Revenue Recognition under International Financial Reporting Standards (IFRS)

As companies prepare for their transition to Ind–AS (IFRS converged accounting standards), there may be several GAAP differences which may require an adjustment to the existing accounting principles applied. Measurement, recognition of revenue and timing thereof is one key area which would be a topic of significant debate irrespective of the actual impact. Companies may have to look the principles considering that they have been applying certain principles over the years. This article aims to discuss some of the aspects of the revenue recognition standard under Ind-AS 18 and certain areas of impact.

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Requirements under Ind-AS 18 (IAS 18) and Comparison to Existing Principles in Indian GAAP

- ***Objective:*** Similar to the requirements of AS 9, IAS 18 deals with the accounting for revenue from sale of goods, rendering of services and use by others of assets belonging to the entity and giving rise to interest, royalties and dividends. Specific guidance on certain aspects such as revenue in case barter transactions, customer loyalty programmes and transfer of asset from customers is contained in Appendix A, B and C respectively.

Ind-AS 11 provides for guidance on the accounting treatment of revenue and costs associated with construction contracts. In this article we do not aim to discuss the requirements of Ind-AS 11.

IFRIC 12 Service Concession *Arrangements and IFRIC 15 Agreements for construction of real* estate were not adopted by the ICAI in the issuance of Ind-ASs. These provide guidance specific to revenue recognition in an industry.

- ***Scope:*** Ind-AS 18 shall be applied in the accounting

of revenue arising from the following transactions and events: a) sale of goods, b) rendering of services and c) the use by others of entity assets yielding interest, royalties and dividends. The scope of Ind-AS 18 is not significantly different from the requirements under AS 9.

- ***Measurement of revenue:*** Fair value: Revenue under IAS 18 is required to be measured at fair value of consideration received or receivable. Fair value takes into consideration trade discounts/volume rebates, other incentives which may include cash settlement discounts. Similarly, when inflow may be deferred, the fair value may be less than the nominal value.

No specific measurement principles are contained under AS 9 with respect to measurement at fair value.

Also see the discussion on customer loyalty programmes below.

1 **Extended credit:** Under AS 9, revenue is recognised at the contractual value of the consideration receivable. Ind AS requires measurement of revenue at fair value of the consideration receivable i.e., if the company offers an extended credit period to customers, revenue is recognised at the present value of future cash inflows. Interest income is recognised over the credit period.

2 **Cash discounts:** Under the existing practice, cash discounts are generally reported as expenditure as incurred. Under Ind-AS, applying the fair value principles, cash discounts would also need to be netted against the revenue.

In summary, if it is probable that a rebate or discount will be passed on to the customer, and the amount can be measured reliably, then the rebate or discount is recognised as a reduction of revenue as the sales are recognised.

- ***Identifying a transaction:*** Recognition principles under IAS 18 are applied separately to each transaction or a component of a transaction.

For instance: sale and subsequent servicing would be two separate components in a transaction. Therefore, if a transaction comprises of more than one activity then revenue is allocated to each identifiable component.

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. While there is no detailed guidance under IAS 18 on how to separate components, guidance may be drawn from Ind-AS 11. This principle is also dealt with in Appendix A, B and C of Ind-AS 18.

Based on the above, the following tests may be applied:

1 The component has stand-alone value to the customer;

2 The fair value of the component can be measured reliably.

These arrangements are commonly referred to as multiple element arrangements. Components identified in the contract with the customer and prices attributed to such components, may not be determinative and allocation of the total sale consideration to such separate components. Accordingly, an allocation would be required to each component. This would become relevant when the timing of recognition of revenue is different for various components.

If it is probable that a rebate or discount will be passed on to the customer, and the amount can be measured reliably, then the rebate or discount is recognised as a reduction of revenue as the sales are recognised.

Application of the above principles would result in differences from the existing accounting practices considering that there is limited guidance considering that companies generally account for such transactions in accordance with the terms of the contract.

Illustration:

Company X, an IT/ITES services provider, sells equipment with installation services for a sum of ₹1,000. The cost of installation services provided by other vendors is at ₹100. Company X also sells equipment without installation services at ₹925.

In this case, the sale of equipment and installation would be regarded as separate components. Revenue from the sale ₹900 (₹1,000 less ₹100) will be recognised when delivered and other recognition principles are met. Revenue of ₹100 from installation will be recognised as and when installation services are provided.

Allocation of Revenue: The method discussed in the illustration above for allocation of revenue is generally referred to *residual fair value approach.* Applying the principles outlined in Appendix B of Ind-AS 18, the total consideration may also be allocated using the relative fair value approach.

Linking transaction: Similar to separating a transaction or component, it is possible that two

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or more transactions need to be linked. This may arise when the commercial effect of each of the transactions cannot be understood without reference to a series of transactions as a whole.

