ACL NETHERLANDS B.V. (AS SUCCESSOR TO AUTONOMY CORPORATION LIMITED), HEWLETT-PACKARD VISION BV, AUTONOMY SYSTEMS LIMITED, HEWLETT-PACKARD ENTERPRISE NEW JERSEY INC.

and

MICHAEL RICHARD LYNCH,
SUSHOVAN TAREQUE HUSSAIN

29 November 2018

Expert Report of Peter Holgate

Contents

Glossary of terms and abbreviations

Term or abbreviation	Definition
Autonomy	Autonomy Corporation plc or, as the context requires, an Autonomy group company
Claimants' Reply	The Claimants' draft Re-Amended Reply and First Claimant's Defence to the First Defendant's Amended Defence and Counterclaim
Conceptual Framework	The IASB's 'Conceptual Framework for Financial Reporting', which replaced the 1989 Framework in September 2010
Code	The Corporate Governance Code (June 2010), which replaced the Combined Code on Corporate Governance
Dr Lynch's Defence	Dr Lynch's Amended Defence and Counterclaim dated 4 April 2017
DTR	The Disclosure and Transparency Rules
GAAP	Generally accepted accounting principles
IAS	International Accounting Standards, issued by the IASB (the later ones are called IFRS)[1]
IAS 1	International Accounting Standard 1 'Presentation of financial statements', issued 1997
IAS 2	International Accounting Standard 2, 'Inventories', issued 1993
IAS 8	International Accounting Standard 8, 'Accounting policies, changes in accounting estimates and errors', issued 2003
IAS 18	International Accounting Standard 18, 'Revenue', issued 1993
IAS 34	International Accounting Standard 34, 'Interim financial reporting', issued 1998
IAS 38	International Accounting Standard 38, 'Intangible assets', issued 1998

[1] In practice, the terms "IAS" and "IFRS" are used interchangeably.

IASB	The International Accounting Standards Board
ICAEW	The Institute of Chartered Accountants in England and Wales
IFRIC	The IASB's IFRS Interpretations Committee
IFRS	International Financial Reporting Standards, issued by the IASB (the earlier standards are called IAS)[2]
IFRS 8	International Financial Reporting Standard 8, 'Operating segments', issued 2006
Mr Hussain's Defence	Mr Hussain's Amended Defence dated 4 April 2017
RRAPoC	Draft Re-Re-Amended Particulars of Claim
SIC	The IASB's Standard Interpretations Committee
1989 Framework	The IASB's 1989 'Framework for the Preparation and Presentation of Financial Statements', which was replaced by the Conceptual Framework in September 2010
2006 Act	The UK Companies Act 2006

[2] See footnote 1.

1. Introduction

1.1. My full name is Peter Alan Holgate. I am an independent accounting adviser. From 1995 to 2013, I was senior accounting technical partner in the United Kingdom firm of PricewaterhouseCoopers LLP (PwC) and its predecessor firm. In that role, I led a team of about 40 people who advised on UK GAAP and international accounting standards. This included dealing with many issues relating to revenue recognition. My qualifications and experience are set out more fully in Appendix 1.

1.2. As part of my role at PwC, I edited and was responsible for the firm's 'Manual of accounting – IFRS for the UK'. I quote from this manual, as well as the manuals of other firms, in this report.

1.3. I have been instructed to provide my expert opinion on various accounting matters relating to the period 2009 to 2011 (which I refer to as the "relevant period" or the "relevant time"). I am instructed to act as an expert accounting witness and not a witness of fact. I am instructed to provide such evidence and report based on my experience and expertise in technical accounting matters. My instructions are set out in Appendix 2.

1.4. The documents that have been provided to me and on which I have relied in making my report are set out at Annex 2 to my instructions.

1.5. I have had no previous involvement with Hewlett Packard, Autonomy, Dr Lynch or Mr Hussain. I should note, for completeness, that I have in the past provided, and continue to provide, accounting services to FTI Consulting ("**FTI**") unrelated to this matter, under a consulting agreement. I am aware that FTI's Mark Bezant is providing expert evidence in this case on behalf of the Claimants on valuation issues. I have not previously worked with Mr Bezant.

1.6. I set out the remainder of my report under the following headings:

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2. Summary of conclusions

2.1. In this part of my report, I briefly summarise the conclusions I have reached in Chapters 4 to 9 of my report.

Chapter 4 (Hardware transactions)

2.2. As explained in Chapter 4, on the basis of the assumptions I have been instructed to make, my conclusions in relation to the issues that I have been asked to consider in relation to hardware transactions are as follows:

2.2.1. Autonomy should have disclosed its sales of hardware in its 2009 and 2010 annual financial statements. Autonomy was not permitted to make positive statements in the front-end (i.e. the narrative portion) of its annual reports or in its interim or quarterly reports which would have been untrue or misleading by virtue of its hardware sales.

2.2.2. All of the costs in respect of the pure hardware purchases should have been accounted for as costs of goods sold; no part of those costs should have been accounted for as sales and marketing expenses.

2.2.3. Autonomy should have disclosed in its published accounting policies the fact that it had accounted for some of the costs in respect of the pure hardware purchases as sales and marketing expenses.

2.2.4. It was not appropriate for Autonomy to recognise $6 million of revenue in Q2 2009 in relation to a hardware transaction with Morgan Stanley.

Chapter 5 (VAR transactions)

2.3. For the reasons set out in Chapter 5 and Appendix 3, I conclude, on the basis of the assumptions I have been instructed to make and other factual information provided to me, that Autonomy should not have recognised revenue on any of the 37 VAR transactions.

Chapter 6 (Reciprocal transactions)

2.4. For the reasons set out in Chapter 6, I conclude, on the basis of the assumptions I have been instructed to make and other factual information provided to me, that Autonomy should not have recognised revenue on any of the 6 reciprocal transactions and, where the price payable by Autonomy under the linked transaction exceeded the amount to be received by Autonomy, Autonomy should have recognised the net cost as an expense.

Chapter 7 (Hosting arrangements)

2.5. For the reasons set out in Chapter 7, I conclude, on the basis of the assumptions I have been instructed to make, that for the hosted transactions in Schedule 6 to the RRAPoC Autonomy should not have recognised the licence fees (in respect of Digital Safe software, software sold for use with Digital Safe and e-Discovery software) upfront. Autonomy should have spread the licence fee revenue over the term that the hosting services were provided on a straight line basis.

For the reasons set out in Chapter 7, I conclude on the basis of the assumptions I have been instructed to make, that for the Schedule 6 Q2 2011 Iron Mountain transaction, Autonomy should not have recognised $8 million of revenue as at 30th June 2011.

Chapter 8 ("Other" transactions)

2.6. For the reasons set out in Chapter 8, I consider that, on the basis of the assumptions I have been instructed to make and other factual information provided to me, Autonomy did not account properly for the 4 "other" transactions. My conclusions on the proper accounting treatment for each of those transactions are set out in Chapter 8.

Chapter 9 (Voluntary Particulars)

2.7. As explained in Chapter 9, I agree with the adjustments to Autonomy's accounting treatment set out in columns B and C of the 53 sets of Voluntary Particulars that have been provided to me.

3. Relevant accounting principles

Accounting principles applicable to Autonomy

3.1. In common with other EU listed companies, Autonomy prepared its consolidated accounts at the relevant time in compliance with international accounting standards. These standards are developed by the IASB and comprise: (a) IAS, developed from 1975 to 2001, and (b) IFRS, developed from 2001 to date. Companies must comply with both IASs and IFRSs. In practice, the terms IAS and IFRS are often used interchangeably and generally refer to both series of standards. In addition to the main body of the standard, IASs and IFRSs contain further material, some of which is non-mandatory but which is commonly relied upon for guidance by companies seeking to apply the standards correctly.[3]

3.2. In addition, at the relevant time, the core requirements that applied in the United Kingdom in respect of Autonomy were:

3.2.1. The 2006 Act.

3.2.2. IFRS interpretations issued by the IFRIC and SIC (commonly referred to as IFRICs and SICs).

3.2.3. The UK Listing Authority's Listing Rules, issued at the relevant time by the Financial Services Authority.[4]

3.2.3.1. The Listing Rules include the requirement to 'comply or explain' – that is, to comply or explain any non-compliance – with the UK Corporate Governance Code.[5]

3.2.3.2. The DTR are supplementary to the Listing Rules.

3.3. Other documents and sources of guidance were authoritative to varying degrees but non-mandatory. These included:

3.3.1. The IASB's 1989 Framework and the replacement Conceptual Framework issued in September 2010. These are discussed in paragraphs 3.13 to 3.14 below.

3.3.2. Statements and recommendations from the professional bodies, such as ICAEW Technical Releases and accounting recommendations.

3.3.3. Established practice at the relevant time. Practices that are generally accepted, even though not codified in official literature, can be regarded as part of GAAP.[6]

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[3] For example, IAS 18, 'Revenue', includes additional non-mandatory guidance in the form of 'Illustrative examples' which "accompany, but are not part of, IAS 18".

[4] The Financial Conduct Authority superseded the Financial Services Authority in 2013.

[5] The UK Corporate Governance Code applied to accounting periods beginning on or after 29 June 2010. It was preceded by The Combined Code, which applied to accounting periods beginning on or after 29 June 2008.

[6] The authorities and other sources discussed in paragraphs 3.1to 3.3above are often known collectively as GAAP (generally accepted accounting principles).

Much of this practice is set out in the guidance from leading accounting firms, to which I refer further below.

3.4. In preparing my report, I have considered each of the sources of guidance described above. Excerpts from the above sources that I believe are relevant and applicable in the context of this case are set out below.

3.5. The requirements that I discuss, and from which I quote, are those relating to the relevant period, unless stated otherwise.

The Companies Act 2006

3.6. Part 15 of the 2006 Act sets out the requirements for UK companies relating to 'accounts and reports'. The 2006 Act sets out the framework and some detailed requirements; accounting standards add further detailed requirements.

3.7. Among the most fundamental of the 2006 Act's requirements is that relating to 'a true and fair view'. Section 393 requires that:

"*(1) The directors of a company must not approve accounts for the purposes of this Chapter unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss—*

(a) in the case of the company's individual accounts, of the company;

(b) in the case of the company's group accounts, of the undertakings included in the consolidation as a whole, so far as concerns members of the company."

3.8. Section 393 applies both to companies that prepare what the 2006 Act calls "Companies Act" accounts[7] (meaning, in practice, accounts under UK GAAP) and to companies, such as Autonomy, that prepare what the 2006 Act calls "IAS" accounts.[8]

3.9. The requirement that the accounts give a true and fair view is overriding. In the case of Companies Act accounts, the overriding nature of the true and fair view requirement is spelt out in the 2006 Act itself.[9] In the case of IAS accounts, the equivalent provisions are found in IAS 1 'Presentation of financial statements'. I discuss IAS 1 from paragraph 3.22 below.

3.10. It is important to note that the requirement is that the accounts should give 'a true and fair view', not 'the true and fair view'. This is widely understood to mean that there may be more than one accounting policy or treatment that is able to result in a true and fair view.

[7] 2006 Act, Sections 396 for 'Companies Act individual accounts' and 404 for 'Companies Act group accounts'.
[8] 2006 Act, Sections 397 for 'IAS individual accounts' and 406 for 'IAS group accounts'.
[9] 2006 Act, Section 396(4) and (5); Section 404(4) and (5).

International accounting standards

3.11. Standards of particular relevance to this case include:

3.11.1. IAS 1 (‘Presentation of financial statements’).

3.11.2. IAS 2 (‘Inventories’).

3.11.3. IAS 18 (‘Revenue’).

3.11.4. IAS 34 (‘Interim financial reporting’).

3.11.5. IFRS 8 (‘Operating segments’).

Each is considered below.

3.12. Before discussing the specifics of each standard, it is worth commenting on the 1989 Framework and Conceptual Framework and the role of substance in the application of accounting standards.

The IASB’s conceptual framework

3.13. The IASB’s original ‘Framework for the preparation and presentation of financial statements’ was published in 1989 (the 1989 Framework). The IASB updated the 1989 Framework and published in its place ‘The Conceptual Framework for Financial Reporting’ (the Conceptual Framework) in September 2010. The Conceptual Framework was a partial revision of the 1989 Framework: it contained new material on the Objective of general purpose financial reporting and on Qualitative characteristics of useful financial information. However, it retained the material from the 1989 Framework on the remaining aspects, that is: the Underlying assumption (i.e. going concern), the Elements of financial statements (i.e. financial position, assets, liabilities, equity, performance, income and expenses), and on Recognition (of assets, liabilities, income and expenses). The revised Conceptual Framework was not completed until 2018. The Conceptual Framework in 2010 therefore represented an interim stage in the project.

3.14. The Conceptual Framework does not have the status of an accounting standard (and nor did the 1989 Framework); it provides a frame of reference to guide the IASB in its development of standards. Nevertheless, it is authoritative in at least two senses. First, it helps guide companies and auditors as to the meaning and intention of individual standards if they are unclear. Second, it provides a reference point for the accounting treatment of transactions for which there are no specific rules.

The role of substance

3.15. An important concept in accounting is ‘substance’. This is sometimes described as ‘economic substance’ or ‘substance over form’.

3.16. The 1989 Framework described substance over form as follows:

"*If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are <u>accounted for and presented in accordance with their substance and economic reality and not merely their legal form</u>. The <u>substance of transactions</u> or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an entity may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the entity continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there was a transaction).*"[10]

3.17. Similarly, part of the Frameworks' discussion of financial position reads as follows:

"*In assessing whether an item meets the definition of an asset, liability or equity, <u>attention needs to be given to its underlying substance and economic reality and not merely its legal form</u>. Thus, for example, in the case of finance leases, the substance and economic reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its useful life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge. Hence, the finance lease gives rise to items that satisfy the definition of an asset and a liability and are recognised as such in the lessee's balance sheet.*"[11]

3.18. In its nature, substance, or substance over form, is an underlying concept and hence is found in the Frameworks. However, there are also requirements relating to substance in specific accounting standards. The case of lease accounting (see previous paragraph) is a leading example. In addition, IAS 1 refers to substance; in the context of requirements to disclose the judgements that management has made in the process of applying the entity's accounting policies, IAS 1 gives the example that:

"*... management makes judgements in determining ...(c) whether, in substance, particular sales of goods are financing arrangements and therefore do not give rise to revenue ...*"[12]

3.19. Moreover, IAS 8, in the context of selection and application of accounting policies, states that:

"*In the absence of an IFRS that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting*

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[10] 1989 Framework, para 35, emphasis added. This wording was not retained in the Conceptual Framework, but this does not signify a dilution of the concept of substance over form. Indeed paragraph 3.26 in the Conceptual Framework's Basis for Conclusions reads: "*Substance over form is not considered a separate component of faithful representation because it would be redundant. Faithful representation means that financial information represents the substance of an economic phenomenon rather than merely its legal form. Representing a legal form that differs from the economic substance of the underlying economic phenomenon could not result in a faithful representation.*"

[11] 1989 Framework, para 51 (also para 4.6 of Conceptual Framework), emphasis added.

[12] IAS 1, para 123(c).

policy that results in information that is …(b) reliable, in that the financial statements … (ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form …"[13]

3.20. IAS 18, which relates to the recognition of revenue, refers to substance a number of times. The following two extracts are the most relevant:

"The recognition criteria in this Standard are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period during which the service is performed. Conversely, the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole. For example, an entity may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction; in such a case, the two transactions are dealt with together."[14]

"*Sale and repurchase agreements (other than swap transactions) under which the seller concurrently agrees to repurchase the same goods at a later date, or when the seller has a call option to repurchase, or the buyer has a put option to require the repurchase, by the seller, of the goods.*
For a sale and repurchase agreement on an asset other than a financial asset, the terms of the agreement need to be analysed to ascertain whether, in substance, the seller has transferred the risks and rewards of ownership to the buyer and hence revenue is recognised. When the seller has retained the risks and rewards of ownership, even though legal title has been transferred, the transaction is a financing arrangement and does not give rise to revenue."[15]

3.21. It is evident, therefore, that reflecting the substance of transactions is, and was, an important aspect of financial reporting. In this section, I have brought together some references to substance in selected IASs. I discuss other aspects of certain IASs next.

IAS 1 ('Presentation of financial statements')

3.22. IAS 1 (and IFRS generally) uses the term 'fair presentation', which is understood by UK accountants to have the same meaning as 'true and fair view'. IAS 1 discusses fair presentation as follows:

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[13] IAS 8, para 10, emphasis added.
[14] IAS 18, para 13, emphasis added
[15] IAS 18, illustrative example 5, emphasis added.

"*Financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the [Conceptual] Framework.*[16] *The application of IFRSs, with additional disclosures where necessary, is presumed to result in financial statements that achieve a fair presentation.*"[17]

"*In virtually all circumstances, an entity achieves a fair presentation by compliance with applicable IFRSs. A fair presentation also requires an entity: …*

(c) to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance."[18]

3.23. These provisions are relevant to my discussion in Chapter 4 of the disclosure of sales of hardware.

3.24. IAS 1 also describes the purpose of financial statements:

"*The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is <u>useful to a wide range of users</u> in making economic decisions.*"[19]

3.25. This confirms that financial statements are drawn up for a wide range of users, not just for the industry cognoscenti.

IAS 2 ('Inventories')

3.26. Much of IAS 2 deals with the methods of determining cost of inventories (also called 'stock') for balance sheet purposes. These provisions are not at issue in the present case. However, IAS 2 also deals with how inventories are treated on their sale. On the sale of an item of inventory, it is no longer presented as an asset on the balance sheet. Instead, its balance sheet carrying value is written off as an expense in the profit and loss account. IAS 2 expresses this as follows:

"*When inventories are sold, the carrying amount of those inventories shall be recognised as an expense in the period in which the related revenue is recognised.*"[20]

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[16] IAS 1, para 15 contains a footnote as follows: "*Paragraphs 15-24 contain references to the objective of financial statements set out in the [1989] Framework. In September 2010 the IASB replaced the [1989] Framework with the Conceptual Framework …, which replaced the objective of financial statements with the objective of general-purpose financial reporting: see Chapter one of the Conceptual Framework.*"
[17] IAS 1, para 15.
[18] IAS 1, para 17(c).
[19] IAS 1, para 9, emphasis added.
[20] IAS 2, para 34.

3.27. IAS 2 adds, under the heading 'Disclosure':

"*The financial statements shall disclose: …*
(d) the amount of inventories recognised as an expense during the period;"[21]

to which it adds:

"*The amount of inventories recognised as an expense during the period, which is often referred to as cost of sales, consists of those costs previously included in the measurement of inventory that has now been sold …*"[22]

3.28. These provisions are relevant to the discussion in Chapter 4 of accounting for the costs associated with sales of hardware.

IAS 18 ('Revenue recognition')

3.29. IAS 18 is the international standard dealing with the recognition of revenue. It was issued in 1993 and was in force at the relevant time.[23]

The objective of IAS 18

3.30. The objective of IAS 18 is to "*prescribe the accounting treatment of revenue arising from certain types of transactions and events*". It notes that revenue is "*income that arises in the course of ordinary activities of an entity*" and that "*[t]he primary issue in accounting for revenue is determining when to recognise revenue*".[24]

The scope of IAS 18 and its applicability

3.31. IAS 18 applies to accounting for revenue arising from:

"*(a) the sale of goods;*

(b) the rendering of services; and

(c) the use by others of entity assets yielding interest, royalties and dividends".[25]

3.32. Goods and services are described by IAS 18 in the conventional manner:

3.32.1. "*Goods includes goods produced by the entity for the purpose of sale and goods purchased for resale, such as merchandise purchased by a retailer or land and other property held for resale*".[26]

[21] IAS 2, para 36.
[22] IAS 2, para 38, emphasis added.
[23] IAS 18 has been replaced by a more detailed standard (IFRS 15, issued 2014, effective 2018).
[24] IAS 18, unnumbered introductory paragraph.
[25] IAS 18, para 1.
[26] IAS 18, para 3.

3.32.2. "*The rendering of services typically involves the performance by the entity of a contractually agreed task over an agreed period of time. The services may be rendered within a single period or over more than one period. ...*".[27]

The fundamentals in relation to the measurement of revenue

3.33. 'Recognition' of revenue refers to whether and, if so, when a particular item is reported as revenue in the profit and loss account (or income statement) by being included in the figure for revenue for the year or other period (e.g. quarter) in question. Much of IAS 18 is concerned with whether and, if so, when revenue should be recognised. In that context, an important issue is whether, for a particular sale (or contract, or transaction) the revenue should be recognised at a particular point in time (as is typically the case for the sale of goods), or gradually over a period of time (as is typically the case when services are delivered over a period of time).

3.34. The key points of IAS 18 are as follows:

3.34.1. Revenue is defined as "*the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants*".[28] This has the effect of distinguishing revenue from receipts such as new share capital. Revenue includes only the gross inflows receivable by the entity on its own account. Therefore, amounts collected on behalf of others, for example sales taxes, are excluded.[29]

3.34.2. Revenue is measured "*at the fair value of the consideration received or receivable*".[30] In many cases, this is the amount of cash received or receivable.

3.34.3. The effect of these definitions is usually straightforward. The amount of revenue is often the price agreed between the parties as being payable. If the price is payable at the time of the sale, or within a short period, that is the amount of the revenue. If there is a significant delay in payment, such that there is in effect a financing element to the transaction, then the interest effect is taken into account such that the amount attributable to revenue is reduced. Normally, a delay of a year or more would be regarded as signifying a financing element. If there is a delay of less than a year, the interest effect is often immaterial and it can be ignored on those grounds.

3.34.4. There are, however, circumstances in which determining fair value is problematic. Assume, for example, that an asset is sold together with various services and there is a desire to recognise the revenue in respect of the sale of the asset up front. In order to recognise the revenue from the sale of the asset separately from the other components, it is necessary to be able to determine the

[27] IAS 18, para 4.
[28] IAS 18, para 7.
[29] IAS 18, para 8.
[30] IAS 18, para 9.

fair value of the asset – and this is not necessarily the same as the amount attributed to it on the invoice or in the contract. If, for example, the asset was sold to various customers at different prices, it may not be possible to determine its fair value. If so, then it would not be permissible to recognise revenue in respect of it at the time of the sale.[31]

Identification of the transaction

3.35. For revenue to be correctly measured, a key aspect is to identify the appropriate transaction. In a simple situation, for example, where each transaction is clearly separate from any other transactions and fair value can be determined for each transaction, the revenue recognition criteria are applied to each transaction separately. However, in other circumstances, identification of the transaction to be accounted for might involve either splitting or aggregating transactions:

3.35.1. "*In certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction <u>in order to reflect the substance of the transaction</u>. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period during which the service is performed*".[32]

3.35.2. "*Conversely, the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole. …*".[33]

3.36. In the first of these two extracts from IAS 18, the phrase 'separately identifiable components' is used. This is not a defined accounting term; the words have their normal English meaning. I interpret the phrase to mean that one should seek to identify components that should not be grouped together, by identifying differences of, for example, the nature of the products or services, or terms of sale, or method and timing of delivery – that is, factors that might make a difference to the way in which the components should be accounted for. In doing so, it is commonly understood to be helpful to consider what the customer believes it is purchasing – including whether one thing or many things – and whether the components are (or have been in the past) sold separately. If a component cannot be sold separately because it does not operate independently of the other components it would not be a separately identifiable component. For instance, if a mobile phone operator sells a package including a handset, line rental and pre-paid calls, and those components are also each sold separately, at standard retail prices, one would need to consider the components separately for accounting purposes. Revenue for the handset could be recognised immediately on delivery, but revenue for the line rental and pre-paid calls would be deferred initially, and recognised over the rental period and as the calls are used. If, however, the handset

[31] IAS 18, para 9
[32] IAS 18, para 13, emphasis added.
[33] IAS 18, para 13.

can only be used on the operator's network (and not on any other network), with the associated line rental, no revenue would be recognised in respect of the handset on its own.[34]

3.37. As regards exchanges of goods or services, sometimes called barter transactions, IAS 18 provides that "*When goods or services are exchanged or swapped for goods or services which are of a similar nature and value, the exchange is not regarded as a transaction which generates revenue. .... When goods are sold or services are rendered in exchange for dissimilar goods or services, the exchange is regarded as a transaction which generates revenue*".[35]

Revenue recognition in relation to the sale of goods

3.38. The key issue in IAS 18 is whether and, if so, when the revenue should be recognised. The criteria, in relation to the sale of goods, are that revenue is recognised only when all the conditions specified in paragraph 14 of the standard have been satisfied, namely:

"*(a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;*

(b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;

(c) the amount of revenue can be measured reliably;

(d) it is probable that the economic benefits associated with the transaction will flow to the entity; and

(e) the costs incurred or to be incurred in respect of the transaction can be measured reliably".[36]

3.39. Each limb of paragraph 14 merits separate consideration.

3.39.1. *Limb (a) – risks and rewards.* IAS 18 states that "*In most cases, the transfer of the risks and rewards of ownership coincides with the transfer of the legal title or the passing of possession to the buyer*".[37] The point in time when the seller has transferred to the buyer the significant risks and rewards of ownership of the goods will often coincide with when all significant performance obligations have been met. This was reflected in the guidance that KPMG issued at the time.[38] Consistent with this, IAS 18 gives an example of where the seller retains significant risks of ownership because not all significant performance

[34] Ernst & Young, International GAAP 2011, p1470

[35] IAS 18, para 12. A particular application of this principle is set out in the IASB's Interpretation, SIC 31 'Revenue – barter transactions involving advertising'. The Interpretation applies IAS 18 and provides that exchanges of advertising give rise to revenue only where the services exchanges are dissimilar and where the amount of revenue can be measured reliably. SIC 31 explains that revenue can be recognised only by reference to non-barter transactions and only then in rare circumstances.

