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Technology Spotlight
The Future of Revenue Recognition

For Private Circulation Only
January 2015

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Executive summary

- On May 28, 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued their final standard on revenue from contracts with customers. The standard, issued as Accounting Standards Update 2014-09 (and codified as Topic 606 in the FASB Accounting Standards Codification) by the FASB and as IFRS 15 by the IASB, outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition standard (including industry-specific guidance in U.S. GAAP[1]).
- The Institute of Chartered Accountants of India (ICAI) has recently issued an Exposure Draft (ED) of the proposed Indian Accounting Standard (Ind AS) 115, Revenue from Contracts with Customers i.e. the proposed IFRS Converged accounting standard for Indian entities, which is similar to IFRS 15.
- The new revenue recognition standard requires that goods or services in a contract that are "highly dependent on, or highly interrelated with, other goods or services promised in the contract" or that "significantly modify or customise" each other are not considered distinct performance obligations. Applying these criteria may require significant judgment.
- When contract consideration is variable, revenue should be recognised only to the extent that it is probable that a significant revenue reversal will not occur. In arrangements involving sales- or usage-based licenses of intellectual property, revenue is recognised only when it is determinable (i.e., when the sale or usage has occurred).
- Entities that license software to customers may need to determine whether they provide a "right to use the entity's intellectual property as it exists at a point in time" (a "static" license for which control is transferred at a point in time) or "access to the entity's intellectual property as it exists throughout the license period" (a "dynamic" license for which control is transferred over time).
- Since the new standard requires significantly more extensive disclosures, technology entities may need to modify their systems and processes to gather information about contracts with customers that is not otherwise readily available.
- This Technology Spotlight discusses the new revenue model and highlights key accounting issues and potential challenges for technology entities.

The new revenue standard supersedes most current revenue recognition guidance, including industry-specific guidance.

[1] The U.S. Securities and Exchange Commission (SEC) has indicated that it plans to review and update the revenue recognition guidance in SEC Staff Accounting Bulletin (SAB) Topic 13, "Revenue Recognition," when the new standard is issued. The extent to which the new standard will affect a public entity will depend on whether the SEC removes or amends the guidance in SAB Topic 13 to be consistent with the new revenue standard.

Background

The goals of the new revenue recognition standard are (1) streamlining, and removing inconsistencies from, revenue recognition requirements; (2) providing "a more robust framework for addressing revenue issues"; (3) making revenue recognition practices more comparable; and (4) increasing the usefulness of disclosures. The new revenue recognition standards states that the core principle for revenue recognition is that an "entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."

The new standard indicates that an entity should perform the following five steps in recognising revenue:-

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

As a result of the new standard, entities will need to comprehensively reassess their current revenue accounting and determine whether changes are necessary.

Thinking It Through

As a result of the new standard, entities will need to comprehensively reassess their current revenue accounting and determine whether changes are necessary. In addition, the new standard requires significantly expanded disclosures about revenue recognition, including both quantitative and qualitative information about (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgment, and changes in judgment, used in applying the revenue model; and (3) the assets recognised from costs to obtain or fulfil a contract with a customer.

Key Accounting Issues

This technology spotlight discusses the new revenue model and highlights key accounting issues and potential challenges for technology entities.

Identifying the Contract with the Customer (Step 1)

A contract can be written, verbal, or implied; however, the new standard applies to a contract only if all of the following criteria are met:

- "The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations."
- "The entity can identify each party's rights regarding the goods or services to be transferred."
- "The entity can identify the payment terms for the goods or services to be transferred."
- "The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract)."
- "It is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer."[2]

If a contract does not meet these criteria at contract inception, an entity must continue to reassess the criteria to determine whether they are subsequently met.

Collectability

The new standard establishes a collectability threshold under which an entity must determine whether "[i]t is probable that the entity will collect the consideration to which it will be entitled." If the threshold is not met, the entity is precluded from applying the remaining steps in the new standard and recognising revenue until it is probable[3] that the consideration will be collected. Any amounts received before collectability is considered probable would be recorded as revenue only if the consideration received is non-refundable and either (1) all performance obligations in the contract have been satisfied and substantially all of the promised consideration has been received or (2) the contract has been terminated or cancelled. If those conditions are not met, any consideration received would be recognised as a liability.

