# Revenue Recognition under Ind AS 115


***Currently, Indian generally accepted accounting principles (GAAP) have limited guidance provided under the two main revenue recognition standards of AS 7 on Construction Contracts and AS 9 on Revenue Recognition. It is difficult to apply the limited guidance in these standards to complex transactions. Although additional guidance was provided by way of Guidance Note on Accounting for Real Estate Transactions on various other kinds of transactions, it was felt that there needed to be a more robust framework for addressing revenue issues and remove inconsistencies and weaknesses in the existing guidance to improve comparability across companies and sectors and to provide more useful information through improved disclosure requirements. Hence, the Institute of Chartered Accountant of India (ICAI) has issued an exposure draft Ind AS 115 (exposure draft) on Revenue from Contracts with Customers. Although, the Ministry of Corporate Affairs (MCA) has made Ind AS mandatory for certain companies beginning from 1st April 2016, the MCA has not yet made the draft Ind AS 115 effective. Once notified, Ind AS 115 would be included in the existing literature under Ind AS. Further, Ind AS 115 will supersede Ind AS 11, Construction Contracts, and Ind AS 18, Revenue and the Appendices A and B to Ind AS 11 i.e Service Concession Arrangements and Service Concession Arrangements : Disclosures, respectively are proposed to be included as Appendices to Ind AS 115. In this article, it is aimed to provide the reader an overview of the exposure draft and the impact it is likely to have on entities in general.***

It is expected that the exposure draft is likely to significantly affect certain sectors more than others, mainly due to the nature of contracts that those sectors enter into (rather than that the exposure draft has specific guidance for that sector). For example, companies in telecommunications, real estate and construction, software, aerospace and defence, licensors in film, pharma and entertainment sector are expected to be significantly impacted.


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Ind AS 115 shall apply to all contracts with customers except the following:

a) Insurance contracts covered by Ind AS 104 Insurance Contracts
b) Lease contracts covered by Ind AS 17 Leases
c) Financial instruments and other rights or obligations that are covered under Exposure draft of Ind AS 109 Financial Instruments, Ind

AS 110 Consolidated Financial Statements, Ind AS 111 Joint Arrangements, Ind AS 27 Separate Financial Statements and Ind AS 28 Investments in Associates and Joint Ventures.

d) non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers

Ind AS 115 follows a 5 step model for recognition of revenue:

**1 Identify the Contract with a Customer**

An entity shall account for a contract with a customer when all the following conditions are met:

- The parties to the contract have approved the contract and are committed to their obligation. Contracts can be written, oral or as per the entity's customary business practice.
- Each party's rights regarding the goods or services to be transferred can be identified.
- Payment terms can be identified for the goods or services to be transferred.
- The contract has commercial substance.
- Collection of consideration is considered probable (this is a new requirement to be considered in identifying whether a contract exists, and evaluates the ability and intention of the customer to pay when due).

The exposure draft also provides that two or more contracts entered into at or around the same time with the same customer or its related parties may need to be viewed as a single contract if the following conditions are satisfied:

1. the contracts are negotiated as a package with a single commercial objective;
2. the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
3. the goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation.

Going forward, entities would need to review contracts in detail with reference to the above conditions to assess if a contract exists under the exposure draft; this evaluation would entail new judgements, evidence, processes and controls.

**The exposure draft has extensive disclosure requirements, the objective of which is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.**

**2 Identify the Performance Obligations in the Contract**

A performance obligation is a promise to transfer goods or services to a customer that meets both the following conditions:

a) Does the customer benefit from the goods or services either on its own or together with other resources that are readily available to the customer; and

b) Whether the promise to transfer that good or service is separately identifiable from other promises in the contract.

Determining if the above criteria is met is about considering if the good or service is highly dependent on or interrelated with other goods or services in the contract. In considering this an entity considers:

- If they are providing a significant service of integration?
- If the entity is customising or modifying the good significantly?
- They could be purchased or not purchased with significantly affecting other promised goods or services?

In case both these conditions are not met, it is not a distinct performance obligation and would need to be combined with other goods and services.

For example, if an entity enters into a contract to build a house for a customer, the potential performance obligations of bricks, windows, fittings and construction services would collectively be a single performance obligation since the entity is providing a significant integration service. In comparison, a customer contract for a sale of a machine with a standard installation (which is also offered by a third party service provider) would involve multiple performance obligations comprising the machine and the installation service.

