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Technology Industry Accounting Guide

Other Accounting and Financial Reporting Topics: Contingencies and Loss Recoveries

March 2023

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Preface

We are pleased to present the inaugural edition of Deloitte's *Technology Industry Accounting Guide* (the "Guide").

The technology industry ecosystem encompasses a wide array of entities, from enterprise software and software-as-a-service (SaaS) providers to hardware and semiconductor manufacturers. The technology industry has also experienced convergence with other types of businesses, creating subsectors such as fintech, health tech, energy tech, education tech, and auto tech, to name a few. Many entities have fueled the significant growth of the technology industry by embracing emerging technologies such as artificial intelligence (AI) and machine learning, everything as a service (XaaS) powered by the cloud, robotics, the Internet of Things (IoT), blockchain, and edge computing. Continuous innovation by technology entities produces novel business models while introducing potentially complex accounting and financial reporting matters.

Finance and accounting professionals in the technology industry face complex issues and must exercise significant judgment in applying existing rules to matters such as revenue recognition, software-related costs, acquisitions and divestitures, consolidation, stock-based compensation, leases, financial instruments, income taxes, digital assets, initial public offerings (IPOs), and disclosures of non-GAAP measures and metrics. To help technology entities work through some of the more difficult accounting and financial reporting issues related to these and other relevant topics, this Guide includes interpretive guidance, illustrative examples, and discussion of recent standard-setting developments (through February 28, 2023).

Appendix A lists the titles of standards and other literature we cited, and Appendix B defines the abbreviations we used.

We hope this Guide is helpful in navigating the various accounting and reporting challenges that technology entities face. We encourage clients to contact their Deloitte team for additional information and assistance.

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Chapter 5 — Other Accounting and Financial Reporting Topics

5.8 Contingencies and Loss Recoveries

ASC 450 defines a contingency as an "existing condition, situation, or set of circumstances involving uncertainty . . . that will ultimately be resolved when one or more future events occur or fail to occur." In the technology industry, contingencies often arise as a result of patent litigation cases, such as lawsuits filed against an entity for patent infringement. Technology entities also are facing increased risks associated with antitrust lawsuits and compliance with various regulatory requirements in different regimes, particularly risks related to consumer privacy, prevention of anticompetitive practices, cybersecurity incidents, discrimination, and classification of workers as employees rather than independent contractors. Technology entities should monitor the tightening regulatory environment in the United States and globally, especially as the regulatory environment continues to evolve quickly.

5.8.1 Loss Contingencies

Contingent liabilities are liabilities for which the possible loss outcome is unknown or uncertain, such as those associated with pending litigation or product warranties. The likelihood that a liability has been incurred ranges from "remote"[1] to "reasonably possible"[2] to "probable."[3] The ASC master glossary's definitions of these terms provide no quantitative thresholds; accordingly, entities need to exercise judgment when applying the terms. While there is diversity in practice related to the likelihood percentage that entities consider "probable" to represent, the threshold for "probable" would need to be at least 70 percent. Although "remote" is not discussed quantitatively in any guidance issued by the FASB, in practice, this term is used to indicate a likelihood of 10 percent or less.

Accrual of a loss contingency is required when (1) it is probable that a loss has been incurred and (2) the amount can be reasonably estimated. An entity must determine the probability of the uncertain event and demonstrate its ability to reasonably estimate the loss from it to accrue a loss contingency. Loss contingencies that do not meet both of these criteria for recognition may need to be disclosed in the financial statements. Various disclosure considerations are required under ASC 450-20 and ASC 275; and SEC Regulation S-K, Item 303, requires discussion of items that might affect an entity's liquidity or financial position in the future, including contingent liabilities.

For more information, see Chapter 2 of Deloitte's Roadmap *Contingencies, Loss Recoveries, and Guarantees*.

[1] As defined in the ASC master glossary, "remote" means that the "chance of the future event or events occurring is slight."

[2] As defined in the ASC master glossary, "reasonably possible" means that the "chance of the future event or events occurring is more than remote but less than likely."

[3] As defined in the ASC master glossary, "probable" means that the "future event or events are likely to occur."