The new standard establishes a collectability threshold under which an entity must determine whether "[i]t is probable that the entity will collect the consideration to which it will be entitled".

For contracts that have a variable sales price (including price concessions), entities would first estimate the consideration due under the contract (see **Determining the Transaction Price (Step 3)** below) and would then apply the collectability threshold to the estimated transaction price.

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[2] In assessing whether it is probable that the entity will collect the consideration, an entity would consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration evaluated may be less than the price stated in the contract if the consideration is variable because the entity may offer price concessions (see step 3 on determining the transaction price).

[3] Under U.S. GAAP, "probable" refers to a "future event or events [that] are likely to occur." This threshold is considered higher than "probable" as used in IFRSs and Ind AS, under which the term means "more likely than not."

Thinking It Through

Technology entities often offer extended payment terms (see **Significant Financing Component** below for additional information). In certain cases (e.g., when the contract is with a financially stressed customer), entities may be unable to assert that the collectability of the total estimated transaction price is probable. In such situations, the contract would not be accounted for under the new standard's remaining steps until collectability is probable. As mentioned above, any amounts that are received before the probability threshold is met would usually be recorded as a liability unless the amount is non-refundable and either (1) all performance obligations under the contract have been satisfied and substantially all of the consideration has been received or (2) the contract has been cancelled, in which case the amount would be recognised as revenue.

If the probability threshold is subsequently met, all remaining revenue related to satisfied performance obligations, including revenue that had been deferred, would be recognised. This treatment may differ from that of current GAAP for the technology entities.

Contract Combination

Although entities would most likely apply the new standard to a single contract, in certain circumstances they may be required to combine a group of contracts and evaluate them as if they were a single contract. Under the new standard, an entity must combine contracts entered into at or near the same time with the same customer (or related parties of the customer) if one or more of the following criteria are met:

- "The contracts are negotiated as a package with a single commercial objective."
- "The amount of consideration to be paid in one contract depends on the price or performance of the other contract."
- "The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation [as defined]."

Although entities would most likely apply the new standard to a single contract, in certain circumstances they may be required to combine a group of contracts and evaluate them as if they were a single contract.

Thinking It Through

Since technology entities commonly enter into multiple agreements with the same customer within a short period, they need to consider whether certain contracts should be combined for revenue recognition purposes. Although the contract combination requirements mentioned above may be similar to certain aspects of existing guidance, entities may need to re-evaluate their conclusions under the new standard to determine whether changes in contract combinations may be necessary.

Contract Modifications

The new standard also provides guidance on accounting for "approved" modifications to contracts with customers. The approval of a contract modification can be in writing, by oral agreement, or implied by customary business practices, and a contract modification is considered approved when it creates new or changes existing enforceable rights or obligations. A contract modification must be accounted for as a separate contract when (1) it results in a change in contract scope because of additional promised "distinct" goods or services (see **Identifying the Performance Obligations (Step 2)** below) and (2) the additional consideration reflects the entity's stand-alone selling price of those additional promised goods or services (including any appropriate adjustments to reflect the circumstances of the contract). If an entity determines that the modification is not a separate contract, the entity would, depending on the specific facts and circumstances of the modified contract, apply one of the following methods:

- Treatment as a new contract (prospective method) — If the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification, the remaining transaction price[4] and any additional consideration promised as a result of the modification are allocated to the remaining performance obligations in the modified contract.
- Cumulative catch-up adjustment (retrospective method) — If the remaining goods or services are not distinct and are part of a single performance obligation that is partially satisfied as of the date of the contract modification, the performance obligation's measure of progress toward completion is updated, which may result in a cumulative catch-up of revenue.
- A combination of these two methods (if both of the above conditions exist).

Thinking It Through

Technology entities often enter into agreements that may amend, terminate, or otherwise change the provisions of the master or original agreement (e.g., side agreements). These entities may need to use judgment in determining whether such agreements represent approved modifications and whether each modification should be accounted for as a separate contract or dealt with under the prospective or retrospective method outlined above. The accounting for such modifications under the new standard may differ from that under current GAAP.