[36] IAS 18, para 14.

[37] IAS 18, para 15.

[38] KPMG, 'Insights into IFRS 2010/11', para 4.2.130.10.

obligations have been met: "*an entity may retain the significant risks and rewards of ownership ... when the goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the entity*."[39]

3.39.2. A further illustration given by IAS 18 is that the seller may retain the risks and rewards of ownership "*when the receipt of the revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of goods.*"[40] KPMG commented on this paragraph of IAS 18 under the heading 'Sell-through arrangement' as follows:

"*In some cases the receipt of revenue by an entity is contingent upon the customer making a sale of the goods. Examples include situations in which inventory has been transferred to another entity (a consignee) who holds it on consignment at its premises, or when sales are made to distributors or other parties acting as agents. Revenue is recognised only when the inventory has been sold by the consignee to third party customers*".[41]

3.39.3. Another way to understand the phrase 'risks and rewards of ownership' is that an entity has the risks and rewards of ownership of some goods if: (a) the entity gains if the goods increase in value or can be used in a profitable manner, for example if they can be sold to a third party at a margin; or (b) the entity suffers if the goods lose value or cannot be used profitably, for example if they cannot be sold to an intended customer.

3.39.4. In relation to risks and rewards of ownership, guidance issued by PwC at the time (for which I was responsible, as I explain at paragraph 1.2 above) stated:

"*Other potential indicators that the risks and rewards of ownership have not passed are:*

- *The seller retains the risk of physical damage to the product.*
- *The buyer lacks economic substance apart from that provided by the seller.*
- *There is significant doubt as to the buyer's intention or ability to take delivery of the goods.*
- *The seller shares in the future revenue of the goods' onward sale (when this is not contingent consideration).*
- *The seller has a repurchase option at a fixed price.*"[42]

[39] IAS 18, para 16(c).
[40] IAS 18, para 16(b).
[41] KPMG, 'Insights into IFRS 2010/11', para 4.2.160.10.
[42] PwC 'Manual of accounting: IFRS for the UK 2011', para 9.63.

3.39.5. Note that limb (a) refers to both the risks and rewards of ownership. Therefore, if a seller has transferred the rewards of ownership to the customer but retained a significant risk in relation to the goods sold, that sale would not qualify for revenue recognition under IAS 18.

3.39.6. *Limb (b) – managerial involvement/ control.* This wording seeks to establish that the purchaser has taken the managerial role and taken effective control of the goods. If the seller still has managerial involvement or control, revenue should not be recognised. As PwC pointed out in their guidance, the concept of control is relatively straightforward: the Conceptual Framework defines an asset in terms of control; so if the seller still controls an item, then that item is the seller's asset and it has not (yet) been sold to the buyer.[43] "Continuing managerial involvement" is a little more judgemental; nevertheless, it makes sense that if A has "sold" goods to B yet A retains managerial involvement, it begs the question as to why B would buy on such terms and whether a genuine sale has occurred. PwC set out the following indicators of continuing managerial involvement or retention of effective control:

- "*The seller can control the future price of the item.*
- *The seller is responsible for the management of the goods subsequent to the sale.*
- *The economics of the transaction compel the buyer to return the goods to the seller.*
- *The seller guarantees the return of the buyer's investment or a return on that investment for a significant period.*
- *The seller has control over the resale of the item to third parties (for example, the seller can control the selling price, timing or counterparty of any resale transaction or, alternatively, resale is entirely prohibited).*"[44]

3.39.7. *Limb (c) – reliable measurement of revenue.* For revenue to be recognised, the amount of the sales transaction needs to be reliably measurable. Clearly, revenue can be recognised only when the amount of the revenue is known. IAS 18 gives some guidance on the point, albeit in the context of recognition of revenue from services; but the guidance applies equally well to the sale of goods. It states:

"*An entity is generally able to make reliable estimates after it has agreed to the following with the other parties to the transaction:*

(a) each party's enforceable rights regarding the service to be provided and received by the parties;

[43] PwC 'Manual of accounting: IFRS for the UK 2011', para 9.81.
[44] PwC 'Manual of accounting: IFRS for the UK 2011', para 9.83.

(b) *the consideration to be exchanged; and*

(c) *the manner and terms of settlement.*"[45]

3.39.8. *Limb (d) – probable benefits.* The words '*economic benefits associated with the transaction … flow[ing] to the entity'* refer in most contexts to whether the seller will be paid. As KPMG noted in their guidance at the time:

"*The probability of future economic benefits relates to the collectability of the revenue. In some cases revenue recognition may not be appropriate until the consideration is received or the cause of uncertainty is removed.*"[46]

3.39.9. The question then arises as to the meaning of 'probable'. As asserted in Dr Lynch's Defence,[47] and acknowledged in the Claimants' Reply,[48] 'probable' in IFRS usage is taken to mean 'more likely than not'. Numerically, this translates into a probability of more than 50%. This, read literally, means that it is appropriate to recognise revenue (assuming the other criteria are met) if the likelihood of being paid by the customer, based on a considered, informed judgement, is 51% or more. This assessment is carried out, necessarily, for each individual transaction. In my experience, I have found that entities tend to require a significantly higher probability than 51% before they will consider it appropriate to recognise revenue.

3.39.10. The assessment of collectability is a matter of judgement. In deciding whether '*it is probable that the economic benefits associated with the transaction will flow to the entity'*, it is necessary to consider all the available evidence. Depending on the circumstances, this could include: the general economic conditions in the customer's industry or country (for example, exchange controls); the assets and economic condition of the customer specifically; the recent pattern of payment (or otherwise) by that customer or similar customers; or any unusual features in the sales contract, or disputes between the seller and the customer.

3.39.11. *Limb (e) – reliable measurement of costs.* For it to be appropriate to recognise revenue, it is not sufficient for the revenue itself to be reliably measurable; the costs also must be reliably measurable. If this were not the case, it would not be possible to report the correct gross profit margin in the income statement. In some cases – such as the sale of standard software, where the significant costs, being the costs of developing the software, have been incurred in the past – no issue arises. However, if a product is sold and yet further work is necessary (for example, on significant customisation or installation), it may be that the costs to be incurred cannot be measured with sufficient reliability. This criterion (e)

[45] IAS 18, para 23.
[46] KPMG 'Insights into IFRS 2010/11', para 4.2.80.10.
[47] Dr Lynch's Defence, para 99.4.5.
[48] Claimants' Reply, para 91.0.

would therefore preclude recognition of revenue. (Other criteria might also not be met in this example.)

Revenue recognition in relation to the provision of services

3.40. IAS 18 also sets out an equivalent rule in relation to the rendering of services. As noted in paragraph 3.33 above, the general approach for revenue from services is gradual recognition over a period. This is expressed as follows:

"*When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised* *by reference to the stage of completion* *of the transaction at the end of the reporting period. The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:*

(a) the amount of revenue can be measured reliably;
(b) it is probable that the economic benefits associated with the transaction will flow to the entity;
(c) the stage of completion of the transaction at the end of the reporting period can be measured reliably; and
(d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably".[49]

"*The recognition of revenue by reference to the stage of completion of a transaction is often referred to as the* *percentage of completion method**. Under this method, revenue is recognised in the accounting periods in which the services are rendered.*"[50]

3.41. Again, each limb merits separate consideration:

3.41.1. *Limb (a) – reliable measurement of revenue.* This is the same criterion as discussed in paragraph 3.39.7 above. I would add that, in the case of a service contract that is in progress: (a) if a single service is being provided, it is necessary to be able to measure reliably the revenue for the whole contract, including future periods; whereas (b) if the revenues for each period (for example, week, month or year) are based on the volumes or other data in that period, then it is not necessary to know reliably the revenues of future periods except to confirm that they are likely to exceed future costs. If future costs were thought likely to exceed future revenues, it would be necessary to provide for those likely future losses.

3.41.2. Limb *(b) – probable benefits.* This also is the same criterion as discussed in paragraphs 3.39.8 to 3.39.10 above. My comments in those paragraphs apply also to the rendering of services.

[49] IAS 18, para 20, emphasis added.
[50] IAS 18, para 21, emphasis added.

3.41.3. *Limb (c) – stage of completion.* This criterion applies only to the rendering of services. The stage of completion may be determined in a number of ways, for example, surveys of the work performed, services performed as a percentage of the total, or costs incurred as a proportion of total costs.[51] Under this criterion, an entity needs to be able to measure the stage of completion reliably in order to know how much revenue should be recognised in the current period.

3.41.4. *Limb (d) – reliable measurement of costs.* Because a service contract may span over a number of accounting periods, including future periods, it is necessary to monitor the revenue and the costs and thus the profit margins, so as to determine the amounts that can appropriately be recognised in each period. For this purpose, it has to be possible to measure reliably the costs incurred and the costs to be incurred. If this is not possible, then revenue cannot be recognised until the uncertainty is resolved.[52]

3.42. IAS 18 adds that, in the context of recognising revenue from service contracts:

"*For practical purposes, when services are performed by an indeterminate number of acts over a specified period of time, revenue is recognised on a straight-line basis over the specified period unless there is evidence that some other method better represents the stage of completion. When a specific act is much more significant than any other acts, the recognition of revenue is postponed until the significant act is executed.*"[53]

Disclosure

3.43. IAS 18 requires disclosure of the following:

"*(a) the accounting policies adopted for the recognition of revenue, including the methods adopted to determine the stage of completion of transactions involving the rendering of services;*

(b) the amount of each significant category of revenue recognised during the period, including revenue arising from:

(i) the sale of goods;

(ii) the rendering of services;

(iii) interest;

(iv) royalties;

[51] IAS 18, para 24.

[52] To be more precise, the only revenue that is recognised in those circumstances is an amount equal to the costs that are recoverable from the customer. Hence no profit margin is recognised and indeed a loss would be reported if the amount that can be recovered from the customer is less than the costs incurred.

[53] IAS 18, para 25.

(v) dividends; and

(c) the amount of revenue arising from exchanges of goods or services included in each significant category of revenue".[54]

Periodic reporting and IAS 34

3.44. During the relevant period, Autonomy reported publicly four times a year. In this section, I explain the rules that applied to each of those reporting events. The distinction in terms of regulation is between:

3.44.1. Annual accounts (in Autonomy's case to 31 December annually);

3.44.2. Interim accounts (in Autonomy's case to 30 June annually); and

3.44.3. Quarterly accounts (in Autonomy's case to 31 March and 30 September annually).

3.45. The full requirements explained in paragraphs 3.1 to 3.11 above apply to annual reporting. Note in particular that it is the annual financial statements (and not the interim or quarterly financial statements) to which the true and fair requirement of company law and the full requirements of IFRS apply. The annual report of a listed company contains a number of sections, the most important of which are as follows.

3.45.1. Chairman's statement. This is an introductory narrative overview provided by the chairman. It is not required but is commonly provided.

3.45.2. Business review. This is a more detailed review of the business, often divided into a business review and a financial review. It is required by the 2006 Act.[55]

3.45.3. Remuneration report. A detailed report on directors' remuneration is also required by 2006 Act.[56] This is the responsibility of the company's remuneration committee.

3.45.4. Corporate governance report. A report on corporate governance is required by DTR 7.2. This includes the requirement that "*The corporate governance statement must contain a description of the main features of the issuer's internal control and risk management systems in relation to the financial reporting process*."[57]

3.45.5. Directors' report. This again is required by the 2006 Act[58], which contains various specific statutory disclosure requirements.[59] Sometimes (and as was the

[54] IAS 18, para 35.
[55] 2006 Act, Section 417.
[56] 2006 Act, Section 412.
[57] DTR 7.2.5.
[58] 2006 Act, Section 415.
[59] 2006 Act, Section 416.

case with Autonomy) the content of the business review is incorporated into the directors' report by reference.

3.45.6. Statement of directors' responsibilities. The DTR require a responsibility statement to be made, by the persons responsible within the issuer, setting out that, to the best of their knowledge: "*(a) the financial statements, prepared in accordance with the applicable set of accounting standards, give a true and fair view of the assets, liabilities, financial position and profit or loss of the issuer …; and (b) the management report includes a fair review of the development and performance of the business and the position of the issuer …together with a description of the principal risks and uncertainties that they face*."[60]

3.45.7. Auditors' report. The auditors' report is expressed as giving an opinion on the financial statements, not the whole annual report. However, the auditors review the remainder of the annual report for consistency with the financial statements and report if they identify material inconsistencies or material misstatements of fact.

3.45.8. Financial statements. The financial statements comprise the balance sheet, income statement (or profit and loss account) and cash flow statement (the 'primary statements'), together with the notes to the accounts. The notes to the accounts include the accounting policies and detailed footnotes that (a) give further details of the items in the three primary statements and (b) provide information on some items that are not in those primary statements, such as contingent liabilities. The requirement for a balance sheet, income statement and notes is set out in the 2006 Act.[61] Accounting standards apply to the financial statements and add further detailed requirements.

3.46. Autonomy published interim accounts to 30 June each year during the relevant period. The DTR required companies to publish a half-yearly report containing a condensed set of financial statements drawn up under IAS 34; an interim management report; and a responsibility statement.[62] IAS 34 'Interim financial reporting' set out a reduced level of disclosure for such interim reports in comparison with what IAS requires for annual accounts. Autonomy's interim accounts to 30 June during the relevant period indicated that they were drawn up in accordance with IAS 34.

3.47. Autonomy also published quarterly financial information as at 31 March and 30 September during the relevant period. Quarterly reporting as such was not required at the relevant time. However, the DTR required companies to publish an Interim Management Statement, the timing of which was as follows:

"*An issuer must make public a statement by its management during the first six-month period of the financial year and another statement by its management during the second*

[60] DTR 4.1.12.
[61] 2006 Act, Sections 394 and 399.
[62] DTR 4.2.

six-month period of the financial year. [This statement] must be made in a period between ten weeks after the beginning, and six weeks before the end of the relevant six-month period".[63]

3.48. Despite the flexibility of timing allowed by DTR 4.3.2 and 4.3.3, Autonomy reported as at 31 March and 30 September in the relevant years.

3.49. The required content of the Interim Management Statement, as stipulated by the DTR, was the following:

"*(1) an explanation of material events and transactions that have taken place during the relevant period and their impact on the financial position of the issuer and its controlled undertakings; and*

(2) a general description of the financial position and performance of the issuer and its controlled undertakings during the relevant period".[64]

3.50. As regards quarterly reports, I would note that the information contained in those reports is generally less detailed than the information in interim reports. Autonomy (correctly) did not assert that its quarterly financial statements complied with IAS 34.

3.51. It is important to note that, while the level of disclosure in these three types of report varies, the accounting principles do not, or should not. Therefore, for example:

3.51.1. The interim accounts to 30 June 2011 noted that:

"*The annual financial statements of Autonomy Corporation plc are prepared in accordance with IFRSs … The condensed set of financial statements included in this half yearly report has been prepared in accordance with IAS 34 'Interim financial reporting' …*

The same accounting policies, presentation and methods of computation are followed in the condensed set of consolidated financial statements as applied in the Autonomy group's 2010 Annual Report".[65]

3.51.2. The quarterly accounts to 31 March 2011 noted that:

"*Whilst the financial information included in this quarterly announcement has been computed in accordance with International Financial Reporting Standards (IFRSs), this announcement does not itself contain all the disclosures required by IFRS.*

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[63] DTR 4.3.2 and 4.3.3.

[64] DTR 4.3.5.

[65] Autonomy interim results, six months ended 30 June 2011, page 13.

The same accounting policies, presentation and methods of computation are followed in the condensed set of financial statements as applied in the group's 2010 Annual Report".[66]

3.52. The key point is that, although there was a lower level of disclosure in interim and quarterly reports than in annual accounts, the accounting 'policies, presentation and methods of computation' – such as the accounting policy for the measurement and recognition of revenue – were stated by Autonomy to be the same as in the annual, audited accounts.

IFRS 8 ('Operating segments')

3.53. IFRS 8's core principle is as follows: "*An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.*"[67]

3.54. IFRS 8 requires companies to provide disclosures that analyse or disaggregate the revenue, results and assets of entities by line of business and geographical area. The disclosure that is required depends in part on the flow of information to what the standard calls the 'chief operating decision maker' ("**CODM**"). Autonomy stated that its CODM was Dr Lynch. If it is correct that the nature of the information that flowed to Dr Lynch was such that it did not analyse or disaggregate Autonomy's revenue, results and assets by line of business and geographical area, then I would agree with the conclusion reached by Autonomy (and Deloitte) at the 2009 and 2010 year-ends that there was only one reportable segment and therefore no requirement for Autonomy to disaggregate its financial information by operating segment.

3.55. However, IFRS 8 also requires some 'entity-wide disclosures'.[68] These apply to an entity even if it has only one reportable segment.[69] The entity-wide disclosures include the requirement that:

"*An entity shall report the revenues from external customers for each product and service, or each group of similar products and services, unless the necessary information is not available and the cost to develop it would be excessive, in which case that fact shall be disclosed.*"[70]

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[66] Autonomy trading update, quarter ended 31 March 2011, page 11.
[67] IFRS 8, para 1.
[68] IFRS 8, paras 31-34.
[69] IFRS 8, para 31.
[70] IFRS 8, para 32.

4. Hardware transactions

4.1. In this Chapter I consider the various accounting issues that arise in relation to Autonomy's hardware transactions.

Issues to be considered in relation to hardware sales

4.2. I have been asked, for the purposes of this report, to consider four issues:

4.2.1. Reporting of hardware sales: was Autonomy required under the relevant accounting rules/ principles (or any other rules) to disclose the nature and extent of its hardware sales, including 'pure hardware sales'[71], in its published information (i.e. its quarterly/ interim/ annual reports)?

4.2.2. Costs allocation: was it permissible under the relevant accounting standards for Autonomy to account for some of the costs in respect of the pure hardware purchases as sales and marketing expenses or should it have accounted for all such costs as costs of goods sold ("**COGS**")?

4.2.3. Disclosure of accounting policy: was Autonomy required under the relevant accounting standards and other principles to disclose in its published information the fact that it had accounted for some of the costs in respect of the pure hardware purchases as sales and marketing expenses?

4.2.4. Morgan Stanley transaction: was it appropriate for Autonomy to recognise $6 million of revenue in Q2 2009 in relation to a hardware transaction with Morgan Stanley?

4.3. Each is considered in turn below.

Reporting of hardware sales

Annual reporting

4.4. I first consider annual reporting. For the reasons I explain below, I believe that Autonomy should have disclosed all sales of hardware in its 2009 and 2010 financial statements. It does not matter to this analysis whether the sales are of 'pure hardware' or hardware that is part of an appliance or 'other hardware'[72]. Neither does it matter to this analysis whether the sales of hardware were for commercially sound reasons (as alleged by the Defendants) or were (as alleged by the Claimants) undertaken primarily to increase reported revenue.

4.5. I first consider the issue in terms of the specific disclosure requirements that applied to Autonomy at the time.

4.5.1. IAS 18 ('Revenue') required disclosure of "*the amount of each significant category of revenue recognised during the period, including revenue arising*

[71] As defined in RRAPoC, para 30.1.2.
[72] As defined in RRAPoC, para 30.1.2.

from: (i) the sale of goods; (ii) the rendering of services ...".[73] I find it surprising that, under the heading sales of 'goods', Autonomy included not only sales of hardware and sales of software, but also items which seem to me in the nature of services rather than goods, such as hosting and maintenance. In any event, sales of hardware are, in my view, significantly different in their nature and economic effect from other sales of 'goods' such as software. Sales of hardware are, therefore, in my view 'significant' enough to require separate disclosure.

4.5.2. IAS 1 ('Presentation of financial statements') provides, under the heading of 'Materiality and aggregation':

"*An entity shall present separately each material class of similar items. An entity shall present separately items of a dissimilar nature or function unless they are immaterial*".[74]

Sales of hardware are dissimilar from sales of software and of services and so should, in my view, have been separately disclosed, if they constituted a material class of revenue.

4.5.3. IFRS 8 ('Operating segments'). IFRS 8 requires companies to give certain disclosures even where they have only one operating segment.[75] Paragraph 32 requires that:

"*An entity shall report the revenues from external customers for each product and service, or each group of similar products and services, unless the necessary information is not available and the cost to develop it would be excessive, in which case that fact shall be disclosed. The amounts of revenues reported shall be based on the financial information used to present the entity's financial statements*".

Given that hardware was dissimilar to Autonomy's other products and services, this provision of IFRS 8 clearly requires, in my view, separate disclosure of revenues from sales of hardware if the information was available (which I am asked to assume it was) and the sales were material (which I discuss below).

4.5.4. Business Review. Section 417 of the 2006 Act required companies such as Autonomy to publish a Business Review containing "*a fair review of the company's business*" and a "*description of the principal risks and uncertainties facing the company*". The fair review required was a "*balanced and comprehensive analysis of (a) the development and performance of the company's business during the financial year, and (b) the position of the company's business at the end of that year, consistent with the size and complexity of the business*." For a quoted company, such as Autonomy, the business review was required "*to the extent necessary for an understanding of*

[73] IAS 18, para 35.
[74] IAS 1, para 29.
[75] IFRS 8, para 31.

the development, performance or position of the company's business", to include "*(a) the main trends and factors likely to affect the future development, performance and position of the company's business*" and where appropriate, "*references to, and additional explanations of, amounts included in the company's annual accounts*".

4.5.5. The Corporate Governance Code. The Code does not set out detailed accounting requirements but does contain a high level requirement that "*The board should present a balanced and understandable assessment of the company's position and prospects*".[76]

4.5.6. Disclosure and Transparency Rules. The DTR do not set out detailed accounting requirements but do require listed companies to publish, as part of their annual report, a management report, which "*must contain (1) a fair review of the issuer's business; [and this review] must (1) be a balanced and comprehensive analysis of (a) the development and performance of the issuer's business during the financial year; and (b) the position of the issuer's business at the end of that year, consistent with the size and complexity of the business …*".[77]

4.6. In my view, each of the standards described above (that is, IAS 18, IAS 1 and IFRS 8) required Autonomy to disclose its hardware sales separately in its annual financial statements if they were material (as to which, see below). This is because (a) hardware and software have such radically different profit margins; and (b) starting to make significant sales of hardware gave Autonomy the ability to increase its revenue in a way that, without separate disclosure of hardware sales, gave the impression that the growth was in its core software business. Disclosure of the sales of hardware was particularly important in the context that Autonomy continued to describe itself as a 'pure software' company, even if that description was used to distinguish Autonomy from software companies that derived significant revenues from the provision of services. The disclosure of the hardware sales would appropriately have been given in the financial statements – for example, on the face of the income statement – or in the notes to the accounts.

