CU)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Software A</td>
<td>10,000</td>
<td>9,300</td>
</tr>
<tr>
<td>Software B</td>
<td>10,000</td>
<td>9,300</td>
</tr>
<tr>
<td>Option to purchase future products at a</td>
<td>1,500</td>
<td>1,400</td>
</tr>
<tr>
<td>discount</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>20,000</td>
</tr>
</tbody>
</table>

The amount allocated to the discount would be recognised in revenue when the performance obligation is satisfied (i.e., when the customer purchases products C, D or E or when the option period expires).

How we see it

Estimating stand-alone selling prices may require a change in practice. IAS18 does not prescribe an allocation method for multiple-element arrangements. Entities may, therefore, be using a variety of methods, which may not be based on current selling prices.

In addition, software entities that develop their accounting policies by reference to the US GAAP requirements in ASC 985-605 will no longer be required to establish VSOE of fair value based on a significant majority of their transactions.

As a result, we expect that many software entities will need to establish methods to estimate their stand-alone selling prices. Some software entities may find that they are able to use the input data used in their current analyses to estimate the stand-alone selling price of a performance obligation. However, it is unclear how much of a change there will be as a result. Software entities will need robust documentation of the calculations they make in estimating stand-alone selling prices.
8. Satisfaction of performance obligations

An entity recognises revenue only when it satisfies a performance obligation by transferring control of a promised good or service to the customer. Control of an asset refers to the ability of the customer to direct the use of and obtain substantially all of the cash inflows, or the reduction of cash outflows, generated by the goods or services. Control also means the ability to prevent other entities from directing the use of, and receiving the benefit from, a good or service.

A performance obligation is satisfied at a point in time unless it meets the criteria to be satisfied over time. When a performance obligation is satisfied over time, the standard requires an entity to select a single method, either an input method or an output method, to measure progress for each performance obligation that best depicts the pattern of the entity’s performance in transferring the good or service (see Section 8.2 below).

8.1 Transfer of control for distinct software licences

The standard provides additional application guidance to help entities determine when control transfers for distinct licences of intellectual property, based on the nature of the promise to the customer. This application guidance is applicable for both perpetual and term software licences.

IFRS 15 states that entities provide their customers with either:

**Right to access**

A right to access the entity’s intellectual property as it exists throughout the licence period, including any changes to that intellectual property

**Licences**

**Right to use**

A right to use the entity’s intellectual property as it exists at the point in time at which the licence is granted

A licence is a promise to provide a right to access if all of the following criteria are met:

- The contract requires, or the customer reasonably expects, that the entity will undertake activities that significantly affect the intellectual property to which the customer has rights
- The rights granted by the licence directly expose the customer to any positive or negative effects of the entity’s activities
- Those activities do not result in the transfer of a good or a service to the customer as those activities occur
If the licence does not meet all three criteria, the licence is a right to use by default and the entity would recognise revenue at the point in time when the licence is delivered.

The key determinant of whether a licence is a right to access is whether the entity is required to undertake activities that affect the licenced intellectual property (or the customer has a reasonable expectation that the entity will do so) and the customer is, therefore, exposed to positive or negative effects resulting from those changes. These activities must not meet the definition of a performance obligation. However, the activities can be part of an entity’s ongoing and ordinary activities and customary business practices (i.e., they do not have to be activities the entity is undertaking specifically as a result of the contract with the customer). Furthermore, IFRS 15 notes that the existence of a shared economic interest between the parties (e.g., sales or usage-based royalties) may indicate that the customer has a reasonable expectation that the entity will undertake such activities.

When an entity is making this assessment (i.e., whether the licence is a promise to provide a right to access), it must exclude the effects of any other performance obligations in the arrangement. For example, assume an entity enters into a software arrangement with a customer for a software licence, with unspecified upgrades on a when-and-if available basis and telephone support. The entity first determines whether the licence, telephone support and the promise to provide unspecified upgrades are separate performance obligations. If the entity concludes that the telephone support is a warranty element, rather than a revenue element, the contract will include two revenue elements: the software licence and the unspecified upgrades. Furthermore, if the entity determines that a licence is distinct, the entity will apply the licence application guidance to determine whether control transfers over time or at a point in time.