Identifying the Performance Obligations (Step 2)

The new standard provides guidance on evaluating the promised "goods or services"[5] in a contract to determine each performance obligation (i.e., the unit of account). A performance obligation is each promise to transfer either of the following to a customer:

- "A good or service (or a bundle of goods or services) that is distinct."
- "A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer."[6]

The new standard provides guidance on evaluating the promised "goods or services" in a contract to determine each performance obligation (i.e., the unit of account).

A promised good or service is distinct (and therefore a performance obligation) if both of the following criteria are met:

- Capable of being distinct — "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."
- Distinct within the context of the contract — "The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract." The new standard provides the following indicators for evaluating whether a promised good or service is separable from other promises in a contract:
  - "The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract . . . . In other words, the entity is not using the good or service as an input to produce or deliver the combined output specified by the customer."
  - "The good or service does not significantly modify or customise another good or service promised in the contract."

[4] Under the revenue model, the transaction price available for allocation would include the "consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognised as revenue."

[5] Although the new standard does not define goods or services, it includes several examples, such as goods produced (purchased) for sale (resale), granting a license, and performing contractually agreed-upon tasks.

[6] A series of distinct goods or services has the same pattern of transfer if both of the following criteria are met: (1) each distinct good or service in the series would meet the criteria for recognition over time and (2) the same measure of progress would be used to depict performance in the contract.

– “The good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract. For example, a customer could decide to not purchase the good or service without significantly affecting the other promised goods or services.”

Thinking It Through

The requirement that the promise to transfer a good or service be “separately identifiable from other promises in the contract” is a new concept under which entities must further evaluate a good or service for separability. Entities may need to use significant judgment when determining whether the goods or services in a contract are “highly dependent on, or highly interrelated with, other goods or services promised in the contract” or whether they “significantly modify or customize” each other. In such circumstances, entities may need to account for a bundle of goods or services, which may qualify for separate accounting under current GAAP, as a single performance obligation (unit of account).

Example 11 in the new revenue standard under U.S. GAAP and IFRS presents two cases that illustrate how technology entities would determine whether goods or services in a software arrangement are distinct. Each case depicts a typical software arrangement involving a license, an installation service, software updates, and technical support. In Case A, the installation service does not significantly modify or customize the software; in Case B, however, the installation service significantly modifies and customizes it. The new revenue standard concludes that the license and installation service would be considered distinct from each other in Case A but not in Case B. Entities with software arrangements similar to the one in Case A should refer to that illustration and reasonably reach the same conclusion.

The assessment of whether goods or services in a contract are highly dependent on, or highly interrelated with, one another may be particularly challenging for entities with technology arrangements. For example, software-as-a-service (SaaS) arrangements are often bundled together with additional products or services, such as implementation or consulting services, in a single arrangement (see **SaaS Arrangements** below for more information). Entities may find it difficult to determine whether the hosted software and other products or services offered are separately identifiable, depending on the nature of each item and how the items interact. However, if certain products or services offered under an arrangement have the same pattern of transfer, entities could effectively measure and recognize them as a single performance obligation under the new revenue standard. This guidance may simplify the identification of all distinct performance obligations under certain contracts.

The assessment of whether goods or services in a contract are highly dependent on, or highly interrelated with, one another may be particularly challenging for technology entities.

Renewal Options

Under the new standard, an option given to a customer to acquire additional goods or services represents a performance obligation if it provides a "material right" to the customer that it otherwise would not have received without entering into the contract. If an option is deemed a performance obligation, an entity must allocate a portion of the transaction price to the option and recognise revenue when control of the goods or services underlying the option is transferred to the customer or when the option expires.

Under the new standard, if the renewal option provides the customer with a material right that it would not have received had it not entered into the contract, the option should be treated as a separate performance obligation.