4.7. The remaining sources reviewed (that is the 2006 Act, the Code and the DTR) would also strongly suggest that disclosure of the hardware sales should have been given, but in my view those requirements are not sufficiently specific as to require such disclosure.

4.8. I now turn to the question of whether the sales of hardware were material and, if so, in what periods they were material. Materiality is defined in IFRS as follows:

4.8.1. In IAS 1:

"*Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of*

[76] Section C1, page 18. The same wording is found in the earlier Combined Code.
[77] DTR, sections 4.1.8 and 4.1.9.

the financial statements. Materiality depends on the size and nature of the omission or misstatement, judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor."[78]

4.8.2. In the 1989 Framework:

"*The relevance of information is affected by its nature and materiality. In some cases, the nature of information alone is sufficient to determine its relevance. For example, the reporting of a new segment may affect the assessment of the risks and opportunities facing the entity irrespective of the materiality of the results achieved by the new segment in the reporting period. In other cases, both the nature and materiality are important, for example, the amounts of inventories held in each of the main categories that are appropriate to the business.*

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful."[79]

4.8.3. In the Conceptual Framework:

"*Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report. Consequently the Board [i.e. the IASB] cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.*"[80]

4.9. As IAS 1 points out in elaboration of its definition of materiality:

"*Assessing whether an omission or misstatement could influence economic decisions of users, and so be material, requires consideration of the characteristics of those users. The [1989 Framework] states in paragraph 25 that 'users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making economic decisions.*"[81]

[78] IAS 1, para 7.
[79] 1989 Framework, paras 29 and 30.
[80] Conceptual Framework, para QC11.
[81] IAS 1, para 7.

4.10. The same idea about users is expressed in the Conceptual Framework in the following way:

"*Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena*".[82]

4.11. This wording supports my views, as expressed at paragraph 3.25 above, that it should not be assumed that a reader of a set of accounts is an expert in the industry or sector in question. The accounts should be understandable to "*users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently*".

4.12. The following table reproduces in simplified form the table at Schedule 1 to the RRAPoC (which I have been asked to assume is accurate) and shows why I believe that sales of hardware were sufficiently material in certain periods to have required disclosure:

Table A – Sales of hardware compared with total reported sales

Quarter	Pure hardware revenue ($m)	Total hardware revenue ($m)	Total reported revenue ($m)	Pure hardware revenue as percentage of total reported revenue	Total hardware revenue as percentage of total reported revenue
Q1 2009	0.0	0.0	129.8	0.0%	0.0%
Q2 2009	6.2	6.2	195.2	3.2%	3.2%
Q3 2009	37.6	38.0	191.6	19.6%	19.9%
Q4 2009	9.1	9.4	223.1	4.1%	4.2%
2009	**53.0**	**53.7**	**739.7**	**7.2%**	**7.3%**
Q1 2010	11.8	12.2	194.2	6.1%	6.3%
Q2 2010	31.1	31.1	221.1	14.0%	14.0%
Q3 2010	26.7	26.8	210.6	12.7%	12.7%
Q4 2010	35.4	35.5	244.5	14.5%	14.5%
2010	**105.0**	**105.6**	**870.4**	**12.1%**	**12.1%**
Q1 2011	20.1	20.1	219.8	9.1%	9.1%

[82] Conceptual Framework, para QC 32 (numbered para 2.36 in more recent editions).

Q2 2011	20.8	20.9	256.3	8.1%	8.2%
H1 2011	**40.9**	**41.0**	**476.0**	**8.6%**	**8.6%**
TOTAL	**198.9**	**200.3**	**2,086.1**	**9.5%**	**9.6%**
Percentage Q3 2009 - Q2 2011				**10.9%**	**11.0%**

4.13. Because I am instructed that Autonomy only started making pure hardware sales in about Q2 2009, such that there were no pure hardware sales in 2008 (or in Q1 2009), I will use pure hardware revenue (rather than total hardware revenue) in Table B below for the purpose of illustrating the growth in revenue between 2008 and 2009 and between 2009 and 2010. I calculate that such growth was as follows:

Table B – Effect of pure hardware sales on revenue growth percentages

	2009 growth over 2008		*2010 growth over 2009*	
	Calculation	Percentage	Calculation	Percentage
Growth as reported	\$739.7m/ \$503.2m	47.0%	\$870.4m/ \$739.7m	17.7%
Growth excluding pure hardware sales	\$686.7m[83]/ \$503.2m	36.5%	\$765.4m[84]/ \$686.7m	11.5%

Growth in revenue is a major performance indicator for listed companies and one that Autonomy frequently cited.[85] In reporting the 2009 figures, the difference between 36.5% growth and 47.0% growth is highly significant in understanding the performance of Autonomy. Likewise, in reporting the 2010 figures, the difference between 17.7% growth (rounded up to 18% in the annual report) and 11.5% is highly significant. To present 47% growth and 18% growth without properly explaining the sources of such growth is misleading reporting.

4.14. The following Table illustrates why information about sales of hardware would have been particularly important to users of the accounts:

[83] \$686.7 million is total 2009 reported revenue of \$739.7 million less pure hardware revenue of \$53.0m.
[84] \$765.4 million is total 2010 reported revenue of \$870.4 million less pure hardware revenue of \$105.0m.
[85] See, for example, the 2009 annual report, pages 10, 11 and 14.

Table C – Effect of hardware sales on gross profit margin

	Software	Hardware	Total
Sales	891	109	1,000
Gross margin	802	(11)	791
Gross profit margin (%)	90%	(10%)	79%

4.15. The figures in Table C are illustrative but as realistic as possible. The sales of pure hardware were 10.9% of total reported sales as shown in Table A for the period from Q3 2009 to Q2 2011. The gross profit percentages applicable to software and hardware are estimates but I am instructed that they are realistic for illustrative purposes. Even if the figures in Table C are not all published, a user who is armed with the figure for hardware sales, and who was aware that margins on software were much higher than on hardware, would at least start to understand the underlying economic situation.

4.16. Table C shows that the gross margins on sales of software and hardware are so different that, even when sales of hardware are only 10.9% of the total, they have a major effect on the overall gross profit percentage. Put another way, in seeking to interpret an overall gross profit of 79%, it is important to know that the majority of sales are at a 90% margin and that a minority of sales are at a gross loss. The analysis assumes that the costs of the hardware are recorded in COGS, an issue I consider further below.

4.17. These three tables, taken together, demonstrate that information about sales of hardware was 'material' in the sense described in IAS 1 and the Conceptual Framework (as well as the 1989 Framework). In my view, the sales of hardware became material from Q3 2009 and should have been disclosed in the 2009 and 2010 annual financial statements (see paragraphs 4.23 to 4.26 below as to what is disclosable in interim and quarterly reports). This view is based on: the absolute amounts of hardware sales, the amounts of hardware sales relative to total revenues, the significant effect that hardware sales have on growth percentages, the vastly different gross profit percentages on hardware and software and the fact that Autonomy continued to describe itself as a pure software company (as to which, see paragraph 4.6 above). These factors, taken together, mean that information about sales of hardware "*could influence decisions that users make on the basis of financial information*".[86] In this particular case, in my view, information about Autonomy's sales of hardware not only 'could' have influenced the decisions of users, but <u>would</u> have done so.

4.18. I have stated in paragraph 4.6 that disclosure of hardware sales was required by the specific requirements of IAS 18, IAS 1 and IFRS 8 if the sales were material; and in paragraph 4.17 that the amounts in question were material.

4.19. In addition to the specific requirements of standards, companies also need to consider the requirement that financial statements must give a true and fair view. I discussed the true and fair requirement in Chapter 3 and noted that the equivalent IAS term is 'fairly

[86] Conceptual Framework, para QC11. See para 4.8.3 above.

presents'. I quoted in Chapter 3 above from IAS 1. The important requirement in the present context is that of paragraph IAS 1, paragraph 17(c), that is, the need to provide additional disclosure in certain circumstances. I set out this requirement again below for convenience:

"*In virtually all circumstances, an entity achieves a fair presentation by compliance with applicable IFRSs. A fair presentation also requires an entity: …*

(c) to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance."[87]

4.20. It should be noted that this requirement applies only if compliance with the specific requirements of IFRS does not result in sufficient information to achieve a fair presentation. In my view, compliance with the specific requirements of each of paragraph 35 of IAS 18, paragraph 29 of IAS 1 and paragraph 32 of IFRS 8 would have resulted in disclosure by Autonomy of its hardware sales and this would, in turn, have resulted in a fair presentation (assuming all other matters were appropriately accounted for and disclosed). But even if those three standards did not in fact require disclosure of hardware sales, I believe that disclosure of hardware sales would need to have been made under this general (fair presentation) requirement of paragraph 17(c) of IAS 1.

4.21. I conclude, therefore, that the hardware sales should have been disclosed in Autonomy's financial statements in the annual reports for 2009 and 2010. I do not consider this to be a marginal or nuanced view. In my opinion, the case for disclosure by Autonomy of its sales of hardware is compelling.

4.22. I would add that the front-end (i.e. the narrative portion) of the annual report must not make statements that are inconsistent with the information in the annual financial statements. Accordingly, it goes without saying that, had Autonomy given disclosure of its hardware sales in its annual financial statements (as I consider it was obliged to do), Autonomy would not have been permitted to say anything in the front-end of its 2009 and 2010 annual reports that was inconsistent with that disclosure. Likewise, the requirement of DTR 4.1.8 that directors present a "*fair review of the issuer's business*" clearly precluded Autonomy's directors from making statements in the front-end that were untrue or misleading. I understand that it will be for the Court to determine whether statements made in the front-end of Autonomy's 2009 and 2010 annual reports were untrue or misleading in light of its hardware sales.

Interim and quarterly reporting

4.23. I now consider whether disclosure of the hardware sales in Autonomy's interim and quarterly reports should have been given.

[87] IAS 1, para 17(c).

4.24. Disclosure is particularly important when there are changes in commercial arrangements or other economic events. In this context, there was an important change in mid-2009. As Table A shows, sales of pure hardware until the end of Q2 2009 had been nil or immaterial. From Q3 2009, sales of hardware became material. I have already indicated my view that disclosure of hardware sales should have been given in the 2009 and 2010 annual financial statements.

4.25. The question then arises as to whether disclosure of hardware sales should have been given in the interim and quarterly reports during 2009, 2010 and in the first half of 2011. As discussed in Chapter 3, different requirements apply to year-end reporting, as compared to interim and quarterly reporting. The true and fair requirement of company law and the full requirements of IFRS apply only to annual financial statements. Accounts drawn up at the interim date (30 June) and the two quarter ends (31 March and 30 September) are subject to less detailed requirements.

4.25.1. Interim reporting under IAS 34[88] involves presentation of condensed primary statements[89] and selected explanatory notes. The requirements for explanatory notes include the following:

"*Additional line items or notes shall be included if their omission would make the condensed interim financial statements misleading.*"[90]

"*An entity shall include in its interim financial report an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period. Information disclosed in relation to those events and transactions shall update the relevant information presented in the most recent annual financial report.*"[91]

"*The nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that are unusual because of their nature, size, or incidence.*"[92]

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[88] The versions of IAS 34 effective in 2009, 2010 and 2011 varied slightly from year to year.

[89] The term 'Primary statements' refers to the balance sheet, income statement (and/ or statement of comprehensive income) and statement of cash flows. Some might also include the Statement of changes in equity as a Primary statement.

[90] IAS 34, para 10. The cited text was the same in each of the versions of IAS 34 effective in 2009, 2010 and 2011.

[91] IAS 34, para 15 in the version effective in 2011. The version of IAS 34 effective in 2011 also included, at para 15A, the following wording: "*A user of an entity's interim financial report will also have access to the most recent annual financial report of that entity. Therefore, it is unnecessary for the notes to an interim financial report to provide relatively insignificant updates to the information that was already reported in the notes in the most recent annual report.*" Para 15 of the version of IAS 34 effective in 2009 and 2010 stated as follows: "*A user of an entity's interim financial report will also have access to the most recent annual financial report of that entity. It is unnecessary, therefore, for the notes to an interim financial report to provide relatively insignificant updates to the information that was already reported in the notes in the most recent annual report. At an interim date, an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period is more useful.*"

[92] IAS 34, para 16A(c). The cited text was the same in each of the versions of IAS 34 effective in 2009, 2010 and 2011, but the relevant paragraph reference for 2009 and 2010 was 16(c).

It will be noted that these requirements are not very specific. Certainly, for Autonomy to have disclosed its hardware sales in an interim report under IAS 34 would have been good practice; but in my view it could sustain the argument that IAS 34 does not require such disclosure. However, this is a matter of degree and a matter of judgement. For example, if the hardware sales were, say, twice their actual level in the 6 months ended 30 June 2010 or 2011, one might take the opposite view.

4.25.2. The requirements for quarterly reporting, described in Chapter 3 of my report, are briefer than those for interim accounts in accordance with IAS 34. Therefore, the case for disclosure of hardware sales in quarterly reports is not as strong as in interim reports. However, as with interim reports, it would certainly have been good practice for Autonomy to disclose its hardware sales, in particular in the report for Q3 2009.

4.26. I have concluded that there was no freestanding obligation to disclose hardware sales in the interim or quarterly reports. But insofar as Autonomy chose to make positive statements in its interim or quarterly reports, it goes without saying that it would be impermissible for any such statements to be untrue or misleading. I understand that it will be for the Court to determine whether Autonomy's interim or quarterly reports contained any statements that were untrue or misleading in light of the hardware sales.

4.27. Considering the annual, interim and quarterly reporting process as a whole, and despite my comments above about interim and quarterly reporting, it is highly likely that, if Autonomy had disclosed hardware sales in its 2009 annual accounts, that would have generated interest and questions from shareholders and analysts; this may well have led to Autonomy management deciding to disclose hardware sales voluntarily in interim and quarterly reporting from Q1 2010 onwards.

Costs allocation

4.28. As stated above, I am asked whether it was permissible under the relevant accounting standards for Autonomy to account for some of the costs in respect of the pure hardware purchases as sales and marketing expenses or whether it should have accounted for all such costs as COGS.

4.29. I note that there are different views among the parties to this case as to whether the purchase of hardware and its sale at low or negative margins was for genuine commercial reasons or was undertaken to increase the reported revenue number. This point has no bearing on my view about the appropriate accounting treatment of the costs of hardware. My view, as explained below, is that all the cost of the hardware should have been accounted for as COGS. No part of it should have been accounted for as sales and marketing expenses. The only exception to this would be if the hardware suppliers were genuinely providing sales and marketing services; even then, it would only be valid to allocate part of the cost to sales and marketing expenses if the fair value of the costs attributable to those services could be measured reliably.

4.30. IAS 2 'Inventories' is relevant to this issue. The standard is primarily concerned with the valuation of inventory for balance sheet purposes. In this context, it states that:

"*The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.*"[93]

4.31. IAS 2 also requires disclosure of "*The amount of inventories recognised as an expense during the period*"[94] and in that context notes that "*The amount of inventories recognised as an expense during the period, which is often referred to as <u>cost of sales</u>, consists of those costs previously included in the measurement of inventory that has now been sold and unallocated production overheads and abnormal amounts of production costs of inventories. The circumstances of the entity may also warrant the inclusion of other amounts, such as distribution costs.*"[95]

4.32. The term 'cost of sales', as used in the previous paragraph, is often, as in this case, termed 'cost of goods sold' (COGS). The meaning of the two terms is the same. Autonomy's published accounts use the term 'cost of revenues', which in my experience is a less common term, but it is clear that the meaning is the same as 'cost of sales' and COGS.

4.33. Autonomy defined 'cost of revenues' in the accounting policies section of its annual reports. In the 2009 annual report (page 42), it used the following words:

"*Cost of revenues: Cost of license revenues includes the cost of royalties due to third party licenses, costs of product media, product duplication and manuals.*"

4.34. In its 2010 annual report (page 51), Autonomy amended the words slightly:

"*Cost of revenues: Cost of license revenues includes the cost of royalties due to third party licenses, costs of product media, product duplication, hardware and manuals.*"

4.35. Two points arise from these two disclosures. First, Autonomy disclosed that there was some hardware cost in 2010, but there was no equivalent disclosure in 2009. Yet there must have been some hardware cost in 2009, because there were significant sales of hardware in 2009 (see Table A above). Second, a reader would be entitled to assume from the 2010 wording, in the absence of other references to the treatment of hardware costs, that all of the cost of hardware was accounted for in 'Cost of revenues', whereas this was not in fact the case.

4.36. It is not clear to me why this accounting policy deals only with the cost of licence revenues, as opposed to the cost of all revenues. I would expect an accounting policy on cost of revenues to deal with the cost of all revenues.

[93] IAS 2, para 10.
[94] IAS 2, para 36(d).
[95] IAs 2, para 38, emphasis added.

4.37. Autonomy also explained briefly its accounting policy for sales and marketing costs: "*sales and marketing costs comprise the costs of the sales force, commissions and costs of promoting new products and entering into new markets*".[96]

4.38. The reasons, I believe, why many companies do not state an accounting policy for COGS (or for sales and marketing expenses) is that it is not a complex or controversial matter. In my view, it is clear to accountants from IAS 2 and obvious to accountants and other business people from a common sense perspective that:

4.38.1. The costs of items that are sold are accounted for in COGS;

4.38.2. Expenses incurred on sales and marketing activities are accounted for in sales and marketing expenses.

4.39. This seems clear and it is not one of those matters in accounting where there are choices or different judgements or disputed theories. It is quite straightforward.

4.40. Straightforward though this is, I will add a few words of elaboration. COGS includes, literally, the cost of goods sold. It does not matter whether the cost is high or low in relation to the sales price of the items sold. Some companies or industries or products have higher gross profit margins than others. (The gross profit is revenue less COGS; and the gross profit margin is gross profit divided by revenue, often expressed as a percentage.) Gross profit margin may vary within a company from one product to another. For example, in a supermarket, the gross profit margin may be different as between food, household goods and clothing. A gross profit margin might be low or negative because the product is unattractive to customers and the entity needs to offer discounts to move the stock. Or it might be that a business is offering a low price to entice a new customer (a 'loss leader'). Or it might be that a supermarket wants to entice a customer through its door with a 'two for the price of one' offer. In some of these examples, there will be a gross loss (i.e. COGS will be higher than revenue). In all events, the cost of making or purchasing that which is sold is a cost of goods sold.

4.41. Sales and marketing expenses is the heading under which entities record the expenses that they have incurred for sales and marketing activities. Examples include: salesmen's salaries, commissions and expenses; advertising; point of sale or display materials; and expenses of developing and using branding. The fact that, for good business reasons, an entity might offer a low price to a customer in order to develop the business relationship does not mean that it is legitimate to convert part of the cost into a sales and marketing expense. Indeed, there is no impact on either COGS or sales and marketing expenses: simply there is lower revenue because the entity has decided to reduce the price to the customer.

4.42. To summarise, making sales at low margins, or even at losses, has no impact on the simple principle that the cost of the goods sold is shown as COGS and the costs of sales

[96] Autonomy annual report 2009, page 43; annual report 2010, page 52, in each case under the heading 'Profit from operations'.

and marketing activities are shown as sales and marketing expenses. The effect of a reduction in sales price is exactly that: revenues are reduced.

Disclosure of accounting policy

4.43. As stated above, I am asked whether Autonomy was required under the relevant accounting standards and other principles to disclose in its published information the fact that it had accounted for some of the costs in respect of the pure hardware purchases as sales and marketing expenses.

4.44. As explained in the previous section, in my view it is clearly contrary to IFRS and wrong in a wider sense to account for part of COGS as sales and marketing expense. This question is therefore unusual in that it asks whether disclosure should be given of an incorrect accounting policy. However, the general requirement to disclose accounting policies does not distinguish between valid and invalid policies.

4.45. The disclosure given by Autonomy in note 2(h) to the 2009 and 2010 consolidated financial statements was:

"sales and marketing costs comprise the costs of the sales force, commissions and costs of promoting new products and entering into new markets"

4.46. I note that this policy for sales and marketing costs does not refer to hardware or hardware reselling; and that the policy for cost of revenue (2010 only, see paragraph 4.34 above) does refer to hardware. This clearly gives the incorrect impression that all hardware cost was included in cost of revenue and none was included in sales and marketing expenses.

4.47. IFRS contains various requirements relating to disclosure of accounting policies that are relevant. IAS 1 requires that:

"*An entity shall disclose in the summary of significant accounting policies: (a) the measurement basis (or bases) used in preparing the financial statements; and (b) the other accounting policies used that are <u>relevant to an understanding of the financial statements</u>.*"[97]

IAS 1's related explanation states that:

"*In deciding whether a particular accounting policy should be disclosed, management considers <u>whether disclosure would assist users in understanding</u> how transactions, other events and conditions are reflected in reported financial performance and financial position.*"[98]

4.48. A related requirement concerns disclosures in respect of judgements made:

"*An entity shall disclose, in the summary of significant accounting policies or other notes, the <u>judgements</u>, apart from those involving estimations ... <u>that management has</u>*

[97] IAS 1, para 117, emphasis added.
[98] IAS 1, para 119, emphasis added.

made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements."[99]

4.49. These requirements clearly point to a need for Autonomy to have disclosed that part of COGS (i.e. the costs of the hardware) had been accounted for as sales and marketing expenses. It would have been 'relevant to an understanding of the financial statements' for a user to have known that gross profit had been increased by moving part of COGS to a heading (sales and marketing expenses) that was presented below gross profit. Likewise, 'disclosure would have assisted users in understanding' the accounting treatment and the underlying business undertaken and margins achieved. In addition, disclosure of the accounting policy would assist users in understanding the 'judgement' that 'management [had] made' (though I regard it, as I believe would other accountants and users, as a misjudgement). Indeed, adding wording dealing with the inclusion of part of COGS in sales and marketing expenses would have been much more important than the disclosure that Autonomy actually gave. This is because the sales and marketing policy wording in the notes to the 2009 and 2010 annual financial statements ("*the costs of the sales force, commissions and costs of promoting new products and entering into new markets"*) was both compliant and reasonably obvious (and therefore arguably unnecessary); whereas the inclusion of part of the hardware costs in sales and marketing expense was both non-compliant and unexpected, and therefore disclosure was necessary.

4.50. As with IFRS generally, accounting policies need to be disclosed only when they are material. In my view the treatment of part of the hardware costs as sales and marketing cost is inherently material qualitatively by virtue of its being non-compliant. It is also material quantitatively as shown by the amounts set out in Schedule 2 to the RRAPoC ($35.8 million in 2009 (21% of total sales and marketing expense); $31.2 million (15.2% of total sales and marketing expense, and 93% of the reported increase in sales and marketing expense) in 2010).

4.51. To summarise: generally there would not necessarily be a need to disclose the accounting policy relating to what is included in sales and marketing expenses. However, in this particular case, as the accounting treatment adopted was non-compliant with IFRS, and given the materiality of the amounts concerned, there was a need for disclosure so as to alert users to the invalidity of the understanding that they would otherwise have derived from the numbers presented.

Morgan Stanley transaction

4.52. As stated above, I am asked to consider whether it was appropriate for Autonomy to recognise $6 million of revenue in Q2 2009 in relation to a hardware transaction with Morgan Stanley. For these purposes, I have been asked to assume:

[99] IAS 1, para 122, emphasis added.

4.52.1. In Q2 2009 Autonomy recognised $6 million of revenue in relation to a sale by Autonomy Inc of hardware to Morgan Stanley pursuant to an agreement dated 30 June 2009.

4.52.2. The (Hitachi) hardware that was sold to Morgan Stanley pursuant to the 30 June 2009 agreement was, contrary to a representation given to Deloitte by Autonomy management, despatched to Morgan Stanley during August and September 2009, and thus in Q3 2009 rather than Q2 2009.

