

Accounting Update

Applying AASB 15 - Technology

May 2018

This publication explores some of the potential effects of the new revenue standard on the technology sector. It supplements our Accounting Update *Applying AASB 15 Revenue* and should be read in conjunction with that publication.

Applying to for-profit entities for financial years commencing from 1 January 2018, AASB 15 *Revenue from Contracts with Customers* replaces AASB 118 *Revenue* and four related AASB Interpretations.

In this publication, we highlight some of the key impacts arising from the introduction of AASB 15 to entities in the technology sector. Arrangements vary significantly between entities within the technology sector and this publication does not attempt to address all the issues that may exist. Entities will need to examine their own specific arrangements to determine the extent to which AASB 15 will impact their organisation.

Identify the performance obligations in the contract

At contract inception, it is necessary to identify all the distinct performance obligations within the contract. Separate performance obligations represent promises to transfer to the customer either:

- i. A good or service (or a bundle of goods and services) that is distinct; or
- ii. 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 is distinct if both:

- i. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer; and
- ii. The good or service is separately identifiable from other goods or services in the contract.

Contracts in the technology sector commonly involve the delivery of multiple goods and services including:

- a. Installation services;
- b. Customised installations;
- c. Software upgrades and enhancements;
- d. Technical support; and
- e. Other professional services.

The goods or services promised in a contract with a customer may be explicitly stated in the arrangement or implied by the

entity's customary business practices. Determination of whether the goods and services are distinct requires significant judgement and analysis. Entities should carefully consider and analyse the terms and conditions of their arrangements to determine whether goods and services are distinct.

The following examples illustrate the identification of performance obligations.

Example 1a - License that is distinct from other goods and services (AASB 15 IE49 -IE53)

ABC Co 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 is routinely performed by other entities and does not significantly modify the software. The software is delivered before the other goods and services and remains functional without the updates and the technical support.

ABC Co 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 AASB 15 is met.

ABC Co also considers the factors in paragraph 29 of AASB 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 AASB 15 is met). ABC Co 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.

ABC Co assesses which goods and services are distinct in accordance with paragraph 27 of AASB 15. It observes that the software is delivered before the other goods and services and remains functional without the updates and the technical support. Thus, it 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.

On this basis ABC Co identifies that there are four performance obligations in the contract being:

- i. The licencing of the software
- ii. Installation service;
- iii. Software updates; and
- iv. Technical support.

ABC Co then must consider paragraphs 31–38 of AASB 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.

Example 1b - Licence is not distinct from other goods and services (AASB 15 IE54 - IE 58)

The promised goods and services are the same as in Example 1a 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.

ABC Co assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 27 of AASB 15.

In this scenario, ABC Co 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 being the functional and integrated software system specified in the contract. In addition, the *software is significantly modified and customised* by the service (refer AASB 15.29(b))

In this instance ABC Co has determined although the customised installation service can be provided by other entities, that within the context of the contract the promise to transfer the licence is not separately identifiable from the customised installation service. Therefore, the criterion in paragraph 27(b) of AASB 15 (on the basis of the factors in paragraph 29 of AASB 15) is not met. Thus, the software licence and the customised installation service are not distinct.

On this basis ABC Co identifies that there are three performance obligations in the contract being:

- i. The customised installation service including the transfer of the software licence;
- ii. Software updates; and
- iii. Technical support.

ABC Co then applies paragraphs 31–38 of AASB 15 to determine whether each performance obligation is satisfied at a point in time or over time.

Contract modifications

A contract modification is a change in the scope or price (or both) of a contract. 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:

- i. the additional goods and services are distinct from the goods and services in the original arrangement; and
- ii. the amount of consideration expected for the added goods and services reflects the stand-alone selling price of those goods or services.