Thinking It Through

Contracts in the technology industry often offer customers the option to renew their contract with the entity at potentially favourable rates once the initial contract term expires or without incurring any additional up-front fees. For example, Software-as-a-Service ("SaaS") vendors may offer customers various incentives to entice them to renew their contract. Under the new standard, if the renewal option provides the customer with a material right that it would not have received had it not entered into the contract, the option should be treated as a separate performance obligation. A material right may be represented by (1) a discounted renewal rate that is incremental to the range of discounts offered to a customer in a given geographical area or market or (2) a waiver of an up-front fee that would have been paid by the customer for a new contract. In these cases, a portion of the original contract consideration would need to be allocated to the renewal option.

Determining the Transaction Price (Step 3)

The new standard requires an entity to determine the transaction price, which is the amount of consideration to which it expects to be entitled in exchange for the promised goods or services in the contract. The transaction price can be a fixed amount or can vary because of "discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items."

Variable Consideration

When the transaction price includes a variable amount, an entity is required to estimate the variable consideration by using either an "expected value" (probability-weighted) approach or a "most likely amount" approach, whichever is more predictive of the amount to which the entity will be entitled.

Some or all of an estimate of variable consideration is only included in the transaction price to the extent that it is probable[7] that subsequent changes in the estimate would not result in a "significant reversal" of revenue (this concept is commonly referred to as the "constraint"). The new standard requires entities to perform a qualitative assessment that takes into account both the likelihood and magnitude of a potential revenue reversal and provides factors that could indicate that an estimate of variable consideration is subject to significant reversal (e.g., susceptibility to factors outside the entity's influence, long period before uncertainty is resolved, limited experience with similar types of contracts, practices of providing concessions, or a broad range of possible consideration amounts). This estimate would be updated in each reporting period to reflect changes in facts and circumstances.

Sales-Based or Usage-Based Royalties

The constraint does not apply to sales- or usage-based royalties derived from the licensing of intellectual property; rather, consideration from such royalties is only recognised as revenue at the later of when the performance obligation is satisfied or when the uncertainty is resolved (e.g., when subsequent sales or usage occurs). Usage- or sales-based fee structures are common in the technology industry, particularly for software licenses.

[7] Like the term "probable" in step 1 regarding the collectability threshold, "probable" in this context has the same meaning i.e. the "future event or events are likely to occur." In IFRS 15 and Ind AS 115, the term "highly probable is used," which has the same meaning as the U.S. GAAP's "probable."

Thinking It Through

Price concessions are common in the technology industry and are often provided to customers as an incentive to renew or upgrade arrangements such as software licenses. Under current GAAP, such price concessions often lead to a deferral of revenue recognition; under the new standard, however, price concessions would be treated as variable consideration in the manner described above. Entities offering price concessions or other incentives that result in variable consideration may need to establish a robust set of controls and procedures for incorporating the impact of variable terms in estimating the transaction price and determining the probability of any future revenue reversals. These controls and procedures would also need to take into account the requirement to update these estimates as of each reporting period.

When determining the probability of a significant revenue reversal in the future, an entity may need to consider the price concessions it has historically offered to customers and the possibility that it will offer a concession larger than initially expected. This assessment may be particularly challenging when there are large volumes of contracts and a broad range of price concessions has been offered historically or is expected to be granted.

Entities offering price concessions or other incentives that result in variable consideration may need to establish a robust set of controls and procedures for incorporating the impact of variable terms in estimating the transaction price and determining the probability of any future revenue reversals.

Significant Financing Component

Adjustments for the time value of money are required if the contract includes a “significant financing component” (as defined in the new standard). Generally, no adjustment is necessary if payment is expected to be received within one year of the transfer of goods or services to the customer. However, if an entity concludes, on the basis of the payment terms, that there is a significant financing component, it should adjust the sales price when recording revenue to present the amount that would have been attained had the buyer paid cash for the goods or services on the date of sale.

Thinking It Through

Payment terms in the technology industry often include up-front fees or extended payment terms, particularly for software entities that have longer-term license contracts with customers. Under current guidance, arrangements that offer extended payment terms often result in the deferral of revenue recognition since the fees are typically not considered fixed or determinable unless the entity has a history of collecting fees under such payment terms without providing any concessions. In the absence of such a history, revenue is recognised when payments become due or when cash is received from the customer, whichever is earlier.

