Ind AS - New Standards on the Block

In this special write-up, the author provides an overview and in-depth analyses of two new Ind AS on the block vis Ind AS 115, Revenue from Contracts with Customer and Ind AS 116, Lease. Issued in March 2018, the new revenue standard, Ind AS 115, is likely to affect the way companies account for revenue. It introduces a new revenue recognition model for contracts with customers. Meanwhile, the Ind AS 116, Leases is another standard which is proposed to be made applicable from financial years commencing on or after 1st April 2019. Almost all companies in every sector have some of their operating assets on leases be it airlines (lease of aircraft) or retailers (lease of stores). Most of the existing leases will run to 2020 or later, and many new leases will be entered into between now and 2019-20. This makes Ind AS 116 much more significant. Read on to know more…

CA. Archana Bhutani
(The author is a member of the Institute. She can be reached at archana.bhutani@yahoo.co.uk.)

How will Ind AS 115, *Revenue from contracts* with customer affect the top line?

A single global standard

The new revenue standard is likely to affect the way companies account for revenue. Issued in March 2018, Ind AS 115 replaces existing Ind AS guidance

Ind AS 115, *Revenue from Contracts with Customer*, contains a single model that applies to contracts with customers and two approaches to recognising revenue: at a point in time or over time. The model features a contract-based five-step analysis of transactions to determine whether, how much and when revenue is recognised.

and introduces a new revenue recognition model for contracts with customers. For some, the new standard will have a significant impact on how and when they recognise revenue, but for others transition will be easier. However, arriving at this conclusion will require an understanding of the new model and an analysis of its application to particular transactions. For example, if a company has operations in telecommunications, software, real estate, aerospace and defence, building and construction or contract manufacturing, then it is more likely to be significantly affected by one or more of the new requirements. However, all companies will be subject to extensive new disclosure requirements.

One model, two approaches, five steps

The standard contains a single model that applies to contracts with customers and two approaches to recognising revenue: at a point in time or over time. The model features a contract-based five-step analysis of transactions to determine whether, how much and when revenue is recognised. The model specifies that revenue is recognised when or as a company transfers control of goods or services to a customer at the amount to which the company expects to be entitled. Depending on whether certain criteria are met, revenue is recognised:

- over time, in a manner that best reflects the company's performance; or
- at a point in time, when control of the goods or services is transferred to the customer.

The five steps are as follows.

1 *Identify the contract with a customer*

A contract with a customer is in the scope of Ind AS 115 when the rights and obligations in the contract are legally enforceable (based on the relevant laws and regulations) and certain criteria, including collection of consideration being probable, are met. If the criteria are not met, then the contract does not exist for purposes of applying the general model of the new standard, and any consideration received from the customer is generally recognised as a deposit (liability).

Under Ind AS 18, a company assesses collectibility when determining whether to recognise revenue. However, under the new standard, the collectibility criterion is included as a gating question. In making the collectibility assessment, a company should consider the customer's ability and intention (which includes assessing its creditworthiness) to pay the amount of consideration when it is due. This assessment is made after taking into account any price concessions that the company may offer to the customer. Judgement may be required to differentiate between a collectibility issue and a price concession.

2 *Identify the performance obligations*

The process of identifying performance obligations requires a company to determine whether it promises to transfer either goods or services that are distinct, or a series of distinct goods or services that meet certain conditions. A good or service is distinct, if both of the following criteria are met:

Criterion 1: Capable of being distinct- Can the customer benefit from the good or service on its own or together with other readily available resources?

Criterion 2: Distinct within the context of the contract- Is the company's promise to transfer the good or service separately identifiable from other promises in the contract?

Ind AS 11 and Ind AS 18 include limited guidance on identifying whether a transaction contains separately identifiable components. Ind AS 115 introduces comprehensive guidance on identifying separate components, which could result in goods or services being unbundled or bundled more frequently than under current practice.

