Ind AS 115, Revenue from Contracts with Customers

ICAI Seminar on Ind AS

1 May 2015

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Agenda

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

Ind AS Standards – MCA notification

MCA vide notification dated 16 February 2015 has issued the Companies (Indian Accounting Standards) Rules, 2015 containing the roadmap for applicability of Ind AS for compliance by specified class of companies. The notification (to be published in the Official Gazette) has been uploaded on MCA website along with 39 Ind AS.

39 standards issued

Incorporates all relevant IFRS, IAS, IFRIC and SIC

Has carve outs and carve ins as compared to IFRS

Incorporates new standards on **revenues** and financial instruments

Implementation roadmap for Ind AS

	Phase I	Phase II
Mandatory adoption	**FY 2016 - 17**	**FY 2017 - 18**
Covered companies		
(a) Listed companies	All companies with equity/debt listed or in the process of being listed in//outside India with net worth >= INR 500 crore	Companies with equity/debt listed or in the process of being listed in//outside India (excluding those listed or in the process of being listed on SME exchange)
(b) Unlisted companies	All companies with net worth >= INR 500 crore	Companies having net worth >= INR250 crore
(c) Group companies	Applicable to holding, subsidiaries, joint ventures, or associates of companies covered in (a) and (b) above	
Any other company can voluntarily adopt Ind AS		

- Applicable to stand-alone and consolidated financial statements
- Net worth to be calculated based on the stand-alone financial statements as on 31 March 2014 or first audited financial statements for accounting period ending after that date
- Net worth – as per definition of Companies Act 2013

- Once applied (even if voluntarily), Ind AS will have to be followed irrevocably
- Banks, NBFCs and Insurance companies not yet covered
- Provision of law (including regulations and rules) to prevail where Ind AS not in conformity with law

Changes to existing revenue guidance

The new revenue standard replaces all existing revenue guidance

Ind AS 115 **replaces**

- AS 7 Construction Contracts
- AS 9 Revenue Recognition
- ASI 14 Disclosure of Revenue from Sales Transactions
- ASI 29 Turnover in case of Contractors
- Guidance Note on Accounting for Real Estate Transactions
- Guidance Note on Accounting for Dot-Com Companies

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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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

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.

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.

The Five Step Model Overview

1 Identify the contract with a customer

2 Identify the performance obligations

3 Determine the transaction price

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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.

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.

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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.

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Allocate the Transaction Price to Performance Obligations

Step 4

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 twelve 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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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

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	Costs to fulfil a contract
Capitalise incremental costs if:	**Capitalise fulfilment costs if:**
✓ Incurred only as result of obtaining the contract	✓ Directly related
✓ Recovery is expected	✓ Generate or enhance resources
e.g. sales commission	✓ 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?

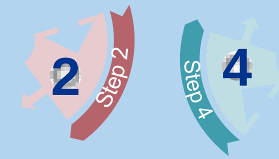
Yes → Performance obligation

No ↓

Not a separate performance obligation

(i.e. assurance warranty)

Apply Ind AS 37



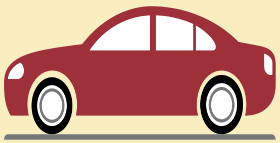
Performance obligation

(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

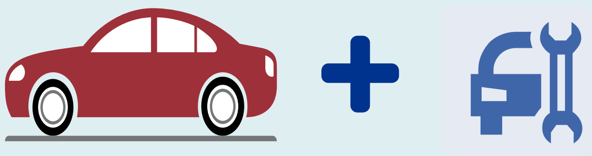
Standard warranty: 3 years or 36,000 miles

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

‘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.

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.

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.

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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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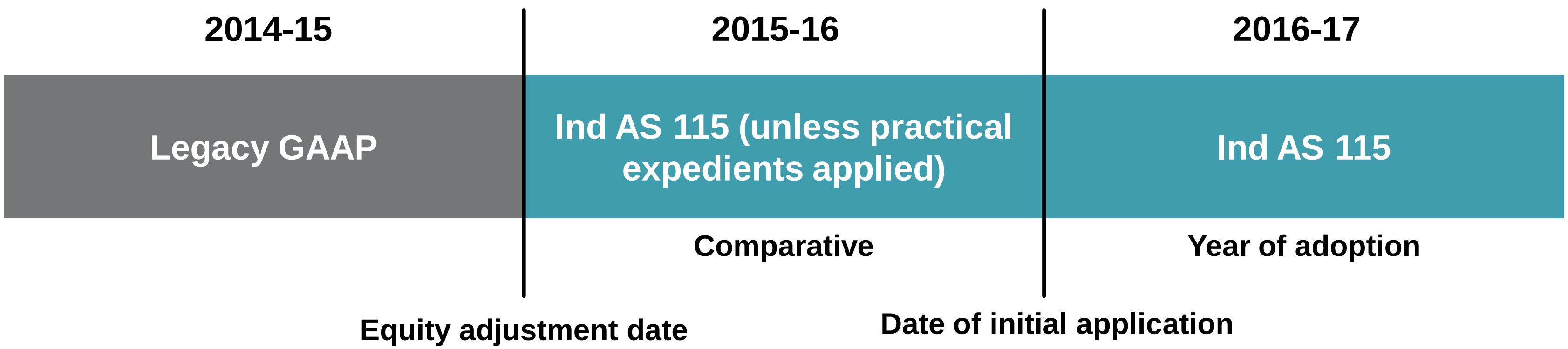
Transition – first time adoption



-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)

- A first-time adopter may use certain specified practical expedients when applying Ind AS 115 retrospectively (eg. for completed contracts, an entity need not restate contracts that begin and end within the same annual reporting period)

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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
Understand
How
Where
When
What
Question
Apply
Why
Answers
Query
Questions

Thank You

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