Under the new standard, if the financing term extends beyond one year and a significant financing component is identified, the entity would need to initially estimate the transaction price by incorporating the impact of any potential price concessions (see **Variable Consideration** above) and then adjust this amount to account for the time value of money. The amount would then be recognised as revenue when the entity transfers control of the good or service to the customer. When the entity is providing financing, interest income would be recognised as the discount on the receivable unwinds over the payment period. However, when the entity receives an up-front fee, the entity is deemed to be receiving financing from the customer, and interest expense is recognised with a corresponding increase to revenue recognised.

Allocating the Transaction Price (Step 4)

Under the new standard, when a contract contains more than one performance obligation, an entity would generally allocate the transaction price to each performance obligation on a relative stand-alone selling price basis. The new standard states that the "best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers." If the good or service is not sold separately, an entity must estimate it by using an approach that maximises the use of observable inputs. Acceptable estimation methods include, but are not limited to, adjusted market assessment, expected cost plus a margin, and a residual approach (when it is not directly observable and either highly variable or uncertain).

Thinking It Through

The new standard allows entities to apply the residual method to determine the stand-alone selling price of delivered or undelivered elements in an arrangement provided that the price of the elements under consideration is highly variable or uncertain. The use of this method to determine the stand-alone selling price of undelivered elements is known as the reverse residual method. However, when applying the residual or reverse residual method, entities still need to consider the standard's overall allocation principle to ensure that unrealistic amounts are not allocated to performance obligations. For instance, if the residual method results in the stand-alone price being determined for a product which does not faithfully depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying its performance obligation to transfer that product, say, because the residual stand-alone selling price is not within the price range in which that product is normally sold, then the residual approach may not be suitable. (See – Case C of example 34 in the new standard of both U.S. GAAP and IFRS)

Recognising Revenue When (or as) Performance Obligations Are Satisfied (Step 5)

Under the new standard, a performance obligation is satisfied (and the related revenue recognised) when "control" of the underlying goods or services (the "assets") related to the performance obligation is transferred to the customer. The new standard defines "control" as "the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset." An entity must first determine whether control of a good or service is transferred over time. If so, the related revenue is recognised over time as the good or service is transferred to the customer. If not, control of the good or service is transferred at a point in time.

Recognising Revenue over Time

Control of a good or service (and therefore satisfaction of the related performance obligation) is transferred over time when at least one of the following criteria is met:

- "The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs."
- "The entity's performance creates or enhances an asset . . . that the customer controls as the asset is created or enhanced."
- "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 performance completed to date."

If a performance obligation is satisfied over time, an entity recognises revenue by measuring progress toward satisfying the performance obligation in a manner that best depicts the transfer of goods or services to the customer. The new standard provides specific guidance on measuring progress toward completion, including the use and application of output and input methods.

Thinking It Through

Software companies often enter into arrangements in which significant production, modification, or customisation of software is required. Many of these entities currently may be accounting for such arrangements by using the percentage-of-completion or completed-contract method. Under the new standard, it may be appropriate for entities to recognise revenue related to software development over time when (1) the developer's performance creates or enhances an asset that the customer controls as it is created (e.g., development of software in a customer's technology environment) or (2) the developer's performance does not create an asset with an alternative use to the developer and the developer has an enforceable right to payment for performance to date (e.g., the software developed is specific to a customer's needs and therefore has no alternative use to the developer).

Revenue from arrangements that satisfy these criteria may be recognised in a manner similar to how it is currently recognised by entities that use the percentage-of-completion method. Revenue from arrangements that fail to meet the requirements above should be recognised at a point in time instead of over time (i.e., in a manner similar to how revenue is currently recognised by entities that apply the completed-contract method).

