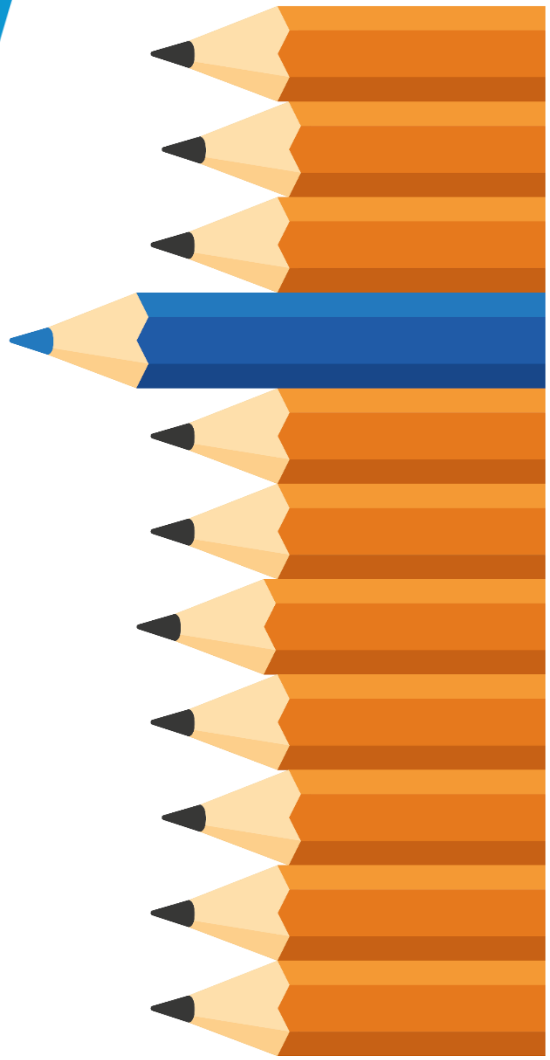
Ind AS 115, Revenue from Contracts with Customers

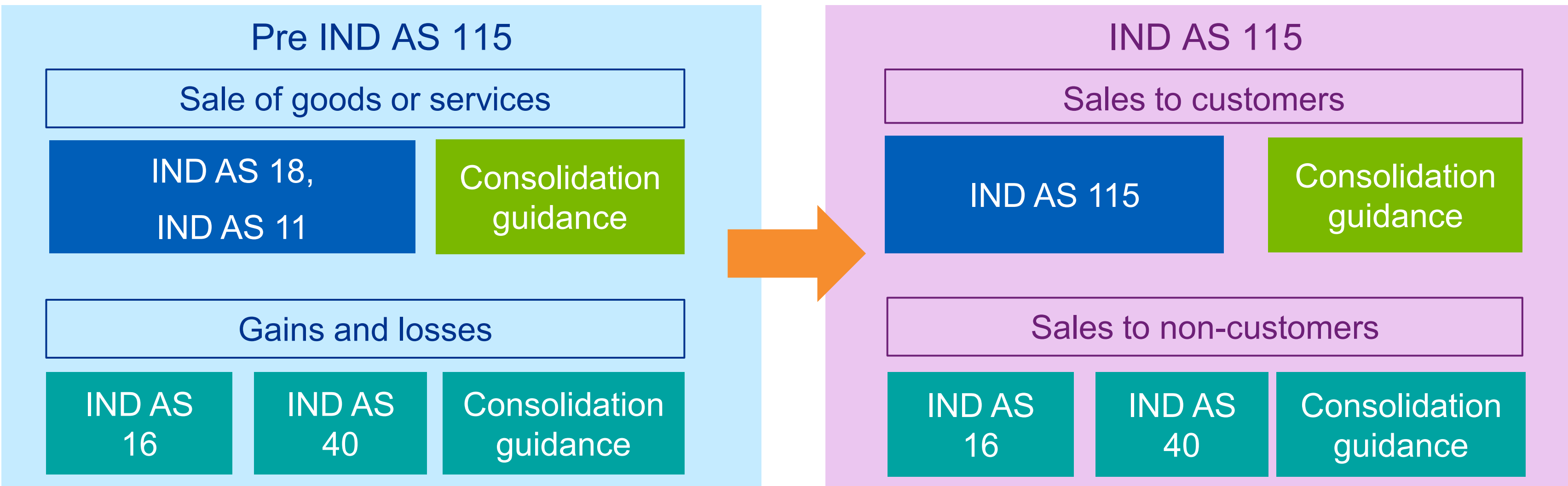
WIRC Seminar on Ind AS

7 July 2018

- ❑ **Overview and Scope**
- ❑ The Five Step Model
- ❑ Contract Costs
- ❑ Application Guidance
- ❑ Presentation and Disclosures
- ❑ Effective Date and Transition
- ❑ Summary and wrap up