5.8.1.1 Elements of a Litigation Settlement

Technology entities may enter into litigation settlements in which the settlement agreement includes past obligations and disputes and modifies the ongoing contractual terms of the business relationship. In those circumstances, a litigation settlement may also include a separate element (such as a revenue element). It is important to identify the different elements and understand the nature of each item, and entities should consider whether the principles in ASC 606 on allocating consideration to different elements of a contract with a customer that are partially within the scope of ASC 606 and partially within the scope of another topic is appropriate.

For more information, see Section 2.2.5 of Deloitte's Roadmap *Contingencies, Loss Recoveries, and Guarantees*.

5.8.1.2 Incurrence of a Future Cost of Doing Business

Technology entities sometimes settle litigation by altering the terms of future business arrangements. However, it is not always clear how to distinguish between the settlement of a past liability and the incurrence of a future cost of doing business. For technology entities, the incurrence of a future cost of doing business is often indicated by a payment stream that is contingent on the future sale of products or services in the ordinary course of business (e.g., royalties due to a licensor for the license and use of IP).

A technology entity may sometimes agree to settle a claim by agreeing to offer the claimant(s) a price concession on future purchases of the entity's goods or services by the claimant(s). In such a scenario, the claimant(s) will be required to make an independent future purchasing decision to realize the benefit of the settlement. An entity that is obligated to provide such price concessions in connection with a settlement will need to assess whether the settlement (1) represents a liability that should be currently recognized for the estimated settlement amount or (2) should be accounted for as a sales incentive in accordance with ASC 606, which generally results in the entity's accounting for the sales incentive at the time the claimant or claimants use the price concession in connection with the purchase of the entity's goods or services.

Irrespective of when the future price concession is accounted for, any settlement with a customer or a vendor would need to be evaluated in accordance with ASC 606 or ASC 705-20, respectively, regarding the income statement presentation of the settlement. That is, the settlement may need to be characterized as a reduction of revenue from a customer under ASC 606 or a reduction of the purchase price of goods or services acquired from a vendor under ASC 705-20.

For more information, see Section 2.2.6 of Deloitte's Roadmap *Contingencies, Loss Recoveries, and Guarantees*.

5.8.2 Gain Contingencies

The standard for recognition of gain contingencies is substantially higher than that for recognition of loss contingencies. ASC 450-30 indicates that a gain contingency should usually not be recognized before realization (i.e., the earlier of when the gain is realized or when it is realizable). A gain contingency should not be recognized even if realization is considered probable.

Because of the number of uncertainties inherent in a litigation proceeding, gain contingencies resulting from favorable legal settlements generally cannot be recognized in income until cash or other forms of payment are received. Gain recognition is not appropriate when a favorable legal settlement remains subject to appeal or other potential reversals. Often, gain contingency recognition will be deferred even after a court rules in favor of a plaintiff. Although an entity may be certain that it will receive proceeds from a legal settlement because there is no possibility of additional appeals, there may still be other uncertainties that indicate that the gain has not yet been realized. If a legal settlement is reached but is pending regulatory or legislative approval, gain recognition is not appropriate until all required levels of regulatory and legislative approval have been obtained. This is the case even if the entity can demonstrate that the settlement meets all criteria that are evaluated by a regulatory body when it is determining whether to grant approval.

For more information, see Chapter 3 of Deloitte's Roadmap *Contingencies, Loss Recoveries, and Guarantees*.

5.8.3 Loss Recoveries

Technology entities may be entitled to recoveries pertaining to a previously recognized financial statement loss (e.g., an impairment of an asset or incurrence of a liability), as well as recoveries from business interruption insurance. Loss recoveries may be received from litigation settlements, insurance proceeds, or reimbursement of an employee's fraudulent activities through liquidation of the employee's assets.

The table below summarizes the four accounting models that an entity should consider when determining the recognition and measurement of expected proceeds related to a recovery: (1) the loss recovery model, (2) the gain contingency model, (3) a determinable mix of the loss recovery and gain contingency models (the "determinable mix model"), and (4) an indeterminable mix of the loss recovery and gain contingency models (the "indeterminable mix model").

