IFRS news
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IFRS 15 for the software industry – PwC In brief

At a glance

It has long been understood that the software industry would be one of the industries more significantly affected by the adoption of IFRS 15. This is because current guidance under IFRS, in particular for licence revenue, is limited, and many entities have historically looked to develop accounting policies based on industry-specific US GAAP which has now been superseded. [In depth 2014-02 on revenue recognition for software] sets out some of the key changes as a result of the standard.
The implementation of IFRS 15 in the software industry is proving to be a challenge, as expected. Even if there is no significant change to the pattern of revenue recognition, management will need to make a number of new judgements and estimates. One of the most significant changes that affects the industry is the recognition of more revenue 'upfront' in the scenario where software is delivered and control passes to the customer.
This document provides additional insight into some of the key judgements facing the industry during the implementation phase.

Judgements and estimates
Determining whether a licence is distinct

Software licences are commonly sold in a bundle that includes updates, also known as post-contract customer support ('PCS'). It is common that the software is a distinct 'right to use' licence, with revenue recognised at the point in time when it is transferred, while the PCS is delivered over time. However, there might be limited circumstances where the licence and updates are combined into a single performance obligation.

The determination of whether licence and updates are separate performance obligations requires judgement. It is common for updates to improve the effectiveness of software. However, for the updates to be combined with the licence, they should fundamentally change the functionality of the software or be essential to its functionality. A combination of a number of factors should be considered, including:
Nature of software – Software that can function on its own without updates is likely a performance obligation that is separate from the updates. There might be limited cases where the updates are essential to the customer's ability to benefit the licence because of the function of the software or the industry in which it operates.

Significance of updates – Updates that change the functionality of the software might indicate that such updates significantly modify the licence. This might be the case for any significant update to the software, but this factor should be considered, along with the other indicators about the nature or frequency of the updates, to determine if such an update is essential to the functionality of the software.

Frequency and acceptance of updates – Frequent updates might indicate that the updates are essential to the operation of the software; however, management should consider not only the frequency but also whether the customers accept the updates.

Updates that are made available but not used might indicate that the software is functional without updates.

If a licence and updates are combined, the outcome is generally a performance obligation that is delivered over time. Example 55 in IFRS 15 provides an illustration of this approach. There might be other performance obligations included as part the PCS package that require separate identification. However, they are often delivered over time and over a similar period as the combined service of software and updates; and, in practice, any allocation of transaction price would not have a significant effect on the timing and amount of revenue recognised.

Set-up and integration activities

Arrangements involving software often include a promise to provide implementation support, such as data conversion, software design or development, and customisation. Entities need to apply judgement to determine whether such activities are accounted for as a separate performance obligation and when revenue should be recognised (that is, at a point in time when the service is complete, or over time as the service is performed). Example 11 in IFRS 15 provides an illustration of this judgement in the context of software that is a 'right of use' licence.

Software as a service (SAAS) arrangements also often include implementation services. It might be more challenging to conclude that the customer is receiving a separate service in the context of an SAAS arrangement. The service often involves configuring the customer's system to interact with the vendor's software to enable it to provide the service.

This could be an indication that the vendor's activities do not transfer anything to the customer, and so they do not represent a separate performance obligation. However, there might be circumstances in which the implementation activities provide a separate benefit to the customer that can be used with another service (such as software provided by another supplier), in which case they do represent a separate performance obligation.

Estimating stand-alone selling price

In software arrangements, entities will often provide multiple distinct goods and services (for example, licences and updates) together as a single package, and they will need to allocate the transaction price based on the relative stand-alone selling prices of those distinct goods and services. In many cases, the stand-alone selling price will not be directly observable, and so it must be estimated. IFRS 15 does not prescribe a specific method to estimate, but the allocation should faithfully represent the price if the items were sold separately.

The most appropriate approach to estimating stand-alone prices will depend on facts and circumstances including the extent of observable selling-price information. We believe that it is acceptable to use a range of prices when determining the stand-alone selling prices, provided that the range reflects the reasonable pricing of each item as if it were priced on a stand-alone basis for similar customers.

It is common for entities to only sell software and PCS as a package, or to only sell maintenance separately as a renewal. IFRS 15 only permits the use of a residual approach in limited circumstances.