A performance obligation can be satisfied at a point in time or over a period of time. A performance obligation is said to be satisfied over

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a period of time, if one of the following criteria is met:

- The customer receives and consumes the benefit provided by the entity at the same time as the entity performs *(e.g.*, Routine or recurring services)
- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced (*e.g.*, Asset built on customer's site)
- The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to demand payment for the performance completed (*e.g.*, Asset built to order).

In case of performance obligation satisfied over a period of time, an entity shall recognise revenue by measuring the progress towards satisfaction of the performance obligation by selecting the method that best depicts performance. The exposure draft specifies both input method (*e.g.*, Costs incurred, labour/machine hours) and output method (*e.g.*, Surveys, milestones reached, units delivered) for measuring progress, depending on the nature of the goods or services that the entity has promised to transfer to the customer.

If the performance obligation is not satisfied over a period of time, an entity satisfies the performance obligation at a point in time. For this purpose, an entity considers the indicators of transfer of control mentioned in the exposure draft–right to payment for the asset, legal title to the asset, transfer of physical possession of the asset, transfer of significant risk and rewards of ownership of the asset, acceptance of the asset etc. The exposure draft shifts focus from transfer of risks and rewards of ownership (which is retained as an indicator of control transfer) to the transfer of control model.

Going forward, entities would need to identify which contracts have multiple goods or services to be delivered and evaluate which of these would need to be accounted for separately; this would require judgment to determine when performance obligation criteria are met and may result in goods and services being bundled (or unbundled) more frequently .

**3 Determine the Transaction Price**

The transaction price has the following features:

- It is the amount of consideration payable by a customer for transferring promised goods or services. The entity needs to include only that amount which is highly probable and will not result in significant revenue reversal (this is termed as the 'constraint' on variable consideration in the exposure draft and judgment will be required when applying the revenue constraint).
- The consideration can be fixed or variable or in a form other than cash. Non-cash consideration is measured at fair value. The exposure draft gives some guidance on factors which needs to be taken into account to measure the amount of variable consideration. The concept of variable consideration is very broad and includes items such as discounts, rebates, credits, refunds, sales returns, performance/ completion bonuses *etc.*
- Contracts with a significant financing component are adjusted to reflect the time value of money (this will involve the complexity of time value of money calculations).

Going forward, entities would need to evaluate contracts which include element of variable consideration and analyse these in relation to the above features and calculate the necessary adjustments.

**4 Allocate the Transaction Price to the Performance Obligations**

An entity would need to allocate the transaction price to the performance obligations in the contract which involves the following:

- The allocation is based on the relative stand-alone selling prices of each distinct goods or service included in the contract (this stand alone selling price is not fair

value). For example, a telecom company offers a two year mobile phone contract for its customers which has two identified performance obligations-firstly a phone and secondly calls and data. Let us assume the transaction price is ₹20,000 for this arrangement. The price of the phone on the manufacturer's website is ₹12,000. The telecom company sells a two year plan without a phone that includes the same level of calls and data for ₹400 per month or ₹9,600 for the two years period. In this case, based on the observable price, the revenue to be recognised towards the phone is ₹11,111 (20,000*12,000/21,600) and towards calls and data would be ₹8,889 (20,000*9,600/21,600).

- The standalone selling price is an observable price from the stand-alone sales of that goods or service and in case it is not available, an entity would need to estimate it. The exposure draft prescribes three methods by which an entity can estimate:
  i. Adjusted market assessment approach–estimate the price that the customer in the market would be willing to pay for those goods or services.
  ii. Expected cost plus margin approach–forecast expected costs for satisfying a performance obligation and then add a appropriate margin.
  iii. Residual approach–it is the total transaction price less the sum of the observable stand-alone selling prices of other goods or services promised in the contract.

Going forward, entities may need to determine if standalone selling prices are available for their goods or services; estimating selling prices and allocation of discounts and variable consideration may require new inputs and significant judgments .

**5 Recognise Revenue**

Revenue is to be recognised when or as the entity satisfies the performance obligation. The revenue recognised is the amount allocated to the completed performance obligation. In case of services which are rendered over a period of time, an entity selects an appropriate method for measuring the entity's progress towards complete satisfaction of that performance obligation.