Illustration

A club services provider company may charge an initial fee upfront with periodic payments for future services. The initial fee may, in substance, be wholly or partly an advance for future services or the future services are essential to the customers receiving the expected benefit of upfront payment.

In such cases, both the upfront fee and continuing performance obligation should be assessed together. Even though the upfront fee may be non-refundable, such fee would generally be deferred and recognised systematically over the period of contractual obligation or an expected period of providing such obligation.

- ***Criteria for revenue recognition:*** The general criteria for revenue recognition are: a) it is probable that the economic benefits of the transaction will flow to the entity, b) the revenue can be measured reliably; and c) the costs (both incurred to date and expected future costs) are identifiable and can be measured reliably. There is no significant difference in the criteria for revenue recognition under AS 9 in comparison to Ind-AS 18.

- ***Timing of recognition of revenue:*** Revenue from sale of goods shall be recognised when

1 an entity has transferred to the buyer significant risks and rewards of ownership of goods and

2 the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold.

Generally, transfer of the significant risks and rewards of ownership will correspond to the transfer of legal title or physical delivery. In other cases, the transfer of risks and rewards of ownership occurs at a different time from the transfer of legal title or the passing of possession. In this evaluation, one of the key considerations is shipment terms, evaluation of abnormal warranty obligations, revenue contingent to the buyers subsequent sale, goods subject to installation or when there is a right to return by the buyer.

Under the current reporting requirements, companies are generally recognising revenue from domestic sales on dispatch from the factory, and on export sales on the bill of lading date. On convergence with Ind-AS, the terms of the sale arrangement may need to be evaluated to determine the timing of recognition.

For instance: We discuss the above mentioned conditions for the timing of recognition of revenue with the help of the following examples:

1 ***Goods shipped subject to right to return:*** When the buyer has a right of return and there is uncertainty about the possibility of return, revenue is not recognised until the shipment has been accepted by the customer, or the goods have been delivered and the time period for rejection has elapsed. (Appendix E to Ind-AS 18). IFRS lacks the extensive prescriptive guidance of US GAAP, focusing its requirements on the ability to make a reliable estimate of future

returns based on prior experience. Guidance therefore for estimation can be taken from US GAAP.

Companies in the pharmaceutical sector provide their customers a right to return. Going by the past experience of an entity, it should considered in the timing of recognition of revenue.

2 ***Bill and hold sales:*** (Appendix E to Ind-AS 18) For bill and hold transactions revenue is not recognised until it is probable that delivery will be made of items already in hand, the buyer has acknowledged the deferred delivery instructions and the usual payment terms apply.

Such bill and hold sales are generally noted in the FMCG sector. An evaluation of whether the conditions above are met would need to be made in order to ensure that revenue can be recognised, specifically an evaluation may be required if the condition of usual payment terms apply.

For example: Companies offer financial incentives to place purchase orders before they need goods. In addition, companies are offer to provide storage and insurance of such goods as the customers cannot store these. In such case, the company may not be in a position to recognise revenue as significant risks and rewards have not passed.

3 ***Upfront payments/milestone payments:*** Several pharmaceutical companies enter into transactions for sale or license of dossiers and arrangements to subsequently supply related drugs over a certain period of time. Timing of the revenue recognition on sale or license of dossiers would need to be evaluated in accordance with the terms of the arrangement i.e., depending upon the extent of flexibility available to the buyer. Under Ind-AS 18, companies should recognise such revenues from sale/license of dossier on completion of the performance obligation under the agreement. An evaluation of the terms of the arrangement would be required if revenue from sale of dossiers should be recognised upfront or should it be linked to the supply transaction and revenue be recognised over the period of the arrangement.

In the evaluation of the timing of recognition of revenue, one of the conditions which needs to be evaluated is the continuing managerial involvement of an entity:

"*Continuing managerial involvement to the degree usually associated with ownership*" is less straightforward. It is unlikely that an entity would retain such involvement without retaining the economic benefits of the asset nor is it likely that a buyer would accept continuing involvement where it had acquired the asset for fair consideration.

Commercially, continuing involvement to the degree envisaged would not normally occur where a genuine sale has taken place. If it does, it is likely that there are other features of the arrangement that need to be considered. Indicators include:

1 The seller can control the future price.
2 The seller is responsible for the management of the goods.
3 The terms of the transaction allow the buyer to compel the seller, or give an option to the seller, to repurchase the item at an amount not equal to fair value.
4 The seller guarantees the return of the buyer's investment or a return on that investment for a significant period.

For instance: Entity ABC manufactures and supplies specialised equipments. The equipment have an expected life of five years. Entity ABC enters into arrangements with its customers for the sale of the equipment. Under the arrangement, the entity sold equipment and in turn the customer leases the equipment to third parties for three years. At the end of the lease term, entity ABC guarantees that the residual value will be ₹ 500,000. Entity ABC has the right of first refusal to repurchase at the end of the three year lease term. If the entity declines to repurchase them, it is liable to pay its customer for the difference between the guaranteed price and the recovery earned by the customer.