Loss recovery model	An asset for which realization is probable should be recognized only up to the amount of the previously recognized loss. The analysis of whether recovery is probable is consistent with the guidance on loss contingency recognition.
Gain contingency model	Recovery proceeds related to a loss that has not been recognized in the financial statements should be accounted for as a gain contingency.
Determinable mix model	A combination of the loss recovery and gain contingency models is applied when recovery proceeds are expected to exceed the amount of the previously recognized loss. The probable recovery proceeds equal to the amount of the recognized loss should be accounted for by using the loss recovery model. The expected proceeds in excess of the recognized loss should be accounted for by using the gain contingency model. For an entity to apply the determinable mix model, there must be a direct linkage between the recovery proceeds and the specifically identifiable recognized loss.
Indeterminable mix model	An indeterminable mix of the loss recovery and gain contingency models results from a situation in which there is no clear evidence that the amount of the recovery proceeds is a recovery of previously recognized losses or costs (i.e., there is no direct linkage) or the amount of the loss or costs previously incurred is not objectively quantifiable (i.e., the losses or costs are not specific, incremental, identifiable costs or losses). Under these circumstances, the application of the gain contingency model would be appropriate for the entire amount of the recovery proceeds.

For more information, see Chapter 4 of Deloitte's Roadmap *Contingencies, Loss Recoveries, and Guarantees*.

5.8.4 SEC Comment Letter Trends

The SEC staff continues to closely monitor SEC registrants' contingency disclosures, and it comments when such disclosures do not comply with U.S. GAAP or SEC rules and regulations.

The SEC staff frequently comments on:

- Lack of specificity regarding the nature of the matter.
- Lack of quantification of amounts accrued, if any, and possible loss or range of loss and/or disclosure about why such an estimate cannot be made.
- Insufficient detail about judgments and assumptions underlying significant accruals.
- Unclear language in disclosures (e.g., not using terms that are consistent with accounting literature, such as "probable" or "reasonably possible") and failure to consider the disclosure requirements of ASC 450, SAB Topic 5.Y, and SEC Regulation S-K, Item 103.
- Lack of disclosure of an accounting policy related to accounting for legal costs (when material) and uncertainties in loss contingency recoveries, including (1) whether ranges of reasonably possible losses are disclosed gross or net of anticipated recoveries from third parties, (2) risks regarding the collectibility of anticipated recoveries, and (3) the accounting policy for uncertain recoveries.

For more information about SEC comment letter themes related to contingencies, see Section 2.3 of Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.