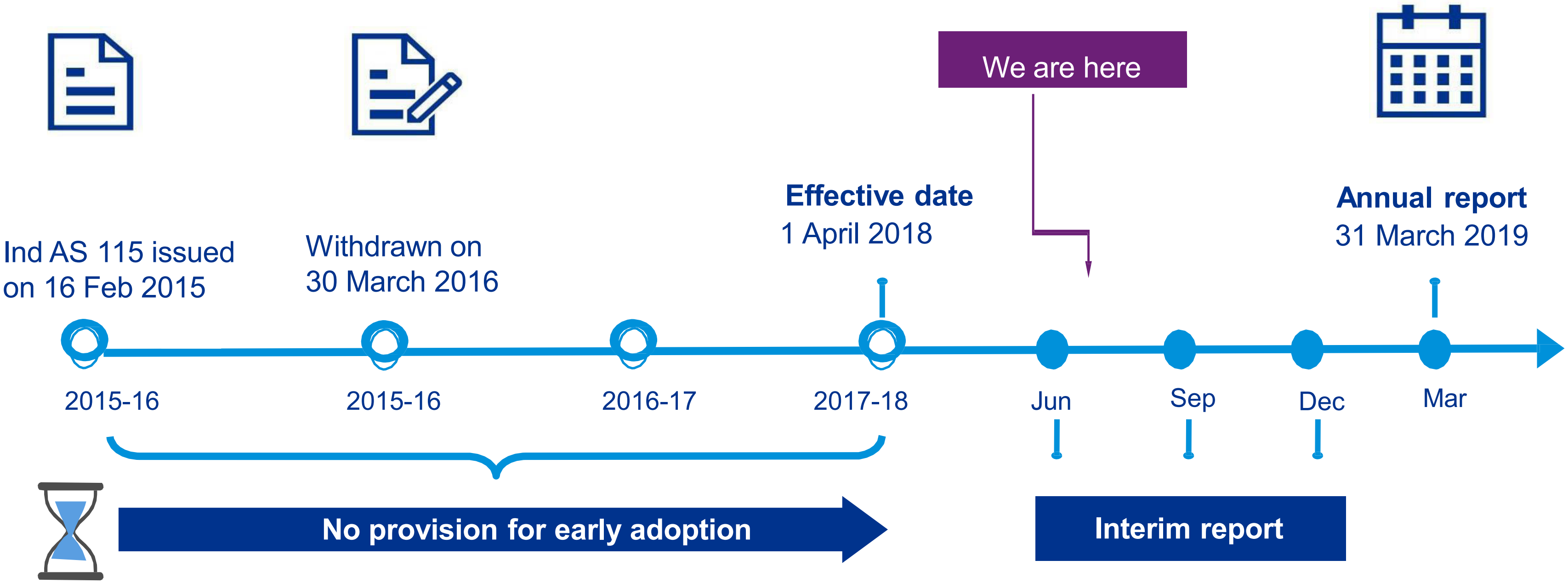


What’s changed



- New over time criteria.
- More guidance on separating goods and services bundled in a contract.
- More guidance on measuring transaction price.
- Replaces certain Guidance Notes (e.g. Real Estate revenue recognition).

Key facts – effective date (Ind AS 115)



Core principle of IND AS 115

......is that an entity recognises ***revenue*** to depict the transfer of ***promised goods and services*** to customers in an amount that reflects the ***consideration*** to which the entity ***expects*** to be entitled ***in exchange*** for those goods or services.

Customer is…

..... “a party that has ***contracted*** with an entity to ***obtain goods or services*** that are an output of the entity’s ordinary activities ***in exchange for consideration***”.