Example 2 – Contract modification

Tech Co enters into an arrangement to provide subscription-based services to a customer over a 12-month period for \$1 million. After six months, Tech Co and the customer agree to modify the contract by adding another 12 months of subscription-based services. The price for the additional service is \$800,000. Using the criteria described above, Tech Co determines that the additional 12 months of subscription-based services are distinct, and the pricing for the additional term of subscription-based services reflects the stand-alone selling price of the services at the time of the contract modification, adjusted for the discount frequently awarded to returning customers.

The contract modification is considered a separate contract for the additional months of services and would not affect the accounting for the existing contract.

However, if Tech Co determined that the price for the additional services did not reflect the stand-alone selling price at the time the contract is modified then the modification does not meet the criteria to be accounted for as a separate contract. In that case, Tech Co accounts for the modification in accordance with paragraph 21(b) of AASB 15 by updating the transaction price and the measure of progress towards complete satisfaction of the performance obligation.

Warranties

It is common for technology entities to provide a warranty in connection with their products.

A warranty that requires an entity to repair or replace a product that develop faults within a specified period in accordance with statutory requirements is designed to protect customers from the risk of purchasing defective products. If the supplier is required by law (such as the Australian Consumer Law) to provide a warranty, the existence of that law indicates that the promised warranty is not a separate performance obligation because it is not distinct in the context of the contract. Such statutory warranties are not recognised as separate performance obligations under AASB 15. Instead, they are measured and recognised as separate liabilities in accordance with AASB 137.

However, where an entity either sells separately or negotiates separately with a customer so that the customer can choose whether to purchase the warranty coverage, or an extended warranty, the warranty provides a service to the customer in addition to the promised product. Consequently, this type of extended warranty represents a separate performance obligation.

Satisfaction of Performance Obligations

AASB 15 requires an entity to recognise revenue when, or as, it satisfies a performance obligation by transferring a promised good or service to a customer. An asset is transferred when, or as, the customer obtains control of that asset. Performance obligations are either satisfied over time or at a point in time. AASB 15 contains specific guidance on performance obligations for licensing of software and technology.

Entities need to consider whether the nature of the entity's promise in granting a licence to a customer is to provide the customer with either:

- a. A right to access the software/intellectual property as it exists throughout the license period; or
- b. A right to use the software/intellectual property as it exists at a point in time at which the license is granted.

To determine whether an entity's promise to grant a licence provides a customer with either a right to access an entity's intellectual property or a right to use an entity's intellectual property, an entity shall consider whether a customer can direct the use of, and obtain substantially all of the remaining benefits from, a licence at the point in time at which the licence is granted. A customer cannot direct the use of, and obtain substantially all of the remaining benefits from, a licence at the point in time at which the licence is granted if the intellectual property to which the customer has rights changes throughout the licence period.

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

- a. 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;
- b. the rights granted by the licence directly expose the customer to any positive or negative effects of the entity's activities; and
- c. those activities do not result in the transfer of a good or a service to the customer as those activities occur.

Licensing arrangements can vary significantly and entities will need to assess the terms and conditions of their arrangements to determine the nature of its performance obligations.

Example 3 – Right to use intellectual property (AASB 15 IE276 - IE277)

Using the same facts as in Example 1a, the entity assesses the nature of its promise to transfer the software licence in accordance with paragraph B58 of AASB 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.

Therefore, the entity concludes 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 and recognises revenue (measured as the transaction price allocated to the licence) when control of the licence is transferred to the customer.

Determine the transaction price

An entity must determine the amount of consideration it expects to receive in exchange for transferring promised goods or services to a customer. Usually, the transaction price is a fixed amount. However, entities must also consider any consideration that is variable which includes, but is not limited to, discounts, prices concessions, usage-based royalties, bonuses and performance incentives. Management must estimate the consideration to which it expects to be entitled to determine the transaction price and to allocate consideration to performance obligations.



To estimate the total variable contract price, an entity applies the method below that better predicts the amount of consideration to which it will be entitled:

- i. The expected value—the sum of probability-weighted amounts in a range of possible amounts; or
- ii. The most likely amount—the single most likely amount in a range of possible outcomes (i.e. the single most likely outcome of the contract).

