In brief
A look at current financial reporting issues

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IFRS 15 for the software industry

At a glance

It has long been understood that the software industry would be one of the industries more significantly affected by the adoption of IFRS 15. This is because current guidance under IFRS, in particular for licence revenue, is limited, and many entities have historically looked to develop accounting policies based on industry-specific US GAAP which has now been superseded. In depth 2017-13 on revenue recognition for software sets out some of the key changes as a result of the standard.

The implementation of IFRS 15 in the software industry is proving to be a challenge, as expected. Even if there is no significant change to the pattern of revenue recognition, management will need to make a number of new judgements and estimates. One of the most significant changes that affects the industry is the recognition of more revenue 'upfront' in the scenario where software is delivered and control passes to the customer.

This document provides additional insight into some of the key judgements facing the industry during the implementation phase.

Judgements and estimates

Determining whether a licence is distinct

Software licences are commonly sold in a bundle that includes updates, also known as post-contract customer support ('PCS'). It is common that the software is a distinct 'right to use' licence, with revenue recognised at the point in time when it is transferred, while the PCS is delivered over time. However, there might be limited circumstances where the licence and updates are combined into a single performance obligation.

The determination of whether licence and updates are separate performance obligations requires judgement. It is common for updates to improve the effectiveness of software. However, for the updates to be combined with the licence, they should fundamentally change the functionality of the software or be essential to its functionality. A combination of a number of factors should be considered, including:

- Nature of software – Software that can function on its own without updates is likely a performance obligation that is separate from the updates. There might be limited cases where the updates are essential to the customer's

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ability to benefit the licence because of the function of the software or the industry in which it operates.

- Significance of updates – Updates that change the functionality of the software might indicate that such updates significantly modify the licence. This might be the case for any significant update to the software, but this factor should be considered, along with the other indicators about the nature or frequency of the updates, to determine if such an update is essential to the functionality of the software.
- Frequency and acceptance of updates – Frequent updates might indicate that the updates are essential to the operation of the software; however, management should consider not only the frequency but also whether the customers accept the updates. Updates that are made available but not used might indicate that the software is functional without updates.

If a licence and updates are combined, the outcome is generally a performance obligation that is delivered over time. Example 55 in IFRS 15 provides an illustration of this approach. There might be other performance obligations included as part the PCS package that require separate identification. However, they are often delivered over time and over a similar period as the combined service of software and updates; and, in practice, any allocation of transaction price would not have a significant effect on the timing and amount of revenue recognised.

Set-up and integration activities

Arrangements involving software often include a promise to provide implementation support, such as data conversion, software design or development, and customisation. Entities need to apply judgement to determine whether such activities are accounted for as a separate performance obligation and when revenue should be recognised (that is, at a point in time when the service is complete, or over time as the service is performed). Example 11 in IFRS 15 provides an illustration of this judgement in the context of software that is a 'right of use' licence.

Software as a service (SAAS) arrangements also often include implementation services. It might be more challenging to conclude that the customer is receiving a separate service in the context of an SAAS arrangement. The service often involves configuring the customer's system to interact with the vendor's software to enable it to provide the service. It is difficult to demonstrate that the customer receives and consumes the service in connection with that implementation, given that the customer never takes control of the vendor's software. This could be an indication that the vendor's activities do not transfer anything to the customer, and so they do not represent a separate performance obligation. However, there might be circumstances in which the implementation activities provide a separate benefit to the customer that can be used with another service (such as software provided by another supplier), in which case they do represent a separate performance obligation.

Estimating stand-alone selling price

In software arrangements, entities will often provide multiple distinct goods and services (for example, licences and updates) together as a single package, and they will need to allocate the transaction price based on the relative stand-alone selling prices of those distinct goods and services. In many cases, the stand-alone selling price will not be directly observable, and so it must be estimated. IFRS 15 does not prescribe a specific method to estimate, but the allocation should faithfully represent the price if the items were sold separately.

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The most appropriate approach to estimating stand-alone prices will depend on facts and circumstances including the extent of observable selling-price information. We believe that it is acceptable to use a range of prices when determining the stand-alone selling prices, provided that the range reflects the reasonable pricing of each item as if it were priced on a stand-alone basis for similar customers.

It is common for entities to only sell software and PCS as a package, or to only sell maintenance separately as a renewal. IFRS 15 only permits the use of a residual approach in limited circumstances. An entity might use the renewal price to determine the amount to be allocated to the software if certain criteria are met and the outcome faithfully represents the price if the software was sold separately. For example, assume that an entity sells licensed software and maintenance to a customer for C1.1m, and it regularly sells PCS for C1m and it licenses software on a stand-alone basis for between C0.5m and C5m. It would not be appropriate to apply the residual approach and allocate C0.1m to the software. This is because the residual approach results in a nominal allocation of selling price to the software licence, which does not faithfully reflect the stand-alone selling price.

Contract term and termination penalties

The contract term is the period during which the parties to the contract have present and enforceable rights and obligations. Determining the contract term could significantly affect the accounting for software transferred at the beginning of the licence. This is because the portion of revenue allocated to the licence for the entire contractual term is recognised when the licence is transferred to the customer. If that contract term is shorter, it will decrease the amount of revenue recognised upfront.