Scope

Part of a Contract

Ind AS 115 | Other Ind AS

✓

Portfolio of Contracts

- Contract 1
- Contract 2
- Contract 3
- Contract 4

✓

De-recognition of non-financial assets ✓

Certain types of non-monetary exchanges ✗

Insurance contract ✗

Contractual rights and obligations in the scope of other Ind ASs ✗

Lease contract ✗

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Ind AS today compared to Ind AS 115

Overall Approach

Revenue may be generated by the sale of goods, construction contracts, the rendering of services, use of entity's assets that generate fees. It is measured at the fair value of the consideration received or receivable

Ind AS 18 Steps		Ind AS 115 Steps
	New	Identify the contract(s) with a customer
Step 1: Identify components	✔	Identify the performance obligations in the contract
	New	Determine the transaction price
Step 2: Allocate consideration	✔	Allocate the transaction price to the performance obligations in the contract
Step 3: Recognise revenue	✔	Recognize revenue when (or as) the entity satisfies a performance obligation

The Five Step Model Overview

1. Identify the contract with a customer
2. Identify the performance obligations
3. Determine the transaction price
4. Allocate the transaction price
5. Recognise revenue

Contract definition

Contract

Entity

Customer

i.e. enforceable rights and obligations

A contract is defined "as an agreement between two or more parties that creates enforceable rights and obligations". Enforceability is a matter of law.
Contracts can be written, oral, or implied by an entity's customary business practices.

Identify the Contract

A contract exists if...

... collection of consideration is considered probable.

... rights to goods or services and payment terms can be identified.

... it has commercial substance.

... it is approved and the parties are committed to their obligations.

Price concession and collectability

- Company C contracts with Customer D for supply of goods for a contract price of CU 100
- Customer D has a poor payment history and often seeks price adjustments after receiving order and so Company C assesses that it is probable it will only collect 70% of the amounts due under the contract

Contract price	100
Expected collection	70
Revenue recognition	70

Subsequently, if Company C expects to collect more than 70, then it recognises the excess as revenue.

If Company C subsequently assesses it will collect less than 70 then the shortfall is recognised as a bad debt expense, which is measured using the guidance on impairment of receivables

If Company C determines that it has granted an additional price concession, then the shortfall would be a reduction of transaction price and revenue

Collectability in case of portfolio of contracts

Entity licences a patent to a customer in exchange for a usage-based royalty

At contract inception, the required criteria for a contract is met; entity recognises revenue when the customer's subsequent usage occurs

- **First year of the contract** - customer provides quarterly reports of usage and pays within the agreed-upon period.
- **Second year of the contract**
  - Customer's financial condition declines - current access to credit and available cash on hand are limited. Customer pays the first quarter's royalties but makes nominal payments for the usage of the patent in Quarters 2–4.

The entity continues to recognise revenue on the basis of the customer's usage; it accounts for any impairment of the existing receivable.

- **Third year of the contract**
  - Customer continues to use the patent. However, the entity learns that the customer has lost access to credit and its major customers and thus the customer's ability to pay significantly deteriorates. Entity concludes that it is unlikely that the customer will be able to make any further royalty payments for ongoing usage of the entity's patent.
  - Due to the significant change in facts and circumstances, entity reassesses the criteria and determines that they are not met because it is no longer probable that the entity will collect the consideration to which it will be entitled.

Entity does not recognise any further revenue associated with the customer's future usage of its patent and accounts for any impairment of the existing receivable.

Combining Contracts

- Contracts may be combined and accounted for as a single contract.

Ind AS 115

Contract 1 | **Contract 2**

- Contracts are combined if entered into at or near the same time with the same customer and one or more of the following criteria are met.

Negotiated as package with a single commercial objective.

Consideration in one contract depends on the other contract.

Goods and services are a single performance obligation.

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Identify Performance Obligations in the Contract

A performance obligation (PO) is a promise to deliver a good or service that meets **both** the following criteria

Criterion 1: Can the customer benefit from the good or service either on its own or together with other resources that are readily available to the customer?

+

Criterion 2: Is the promise to transfer the good or service separately identifiable from other promises in the contract?

Yes → **Distinct performance obligation**

No → **Not distinct – combine with other goods and services**

Exception: A series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer may be a single performance obligation.

Performance obligations

Do the various promises and elements of your contracts meet the new 'distinct' test to be accounted for separately?

Capable of being distinct + **Distinct in the context of the contract**

Think about…

Customer options | Warranties | Shipping and handling | Licences

Single Performance Obligation?