4.53. In a sale of goods transaction such as this one, the application of IAS 18's criteria for revenue recognition are quite straightforward. Unless there were any complications or unusual features – and I am not aware of any – the date of delivery of the goods to Morgan Stanley (MS) is a strong indicator of the date on which revenue should have been recognised. More formally, the transaction can be tested against the standard's criteria as follows:

Extract from IAS 18	*My commentary*
14. Revenue from the sale of goods shall be recognised when all the following conditions have been satisfied:	Note that <u>all</u> of the following five criteria must be met.
(a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;	In the absence of evidence to the contrary, risks and rewards of ownership of the hardware would be transferred to MS at the time of delivery, which I understand to be August/ September 2009. Hence, limb 14(a) <u>is not met</u>.
(b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;	Again, in the absence of evidence to the contrary, it appears that Autonomy would not have transferred continuing managerial involvement with the goods in question until the time of delivery, which I understand to be August/ September 2009. Hence, limb 14(b) <u>is not met</u>.

(c)	the amount of revenue can be measured reliably;	It appears that the selling price of $6 million was known as at 30 June 2009. Hence, limb 14(c) is met.
(d)	it is probable that the economic benefits associated with the transaction will flow to the entity; and	As there had been no delivery or transfer of control at 30 June 2009, it can be inferred that there was no reason, as at 30 June 2009, why MS would have been willing to pay for the goods. Hence, limb 14(d) is not met.
(e)	the costs incurred or to be incurred in respect of the transaction can be measured reliably.	This point is not covered in the facts that I am asked to assume. However, it seems likely from the context that Autonomy would have known, at 30 June 2009, the cost of the goods in question and that, therefore, limb 14(e) is met.

4.54. It seems clear to me that only two of IAS 18's five criteria for revenue recognition were met as at 30 June 2009. Hence it was contrary to IFRS to recognise revenue on this transaction in Q2 2009

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5. VAR transactions

Introduction

5.1. I am asked to consider the appropriate accounting treatment, in particular the appropriate revenue recognition principles, for the VAR transactions contained in Schedule 3 to the RRAPoC. I am first asked to consider the VAR transactions in general; and then (in Appendix 3), I consider each of the 37 individual transactions.

5.2. In relation to VAR transactions generally, I have been asked to assume the following facts and circumstances, a number of which commonly apply to the 37 transactions:

5.2.1. Assumption 1: There had been no communication between Autonomy and the VAR relating to a transaction involving the identified end-user until immediately prior to the end of the relevant quarter (para 74.3.1 RRAPoC).

5.2.2. Assumption 2: There was no price negotiation between the VAR and Autonomy (para 74.3.1 RRAPoC).

5.2.3. Assumption 3: The VAR had made no prior efforts to sell such a licence to, and had had no prior relationship or contact with, the identified end-user (paras 74.3.2 and 74.3A RRAPoC).

5.2.4. Assumption 4: The VAR did not undertake or propose to provide any added value, or any service, to the end-user (para 74.3.3 RRAPoC).

5.2.5. Assumption 5: Assumption 5: For VAR transactions involving the sale of a licence to use Digital Safe software (and software to be used with Digital Safe), the Digital Safe software could only be implemented and thereafter operated by Autonomy (and not by the VAR) (paras 74.3.3A and 110.1 RRAPoC and para 81.3 Hussain Amended Reply).

5.2.6. Assumption 6: The VAR did not have the means to pay the Autonomy group company in the absence of an onward sale of the relevant licence to the identified end-user (para 74.3.4 RRAPoC).

5.2.7. Assumption 7: For sales to Capax Discovery as VAR: Capax Discovery was a newly incorporated company in March 2009 and therefore had no financial history at that time. Capax Discovery wrote to Autonomy in March 2009, providing financial information for Capax Global "*on the express understanding that Capax Global is a separate and distinct entity from Capax Discovery. All contractual obligations will be between Capax Discovery and Autonomy only*" (para 144B.3.1 RRAPoC).

5.2.8. Assumption 8: The VAR did not, after the agreement between Autonomy and the VAR had been entered into, make any effort to sell a licence for the relevant software to the end-user. Instead, the Autonomy group company continued its own efforts to achieve a sale of the licence directly with the end-user (and without consultation with the VAR) (para 74.4.1 RRAPoC).

5.2.9. Assumption 9: The purchase orders or sales agreements for the transactions between Autonomy and the VAR specified that the software was for onward licensing to the particular end-user (para 74.2 RRAPoC).

5.2.10. Assumption 10: There was an agreement or understanding (whether or not legally enforceable) between the Autonomy group company and the VAR, which was not apparent on the face of the written contractual documentation between the Autonomy group company and the VAR, to the effect that the VAR would not be required to satisfy any liability to Autonomy from its own resources (para 74A RRAPoC).

5.2.11. Assumption 11: The VAR was relieved of its ostensible liability to pay the price for the Autonomy software licence it had purchased by one or more of the following means: (a) the purported sales agreement between Autonomy and the VAR being cancelled, (b) a credit note being issued to the VAR discharging its ostensible liability to pay the price, or (c) the VAR's debt being written off (para 74.4.3.1 RRAPoC).

5.2.12. Assumption 12: Where the Autonomy group company subsequently achieved a direct sale to the end-user, the Autonomy group company arranged for the end-user to pay the VAR so that the VAR could then pay the relevant Autonomy group company (para 74.4.3.2 RRAPoC).

5.2.13. Assumption 13: An Autonomy group company was caused to make a payment to the VAR to purchase rights, goods or services that the Autonomy group company did not need (and which had no discernible value to it), but which had the purpose and effect of putting the VAR in funds which it then used to pay for the Autonomy software licence (para 74.4.3.3 RRAPoC).

Collectively, "**the general assumptions**".

5.3. The question implicit in the general assumptions is whether (and, if so, when) revenue should have been recognised by Autonomy, as supplier to the VAR, in the circumstances described.

Consideration of the general assumptions

5.4. In this section, I consider each of the general assumptions in the context of IAS generally and IAS 18 specifically. A number of the general assumptions are commonly found in the 37 VAR transactions under examination. However, none of the 37 transactions feature all 13 general assumptions. The spreadsheet at Appendix 4 shows which assumptions apply to which transactions. It will be noted that the most commonly occurring assumptions are 1-4 and 8-10. In total, 26 of the 37 transactions feature these assumptions, as well as some others.

5.5. I start by considering assumption 10. Although it relates to certain limbs within paragraph 14 of IAS 18 (for which see below), it also speaks strongly to the substance (that is, lack of substance) of the 30 transactions in which it features (see Chapter 3 for a discussion of the importance that substance plays in IAS). Assumption 10 is set out in full above but in simple terms states that, whereas there might appear (on the face of the contractual documentation) to be a sale for which the VAR needs to pay the invoiced amount, in fact the substance of the transaction was that there was no such need to pay, as there was what is commonly called a 'side agreement' which says that there is no need for the VAR to pay Autonomy from its own resources. This is a highly unusual feature to find in a sales arrangement. Normally, of course, the reverse would be the case, that is, a purchaser would satisfy the liability to its supplier from its own resources. Such an agreement or understanding strikes at the heart of the transaction. In a commercial transaction, it is often contractually specified that the purchaser will pay for the goods or services; where it is not contractually specified, it is implicit that the purchaser will pay. Indeed, as regards the transactions to which assumption 10 applies, there is documentation stating, in the normal way, that the VAR will pay, and on what dates it will pay, the purchase price. The presence of a side agreement or understanding contradicts the formal provisions of the contract regarding payment; it evidences that the intention of the parties is that a conventional sale is not taking place at all. It tells us that there might be some kind of conditional sale, but that is quite different; a conditional sale does not merit accounting recognition until the conditions are satisfied.

5.6. Payment for goods or services supplied is so fundamental a feature of a commercial contract that an agreement or understanding indicating that payment out of the VAR's own resources is not necessary fundamentally changes the substance of the transaction: a transaction with this feature is artificial and lacks substance. This would be the case even if the understanding were unenforceable in a Court of law. It remains the case that, because the parties intended the side agreement or understanding to apply, the transaction lacked substance.

5.7. In summary, the 30 transactions that feature assumption 10 (which are clearly identified in Appendix 4) lacked substance and so revenue should not have been recognised in respect of them.

5.8. I would add that, as well as striking at the heart of the substance of the transaction, assumption 10 also relates to three of the criteria in IAS 18, paragraph 14, namely:

5.8.1. In circumstances where the VAR does not have to pay for the software from its own resources, it is clear that Autonomy would not have transferred to the VAR the risks and rewards of ownership of the goods (para 14(a)). Indeed IAS 18 gives this situation as a specific example of where risks and rewards are not transferred: "*Examples of situations in which the entity may retain the significant risks and rewards of ownership are … (b) when the receipt of the* *revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of the goods*."[100]

5.8.2. Furthermore, if a VAR does not have to settle the invoiced amount out of its own resources, criterion 14(d) would be breached. That is, one could not conclude that "*it is probable that the economic benefits associated with the transaction will flow to the entity*."

5.8.3. Likewise, if there is such a significant doubt about the recoverability of the invoiced amount, it is highly likely that Autonomy would not have passed managerial involvement or control to the VAR where Autonomy was itself pursuing an end-user sale (para 14(b)).

5.9. I now consider assumptions 1-4 and then 9; these do not readily relate to the criteria for recognition of revenue in paragraph 14 of IAS 18, but relate to substance:

5.9.1. **Assumption 1: There had been no communication between Autonomy and the VAR until immediately prior to the end of the relevant quarter.** For a significant sale to occur, as it were, suddenly, with no prior communication is highly unusual. It raises questions about the substance of the transaction. What were the circumstances surrounding the goods that Autonomy suddenly decided to sell to a VAR and the VAR, equally quickly, with little or no opportunity for investigation, decided to buy?

5.9.2. **Assumption 2: There was no price negotiation between the VAR and Autonomy.** Again, this is highly unusual. There might be an exception to this where the goods in question had a market price (for example, oil). Another possible exception would be if there was an established pattern of trade between the two parties and the price was predetermined under a supply agreement. A third case would be where the purchaser badly needed the goods and they were not available elsewhere. But none of these circumstances applied in this case. Instead, the question is: why would a VAR agree to a price proposed by Autonomy without any negotiation? A possible answer is that the VAR was a naïve and inexperienced party. But this seems unlikely. A more obvious answer is that the VAR was not truly taking on the risk of the goods in question.

5.9.3. **Assumption 3: The VAR had made no prior efforts to sell such a licence to, and had had no prior relationship or contact with, the identified end-user.** In a straightforward sense, one might think that, from Autonomy's point of view, the relationship and interaction between the VAR and the end-user does not greatly matter. If Autonomy were selling to the VAR in a genuine, straightforward manner, it would matter little what the VAR then did with the goods. But as the other assumptions which apply variously to the specific transactions dealt with below illustrate, the sale by Autonomy to the VAR was far from genuine and straightforward, and hence the question arises as to the

[100] IAS 18, para 16(b)

objectives of Autonomy in apparently switching at the last minute to a customer (the VAR) who did not need the goods, who (in many cases) lacked the ability to pay for them and who had no prior contact with the one party (the intended end-user) to whom it was permitted (on paper) to sell the goods, who (generally) did need them and could pay for them. Moreover, such a switch of supplier would have been perplexing to the intended end-user. Where the end-user was an existing Autonomy customer (for example, Kraft and Eli Lilly), then one would have thought that both Autonomy and the customer/ end-user would have wanted to maintain its existing relationship. If the end-user were a new customer to Autonomy, then Autonomy would surely not wish to confuse a new customer by suddenly selling the goods under discussion to a third party who was unknown to the new customer. This assumption therefore raises questions about whether the sale to the VAR was genuine.

5.9.4. **Assumption 4: The VAR did not undertake or propose to provide any added value, or any service, to the end-user.** Normally in a multi-party commercial relationship, each party provides a service or adds value in some way, so as to justify its role and its economic return. A VAR would, therefore, be expected to add value either by assisting in securing the sale or in offering further services to the end-user (or both). There is no rule in either commercial practice or in IAS 18 that precludes a party from being involved in a transaction without adding any value. The question is more one for (in this context) Autonomy as to why it would allow a VAR a margin in the transaction (a margin that would otherwise be realised by Autonomy) without the VAR offering anything to the end-user in terms of value added services, or pay the VAR a significant Marketing Assistance Fee (MAF) without the VAR apparently being involved in the sale process. Indeed, in one sense, the value that the VAR adds may well be negative in that the VAR may have less to offer the end-user than Autonomy does in terms of, for example, knowledge about the product being sold. The involvement of a VAR, and giving the VAR some of the margin or a MAF, is therefore either irrational commercial behaviour, or the VAR was providing value in some other way. A possible answer is that Autonomy gave a margin or MAF to the VAR as the price of trying (but failing, in my view) to justify revenue recognition that could not otherwise occur or earlier revenue recognition than would have arisen from a sale direct to the end-user.

5.10. I pause at this point to comment on the combined effect of assumptions 1 to 4. These assumptions do not relate specifically to the IAS 18 criteria for revenue recognition, but they do relate to substance. A purported sale in which there is (assumption 1) no prior communication between Autonomy and the VAR and (assumption 2) no discussion of price already starts to appear to be highly unusual. Add to that (assumption 3) that there had been no contact or relationship between the VAR and the intended end-user, and one is bound to ask why a VAR would enter into a large purchase from Autonomy in those circumstances. Add (assumption 4) the feature that the VAR would not supply services or add any value to the transaction – and the transaction seems to have no economic basis.

The combined effect of these four assumptions is that the transactions to which they apply have no substance and are artificial.

5.11. I now add assumption 9: The purchase orders or sales agreements for the transactions between Autonomy and the VAR specified that the software licence was for onward licensing only to the particular end-user. Where, as posited here, the contract specified the end-user to which the VAR was to sell the goods, this strongly suggests that the 'sale' from Autonomy to the VAR lacked substance and was artificial. I cannot imagine that a VAR would purchase a defined set of software licences having no knowledge of the likelihood that the sale would complete and no means of selling the goods it was purchasing to anyone else. Moreover, assumption 3 is that the VAR had no prior relationship with, and had made no prior effort to sell a licence to, the identified end-user. Assumption 9 tells us that the sale to the VAR was not the end of the story as far as Autonomy was concerned; indeed it suggests that the sale to the VAR is not an important part of the story at all.

5.12. Assumption 9 is indicative of a lack of substance but in isolation does not demonstrate it strongly. However, adding it strengthens the conclusion already reached based on assumptions 1 to 4, namely that the transactions to which those assumptions relate lack substance and are artificial.

5.13. As just stated, based on assumptions 1 to 4 and 9, it is clear to me that the purported sales to the VARs were not genuine and lacked substance. In paragraph 5.8 above I reached the same conclusion in relation to assumption 10 alone: the conclusion from my analysis of assumptions 1-4 and 9, and from my analysis of assumption 10, reinforce each other.

5.14. The conclusion, in respect of the 30 VAR transactions discussed above (being those to which assumption 10 relates and 26 out of those 30 being those to which assumptions 1-4 and 8-10 relate), that there was no substance in Autonomy's sale to the VARs is further reinforced when one takes into account what happened after the 'sale' to those VARs:

5.14.1. none of the transactions proceeded to a sale by the VAR to the end-user; and the VAR was protected from incurring any losses in one of a number of ways (cancellation of sales agreement, credit note issued, debt owing by VAR to Autonomy written off, Autonomy arranging for the end-user to direct funds to VAR, VAR put in funds by Autonomy which were then used to pay Autonomy). This casts considerable doubt on whether any of the 'sales' to the VARs had substance.

5.14.2. 19 of the 30 deals were ultimately concluded between Autonomy and the end-user. The fact that a deal was done between Autonomy and the end-user confirms that there was no substance to the agreement between Autonomy and the VAR and that the VAR was merely used as an attempt to accelerate the recognition of revenue; and

5.14.3. The other 11 of the 30 transactions never proceeded to a deal with the end-user at all, either from the VAR or in the form of a direct deal between Autonomy and the end-user. (I refer to the VAR spreadsheet at Appendix 4. The third column shows 18 transactions marked "NTC" (no transaction concluded). Of these 18, the 11 that I am discussing here are those to which assumption 10 applies). With such a high failure rate, any sale by Autonomy to a VAR could only be regarded as a speculative arrangement but not as a transaction that had the substance of a sale.

5.15. We have seen in Chapter 3 (at paragraphs 3.15-3.21) that substance plays an important part in IAS, including in IAS 18. However, regardless of the requirements of IAS, my view is, simply on a common sense basis, that these transactions lacked substance, were artificial and so should not have been recognised as revenue.

5.16. As noted above, 26 of the 37 transactions feature assumptions 1-4 and 8-10. I have already discussed the effect of assumptions 10, and then 1-4 and then 9, these being the assumptions that relate to substance.

5.17. I now consider the effect of assumption 8. This assumption (and the six that I deal with below) relate to the specific revenue recognition criteria in IAS 18 paragraph 14. It should be recalled that revenue may not properly be recognised on a transaction if the transaction does not satisfy *all* of the sub-parts of IAS 18:14. See paragraph 3.38 above:

5.17.1. **Assumption 8: The VAR did not, after the agreement between Autonomy and the VAR had been entered into, make any effort to sell a licence for the relevant software to the end-user. Instead, the Autonomy group company continued its own efforts to achieve a sale of the licence directly with the end-user (and without consultation with the VAR).** It is self-evident that, in a normal business context, where a vendor sells to a customer (in this context, a "reseller"), with the intention that a third party should be the end customer, it is the reseller that would carry out the sales effort with the third party. This is because, if the reseller had genuinely bought the item, the reseller would have everything to gain or lose by succeeding or failing to make the sale to the end-user – that is, the reseller would have the risks and rewards relating to the item it had bought. If, as posited here, it is Autonomy who continued that sales effort, that is strong evidence that it had not transferred to the reseller the risks and rewards with respect to licences that the reseller purported to purchase. This is particularly so where key commercial terms with the identified end-user such as the nature of the goods or services sold and their prices have not been agreed at the time of the purchase order (as I can see was the case for some of the 37 transactions discussed at Appendix 3). Likewise, a vendor who continued the sales effort would clearly have retained managerial involvement in and control over the goods in question.

<u>Conclusions</u>:

(1) Analysis of assumption 8 demonstrates that the transaction did not affect the role and responsibility of Autonomy such that it fails to meet IAS 18 paragraphs 14(a) (risks and rewards) and 14(b) (managerial control).

(2) When assumption 8 is added to the assumptions discussed above, it further reinforces my conclusion that the transaction lacked substance.

5.18. At this point, I have considered the combined effect of assumptions 1-4 and 8-10, these being the assumptions (among others) that apply in 26 of the 37 transactions. In respect of these 26 transactions it is clear that:

5.18.1. The transactions were artificial and lacked substance (assumptions 1-4, 9 and 10);

5.18.2. Autonomy retained "*the significant risks and rewards of ownership of the goods*"[101] in question (assumptions 8 and 10);

5.18.3. Autonomy retained "*continuing managerial involvement to the degree usually associated with ownership [and] effective control over the goods*"[102] (assumptions 8 and 10); and

5.18.4. It was not "*probable that the economic benefits associated with the transaction will flow to*"[103] Autonomy (assumption 10).

5.19. In summary, in respect of the accounting for these 26 transactions:

5.19.1. The transactions had no substance and so should not have been accounted for as sales; and

5.19.2. Even if that were disregarded, they failed to meet paragraphs 14(a), 14(b) and 14(d) of IAS 18 and so should not have been accounted for as sales at the time of the ostensible sale to the VAR.

5.20. Where, as is the case here, there was no substance to the transaction with the VAR and three of the five criteria in paragraph 14 of IAS 18 were not met, the recognition of revenue on these transactions was, in my view, a fundamental non-compliance with IAS 18.

5.21. I now consider the remaining six assumptions. These relate to the revenue recognition criteria in IAS 18, as follows:

5.21.1. **Assumption 5: For VAR transactions involving the sale of a licence to use Digital Safe software (and software to be used with Digital Safe), the Digital Safe software could only be implemented and thereafter operated by Autonomy (and not by the VAR).** Where the VAR transaction involved the sale of a licence to use Digital Safe software (and software to be used with

[101] IAS 18, para 14(a)
[102] IAS 18, para 14(b)
[103] IAS 18, para 14(d)

Digital Safe)[104], there are two separate points. Firstly, there is no need to consider whether recognition of revenue on a sale to a VAR is valid, because, as I explain in Chapter 7 at paragraphs 7.6 to 7.22 below, there was no substance to the sale of a licence to use Digital Safe software (and software to be used with Digital Safe) so revenue should not have been recognised upfront in respect of the sale of the licence. This applies to *any* sale of Digital Safe software (and software to be used with Digital Safe) by Autonomy, whether to the end-user or to a VAR for resale (and certainly where the end-user's data is to be hosted in Autonomy's data centres). Secondly, even if that general point were disregarded, a more detailed consideration leads to the same conclusion. In a bona fide transaction that did not involve a VAR, a typical contract between Autonomy and the end-user for a licence to use Digital Safe software (and software to be used with Digital Safe) involved the supply of the software, implementation, monitoring and support of the same, together with hosting over a period of time. It is that combination that is of value to an end-user. The Digital Safe software was of no value to the end-user absent Autonomy's implementation and operational services. It follows that the supply of only the Digital Safe software (and software to be used with Digital Safe) to a VAR had no economic significance: (a) from Autonomy's point of view, it did not supply anything of independent value to the VAR, and so no revenue should have been recognised; (b) from the VAR's point of view, it did not acquire anything that it could either use itself or on-sell to an end-user in the absence of the 'related services' (implementation and monitoring and support); and the VAR was not in a position to provide those related services to an end-user.[105]

Conclusions:

(1) Analysis of assumption 5 demonstrates, in itself, that Autonomy retained significant involvement in the transaction such that it failed to meet IAS 18, paragraph 14(b) (managerial involvement/ control). Autonomy also retained the risks and rewards of ownership over the software such that it failed to meet IAS 18, paragraph 14(a).

(2) Assumption 5 viewed independently, and as added to the assumptions discussed above, further reinforces the point about lack of substance.

5.21.2. **Assumption 6: The VAR did not have the means to pay the Autonomy group company in the absence of an onward sale of the relevant licence to the identified end-user.** If a customer does not have the means to settle the purchase price of the goods it is buying, that invalidates the recognition of a sale by the seller. IAS 18, paragraph 14(d) requires, among other things, that *"it is probable that the economic benefits associated with the transaction will flow to*

[104] See Chapter 7 where I discuss the implications of this.

[105] A VAR *could* in due course sell the Digital Safe software to an end-user and at the same time, through some kind of joint-supply agreement, arrange for Autonomy to provide the related services. However, I am asked to assume that that is not what happened and, in any case, it would occur only when the end-user is ready to contract.

the entity". It follows clearly from this that, if the customer does not have the means to pay, recognition of revenue is invalid. The question then is whether the additional words *"in the absence of an onward sale of the relevant licence to the identified end-user"* affects that conclusion. They mean that the VAR could not pay Autonomy unless and until the VAR made a sale to the end-user. But there were no cases in which the VAR made a sale to the end-user, so these additional words are of no relevance. This sixth assumption (VAR's inability to pay), therefore results in the recognition of revenue by Autonomy being invalid at the time of the 'sale' to the VAR.

<u>Conclusion</u>: Analysis of assumption 6 demonstrates that the transaction fails to meet IAS 18, paragraph 14(d) (probable economic benefits). Based on this assumption alone, it was improper to recognise revenue in 19 of the 37 VAR transactions.

5.21.3. **Assumption 7: For sales to Capax Discovery as VAR: Capax Discovery was a newly incorporated company in March 2009 and therefore had no financial history at that time. Capax Discovery wrote to Autonomy in March 2009, providing financial information for Capax Global "on the express understanding that Capax Global is a separate and distinct entity from Capax Discovery. All contractual obligations will be between Capax Discovery and Autonomy only".** The effect of this letter seems clear, namely that Capax Global's financial strength was not relevant. Therefore, any assessment of creditworthiness should have focused on Capax Discovery, which was the entity with which Autonomy was contracting. If, in the event of any difficulty, Capax Global were to step in and give support, that would be entirely voluntary on its part and therefore not something that could be relied on by Autonomy. As Capax Discovery was a new company with no trading history, there was no available evidence of its ability to pay and therefore no basis for concluding that it could or would do so.