In this situation, the entity should not recognise revenue on sale. The substance appears to be that entity has leased equipment to its customers.

- ***Customer loyalty programmes:*** Appendix B to Ind-AS 18 provides guidance on accounting for award credits. Applying the principles of identifying a component, the

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Currently, there is limited guidance in this area and the practice varies in this area. For instance: based on the publicly available financial statements of two large listed airline companies, it is evident that frequent flyer programmes operated are accounted as costs in the financial statements i.e., provisions are considered based on incremental costs.

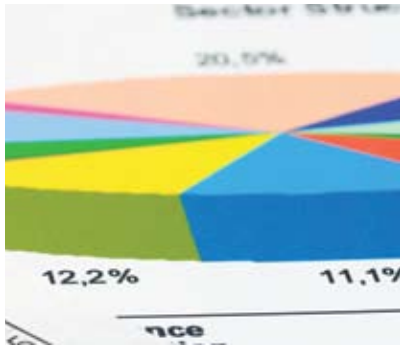
- **Transactions involving exchange of goods/services:** In certain cases, transactions may be undertaken other than by way of cash i.e., transactions involving swapping of goods or services. IAS 18 provides that when goods are sold in exchange for similar goods, the exchange is not regarded as a transaction which generates revenue. Revenue in other cases is measured at the fair value of goods received, unless this cannot be measured reliably.

As of date, practice in this area varies for different companies.

For instance: Accounting for such swapping of goods/services may be relevant for several companies including telecom companies. Generally, telecom companies engage in exchange of network or bandwidth capacity in a particular location with network or capacity in an alternate location. The transaction's commercial substance must be considered. To the extent that the swap does not have substance, companies should not record revenue or costs in respect of the capacity exchanged. To the extent that the transaction has substance, it may be appropriate to recognise revenue.

- ***Service contracts:*** Revenue in case of contracts involving rendering of services are recognised in the same manner as in construction contracts i.e., if the outcome can be measured reliably then revenue is recognised using the percentage completion method, else recognised only to the extent expenses have been incurred.

Fees for providing *continuing services,* whether they are part of an initial fee or are charged as a separate fee, are recognised as revenue as the services are rendered. Any initial or entrance fee is recognised as revenue when there is no significant uncertainty as to its collection and the entity has no further obligation to perform any continuing services. This has also been discussed in the illustration on fee charged by the club services provider, above.



If it is determined that some or all of the revenue arising from the customer contribution relates to the ongoing supply of goods or services, then revenue is recognised as those services are delivered. Typically such revenue is recognised over the term specified in the agreement with the customer. If, however, no such term is specified, then the period of revenue recognition is limited to the useful life of the transferred asset.

In continuation with the illustration, in some cases an initial fee is levied followed by, or including, separate fees for services, but the separate fees do not cover the cost of the continuing services together with a reasonable profit. In these cases part of the initial fee, sufficient to cover the costs of continuing services and to provide a reasonable profit on those services, is deferred and recognised as revenue as the services are rendered. This is also discussed in the Appendix E(18b) of Ind-AS 18.

When services are performed through an indefinite number of repetitive acts over a specified period of time, revenue is recognised on a straight-line basis over the specified period unless some other method better represents the stage of completion. When a specific act is much more significant than any other acts, revenue is recognised only after the significant act is performed.

For instance: *Upfront loan processing charges:* It is necessary to distinguish between fee that is an integral part of the effective interest rate of a financial instrument (for example: a loan transaction) or fee earned for providing a service. Fee received which is an integral part of the effective interest rate is treated as an adjustment to the effective interest computations in accordance with Ind-AS 39.

1 Commitment fee paid towards origination of loan would be outside the scope of Ind-AS

39 and consequently, no treated as an adjustment to the effective interest computations.

Specific Matters in Connection with Revenue Recognition

- ***Software revenue recognition:*** Ind-ASs do not contain any specific guidance on accounting for revenue from software transactions. Accordingly, the general guidance discussed above would be applied in the recognition of revenue from software transactions.

We discuss the criteria for different kinds of software transactions below:

1 When software is only sold: The criteria for sale of goods would apply,
2 When services are provided for software sold such as upgrades, the revenue from providing these services should be deferred and recognised when the services are provided,
3 When customised software services are provided i.e., software provided is customised to the requirements of the buyer, revenue is recognised with reference to the percentage of completion,
4 When the software entity enters into a licensing arrangement, the revenue is accounted for in accordance with the substance of the arrangement i.e., in accordance with Ind-AS 18 (para 20).

