Indian Accounting Standard (Ind AS) 115, Revenue from Contracts with Customers

India had the unique opportunity to early adopt Ind AS 115 as compared to rest of world. Nonetheless, entities will have to once again undergo the process of unlearning and relearning. The five step model is robust and would serve as a useful compass for all types of transactions in the new digital era. The new challenges which would emerge due to the new standard would have to be addressed over a period of time (issue which were resolved under old standard may resurface under the new standard). However consistency, uniformity, transparency and detailed guidance for accounting revenue in case of complex transaction would outweigh the difficulties. The impact of accounting on transition to new standard under Income tax law could be an additional challenge which Corporate India will have to deal with. Application of Ind AS 115 will require new as well as different thinking! Read on to know more…

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Overview

Considering the need to converge on one of the most significant pillar of financial statement, 'Revenue', IASB and FASB after more than a decade of joint work in May 2014 issued converged guidance on recognizing revenue in contracts with customers. The IASB titled the standard as 'IFRS 15- Revenue from Contracts with Customers' and FASB also titled it 'Revenue from Contracts with Customers (Topic 606)'.

Ind AS Implementation

Ind AS 115 which is aligned to IFRS 15 was notified by MCA on 28th March, 2018 & is applicable for accounting periods beginning on or after 1st April, 2018.

Ind AS 115 & IFRS 15 replaces the following standards and interpretations :

Indian Accounting Standard	Title	IFRS
Ind AS 18	Revenue	IAS 18
Ind AS 18	Guidance note on accounting for Real Estate Transactions (note 1)	IFRIC 15
Appendix A to Ind AS 18	Revenue-xxx Barter Transactions involving Advertising services	SIC 31
Appendix B to Ind AS 18	Customer Loyalty Programmes	IFRIC 13
Appendix C to Ind AS 18	Transfer of Assets from Customers	IFRIC 18
Ind AS 11	Construction Contracts	IAS 11

Note 1 - Guidance note withdrawn by ICAI in terms of announcement dated 1st June, 2018.

Note 2 - Service Concession Arrangement & disclosures which was part of Ind AS 11 (Appendix A & B) will now be part of Ind AS 115 (Appendix D & E).

Reasons for issuing the new standard on Revenue:

a. remove inconsistencies and weakness in existing revenue recognition guidelines

b. improve comparability of revenue recognition practices across entities, jurisdictions and capital markets

Ind AS 115 provides more guidance for deciding whether revenue is recognised at a point in time or over time. It also provides new and more detailed guidance on specific topics such as multiple element arrangements, variable consideration, contract modification, price allocation, warranties, licensing, etc.

Comparison with Ind AS 18/11 & Ind AS 115

Ind AS 18/11	Ind AS 115
Separate models for: • Construction contracts • Goods • Services	Single model for performance obligations • Satisfied over time • Satisfied at a point in time
Focus on risks and rewards	Focus on control
Limited guidance on: • Multiple element arrangements • Variable considerations • Licenses	More guidance on: • Separating elements • Allocating the transaction price • Variable consideration • Licenses • Options • Repurchase arrangements
Revenue measured at the fair value of the consideration received or receivable.	Consideration measured as the amount the entity expects to be entitled to.
Contract Revenue-initial amount & variations in contract work.	Transaction price including variable consideration.
Limited disclosure under Ind AS 18.	Sufficient disclosure to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts.

c. provide more useful information to users of financial statements through improved disclosure requirements

d. provide a single comprehensive framework to recognize revenue from customers

- Ind AS 115 provides more guidance for deciding whether revenue is recognised at a point in time or over time. It also provides new and more detailed guidance on specific topics such as multiple element arrangements, variable consideration, contract modification, price allocation, warranties, licensing, etc.

Scope:

- The new revenue model would apply to all contracts with customers except Leases, Insurance contracts, Financial Instruments including those covered by Consolidated Financial Statements/ Joint Arrangements/ Separate Financial Statements/ Investments in Associates and Joint Ventures and non-monetary exchange between entities in same business line to facilitate sales to customers or potential customers. Extraction of mineral ore will be covered as this is not specifically scoped out.

- In case a contract which is partially within the scope of Ind AS 115 & another standard, in case the other standard specify how to separate or measure one or more parts of the contracts, then an entity shall first apply requirement of that standard and in absence thereof, Ind AS 115 will be applied.

Five- step model-heart of the standard:

Step by step guidance on when, how and how much should the revenue be recognised:

Step 1: Identify Contract(s) with a customer

A contract is an agreement between two or more parties that creates enforceable rights and obligations and which has been agreed upon with a customer and meets specified criteria. The contract could be oral or written or based on customary industry practise. In some cases, Ind AS 115 requires an entity to combine contracts & account for them as one contract. Ind AS 115 also provides requirements for the accounting for contract modifications.