<u>Conclusion</u>: Analysis of assumption 7 demonstrates that the transaction fails to meet IAS 18, paragraph 14(d) (probable economic benefits)

5.21.4. **Assumption 11: The VAR was relieved of its ostensible liability to pay the price for the Autonomy software licence it had purchased by one or more of the following means: (a) the purported sale agreement between Autonomy and the VAR being cancelled, (b) a credit note was issued to the VAR discharging its ostensible liability to pay the price, or (c) the VAR's debt was written off.** Most businesses of any size have had experiences in customer relationships in which they have had to cancel a sales agreement or issue a credit note or write off a debt in full. However, generally these are rare and unfortunate events, not routine ways of conducting business and are not based on a prior agreement or understanding that the counterparty to a transaction will be protected from risk (i.e. assumption 10). Where one, or a combination, of these features was adopted as a routine or even occasional way of dealing with situations that occur from time to time, they constitute strong evidence that the sale to the VAR was not genuinely made and that there was no transfer of the risks and rewards of ownership.

I note in passing that treatment 11(c) (write off of the debt) is inappropriate. If a sale is genuinely made yet results in non-payment, it is correct to retain the sale as part of revenue and to record a bad debt expense. However, where, as here, the sale had no substance and the write off of the debt was simply the mechanism for cancelling the sale, the appropriate accounting treatment is to record nil as revenue and nil as bad debt expense.

Conclusions:

(1) Analysis of assumption 11, insofar as it means that the VAR did not make payment, demonstrates that the transaction fails to meet IAS 18 paragraph 14 (d) (probable economic benefits). In addition, insofar as these features suggest that the sale to the VAR was not genuinely made, there was no transfer of the risks and rewards of ownership such that the transaction fails to meet IAS 18 paragraph 14 (a) (risks and rewards).

(2) When assumption 11 is added to the assumptions discussed above, it further reinforces the point about lack of substance.

5.21.5. **Assumption 12: Where the Autonomy group company subsequently achieved a direct sale to the end-user, the Autonomy group company arranged for the end-user to pay the VAR so that the VAR could then pay the relevant Autonomy group company.** The key question that arises here is why the Autonomy group company would seek to achieve a direct sale with the end-user. The situation evidences very strongly that the 'sale' to the VAR was artificial. The Autonomy group company might assist the VAR with the VAR's sales effort but that is a different arrangement to what is described. It is equally artificial for the Autonomy group company to ask the end-user to pay the VAR – a party with which the end-user had had little or no contact.

Conclusions:

(1) Analysis of assumption 12 demonstrates that the transaction fails to meet IAS 18 paragraphs (a) (risks and rewards) and (b) (managerial control). In addition, IAS 18 paragraph 14 (d) (probable economic benefits) is not satisfied but I regard this limb as less central to assumption 12 than paragraphs 14 (a) and (b).

(2) When assumption 12 is added to the assumptions discussed above, it further reinforces the point about lack of substance.

5.21.6. **Assumption 13: An Autonomy group company was caused to make a payment to the VAR to purchase rights, goods or services that the Autonomy group company did not need (and which had no discernible**

value to it), but which had the purpose and effect of putting the VAR in funds which it then used to pay for the Autonomy software licence. It is clearly not normal commercial practice for an entity to purchase goods from any party that it does not need. These types of arrangement are generally artificial. To buy goods that are not needed is in effect a disguised gift; it is a transfer of value with little or nothing of value being received in exchange. For Autonomy to have made a disguised gift to a VAR in order that the VAR could settle the amount outstanding invalidates Autonomy's original sale, as, taking the two transactions together, Autonomy has not gained from the transactions.

Conclusions:

(1) Analysis of assumption 13 demonstrates that the transaction fails to meet IAS 18 paragraph 14 (a) (risks and rewards) and (d) (probable economic benefits).

(2) When assumption 13 is added to the assumptions discussed above, it further reinforces the point about lack of substance.

5.22. Looking at assumptions 11, 12 and 13 together is instructive. All three can be regarded as different ways of putting assumption 10 into effect. 36 (i.e. all but one) of the transactions feature one or more of assumptions 11, 12 and 13. That is, 36 end up with either the amount owing by the VAR to Autonomy being cancelled (cancellation of the agreement, credit note or write off) or funds from Autonomy's sale to the end-user being routed through the VAR, or the VAR being put in funds by an artificial purchase from the VAR by Autonomy. Put another way, *none* of the 36 transactions involved the VAR settling Autonomy's invoice in a conventional straightforward way (the sole exception to this being transaction 5 (MicroTech/ DiscoverTech) which, as discussed below, was very different from the other 36 transactions). Not only do assumptions 11-13 reinforce the existence of the agreement referred to at assumption 10, they speak directly to the question of collectability (criterion 14(d) of IAS 18) and are so fundamental that they also demonstrate that the transactions lacked substance.

5.23. A different point also needs to be made about assumptions 11, 12 and 13. They all relate to events that occurred after the date of what was held out as a sale by Autonomy to the VAR. However, they are all different ways of implementing the agreement/ understanding referred to at assumption 10, which existed at the time of the transaction. It might be argued that, ignoring assumption 10 and viewing assumptions 11-13 in isolation, these factors could not reasonably have been taken into account in considering the accounting for the transaction at the time it was effected. This would have been a fair point as regards the first, or perhaps the first few such transactions, but it would soon have become clear that a pattern of frequent cancellations, in one form or another, was emerging. That pattern should have signaled that something unusual was occurring and have led to a reconsideration of the appropriate accounting treatment of subsequent transactions – namely that the sales had no substance and that no revenue should be recognised in respect of them.

5.24. The following Table summarises the above paragraphs by showing, for each assumption, the manner in which that assumption, if present in a particular transaction, would render it invalid to recognise revenue under IAS 18.

Table D – Summary of how the general assumptions relate to non-compliance with IAS requirements

	Requirement of IAS	Relevant assumption	Comment
1	Requirement to follow substance over form (Conceptual Frameworks, IAS 1, IAS 18)	1-4, 9,10[106]	See from paragraph 5.5
2	IAS 18 paragraph 14's criteria for revenue recognition on sale of goods: "*Revenue from the sale of goods shall be recognised when all the following conditions have been met:*		Note that all of the following five criteria have to be met in order for revenue to be recognised
3	*(a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;*	8, 10, 11, 12, 13	VAR made no sales effort (8) VAR not liable to pay from its own resources (10) VAR was relieved of liability to pay (11) Autonomy ask end-user to pay the VAR after a direct sale to end-user (12) Autonomy put VAR in funds by artificial transaction (13)
4	(b) *the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;*	5, 8, 10, 12	Digital Safe is run by Autonomy (5) VAR made no sales effort (8) It is highly likely that Autonomy would not have

[106] As set out in the body of my report, the other assumptions are also relevant to or reinforce my view as to substance.

			passed managerial involvement or control to the VAR (10) Autonomy ask end-user to pay the VAR after a direct sale to end-user (12)
5	(c) *the amount of revenue can be measured reliably;*		See paragraph 5.25.1 below
6	(d) *it is probable that the economic benefits associated with the transaction will flow to the entity; and*	6, 7, 10, 11, 12, 13	VAR did not have the means to pay (6) Capax has no funds and parent would not support Capax Discovery (7) VAR not liable to pay from its own resources (10) VAR was relieved of liability to pay (11) Autonomy ask end-user to pay the VAR after a direct sale to end-user (12) Autonomy put VAR in funds by artificial transaction (13)
7	(e) *the costs incurred or to be incurred in respect of the transaction can be measured reliably"*		See paragraph 5.25.2 below

5.25. As shown above, para 14 of IAS 18 contains five criteria: (a) to (e). The assumptions relate to criteria 14 (a), (b) and (d).

5.25.1. As to criterion 14(c), I have been instructed not to consider this criterion. As I explain at paragraph 3.38 above, revenue cannot be properly recognised when any part of IAS 18 paragraph 14 is not satisfied. Given my conclusion (based on a consideration of 14(a), (b) and (d) only) that IAS 18 paragraph 14 is not met in relation to each of the 37 transactions set out in Appendix 3, consideration of 14(c) would not change that conclusion.

5.25.2. As to criterion 14(e): in the VAR transactions under consideration, this criterion is likely to be met, or is not relevant; and in either case it would be an unnecessarily repetitive comment and so I do not address this criterion in Appendix 3.

6. <u>Reciprocal transactions</u>

Reciprocal transactions

Introduction

6.1 This chapter sets out my views on the accounting for a number of 'reciprocal transactions' entered into by Autonomy between 31 March 2009 and 31 March 2011. These transactions (which some may describe as barter transactions) typically involve Autonomy selling goods or services to third parties and, at or around the same time, buying goods or services from the same third party.

6.2 The key accounting question arising is whether the sales and purchases by Autonomy should be recorded:

a. Gross, at the face value of the sales and purchases; or
b. Gross, at the fair value of the sales and purchases; or
c. Net – that is, recognising only any net payment or receipt.

6.3 As explained at paragraph 3.36, the revenue recognition criteria are usually applied separately to each transaction. If a sale meets the criteria for revenue recognition in IAS 18, it is usually recognised as revenue. However, as set out at paragraph 3.20, IAS 18 paragraph 13 states that when two or more transactions "are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole" it is necessary to consider the transactions together to understand the substance of the linked transaction. If, as is the case here, a company buys goods or services from a third party and, at or around the same time, sells goods or services to the same party, the details need to be examined to determine whether revenue should be recognised.

6.4 Determining substance is more a matter of the application of everyday commercial common sense than accounting analysis. Assume that A agrees to sell a product to B, and in return B agrees to provide services to A (as was the case in Schedule 5, Transaction 1). If the goods are sold by A at a reasonable commercial price (fair value) and are wanted by B; and if the services are provided by B at a reasonable commercial price and are wanted by A, then the transactions are genuine and should be recorded at fair value. But if the goods purportedly sold by A are of very low value, or have little or no relevance to B, or are not delivered, or are delivered by A but not used by B, then the sale has no meaning or substance, and should not be recognised in A's accounting records and financial statements as a sale. Equally, if the services purportedly provided by B are of little or no value to A, or are never in fact provided, then the purchase has no meaning or substance, and so should not be recognised in A's accounting records and financial statements as a purchase. Any net payment between A and B would need to be recorded: if a net payment, then as an expense; and if a net receipt, then as 'other income' (rather than revenue).

6.5 As set out at paragraph 3.37, IAS 18, paragraph 12 deals with reciprocal transactions as follows:

"When goods or services are exchanged or swapped for goods or services which are of a <u>similar</u> nature and value, the exchange is not regarded as a transaction which generates revenue. This is often the case with commodities like oil or milk where suppliers exchange or swap inventories in various locations to fulfil demand on a timely basis in a particular location. When goods are sold or services are rendered in exchange for <u>dissimilar</u> goods or services, the exchange is regarded as a transaction which generates revenue. The revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents transferred. When the <u>fair value</u> of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents transferred."[107]

6.6 There is sometimes a judgement attached to the question of whether the goods or services that are sold/exchanged are 'similar'. But in general the implementation of IAS 18, paragraphs 12 and 13 and the interpretation of 'similar' will be clear.

6.7 Regardless of whether the goods or services are dissimilar (and as referred to in Chapter 3), the question of substance is important in determining the accounting treatment of a given transaction or set of related transactions. This question can be approached in one of two ways, but they lead to the same answer. If a transaction has no substance:

a. One accounting approach is simply to say that there is no substance, therefore there is no accounting recognition. If it is a potential revenue transaction but has no substance, then no revenue is recognised. (Any net payment would need to be recognised as discussed in paragraph 6.4 above.)
b. The longer accounting analysis (which arrives at the same result) would be:

    i. Note that the sale and the purchase are linked;
    ii. Consider paragraph 13 of IAS 18: this indicates that, in order to reflect their substance, the two transactions should be dealt with together;
    iii. Consider the more detailed guidance in paragraph 12 of IAS 18: (1) if the assets are of a similar nature, the exchange does not generate revenue; and (2) Where the assets are dissimilar, the exchange is accounted for but at fair value. In a transaction of no substance, fair value is nil. For example, if software that has no use or value to the recipient is exchanged for (dissimilar) services that are not wanted or used by the recipient, the fair value of both would be nil;
    iv. Consider paragraph 14 of IAS 18: in a transaction of no substance no economic benefits would flow to the seller and IAS 18.14(d) is not met and no revenue should be recognised on the sale.

[107] IAS 18 para 12, emphasis added

6.8 In paragraph 6.7b.iii(2) above, the example assumes that the fair value of both the sale and the purchase is nil. However, in some cases, it might be that the purchase is of no value (for example, the goods are of no use to the purchaser) but there is value in the goods that are sold in exchange. Such an exchange does not make commercial sense. To record the sale/purchase transaction at the fair value of the sale would mean also recording the (worthless) purchase at the same amount as the sale; this would not make sense. The only practical route is to attribute no value to either the purchase or the sale. This is consistent with IAS 18, paragraph 9, which states: "Revenue shall be measured at the fair value of the consideration received or receivable". The consideration received is the (worthless) goods received in exchange.

6.9 I now turn to examine the six transactions whose accounting treatment I have been instructed to consider. In the remainder of this chapter, the sections 'Factual Summary' and 'Assumptions' are taken from my instructions. I have also reviewed Schedule 5 to the RRAPoC. The 'Analysis' section sets out my own views, based on the Factual Summary, the Assumptions and the facts set out in Schedule 5.

Schedule 5, Transaction 1 – Capax Discovery ("Capax")

Factual Summary

6.10 Capax purchased Electronic Data Discovery ("**EDD**") software from Autonomy Inc on three occasions from 31 March 2009 to 6 April 2011 for a total of $14.13 million:

(i) On 31 March 2009, Capax purchased EDD software for $8.25 million from Autonomy Inc ($7.5 million for the initial licence fee and $750,000 for two years' support and maintenance) ("**Sale 1**");

(ii) On 31 December 2009, Capax purchased additional EDD software for $4.2 million from Autonomy Inc ($4 million for the licence fee and $200,000 for one year's support and maintenance) ("**Sale 2**"). Under the terms of the agreement, Autonomy Inc licensed additional software to Capax and extended the term of the original EDD software licence from 5 to 6 years; and

(iii) On 6 April 2011, Capax entered into a third agreement with Autonomy Inc under which Capax purchased the right to install the software made available at its UK Data Centre for $1.68 million from Autonomy Inc ($1.6 million for the licence fee and $80,000 for support and maintenance) ("**Sale 3**").

6.11 Autonomy group companies paid Capax $14,397,682 for EDD related services, in the period Q2 2009 to Q4 2011, and made payments totalling $3,040,139 to Capax and Capax Global for purported supplemental Enterprise Archive Solution ("**EAS**") support in the period Q1 2010 to Q3 2011. These payments were used by Capax to fund the instalment payments due from Capax under the EDD software licenses.

6.12 Schedule 5, Transaction 1 shows the payments made by Autonomy group companies to

Capax and Capax Global and the receipts by Autonomy Inc from Capax.

Assumptions

6.13 Assumption 1: The sales transactions would not have occurred but for the purchase transactions.

6.14 Assumption 2: A reason for the counterparty's purchase of a licence from Autonomy was Autonomy's willingness to purchase products or services from the counterparty in transactions that resulted in a net payment of cash to the counterparty.

6.15 Assumption 3: It is unlikely that the counterparty would have had the funds needed to pay for its purchase from Autonomy in the absence of the sale of purported services by it to Autonomy.

6.16 Assumption 4: The amount paid by the Autonomy group company for the counterparty's services exceeded the price paid by the counterparty to acquire Autonomy products such that the Autonomy group company paid (or agreed to pay) substantial net amounts to the counterparty as part of these arrangements.

6.17 Assumption 5: The Autonomy group company had no independent need for the services that it purchased from the counterparty and such services had no discernible value to the Autonomy group company.

6.18 Assumption 6: The amount paid by the Autonomy group company for the counterparty's services was in excess of the fair value (if any) for such services.

6.19 Assumption 7: The Autonomy group company did not even attempt to obtain or utilise the services that it had purchased for a period of months after its nominal purchase, if at all.

Analysis

6.20 On the basis of assumptions 1 to 3 above, it is clear from IAS 18, paragraph 13 that the sale of software to Capax and the purchase of the EDD and EAS services from Capax were linked and should be considered together to understand the substance of the linked transaction.

6.21 It is clear from assumptions 5 and 7 above that the linked transaction was artificial and lacked substance.

6.22 It is clear from assumption 6 that Autonomy's purchase was not carried out at fair value. The implications of this for the recognition of the sales are discussed in paragraph 6.8 above.

6.23 Considering these points in the light of my introductory analysis, it is clear that Autonomy's accounting treatment should have been to record nil revenue on the sale and to record the net payment to Capax (see assumption 4) as an expense.

6.24 Given my conclusion on substance, it is not necessary to consider IAS 18, paragraph 12. Nevertheless, an analysis under IAS 18, paragraph 12 would lead to the same result (irrespective of whether the exchange was regarded as similar or dissimilar). There are no grounds to justify accounting for the sale of the software and the purchase of the service separately (i.e. on a gross basis). To justify separate or gross treatment, the linked transaction would need to have substance, which it does not.

6.25 In view of the fact that Autonomy received no cash (on a net basis) and received nothing else of discernible value, no economic benefits flowed to Autonomy and so IAS 18.14(d) was also not met.

Schedule 5, Transaction 2 – VMS

Factual Summary

6.26 On 30 June 2009: (1) Autonomy Inc sold a suite of software licences to VMS Inc for $9 million ($8,571,429 for the software licence fee and $428,571 for one year's support and maintenance); and (2) Autonomy Inc bought rights to use VMS LP's data feed for 3 years for $13 million ("**Transaction 1**").

6.27 On 31 December 2010: (1) Autonomy Inc sold hardware to VMS Inc for $6,004,067 and software to VMS LP for $5 million ($4,750,000 for the software licence fee and $250,000 for one year's support and maintenance); and (2) Autonomy Inc purchased additional data and further licensing rights from VMS LP in relation to the VMS data feed for $8.4 million (including the right to sub-licence VMS data to end-users, which AU was prohibited from doing so under Transaction 1) and the term of the 30 June 2009 agreement was increased to 5 years ("**Transaction 2**").

6.28 When Autonomy Inc made payments to VMS Inc and/or VMS LP (together **"VMS"**), VMS made corresponding payments to Autonomy Inc (see Schedule 5, Transaction 2).

6.29 Overall, Autonomy made payments to VMS of $17 million and VMS made payments to Autonomy of $12 million. On a net basis, therefore, Autonomy paid $5 milion to VMS. In addition, Autonomy incurred a cost of £1,797,512 in buying hardware that it supplied to VMS from a third party.

Assumptions

6.30 Assumption 1: The sales transactions would not have occurred but for the purchase transactions.

6.31 Assumption 2: A reason for the counterparty's purchase of a licence from Autonomy was Autonomy's willingness to purchase products or services from the counterparty in transactions that resulted in a net payment of cash to the counterparty.

6.32 Assumption 3: It is unlikely that the counterparty would have had the funds needed to pay for its purchase from Autonomy in the absence of the sale by it to Autonomy.

6.33 Assumption 4: The amount paid by the Autonomy group company for the counterparty's products/services exceeded the price paid by the counterparty to acquire Autonomy products and services such that the Autonomy group company paid (or agreed to pay) substantial net amounts to the counterparty as part of the arrangements between them.

6.34 Assumption 5: The Autonomy group company had no independent need for the products that it purchased from the counterparty and which had no discernible value to the Autonomy group company.

6.35 Assumption 6: The amount paid by the Autonomy group company for the counterparty's products/services was in excess of the fair value (if any) for such products.

6.36 Assumption 7: The Autonomy group company did not even attempt to obtain or utilise the product that it had purchased for a period of months after its nominal purchase.

Analysis

6.37 On the basis of assumptions 1-3 above and the fact the transactions were entered into on the same day, it is clear from IAS 18, paragraph 13 that the sale of goods to VMS and the purchase of rights to the VMS data feed from VMS were linked and should be considered together.

6.38 It is clear from assumptions 5 and 7 that the linked sales/purchases were artificial and lacked substance.

6.39 It is clear from assumption 6 that Autonomy's purchases were not carried out at fair value. The implications of this for the recognition of the sales are discussed in paragraph 6.8 above.

6.40 I am instructed (see paragraph 6.29 above) that, in relation to Transaction 2, Autonomy incurred a cost of £1,797,512 (equivalent to $2,876,019) in buying the hardware that it supplied to VMS from a third party. It might seem that at least this part of Transaction 2 should merit accounting recognition: it is likely that the purchase cost was the fair value of the hardware; and it might seem appropriate for Autonomy to record revenue of this amount or something close to it[108]. If the purchase and sale of the hardware were done in isolation, then accounting for the purchase and sale in the normal way would be appropriate. But in the wider context of Transaction 2 as a whole, the normal rules do not apply. This is because Transaction 2 as a whole is artificial and lacks substance. The only meaningful observation that can be made for accounting purposes is that there was a net payment by Autonomy to VMS of $1 million; and that in addition Autonomy incurred a cost of $2,876,019 in buying hardware. Autonomy's accounting treatment

[108] As noted elsewhere in this report, margins on the sale of hardware are typically small.

should have been to record nil revenue on the sales and to record the net payment of $1 million to VMS (see assumption 4) and the cost of the hardware as an expense.

6.41 I note that Autonomy capitalised the rights that it bought from VMS. Rights can be capitalised but only when they represent a valuable asset to the purchaser[109]; the assumptions above indicate that this is not the case. So it would not be appropriate to capitalise the cost of the rights. The amount should be treated as an immediate expense.

6.42 In view of the fact that Autonomy received no cash (on a net basis) and received nothing else of discernible value, no economic benefits flowed to Autonomy and so IAS 18.14(d) was also not met.

Schedule 5, Transaction 3 – FileTek Inc ("FileTek")

Factual Summary

6.43 On 31 December 2009: (1) Autonomy Inc sold a software licence to FileTek for $8,480,000 ($8 million for the one-time software licence fee and $480,000 for the first year of support); and (2) Autonomy Inc purchased licences for StorHouse software and support for $10,367,280 (capped at 60 users and structured data volume restricted to 1 petabyte) ("**Transaction 1**").

6.44 On 31 March 2010: (1) Autonomy Inc sold a software licence to FileTek for $9,010,000 ($8.5 million for the one-time software licence fee and $510,000 for the first year of support); and (2) on 11 May 2010, Autonomy Inc purchased further licences for StorHouse software and support for $11,518,214 (unlimited amount of data for 5 years) ("**Transaction 2**").

6.45 When Autonomy Inc made payments to FileTek, FileTek made corresponding payments to Autonomy Inc (see Transaction 3, Schedule 5 of the RRAPoC).

6.46 StorHouse software archived and then searched structured data (i.e. databases) e.g. it was essentially a filing system where customers could offload its databases to the cloud and then conduct searches across those databases.

Assumptions

6.47 Assumption 1: The sales transactions would not have occurred but for the purchase transactions.

6.48 Assumption 2: A reason for the counterparty's purchase of a licence from Autonomy was Autonomy's willingness to purchase products or services from the counterparty in transactions that resulted in a net payment of cash to the counterparty.

[109] IAS 38, para 21 says that "*An intangible asset shall be recognised if, and only if, (a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and (b) the cost of the asset can be measured reliably*."

6.49 Assumption 3: It is unlikely that the counterparty would have had the funds needed to pay for its purchase from Autonomy in the absence of the sale by it to Autonomy.

6.50 Assumption 4: The amount paid by the Autonomy group company for the counterparty's products exceeded the price paid by the counterparty to acquire Autonomy products and services such that the Autonomy group company paid (or agreed to pay) substantial net amounts to the counterparty as part of both arrangements.