An entity enters into a contract to build a house for a customer.

Potential Performance Obligations

Bricks	Windows	Fittings	Construction service

Q: Do the goods and services individually meet the criteria?

Criterion 1 – Benefit on its own ✔	Criterion 2 – Good or service separately identifiable ✘
Each material could be used with another readily available item.	Entity is providing a significant integration service.

Multiple Performance Obligations?

- Customer contract for a sale of a machine and standard installation.
- Installation services are also offered by third party providers.

Potential Performance Obligations

Machine	Installation

Q: Does the machine meet the performance obligation criteria?

Criterion 1 – Benefit on its own ✓	Criterion 2 – Good or service separately identifiable ✓
Machine can be used with other available inputs. I.e. third party installation.	No significant integration service, because installation is a standard service.

Customer options

Do you need to defer revenue because your sales transactions give rise to material rights?

A material right is an option to acquire additional goods or services…

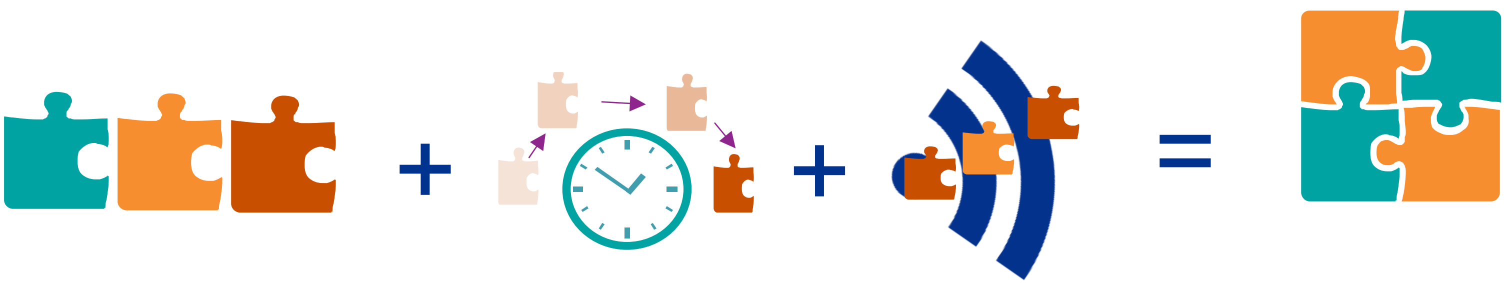
Obtained by entering into the original contract	+	At a price lower than their stand-alone selling prices

Think about…

Loyalty schemes | Coupons and vouchers | Free gift cards | Discounts on future purchases

Identify performance obligations - series exception

A series of distinct goods or services is treated as a single performance obligation if ***all*** the criteria below are met.



Distinct goods or services are substantially the same.

Each distinct good or service is satisfied over time.

Same pattern of transfer for good or service.

Single performance obligation.

The Five Step Model Overview

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Determine the Transaction Price

Variable consideration and the constraint

Consideration payable to a customer

…reduction to the transaction price unless it's a payment for a distinct good or service.

Transaction Price

Non-cash consideration

…measured at fair value unless it cannot be reliably measured.

Significant financing component

Exception: Variable consideration is not estimated for sales – or usage-based royalties on licenses of intellectual property.

Variable Consideration

Variable consideration can be

- Discounts
- Credits
- Incentives
- Performance bonuses
- Many more...

Variable consideration is estimated using most appropriate method of either:

- Expected Value
- Most Likely Amount

Estimating Variable Consideration

Contract to build a jet for a customer. The transaction price includes:

- Fixed amount: INR100.
- Completion bonus: INR100 if completed two months prior to a specified date.
- Performance bonus: INR0 – INR100 depending on the number of flights in its first 12 months of service.

Q: How would the entity estimate variable consideration?

Fixed Amount	Completion Bonus	Performance Bonus
Not Variable	Most likely amount	Expected value

Constraint on Variable Consideration

Application

Transaction price – include the amount that is 'highly probable' will not result in significant revenue reversal.

Qualitative Assessment

- The risk of a reversal arising from an uncertain future event.
- The magnitude of the reversal if the uncertain event occurs.

