New on the Horizon: Revenue recognition for technology companies

You said… the 2010 proposals would be difficult to apply. These are the revised proposals.

In November 2011, the IASB and the FASB (the Boards) published a revised joint exposure draft on revenue recognition (the 2011 ED). The original proposals issued in June 2010 (the 2010 ED) were revised to address a number of concerns expressed by constituents, including technology companies.

While the Boards have addressed some of the technology companies’ concerns, a question remains as to whether technology companies feel that the revised proposals are clear enough to be applied consistently across the range of multiple-element contracts entered into with customers.

The key challenge for technology companies will be determining the number of the performance obligations and allocating the transaction price to them. Also, the 2011 ED may result in changes in the timing of revenue recognition. Apart from that, some fear that technology companies may need to invest significant amounts in new information systems to implement and apply the new requirements.

This publication focuses on the potential impact of the revised proposals on technology companies, discusses whether previous concerns expressed by technology companies have been addressed and highlights potential remaining challenges facing technology companies. For a full discussion of the revised proposals, read our cross-sector publication New on the Horizon: Revenue from contracts with customers.
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<td><strong>Identifying individual contracts with customers</strong>&lt;br&gt;See step 1 below</td>
<td>Two or more contracts would be combined if entered into at or near the same time with the same customer (or related parties) and:&lt;br&gt;• the contracts are negotiated as a package with a single commercial objective;&lt;br&gt;• the amount of consideration in one contract depends on the other contract; or&lt;br&gt;• the goods and services in the contracts are a single performance obligation.</td>
<td>Proposal to segment contracts was withdrawn.</td>
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<td><strong>Identifying the separate performance obligations in the contract</strong>&lt;br&gt;See step 2 below</td>
<td>A performance obligation is a promise (whether explicit or implicit) in a contract with a customer to transfer a good or service to the customer. Companies would account for a promised good or service as a separate performance obligation if it is ‘distinct’. However, goods and services are not distinct if they are highly inter-related, a significant integration service is required and the bundle is significantly modified or customised. In addition, if the pattern of transfer of control to the customer of distinct goods and services is the same, then they could be accounted for as one performance obligation.</td>
<td>New proposals introduced for bundling of goods and services. The ‘distinct’ principle is retained, although some guidance amended. No distinct profit margin necessary to separate performance obligations. Performance obligations may be implied.</td>
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<td><strong>Accounting for variable consideration</strong>&lt;br&gt;See step 3 below</td>
<td>A company would estimate variable consideration using either the expected value method or the most likely amount method, whichever is better at predicting the amount of consideration that the company will be entitled to.</td>
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<td><strong>Allocating the transaction price to the performance obligations – variable transaction price</strong>&lt;br&gt;See step 4 below</td>
<td>At contract inception, the company generally would allocate the transaction price to separate performance obligations in proportion to the relative stand-alone selling prices of the underlying goods and services. When stand-alone selling prices are not directly observable, a company would estimate them using approaches such as the ‘expected cost plus a margin approach’, the ‘adjusted market assessment approach’, or the ‘residual approach’ if the price of one of the obligations is highly variable or uncertain.</td>
<td>Few changes. Significantly for technology companies, the 2011 ED allows companies to use the residual approach if the price of a good or service is highly variable or uncertain.</td>
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<td><strong>Recognising revenue over time or at a point in time</strong>&lt;br&gt;See step 5 below</td>
<td>A company would first determine whether the performance obligation is satisfied over time. If so, revenue would be recognised over time, using the method that best depicts the transfer of goods and services to the customer. The accounting outcome may be similar to the current percentage of completion method. If not, then revenue would be recognised at the point in time when control transfers to the customer.</td>
<td>New criteria added to determine if a performance obligation is satisfied over time.</td>
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<td><strong>Licensing</strong></td>
<td>A licence provided by a company to a customer would give rise to a performance obligation that the company satisfies at the point in time when the customer obtains control of the licence.</td>
<td>Distinction between non-exclusive and exclusive licences removed.</td>
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The five-step model for revenue recognition

The revised proposals retain the five-step model for determining when to recognise revenue, based on the core principle that revenue is recognised when or as a company transfers control of goods and services to customers.