Other Accounting Issues

Accounting for Licenses

A technology entity may transfer to its customer a license granting a right to the entity's intellectual property (e.g., software, patents, trademarks, or copyrights). The new standard requires entities to determine whether the license is distinct (as defined in the new standard) from other promised goods or services in the contract (see **Identifying Performance Obligations (Step 2)** above). An entity must determine whether a distinct license gives the customer the "right to use the entity's intellectual property as it exists at the point in time at which the license is granted" (a "static" license for which control is transferred at a point in time) or a "right to access the entity's intellectual property as it exists throughout the license period" (a "dynamic" license for which control is transferred over time).

For a distinct license to represent a right to access the entity's intellectual property, all of the following criteria must be met:

- The contract requires (or the customer reasonably expects) the entity to undertake activities that significantly affect the intellectual property.
- The rights granted by the license directly expose the customer to any positive or negative effects of the activities.
- Those activities do not result in the transfer of a good or service to the customer.

If such criteria are met, the consideration allocated to the license is recognised as revenue over time. If such criteria are not met, the license is deemed a right to use and the consideration allocated to it is recognised at a point in time.

If the new standard's "right to access" criteria are met, the consideration allocated to the license is recognised as revenue over time; if such criteria are not met, the consideration allocated to the license is recognised at a point in time.

Thinking It Through

Technology entities often license software to a customer in an arrangement that includes other services or specified upgrade rights. To apply the license guidance outlined above, an entity will initially need to determine whether the license is distinct from the other promised goods or services. As discussed in **Identifying the Performance Obligations (Step 2)** above, it may be challenging to assess the level of dependency and interrelationship between promises in a given technology arrangement and conclude whether the license is distinct. However, for typical software arrangements involving a license and post-contract customer support (PCS), it is likely that an entity will often conclude that the license is distinct assuming that the PCS does not significantly modify the software.

If the technology entity concludes that a license is distinct from other promises in the same contact, it may need to use judgment in determining which activities it is required (or can be reasonably expected) to perform as well as whether those activities “significantly affect” licensed intellectual property, such as software. Such activities would not include items such as upgrades or other PCS that are considered distinct performance obligations since those items result in the transfer of an additional good or service to the customer.

Entities may need to use significant judgment in determining whether the activities they are required or expected to perform during the license period will significantly affect the software and expose the licensee to the positive and negative effects of such activities. If the software largely functions as intended, PCS is identified as a separate performance obligation, and the entity is generally not required to undertake additional activities that will significantly affect the software, the license would generally be considered static and revenue would accordingly be recognised when the license is transferred to the customer. However, this may not be the case for all software licenses, and entities may need to use significant judgment in determining whether the activities they are required or expected to perform during the license period will significantly affect the software and expose the licensee to the positive and negative effects of such activities.

As noted in **Sales-Based or Usage-Based Royalties** above, revenue from software licenses that have sales- or usage-based fee structures will only be recognised as the subsequent sales or usage occurs.

Sell-Through Arrangements

Technology entities often enter into arrangements with intermediaries (such as a dealer or distributor) for the sale of their products. Under existing guidance, revenue is often deferred until the intermediary has subsequently sold the goods to an end customer, typically because one or both of the following are true:

- The sales price may only be fixed or determinable at that point.
- Transfer of the risks and rewards of ownership of the goods (i.e., delivery) only occurs upon final sale.

The new standard precludes an entity from recognising revenue related to a good physically transferred to a third party on consignment until control of that good is transferred to the third party. However, if the arrangement does not involve consignment, an analysis of the control indicators for determining at what point control is transferred is critical to determining when revenue may be recognised.

The new standard precludes an entity from recognising revenue related to a good physically transferred to a third party on consignment until control of that good is transferred to the third party.

When control is deemed to pass to an intermediary, revenue may be recognised earlier than under current practice.

Thinking It Through

Entities will need to evaluate arrangements in which goods are sold through an intermediary to determine when control passes (i.e., the point in time at which control is transferred). In making this determination, they will have to assess all facts and circumstances by considering the indicators in the new standard (i.e., right to payment, title, physical possession, rights and rewards, and customer acceptance). Their assessment may require significant judgment and could result in a different revenue recognition pattern.