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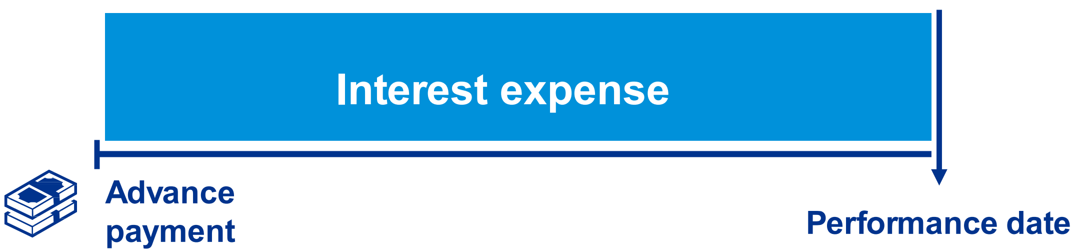
Significant Financing Component

Significant financing component	• Transaction price compared to cash selling price. • Period between payment and delivery. • Other reasons for payment terms.
Discount rate	• Rate that would be used in separate financing transaction between the entity and customer.
Practical Expedient	• No adjustment required if the period between performance and payment is 12 months or less.

Financial assistance by customer

Do advance payment terms in your contracts give rise to a significant financing component?



Practical expedient – No need to recognise if period between payment and performance is < 1 year

performance is at the customer's discretion, then there is no significant financing component

The Five Step Model Overview

1 Identify the contract with a customer

2 Identify the performance obligations

3 Determine the transaction price

4 Allocate the transaction price

5 Recognise revenue

Allocate the Transaction Price to Performance Obligations

Allocate based on relative stand-alone selling prices

Performance obligation 1	Performance obligation 2	Performance obligation 3

Determine stand-alone selling prices

Best evidence

Observable price

If not available

Estimate price

Adjusted market assessment approach

Expected cost plus a margin approach

Residual approach only if selling price is highly variable or uncertain

~~Contractual price or Fair value measurement~~

Estimating the Selling Price

A two year mobile phone contract where two performance obligations are identified; 1) phone and 2) data, calls and texts.

- Total transaction price = INR650.
- Price of the phone on the maker's website = INR350.
- The entity sells a 24 month plan without a phone that includes the same level of data, calls and texts for INR15 per month = INR360 (24 x INR15).

Q: What methods could the entity use to allocate the transaction price?

Observable price	Adjusted market	~~Cost plus~~	~~Residual~~

Phone allocation – INR650 x (INR350/INR710) = INR320
Data, calls and texts – INR650 x (INR360/INR710) = INR330