### Step 1: Identify the contract with the customer

**What is ‘the contract’?**

A contract need not be written but may be oral or implied by the company’s customary business practice. A contract would exist for the purpose of applying the requirements in the 2011 ED only if:

- the contract has commercial substance (i.e. the company’s future cash flows are expected to change as a result of the contract);
- the parties to the contract have approved the contract and are committed to satisfying their respective obligations;
- the company can identify each party’s enforceable rights regarding the goods or services to be transferred; and
- the company can identify the terms and manner of payment for those goods or services.

A contract would not exist if either party can terminate a wholly-unperformed contract without penalty. A contract is wholly-unperformed if (1) the company has not yet transferred goods or services and (2) the company has not yet received and is not entitled to receive any consideration.

**When to combine contracts?**

In most cases, the company would apply the requirements of the 2011 ED to a single contract with a customer. However, in some cases the company may be required to combine contracts. Two or more contracts would be combined if entered into at or near the same time with the same customer (or related parties) and:

- the contracts are negotiated as a package with a single commercial objective;
- the amount of consideration in one contract depends on the other contract; or
- the goods and services in the contract are a single performance obligation.

**KPMG Observations**

Technology companies often sign several contracts with customers, for example for delivery of hardware or software licences, and for provision of support and post-contract services. Assessing whether several contracts should be combined is the first step in determining the unit of account for revenue recognition purposes under the 2011 ED. Current IFRS and US GAAP include guidance on combining contracts; however, the current criteria are not identical to one another nor are they the same as the criteria in the 2011 ED. This may result in different outcomes under the 2011 ED than under current practice.
Step 2: Identify the separate performance obligations in the contract

When to separate and when to bundle performance obligations?

Similar to the 2010 ED, the revised revenue proposals would be applied to separate performance obligations.

A performance obligation is a promise (whether explicit or implicit) in a contract with a customer to transfer a good or service to the customer. In order to identify performance obligations that are accounted for separately, a technology company would consider whether the promised goods and services are ‘distinct’, by applying the criteria outlined below.

**KPMG Observations**

Current IFRSs do not provide comprehensive guidance on identifying separate components that applies to all revenue-generating transactions, although IAS 18 Revenue requires companies to consider whether a transaction contains ‘separately identifiable components’. In addition, there is guidance on identifying components in specific circumstances in IAS 11 Construction Contracts, IFRIC 13 Customer Loyalty Programmes, IFRIC 15 Agreements for the Construction of Real Estate and IFRIC 18 Transfers of Assets from Customers. Some technology companies apply this specific guidance by analogy to other types of contracts, including software and IT services contracts. Some technology companies apply by analogy aspects of US GAAP.

IFRIC 18 contains two criteria for separating components:
- the component has stand-alone value to the customer; and
- the fair value of the component can be measured reliably.

Under current US GAAP, the key criterion for separating components in a multiple-element software contract is whether there is Vendor Specific Objective Evidence (VSOE) of fair value for the undelivered elements. At present, some technology companies that sell software licences and provide post-contract customer support may not separate those two components if they are not able to measure reliably the fair value of the post-contract customer support service.

Under the 2011 ED, the ability to measure reliably the fair value of each individual component is not a hurdle for separating components. Instead, the goods and services are accounted for separately if they are ‘distinct’. Under the 2011 ED, software licences delivered upfront may be considered distinct if the customer would be able to use the software on its own, separate from the post-contract support. In such cases, the recognition of revenue related to the software licence could be accelerated compared to current practice. Similar considerations may apply to specified upgrades of software licences.
Under the 2011 ED, the key criterion for determining whether goods and services should be bundled in a single performance obligation is the degree of integration and customisation provided by a technology company.