For instance: license provided for use of technology over a specified period of time is recognised on a straight line basis over the life of the arrangement. Alternately, in case where rights are provided for a non-refundable fee under a non-cancellable arrangement and the licensor has no further performance obligations, the arrangement would in substance qualify as a sale transaction.

- *Transfer of assets from customers (Appendix C of Ind-AS 18)*

Appendix C (equivalent to IFRIC 18 issued by the IASB) provides guidance on transfers of property, plant and equipment (or cash to acquire these assets) for entities that receive such assets from their customers in return for a network connection and/or an ongoing supply of goods or services. This may apply in case of companies in the utility industry such as auto and auto components or the FMCG industry where tools, dies are provided to the contractor.

In connection with such transfers, the entity receiving should consider the following to ascertain the timing of recognition of revenue.

1 Is the definition of an asset met: an assessment is required if the transferred item meet the definition of an asset in accordance with the framework. If the conditions are met, the asset would be recognised in accordance with Ind-AS 16.

2 What are the performance obligations as a result of receiving the asset and can these obligations be separated for revenue recognition purposes i.e., are there separately identifiable services?

Once an asset is recognised, the credit is recognised if there is one or more services are provided in connection with the transferred item. There is no detailed guidance in Appendix C on identifying whether there is a separate performance obligation. Facts and circumstances of each case would need to be considered in arriving at a conclusion.

If goods or services are provided to the customer at a price lower than would be charged without the transfer of property, plant and equipment then such transfer can be identified towards future performance obligations.

3 When should revenue related to the identifiable performance obligation be recognised?

If it is determined that some or all of the revenue arising from the customer contribution relates to the ongoing supply of goods or services, then revenue is recognised as those services are delivered. Typically such revenue is recognised over the term specified in the agreement with the customer. If, however, no such term is specified, then the period

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IFRS contains general principles for revenue recognition that would need to be applied for different types of transactions. While the general guidance is largely similar to the requirements under Indian GAAP, various differences exist including differences in the application of current accounting requirements specifically relating to the accounting for contracts involving multiple deliverables or accounting of revenue at fair value.

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Forthcoming Requirements

As Indian companies prepare to converge with the revenue standard and other IFRSs, IASB and FASB had earlier during 2010 issued an exposure draft to replace the existing revenue recognition standards under the Memorandum of Understanding.

As per the exposure draft, IASB intends to replace the existing guidance. The new model provides for the following in comparison to the existing requirements under IAS 18:

- ***Identification and segmentation of contracts into performance obligations:*** Specific guidance is contained in the exposure draft on identifying a contract and identifying separate performance obligations in the contract.

Indicators that the contracts are inter-dependent are:

1 the contracts are entered into at or near the same time;
2 they are negotiated as a package with a single commercial objective; and
3 they are performed either concurrently or consecutively.

- ***Determination of transaction price:*** The exposure draft proposes that an entity also include variable consideration from the time that it can be estimated. In addition, there is specific guidance on a) the effect of the time value of money i.e., imputed interest is required to be considered even on advance payments, b) the effect of customer credit risk.

- ***Allocation:*** The exposure draft provides for specific guidance on allocation of transaction price to the different components. The entity would allocate the transaction price to separate performance obligations in proportion to their relative stand-alone selling prices. Such guidance in not contained explicitly in the existing standard.

- ***Recognition of revenue:*** Specific guidance is contained in relation to when a performance obligation is satisfied. This is in case where the transfer of a good or service to the customer will take place at one point in time.

In other cases, it will take place continuously over a period of time. It may be difficult to determine whether the entity transfers control of the goods or services continuously or at a point in time, particularly when the entity promises to produce, manufacture or construct an asset specifically for a customer. In such cases, the entity would evaluate whether the customer controls the asset as it is produced, manufactured or constructed, meaning that the customer has the present ability to direct the use of and receive the benefit from the work in progress. If it is the case, control of promised goods or services is transferred continuously. Otherwise, it would be transferred at one point of time, generally when the asset is completed. In summary, the Percentage of completion method is withdrawn but similar methods could be applied when control is transferred continuously.

Conclusion

Convergence with IFRS and adoption of Ind-ASs would require companies to revisit their accounting policies under the existing reporting requirements and make an assessment of areas where there would be a change or where a detailed evaluation may be required. Revenue recognition is one area which may have a pervasive impact on the financial statements of the entity or the manner in which contracts or transactions are perceived by an entity. IFRS contains general principles for revenue recognition that would need to be applied for different types of transactions. While the general guidance is largely similar to the requirements under Indian GAAP, various differences exist including differences in the application of current accounting requirements specifically relating to the accounting for contracts involving multiple deliverables or accounting of revenue at fair value. An early preparation for the convergence would enable companies to work towards re-visiting their existing transactions and ensuring that the requirements of IAS 18 are met.

As companies prepare for the convergence with IFRS, there is a continuous change in the International Standards. ■