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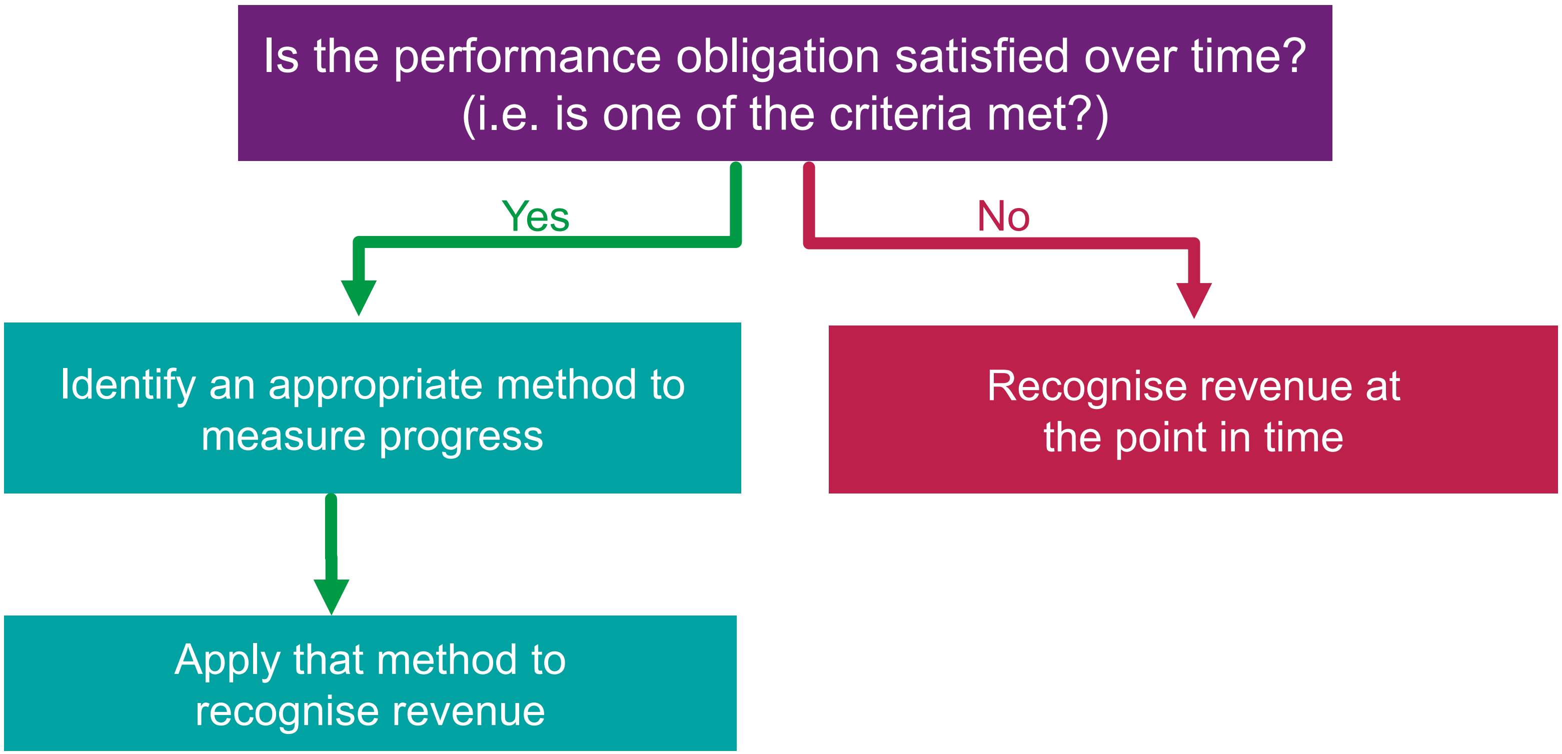
Evaluate when control transfers



Recognise Revenue as Performance Obligations Satisfied

An performance obligation is satisfied over time if either:

1 Customer simultaneously receives and consumes the benefits as the entity performs.

Routine or recurring services.

2 The customers controls the asset as the entity creates or enhances it.

Asset built on customer's site.

3 The entity's performance does not create an asset for which the entity has an alternate use and there is a right to payment for performance to date.

Asset built to order.

Over Time Criteria

- Entity agrees to build a specialised equipment to integrate with the customer's existing plant.
- Customer can cancel contract on 30 days notice.
- If the contract is cancelled the entity has a right to payment that covers costs incurred.
- Customer has agreed to make quarterly payments.

Q: Do the terms meet the no alternate use and right to payment criteria?

No alternate use	Right to payment
✓	✗

- Payment needs to approximate selling price of goods and services transferred to date – i.e. payment amount should include a profit margin.

Measuring Performance Over Time

Step 5

For each performance obligation an entity chooses the method that best depicts performance.

Output method

- Surveys
- Milestones reached
- Units delivered

Input method

- Costs incurred
- Labour hours
- Machine hours

- Units delivered and similar methods not appropriate if work in progress is material.
- Adjustments required for wastage and uninstalled materials when cost method used.

Transfer of Control Indicators

Transfer of control at a point in time when customer has…

- A present obligation to pay
- Legal title
- Physical possession
- Risks and rewards of ownership
- Accepted the asset

Exception: Separate requirements for distinct licences of intellectual property.

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Contract Costs

Costs to obtain a contract

Capitalise incremental costs if:

- ✓ Incurred only as result of obtaining the contract
- ✓ Recovery is expected

e.g. sales commission

Costs to fulfil a contract

Capitalise fulfilment costs if:

- ✓ Directly related
- ✓ Generate or enhance resources
- ✓ Recovery is expected

Practical expedient

Amortisation period < 1 year?

