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IFRS industry insights: Technology sector

New revenue Standard could have a major impact on profile of revenue and profit recognition and may require system changes

Headlines

- The **profile of revenue and profit recognition** will change for some entities as the new Standard is more detailed and more prescriptive than the existing guidance and introduces new complexities. In particular, technology companies will need to consider:

  – the extent to which **distinct goods or services** are supplied, which should be accounted for separately;

  – whether revenue should be recognised **over time** or at **a point in time**;

  – the **types of licence** that are sold and whether the accounting treatment will need to change;

  – the impact of new guidance where pricing mechanisms include **variable amounts**; and

  – how to account for **contract modifications**.

- The new Standard requires significantly more **disclosures** relating to revenue and entities will need to ensure that **appropriate processes** are in place to gather the information.

What's happened?

The International Accounting Standards Board (IASB) has published a new Standard, IFRS 15 *Revenue from Contracts with Customers* ('the new Standard'). The new Standard outlines a single comprehensive model of accounting for revenue arising from contracts with customers and supersedes current revenue recognition guidance, which is found currently across several Standards and Interpretations within IFRSs. The core principle is that an entity recognises revenue to reflect the transfer of goods or services, measured as the amount to which the entity expects to be entitled in exchange for those goods or services.

The new Standard is effective for reporting periods beginning on or after 1 January 2017, with earlier application permitted. Entities can choose to apply the Standard retrospectively or use a modified approach in the year of application. It is the result of a convergence project with the US Financial Accounting Standards Board (FASB) that began in 2002. Almost fully converged, the most significant differences between IFRSs and US GAAP relate to interim disclosures and timing of adoption.

Implications for the technology sector

Below, we highlight certain key impacts resulting from the new Standard that will be of particular interest to those in the technology sector and then consider parts of the new Standard that may contribute to those impacts. Of course many more complexities exist and, as described below, Deloitte has produced further guidance which explores these in greater detail.

How might this affect you?

The timing of revenue and profit recognition may be significantly affected by the new Standard

Whereas previously IFRSs allowed significant room for judgement in devising and applying revenue recognition policies and practices, IFRS 15 is more prescriptive in many areas relevant to the technology sector. Applying these new rules may result in significant changes to the profile of revenue and, in some cases, cost recognition.

This is not merely a financial reporting issue. As well as **preparing the market and educating analysts** on the impact of the new Standard, entities will need to consider wider implications. Amongst others, these might include:

- changes to **key performance indicators** and other **key metrics**;
- changes to the profile of **tax cash payments**;
- availability of **profits for distribution**;
- for **compensation and bonus plans**, impact on the timing of targets being achieved and the likelihood of targets being met; and
- potential non-compliance with **loan covenants**.

Current accounting processes may require significant changes to cope with the new Standard

As explained below, IFRS 15 introduces new requirements to move to a more conceptual approach. The complexity of applying this approach and of producing the detailed disclosures required by the new Standard in the technology sector may require modifications to existing accounting systems and, in some cases, entities may conclude that they should develop new systems solutions.

In determining the extent to which systems modifications will be required, entities will wish to consider the need for sufficient flexibility to cope with future changes in the pricing and variety of product offerings made to customers. The 1 January 2017 effective date may set a challenging timeframe for developing new systems.

What are the most significant changes?

How to identify and allocate revenue to the different goods and services?

Previously, given the lack of specific guidance in IFRSs, there was greater room for judgement when identifying the goods and services within a contract and then allocating the revenue to those goods and services. Entities may have to amend their current accounting policies as a result of the more detailed guidance in IFRS 15. The new Standard requires the revenue from a contract to be allocated to each distinct good or service provided on a relative standalone selling price basis, though a 'residual' approach is permitted in limited circumstances.

Applying the new approach to a software licence, for example, it will first be necessary for entities to consider whether any subsequent services, such as consulting services for customisation / installation, customer support or upgrades, represent distinct elements to which revenue should be separately allocated. Where it is concluded that certain elements should be accounted for separately, entities will then typically look to the standalone selling price to apportion the relevant amount of the transaction price to each distinct element in the contract.