A software licence that represents a right to use the software is recognised at a point in time if the entity has no contractual (explicit or implicit) obligation to undertake activities that will significantly affect the software licence during the licence period beyond any changes and activities associated with the unspecified future upgrade rights. In the example in the preceding paragraph, all three criteria for a right to access are not met, and the entity’s promise is a right to use the licence (and therefore revenue is recognised at a point in time).
IFRS 15 includes the following example of a right to use licence:

<table>
<thead>
<tr>
<th>Extract from IFRS 15</th>
</tr>
</thead>
<tbody>
<tr>
<td>Example 54 – Right to use intellectual property (IFRS 15.IE276-IE277)</td>
</tr>
</tbody>
</table>

Using the same facts as in Case A in Example 11 (see paragraphs IE49–IE53), the entity identifies four performance obligations in a contract:

a) the software licence;
b) installation services;
c) software updates; and
d) technical support.

The entity assesses the nature of its promise to transfer the software licence in accordance with paragraph B58 of IFRS 15. The entity observes that the software is functional at the time that the licence transfers to the customer, and the customer can direct the use of, and obtain substantially all of the remaining benefits from, the software when the licence transfers to the customer. Furthermore, the entity concludes that because the software is functional when it transfers to the customer, the customer does not reasonably expect the entity to undertake activities that significantly affect the intellectual property to which the licence relates. This is because at the point in time that the licence is transferred to the customer, the intellectual property will not change throughout the licence period. The entity does not consider in its assessment of the criteria in paragraph B58 of IFRS 15 the promise to provide software updates, because they represent a separate performance obligation. Therefore, the entity concludes that none of the criteria in paragraph B58 of IFRS 15 are met and that the nature of the entity's promise in transferring the licence is to provide a right to use the entity's intellectual property as it exists at a point in time—ie the intellectual property to which the customer has rights is static. Consequently, the entity accounts for the licence as a performance obligation satisfied at a point in time.

Alternatively, a software licence that represents a right to access the software is recognised over the licence period if an entity concludes that there are activities that will significantly affect the software licence during the licence period beyond the unspecified future upgrades. That is, while the unspecified upgrades can directly change the intellectual property, other activities could also significantly affect it.

Software entities may find that many licences of software will represent rights to use the software and the related revenue will be recognised at a point in time. This is because the benefits from the entity's activities in the contract (e.g., unspecified upgrade rights) are promises of service that are separate performance obligations and not contemplated in the assessment for determining the nature of the licence.

**How we see it**

Software entities will need to carefully assess their specific facts and circumstances, while also monitoring the Boards' and TRG's discussions. The TRG has already discussed several issues involving licences of IP and the determination of whether a licence of IP is transferred to the customer at a point in time or over time. Entities may also wish to monitor the AICPA task force's discussions.
8.1.1 Electronic delivery of software
Entities may deliver software to customers electronically by placing the software on their websites for download. In other cases, the customer may be provided with an authorisation code to access multiple copies of licenced software. Under current IFRS, an entity considers whether the licencee can exploit the rights conveyed freely and the licensor has no remaining obligations to perform.\(^{10}\) If so, revenue is recognised when those rights are conveyed, which may be when the entity provides the necessary access code to the customer that allows the customer to begin downloading the licenced software and the entity’s server is functioning.

Under IFRS 15, an entity will first need to determine whether it is transferring the software licence over time or at a point in time. If the licence is transferred at a point in time, the timing of revenue recognition may be consistent with current practice, depending on when an entity concludes control is transferred.