**KPMG Observations**

The 2011 ED includes a non-authoritative illustrative example, in which a company licenses customer relationship management software to a customer and promises to provide consulting services to significantly customise the software to the customer’s IT environment. In this case, the 2011 ED notes that the company provides a significant integration service and that the software is significantly customised in accordance with the customer’s specifications. For these reasons, the company would account for the licence and consulting services together as one performance obligation because the goods and services are not distinct.

The accounting outcome may be similar to the current IFRS and US GAAP approaches, under which a software licence and related professional services are accounted for together if the services are considered essential to the functionality of the software being licensed. However, it may be challenging in some cases for software companies to determine what level of customisation of a software product is considered to be ‘significant’; judgement will be required in such cases.

If the pattern of transfer of control to the customer of distinct goods and services is the same, they could be accounted for as one performance obligation.

**Example – Upgrade right is a separate performance obligation**

Company B enters into a contract with Customer C to deliver off-the-shelf payroll software Version 2.0 and to provide telephone support service for one year, for a non-refundable fee. C can renew the telephone support service at the end of the first year based on the then existing price list. B generally sells the payroll software bundled with the first year of telephone support to new customers. Other vendors sell broadly similar payroll software. B plans to release Version 2.1 of the payroll software in the near term and promises that C will receive Version 2.1 when it is released at no additional charge, although other existing users of Version 2.0 wishing to upgrade to Version 2.1 may be charged a fee for the upgrade.

B determines that it has three separate performance obligations – the payroll software Version 2.0, one year of telephone support, and C’s right to upgrade to Version 2.1 – based on the following analysis:

- **Software Version 2.0.** Although B generally sells the software along with the first year of telephone support services, it is off-the-shelf software that can run without the telephone support service, and B could sell it separately. Further, the software has utility on its own, independent of the telephone support services and the upgrade right. Therefore, the software is considered distinct from the other performance obligations in the contract.

- **Telephone support service.** B provides telephone support services on a stand-alone basis to existing customers, and therefore telephone support is considered a distinct performance obligation.

- **Upgrade right Version 2.1.** The upgrade right has a distinct function, it can run with readily available resources (e.g. Version 2.0 of the software) and it is sold separately.

**KPMG Observations**

Software contracts for post-contract customer support often include various components such as technical support, ‘bug’ fixes, and rights to upgrades on a when-and-if available basis. At present, some software companies may not separate those components if they are not able to measure reliably their fair value on an individual basis. Under the 2011 ED, each of these components is likely to have benefit to the customer with the delivered licence, and therefore may be considered distinct. Additionally, it is not clear whether a practical expedient allowing companies to account for distinct goods or services as one performance obligation if they have the same pattern of transfer to the customer could be applied in such cases. Although the actual pattern of transfer of the various components of the post-contract support may not be the same or similar, the services are provided over the same period of time.
Example – Initial set-up service is not a separate performance obligation

Cloud Service Provider (CSP) Z enters into a three-year contract with Customer X, under which X pays an amount of 600,000 for the following products and services:

- initial set-up services to customise, configure and install the cloud service prior to service commencement;
- 1,000 hours of ongoing other professional services that are not essential to the initial service commencement (i.e. ongoing configuration, data migration and support). Any additional time beyond the contracted 1,000 hours will be invoiced at 150 per hour. Z routinely charges other customers on a time and materials basis at 150 per hour when such professional services are sold separately; and
- non-cancellable one-year access to the cloud services. These cloud services are renewable at the customer’s option at 500,000 per year for each of the remaining two years under the contract.

X is unable to use the cloud service until the set-up is completed. The set-up services provided under the contract with X cannot be used with another service offering and no other parties can provide set-up services for Z’s cloud offerings.

Z routinely sells the one-year access to cloud services to other customers for 500,000 per year; Z does not charge customers for initial set-up services as an incentive to sign up to the first year of the cloud service. Further, other CSPs routinely provide similar cloud services on a stand-alone basis.