This may significantly change the profile of revenue recognition for some entities and, where an entity has a large number of customer contracts with various combinations of available options, there may be some significant practical challenges to overcome in order to ensure systems are in place to deal with the new requirements.

Should revenue be recognised over time or at a point in time?

IFRS 15 introduces a new approach to determine whether revenue should be recognised over time or at a point in time. Three scenarios are specified in which revenue will be recognised over time – broadly, they are when (i) the customer receives and consumes the benefits of the seller's performance as the seller performs; (ii) the seller is creating a 'work in progress' asset which is controlled by the customer; and (iii) the seller is creating a 'work in progress' asset which could not be directed to a different customer and in respect of which the customer has an obligation to pay for the entity's work to date. If revenue is to be recognised over time, a method should be used which best reflects the pattern of transfer of goods or services to the customer. If a transaction does not fit into any of the three scenarios described above, revenue will instead be recognised at a point in time, when control passes to the customer.

In the technology sector, if an entity is manufacturing items for a specific customer, this may require a careful analysis in light of the new requirements. Quite small differences between otherwise similar contracts could have a fundamental impact on the timing of revenue recognition. It will often be particularly important to focus on contractual terms that allow the customer to cancel, curtail or significantly modify a contract and whether, in such cases, the seller is entitled to adequate compensation for work performed to date.

When should a sale of goods be recognised?

Under IAS 18, the timing of revenue recognition from the sale of goods is based primarily on the transfer of risks and rewards. IFRS 15 instead focuses on when control of those goods has transferred to the customer. This different approach may result in a change of timing for revenue recognition for some entities.

How will the type of licence sold impact when revenue is recognised?

IFRS 15 distinguishes between licences that represent the transfer of a right to use an entity's intellectual property and licences that represent the provision of access, over a period of time, to an entity's intellectual property, and specifies criteria to determine which type of licence is being sold. Revenue for the former will typically be recognised at a point in time; revenue for the latter will typically be recognised over the period of access. Entities within the technology sector will need to examine licence arrangements in the light of this new guidance, and may need to change their existing accounting in some cases. Where a change is required, this may have a significant impact on the timing of revenue recognition.

When should variable or uncertain revenues be recognised?

Contracts in the technology sector can be of a long-term nature and will often include significant variable elements, such as performance bonuses or penalties, discounts, fees based on usage (such as 'click-throughs'), as well as the potential for subsequent downwards price renegotiations. For example, the transaction price would be considered variable if it depended on the price at which a product is resold by a reseller or distributor or on achieving certain milestones. There are new specific requirements in respect of variable consideration such that it is only included in the transaction price if it is highly probable that the amount of revenue recognised would not be subject to significant future reversals as a result of subsequent re-estimation. This approach to variable and contingent consideration is different from that previously reflected in IFRSs and, in certain scenarios, will require a significant degree of judgement to estimate the amount of consideration that should be taken into account. Accordingly, the profile of revenue recognition may change for some entities as a result.

What is the impact if a contract is modified?

In the past, IFRSs included only limited guidance on how to account for modifications to a contract. IFRS 15 includes detailed guidance on whether a contract modification should be accounted for prospectively (as an adjustment to future revenues) or retrospectively (via an adjustment of accumulated revenue when the modification occurs). It is not uncommon for the scope or price of arrangements in the technology sector to be modified and therefore these requirements may result in a change of practice for some entities.

What else might change?

In addition to the key changes discussed above, the new Standard introduces detailed guidance in many areas regarding the reporting of revenue and entities will need to ensure that they have considered all of these when assessing the extent to which their accounting policy for revenue may need to be amended.

More detailed information on the impact of IFRS 15 can be found in Deloitte's IFRS in Focus publication available from www.iasplus.com. Further industry publications are also available here.

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