Step 2: Identify performance obligations in Contract

A contract includes promises to transfer goods or services to a customer. If those goods or services are distinct, the promises are performance obligations and are accounted for separately. A good or services is distinct if the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer and the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

Step 3: Determine transaction price

The transaction price is the amount of consideration (for example, payment) to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for e.g. Goods and Service Tax).

The transaction price can be fixed amount of customer consideration, but it may sometimes include variable consideration or consideration in a form other than cash.

Step 4: Allocate the transaction price to the performance obligations in the contract

An entity typically allocates the transaction price to each performance obligation on the basis of the relative stand-alone selling prices of each distinct good or services promised in the contract. If a stand-alone price is not observable, an entity estimates it. Various methods that may be used, including:

- Adjusted market assessment approach
- Expected cost plus a margin approach
- Residual approach (only permissible in limited circumstances)

Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation

An entity recognises revenue when it satisfies a performance obligation by transferring a promised good or services to a customer (When customer obtains control of that good or service).

A performance obligation may be satisfied at a point in time or over time. For performance obligations satisfied over time, an entity recognises revenue over time by selecting an appropriate method for measuring the entity's progress towards complete satisfaction of that performance obligations.

New and important terms / concepts

Recognition of revenue at a point in time or over time

The entity will recognize a revenue over time if any of the following criteria are met:

- The customer receives and consumes the benefits of the seller's performance as the seller performs
- The seller creating a work in progress asset which is controlled by the customer
- The seller creating a work in progress asset which could not be directed to a different customer and in respect of which the customer has an obligation to pay for the entity's work to date

Over a period of time is somewhat akin to percentage of work completed method (POCM) under the erstwhile Ind AS 11 Construction contracts and the Guidance Note on Accounting for Real Estate Transactions.

An entity will recognise a revenue at a point in time for performance obligations that do not meet the criteria for recognition of revenue over time.

Factors which may indicate that control is passed at a point in time include, but are not limited to:

- The entity has a present right to payment for the asset;
- The customer has legal title to the asset;
- The entity has transferred physical possession of the asset;
- The customer has significant risks and rewards related to the ownership of the asset; and
- The customer has accepted the asset.

Contract Cost

Ind AS 115 provides a guidance about two types of costs related to the contract, namely cost to obtain the contract and cost to fulfil the contract

Incremental costs to obtain a contract

These are the incremental costs to obtain a contract & would not have been incurred if the contract was not obtained- example sales commission. Such costs are not expensed in profit or loss as incurred but are recognized as a Contract asset provided they are expected to be recovered. For contract duration below 12 months as a practical expedient, such costs can be treated as expense.

Costs to fulfil a contract

Costs incurred to fulfil a contract with a customer are not within the scope of another standard are recognised as an asset only if all the following criteria are met:

a. Costs are directly related to contract
b. Costs generate or enhance resources that will be used to satisfy performance obligations in future
c. The entity expects to recover the cost

Examples: Direct labour, direct materials, payments to subcontractors, etc.

Contract Modifications

A contract modification is a change in the scope or price (or both) that is approved by the contracting parties & can be accounted as a separate contract provide both of the conditions are met:

- The scope of the contract increases because of the addition of promised goods or services that are distinct
- Price of the contract increases by an amount of consideration that reflects the entity's stand-alone selling price of the additional goods or services & any other adjustments

E-commerce market place where bundle of products on on-going basis are added to the contract and prices of existing/new products are not always on standalone price, the revenue per product (balance of original and new products/ quantities) will have to be determined carefully.

Repurchase agreements

A repurchase agreement is a contract in which an entity sells an asset and also promises or has the option (either in the same contract or in another

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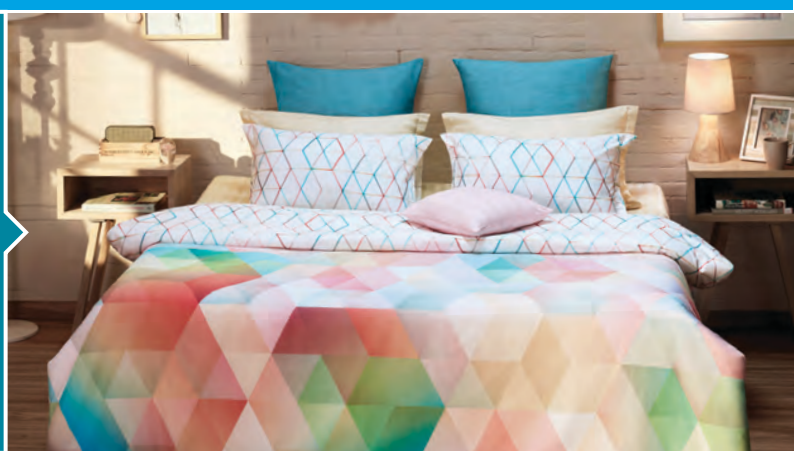