8.2 Transfer of control for performance obligations excluding distinct licences
IFRS 15 indicates that an entity must determine, at contract inception, whether it will transfer control of a promised good or service over time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. A performance obligation is satisfied over time if it meets one of the following criteria:

- The customer simultaneously receives and consumes the benefits provided by the entity’s performance as the entity performs - by providing hosting services, for example.
- The entity’s performance creates or enhances an asset that the customer controls as the asset is created or enhanced. An example would be a promise to develop an IT system on the customer’s premises, if the customer controls the system during the development period.
- The entity’s performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for the performance completed to date. An example would be significantly customising an asset to the customer’s specifications and the entity also has a right to payment for performance completed to date. As a result of the customisation, it is less likely that the entity would be able to use the asset for another purpose (e.g., sell to a different customer) without incurring significant costs to re-purpose the asset.

If an entity determines that a performance obligation is satisfied over time, it recognises revenue over the period the performance obligation is satisfied, using an output or input method that best depicts the pattern of the transfer of control over time.

Output methods are used to recognise revenue on the basis of units produced or delivered, contract milestones, time elapsed or surveys of services transferred to date relative to the total services to be transferred. The Boards have provided a practical expedient for an entity that has a right to payment from a customer in an amount that corresponds directly with the value of the entity’s performance completed to date to recognise revenue in the amount for which it has a right to invoice. Software entities may find it appropriate to apply this practical expedient to a professional services contract in which it charges a fixed amount for each hour of service provided. This expedient only applies

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\(^{10}\) IAS 18.IE20
when the performance obligation is satisfied over time and an output method is used to measure progress.

Input methods are used to recognise revenue on the basis of the entity’s efforts (or inputs) to the satisfaction of a performance obligation relative to the total expected inputs needed to satisfy that performance obligation. Input methods can include labour hours used, costs incurred, time elapsed or machine hours used. The standard does not indicate a preference for either type of method (output or input). However, it does require that the selected method be applied consistently to similar performance obligations and in similar circumstances.

Although the standard requires an entity to update its measure of progress, it does not allow a change in methods. For example, it would not be appropriate for an entity to start recognising revenue for a performance obligation based on labour hours expended and then switch to milestones.

For performance obligations that are not transferred over time, control is transferred at a point in time. For example, when a customer purchases computer hardware, control generally transfers to the customer when the computer hardware is provided. The standard provides indicators to help entities determine when control transfers, including right to payment, legal title, physical possession, risks and rewards of ownership and customer acceptance.

**How we see it**

Software entities will need to determine the pattern of transfer for a performance obligation satisfied over time. For example, if unspecified upgrades and enhancements are determined to be a performance obligation satisfied over time, the software entity will need to determine an output or input method that best depicts the pattern of transfer of control over time. Based on its experience, the software entity may be able to conclude that unspecified upgrades and enhancements are provided to customers on an annual, quarterly or ad-hoc basis. That is, revenue would be recognised on the basis of the entity’s efforts or another measure that best depicts the pattern of transfer of control, which may not necessarily result in revenue being recognised rateably over the contractual period.

**9. Reseller and distributor arrangements**

IFRS 15 also could change practice for entities that sell their products through distributors or resellers (collectively referred to in this section as resellers). It is common in the software industry for entities to provide resellers with greater rights than end-customers in order to maintain a mutually beneficial relationship and maximise future sales through the reseller. For example, an entity may provide a reseller with price protection and extended rights of return.

Under IFRS 15, entities will need to first evaluate when control of the product transfers to the end-customer. To do this, entities may need to assess whether their contracts with resellers are consignment arrangements, under which control would likely not transfer until delivery to the end-customer. The standard provides three indicators that an arrangement is a consignment arrangement:

- The product is controlled by the entity until a specified event occurs (such as the sale of the product to a customer of the dealer) or until a specified period expires.
- The entity is able to require the return of the product or transfer the product to a third party (e.g., another dealer).
The dealer does not have an unconditional obligation to pay for the product (although it may be required to pay a deposit). An entity does not recognise revenue upon delivery of a product to a reseller if the delivered product is held on consignment because control of the product has not transferred. The entity would wait until the reseller sells the product to an end customer to recognise revenue, which would be considered the point in time that the entity has transferred control of the product. The result would be similar to current IFRS requirements of deferring revenue recognition until the reseller sells the product to an end customer.\footnote{IAS 18.IE2(c), IE6}

If an entity concludes its contract with a reseller is not a consignment arrangement, the reseller will likely be considered a customer of the entity. The entity would be required to recognise revenue upon the transfer of control of the promised goods in an amount that reflects the amount to which the entity expects to be entitled.