3 *Determine the transaction price*

The 'transaction price' is the amount of consideration to which a company expects to be entitled in exchange for transferring goods or services to a customer, excluding amounts collected on behalf of third parties – e.g. GST.

To determine this amount, a company should

consider multiple factors including any variable consideration, significant financing component, non-cash consideration and consideration payable to a customer. Company will have to estimate the transaction price at contract inception and update the estimate each reporting period for any changes in circumstances.

It may be noted that items such as discounts, rebates, refunds, rights of return, credits, price concessions, incentives, performance bonuses, penalties, or similar items may result in variable consideration. Promised consideration can also vary if it is contingent on the occurrence or non-occurrence of a future event.

Judgement may be required to determine the appropriate accounting – Volume discounts or rebates may be variable consideration or may convey a material right. Similarly, liquidated damages may represent variable consideration or a product warranty. After estimating the variable consideration (based on expected value or most likely amount method, whichever is more appropriate), a company may include some or all of it in the transaction price–but only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

To estimate the transaction price in a contract, the standard requires a company to adjust the promised amount of consideration for the time value of money if that contract contains a significant financing component (subject to a practical expedient).

Consideration payable to a customer includes cash amounts that a company pays or expects to pay to the customer, or to other parties that purchase the company's goods or services from the customer. Consideration payable to a customer also includes credits or other items–e.g. a coupon or voucher–that can be applied by the customer against the amount owed to the company or to other parties that purchase the company's goods or services from the customer. Company will need to evaluate the consideration payable to a customer to determine whether the amount represents a reduction of the transaction price, a payment for distinct goods or services, or a combination of the two.

Currently, there is some diversity in practice over whether incentives are accounted for as a reduction in revenue, an expense (e.g. sales and marketing), or a separate deliverable (as in the case of customer loyalty programs), depending on the type of incentive. The requirements of the new standard may change the accounting for some companies.

4 *Allocate the transaction price*

The transaction price is allocated to each performance obligation–generally each distinct good or service–to depict the amount of consideration to which a company expects to be entitled in exchange for transferring the promised goods or services to the customer.

The transaction price is generally required to be allocated to each performance obligation in proportion to its stand-alone selling price. However, when specified criteria are met, a discount or variable consideration is allocated to one or more, but not all, performance obligations. Ind AS 18 is largely silent on the allocation of consideration to components of a transaction other than guidance on allocation for service concession arrangements and customer loyalty programs. Ind AS 115 introduces guidance applicable to all in-scope contracts with customers.

5 *Recognise revenue*

Revenue is recognised when or as the company satisfies a performance obligation by transferring a good or service to a customer, either at a point in time (when) or over time (as). A good or service is 'transferred' when or as the customer obtains control of it. At contract inception, a company should first evaluate whether it transfers control of the good or service over time – if not, then it transfers control at a point in time. While doing so, it should use the following criteria :

The customer simultaneously receives and consumes the benefits provided by the company's performance as the company performs	Routine or recurring services – e.g. cleaning services
The company's performance creates or enhances an asset that the customer controls as the asset is created or enhanced	Building an asset on a customer's site

The company's performance does not create an asset with an alternative use to the company and the company has an enforceable right to payment for performance completed to date	Building a specialised asset that only the customer can use, or building an asset to a customer's specifications

If one or more of these criteria are met, then the company recognises revenue over time, using a method that depicts its performance – i.e. the pattern of transfer of control of the good or service to the customer. If none of the criteria is met, then control transfers to the customer at a point in time and the company recognises revenue at that point in time.

In practice, many contracts for the rendering of services will meet Criterion 1, and many construction contracts will meet Criterion 2 and/or Criterion 3. However, detailed analysis may be required to assess these and other arrangements, notably pre-sale contracts for real estate.