The initial set-up services are not distinct from the cloud services, because they are highly inter-related, involve a significant integration service and the bundle is customised for X’s needs. Therefore, the initial set-up services and the cloud services will be considered a single performance obligation.

In this example Z has two performance obligations: the other professional services for up to 1,000 hours; and the ongoing cloud services for a one-year term, which include the initial set-up services. These services are considered distinct from one another as they are sold separately by Z and they have a different pattern of transfer to X. The option to purchase additional professional services beyond the contracted 1,000 hours at the standard rate does not grant X a material right that it would not receive without entering into the contract, and therefore does not create a separate performance obligation in this example; this is discussed below.

Note: This example does not address the allocation of revenue to separate performance obligations. This issue is discussed under Step 4.

How to treat options for additional goods or services?

An option to acquire additional goods or services granted in a contract with more than one performance obligation would give rise to a separate performance obligation if that option provides a material right to the customer that it would not receive without entering into that contract (e.g. a discount that is incremental to that typically given for those goods or services in that geographical area or market).

KPMG Observations

At present, options to acquire additional copies of software that has been already delivered or to add additional customer users are generally not considered separate performance obligations. Certain discounts in software contracts that are currently not accounted for separately might be considered separate performance obligations under the 2011 ED.
Step 3: Determine the transaction price

How to estimate the transaction price when the consideration is variable?

The transaction price is the estimated total amount of consideration to which the company expects to be entitled under the contract in exchange for transferring goods or services (excluding amounts collected on behalf of third parties). Consideration may be variable as a result of incentives, including discounts and rebates, contingent or performance-based fees or other similar items.

If the consideration in a contract is variable, then a company would estimate it using one of the following methods:

- the expected value; or
- the most likely amount.

However, this is not a free choice and it would depend on whether one or the other approach better predicts the amount of consideration to which a company expects to be entitled.

### Expected value

- Probability-weighted amounts in a range of possible consideration amounts
- May be appropriate if a company has a large number of contracts with similar characteristics
- Can be based on a limited number of discrete outcomes and probabilities

### Most likely amount

- The single most likely amount in a range of possible consideration amounts
- May be appropriate if the contract has only two possible outcomes

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**Example – Estimating the transaction price when the consideration is variable**

Company S enters into a contract with Customer B to provide support services for its software at a monthly fee of 10,000. As part of the service, S is responsible for solving any technical issues with the software within five business days, on average, during a given month. If, on average, during a given month issues are not resolved within five business days, then monthly service fees are reduced as follows:

<table>
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<th>Terms</th>
<th>Reduction in fees</th>
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<tr>
<td>Average time to resolve issues exceeds 5 business days</td>
<td>10%</td>
</tr>
<tr>
<td>Average time to resolve issues exceeds 10 business days</td>
<td>25%</td>
</tr>
<tr>
<td>Average time to resolve issues exceeds 20 business days</td>
<td>50%</td>
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</tbody>
</table>

The software was previously purchased by B from S, and S expects the requests for support to be routine in nature. Based on its experience with similar customers, who purchased the same software package, S makes the following estimates:

<table>
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<th>Possible outcomes</th>
<th>Probabilities</th>
<th>Expected fees</th>
</tr>
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<tbody>
<tr>
<td>Average time to resolve issues less than 5 business days</td>
<td>80%</td>
<td>(10,000 x 80%) = 8,000</td>
</tr>
<tr>
<td>Average time to resolve issues exceeds 5 business days</td>
<td>10%</td>
<td>900 (10,000 x 90% x 10%)</td>
</tr>
<tr>
<td>Average time to resolve issues exceeds 10 business days</td>
<td>10%</td>
<td>750 (10,000 x 75% x 10%)</td>
</tr>
<tr>
<td>Average time to resolve issues exceeds 20 business days</td>
<td>0%</td>
<td>Nil</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100%</strong></td>
<td><strong>9,650</strong></td>
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S determines that the expected value method will better predict the amount of consideration to which it expects to be entitled and the monthly consideration is estimated in the amount of 9,650.