Appendix A — Titles of Standards and Other Literature

AICPA Literature

Accounting and Valuation Guide

Valuation of Privately-Held-Company Equity Securities Issued as Compensation

Audit and Accounting Guide

Revenue Recognition

Practice Aid

Accounting for and Auditing of Digital Assets

FASB Literature

ASC Topics

ASC 205, *Presentation of Financial Statements*

ASC 210, *Balance Sheet*

ASC 235, *Notes to Financial Statements*

ASC 260, *Earnings per Share*

ASC 270, *Interim Reporting*

ASC 275, *Risks and Uncertainties*

ASC 310, *Receivables*

ASC 320, *Investments — Debt Securities*

ASC 321, *Investments — Equity Securities*

ASC 323, *Investments — Equity Method and Joint Ventures*

ASC 325, *Investments — Other*

ASC 326, *Financial Instruments — Credit Losses*

ASC 330, *Inventory*

ASC 340, *Other Assets and Deferred Costs*

ASC 350, *Intangibles — Goodwill and Other*

ASC 360, *Property, Plant, and Equipment*

ASC 405, *Liabilities*

ASC 450, *Contingencies*

ASC 460, *Guarantees*

ASC 470, *Debt*

ASC 480, *Distinguishing Liabilities From Equity*

ASC 505, *Equity*

ASC 605, *Revenue Recognition*

ASC 606, *Revenue From Contracts With Customers*

ASC 610, *Other Income*

ASC 705, *Cost of Sales and Services*

ASC 710, *Compensation — General*

ASC 712, *Compensation — Nonretirement Postemployment Benefits*

ASC 715, *Compensation — Retirement Benefits*

ASC 718, *Compensation — Stock Compensation*

ASC 720, *Other Expenses*

ASC 730, *Research and Development*

ASC 740, *Income Taxes*

ASC 805, *Business Combinations*

ASC 808, *Collaborative Arrangements*

ASC 810, *Consolidation*

ASC 815, *Derivatives and Hedging*

ASC 820, *Fair Value Measurement*

ASC 825, *Financial Instruments*

ASC 840, *Leases*

ASC 842, *Leases*

ASC 845, *Nonmonetary Transactions*

ASC 848, *Reference Rate Reform*

ASC 860, *Transfers and Servicing*

ASC 940, *Financial Services — Brokers and Dealers*

ASC 944, *Financial Services — Insurance*

ASC 946, *Financial Services — Investment Companies*

ASC 985, *Software*

ASUs

ASU 2014-01, *Investments — Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects* — a consensus of the FASB Emerging Issues Task Force

ASU 2014-09, *Revenue From Contracts With Customers (Topic 606)*

ASU 2016-08, *Revenue From Contracts With Customers (Topic 606): Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net)*

ASU 2016-10, *Revenue From Contracts With Customers (Topic 606): Identifying Performance Obligations and Licensing*

ASU 2016-12, *Revenue From Contracts With Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*

ASU 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*

ASU 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue From Contracts With Customers*

ASU 2018-07, *Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*

ASU 2018-11, *Leases (Topic 842): Targeted Improvements*

ASU 2018-15, *Intangibles — Goodwill and Other — Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract* — a consensus of the FASB Emerging Issues Task Force

ASU 2019-08, *Compensation — Stock Compensation (Topic 718) and Revenue From Contracts With Customers (Topic 606): Codification Improvements — Share-Based Consideration Payable to a Customer*

ASU 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting*

ASU 2020-06, *Debt — Debt With Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging — Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*

ASU 2021-02, *Franchisors — Revenue From Contracts With Customers (Subtopic 952-606): Practical Expedient*

ASU 2021-04, *Earnings per Share (Topic 260), Debt — Modifications and Extinguishments (Subtopic 470-50), Compensation — Stock Compensation (Topic 718), and Derivatives and Hedging — Contracts in Entity's Own Equity (Subtopic 815-40): Issuer's Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Written Call Options* — a consensus of the FASB Emerging Issues Task Force

ASU 2021-08, *Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities From Contracts With Customers*

ASU 2022-06, *Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848*

Concepts Statements

No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*

No. 8, *Conceptual Framework for Financial Reporting — Chapter 4,* Elements of Financial Statements

Proposed ASU

No. 2022-ED300, *Business Combinations — Joint Venture Formations (Subtopic 805-60): Recognition and Initial Measurement*

IRC

Section 382, "Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change"

Section 409A, "Inclusion in Gross Income of Deferred Compensation Under Nonqualified Deferred Compensation Plans"

IFRS Literature

IFRS 15, *Revenue From Contracts With Customers*

IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*

SEC Literature

FRM

Topic 7, "Related Party Matters"

Topic 10, "Emerging Growth Companies"

Interpretive Release

No. 33-10751, *Commission Guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations*

Regulation S-K

Item 10(e), "General; Use of Non-GAAP Financial Measures in Commission Filings"

Item 103, "Business; Legal Proceedings"

Item 303, "Management's Discussion and Analysis of Financial Condition and Results of Operations"

Regulation S-X

Rule 3-13, "Filing of Other Financial Statements in Certain Cases"

Rule 5-03, "Statements of Comprehensive Income"

Rule 11-01, "Presentation Requirements"

SAB Topics

No. 1, "Financial Statements"

- No. 1.B, "Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity"
- No. 1.M, "Materiality"

No. 5.Y, "Miscellaneous Accounting; Accounting and Disclosures Relating to Loss Contingencies"

Securities Exchange Act of 1934

Section 13, "Periodical and Other Reports"

Section 15(d), "Registration and Regulation of Brokers and Dealers; Supplementary and Periodic Information"