Expense costs as incurred

Costs to Fulfil a Contract

Direct costs that are eligible for capitalisation if other criteria are met ✓	Costs to be expensed when incurred ✗
Direct labour (e.g. employee wages)	**General and administrative costs** – unless explicitly chargeable under the contract
Direct materials (e.g. supplies)	**Costs that relate to satisfied performance obligations**
Allocation of costs that relate directly to the contract (e.g. depreciation and amortisation)	**Costs of wasted materials, labour, or other contract costs**
Cost that are explicitly chargeable to the customer under the contract	**Costs that do not clearly relate to unsatisfied performance obligations**
Other costs that were incurred only because the entity entered into the contract (e.g., subcontractor costs)	

Amortisation and Impairment

Amortisation period

- Systematic basis consistent with the pattern of transfer
- Considers anticipated contracts (e.g. renewal options)

Impairment loss recognised to the extent that the carrying amount exceeds:

Remaining amount of consideration expected to be received − Costs directly related to providing goods or services

Reversals of impairment

- When conditions improved

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Sales with a Right of Return

Recognise initially:

- Revenue if entity expects to be entitled
- A refund liability
- An asset – right to returned products

With the following subsequent effects:

- Revenue is reassessed
- Refund liability is remeasured
- Asset is remeasured

An entity applies the variable consideration guidance when determining the amount it expects to be entitled to.

Sales with a Right of Return

- Company B sells 50 tablet devices @ INR200 each, total INR10,000.
- Return undamaged device within 30 days for a full cash refund.
- Cost of each device is INR150.
- Based on its past experience, B estimates that 3 tablets will be returned (most likely approach).

Q: What entries should B record on transfer of the products?

	Debit	Credit
Cash (or receivable)	10,000	
Refund liability (INR200 x 3 tablets to be returned)		600
Revenue		9,400
Asset (INR150 x 3 tablets to be returned)	450	
Cost of sales	7,050	
Inventory		7,500

Sales with a Right of Return

Gross presentation

- Allowance for returns is presented gross:
  - as a refund liability; and
  - an asset for recovery of transferred goods.

End result is broadly similar in practice

- New judgements required for estimating variable consideration and applying the constraint.
- Portfolio level estimates may be required.

Warranties

Does the customer have the option to purchase the warranty separately?

Yes → Performance obligation

No ↓

Are additional services provided as part of warranty?

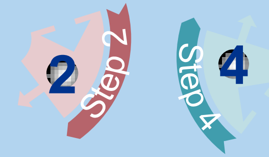
Yes → Performance obligation

No ↓

Not a separate performance obligation

(i.e. assurance warranty)

Apply Ind AS 37



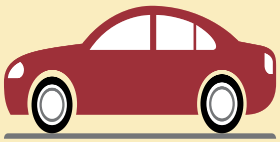
Performance obligation

(i.e. service warranty)

Factors to consider whether a warranty provides an additional service:		
Is it required by law?	Is it longer than customary?	What tasks are performed?

Warranties

- Car manufacturer N sells to customer A:



Car

+

Standard warranty: 3 years or 36,000 miles

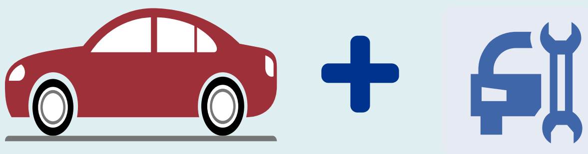
+

Extended warranty: additional 3 years or up to 70,000 miles for INR5,000

Q: How many performance obligations are there in the contract?

Performance Obligations

Performance obligations:



AND

Car and standard warranty

Extended warranty

Standard warranty is an assurance type warranty

Apply Ind AS 37

The customer has the option to purchase the extended warranty separately.

The extended warranty provides additional services to the customer.

Warranties

What's CHANGED?

'Service' warranties accounted for as a performance obligation

- Rather than evaluating whether risks and rewards of ownership have passed to the buyer, assess whether additional services are provided.
- Presence of a warranty does not preclude revenue recognition.

What is the IMPACT?

Revenue recognition may be accelerated

- Allocation of the transaction price to a performance obligation.

Principal versus Agent

If the entity obtains control of a promised good or service in advance of transferring the good or service to a customer

then

The entity is principal in the transaction

Revenue recognised gross

Another party is primarily responsible for fulfilling the contract

The entity does not have discretion in establishing prices

The entity does not have inventory risk

The entity's consideration is in the form of a commission

The entity is not exposed to credit risk

Indicators that the entity is agent in the transaction

Revenue recognised net

Application Guidance: Other Topics

Customer options for additional goods or services

e.g. sales incentives, loyalty points, contract renewal options

Does the option provide a *material right* the customer would otherwise not receive?