Note: Using the most likely method, the consideration would be 10,000.
KPMG Observations

In general, the 2011 ED is not expected to result in a significant change in determining the variable consideration by technology companies relative to the 2010 ED. The 2010 ED would have required using the expected value method, which may be different from current practice and could be challenging to apply. Under the 2011 ED, companies would be able to choose between these two approaches. However, it is not a free choice and it would depend on whether one or the other approach better predicts the amount of consideration to which a company expects to be entitled. The selected approach would have to be applied consistently throughout the contract.

How is credit risk reflected?

The transaction price would not be adjusted for customer credit risk; this is a change from the proposals in the 2010 ED. The 2011 ED requires that the effects of customer credit risk be presented as a line item adjacent to revenue in the statement of comprehensive income. Any impairment losses on trade receivables and on contract assets would be recorded separately from revenue but on this adjacent line (i.e. above the gross profit margin).

KPMG Observations

The 2011 ED alleviates concerns about the proposal in the 2010 ED to account for the original estimate of credit risk directly through revenue. Under the 2011 ED, credit risk is not included in the measurement of the transaction price used for recognising revenue. Many technology and other companies currently account for credit risk as a financing cost or record the cost as an operating expense as part of operating profit. Moving impairment losses above the gross profit margin line would affect a number of KPIs calculated by technology companies.

KPMG Observations

• whether the total consideration would differ substantially if payment was made in cash promptly in accordance with typical credit terms in the industry and jurisdiction; and
• the interest rate in the contract as compared to the market rate.

As a practical expedient, a company would not be required to make this assessment if the period between transfer of control of goods or services and payment is expected to be one year or less.

The company would present the effect of the financing component separately from revenue from other goods or services.

How to reflect the time value of money?

The 2011 ED proposes that a company adjust the amount of consideration to reflect the time value of money if the contract includes a significant implicit or explicit financing component. Factors to consider in assessing whether a financing component is significant include:

• the length of time between transfer of and payment for the good or service;
• whether the total consideration would differ substantially if payment was made in cash promptly in accordance with typical credit terms in the industry and jurisdiction; and
• the interest rate in the contract as compared to the market rate.

As a practical expedient, a company would not be required to make this assessment if the period between transfer of control of goods or services and payment is expected to be one year or less.

The company would present the effect of the financing component separately from revenue from other goods or services.

KPMG Observations

Some common transactions, such as prepayments for post-contract support for a term of one year or less, or long-term contracts, under which the time lag between payments and the transfer of goods or services does not extend over one year, are unlikely to be affected by the proposals in the 2011 ED. However, contracts with extended payment terms greater than one year may be impacted by the time value of money proposals.

Additionally, IFRSs do not contain an explicit requirement to adjust advance payments to reflect the time value of money and there is divergence in practice at present. Under the 2011 ED, both payments received in advance and in arrears would be subject to the time value of money requirements.
Step 4: Allocate the transaction price to the separate performance obligations

The 2011 ED retains the proposal to allocate, at contract inception, the transaction price to separate performance obligations in proportion to their relative stand-alone selling prices. When stand-alone selling prices are not directly observable, a company would estimate them using a suitable approach, such as the adjusted market assessment approach, expected cost plus a margin approach or, in limited circumstances, the residual approach.

**Adjusted market assessment**

This approach involves an estimation of the price that customers would pay for the product sold by considering the pricing of similar products in the marketplace and making adjustments to reflect the company’s cost and margin structure.

**Expected cost plus a margin**

This approach involves estimating the company’s projected costs for the good or service and then adding an appropriate margin.