Under Ind AS 18, revenue from the sale of goods is recognised based on when, among other criteria, the company has transferred to the buyer the significant risks and rewards of ownership. Under this approach, which is unlike the new standard, revenue is typically recognised at the point in time at which risks and rewards pass rather than when control transfers. Under Ind AS 11 and Ind AS 18, there are three circumstances in which revenue is recognised over time:

- the contract is a construction contract in the scope of Ind AS 11;
- the contract is for the sale of goods under Ind AS 18, and the conditions for the recognition of a sale of goods are met progressively over time; and
- the contract is for the rendering of services.

Applying the new criteria may alter the timing of revenue recognition.

Analysis of specific facts and circumstances will be a key consideration for real estate arrangements. Applying the new standard–especially when assessing whether Criterion 3 is met–will require consideration of the specific facts and circumstances of each case. Given the judgement that may be required in this assessment, the recognition of revenue for real estate arrangements may continue to be a challenging area in practice.

Revenue recognition may be accelerated or deferred

Revenue may be recognised at a point in time, when control of the good or service is transferred to the customer or over time in a manner that best reflects the company's performance.

For complex transactions with multiple components and/or variable amounts of consideration, or when the work is carried out for an extended period of time, the application of the standard may lead to revenue being accelerated or deferred as compared to the requirements of Ind AS 18.

New estimates and judgements

New estimates and judgemental thresholds have been introduced and these may affect the amount and/or timing of revenue recognised. They include:

- estimating and recognising variable consideration;
- identifying separate goods and services in a contract; and
- estimating stand-alone selling prices.

Significant judgement may be required to determine how these estimates and thresholds apply to a company. These might be particularly difficult to apply in certain cases e.g. a new business line or new products is being launched, or the company is entering a new market.

Stage-of-completion accounting has been retained

The standard includes new criteria to determine when revenue should be recognised over time. Revenue for some contracts that were accounted for under the stage-of-completion method may now instead be recognised on contract completion; similarly for other contracts, the new model may result in stage-of-completion method being applied for the first time.

Making this assessment will require a detailed review of contract terms. Applicable laws may also be relevant in some cases e.g. property law in case of contracts to sell real estate.

Notable differences from current practice

- All guidance contained in a single standard
- Control-based model ('risks and rewards' concept is retained as an indicator of control transfer)
- Consideration measured as the amount to which the company expects to be entitled, rather than fair value

- New guidance on separating goods and services in a contract
- New guidance on recognising revenue over time

The new standard provides application guidance on numerous related topics, including warranties and licenses. It also provides guidance on when to capitalise the costs of obtaining a contract and some costs of fulfilling a contract.

To address the relevant business implications, companies will need to assess the extent of the impacts including communications with various stakeholders.

New guidance on costs

New judgements will be required when accounting for contract costs, as the new standard replaces the cost guidance in Ind AS 11 *Construction Contracts* with new guidance on the costs of obtaining and fulfilling a contract. This will directly affect profit recognition, especially when revenue is recognised over time. Companies will need to evaluate the impact of the new guidance to assess the costs to be capitalised and the period over which they can be amortised.

New disclosure requirements

The standard includes extensive new disclosure requirements. Companies may have to redesign, and in many cases significantly expand, the information captured in order to meet the disclosure requirements. The new disclosures could convey important additional information about business practices and prospects to investors and competitors. There are no exemptions for commercially sensitive information.

Transition options

A company can apply the standard to all of its contracts with customers using either:

- the retrospective method or
- the cumulative effect method

To ease implementation, the standard provides certain practical expedients for the transition methods

Ind AS 116, *Leases*

Ind AS 116, Leases is another standard which is proposed to be made applicable from financial years commencing on or after 1st April 2019. Almost all companies in every sector have some of their operating assets on leases be it airlines (lease of aircraft) or retailers (lease of stores). Most of the existing leases will run to 2020 or later, and many new leases will be entered into between now and 2019-20. This makes the new standard much more significant.