An entity might use the renewal price to determine the amount to be allocated to the software if certain criteria are met and the outcome faithfully represents the price if the software was sold separately. For example, assume that an entity sells licensed software and maintenance to a customer for C1.1m, and it regularly sells PCS for C1m and it licenses software on a stand-alone basis for between C0.5m and C5m. It would not be appropriate to apply the residual approach and allocate C0.1m to the software. This is because the residual approach results in a nominal allocation of selling price to the software licence, which does not faithfully reflect the stand-alone selling price.

Contract term and termination penalties

The contract term is the period during which the parties to the contract have present and enforceable rights and obligations. Determining the contract term could significantly affect the accounting for software transferred at the beginning of the licence. This is because the portion of revenue allocated to the licence for the entire contractual term is recognised when the licence is transferred to the customer. If that contract term is shorter, it will decrease the amount of revenue recognised upfront.
Entities need to consider termination clauses when assessing the contract term. If an entity enters into a contract for a term of several years, but that contract can be terminated early for no compensation, the contract might, in substance, be a shorter-term contract with a right to renew. Management should assess a renewal to determine if it provides a material right similar to other types of customer option. In contrast, a contract that can be terminated early, but requires payment of a substantive termination penalty, is likely to have a contract term equal to the stated term.

We believe that termination penalties could take various forms, including cash payments (which might be paid upfront) or the transfer of an asset to the vendor. Judgement should be applied in determining whether a termination penalty is substantive. A payment need not be labelled a 'termination penalty' for it to create enforceable rights and obligations. A substantive termination penalty might exist if a customer gives up, with no right to a refund, the rights to a licence that it has already paid a significant upfront fee to obtain.

Distinguishing usage-based royalties from additional rights

Many software licence arrangements include a variable fee linked to usage of the software. Entities will need to distinguish between fees representing a usage-based royalty (a form of variable consideration) and an option to acquire additional goods or services. A usage-based royalty is recognised when the usage occurs or the performance obligation is satisfied, whichever is later. Fees received when an option to acquire additional rights is exercised are recognised when the additional rights are transferred; however, at contract inception, management would need to assess whether the option provides a material right. If it does, revenue might be recognised later, because a portion of the transaction price is allocated to the option and deferred until the option is exercised or expires.
Judgement might be required to distinguish between a usage-based royalty and an option to acquire additional goods or services. If a licensor is entitled to additional consideration based on the usage of software to which the customer already has rights, without providing any additional or incremental rights, the fee is generally a usage-based royalty.

In contrast, if a licensor provides, for an incremental fee, additional or incremental rights that the customer did not previously control, the customer is likely exercising an option to acquire additional rights.

Capitalising and amortising commissions

IFRS 15 requires entities to capitalise incremental costs of obtaining a contract (for example, sales commissions) in most situations. The asset is both assessed for impairment and amortised on a systematic basis that is consistent with the transfer of the related services.
Determining the amortisation period can be complex, because it does not necessarily reflect the length of the contract period. In particular, where there are anticipated renewals, the amortisation period should include anticipated renewals, unless the entity also incurs a commensurate cost for renewals.

Assessing whether costs incurred for contract renewals are 'commensurate with' costs incurred for the initial contract could require judgement. The assessment should not be based on the level of effort required to obtain the initial and renewal contracts. Instead, it should generally be based on whether the initial and renewal commissions are reasonably proportional to the respective contract values.

Where renewal commissions are paid but are not commensurate with initial commissions, the initial commission should be amortised over a period longer than the initial contract term. An entity might amortise the initial commission over the average customer life of five years and expense renewal commissions as incurred.

It also might split the initial commission into two components: one reflecting an amount commensurate with the renewal commission; and the remainder treated as an upfront commission that is amortised over the estimated customer life. Other approaches could also be acceptable if they are consistent with the pattern of transfer of the services related to the asset. For example, where there is a term licence, and a large proportion of revenue is recognised upfront, it might be appropriate to recognise a similar proportion of commission upfront.

Determining the contract

Previous revenue guidance did not provide explicit guidance on identifying a contract, but this is an important step in applying IFRS 15. This might cause an entity to change the way that it thinks about contracting. For example, an entity might conclude that there is a contract in place before a signed legal agreement exists, whereas historically this might not have been the case. This could affect the accounting conclusion as well as disclosures about remaining performance obligations.
A contract can be written, oral, or implied by an entity's customary business practices. Generally, any agreement that creates legally enforceable rights and obligations meets the definition of a contract. Sometimes, the parties will enter into amendments or 'side agreements' to a contract that either change the terms (for example, contract term) of, or add to, the rights and obligations of that contract (for example, providing customers with options or discounts), or change the substance of the arrangement. All of these items have implications for revenue recognition; therefore, understanding the entire contract, including any amendments, is critical to the accounting conclusion. See the discussion on 'contract term' above.