**Residual**

This approach is used when selling prices for the product are either highly variable or uncertain and observable prices are available for the remaining performance obligations. In these instances, the selling price may be the total transaction price, less the stand-alone selling prices of the other deliverables (the residual).

Similarly, if the transaction price includes a contingent amount for a distinct good or service, then this would be allocated to a specific performance obligation if:

- the contingency relates specifically to satisfaction of a specific performance obligation; and
- the result of the allocation is consistent with the basic principle that consideration allocated reflects the amount to which the company expects to be entitled in exchange for satisfying each individual performance obligation.

**KPMG Observations**

Software companies were concerned that the 2010 ED did not allow use of the residual method for allocating transaction price to separate performance obligations. The residual approach is used in a variety of contexts under current standards.

The 2011 ED allows use of the residual approach if prices are highly variable or uncertain. However, the residual approach under the 2011 ED differs from the residual approach under current standards. Under current standards, it is considered inappropriate to measure the undelivered component by deducting the fair value of delivered components from the total consideration (the ‘reverse residual approach’). The reverse residual approach may be acceptable under the 2011 ED in certain circumstances if observable stand-alone selling prices for delivered performance obligations under the contract are available but the stand-alone selling prices for undelivered performance obligations are highly variable or uncertain.

If a bundle of goods and services is sold at a discount to the sum of the stand-alone selling prices of the goods and services, then the company would allocate the discount to all of the separate performance obligations unless:

- each good or service (or each bundle of goods or services) is sold regularly on a stand-alone basis; and
- the observable stand-alone selling prices indicate that the discount should be applied to one or more specific performance obligations.

If both criteria are met, then the discount would be allocated to the separate performance obligation(s) that it relates to, as indicated by the observable stand-alone selling prices.
Step 5: Recognise revenue when (or as) each performance obligation is satisfied

The 2011 ED retains the core principle that revenue is recognised when or as performance obligations are satisfied through the transfer of control of a good or service to a customer; however, unlike the 2010 ED, it provides specific criteria to assess whether a performance obligation is satisfied over time or at a point in time.

The 2011 ED proposes that a company first determine whether a performance obligation is satisfied over time. If so, revenue would be recognised over time. If not, revenue would be recognised at a point in time when control transfers to the customer.

What are the criteria for recognising revenue over time?

Performance does not create an asset with an alternative use* to the company and any one of the below criteria is met:

- Customer simultaneously receives benefits as company performs
- Task would not need to be reperformed
- Company has right to payment for performance and expects to fulfill contract

Performance obligations satisfied over time:

- e.g. On-site improvements to customer’s IT systems
- e.g. Maintenance support
- Unlikely to apply to technology companies
- e.g. Technology company develops customised software, expects to complete it and is entitled to payment for progress to date

* An alternative use exists if the company has an ability to direct the asset to another customer

Example – Revenue recognition over time

Company S enters into a contract with Customer C to develop and install customer relationship management (CRM) software. Progress payments are made upon completion of each milestone of the contract. If the contract is terminated, then the partly completed CRM software passes to C. S is prohibited from redirecting the software to another customer.

In this example, S does not create an asset with an alternative use because it is prohibited from redirecting the software to another customer, it is entitled to payments for performance to date and expects to complete the project. Therefore, S concludes that the contract meets the criteria for recognising revenue over time.

KPMG Observations

Technology companies expressed significant concerns that it was not clear how the ‘continuous transfer’ concept proposed in the 2010 ED would apply to services; and that revenue for some arrangements that is currently recognised using the percentage of completion method would have to be recognised at a point in time.

The 2011 ED proposes more refined criteria for determining whether a performance obligation is satisfied over time or at a point in time. Some technology companies may consider the revised proposals good news as under the 2011 ED a broader range of contracts may qualify for percentage of completion accounting, including a number of arrangements in the technology sector such as integration, outsourcing and consulting services.