In determining the amount to which they expect to be entitled, software entities will be required to consider whether they will provide resellers with explicit or implicit concessions (e.g., price protection, expanded return rights) that will make the transaction price variable. In these instances, an entity will need to estimate the transaction price and, considering the constraint, include only the amount for which the entity determines it is highly probable that a significant reversal will not occur. An entity will need to carefully consider whether it can include the variable consideration resulting from the concessions it offers to its reseller customer(s) in its transaction price. The standard indicates that when an entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances, this is a factor that could increase the likelihood (or magnitude) of a revenue reversal. Entities will need to assess the facts and circumstances of their contracts to determine whether current practice will change under the new standard.

10. Contract costs

Under the new standard, there are two types of contract costs where an asset must be recognised:

- Incremental costs of obtaining a contract with a customer if the entity expects to recover those costs
- Costs incurred in fulfilling a contract with a customer that are not within the scope of another IFRS (for example, IAS 2 Inventories, IAS 16 Property, Plant and Equipment or IAS 38 Intangible Assets), provided these costs relate directly to a contract (or to an anticipated contract that the entity can specifically identify), generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future and are recoverable

IFRS 15 requires these costs to be recognised as an asset and amortised on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. Impairment assessments are also required for such assets.
10.1 Costs of obtaining a contract
Under IFRS 15, the incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) will be recognised as an asset if the entity expects to recover them. Recovery can be direct (i.e., through reimbursement under the contract) or indirect (i.e., through the margin inherent in the contract). As a practical expedient, the standard permits immediate expense recognition of the contract acquisition costs when the asset that would have resulted from capitalising such costs would have been amortised in one year or less. While not explicitly stated, we believe entities are permitted to choose this approach as an accounting policy election and, if they do, they must apply it consistently to all short-term contract acquisition costs.

Today, there is diversity in practice for capitalising costs incurred to obtain a contract because there is limited guidance. IFRS 15 represents a significant change for entities that currently expense the costs of obtaining a contract and will be required to capitalise them under the new standard. In addition, this may be a change for entities that currently capitalise costs to obtain a contract, particularly if the amounts currently capitalised are not incremental and, therefore, would not be eligible for capitalisation under IFRS 15.

Entities will need to exercise judgement when determining whether costs incurred in obtaining a contract are incremental (i.e., costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained). IFRS 15 cites sales commissions as an example of an incremental cost that may require capitalisation under the standard. In contrast, bonuses and other compensation that are based on other quantitative or qualitative metrics (e.g., profitability, earnings per share, performance evaluations) likely do not meet the criteria for capitalisation because they are not directly related to obtaining a contract. Entities also may pay commissions upon the renewal of a contract or bonuses based on the achievement of an individual's sales goal or total bookings. Other bonus programmes may have escalation provisions under which the bonus amount increases as an individual meets performance targets. The standard provides little additional guidance about the types of costs that may be considered incremental to obtaining a contract. As such, this determination may be difficult for entities, particularly when such costs relate to multiple contracts or are incurred over a period of time.

10.2 Costs of fulfilling a contract
Entities may incur certain costs to fulfil a contract, such as set-up costs in cloud arrangements. An entity will, first, apply other standards to account for such costs (e.g., software development costs under IAS 38, inventory under IAS 2 and property, plant and equipment under IAS 16). If such costs are not within the scope of another standard, an entity will apply the requirements in IFRS 15. Under IFRS 15, entities will capitalise the costs to fulfil a contract if they relate directly to the contract, generate or enhance the resources used to satisfy performance obligations and are expected to be recovered.