Principal versus agent

It is common for software entities to enter into arrangements that involve two or more unrelated parties that contribute to providing a specified good or service to a customer. For example, software entities might sell third party software, hardware or services in addition to their own products and services. Management needs to determine whether the entity is a principal or agent separately for each specified good or service promised to a customer. This will determine whether or not revenue is presented gross (when acting as principal) or presented net (when acting as agent).

Disclosures

In software arrangements, often there can be contract deliverables that are not yet billed (for example, future maintenance periods). IFRS 15 requires these to be disclosed, in addition to an explanation of what comprises accrued and deferred revenue (contract liabilities and contract assets) and over what period the services have been, or will be, performed.

IAS 1 requires entities to disclose certain information about significant judgements and estimates. Management might conclude that the judgements and estimates made in the application of IFRS 15 result in similar accounting to previous GAAP, but the thought process is likely to be different.

This might mean that the judgements and estimates disclosed are different.

It is essential that entities update their accounting policies and disclosures on significant judgements and estimates to reflect the application of IFRS 15.

IFRS 15 also requires a number of new disclosures, relating to significant judgements that are applied, which supplement IAS 1. These include disclosing judgements made in applying the standard which significantly affect the determination of the amount and timing of revenue from contracts with customers, in particular when performance obligations are satisfied and the transaction price and its allocation to performance obligations.

When does this apply?

IFRS 15 applies for entities with financial years beginning on or after 1 January 2018.

In transition - the latest on IFRS 17 implementation - Jan 2019

IASB proposes to further amend IFRS 17

IASB agrees to propose certain further amendments to IFRS 17 to better reflect the economics of insurance contracts

At a glance

On 23 January 2019 the IASB continued its discussions on IFRS 17/ It tentatively agreed to propose amendments to IFRS 17 to:

- Require allocation of insurance acquisition cash flows to anticipated future renewals;
- Require recognition of a gain in profit or loss when an insurer recognises losses on onerous underlying insurance contracts at initial recognition, to the extent that a reinsurance contract held covers the losses of each contract on a proportionate basis;
- Expand the scope for the risk mitigation exemption for insurance contracts with direct participation features to reinsurance contracts held that are used to mitigate financial risk. However, the Board will not expand the scope of the variable fee approach to reinsurance contracts issued or held; and
- Require consideration of the existence of an investment return service in allocating the CSM using coverage units.

The Staff plans to bring papers on the remaining implementation concerns and challenges to the Board during the first quarter of 2019. At a future meeting the Board plans to consider the package of all the proposed amendments to ensure that they comply with the criteria the Board agreed in October 2018 and will consider the need for additional disclosures as a consequence of the proposed amendments.

The Board expects to publish an Exposure Draft of the amendments to IFRS 17 around the end of the first half of 2019, to be in a position to finalise amendments such that 1 January 2022 remains as the proposed effective date of IFRS 17.

The views in this In transition are based on our observations from the 23 January 2019 meeting, and they might differ in some respects from the official minutes of the meeting to be published by the IASB at a later date.

Background

1. In connection with the issuance of IFRS 17, the IASB established a transition resource working group ('TRG') to provide a public forum for stakeholders to follow the discussion of questions raised on implementation of the new standard.

2. Since the issuance of the standard, IASB staff have also been engaged in a variety of activities with stakeholders to follow the implementation of IFRS 17. At the IASB meeting on 24 October, the Board agreed to explore potential amendments to IFRS 17 based on a list of implementation issues and concerns compiled by the staff. The Board noted that the criteria sets a high hurdle for change, and any amendments suggested would need to be narrow in scope and deliberated quickly to avoid significant delays in the effective date.

3. In November 2018, the IASB Board agreed to start the process to amend IFRS 17 to defer the mandatory effective date of IFRS 17 by one year. Subject to IASB due process, entities will be required to apply IFRS 17 for annual periods beginning on or after 1 January 2022.

The Board noted that limiting the deferral to one year would minimise disruption to entities that are furthest advanced in implementation, address users' concerns that adoption of IFRS 17 and IFRS 9 should not be significantly delayed, and provide a clear signal to the industry that it should not stop implementation projects.