Whilst many services provided by technology companies are likely to meet the criteria for recognising revenue over time, the analysis for software developers may be more challenging. At present, to qualify for percentage of completion accounting under IAS 11 the software being developed needs to be sufficiently customised to meet the definition of a construction contract.
Customisation is not the critical criterion for recognising revenue over time under the 2011 ED. As illustrated above, in order to recognise revenue over time under the 2011 ED, a software developer would need to demonstrate that it creates or enhances the asset that the customer controls as the asset is created or enhanced, or that it does not create an asset with an alternative use and one of the following three criteria is satisfied:

- the customer receives a benefit as the software is being developed or customisation is being performed;
- an alternative developer can complete the project if it is terminated prior to completion; and
- the software developer expects to fulfil the contract and is entitled to payment for work completed to date.

It may be challenging for a software developer to demonstrate that software being developed does not have an alternative use, especially if the developer works off site and retains the intellectual property rights to the code.

Other application issues

How to account for licences?

A licence provided by a technology company to a customer would give rise to a performance obligation that the technology company satisfies at a point in time when the customer obtains control of the licence. If the technology company also provides other goods or services to the customer, then it would consider whether to combine the various performance obligations. This may result in the revenue relating to the licence being recognised over time, if the licence is not accounted for as a separate performance obligation.

KPMG Observations

IAS 18 states that fees and royalties are recognised according to the substance of the arrangement, noting that in some cases the fees will be recognised over time (perhaps on a straight-line basis) and in some cases the arrangement will be similar to a sale such that the fees will be recognised upfront. However, only one of the examples in IAS 18 refers to control as a key factor in determining the pattern of revenue recognition. It is likely therefore that the 2011 ED’s proposals would result in changes in practice in some cases.

The 2011 ED notes that control of rights to use intellectual property cannot be transferred before the beginning of the period during which the customer can use and benefit from the licensed intellectual property. For example, if a software licence period begins before the customer obtains an access code that enables the customer to use the software, then in some cases the technology company may not be able to recognise revenue before providing the access code to the customer.

Unlike the 2010 ED, the 2011 ED does not distinguish between exclusive and non-exclusive licences; instead, all licences would be subject to the same requirements.

How to account for royalty-based fees?

If the licence fee is variable, then the cumulative amount of revenue recognised to date would be limited to the amount to which the company is reasonably assured to be entitled. This could be a case with royalty-based licence fees. Additionally, the 2011 ED states that if a company licenses intellectual property and receives a sales-based royalty, then the company would not be reasonably assured to be entitled to the additional amount of consideration until the uncertainty is resolved, e.g. when the customer’s subsequent sales occur.
Company B develops a software programme for editing images. On 1 July 2012, it grants a licence to its software programme to Company G, which sells off-the-shelf software packages. The licence fee is payable in instalments over a three-year period, based on a percentage of revenue received by Company G from the sales of the software package, which includes B’s programme, with a minimum guaranteed fee payable over three years.

B concludes that it transfers control of the intellectual rights to G on 1 July 2012. That is, B satisfies its performance obligation on that date. However, B would not be reasonably assured of the amount of the sales-based portion of the licence fee until G sells software packages to its clients. Therefore, B recognises revenue only for the present value of the minimum guaranteed fee on 1 July 2012. B recognises the variable consideration portion of the licence fee as the amount becomes reasonably assured.

How to account for costs to fulfil a contract?

Under the 2011 ED, a company would first consider whether the costs of fulfilling a contract are in the scope of another IFRS; if this is the case, then the company would apply the guidance in that other IFRS. The 2011 ED also proposes amending IAS 2 Inventories to scope out the costs of a service provider. If the costs of fulfilling a contract are not within the scope of other IFRSs, then a company would capitalise the costs if they:

- relate directly to a contract (or a specific anticipated contract);
- generate or enhance resources of the company that are used to fulfil the performance obligation; and
- are expected to be recovered.

Otherwise, the company would expense the costs as incurred.