## Contract Costs

The exposure draft provides guidance on accounting for incremental costs incurred for securing a contract and costs incurred to fulfill the contract.

An entity shall capitalise incremental costs if they are incurred only as a result of obtaining the contract and those costs are expected to be recovered. For example, sales commission to be paid on a contract. The exposure draft provides for a practical expedient that if the amortisation period of the asset is one year or less, these costs can be expensed as incurred.

The costs to fulfill a contract would be capitalised if the costs relate directly to a contract and the costs generate or enhance resources of the entity that will be used in satisfying the performance obligations in the future and the costs are expected to be recovered. Examples of costs that are eligible for capitalisation if other criteria are met include direct labour such as employee wages, direct materials, allocation of costs that directly relate to the contract such as depreciation, costs that are explicitly chargeable to the customer under the contract , subcontractor costs *etc.* Typically, general and administrative costs and costs of wasted material, labour and other contract costs are required to be expensed when incurred. The exposure draft provides that the capitalised costs would be amortised on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates.

Entities should now evaluate whether there are differences between the current accounting and the contract costs guidance specified in the exposure draft.

## Contract Modification

A contract modification is a change in the scope or price (or both) of a contract that is approved by the parties to the contract. A contract modification

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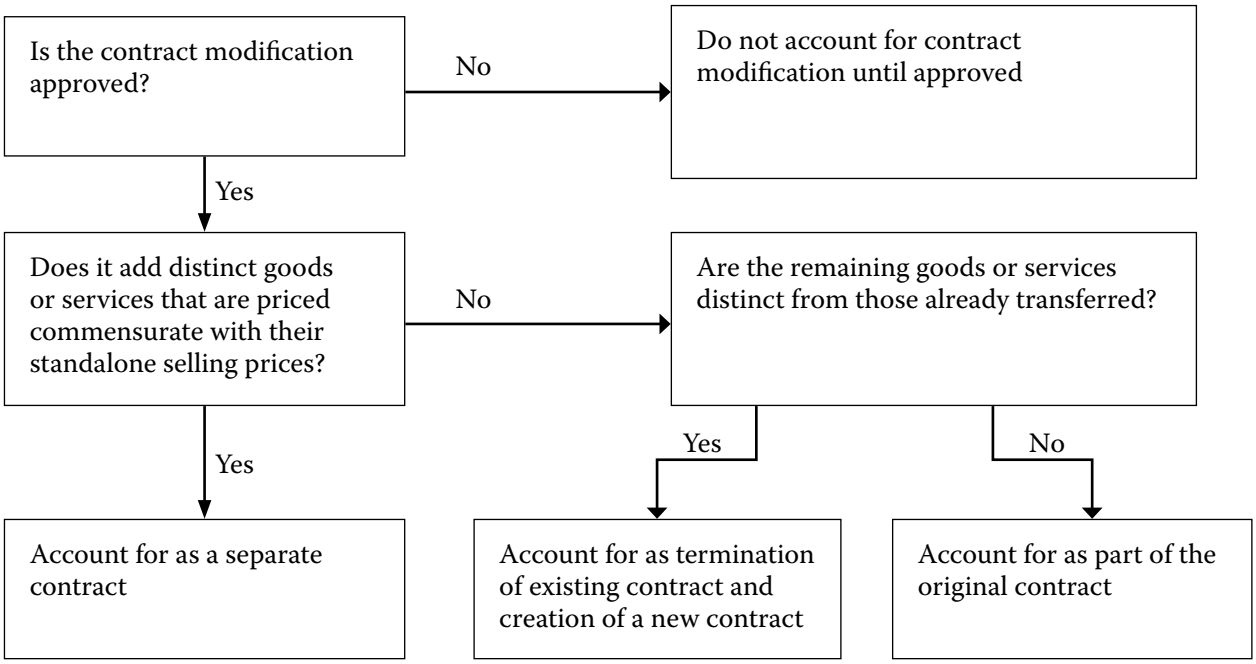
exists when the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract. A contract modification could be approved in writing, by oral agreement or implied by customary business practices. Some examples of typical transactions and industries affected include upgrade of a mobile phone contract, change of internet/cable plan, change in specification of an asset in a construction contract etc.