When control is deemed to pass to the intermediary, revenue may be recognised earlier than under current practice. In such situations, the sales price could be variable as a result of the arrangement with the intermediary. Accordingly, entities are required to estimate the transaction price to which they expect to be entitled and must consider the constraint guidance, specifically the probability of future revenue reversals (see **Determining the Transaction Price (Step 3)** above), before recognising revenue.

In addition, when goods or services provided to an intermediary are transferred subject to a return provision, entities should assess whether to apply the new standard's guidance on rights of return. The new standard specifically requires entities that sell goods with a right of return to recognise (1) revenue in the amount to which they expect to be entitled (considering any refund provisions), (2) a liability for any refunds or credits to be provided, and (3) an asset for any right to recover the product from the customer. However, when an entity anticipates significant levels of returns, it should consider how those expected returns could affect its decisions about whether control of the goods has passed to a customer.

SaaS Arrangements

The new standard will change several aspects of accounting for hosting arrangements, including SaaS arrangements that offer customers the use of cloud-based application software. Access to hosted SaaS arrangements is frequently offered together with a bundle of additional services, such as implementation or customisation and configuration services. SaaS vendors will need to determine whether each promised good or service is distinct under the new standard.

In applying the new standard, SaaS vendors would be required to recognise up-front fees over a period extending beyond the initial contract period only if the customer has the option to renew the SaaS contract and the renewal option provides the customer with a material right.

Thinking It Through

Many SaaS arrangements also involve set-up or “activation” fees, which typically are charged in addition to the subscription fee for the related hosting service. Activation fees generally do not involve the provision of a service other than simply “activating,” or permitting a customer to access the hosted software application. Other set-up services may require incremental work before a customer can access the software application. However, vendors need to consider whether the set-up services involved are essential to the functionality of the hosted software application. Frequently, customers are unable to access or use the software until the set-up services have been completed. These services are generally expected to benefit customers for the period they use the services (including potential renewal periods); as a result, the revenue allocated to the services is recognised over the initial contract period or over the estimated customer relationship period if longer.

The new standard provides guidance on non-refundable up-front fees which states that entities must assess whether a “fee relates to the transfer of a promised good or service.” In applying the new standard, SaaS vendors would be required to recognise up-front fees over a period extending beyond the initial contract period only if the customer has the option to renew the SaaS contract and the renewal option provides the customer with a material right. The new standard’s requirement to incorporate only renewal options that represent material rights into their estimation of a customer relationship period may not always be consistent with current GAAP, which may take into account renewal options that are not necessarily considered material rights. As noted in **Renewal Options** above, material rights would need to be accounted for as separate performance obligations under the new standard.

Further, revenue from SaaS arrangements that include a license of intellectual property and have usage-based fee structures are likely to be recognised only when subsequent usage occurs (see **Sales-Based or Usage-Based Royalties** above for more information).

Warranties

Technology companies often provide a range of warranties for their various products. The new standard allows entities to continue to use a cost accrual model to account for warranty obligations, but only for warranties ensuring that the good or service complies with agreed-upon specifications. To the extent that a warranty provides a service beyond ensuring that the good or service complies with agreed-upon specifications, it would be accounted for as a performance obligation (consideration would be allocated to this obligation and recognised as it is satisfied). Further, if the customer has the option to purchase the warranty separately, it would also be accounted for as a performance obligation.

Product liabilities, such as compensation paid by an entity for harm or damage caused by its product, do not represent a performance obligation in the contract and would continue to be accounted for in accordance with the existing literature.

Thinking It Through

Although the new standard is unlikely to significantly change how technology entities account for most of their warranties, entities will need to verify that the warranties they offer do not provide services beyond ensuring that the good or service complies with agreed-upon specifications. Further, although this guidance applies to hardware manufacturers, it may also be relevant to software entities.

Contract Costs

Technology companies may need to reconsider their policies when accounting for costs such as sales commissions, which are often significant.