6.51 Assumption 5: The Autonomy group company had no independent need for the products that it purchased or licensed from the counterparty and which had no discernible value to the Autonomy group company.

6.52 Assumption 6: The amount paid by the Autonomy group company for the counterparty's products was in excess of the fair value (if any) for such products.

6.53 Assumption 7: As regards Transaction 1, the Autonomy group's analysis of the need for, or utility to the Autonomy group of, the counterparty's product was cursory and first took place on the day before Autonomy's agreement to make that purchase (even though the transactions involved millions of dollars) and, it is to be inferred, took place for the benefit of Autonomy's auditors, Deloitte.

6.54 Assumption 8: The Autonomy group company did not even attempt to obtain or utilise the software that it had purchased for a period of months after its nominal purchase, if at all.

Analysis

6.55 On the basis of assumptions 1-3 above and the fact the transactions were entered into on the same day, it is clear from IAS 18, paragraph 13 that the sale of goods to FileTek and the purchase of licences for StorHouse software from FileTek were linked and should be considered together.

6.56 It is clear from assumptions 5, 7 and 8 taken together that the linked sales/purchases were artificial and lacked substance.

6.57 It is clear from assumption 6 that Autonomy's purchases were not carried out at fair value. The implications of this for the recognition of the sales are discussed in paragraph 6.8 above.

6.58 Considering these points in the light of my introductory analysis, it is clear that Autonomy's accounting treatment should have been to record nil revenue on the sales and to record the net payments to FileTek (see assumption 4) as an expense.

6.59 In view of the fact that Autonomy received no cash (on a net basis) and received nothing else of discernible value, no economic benefits flowed to Autonomy and so IAS 18.14(d) was also not met.

Schedule 5, Transaction 4 – Vidient Systems Inc ("Vidient")

Factual Summary

6.60 On 31 December 2009: (1) Virage Inc (Autonomy's security and surveillance division) sold software to Vidient for $2,625,000 ($2.5 million for the software licence fee plus $125,000 in respect of support and maintenance for one year); and (2) on 1 January 2010, Autonomy Inc purchased from Vidient a licence to SmartCatch software for $3.15 million ($3 million for the SmartCatch licence fee for three years plus $150,000 in respect of support and maintenance for one year) from Vidient ("**Transaction 1**").

6.61 On 30 September 2010: (1) Virage Inc sold further software to Vidient for $2.1 million software ($2 million for the software licence fee plus $100,000 in respect of support and maintenance for one year); and on 22 October 2010: (2) Autonomy Inc entered into an agreement with Vidient to allow Autonomy Inc to distribute and perform system integration on Vidient's SmartCatch software for $2.31 million. This agreement was then revised into two separate agreements totalling $2.31 million, with an effective date of 26 October 2010 ("**Transaction 2**"), being:

(i) A Software Distributor Agreement between ASL and Vidient for $2,025,000 (which included a $100,000 development software fee and $14,000 for support and maintenance for one year); and

(ii) A Software License Agreement between ASL and Vidient for $285,000 for SmartCatch analytics software (including $35,000 for one year's support and maintenance).

6.62 When Autonomy Inc and ASL made payments to Vidient, Vidient made corresponding payments to Autonomy Inc (see Transaction 4, Schedule 5 of the RRAPoC).

6.63 SmartCatch was a video surveillance product which monitored video feeds from closed circuit TV systems for suspicious activity.

Assumptions

6.64 Assumption 1: The sales transactions would not have occurred but for the purchase transactions.

6.65 Assumption 2: A reason for the counterparty's purchase of a licence from Autonomy was Autonomy's willingness to purchase products or services from the counterparty in transactions that resulted in a net payment of cash to the counterparty.

6.66 Assumption 3: It is unlikely that the counterparty would have had the funds needed to pay for its purchase from Autonomy in the absence of the sale by it to Autonomy.

6.67 Assumption 4: The amount paid by the Autonomy group company for the counterparty's products exceeded the price paid by the counterparty to acquire Autonomy products and services such that the Autonomy group company paid (or agreed to pay) substantial net amounts to the counterparty as part of the arrangements.

6.68 Assumption 5: The Autonomy group company had no independent need for the products that it purchased or licensed from the counterparty and which had no discernible value to the Autonomy group company.

6.69 Assumption 6: The amount paid by the Autonomy group company for the counterparty's products was in excess of the fair value (if any) for such products.

6.70 Assumption 7: As regards Transaction 1, the Autonomy group's analysis of the need for, or utility to the Autonomy group of, the counterparty's product was cursory and took place on the day before its agreement to make that purchase (even though the transaction involved millions of dollars) and, it is to be inferred, took place for the benefit of Autonomy's auditors, Deloitte.

6.71 Assumption 8: The Autonomy group company did not even attempt to obtain or utilise the product that it had purchased for a period of months after its nominal purchase, if at all.

Analysis

6.72 On the basis of assumptions 1-3 above, it is clear from IAS 18, paragraph 13 that the sale of goods to Vidient and the purchase of licences for software from Vidient were linked and should be considered together.

6.73 It is clear from assumptions 5, 7 and 8 taken together that the linked sales/purchases were artificial and lacked substance.

6.74 It is clear from assumption 6 that Autonomy's purchases were not carried out at fair value. The implications of this for the recognition of the sales are discussed in paragraph 6.8 above.

6.75 Considering these points in the light of my introductory analysis, it is clear that Autonomy's accounting treatment should have been to record nil revenue on the sales and to record the net payment to Vidient (see assumption 4) as an expense.

6.76 In view of the fact that Autonomy received no cash (on a net basis) and received nothing else of discernible value, no economic benefits flowed to Autonomy and so IAS 18.14(d) was also not met.

Schedule 5, Transaction 5 - EMC Corporation ("EMC")

Factual Summary

6.77 On 30 September 2010: (1) Verity Inc (an Autonomy group company) sold software licences to EMC (this was the sixth amendment of the original Verity OEM agreement dated 14 February 2002 between Verity and EMC) for $5,257,350 (being $5,007,000 for the software licences plus $250,350 in respect of support and maintenance for one year); and (2) Autonomy Inc purchased software, hardware and support and maintenance from EMC for $8,947,386 ($9,627,804 including sales taxes).

Assumptions

6.78 Assumption 1: The sales transaction would not have occurred but for the purchase transaction.

6.79 Assumption 2: The reason for the counterparty's purchase of a licence from Autonomy was Autonomy's willingness to purchase products or services from the counterparty in transactions that resulted in a net payment of cash to the counterparty.

6.80 Assumption 3: The amount paid by the Autonomy group company for the counterparty's products exceeded the price paid by the counterparty to acquire Autonomy products and services such that the Autonomy group company paid (or agreed to pay) substantial net amounts to the counterparty as part of the arrangements.

6.81 Assumption 4: The amount paid by the Autonomy group company for the counterparty's products, rights and/or services was in excess of the fair value for such products, rights and/or services.

6.82 Assumption 5: EMC did not use the software sold to it by Verity Inc and regarded it as merely a component of a "*swap transaction*".

Analysis

6.83 It appears from assumptions 1 and 2 that the two transactions were linked and should be considered together.

6.84 I note that the price paid by Autonomy for EMC's products, rights and/or services was in excess of their fair values. But this does not rule out that those products, rights and/or services might have had a fair value; indeed this seems likely as part of the transaction was the purchase by Autonomy of EMC hardware.

6.85 I also note that EMC did not use the software sold to it by Verity. This element of the transaction therefore appears to lack substance. Further, in view of the fact that Autonomy received no cash (on a net basis) no economic benefits flowed to Autonomy and so IAS 18.14(d) was not met. Revenue should not therefore have been recognised on the sale.

6.86 Of course this says nothing about whether Autonomy used the products, rights and/or services that it bought from EMC. It appears that the net amount paid by Autonomy is attributable to the purchase of some or all of EMC's products, rights and/or services; and this amount should be capitalised by Autonomy, to the extent that it represents the fair value of the acquired hardware and software.

Schedule 5, Transaction 6 – MicroTech

Factual Summary

6.87 On 30 March 2011: (1) Autonomy Inc sold a software licence to MicroTech for $4,053,491 (including $193,023 in respect of support and maintenance for one year), payable in 6 instalments over a two year period from June 2011 to March 2013; and (2) Autonomy Inc and MicroTech entered into an agreement by which Autonomy Inc assigned the right to MicroTech to issue support invoices to, and collect related fees from Bank of America on its behalf (in a total of $4,503,880).

6.88 However, instead of issuing invoices to Bank of America, MicroTech issued invoices to Autonomy Inc for certain of the amounts owed by Bank of America (totalling $714,082 – which was paid on 10 June 2011). This payment of $714,082 by Autonomy Inc to MicroTech was equal to the amount MicroTech paid to Autonomy Inc on 1 September 2011.

6.89 The balance due from MicroTech to Autonomy Inc under the software licence agreement dated 30 March 2011 ($3.3 million) was cancelled.

Assumptions

6.90 Assumption 1: The sales transaction would not have occurred but for the assignment.

6.91 Assumption 2: The value of the rights assigned by the Autonomy group company to the counterparty exceeded the price paid by the counterparty to acquire Autonomy products and services such that the counterparty was entitled to substantial net amounts as part of the arrangements, although in the event there was a net nil cash movement.

Analysis

6.92 Autonomy appears to have made a sale of a software licence to MicroTech. However Autonomy did not purchase anything from MicroTech.

6.93 Rather, so as to put MicroTech in funds and thereby allow MicroTech to pay Autonomy for the software licence, Autonomy put in place an arrangement to allow MicroTech to receive funds from Bank of America that would otherwise have been the entitlement of Autonomy.

6.94 However, MicroTech did not avail themselves of this facility. Instead MicroTech issued invoices to Autonomy for certain of the amounts owed by Bank of America. Autonomy paid the invoices, and in turn MicroTech paid the same amount back to Autonomy. However, the reference to MicroTech issuing invoices to Autonomy, and to Autonomy paying the invoices, should not be taken to imply that Autonomy bought anything from MicroTech. The invoices were in reality just a request for funds.

6.95 In short, despite the structure that was put in place, Autonomy paid amounts to

MicroTech and MicroTech then returned those amounts to Autonomy. This is clearly a circular flow of funds and does not amount to settlement by MicroTech of its outstanding invoices.

6.96 The structure that Autonomy put in place, and the alternative of paying its own funds to MicroTech, demonstrate that the sale of a software licence to MicroTech had no substance, as there was clearly no intention that Autonomy would expect MicroTech to pay out of its own funds, and that IAS 18.14(d) was not met.

6.97 Therefore the sale of the software licence should not have been accounted for as revenue by Autonomy.

7. Hosting arrangements

Digital Safe transactions

Introduction

7.1. This part of my report concerns the accounting treatment of the hosted arrangements involving Digital Safe and/ or software to be used with Digital Safe, which are listed in Schedule 6 to the RRAPoC[110]. I understand that the Claimants do not take issue for the purpose of these proceedings with the accounting treatment for "on premise" deals, i.e. where Digital Safe was implemented at the customer's own site.

7.2. My understanding is that hosted Digital Safe arrangements involved Autonomy providing an archiving service to its customers whereby customers' data was stored in Autonomy's data centres in compliance with certain regulatory requirements. The Digital Safe software used by Autonomy in connection with the provision of this hosting service enabled the capture and indexing of customers' data to facilitate subsequent search and retrieval of the data. Prior to 2008, hosted customers were charged a fee for the hosting service on a per MB basis depending on the volume of data captured, indexed and archived in a Digital Safe, and revenue was recognised over the period during which the service was provided. The hosted Digital Safe transactions in Schedule 6 to the RRAPoC involved the sale of (i) a software licence and (ii) hosting and related services (at a reduced fee). Autonomy recognised the licence fee upfront and fees for the hosting and related services over the term that the services were provided.

7.3. I am asked to consider the appropriate accounting treatment, in particular the appropriate revenue recognition principles, for the hosted Digital Safe transactions (involving the payment of an upfront licence fee) listed in Schedule 6 to the RRAPoC, on the assumption that the key characteristics of such hosted deals were as follows:

7.3.1. After Autonomy sold customers licences to the Digital Safe software, new customers received substantively the same service as they would have done if they had contracted on a Software-as-a-Service (SaaS)[111] basis, and existing customers received substantively the same service as they had previously received under their prior SaaS arrangements, albeit under a different legal/ payment structure. The Digital Safe system (comprising the Digital Safe software - which performed the capture and index function - and the hardware) was at all times installed only at Autonomy's data centres.

7.3.2. A Digital Safe licence was of no independent value to a hosted customer. A customer could not customise, configure or implement the Digital Safe system (including the software) for use on its own premises. This could only be performed by Autonomy, using Autonomy's proprietary knowledge and

[110] Designated as "DS" (i.e. Digital Safe) Licence Type in Schedule 6 to the RRAPoC.
[111] Software-as-a-Service is a model in which software is centrally hosted and used by the customer on a subscription basis.

resources. The implementation process for use on a customer's premises was complex and took several weeks (at a minimum) to complete. Unless and until that process had been undertaken, the Digital Safe system was incapable of operation. Provision of the necessary Autonomy customisation, configuration and implementation services for the use of Digital Safe on a customer's premises did not generally form part of the contracts with hosted customers.

7.3.3. The Digital Safe system (including the software) required ongoing managed services (without which it would malfunction and ultimately stop working altogether). In practice, only Autonomy could provide these services and provision of them for use of Digital Safe on a customer's premises did not form part of the contracts with hosted customers.

7.3.4. There were no user-manuals regarding either the implementation or ongoing support and management of Digital Safe, and no third parties (let alone customers) who could provide such services.

7.3.5. Where hosted Digital Safe deals involved the sale of software other than the Digital Safe software, such software could only be used, or was sold for use, with Digital Safe.

7.3.6. The negotiations between Autonomy and the existing hosted customers preceding the restructured hosting transactions were largely instigated by Autonomy (not the customer). In the case of both new and existing customers the licence model was proposed by Autonomy and the negotiations largely centred on price (i.e. the amount that the customer would save over the lifetime of the contract). Autonomy's primary purpose in structuring the deals to include a licence was the upfront recognition of revenue.

7.3.7. The intention and understanding of both Autonomy and the customers was that, after the sale of the licence, the Digital Safe system and the customers' data would be hosted, and all associated services would be performed, by Autonomy at its data centres.

7.3.8. None of the hosted customers brought the Digital Safe system (comprising the Digital Safe software and accompanying hardware) in house.

Commercial observations

7.4. Before commenting on the appropriate accounting treatment, I would make the following observations about the commercial aspects of the hosted Digital Safe arrangements in Schedule 6 to the RRAPoC:

7.4.1. The service provided to the customer was the capturing, indexing and archiving of data to be stored in Autonomy's data centres. As I understand it, Autonomy received data for this purpose over the duration of the contract.

7.4.2. Autonomy used its Digital Safe software to provide the capturing, indexing and archiving services.

7.4.3. Although a new customer entering into a hosted arrangement was granted a licence to use the Digital Safe software, the software in fact remained in Autonomy's data centres and was used by Autonomy to provide the services to the customer. Even if a hosted customer wanted to take the Digital Safe system (including the software) on premise at some stage within the term of the software licence, the customer would not have had the technical knowledge and understanding to be able to make use of it. Therefore, to speak of granting to the customer a licence to use the Digital Safe software had no real meaning for practical purposes.

7.4.4. The position was the same for existing Digital Safe customers to whom Autonomy granted a new licence to use the Digital Safe software at the time of a renegotiation. Even where the new Digital Safe licence had additional features and/ or was for a longer period or greater capacity, to speak of granting to the customer a licence to use that software had no real meaning for practical purposes (while the longer period or greater capacity may have had value to the customer, that value was in the service to be received over the duration of the contract, not in the licence).

7.4.5. To the extent the hosted Digital Safe arrangements involved other software, that software was to be used with the Digital Safe software as part of the hosted Digital Safe arrangement and was not sold for use outside of that arrangement. As such, a licence to use other software had no real meaning for practical purposes.

Accounting analysis

7.5. I address first the hosted transactions involving the sale of a licence to the Digital Safe software; I address transactions involving the sale of a licence to software to be used with Digital Safe in paragraph 7.18 below.

7.6. As I explain in Chapter 3 at paragraph 3.15 onwards of my report, substance (also called 'economic substance' or 'substance over form') is an important underlying concept in accounting. Identifying substance is to some extent a matter of professional judgement, but the substance of a transaction or arrangement can most straightforwardly be described as being represented or observed by its commercial effect in practice. As quoted in chapter 3, the Conceptual Framework refers, in describing substance, to 'economic reality', which is a very similar notion to 'commercial effect in practice'. If a transaction has a particular legal form but the substance is different, it is the substance that determines the accounting treatment. If a transaction has no substance then it should have no accounting effect. The sale of a licence to Digital Safe had no commercial effect in practice and therefore no substance[112]. Particularly important in identifying substance are the assumptions stated in paragraphs 7.3.1, 7.3.6, 7.3.7 and 7.3.8 above. The substance of the arrangement was (for new customers) and continued to be (for existing customers) the services of capturing, indexing and archiving data throughout the contract period. These services were unaffected by the sale of a licence to the customer. The licence fee, when properly considered, was therefore payment towards the provision of these services. As I explain in further detail at paragraphs 7.11 to 7.17 below, the appropriate accounting treatment for the fees payable for such services (including the upfront licence fee) is:

7.6.1. For existing customers: continuation of recognition of revenue over the period that the services were rendered.

7.6.2. For new customers: recognition of revenue over the period that the services were rendered.

7.6.3. No upfront recognition of revenue in respect of the grant to the customer of the right to use the Digital Safe software. This is because, as illustrated in paragraphs 7.4.3 and 7.4.4 above, there was no commercial meaning or significance to such a grant. This view applies both to any grant of rights to new customers to use the Digital Safe software and to any grant as part of a renegotiation of a contract with an existing customer.

7.7. Further to the consideration of substance, an important issue in accounting for revenue is whether transactions should be considered together or separately. As already discussed in Chapter 3, this is set out in paragraph 13 of IAS 18. The simple starting assumption is that revenue recognition should be considered for each individual transaction. However, there are circumstances in which, for the purposes of determining the substance and therefore the accounting treatment, either: (a) what is apparently a single transaction needs to be broken down into two or more components; or (b) two or more transactions need to be considered together.

7.8. In the context of the hosted Digital Safe transactions in Schedule 6 to the RRAPoC, paragraph 13 of IAS 18 applies as follows. There were, in terms of legal structure and payment profile, two different components, that is, the grant of the licence and the provision of ongoing services. However, the licence for Digital Safe was not a separately identifiable component of the hosting arrangement that could be provided on a standalone basis, i.e. it could not be used by a customer independently from the hosting and related service components of a Digital Safe arrangement – it was not feasible, from a commercial or technical perspective, for the licence to be sold as a separable good (see Chapter 3, paragraphs 3.35 and 3.36). In reaching this conclusion I have relied, in particular, on the assumptions stated in paragraphs 7.3.2, 7.3.3 and 7.3.4. As a result, the revenue recognition criteria in IAS 18 should be applied to each Digital Safe transaction

[112] There was no substance in the sense that things carried on as before: the service provided was unaffected by the contractual changes that had been made. Of course there was a commercial effect to the extent that Autonomy reduced the overall price.

as a whole in accordance with its overall substance, namely the provision of a data hosting service over a period of time, with no part of the revenue recognised upfront (as set out above in paragraph 7.6).

7.9. As explained in Chapter 3, at paragraph 3.40, the revenue recognition criteria for the rendering of services are set out in paragraph 20 of IAS 18, as follows:

"When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the end of the reporting period. The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:

(a) *the amount of revenue can be measured reliably;*

(b) *it is probable that the economic benefits associated with the transaction will flow to the entity;*

(c) *the stage of completion of the transaction at the end of the reporting period can be measured reliably; and*

(d) *the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.*"

7.10. It seems to me likely that these criteria would be met for a typical Digital Safe transaction (though to be definitive in that conclusion one would need detailed information contract by contract). As to criterion (a): the initial revenue (identified as relating to the sale of the licence) would be known. The fees in subsequent periods (identified as relating to the hosting and related services) would not be known until those subsequent periods as they would be based on volumes processed in those periods. But when known, they would become part of the revenue for the year in question. As to criterion (b), collectability is unlikely to be a problem due to the front-loading of cash receipts. As to criterion (c) the contract has a clear timescale and consideration of stage of completion at any particular period is considered further in paragraph 7.16 below. As to criterion (d), the costs of the development of the software have been incurred prior to the contract; it should be possible to estimate with reasonable reliability that total costs (including future costs based on volumes processed and the overheads of the Digital Safe business) should not exceed total revenue, however I have seen no information regarding costs to enable a more definitive view. Further consideration is given to the pattern of costs over the period during which the services were rendered in paragraph 7.16 below. I note, however, that whether the criteria for the rendering of services are met does not seem to be in contention between the parties.

7.11. In general, the appropriate pattern of recognising the total revenue arising from a Digital Safe transaction is based on the work done in the various periods. The pattern of cash flows does not of itself affect the decision about the pattern, or timing, of revenue recognition. Paragraph 24 of IAS 18 says that "*[p]rogress payments and advances received from customers often do not reflect the services performed*". As the pattern of cash flows from the customer does not determine the pattern of revenue recognition, it follows that a change in the pattern of those cash flows does not determine it either.

7.12. I illustrate this with an example. If a cleaning company agrees a contract with a customer to clean its premises weekly for two years, the revenue would be recognised evenly over the two year period; and this would be the case whether the cash flows were (a) full payment upfront, (b) full payment in arrears (assuming collectability), (c) 24 monthly payments, or (d) any other pattern. Likewise, a change of terms during the contract from (say) continuing with the 24 monthly instalments to immediate payment of the remaining instalments, less a discount, would not change the pattern of recognition of revenue over 24 months (save that the total amount would be reduced by the early settlement discount).

7.13. In the context of accounting for a Digital Safe transaction as a service, the volumes processed in each period would be known at the end of each period and those volumes would be the basis of calculating the ongoing invoiced amounts. Those amounts would be recognised as revenue in the period of question. The question then arises as to how the upfront charge for the licence should be spread.

7.14. As noted in Chapter 3, at paragraph 3.42, paragraph 25 of IAS 18 states that:

"For practical purposes, when services are performed by an indeterminate number of acts over a specified period of time, revenue is recognised on a straight-line basis over the specified period unless there is evidence that some other method better represents the stage of completion. When a specific act is much more significant than any other acts, the recognition of revenue is postponed until the significant act is executed."

7.15. In commenting on this requirement, Ernst & Young cite outsourcing contracts and say:

"These arrangements are common across a wide range of services including processing, provision of telecommunications services, general professional advice, help desk support, accounting advice, maintenance and cleaning. The 'service' to which IAS 18's method applies is the individual act, whether it be the individual process, answering the telephone help line or cleaning the office each night. Clearly in most cases it would not be feasible to identify the costs and revenue for each of these acts so revenue is taken on a straight line over the contract term and costs are expensed as incurred." [113]

7.16. The question arises in the context of spreading the upfront licence fee whether the straight line approach should be followed or whether another basis is more appropriate. In my view, the straight line method is preferable. Paragraph 25 of IAS 18 (which prescribes the straight line method) deals with the situation of repetitive tasks and this suits the Digital Safe hosting transactions under consideration. Even if one wanted to mimic the pattern that the fees would have taken absent the introduction of the licence fee, it would in practice be difficult to do that, as it would involve forecasting the time required to get the Digital Safe system up and running, the volume of data to be ingested over the lifetime of the contract, when that data would be ingested, the level of related services to

[113] Ernst & Young, International GAAP 2011, page 1476

be provided and whether/ when any data would be removed from the Digital Safe system. The straight line method also has the attraction of being a reflection of the fact that, to the extent that the new contract featured a significant sum receivable upfront and a reduced amount receivable in subsequent periods, Autonomy's new economic position contained more fixed return and less return that depended on future (generally increasing) volumes.

7.17. In summary, there should be no upfront recognition of revenue from sales of Digital Safe software. The amount attributed to the licence should be recognised over the period that the services were provided, along with the other elements of the revenue from the contract. The pattern of recognition of the revenue over time should not be affected by the pattern of cash flows.