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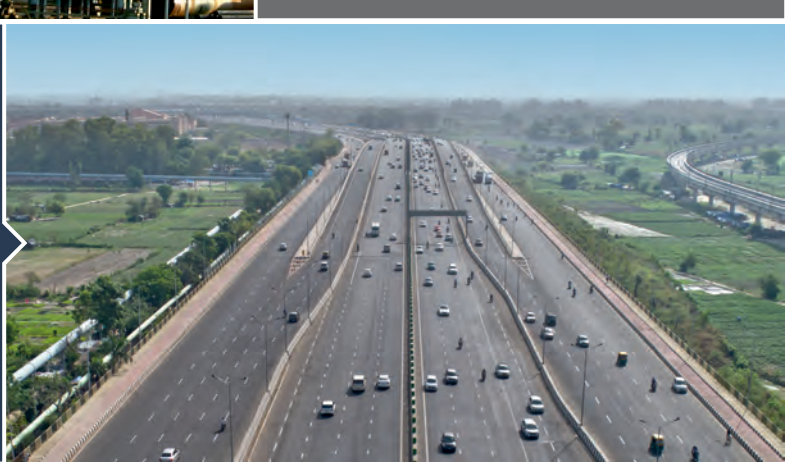

contract) to repurchase the asset. The repurchased asset may be the asset that was originally sold to the customer, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component.

Non-refundable upfront fees includes additional fees charged at (or near) the inception of the contract (e.g. joining fees, activation fees, set-up fees etc.). Treatment depends on whether the fee relates to the transfer of goods or services to the customer at inception. In most of the cases, it would be enabler for provision for future supply of goods and services and hence will be treated as advance payment.

Repurchase agreements generally come in three forms:

- an entity's obligation to repurchase the asset (a forward)
- an entity's right to repurchase the asset (a call option)
- an entity's obligation to repurchase the asset at the customer's request (a put option)

Under all the scenarios detailed accounting guidance is provided as to whether the transaction is to be accounted as (a) Lease transaction, (b) financing arrangement or (c) sale of product with a right to return.

Variable considerations

If the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration (subject to constraint) to which the entity will be entitled in exchange for transferring the promised goods or services to a customer.

Examples: Discounts, rebates, refunds, credits, incentives, performance bonuses, penalties, etc.

An entity shall estimate an amount of variable consideration by using either of the following methods :

- The expected value based on probability weighted amounts within a range (i.e. for large number of similar contracts)
- The most likely amount (where there are few amounts to consider)

Constraining estimate : include variable consideration only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

Warranties

Assurance type (apply Ind AS 37) :

- An assurance to the customer that the good or service will function as specified
- The customer cannot purchase this warranty separately from the entity

Service type (accounted for separately in accordance with Ind AS 115) :

- A service is provided in addition to an assurance to the customer that the good or service will function as specified
- This applies regardless of whether the customer is able to purchase this warranty separately from the entity

In determining the classification (or part thereof) of a warranty, an entity considers:

Legal requirements:	warranties required by law are usually assurance type
Length:	longer the length of coverage, more likely additional services are being provided
Nature of tasks:	do they provide a service or are they related to assurance

Non-refundable upfront fees

Includes additional fees charged at (or near) the inception of the contract (e.g. joining fees, activation fees, set-up fees etc.). Treatment depends on whether the fee relates to the transfer of goods or services to the customer at inception. In most of the cases, it would be enabler for provision for future supply of goods and services and hence will be treated as advance payment. The revenue

recognition period may in some cases be longer than the contractual period if the customer has a right to, and is reasonably expected to, extend/ renew the contract.

Licensing (of an entity's intellectual property (IP))

Ind AS 115 includes specific guidance on accounting for Licences & whether it is distinct from other goods or services or not.

The new standards focus on qualitative and quantitative disclosures. The disclosure requirements are more exhaustive but at the same time the standard requires a balance between too much information and too little information. The objective of the disclosure requirements in the new standards is to provide "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."

Other items:

This article deals with only few of the topics and not with application concerning specific conditions and situations. Considering that Ind AS 11 & Ind AS 18 are being combined into single standard, Ind AS 115 also lays down principles as to whether Goods and Services will constitute distinct contract or single performance obligation. In particular Engineering, Procurement, Construction and/ or Management (EPC or EPCM), Hospitality (wedding function wherein rooms, function areas & other services are provided), Telecom / IT & IT enabled industry, Engineering companies in supply of capital goods with extensive integration into existing facilities will have to reassess / analyse the ongoing contracts in light of the principles enunciated. Once having analysed, each component will also have to be tested whether the performance obligation is satisfied at a point in time or over time. There can be various combination in a single contract and price allocation to each of the component will have to be determined.