4. In December 2018 the IASB continued discussions of the concerns and implementation challenges raised by stakeholders of IFRS 17. The IASB agreed to propose one narrow-scope amendment to require presentation of insurance contracts on the balance sheet at the portfolio level rather than at the grouping level used for contract measurement purposes. The other eleven implementation challenges discussed in this meeting did not result in any proposed amendments.

Overview of items discussed during the January IASB Board meeting

5. Continuing with the discussions of concerns and implementation challenges raised by IFRS 17 stakeholders, at the January 2019 meeting the Board evaluated 5 of the 25 concerns and implementation challenges reported in October 2018, noting that the remaining six issues plus the question postponed in December would be discussed further in the first quarter for 2019 aiming for issuance of an exposure draft containing the proposed changes around the end of first half this year.

6. Below is the summary of the decisions reached by the IASB in this meeting on potential amendment of the standard applying the evaluation criteria agreed in October 2018.

Staff paper	***Concerns and implementation challenges***	***IASB decision***
Insurance acquisition cash flows for renewals outside the contract Boundary (Staff paper 2A)	Insurance acquition cash flows directly attributable to newly issued contracts that economically anticipates future renewals outside the contract boundary	Amend
Reinsurance contracts held - onerous underlying insurance contracts (Staff paper 2B and 2C)	Losses from onerous underlying insurance contracts that are covered by proportionate reinsurance contracts held	Amend
Reinsurance contracts held - underlying insurance contracts with direct participation features (Staff paper 2D)	Reinsurance contracts ineligible for the variable fee approach Limitation of risk mitigation exemption for insurance contracts with direct participation features	Not Amend
Recognition of the contractual service margin in profit or loss in the general model (Staff paper 2E)	Amortisation of the contractual service margin for contracts under the general model that include an investment return service	Amend

16. The Staff noted that subsequent to publication of the staff papers several stakeholders have reached out expressing concerns that the expanded scope only applies to proportionate reinsurance contracts. The Board agreed with the staff's explanation of the limited scope of the proposed amendment, noting that for proportionate contracts there is a direct linkage between the reinsurance and underlying contracts on inception. That is, claims are reimbursed as a specified percentage of the claims incurred. One member noted that the Board is being pragmatic in this proposed amendment as the loss on the underlying contract could be due to cash flows other than claims, Several Board member agreed with the rationale for restricting the amendment to proportionate reinsurance contracts but that the term by 'proportionate' should be included either in the defined terms in the standard or more explanation given in the basis for conclusions.

Risk mitigation exception to the variable fee approach

17. The Board agreed to amend IFRS 17 to expand the scope of the risk mitigation exception for insurance contracts with direct participation features so that it applies not only when derivatives are used, but also when entities use reinsurance contracts to mitigate the financial risks in these contracts. In order to be eligible for this exception, the conditions outlined in the current standard must be met for reinsurance contracts.

18. Under IFRS 17 as currently written, when entities use derivatives to mitigate the financial risks arising from insurance contracts and certain criteria are met, an entity is permitted to recognise changes in financial risk in profit or loss instead of adjusting the CSM as is normally required under the variable fee approach ('VFA') for participating contracts. This exception was included to allow entities to avoid the accounting mismatch that would otherwise result and better reflect the net economics of an entity's decision to hedge the financial risk inherent in the participating contracts, for example minimum return guarantees. The staff papers note that some reinsurance held may act in the same mitigating way as derivatives, and therefore the same accounting election should apply when an entity purchases reinsurance for this financial risk mitigation purpose.

19. In its December 2018 Board meeting the IASB agreed to discuss the retrospective application of the risk mitigation exemption on transition at a future meeting. The IASB did not have that discussion at this meeting, but is expected to discuss it in the upcoming months.

Explanation of the scope of the variable fee approach

20. The VFA applies to contracts that meet the definition of insurance contracts with direct participation features, where the entity promises an investment return based on underlying items less a variable fee. IFRS 17 notes that neither reinsurance contracts held nor reinsurance contracts issued are eligible for the VFA. Some stakeholders raised concerns that accounting mismatches will occur when underlying contracts are accounted for under the VFA and the reinsurance held contract is accounted for under the general measurement model.

The staff paper noted these concerns and recommended to not expand the scope of the VFA to reinsurance contracts issued or held and instead amend the risk mitigation exception.