7.18. I understand that a number of the hosted Digital Safe transactions included in Schedule 6 to the RRAPoC involved the sale of software that was not itself Digital Safe. Given that I have been asked to assume that such software "*could only be used, or was sold for use, with Digital Safe*",[114] it follows that my conclusions above in respect of licences to use Digital Safe software apply also to licences to use such related software. If there was a sale of a licence and the software licensed was in fact used by the customer separately from Digital Safe, then the licence sale may qualify for immediate revenue recognition, depending on the exact situation. But where, as here, the software licensed could only be used, or was sold for use, with Digital Safe, the effect is the same as it is for the sale of a licence to the Digital Safe software itself. The services provided to the customer were unaffected by the sale of a licence to the customer; it had no commercial effect in practice and therefore no substance. There was nothing transferred to the customer that was of value independent of the provision of Digital Safe services.

7.19. For completeness, even if I am wrong about the substance of the Digital Safe transactions and whether the software licence was a separately identifiable component of the hosting arrangement (such that the revenue recognition criteria for the sale of goods – instead of the rendering of services - are applicable to the grant of the licence), I do not believe that those criteria were met.

7.20. The criteria in IAS 18 for sales of goods are set out in Chapter 3, but are repeated here for convenience, with my commentary in the second column:

[114] See the assumption in paragraph 7.3.5 above.

Para of IAS 18	Text	My commentary
14	*"Revenue from the sale of goods shall be recognised when all the following conditions have been satisfied:*	
(a)	*the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;*	In the hosted Digital Safe transactions, (i) the Digital Safe software remains used by Autonomy, sits on Autonomy's hardware in Autonomy's data centres and is maintained by Autonomy employees; (ii) even if the customer wanted to implement Digital Safe on premise, the customer would not be able to do so (without Autonomy). The sale of the licence has no effect on these features. To the extent a licence to other software is sold to be used with the Digital Safe system, Autonomy similarly retains the risks and rewards of ownership over that software (even where it sits on the customer's premises) as it is used as part of the hosted Digital Safe arrangement, which is operated and managed by Autonomy. It is clear that criterion (a) is not met: the risks and rewards relating to the Digital Safe system – including the software - remain with Autonomy (for example, if it malfunctioned, it would be for Autonomy to fix it or find another solution).
(b)	*the entity retains neither continuing managerial involvement to the degree usually associated with*	In the hosted Digital Safe transactions, Autonomy retains managerial involvement with the Digital Safe software in that the software is installed on its own servers, in its own

	ownership nor effective control over the goods sold;	premises and operated by its own people. Likewise it controls the software and the customer has no access to it in Autonomy's data centres. To the extent a licence to other software is sold to be used with the Digital Safe system, Autonomy similarly retains managerial involvement and control over that software (even where it sits on the customer's premises) as it is used as part of the hosted Digital Safe arrangement. Hence criterion (b) is not met.
(c)	*the amount of revenue can be measured reliably;*	A specific price is attributed to the software in the hosting contracts with customers. However, that price seems to be determined according to what cash flows were desired on various dates, rather than being based on any fair values (reliable or otherwise). Further, the Digital Safe contracts typically specify only a single price for all of the software provided, making it difficult (if necessary) to determine a reliable fair value for individual pieces of software. More evidence would be needed about the fair value of the licence before one could conclude on whether criterion (c) is met.
(d)	*it is probable that the economic benefits associated with the transaction will flow to the entity; and*	Assuming that the customer accepts the terms and the transaction goes ahead, collectability does not seem to be an issue. Hence criterion (d) is met.

(e)	*the costs incurred or to be incurred in respect of the transaction can be measured reliably."*	It appears that the majority of the costs of developing the software will have been incurred in the past, and so will be known and reliably measurable. It is possible that there would be future costs of customisation and installation and these might not be reliably measurable until the hosted Digital Safe or software to be used with Digital Safe was up and running. Subject to this last point, it is likely that criterion (e) is met.

7.21. In the case of the sale of goods, for revenue to be recognised, all five criteria need to be met. As shown in the Table, one is met; a further two may well be met, depending on the exact facts and evidence; but two ((a) and (b)) are not met (indeed, (a) and (b) would not be met at any time during the hosted arrangement). Therefore, paragraph 14 of IAS 18 as a whole is not met and the upfront recognition of revenue in respect of sales of licences in hosted Digital Safe transactions is non-compliant with IFRS. This conclusion applies both to any grant of rights to use the Digital Safe software or the software to be used with Digital Safe when a contract is signed and to any grant as part of the renegotiation of an existing contract.

7.22. The conclusion that the sale of the licence does not meet the criteria for recognition of revenue for sale of goods is consistent with my analysis (above) of the substance of the transaction as a service performed over a period and with my view that the licence is not a separately identifiable component of the hosting arrangement.

E-Discovery transactions

Introduction

7.23. This part of my report concerns the accounting treatment of the hosted e-Discovery arrangements listed in Schedule 6 to the RRAPoC[115]. I understand that the Claimants do not take issue for the purpose of these proceedings with the accounting treatment for "on premise" deals, i.e. where e-Discovery software was implemented at the customer's own site.

7.24. My understanding is that hosted e-Discovery arrangements involved Autonomy providing a variety of services to its customers in connection with the electronic discovery process in legal proceedings. The e-Discovery software was hosted in Autonomy's data centres (where the customer's data was also stored) and used by

[115] Designated as "ED" (i.e. e-Discovery) Licence Type in Schedule 6 to the RRAPoC.

Autonomy in connection with the provision of the electronic discovery services, enabling the collection, review/ interrogation and production of data in legal proceedings or investigations. Prior to 2008, hosted customers were charged a unit price for each of the various services that were provided, and revenue was recognised over the period during which the services were provided. The hosted e-Discovery transactions in Schedule 6 to the RRAPoC involved the sale of (i) a software licence and (ii) hosting and other e-Discovery services (at a reduced fee). Autonomy recognised the licence fee upfront and fees for the hosting and other e-Discovery services over the term that the services were provided.

7.25. I am asked to consider the appropriate accounting treatment, in particular the appropriate revenue recognition principles, for the hosted e-Discovery transactions (involving the payment of an upfront licence fee) listed in Schedule 6 to the RRAPoC, on the assumption that the key characteristics of such hosted deals were as follows:

7.25.1. Autonomy performed a variety of services as part of its hosted e-Discovery offering, many of which (e.g. performing quality control checks, resolution of data imaging/ processing issues, e.g. from password protected, encrypted or corrupted documents, data culling, batching, report production, format conversion and load file creation) were not performed automatically by the software, but rather required action or intervention by Autonomy personnel. This process was akin to a production line requiring a significant level of involvement from Autonomy staff at each stage of the e-Discovery process.

7.25.2. With the exception of the deals with BP, the term of each of the hosted e-Discovery licences was relatively short (two to three years) and Autonomy was contracted to provide services for the duration of the term. BP had a perpetual licence with a limited capacity and Autonomy was contracted to provide services for an initial term of three years. During the initial three year period BP was to pay a monthly Application Service Fee of $4/ GB/ month, following which the Application Service Fee increased to $10/ GB/ month.

7.25.3. Each hosted e-Discovery customer received substantially the same service regardless of whether it had acquired a licence, i.e. the same service as a customer who contracted on a SaaS basis; only the legal/ payment structure varied. Existing hosted customers who had originally contracted on a SaaS basis received substantially the same service as they had previously.

7.25.4. Unlike the Digital Safe software, the e-Discovery software was capable of being used independently of an Autonomy hosted arrangement, but was either sold as standalone software (which the customer would use itself, without Autonomy providing e-Discovery services) or as part of a hosted arrangement. If a hosted customer decided to take the e-Discovery software on premise during the term of the licence, Autonomy would not have provided the services that the customer expected to receive and for which it had effectively prepaid through payment of the upfront licence fee. Generally, it would not have been practicable for the hosted customers to take the software and the data in-house to perform the services themselves.

7.25.5. The intention and understanding of both Autonomy and the customers was that the software and data would be hosted and maintained by Autonomy in its data centres, and the associated e-Discovery services would be performed by Autonomy, for at least the contractually agreed period. This is what happened in practice.

7.25.6. The negotiations between Autonomy and the customers were focused on price. Autonomy typically introduced the option of an upfront licence fee and highlighted the significant discounts it offered the customer as compared to the price on a SaaS basis. From the perspective of the customers, the transactions involved the purchase of hosted e-Discovery services with an upfront prepayment in the form of a licence fee. Autonomy's primary purpose in structuring the deals to include a licence was the upfront recognition of revenue.

7.25.7. Autonomy management did not have an established fair value for each of the individual components of hosted e-Discovery deals.

7.25.8. There was only a small number of hosted e-Discovery deals including an upfront licence fee and they differed materially in terms of authorised users, capacity/ limitations, structure of pricing, contract term and the prices charged.

7.25.9. Autonomy did not apply standard prices for e-Discovery software licences sold for use independently of an Autonomy hosting arrangement.[116] Software was sold to different customers by Autonomy at different prices depending on the individual customer's perception of the value of the software to that particular customer in that particular customer's environment.

7.25.10. There was no standard or quoted price list for the different services provided in hosted e-Discovery deals involving the purchase of a licence. There was a price list for these services when provided as part of a SaaS deal, but this did not take into account the price paid for a licence. Similarly, the price lists attached to the hosting contracts were for services to be provided beyond the licence term and/ or capacity, and therefore did not take into account the price paid for a licence. In any event, price was often heavily negotiated such that there was no "typical charge" for the individual components of a hosted e-Discovery deal.

7.25.11. There was no disaggregated management information relating to the cost of providing the individual components of hosted e-Discovery deals. In particular, Autonomy did not record costs by business area (e.g. for e-Discovery or components thereof) nor did it prepare management accounts containing a profit and loss/ contribution statement by business area.

[116] For the avoidance of doubt, such transactions do not form part of the Claimants' case and are therefore not included in Schedule 6 to the RRAPoC.

7.25.12. The infrastructure and costs involved in delivering a hosted e-Discovery service are different to a hosted Digital Safe service. The two types of deal are not comparable in terms of cost or fair value.

Commercial observations

7.26. Before commenting on the appropriate accounting treatment, I would make the following observations about the commercial aspects of the hosted e-Discovery arrangements in Schedule 6 to the RRAPoC:

7.26.1. The service provided to the customer was the electronic discovery services (enabling customers to collect, review/ interrogate and produce data in legal proceedings including both litigation and investigations) in respect of data that was stored in Autonomy's data centres.

7.26.2. Autonomy used its e-Discovery software in providing the e-Discovery services.

7.26.3. Although a new customer entering into a hosted arrangement was granted a licence to use the e-Discovery software, the software in fact remained in Autonomy's data centres and was used by Autonomy to provide the e-Discovery services to the customer. Therefore, to speak of granting to the customer a licence to use the e-Discovery software had no real meaning for practical purposes.

7.26.4. The position was the same for existing e-Discovery customers to whom Autonomy granted a new licence to use the e-Discovery software at the time of a renegotiation. Even where the new e-Discovery licence had additional features and/ or was for a longer period or greater capacity, to speak of granting to the customer a licence to use that software had no real meaning for practical purposes (while the longer period or greater capacity may have had value to the customer, that value was in the service to be received over the duration of the contract, not in the licence).

Accounting analysis

7.27. I comment first on the accounting treatment of all the hosted e-Discovery transactions in Schedule 6 to the RRAPoC save for the two deals with BP in Q2 2010. The BP transactions are discussed in paragraph 7.31 below.

7.28. In the same way that substance, as addressed in detail at paragraph 7.6 above, is relevant in the Digital Safe context, it is also relevant in the e-Discovery context. The sale of an e-Discovery licence as part of a hosted arrangement had no commercial effect in practice and therefore no substance. Particularly important in identifying substance are the assumptions in paragraphs 7.25.3 and 7.25.5 above). The substance of the transaction was (for new customers) and continued to be (for existing customers) the provision of e-Discovery services including data capture, processing, indexing, archiving and production. These services were unaffected by the sale of an e-Discovery licence. The licence fee, when properly considered, was therefore an advance payment for the provision of these services. As I explain in further detail at paragraphs 7.33 to 7.35 below, the appropriate accounting treatment for the fees payable for such services (including the upfront licence fee) is:

7.28.1. For existing customers: continuation of recognition of revenue over the period that the e-Discovery services were rendered.

7.28.2. For new customers: recognition of revenue over the period that the e-Discovery services were rendered.

7.28.3. No upfront recognition of revenue in respect of the grant to the customer of the right to use the e-Discovery software. This is because, as illustrated in paragraphs 7.26.3 and 7.26.4 above, there is no commercial meaning or significance to such a grant. This view applies both to any grant of rights to new customers to use the e-Discovery software and to any subsequent grant as part of a renegotiation of an existing contract.

7.29. As I explain in Chapter 3 and paragraph 7.7 of this chapter (in the context of Digital Safe), further to the consideration of substance, an important issue in accounting for revenue is whether transactions should be considered together or separately.

7.30. In the context of the e-Discovery transactions, paragraph 13 of IAS 18 applies as follows. There were, in terms of legal structure and payment profile, two different components, that is, the grant of the licence and the provision of ongoing services. The assumption in paragraph 7.25.4 sets out that the e-Discovery software was capable of being sold and operated independently of an Autonomy hosted arrangement. However, the on premise arrangements in which e-Discovery software was sold and operated independently of an Autonomy hosted arrangement are different from the hosted transactions; and the fact that, in those independent transactions, the software licence was considered to be a separately identifiable component of the overall arrangement, says nothing about how the licence is to be regarded in the hosted e-Discovery arrangements. Paragraph 13 of IAS 18 provides for the revenue recognition criteria to be applied to each component individually if it is necessary in order to reflect the substance of the transaction. Given that the assumptions in paragraphs 7.25.4 and 7.25.5 also state that it was not generally practicable for customers to take the software and their data in-house to perform the e-Discovery services themselves, and that it did not happen in practice in the transactions under consideration, this supports my view expressed above that there was no substance to the grant of the licence. The revenue recognition criteria should therefore be applied to the transaction as a whole in order to reflect the combined substance of the two elements of the transaction taken together, which, as I previously stated, was the provision of e-Discovery services over a period of time.

7.31. As noted above, the facts relating to the BP contracts are slightly different. However, the fact that BP had a perpetual licence does not affect my analysis of the substance of the transaction or its accounting treatment, as in practice (based on the assumptions in paragraphs 7.25.2, 7.25.3 and 7.25.4): (i) the licence was limited; (ii) BP was also receiving substantially the same service as the other hosted e-Discovery customers; (iii) it was impracticable for BP to take the software in-house; and (iv) the perpetual licence gave BP no more control over the software whilst hosted than if the licence was for a finite period. That is, in substance the BP contract is similar to the other e-Discovery contracts. There was a low monthly Application Service Fee in the initial three years compared with a higher monthly Application Service Fee subsequently, but its only significance, other than strengthening my conclusion in relation to criterion (c) of paragraph 14 of IAS 18 (set out in paragraph 7.37 below), is that the initial contract should have been reviewed to see if it was loss-making. If so, provision for the losses should have been made. But this is an entirely different matter from whether revenue should have been recognised upfront in respect of the licence.

7.32. As I explain in paragraph 7.9 above, the revenue recognition criteria for the rendering of services are set out in paragraph 20 of IAS 18. It seems to me likely that the criteria would be met for a typical e-Discovery transaction (though to be definitive in that conclusion one would need detailed information contract by contract). As to criterion (a): the initial revenue (identified as relating to the sale of the licence) would be known. The fees in subsequent periods would not be known until those subsequent periods as they would be based on volumes in those periods. But when known, they would become part of the revenue for the year in question. As to criterion (b), collectability is unlikely to be a problem due to the front-loading of cash receipts. As to criterion (c) the contract has a clear timescale and consideration of stage of completion at any particular period is considered further in paragraph 7.34 below. As to criterion (d), the costs of the development of the software have been incurred prior to the contract; it should be possible to estimate with reasonable reliability that total costs (including future costs based on volumes processed, the level of services provided and the overheads of the e-Discovery business) should not exceed total revenue, however I have seen no information regarding costs to enable a more definitive view. Further consideration is given to the pattern of costs over the period during which the services were rendered in paragraph 7.34 below. I note, however, that whether the criteria for the rendering of services are met does not seem to be in contention between the parties.

7.33. As I explain in paragraph 7.11 above in the Digital Safe context, in general, the appropriate pattern of recognising the total revenue arising from an e-Discovery transaction is based on the work done in the various periods. The pattern of cash flows, or a change in the pattern of cash flows, does not of itself affect the decision about the pattern, or timing, of revenue recognition.

7.34. In the context of accounting for an e-Discovery transaction as a service, the volumes processed/ services provided in each period would be known at the end of each period and would be the basis of calculating the ongoing invoiced amounts. Those amounts would be recognised as revenue in the period in question. The question then arises as to how the upfront charge for the licence should be spread. As set out at paragraphs 7.14 and 7.15 above, paragraph 25 of IAS 18 and the Ernst & Young commentary are relevant to this question. In my view, the straight line method is preferable. Paragraph 25 of IAS 18 (which prescribes the straight line method) deals with the situation of repetitive tasks and this suits the e-Discovery hosting transactions under consideration Even if one wanted to mimic the pattern that the fees would have taken absent the introduction of the licence fee, it would in practice be difficult to forecast the future demand for e-Discovery services, which might increase or, if a significant case was disposed of, decrease significantly. It would involve forecasting the volume of data to be ingested over the lifetime of the contract, when that data would be ingested, the level of e-Discovery services required over the contract, the level of Autonomy involvement required and whether/ when any data would be removed. The straight line method also has the attraction of being a reflection of the fact that, to the extent that the new contract featured a significant sum receivable upfront and a reduced amount receivable in subsequent periods, Autonomy's new economic position contained more fixed return and less return that depended on future services.

7.35. In summary, there should be no upfront recognition of revenue from sales of e-Discovery software. The amount attributed to the licence should be recognised over the period that the services were provided, along with the other elements of the revenue from the contract. The pattern of recognition of the revenue over time should not be affected by the pattern of cash flows.

7.36. For completeness, even if I am wrong in my conclusions about the substance of the e-Discovery transactions (such that the revenue recognition criteria for the sale of goods apply to the grant of the licence), I do not believe that those criteria were met.

7.37. As I explain at paragraph 7.21 above, in the case of the sale of goods, for revenue to be recognised, all five criteria in paragraph 14 of IAS 18 need to be met. Three criteria ((a), (b) and (c)) were not met in the e-Discovery context. As regards criterion (a), I refer to the assumption in paragraph 7.25.5 which sets out that the data and e-Discovery software were hosted by Autonomy in its data centres, and the assumption in paragraph 7.25.4 which sets out that it would not generally have been practicable for hosted customers to take the software and data in-house to perform the e-Discovery services themselves. As regards criterion (b), I refer again to assumption 7.25.5. As regards criterion (c), generally speaking it might be possible to establish a reliable fair value of individual components based on: (i) price (those components being sold at broadly consistent prices by the company in question and/ or in the wider market); or (ii) cost plus margin (i.e. the fully absorbed cost of performing/ providing those components, plus an appropriate profit margin). However, in the case of e-Discovery, the assumptions in paragraphs 7.25.7 to 7.25.12 indicate that there was: (i) a high degree of variability in the prices charged for the e-Discovery software and related services in a hosting arrangement; and (ii) a lack of sufficiently disaggregated and relevant management information relating to costs. This means that it would not have been possible to reliably measure the revenue attributable to the software licence, either using the residual method (i.e. where fair value is capable of being established in respect of all other components of the transaction and therefore a fair value is attributed to, in this case, the licence, by reference to the residual amount of the revenue for the transaction) or otherwise.

7.38. Therefore, paragraph 14 of IAS 18 as a whole was not met and the upfront recognition of revenue in respect of sales of licences in hosted e-Discovery transactions was non-compliant with IFRS. The revenue should have been recognised over a period of time, with no part of the revenue recognised upfront (as set out above at paragraph 7.35). This conclusion applies both to any grant of rights to use the e-Discovery software when a contract is signed and to any grant as part of the renegotiation of an existing contract.

7.39. The conclusion that the sale of the licence does not meet the criteria for recognition of revenue for sale of goods is consistent with my analysis (above) of the substance of the transaction as a service performed over a period.

Schedule 6 Q2 2011 Iron Mountain transaction

Introduction

7.40. I am asked to consider the appropriate accounting treatment, in particular the appropriate revenue recognition principles, for the Q2 2011 Iron Mountain transaction listed in Schedule 6 to the RRAPoC. I have read Schedule 6, Note 11 of the RRAPoC. I have been asked to assume the following:

7.41. On 3 June 2011, Autonomy Corporation plc acquired the Iron Mountain Digital (“**IMD**”) business from Iron Mountain Inc. Autonomy Inc entered into a $9.5 million VAR agreement with Iron Mountain Information Management Inc ("**Iron Mountain**"), with an effective date of 3 June 2011. The VAR agreement permitted Iron Mountain to resell various IMD products, service products and support. The VAR agreement stipulated a one-time, non-cancellable and non-refundable fee of $9.5 million, of which:

- $1.5 million was in respect of an "*ARM [Autonomy Records Manager] Prepaid License Fee*"; and
- $8 million was in respect of prepaid royalty fees for resale by Iron Mountain of:

a) products: Connected Backup (licensed model) and NearPoint ("**Products**");
b) service products: Autonomy LiveVault Services, Autonomy Connected Backup Services, Autonomy Tape Restoration Services and Digital Records Center Compliant Messaging (DRC-CM) Services (or any successor service offering) ("**Service Products**"); and
c) support services ("**Support**"),

throughout the three year term of the VAR agreement.

7.42. On 30 June 2011, Autonomy Inc recognised licence revenue of $9.5 million.

7.43. Autonomy initially delivered one copy of the Products to Iron Mountain and Iron Mountain was able to make additional copies of the Products only to the extent required for demonstration, training or development purposes. Iron Mountain was required to submit a written purchase order to Autonomy for each resale of the Products, Service Products and Support. Autonomy had the right to reject any purchase order prior to the shipment of the Products or provision of the Service Products and / or Support. To the extent that Iron Mountain would go on to sell Products to end customers, Autonomy would therefore still have to deliver the Products, on an order by order basis.

7.44. The Service Products involved Autonomy providing services to the end customers, including hosting the end customers' data for an agreed period of time.[117] To the extent Iron Mountain would go on to sell Service Products to end customers, Autonomy retained an ongoing obligation to Iron Mountain to provide their customers with hosted services.

7.45. Autonomy also had ongoing obligations to provide Second Line Support services to Iron Mountain in respect of the Products and Service Products. The annual fee for the Second-Line Support of the Products and Service Products would be 10% of the amounts paid by the end customer to Iron Mountain for the Products and Service Products.

7.46. The VAR agreement sets out the basis of the royalty fees due from Iron Mountain for each of the Products and Service Products (in each case calculated as a percentage, either 50% or 70% of the fee charged by Iron Mountain to the end customer).

7.47. Iron Mountain would not owe Autonomy any further fees for the Products, Service Products and Support until the total aggregate value of fees due from Iron Mountain reached $8 million. Thereafter, fees would be due in accordance with the terms of the VAR agreement i.e. calculated on the same basis as during the utilisation of the $8 million.

7.48. The utilisation of the $8 million was dependent on the combination (unknown at the outset of the VAR agreement and which would not have been possible to reliably predict at the time the VAR agreement was entered into) of Products and Service Products that Iron Mountain would go on to resell, the level of Support associated with each and the prices charged by Iron Mountain to the end customers.

7.49. Records were kept by Autonomy of the sales made by Iron Mountain and the royalty fees earned by Autonomy, in order to calculate and monitor the utilisation of the $8 million prepayment. The records show that:

(a) As at 30 June 2011, only negligible sales had been made by Iron Mountain and Autonomy had only just started to provide the services associated with the Service Products and the Support;

(b) The vast majority of the sales made by Iron Mountain under the VAR agreement were of Autonomy LiveVault Services and Autonomy Connected Backup Services, both Service Products involving Autonomy hosting the end customers' data; and

[117] An exception was the Autonomy Tape Restoration Services, which were professional services.