Current lease accounting requires companies to only disclose details of their off-balance sheet leases which requires many financial statement users to adjust for such leases. Ind AS 116 will require most companies to bring the leases on-balance sheet recognising new assets and liabilities. Companies that lease assets will see an increase in reported assets and liabilities besides impact on other financial metrics. The key change will be the increase in transparency and comparability. For the first time, analysts and users will be able to see a company's own assessment of its lease liabilities, calculated using a prescribed methodology that all companies reporting under Ind AS will be required to follow.

Lessees to face major changes

At the simplest level, the accounting treatment of leases by lessees will change fundamentally. Ind AS 116 eliminates the current dual accounting model for lessees, which distinguishes between on-balance sheet finance leases and off balance sheet operating leases. Instead, there is a single, on-balance sheet accounting model that is similar to current finance lease accounting. The lease becomes an on-balance sheet liability that attracts interest, together with a new asset on the other side of the balance sheet. Thus, lessees will appear to have more asset but will also become more heavily indebted.

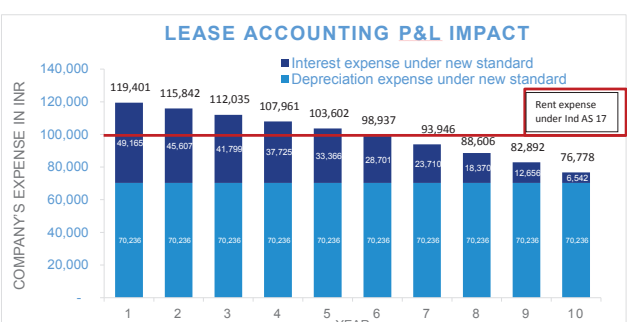
The impact of bringing operating leases on-balance sheet is not limited to balance sheet; it will also change the profit and loss account of lessees. Currently, operating lease expenses are charged to the profit and loss account on a straight-line basis over the life of a lease. Under the new standard, leases will be accounted for as if the company had borrowed funds to purchase an interest in the leased asset. This typically results in higher interest expense in the early years compared to the later years, similar to any debt which is amortised. Consequentially, this means that total lease expense in the profit and loss will be higher in the early years of a lease – even if a lease has fixed regular cash rental payments. Thus, companies will recognise a front-loaded pattern of expense for most leases. As a result, total lease expense will be higher, profits will decrease compared to current operating lease accounting,

companies will record lower earnings per share. However, since the lease expense will be presented as interest and depreciation expense, rather than an operating expense, the lessee's EBITDA will be higher. This may raise some significant issues for major renters of property (e.g. retailers, banks) and companies that lease other assets (e.g. planes, vehicles and machinery). However, the front-loaded pattern of total lease expense may average out across a portfolio of leases in a large, stable business. However, the front-loading effect could be significant in aggregate for a growing business, or a business that is undertaking a major refresh of its portfolio of leased assets. The standard will have many other consequential effects.

Lessee accounting model

Balance sheet	**Profit or loss**
Asset = 'Right of use' of underlying asset **Liability** =Obligation to make lease payment	**Lease expense** Depreciation + Interest } Front loaded total lease expense

To understand the new lessee model, consider a 10 year operating lease with annual rent of INR 100,000. Assume a discount rate of 7%. Annual rental expense that will be recognised under Ind AS 17 is INR 100,000. However, the position under the new standard is illustrated through the chart below.



The new guidance under Ind AS 116 will also change the cash flow statement, because lease payments that relate to contracts that have previously been classified as operating leases are no longer presented as operating cash flows in full. Cash payments for the principal portion of the lease liability are classified within financing activities.

New model, new definition

Assessing whether an arrangement is, or contains, a lease will be one of the biggest practical issues when applying the new standard. In effect, lease definition becomes the test that will determine whether an arrangement is on- or off-balance sheet for a lessee.

A contract is, or contains, a lease if:

- fulfilment of the contract depends on the use of an **identified asset**; and
- the contract conveys the **right to control the use** of the identified asset

Under the new standard a lease will continue to be a contract that conveys the right to use an asset for a period of time in exchange for consideration. However, the new standard increases the focus on which party controls the use of the identified asset.