The exposure draft prescribes contract modification to be accounted as depicted in the following flow-chart:




A contract modification is only accounted for once it is approved, which requires the modification to be legally enforceable. Legal enforceability will depend on the terms of the contract and local laws which could be jurisdictional and in some cases could result in differences compared to current practice.

Entities should now evaluate whether there are differences between the current accounting and the contract modifications guidance specified in the exposure draft and take steps to account as specified in the exposure draft.

## Presentation and Disclosures

The exposure draft has extensive disclosure requirements, the objective of which is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, an entity shall disclose qualitative and quantitative information about all of the following:

1 **Its contracts with customers**
- disaggregation of revenue
- Movement in contract assets, liabilities and costs (when either party to the contract has performed any part of the contract, an entity shall present a contract asset, if the entity's performance is greater than the customer's payment and a contract liability, if the customer's payment is greater than the entity's performance)
- performance obligations
- transaction price allocated to remaining performance obligation

2 **Significant judgements, and changes in the judgements, made in applying this standard to those contracts**
- determining the timing of satisfaction of performance obligations
- determining the transaction price and amounts allocated to performance obligations

3 **Any asset recognised from the costs to obtain or fulfill a contract with a customer**
Entities should evaluate the differences between what is currently presented and what is required under the exposure draft and should ensure that adequate processes and systems are put in place to ensure appropriate and timely availability of information.

## Transition Requirements

The transition requirements for this exposure draft are specified in the exposure draft on Ind AS 101 – First-time adoption of Indian Accounting Standards. When entities transition from the current revenue accounting to accounting under Ind AS 115, there are three practical expedients when applying the exposure draft retrospectively.

An entity could choose to:

- not restate contracts that begin and end in the same annual reporting period, for completed contracts;
- for completed contracts that have variable consideration, use the transaction price as of the completion date for completed contracts that include variable consideration; or
- for all reporting periods presented before the beginning of the first Ind AS reporting period, not disclose the amount of the transaction price allocated to remaining performance obligations or an explanation of when that revenue will be recognised for comparative periods.

For any of the above mentioned options which an entity may select, the entity shall apply that expedient to all contracts within all reporting periods presented. Further, a first-time adopter is not required to restate contracts that were completed before the earliest period presented. A completed contract is a contract for which the entity has transferred all of the goods or services identified in accordance with previous GAAP.

Entities should evaluate which transition option suits best to its own set-up and plan necessary steps for its implementation.

## Impact of the Exposure Draft

It is expected that Ind AS 115 would have a significant impact on the following:

1 For complex transactions with multiple components and/or variable consideration, or when the work is carried out under contracts for an extended period of time, applying the exposure draft could lead to revenue being accelerated or deferred.

2 Entities will need to evaluate whether to recognise revenue on contract completion (or as) the contract is fulfilled. Applying the new criteria in this area will require a detailed review of contract terms and–for contracts for the sale of real estate–property law.

3 The exposure draft introduces a number of new estimates and judgemental thresholds that may affect the amount or timing of revenue recognised. Examples include estimates of:
   - the most likely or probability-weighted amount of variable consideration, which is needed to estimate the transaction price;
   - the stand-alone selling price of a good or service, which is needed to allocate the transaction price between different performance obligations;
   - the discount rate to be used to adjust for a significant financing component.

4 The exposure draft contains extensive new disclosure requirements. Entities will be required to re-evaluate, and in many cases significantly expand the notes to the financial statements dealing with revenue. Preparing the new disclosures could be time-consuming, and changes in systems and processes may be required to capture and audit the required data, for the current and comparative periods.

5 Changes to the timing of revenue recognition may affect the timing of tax payments, the ability to pay dividends in some jurisdictions, or compliances with loans covenants. Staff bonuses and incentive plans may need to be realigned, to ensure they are in line with corporate goals.

6 IT system changes may be required to capture the data to comply with the new requirements. Processes may need to be re-evaluated to factor management judgement where required.

7 Investors and other stakeholders will want to understand the impact of the exposure draft on the overall business, probably before it becomes effective. Areas of interest may include the effect on financial results, the costs of implementation, any proposed changes to business practices and the transition approach selected.

Considering the significant changes brought about by the exposure draft, it is highly recommended that entities start evaluating the likely impact of the proposed standard on revenue recognition. ■