Superseded Literature

AICPA Technical Practice Aid

Section 5100.68, "Revenue Recognition: Fair Value of PCS in Perpetual and Multi-Year Time-Based Licenses and Software Revenue Recognition"

EITF Abstract

Issue No. 01-8, *Determining Whether an Arrangement Contains a Lease*

FASB Concepts Statement

No. 6, *Elements of Financial Statements* — a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)

Other Literature

FASB TRG Agenda Papers

TRG Agenda Paper 23, *Incremental Costs of Obtaining a Contract*

TRG Agenda Paper 41, *Measuring Progress When Multiple Goods or Services Are Included in a Single Performance Obligation*

TRG Agenda Paper 44, *July 2015 Meeting — Summary of Issues Discussed and Next Steps*

TRG Agenda Paper 57, *Capitalization and Amortization of Incremental Costs of Obtaining a Contract*

TRG Agenda Paper 59, *Payments to Customers*

TRG Agenda Paper 60, *November 2016 Meeting — Summary of Issues Discussed and Next Steps*

Appendix B — Abbreviations

Abbreviation	Description
AI	artificial intelligence
AICPA	American Institute of Certified Public Accountants
ASC	FASB Accounting Standards Codification
ASR	accelerated share repurchase
ASU	FASB Accounting Standards Update
BC	Basis for Conclusions
BCF	beneficial conversion feature
C&DI	SEC Compliance and Disclosure Interpretation
CAM	critical audit matter
CAQ	Center for Audit Quality
CCF	cash conversion feature
CECL	current expected credit loss
CIMA	Chartered Institute of Management Accountants
CPM	cost per mille
CRM	customer relationship management
DLOM	discount for lack of marketability
DTA	deferred tax asset
DTL	deferred tax liability
EBITDA	earnings before interest, taxes, depreciation, and amortization
EDGAR	SEC's Electronic Data Gathering, Analysis, and Retrieval System
EGC	emerging growth company
EITF	FASB Emerging Issues Task Force
EPS	earnings per share

Abbreviation	Description
ERP	enterprise resource planning
ex-TAC	excluding traffic acquisition costs
Exchange Act	Securities Exchange Act of 1934
FASB	Financial Accounting Standards Board
FAST Act	Fixing America's Surface Transportation Act
FIFO	first in, first out
FinREC	AICPA Financial Reporting Executive Committee
FRM	SEC Financial Reporting Manual
GAAP	generally accepted accounting principles
GAAS	generally accepted auditing standards
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IC	independent contractor
ICFR	internal control over financial reporting
IFRS	International Financial Reporting Standard
IoT	Internet of Things
IP	intellectual property
IPO	initial public offering
IPR&D	in-process research and development
IRC	Internal Revenue Code
IT	information technology

Abbreviation	Description
JOBS Act	Jumpstart Our Business Startups Act
KPI	key performance indicator
LIBOR	London Interbank Offered Rate
LIFO	last in, first out
LLC	limited liability company
M&A	merger and acquisition
MD&A	Management's Discussion and Analysis
NFT	nonfungible token
NOL	net operating loss
OCA	SEC's Office of the Chief Accountant
OEM	original equipment manufacturer
PBE	public business entity
PCAOB	Public Company Accounting Oversight Board
PCS	postcontract customer support
Q&A	question and answer
R&D	research and development
RMN	retail media network
ROU	right-of-use

Abbreviation	Description
S&P 500	Standard & Poor's 500 stock market index
SaaS	software as a service
SAB	SEC Staff Accounting Bulletin
Sarbanes-Oxley	Sarbanes-Oxley Act of 2002
SEC	U.S. Securities and Exchange Commission
Securities Act	Securities Act of 1933
SG&A	selling, general, and administrative
SKU	separate stock-keeping unit
SPAC	special-purpose acquisition company
SRC	smaller reporting company
SSP	stand-alone selling price
TMT	Technology, Media, & Telecommunications
TPA	AICPA Technical Practice Aid
TRG	FASB/IASB transition resource group for revenue recognition
VIE	variable interest entity
XaaS	everything as a service