Entities need to consider termination clauses when assessing the contract term. If an entity enters into a contract for a term of several years, but that contract can be terminated early for no compensation, the contract might, in substance, be a shorter-term contract with a right to renew. Management should assess a renewal to determine if it provides a material right similar to other types of customer option. In contrast, a contract that can be terminated early, but requires payment of a substantive termination penalty, is likely to have a contract term equal to the stated term.

We believe that termination penalties could take various forms, including cash payments (which might be paid upfront) or the transfer of an asset to the vendor. Judgement should be applied in determining whether a termination penalty is substantive. A payment need not be labelled a ‘termination penalty’ for it to create enforceable rights and obligations. A substantive termination penalty might exist if a customer gives up, with no right to a refund, the rights to a licence that it has already paid a significant upfront fee to obtain.

Distinguishing usage-based royalties from additional rights

Many software licence arrangements include a variable fee linked to usage of the software. Entities will need to distinguish between fees representing a usage-based royalty (a form of variable consideration) and an option to acquire additional goods or services. A usage-based royalty is recognised when the usage occurs or the performance obligation is satisfied, whichever is later. Fees received when an option to acquire additional rights is exercised are recognised when the additional rights are transferred; however, at contract inception, management would need to assess whether the option provides a material right. If it does, revenue might be recognised

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later, because a portion of the transaction price is allocated to the option and deferred until the option is exercised or expires.

Judgement might be required to distinguish between a usage-based royalty and an option to acquire additional goods or services. If a licensor is entitled to additional consideration based on the usage of software to which the customer already has rights, without providing any additional or incremental rights, the fee is generally a usage-based royalty. In contrast, if a licensor provides, for an incremental fee, additional or incremental rights that the customer did not previously control, the customer is likely exercising an option to acquire additional rights.

Capitalising and amortising commissions

IFRS 15 requires entities to capitalise incremental costs of obtaining a contract (for example, sales commissions) in most situations. The asset is both assessed for impairment and amortised on a systematic basis that is consistent with the transfer of the related services. Determining the amortisation period can be complex, because it does not necessarily reflect the length of the contract period. In particular, where there are anticipated renewals, the amortisation period should include anticipated renewals, unless the entity also incurs a commensurate cost for renewals.

Assessing whether costs incurred for contract renewals are 'commensurate with' costs incurred for the initial contract could require judgement. The assessment should not be based on the level of effort required to obtain the initial and renewal contracts. Instead, it should generally be based on whether the initial and renewal commissions are reasonably proportional to the respective contract values.

Where renewal commissions are paid but are not commensurate with initial commissions, the initial commission should be amortised over a period longer than the initial contract term. An entity might amortise the initial commission over the average customer life of five years and expense renewal commissions as incurred. It also might split the initial commission into two components: one reflecting an amount commensurate with the renewal commission; and the remainder treated as an upfront commission that is amortised over the estimated customer life. Other approaches could also be acceptable if they are consistent with the pattern of transfer of the services related to the asset. For example, where there is a term licence, and a large proportion of revenue is recognised upfront, it might be appropriate to recognise a similar proportion of commission upfront.

Determining the contract

Previous revenue guidance did not provide explicit guidance on identifying a contract, but this is an important step in applying IFRS 15. This might cause an entity to change the way that it thinks about contracting. For example, an entity might conclude that there is a contract in place before a signed legal agreement exists, whereas historically this might not have been the case. This could affect the accounting conclusion as well as disclosures about remaining performance obligations.

A contract can be written, oral, or implied by an entity's customary business practices. Generally, any agreement that creates legally enforceable rights and obligations meets the definition of a contract. Sometimes, the parties will enter into amendments or 'side agreements' to a contract that either change the terms (for example, contract term) of, or add to, the rights and obligations of that contract (for example, providing customers with options or discounts), or change the substance of the arrangement. All of these items have implications for revenue recognition; therefore, understanding

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the entire contract, including any amendments, is critical to the accounting conclusion. See the discussion on ‘contract term’ above.

Principal versus agent

It is common for software entities to enter into arrangements that involve two or more unrelated parties that contribute to providing a specified good or service to a customer. For example, software entities might sell third party software, hardware or services in addition to their own products and services. Management needs to determine whether the entity is a principal or agent separately for each specified good or service promised to a customer. This will determine whether or not revenue is presented gross (when acting as principal) or presented net (when acting as agent).

Disclosures

In software arrangements, often there can be contract deliverables that are not yet billed (for example, future maintenance periods). IFRS 15 requires these to be disclosed, in addition to an explanation of what comprises accrued and deferred revenue (contract liabilities and contract assets) and over what period the services have been, or will be, performed.

IAS 1 requires entities to disclose certain information about significant judgements and estimates. Management might conclude that the judgements and estimates made in the application of IFRS 15 result in similar accounting to previous GAAP, but the thought process is likely to be different. This might mean that the judgements and estimates disclosed are different. It is essential that entities update their accounting policies and disclosures on significant judgements and estimates to reflect the application of IFRS 15.

IFRS 15 also requires a number of new disclosures, relating to significant judgements that are applied, which supplement IAS 1. These include disclosing judgements made in applying the standard which significantly affect the determination of the amount and timing of revenue from contracts with customers, in particular when performance obligations are satisfied and the transaction price and its allocation to performance obligations.

When does this apply?

IFRS 15 applies for entities with financial years beginning on or after 1 January 2018.

Where do I get more details?

For questions on this publication, contact Andrea Allocco (a.allocco@pwc.com) or Jennifer Lau (jennifer.y.lau@pwc.com).

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