Right to control the use-A customer-lessee has control over the use of an identified asset, if it has both of the following:

– the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use; and
– the right to direct the use of the asset or to direct others to operate it.

Right to direct the use of the asset-A customer- the potential lessee- has the right to direct the use of an identified asset in either of the following situations:

- the customer has the right to direct how and for what purpose the asset is used throughout the period of use or
- all relevant decisions about how and for what purpose the asset is used are predetermined and:
  – the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or
  – the customer designed the asset (or specific aspects of the asset) in a way that predetermined how and for what purpose the asset will be used throughout the period of use.

Some of the arrangements that are currently accounted for as leases may fall outside of the new definition.

Lessee accounting

Initial measurement–

Lease liability is measured upon initial recognition as sum of present value of lease rentals and present value of expected payments at the end of lease. Right of use asset is measured upon initial recognition at cost that includes (a) lease liability, (b) Initial direct cost (c) prepaid lease rentals, (d) estimates of restoration, removal and dismantling cost and (e) lease incentive received.

Subsequent measurement–

After initial recognition, the lease liability is measured at amortised cost using the effective interest method. The lease liability is re-measured by the lessee upon the occurrence of certain events (e.g., change in the lease term, change in variable rents based on an index or rate).

Generally, a lessee measures right-of-use assets at cost less accumulated depreciation and accumulated impairment losses. If right-of-use assets relate to a class of property, plant and equipment (PPE) to which the lessee applies the revaluation model in Ind AS 16, then a lessee may elect to apply that revaluation model to all of the right-of-use assets that relate to that class of the PPE. Further, right-of-use assets are subject to impairment testing and hence a lessee will have to apply Ind AS 36 Impairment of Assets to determine whether the right-of-use asset is impaired and to account for any impairment loss identified.

Lessor accounting model

As regards lessor accounting, the lease classification test (finance lease and operating lease) as in Ind AS 17 continues. Thus, there is no symmetry between lessee and lessor accounting. Sale-and-leaseback guidance, Sub-lease guidance, Accounting for lease modifications, Disclosure requirements.

Practical expedients

To ease the pressure of implementation of the standard and reduce the compliance costs for preparers, the standard provides significant practical expedients:

- Applying the new lease definition only to new contracts and grandfather the assessment of which existing contracts are, or contain, leases
- Optional exemption for short-term leases (lease term of 12 months or less)
- Portfolio accounting permitted if it does not differ materially from applying the requirements to individual leases

In order to be ready for Ind AS 116, *Leases*, companies should start thinking about their implementation plans now. Despite the practical expedients provided, the standard is likely to have a great impact on a large number of companies and transition will require time. The possible impacts are too far reaching to wait until the last minute. Preparation should begin now.

- Optional **lessee** exemption for leases of low-value items
- Multiple transition options.

Key impacts

Apart from the discussion above, the other key impacts of Ind AS 116 may include the following:

- The standard introduces new estimates and judgmental thresholds that affect the identification, classification and measurement of lease transaction. Requirement of reassessment of certain key estimates and judgements will also introduce volatility to assets and liabilities for lessees.
- Companies may consider changes in contract terms and business practices to minimise the impact of the standard.
- New systems and processes may be required to capture the data necessary to comply with the new requirements.
- Companies will need to make decisions about how to transition to the new standard.
- Communication with stakeholders will require careful consideration.

Things to think about now

In order to be ready for the standard, companies should start thinking about their implementation plans now. Despite the practical expedients provided, the standard is likely to have a great impact on a large number of companies and transition will require time. The possible impacts are too far reaching to wait until the last minute. Preparation should begin now. As a starting point, the following aspects should be considered just to get an impression of scale of the challenge ahead:

- Which contracts are, or contain, leases?
- Which transition options to choose? Is there a database of all leases?
- Are systems and processes in place?
- What about ratios and covenants? ■