The standard discusses and provides examples of costs that may meet the first criterion for capitalisation (i.e., costs that relate directly to the contract). Examples include direct labour, direct materials, allocation of costs directly related to the contract, costs explicitly chargeable to the customer and other costs that are only incurred because the entity entered into the contract.
In order for costs to meet the ‘expected to be recovered’ criterion, costs need to be either explicitly reimbursable under the contract or reflected in the pricing on the contract and recoverable through margin. The standard does not specify whether contract costs need to be recoverable over the stated contractual period or the period of expected performance (i.e., the customer life). However, because IFRS 15 states that the amortisation period can exceed the contract period, it is likely that entities will use the longer period in determining whether contract costs are recoverable (i.e., using the customer life for this determination).

**How we see it**

The requirements to capitalise incremental costs of obtaining a contract and direct costs of fulfilling a contract may represent a significant change for software entities that currently expense such costs as incurred.

Since IFRS 15 may change how software entities account for commission expense, entities may wish to consider revisiting their current compensation plans.

**10.3 Amortisation and impairment**

Any capitalised contract costs are amortised on a systematic basis that is consistent with the transfer of the goods or services to which the asset relates. The standard permits entities to take into account the expected renewal period in their assessment of the appropriate amortisation period.

Any asset recorded by the entity is subject to an ongoing impairment assessment. An impairment exists if the carrying amount of any asset(s) exceeds the unconstrained amount of consideration the entity expects to receive in exchange for providing those goods and services, less the remaining costs that relate directly to providing those goods and services.

**11. Warranties**

A customer may have the option to separately purchase a warranty on a product (e.g., computer hardware, networking equipment) for a period of time at the point of sale or the warranty may be explicitly stated in the contract. Entities may also provide maintenance services, such as bug fixes for a software licence, that may be considered to be a warranty. The standard identifies two types of warranties:

- Warranties that provide a service to the customer in addition to assurance that the delivered product is as specified in the contract (service-type warranties)
- Warranties that promise the customer that the delivered product is as specified in the contract (assurance-type warranties)

If the customer has the option to purchase the warranty separately or if the warranty is not separately priced or negotiated, but provides a service to the customer beyond fixing defects that existed at the time of sale, the entity is providing a service-type warranty. This type of warranty represents a distinct service and is a separate performance obligation. Revenue related to the warranty is recognised over the period the warranty service is provided.

Assurance-type warranties do not provide an additional good or service to the customer (i.e., they are not separate performance obligations). By providing this type of warranty, the selling entity has effectively provided a quality guarantee (e.g., to replace or repair a defective product). Such warranties will continue to be accounted for in accordance with IAS 37.
If an entity provides both assurance-type and service-type warranties within an arrangement, an entity is required to accrue for the expected costs associated with the assurance-type warranty and account for the service-type warranty as a performance obligation. If the entity cannot reasonably account for them separately, the warranties are accounted for as a single performance obligation (i.e., revenue would be allocated to the combined warranty and recognised over the period the warranty services are provided).

12. Next steps

We encourage software entities to gain an understanding of IFRS 15 and evaluate how it will affect their specific revenue recognition policies and practices.

Software entities should perform a preliminary impact assessment so they can determine how to prepare to implement the new standard. While the effect on entities will vary, some may face significant changes in revenue recognition. All entities will need to evaluate the requirements of the new standard and make sure they have processes and systems in place to collect the necessary information to implement IFRS 15 and make the required disclosures, even if their accounting results will not change significantly. This includes an evaluation of the impacts and whether any changes will be required to their accounting policies, accounting systems or internal controls over financial reporting.

Software entities may also wish to monitor the discussions of the Boards, TRG and the software industry task force formed by the AICPA to discuss interpretations and the application of the new standard to common transactions.\(^{12}\)

Software entities also should consider how they will communicate the changes with investors and other stakeholders, including their plan for disclosures about the effects of new accounting standards which are issued, but not yet effective, as required under IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

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