A measure of variable consideration is included in the transaction price only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur. The 'highly probable' threshold is a higher hurdle than 'probable' used in AASB 118. This is likely to result in revenue relating to variable consideration being deferred and recognised later compared to AASB 118.

Technology companies may offer payment terms that exceed the period during which the customer is expected to use the license or intellectual property (i.e. extended payment terms). This is could be an indication that the contract or arrangement with a customer has a material financing component which would need to be accounted for separately.

When a contract has a significant financing element, the effects of the time value of money are taken into account by adjusting the transaction price and recognising interest income over the financing period. However, a finance component does not exist if the timing of the future billings coincides with when the entity expects to perform under the contract. Consequently, entities will have to evaluate whether a contract includes a significant financing component.

Reseller and distributor arrangements

It is common in the technology sector for entities to sell their products through distributors or resellers. An entity may provide a reseller with price protection or extended rights of return. Entities will need to evaluate whether their contracts with resellers are consignment arrangements, under which control of the product would likely not transfer until delivery to the end-customer.

Indicators that an arrangement is a consignment arrangement include, but are not limited to:

- a. 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;
- b. the entity is able to require the return of the product or transfer the product to a third party (such as another dealer); and
- c. the dealer does not have an unconditional obligation to pay for the product (although it might 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 waits 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.

If an entity concludes that its contract with a reseller is not a consignment arrangement, the reseller is considered the customer. The entity is 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

this case, the entity also considers whether it will provide resellers with explicit or implicit concessions (e.g., price protection, expanded return rights, stock rotation rights) that will make the transaction price variable.

Conclusion

The introduction of AASB 15 has the potential to change the timing of revenue recognition for technology companies. Nexia's Financial Reporting Advisory specialists can assist you analyse the potential impacts of the new revenue model on your operations and whether any changes to your present accounting processes may be required.

Australia

Adelaide Office

Level 3, 153 Flinders Street Adelaide SA 5000
p +61 8 8139 1111, f +61 8 8139 1100
receptionSA@nexiaem.com.au

Brisbane Office

Level 28, 10 Eagle Street Brisbane QLD 4000
p +61 7 3229 2022, f +61 7 3229 3277
email@nexiabrisbane.com.au

Brisbane South Office

1187 Logan Road, Holland Park QLD 4121
p +61 7 3343 6333, f +61 7 3849 8598
email@nexiabrisbane.com.au

Canberra Office

Level 7, St George Centre, 60 Marcus Clarke Street
p +61 2 6279 5400, f +61 2 6279 5444
mail@nexiacanberra.com.au

Darwin Office

Level 2, 62 Cavenagh Street Darwin NT 0800
p +61 8 8981 5585, f +61 8 8981 5586
receptionNT@nexiaem.com.au

Melbourne

Level 12, 31 Queen Street Melbourne VIC 3000
p +61 3 8613 8888, f +61 3 8613 8800
info@nexiamelbourne.com.au

Perth

Level 3, 88 William Street, Perth WA 6000
p +61 8 9463 2463, f +61 8 9463 2499
info@nexiapertth.com.au

Sydney

Level 16, 1 Market Street, Sydney NSW 2000
p +61 2 9251 4600, f +61 2 9251 7138
info@nexiasydney.com.au

New Zealand

Christchurch

Level 4, 123 Victoria Street, Christchurch
p +64 3 379 0829, f +64 3 366 7144
office@nexiachch.co.nz

www.nexia.com.au

The material contained in this publication is for general information purposes only and does not constitute professional advice or recommendation from Nexia Australia. Regarding any situation or circumstance, specific professional advice should be sought on any particular matter by contacting your Nexia Advisor. Liability limited by a scheme approved under Professional Standards Legislation other than for the acts or omission of financial services licensees.