Recognition of the contractual service margin in profit or loss in the general model

21. The Board agreed to propose an amendment so that in the general model, the CSM is allocated on the basis of coverage units that are determined by considering both insurance coverage and 'investment return service.' An 'investment return service' can only exist where an investment component is present. However, the staff noted that the existence of an investment component will not automatically mean that an investment return service is present. The staff noted that the 'investment return service' is different from asset management services performed in conjunction with a participating contract subject to the VFA because for non-VFA contracts the entity is not managing assets on behalf of the policyholders (i.e. not providing asset management services). Instead it is providing the policyholder with access to an investment return that would not otherwise be available to the policyholder because of the amounts invested, liquidity, complexity or expertise.

22. Under the proposal, an entity would be required to use judgement, consistently applied, in deciding whether an investment return service exists; no objectives or criteria for that determination will be included in the standard.

The investment return service would end when the entity has made all investment related payments to the policyholder under the contract. The assessment of the relative weighting of the benefits provided by the insurance coverage and the investment return services and their pattern of delivery would not be prescribed but instead would be determined on a systematic and rational basis by management. In addition, cash flows relating to fulfilling the investment return service (but excluding gains/losses on any investments) would be included in the measurement of the insurance contract. For the determination of PAA eligibility, an entity should consider both the insurance coverage and any investment return service.

23. The Board is proposing the above changes based on stakeholder feedback at the May 2018 TRG and through various other outreach that some contracts that do not meet the VFA criteria nevertheless provide investment-related services or other services. They agreed that investment services should be reflected in the coverage units that are used to allocate CSM over the period of the services provided.

24. However, some Board members expressed some concern with how the definition for such services would be interpreted, including the words 'providing the policyholder with access to an investment return' and thought that perhaps the staff should consider adding some wording in drafting, even if only in the basis for conclusions, to clarify the meaning. Board members also discussed whether some guidance should be provided on how to evaluate and account for situations where an investment return service might be inconsequential or de minimis, or only manifests itself in remote scenarios.

25. Board members also expressed some concern with how the 'relative weighting of benefits' and 'pattern of delivery' on 'a systematic and rational basis' would be interpreted, noting that there was much room for judgement. However, they also acknowledged that other areas of the standard also require similar judgements and so the staff should exercise care and not be too prescriptive in this amendment.

26. In summary, the Board acknowledged that the introduction of investment return services will have a significant impact on the pattern of profit recognition where such components exist. Significant judgement is required in determining the existence of an investment return service, the weighting of components and the pattern of delivery, with all needing to be applied consistently. Board members suggested that this amendment may require additional disclosures, which the staff will consider at a future date.

Future expected discussions

27. The Board noted that discussions on the remaining implementation challenges and concerns will continue in future Board meetings, with deliberations expected to be completed in the first quarter of 2019. The Staff propose to bring back a summary of all suggested amendments and assess the total package of amendments against the criteria previously agreed to and consider the need for any amendments in the disclosures as a consequence of the proposed amendments.

28. In its papers for the October 2018 Board meeting the IASB staff presented 25 identified implementation challenges. Of the remaining concerns to be discussed at a future meeting, the staff's preliminary views in the papers for the October Board meeting indicate that it might be possible to potentially amend IFRS 17 for the following issues in a way that meets the criteria for amendment:

- Modified retrospective approach
- Loans and other forms of credit that transfer insurance risk

29. The staff's preliminary views in the papers for the October Board meeting are that the following remaining issues may not meet the criteria for amendment:

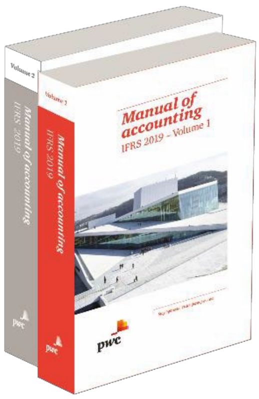
- Level of aggregation
- OCI on FV transition approach
- Date of initial application of comparatives
- Optionality on transition
- Retrospective application of risk mitigation exception on transition (Deferred from December 2018 Board meeting)

Word on the Wharf?

The January 2019 IASB update has been published and the work plan updated.

The topics, in order of discussion, were:

- Amendments to IFRS 17 Insurance Contracts
- Extractive Activities
- Rate Regulated Activities
- Implementation



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