Yes – account for as a performance obligation. Revenue recognised when future goods or services transferred or option expires.

Customers' unexercised rights (breakage)

e.g. gift vouchers, non-refundable tickets

Expect to be entitled to breakage amount?

Yes – recognise breakage amount as revenue in proportion to pattern of rights exercised.

No – recognise as revenue when likelihood of customer exercise becomes remote.

Application Guidance: Other Topics

Non-refundable upfront fees

e.g. joining fees, activation fees, setup fees

Does the fee result in the transfer of a promised good or service?

If not – advance payment for future goods or services. Revenue recognised when those goods or services are provided.

Consignment arrangements

e.g. delivery to a dealer or distributor prior to sale end to customer

Is delivered inventory controlled by the entity? (e.g. control not transferred until sale or expiry of a specified period)

If so – revenue is not recognised on delivery of the products to the intermediary.

Application Guidance: Other Topics

Bill and hold arrangements

i.e. entity bills customer but retains physical possession

Consider whether:

- the reason for arrangement is substantive;
- the product is separately identified;
- the product is ready for physical transfer; and
- the entity has the ability to use the product or direct it to another customer.

Step 5
5

Customer acceptance

e.g. trial period, cancellation clauses or remedial action that can be taken by a customer

Can the entity objectively determine that control of a good or service has been transferred in accordance with the contract?

Consider the entity's experience with similar contracts; remaining performance obligations.

Step 5
5

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Presentation

Contract asset or contract liability is recognised when the:

- entity performs by transferring goods or services; or
- customer performs by paying consideration to entity.

(net) contract asset
if rights > obligations

Rights and obligations

(net) contract liability
if obligations > rights

Receivable

- Unconditional right to consideration
- Distinguished from contract assets

Capitalised contract costs

- Presented according to nature or function
- Separate presentation from contract assets

Disclosure

Objective: help users understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers

Contracts with customers	Significant judgements and changes in judgements
Disaggregation of revenue	Determining the timing of satisfaction of performance obligations
Changes in contract assets, liabilities and costs	Determining the transaction price
Performance obligations	Determining amounts allocated to performance obligations

Assets recognised from the costs to obtain or fulfil a contract

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Key facts – transition options (Ind AS 115)

Approach	2016-17	2017-18	2018-19	Date of equity adjustment
Full retrospective – no practical expedients	Ind AS 11/18	Ind AS 115	Ind AS 115	1 April 2017
Full retrospective – practical expedients	Ind AS 11/18	Mixed requirements	Ind AS 115	1 April 2017
Cumulative effect	Ind AS 11/18	Ind AS 11/18	Ind AS 115	1 April 2018

Cumulative effect method: entity also needs to disclose revenue amounts that would have been presented under Ind AS 11/18

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Key Facts – Notable Differences from Current Requirements

Current guidance	New standard
Guidance contained in multiple standards and interpretations.	All guidance contained in a single standard
Risk and rewards based model.	Control based model. Risk and rewards is retained as indicator of control transfer for performance obligations satisfied at a point in time.
Revenue is recognised mainly considering the form of the contract.	Revenue is recognised considering the substance of the contract.
No specific guidance on identifying performance obligations in a contract.	Specific guidance on identifying performance obligations in a contract.
Revenue is recognised at the contractual value of the consideration.	Revenue is recognised at the amount of the consideration to which an entity expects to be entitled.

Key Facts – Notable Differences from Current Requirements

Current guidance	New standard
Does not provide guidance on combining contracts (except for construction contracts). Currently, revenue is mainly recognised based on the legal form of the contract and at prices stated therein.	Explicit guidance on combining of contracts.
No explicit guidance for gross versus net reporting of revenue exists and practice in this area varies.	The requirement of gross versus net reporting is driven by an assessment of principle versus agent relationship.
Limited/no guidance on specific areas like barter, loyalty programmes, costs to obtain a contract , licences etc	Specific guidance on these areas to enable consistency in practice.
Limited disclosure requirements.	Several qualitative and quantitative disclosures required.

Some Key Sectors likely to be impacted

Questions?


Ask
Answer
Who
Apply
Question
Answers
Why
Understand
Where
What
How
Questions
When
Query

Thank You

Aniruddha Godbole