(c) As at March 2013, $3.7 million (of the $8 million prepaid royalty fee) had been utilised.

Accounting analysis

7.50. The effective date of the VAR agreement was 3 June 2011, being the same date as Autonomy acquired the IMD business from Iron Mountain Inc. Therefore the two transactions need to be considered together.

7.51. The payment of $8 million is termed a prepaid royalty fee and no further fees are payable until the prepaid royalty fee has been used up. Thereafter, fees are payable in accordance with the terms of the VAR agreement. It is possible that the payment of $8 million could have been set at a different amount but, due to the operation of the VAR agreement, that would mainly have been a matter of bringing forward or delaying the date as of which the prepayment is used up and royalties again become payable. Therefore the VAR agreement seems to operate independently of the acquisition of the IMD business, even though the two occurred on the same date.

7.52. The accounting treatment adopted for the $8 million was to recognise it immediately as revenue on 30 June 2011. Although the $8 million was termed a prepaid royalty fee, it was in substance a prepayment in respect of the sale of goods (in relation to Iron Mountain's future sales of Products), hosting services to be provided by Autonomy to Iron Mountain's end customers (in relation to Iron Mountain's future sales of Service Products) and Support services to be provided by Autonomy to Iron Mountain.

Sales of goods

7.53. As explained in Chapter 3, paragraph 3.38 above, the revenue recognition criteria for the sales of goods are set out in paragraph 14 of IAS 18. I consider the various limbs within paragraph 14 of IAS 18 in Chapter 3, paragraphs 3.38 to 3.39. It seems clear from paragraph 7.43 above, that Autonomy does have continuing obligations under the VAR agreement and that Autonomy retained effective control over the Products until the individual purchase orders were received from Iron Mountain and the Products had been delivered by Autonomy. Autonomy would not have transferred the risks and rewards of ownership of the Products until that time (IAS 18, paragraphs 14 (a) and (b)).

7.54. Furthermore, considering paragraph 7.48 above, it seems to me that, at the time the VAR agreement was entered into, it was not possible to reliably measure the portion of the $8 million that would ultimately arise from the sales of Products by Iron Mountain. This would only be known when the sales of Products had been made (IAS 18, paragraph 14 (c)). It would have been possible for Autonomy to recognise a portion of the $8 million prepayment upfront only to the extent Autonomy had delivered the Products by 30 June 2011. However, this does not appear to be the case.

7.55. In summary, revenue should have been recognised as the sales of the Products were made and the Products were delivered by Autonomy.

Rendering of services

7.56. Revenue for the rendering of services should have been recognised as those services were delivered, in accordance with paragraphs 20 and 25 of IAS 18 (which I referred to earlier in this Chapter at paragraphs 7.9, 7.14 and 7.15). Paragraph 7.49(a) above states that, as at 30 June 2011, only negligible sales had been made by Iron Mountain and Autonomy had only just started to provide the services associated with the Service Products and the Support. Therefore, by reference to the "*stage of completion*" in paragraph 20 of IAS 18, only negligible revenue should have been recognised by Autonomy as at 30 June 2011.

Royalties

7.57. As explained in paragraph 7.52 above, although the $8 million prepayment was termed a prepaid royalty fee, it was in substance a prepayment in respect of future sales of goods and provision of services and support. Even if a portion of the $8 million relating to the future sales of Products could be said to be royalties, the requirements of IAS 18 in respect of royalties would result in the same accounting treatment as described above. The revenue recognition criteria for royalties are set out in the following paragraphs of IAS 18:

"*Revenue arising from the use by others of entity assets yielding interest, royalties and dividends shall be recognised on the bases set out in paragraph 30 when:*

(a) It is probable that the economic benefits associated with the transaction will flow to the entity; and

(b) The amount of the revenue can be measured reliably." (Paragraph 29)

"*Royalties shall be recognised on an accrual basis in accordance with the substance of the relevant agreement.*" (Paragraph 30(b)

"*Royalties accrue in accordance with the terms of the relevant agreement and are usually recognised on that basis unless, having regard to the substance of the agreement, it is more appropriate to recognise revenue on some other systematic and rational basis.*" (Paragraph 33)

Paragraphs 29, 30 (b) and 33 of IAS 18 say that royalty income should be recognised when the revenue is earned. In the present context, that would mean (on the basis that Autonomy retained effective control of, and an ongoing obligation to deliver, the Products) when Iron Mountain sold the relevant Products to end customers and Autonomy delivered the Products. This is consistent with the accounting treatment in relation to the sales of goods. If the provision of services associated with the Service Products or Support were to be assessed by reference to the requirements for royalties, revenue should only have been recognised as described above in paragraph 7.56 in relation to the rendering of services.

A non-refundable and non-cancellable fee

7.58. It could be argued that the $8 million is received and is non-refundable and non-cancellable; that Autonomy has done all that it needs to do in order to earn this royalty revenue; that it has no further obligations; and therefore that the whole $8 million can be recognised as immediate revenue, in my view that would be incorrect, based on the details set out above. It seems clear to me from paragraphs 7.43, 7.44 and 7.45 above that Autonomy does have continuing obligations. Even though it is Iron Mountain that is conducting the sale of the Products, Service Products and Support to the end customer, nonetheless Autonomy is involved in the delivery of those Products, the provision of hosting services in respect of the Service Products and the provision of Support to Iron Mountain. Because of this, Autonomy should have recognised the revenue when it had (i) delivered the Products, (ii) performed the hosting services relating to the Service Products and (iii) provided the Support**.**

8. <u>"Other" transactions</u>

Schedule 7, Transaction 1: Tottenham Hotspur PLC ("THS")

Facts

<u>Transaction 1</u>

8.1. On 30 June 2010, ASL entered into an agreement with THS to provide software licences, Optimost services, a production server and support and maintenance for a total of £3.9 million. ASL was also to provide 200 days' professional services for an additional fee of £100,000 in order to provide THS with "*a fully implemented system*". The licences were "*to enable a system to provide the following functions at the level found in a Premiership football club's ordinary operations: CRM, ticketing, player analysis, retail, internet and web design. It is the goal of the parties for Licensee to represent the most technically advanced club amongst its peers*". Usage of the software was limited to Licensee's website and associated domains owned by Licensee ("**Sale 1**").

8.2. On 5 July 2010, ASL and Autonomy entered into a Shirt Sponsorship Agreement with THS. The sponsorship fee in the first season, 2010/11 was £9 million. The fee for the 2011/12 season was £12 million, to be reduced to £9 million if THS failed to generate £4 million of "Qualifying Revenues". Qualifying Revenues were revenues from sales by Autonomy to customers introduced by THS. THS was entitled to a MAF (payable on a quarterly basis) of 30% of all Qualifying Revenues ("**Purchase 1**").

<u>Transaction 2</u>

8.3. On 31 March 2011, ASL entered into a further agreement with THS to provide additional software licences and managed services. The licence fee was £4 million plus a support and maintenance fee of £200,000 ("**Sale 2**").

8.4. Also on 31 March 2011, the Shirt Sponsorship Agreement was amended so as (1) to increase the sponsorship due for the 2011/12 season from £9 million to £11 million and (2) to alter the definition of Qualifying Revenues to include licence revenues paid by THS to ASL (including the £3.9 million payable to ASL under Sale 1 and the £4 million due under Sale 2). The effect of this last element of the amendment was that a MAF of £2,370,000 was due from AU to THS ("**Purchase 2**").

8.5. Further details are set out in Schedule 7 (Transaction 1) of the RRAPoC.

Assumptions

8.6. Assumption 1: The software was not of use to THS until the system described in the Sale 1 Agreement had been delivered.

8.7. Assumption 2: As regards Sale 1, there was no defined statement of work for the project, no key delivery milestones against which a meaningful assessment of the stage of completion for the project could be measured, no definition of deliverables and no defined acceptance criteria.

8.8. Assumption 3: As at 31 December 2010, no services had been provided by ASL so no costs had been incurred.

8.9. Assumption 4: Sale 2 did not deliver any significant incremental value to THS (the licensed software formed part of the overall project to deliver THS' website requirements). Similarly, Purchase 2 did not deliver any significant incremental value to ASL.

8.10. Assumption 5: Sale 2 and Purchase 2 were entered into on the same day and were for broadly the same value (Sale 2: £4.2 million, Purchase 2: £2 million additional sponsorship and £2.37 million MAF = £4.37 million).

8.11. Assumption 6: Assumption 2 applied equally to Sale 2.

8.12. Assumption 7: At 30 June 2011, THS had not received a working solution from ASL.

8.13. Assumption 8: At 30 June 2011, it is estimated that 213 days of professional services had been provided by ASL to THS at a cost of $341,280.

Analysis

8.14. It appears that:

8.14.1. The timing of the transactions indicates that the sales to THS and the Sponsorship agreement are linked. They therefore need to be considered together (IAS 18.13).

8.14.2. The substance of the deliverable to be provided by Autonomy to THS was a working 'solution' (i.e. "*a fully implemented system*" as referred to at paragraph 8.1 above), not simply a piece of software. The provision of services appears integral to that solution.

8.14.3. Hence, nothing of immediate value was transferred to THS on either 30 June 2010 or 31 March 2011. Therefore no revenue should have been recognised (on Sale 1 or Sale 2) at either of those dates.

8.14.4. As regards Transaction 1, the deliverable was not well-defined (assumption 2). Hence, it was not possible to measure with any reliability important measures such as the stage of completion or costs to complete the project (as is required in order to recognise revenue from services under IAS 18 paragraph 20 – see Chapter 3 for more detail).

8.14.5. At 31 December 2010, no costs had been incurred and no services provided to THS (assumption 3). So there was no revenue and no cost to account for in the 31 December 2010 accounts.

8.14.6. As at 30 June 2011, THS had not received a working solution (assumption 7) although some work had been carried out (assumption 8). Autonomy should only have recognised revenue to the extent that recoverable costs had been incurred (IAS 18 paragraph 26).

8.14.7. I note from paragraph 1.4 above that, upon the change of terms as at 31 March 2011, a Marketing Assistance Fee (MAF) was payable by Autonomy to THS based on amounts that included the sales made by Autonomy to THS. It is difficult to understand how THS could assist in the marketing of Autonomy's services to itself (i.e. to THS). This appears to be an artificial arrangement.

8.15. Assumptions 4 and 5 suggest that Sale 2 and Purchase 2 were linked and therefore need to be considered together (IAS 18 paragraph 13). Similar considerations to those set out in Chapter 6 would then apply.

Schedule 7, Transaction 2: PRISA

Facts

8.16. On 10 December 2010, Autonomy Spain SL, an Autonomy group company ("**AU**") and Ediciones El Pais S.L. (on behalf of itself and Prisa Digital S.L. ("**Prisa**")) entered into an Agreement for the sale by AU of software, support and maintenance and 2,640 days of professional services (at a rate of €850 per day) and 15 days of training to Prisa, for use on Prisa's website, audio, video and other digital products. Fees totalled €9.6m (€6.8m in respect of software licenses).

8.17. The Agreement stipulated the terms relating to the professional services and called for the parties to agree on a statement of work.

8.18. Prisa was permitted to use the software "*for the purposes of digitising Licensee Content by searching and indexing ... the Licensee's (i) websites...(ii) and audio, video, and other digital products*".

8.19. Further details are set out in Schedule 7 (Transaction 2) of the RRAPoC.

Assumptions

8.20. Assumption 1: The goods and services provided under the Agreement were intended to transform Prisa's existing operations into more digital web-based products. A substantial amount of services were expected to be required to deliver the project.

8.21. Assumption 2: At the time the licence revenue was recognised (31 December 2010) there was no clear statement of work for the project, nor were the deliverables or acceptance criteria defined.

8.22. Assumption 3: As at 31 December 2010, no services had been provided to Prisa.

8.23. Assumption 4: The only significant statement of work agreed with Prisa related to the CadenaSer website project. This was agreed in December 2011.

8.24. Assumption 5: At 30 June 2011, Prisa had not received a working solution from AU.

8.25. Assumption 6: At 30 June 2011, it is estimated that 592 days of professional services had been provided by AU to Prisa at a cost of $947,000.

Analysis

8.26. From the assumptions and facts above and Schedule 7, it seems clear that Autonomy was in substance providing to Prisa a 'solution' (i.e. the system referred to at paragraph 8.18 above), not simply a piece of software. The provision of services appears integral to that solution.

8.27. Nothing of immediate value was transferred to Prisa on 31 December 2010. Accordingly no revenue should have been recognised on that date.

8.28. There was no clear statement of work for the project, nor were the deliverables or acceptance criteria defined (assumption 2). In these circumstances, it is not possible to measure the costs reliably (as is required in order to recognise revenue from services under IAS 18 paragraph 20 – see Chapter 3 for more detail).

8.29. At 30 June 2011, Prisa had not received a working solution from AU (assumption 5), although some work had been carried out (assumption 6). Autonomy should only have recognised revenue to the extent that recoverable costs had been incurred (IAS 18 paragraph 26).

Schedule 7, Transaction 3: Amgen

Facts

8.30. On 21 December 2010, Autonomy Inc. and Amgen entered into a Hosting Services and License Addendum.

8.31. Under the Hosting Services and License Addendum, Autonomy sold Amgen a licence to software called Autonomy Anywhere Archive for a fee of $3.5 million and infrastructure and support for a fee of $6,379,363.

8.32. Further details are set out in Schedule 7 (Transaction 3) of the RRAPoC.

Assumptions

8.33. I have been asked to assume the following:

8.33.1. Under the Hosting Services and License Addendum, Autonomy would provide Amgen with hosted Digital Safe services using infrastructure dedicated for Amgen's sole use.

8.33.2. Both the infrastructure and Autonomy Anywhere Archive were to be used with the Digital Safe solution. Autonomy Anywhere Archive was to operate as "*an add-on module for the archive*" and was to be used "*only and solely in connection with the access of Company Data archived in the Digital Safe system*" (Hosting Services and License Addendum).

8.33.3. The assumptions set out at paragraphs 7.3.2 to 7.3.7 above in respect of Digital Safe hosting transactions apply equally here.

8.33.4. No meaningful delivery of the Digital Safe solution had occurred by 31 December 2010 or by the end of the relevant period (30 June 2011) – Digital Safe had not been implemented and no hosting services had been provided to Amgen prior to this date.

Analysis

8.34. In my accounting analysis of hosted Digital Safe transactions at paragraphs 7.5 to 7.22 above, I explained that there was no substance to the sale of a licence to Digital Safe software (or software to be used with Digital Safe) and, further, that a licence to Digital Safe software (or software to be used with Digital Safe) was not a separately identifiable component of the hosting arrangement. Any revenue from the sales of such software licences (in this case, the sale to Amgen of a licence to Autonomy Anywhere Archive, which was software to be used with Digital Safe) should, for the same reasons, have been recognised over the period that the hosting services were provided.

8.35. The Hosting Services and License Addendum (dated 21 December 2010) included, in addition to the software licence fee for Autonomy Anywhere Archive, service fees which included a $6.3 million fee in respect of infrastructure and support. I have been asked to assume (at paragraph 8.33.1 above) that the charge for infrastructure and support was to cover, amongst other services, the hosting of Amgen's data on dedicated servers (as opposed to on servers shared by multiple customers) in Autonomy's facilities. Regardless of whether Digital Safe was on dedicated servers or not, the arrangement as a whole was the provision of a hosted Digital Safe service so it was not appropriate to recognise any revenue upfront in respect of the infrastructure and support element. The infrastructure used by Autonomy to provide the hosted Digital Safe service was not a separately identifiable component of the hosting arrangement given that it did not operate independently of the Digital Safe services. This means that the revenue recognition criteria should have been applied to the transaction as a whole in accordance with its overall substance, namely the provision of a service over time. Like the licence fee for the software, the infrastructure and support fee should have been recognised over the period that the hosting services were provided in accordance with paragraph 20 of IAS 18 (the requirements of which are set out in paragraph 7.9 above).

8.36. In practice, as the Digital Safe had not been implemented and the provision of hosting services had not begun by 31 December 2010 or by 30 June 2011 (see paragraph 8.33.4 above), the recognition of revenue for both the Autonomy Anywhere Archive software and the infrastructure and support (even on a rateable or gradual recognition basis) should not have started by either of those two dates. This is because, as regards criterion (c) of paragraph 20 of IAS 18 and the stage of completion of the transaction, no meaningful delivery of the Digital Safe system or provision of the hosting services had commenced.

8.37. Even if I am wrong on my conclusions at paragraphs 8.34 and 8.35 above (such that the revenue recognition criteria for the sale of goods is relevant), the fact that the Digital Safe system had not been implemented by 31 December 2010 or by 30 June 2011 is clear evidence (in addition to that set out in paragraphs 7.20 and 7.21 above in relation to Digital Safe transactions more generally) that criteria (a) (on the transfer of significant risks and rewards) and (b) (regarding managerial involvement and effective control) in paragraph 14 of IAS 18 (set out in full at paragraph 3.38 above) had not been met. As such, no revenue should have been recognised by either of those two dates under paragraph 14 of IAS 18.

Schedule 7, Transaction 4: Iron Mountain

Facts

8.38. On 3 June 2011, Autonomy acquired the Iron Mountain Digital business from Iron Mountain Inc and, on the same day, Autonomy sold a perpetual licence for IDOL to Iron Mountain for a license fee of $1,500,000 (plus a first year annual support and maintenance fee of $75,000).

8.39. On 9 June 2011, license revenue of $1,500,000 was recognised, and on 30 June 2011, a consolidation adjustment was posted relating to the fair value of the license. The adjustment recognised additional licence revenue of $5,500,000 in Autonomy Inc (bringing the total amount of revenue recognised in relation to this transaction to $7,000,000).

8.40. Further details are set out in Schedule 7 (Transaction 4) of the RRAPoC.

Assumptions

8.41. Assumption 1: IDOL software had no standard price and no established fair value. It was sold to different customers at very different prices based upon the individual customer's perception of the value of the software to that customer in the customer's particular environment.

8.42. Assumption 2: The fair value of $7,000,000 was arrived at based on the average price for four transactions. These four transactions were not similar to the licence sold to Iron Mountain as regards the type of software licensed, the terms of use and any restriction on use, the number of users or the duration of the contract.

Analysis

8.43. The sale of the perpetual licence for IDOL to Iron Mountain and the acquisition of the Digital business of Iron Mountain occurred on the same day and it is clear that they are linked. The first question is whether Iron Mountain wanted or had any use for the IDOL software. If not, the sale had no substance and the appropriate accounting treatment would have been to treat the $1.575 million that Iron Mountain paid to Autonomy as a reduction in Autonomy's acquisition cost of the Iron Mountain Digital business.

8.44. I make the assumption, however, based on the size of Iron Mountain and the value and reputation of IDOL as a product, that the sale was genuine (that is, was genuinely desired by, and useful to, Iron Mountain), in which case it should have been accounted for as revenue at fair value. The question is: what is fair value? Two prices are referred to above: the $1.5 million that was the transaction price on 3 June 2011, and the $7m to which the transaction was revalued on 30 June 2011. The assumptions that I am asked to make suggest that there is no such thing as a single fair value for the IDOL licence, as much depends on transaction-specific and customer-specific considerations.

8.45. Page 11 of Schedule 7 to the RRAPoC explains why the $7 million was not a reliable fair value because it was based on prices for four IDOL deals that were not similar to the Iron Mountain sale. Schedule 7 also notes that the IDOL software was licensed to different customers at a wide variety of prices.

8.46. But the question remains: if the $7 million was not fair value, is it clear that the transaction price of $1.5 million was fair value? It is not possible to be definitive here. If IDOL software (similar in its terms, restrictions, duration etc.) had been sold to customer X for $1 million and to customer Y for $3 million, one would regard those prices as valid for revenue recognition prices in the absence of any complicating factor. In this Iron Mountain context there is a complicating factor in that Autonomy was acquiring the Iron Mountain Digital business at the same time and this raises a question as to whether the pricing of the sale of the software and the acquisition price might be linked and affect each other. On the other hand, (a) I am not aware of anything that suggests such an effect, (b) it seems clear that the IDOL product is a valuable product (i.e. it is not a pointless or useless sale) and (c) a price at which to record the sale has to be determined and no other number suggests itself as being preferable to $1.5 million. On balance, therefore, I would accept the $1.5m as being a reasonable fair value at which to record the sales transaction.

9. Voluntary Particulars

I have been instructed to review 53 sets of Voluntary Particulars which I understand have been served by the Claimants in these proceedings in relation to their case as set out in Schedules 4 and 6 of the draft Re-Re-Amended Particulars of Claim.

The Voluntary Particulars begin by identifying, in column A, entitled "Booked", how Autonomy in fact accounted for the disputed transactions on its income statement and/or balance sheet in the relevant quarters. The figures given for this are generally hyperlinked through to supporting documentation, such as the corresponding entries in the general ledger. Although I have reviewed that supporting documentation, I understand that the way in which Autonomy accounted for the disputed transactions is a question of fact rather than one on which my opinion is required. That said, I have not observed any discrepancies between the supporting documentation and the figures recorded in column A.

The Voluntary Particulars then indicate, in column B, entitled "Should have been", what the Claimants say the proper accounting treatment would have been, on the assumption that the Claimants' criticisms of the accounting treatment actually applied by Autonomy are well-founded. Column C then identifies the "Adjustment required", being the difference between Autonomy's actual treatment of the disputed transactions and what the Claimants say was the correct accounting treatment.

I have carefully reviewed all 54 of the Voluntary Particulars in order to determine whether I agree or disagree with the Claimants' case as set out in columns B and C and whether there are any adjustments that I would propose to the way in which the Claimants have addressed them, on the assumption that the Claimants' criticisms of Autonomy's accounting treatment are established (I have already expressed my views in relation to those criticisms in the previous Chapters of this report). The outcome of my review is that I agree with the adjustments identified in columns B and C, which do not in my view require adjustment.

I should say that, in order to familiarise myself with the nature and format of the Voluntary Particulars before conducting my own detailed review of them, I took the opportunity to receive introductions to them from personnel at PwC who I understand assisted the Claimants with their production. I understand that I am required to set out in my report the substance of all material instructions, whether written or oral. Such explanations as I have received from PwC have not gone beyond an introduction to the Voluntary Particulars and I have not been given any additional information beyond that which is set out in the Voluntary Particulars themselves. I do not consider, therefore, that I have received any further material instructions as regards my consideration of the Voluntary Particulars that I need to set out in my report.

10. Declaration

10.1. I confirm that I have made clear which facts and matters referred to in this report are within my own knowledge and which are not. Those that are within my own knowledge I confirm to be true. The opinions I have expressed represent my true and complete professional opinions on the matters to which they refer. I understand that my duty in providing written reports and giving evidence is to help the Court on matters within my expertise and that this duty overrides any obligation to my employer or any other person. I have complied with my duty and will continue to comply with it in this matter. I am aware of the requirements of CPR Part 35, the Practice Direction to Part 35 and the Guidance for the Instruction of Experts in Civil Claims 2014.

10.2. I have included in my report those matters, of which I have knowledge or of which I have been made aware, that might adversely affect the validity of my opinion. I have clearly stated any qualifications to my opinion.

10.3. I have indicated the sources of all information I have used.

10.4. I have not, without forming an independent view, included or excluded anything which has been suggested to me by others (in particular my instructing lawyers).

10.5. I will notify those instructing me immediately and confirm in writing if for any reason my existing report requires correction or qualification.

10.6. I understand that:

10.6.1. my report, subject to any corrections before swearing as to its correctness, will form the evidence to be given under oath or affirmation;

10.6.2. I may be cross-examined on my report by a lawyer assisted by an expert; and

10.6.3. I am likely to be the subject of public adverse criticism if the Court concludes that I have not taken reasonable care in trying to meet the standards set out above.

10.7. I confirm that I have not entered into any arrangement where the amount or payment of my fees is in any way dependent on the outcome of the case.

Signature...

Name PETER ALAN HOLGATE

Date 29 / 11 / 18