The new standard contains criteria for determining when to capitalise costs associated with obtaining and fulfilling a contract. Specifically, entities are required to recognise an asset for incremental costs of obtaining a contract (e.g., sales commissions) when those costs are expected to be recovered (the new standard provides a practical expedient allowing entities to "expense these costs when incurred if the amortisation period is one year or less"). Costs of fulfilling a contract (that are not within the scope of other standards) would be capitalised only when they (1) are directly related to a contract, (2) generate or enhance resources that will be used to satisfy performance obligations, and (3) are expected to be recovered. The new standard also requires entities to expense certain costs, such as those related to satisfied (or partially satisfied) performance obligations. Capitalised costs would be amortised in a manner consistent with the pattern of transfer of the goods or services to which the asset is related (which may extend beyond the original contract term in certain circumstances).

Thinking It Through

Technology companies may need to consider the impact of this guidance on their current policies for capitalising the costs of obtaining a contract. The new standard may require entities to change their policy when they have previously expensed these costs or amortised them in a manner inconsistent with the new standard's requirements. In particular, technology companies may need to reconsider their policies when accounting for costs such as sales commissions, which are often significant.

Disclosures

The new standard requires entities to disclose both quantitative and qualitative information that enables "users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers." The new standard's disclosure requirements, which are significantly more comprehensive than those in existing revenue standards, include the following:

- Presentation or disclosure of revenue and any impairment losses recognised separately from other sources of revenue or impairment losses from other contracts.
- A disaggregation of revenue to "depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors" (the new standard also provides implementation guidance).
- Information about (1) contract assets and liabilities (including changes in those balances), (2) the amount of revenue recognised in the current period that was previously recognised as a contract liability, and (3) the amount of revenue recognised in the current period that is related to performance obligations satisfied in prior periods.
- Information about performance obligations (e.g., types of goods or services, significant payment terms, typical timing of satisfying obligations, and other provisions).
- Information about an entity's transaction price allocated to the remaining performance obligations, including (in certain circumstances) the "aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied)" and when the entity expects to recognise that amount as revenue.
- A description of the significant judgments, and changes in those judgments, that affect the amount and timing of revenue recognition (including information about the timing of satisfaction of performance obligations, the determination of the transaction price, and the allocation of the transaction price to performance obligations).
- Information about an entity's accounting for costs to obtain or fulfil a contract (including account balances and amortisation methods).
- Information about the policy decisions (i.e., whether the entity used the practical expedients for significant financing components and contract costs allowed by the new standard).

Considerations and Challenges for Technology Entities

Systems, Processes and Controls

To comply with the new standard's accounting and disclosure requirements, technology entities will have to gather and track information that they may not have previously monitored. The systems and processes associated with such information may need to be modified to support the capture of additional data elements that may not currently be supported by legacy systems. Further, to ensure the effectiveness of internal controls over financial reporting, management will want to assess whether it should revise existing, and implement additional, controls. In assessing the effect of applying the new standard on systems, processes, and internal controls, technology entities may need to critically analyse all of the effects of implementing the new standard's requirements by considering questions such as the following:

To comply with the new standard's accounting and disclosure requirements, technology entities will have to gather and track information that they may not have previously monitored.

- What processes should entities implement to identify all goods and services in a contract with a customer?
- How will entities estimate the stand-alone selling price for contracts involving multiple goods or services?
- How will entities ensure consistency of judgments in identifying performance obligations, estimating stand-alone selling prices, and measuring progress toward completion?
- What systems, processes, and controls are necessary to reliably estimate variable consideration and determine whether it is probable that a significant reversal of revenue will not occur?
- Will entities need new processes and controls to identify and capitalise contract costs that would be considered incremental?
- Will entities need to implement new processes and controls to periodically review contract costs and to test capitalised amounts for recoverability or impairment?
- When should new policies and procedures be designed and implemented?

Increased Use of Judgment

Management will need to exercise significant judgment in applying certain aspects of the new standard's requirements, including those related to the identification of performance obligations and allocation of revenue to each performance obligation. It is important for technology entities to consider how the standard specifically applies to them so that they can prepare for any changes in revenue recognition patterns.

Thinking Ahead

Although the exposure draft on revenue recognition is not effective until finalised by the ICAI and notified by the Ministry of Corporate Affairs, technology entities should start carefully examining the exposure draft and assessing the impact it may have on their current accounting policies, procedures, systems, and processes.

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