Impact on bottom-line due to changes in guidance on top line

- It is difficult to conclude whether revenue would be accelerated or postponed, each industry will have different impact.
- Due to combining of contracts, revenue would be deferred, but due to separating of performance obligations, the revenue may be recognised earlier.
- For real estate the impact has been elaborated below in the section on challenges
- For software, telecom and construction companies the impact would be significant on certain specific nature of transactions.
- Incremental cost to acquire a contract being accounted as an asset as opposed to expense will improve the net result position.
- Given the pervasive nature of the impact of the standard, in addition to the financial reporting impact, companies would also have to assess impact on business contracts and processes, as well as the needs of stakeholders such as investors and analysts.

Presentation and disclosures

The new standards focus on qualitative and quantitative disclosures. The disclosure requirements are more exhaustive but at the same time the standard requires a balance between too much information and too little information.

The objective of the disclosure requirements in the new standards is to provide "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, entities are required to provide disclosures about its contracts with customers, the significant judgements and changes in those judgements used in applying the standards and assets arising from costs to obtain and fulfil its contract.

Transition

An entity can elect to adopt the new standard retrospectively with or without optional practical expedient or through cumulative effect adjustment on the date of initial application i.e. 01st April, 2018

Contract	Period	Full retrospective approach	Cumulative effect approach
A	01st April, 2017-31st March, 2018	Begins and ends in same financial year and completed before the date of initial application – Practical expedient available	Contract completed on or before the date of initial application- **Do not apply**
B	Begins in 01st April, 2015 and ends on 31st March, 2018	Adjust opening balance of each affected component of equity for the earlier prior period presented (01st April, 2017)	Contract completed on or before the date of initial application- **Do not apply**
C	Begins in 01st April, 2015 and ends on 31st March, 2020	Adjust opening balance of each affected component of equity for the earlier prior period presented (01st April, 2018)	Adjust opening balance of each affected component of equity at date of initial application (01st April, 2018). Also disclosures are required.

Challenges

- Where an entity concludes that revenue should be recognised over time, it will need to consider how to measure progress towards complete satisfaction of performance obligations. (Measure of progress excludes any goods or services for which control is not transferred to customers). Measure of progress and percentage of revenue to be recognised may be affected in case of real estate sector which hitherto was based on Guidance Note on Real Estate Transaction. In absence of bright line test, judgement will be applied and in specific para 44 and 45 relating to reasonable measure of progress will need to be applied.

- Whether a **contract modification** should be accounted for prospectively or retrospectively & how to account of variable consideration not recognised earlier due to constraint.

- Whether to capitalise certain costs, distinguishing between those costs associated with **obtaining contract** (e.g. sales commission) and those costs associated with **fulfilling a contract.** E.g. Bid costs incurred prior to contract being awarded.

- Determination, allocation & re-assessment of transaction price including non-cash consideration by customer at fair value, variable consideration taking into account various factors. In Retail, wholesale and distribution sector, it is common for **warranties** to include both elements i.e. assure the quality of the product and provide a free maintenance plan. In such cases judgement will be needed in order to determine how to allocate transaction price to a product and service in a reasonable manner.
- In cases where the amounts collected (non-refundable or otherwise) were treated as a liability since conditions of revenue recognition were not met earlier, will have to be reassessed on continuous basis for determining whether the conditions of para 9 have been met subsequently or not

or one of the event specified in para 15 has occurred i.e. (i) no further obligation remaining & whole or substantially whole of promised consideration received and that amount is no longer refundable or (2) contract is terminated and consideration received is non-refundable. What constitutes termination of contract will have to be assessed in light of the principles enunciated under contract law or under the terms of the contract before the entity can conclude that condition of para 15(b) are met.

- To build in comprehensive Revenue recognition test module in the software which amongst various items includes nature of contract verbal, written or customary practice, rights of each parties, payments terms clearly identified, whether contract has commercial substance, collection probability test, how variable consideration is dealt with, whether contract contains multiple performance obligation /deliverable elements including whether goods and services promised are distinct or not, treatment in case contract is modified, performance obligation whether met at a point in time or over time, when control is deemed to have been passed, information for compliance with disclosures etc

Conclusion

With the challenges come the opportunity, the new standard has articulated in detail the accounting for several type and nature of transaction & also provides the much needed clarity to avoid ambiguity/diversity while dealing with complex situation and cases where there are multiple elements. In nutshell, the standard continues to propagate prudence apart from other qualitative principles whether during course of recognising revenue or whilst entering into commercial contracts. ■

Better than a thousand hollow words, is one word that brings peace - Buddha