The 2011 ED includes a list of direct costs that would be eligible for capitalisation if other criteria are met, as well as a list of costs that would not be eligible for capitalisation and therefore would be recognised as expenses when incurred.

Direct costs that would be eligible for capitalisation if other criteria are met

- Direct labour (e.g. employee wages)
- Direct materials (e.g. inventory to customer)
- Allocation of costs that relate directly to the contract (e.g. depreciation)
- Costs that are explicitly chargeable to the customer under the contract
- Other costs that were incurred only because the entity entered into the contract (e.g. subcontractor costs)

Costs expensed when incurred

- General and administration costs unless explicitly chargeable to the customer under the contract
- Costs of wasted materials, labour or other contract costs not reflected in price
- Costs that relate to satisfied performance obligation (i.e. transfer of control already occurred)
- Costs that relate to remaining performance obligations, but cannot be distinguished from costs that relate to satisfied performance obligations

How to account for incremental costs of obtaining a contract?

Under the 2010 ED, the costs of obtaining a contract were to be expensed as incurred. In response to concerns raised by a number of constituents in various industries, including some technology companies, the 2011 ED proposes that companies capitalise the incremental costs of obtaining a contract if they are expected to be recovered, unless the contract duration is one year or less. Incremental costs are those that would not have been incurred if the contract had not been obtained.

The qualifying costs of obtaining a contract would be recognised as an asset, amortised over the expected period of benefit and tested for impairment.
At present, there is diversity in the technology sector in relation to the accounting for costs of acquiring a customer or contract. Some companies capitalise such costs and some expense them as incurred. Those technology companies that currently expense all subscriber acquisition costs may meet the criteria to capitalise and amortise the incremental costs of obtaining a contract with a duration of more than one year.

How to determine whether a performance obligation is onerous?

The 2011 ED retains the proposal to apply the ‘onerous test’ at a performance obligation level rather than at a contract level. The scope of the onerous test would be limited to performance obligations that are satisfied over a period of more than one year.

The proposals in the 2011 ED could lead to a technology company recognising an up-front loss on a performance obligation within an overall profitable contact. Conversely, it may be a case that a contract is deemed onerous at present under IAS 37 Provisions, Contingent Liabilities and Contingent Assets, but if it is satisfied at a point in time or its duration is less than a year, then no up-front loss would be recognised under the 2011 ED. However, the assets related to the contract will be still subject to impairment review under the respective IFRSs.

Getting ready

The revenue project has not been finalised and the proposals are subject to further re-deliberations by the Boards in the coming months. However, technology companies may start considering the potential impact of the proposals on their financial reporting, operations, internal systems and on communication with stakeholders.

- **Contracts analysis.** Technology companies would be required to analyse the terms and conditions of their contracts, determine the number of performance obligations in accordance with the 2011 ED, and consider whether these performance obligations meet the criteria for recognition of revenue over time or at a point in time.

- **Compensation contracts with sales staff and external agents.** Incremental commissions paid to internal sales staff and external agents would need to be revisited with the understanding that some costs would be required to be capitalised. Additionally, some commissions paid by technology companies may be based on revenue targets; such arrangements may need to be revisited with a view that timing of revenue recognition for some arrangements may change.

- **Staff training.** The final standard may result in changes to current accounting practices, and may affect operating practices as well. The training of finance staff will be essential as parallel record-keeping may be required in the period preceding the effective date to provide for comparative figures. For example, if the new standard becomes effective from 1 January 2015, then parallel record-keeping may be required from 1 January 2014 for a calendar-year company that reports one year of comparative financial information, and potentially for a longer period if a company would need to present comparative financial information for more than one year.

- **Setting expectations upfront.** The proposals may impact the timing of revenue recognition for some technology companies, and affect various KPIs used by the sector; therefore, communications with the investor community and analysts should be considered.

- **Disclosure requirements.** The disclosure requirements proposed in the 2011 ED are extensive and may require tracking and recording additional data and introducing new IT systems.
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