Revenue Recognition

Refresher course on IND AS – Practical aspects. 9th August 2020

CA Nitish Kirtikar

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IND AS 115 Revenue from contracts with Customers

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Conceptual framework for financial reporting

Elements of financial statements as given in the Framework for the preparation of the Financial statements

Asset:- Asset is a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow

Liability:- A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

Equity:- The residual interest in the asset of the entity after deducting all its liabilities. It presents the cumulative net results of the past transactions and other events affecting the entity since day one of its inception.

Income:- Income is the increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that results in increase in equity, other than those relating to contributions from equity participants. It encompasses both revenue and gains. Revenue arises in the normal course of business by its ordinary activities and is referred by different names likes sales, fees, commission, rent, interest, dividend, royalty etc.

Expense:- It is the decrease in economic benefits during the accounting period in the form of outflows or depletion of assets or incurrence of liabilities those results in decrease in equity, other than those relating to contribution to equity participants. It encompasses both losses and expenses that arise in the course of ordinary activity of the entity.

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IFRS 15 – Revenue from contracts with Customers

- **Effective date:-** 1st January 2018
- **Status:-** Replaces IAS18, IAS11, IFRIC13, IFRIC15, IFRIC18 and SIC31

The new standard provides a framework that replaces existing revenue guidance in US GAAP and IFRS. It moves away from the industry- and transaction-specific requirements under US GAAP, which are also used by some IFRS preparers in the absence of specific IFRS guidance.

New qualitative and quantitative disclosure requirements aim to enable financial statement users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

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IND AS115 – Revenue from contracts with Customers

Introduction

The Ministry of Corporate Affairs (MCA), on 28 March 2018, notified Ind AS 115, *Revenue from Contracts with Customers* (which is based on IFRS 15, *Revenue from Contracts with Customers*) as part of the Companies (Indian Accounting Standards) Amendment Rules, 2018. The new standard is effective for accounting periods beginning on or after 1 April 2018, thus aligning the Ind AS 115 applicability date with the IFRS applicability date i.e. 1 January 2018.

The new standard replaces existing revenue recognition standards Ind AS 11, *Construction Contracts* and Ind AS 18, *Revenue* and revised guidance note of the Institute of Chartered Accountants of India (ICAI) on Accounting for Real Estate Transactions for Ind AS entities issued in 2016.

This standard also modifies other Ind AS for e.g. Ind AS 16, *Property, Plant and Equipment* for determining the date of sale of Property, Plant and Equipment (PPE) i.e. date of disposal of an item of PPE is the date the recipient obtains control of that item in accordance with Ind AS 115. The corresponding changes to other Ind AS have also been notified.

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Ind AS 115 – Revenue from contracts with Customers

Core principle of this Standard is that an entity shall **recognize revenue when (or as) an entity transfers CONTROL of goods or services to a customer at the amount to which the entity expects to be entitled** in exchange for those goods or services.

This Standard specifies the accounting for an **individual contract with a customer**. However, as a practical expedient, an entity may apply this Standard to **a portfolio of contracts (or *performance obligations*) with similar characteristics** if the entity reasonably expects that the effects on the financial statements of applying this Standard to the portfolio would not differ materially from applying this Standard to the individual contracts (or performance obligations) within that portfolio.

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Ind AS 115 – Revenue from contracts with Customers

Scope

An entity shall apply this Standard to all contracts with customers, except the following:

(a) lease contracts [Ind AS 17, *Leases]*;

(b) insurance contracts [Ind AS 104, *Insurance Contracts]*;

(c) financial instruments and other contractual rights or obligations within the scope of Ind AS 109, Ind AS 110, Ind AS 111, Ind AS 27 and Ind AS 28; and

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

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Exchange transaction

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Case study 1: Company X is in the business of buying and selling commercial property. It sells a property to Purchaser Y. Is this transaction within the scope of IND AS 115 ?

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Solution to Case study 1: This transaction is in the scope of the new standard because Purchaser Y has entered into a contract to purchase an output of Company X's ordinary activities and is therefore considered a customer of Company X.

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Case study 2: Company X is a manufacturing entity selling its Corporate headquarters to Purchaser Y. Is this transaction within the scope of IND AS 115 ?

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Ind AS 115 – Revenue from contracts with Customers

Solution to Case study 2: This transaction is not in the scope of IND AS 115 because selling real estate is not an ordinary activity of Company X.

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Ind AS 115 – Revenue from contracts with Customers

Contributions

A contribution is a nonreciprocal transfer of cash or other assets, rather than an exchange transaction – i.e. it is not given in exchange for goods or services that are an output of the entity's ordinary activities. Accordingly, contributions are not transactions with a customer, because a customer is defined in the new revenue standard as 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. Therefore, contributions are not in the scope of the new revenue standard.

A not-for-profit entity may enter into some transactions that are contributions, and others that are not. A not-for-profit entity therefore needs to evaluate which, if any, of its transactions are either fully or partially in the scope of the new revenue standard.

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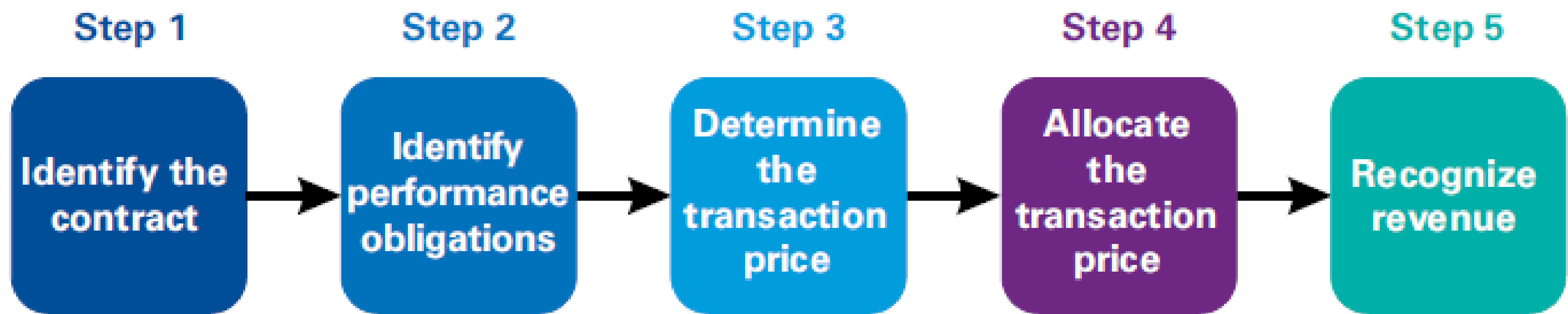
Ind AS 115 – Revenue from contracts with Customers

5 step model for recognizing revenue

Entities will apply a five-step model to determine when to recognize revenue, and at what amount. The model specifies that revenue is recognized when or as an entity transfers control of goods or services to a customer at the amount to which the entity expects to be entitled. Depending on whether certain criteria are met, revenue is recognized:

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



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5 step model for recognizing revenue

Step 1: Identify the contract with a customer

- A contract creates enforceable rights and obligations
- It may be written, oral or implied by the entity's customary business practices
- A contract must meet 3 minimum criteria i.e. It is a substantive agreement; payment terms and each party's rights can be identified; parties plan to enforce their rights

Step 2:-Identify the Performance obligations in the Contract

- If there is more than one performance obligation [good or service] represented in the contract, each should be accounted for separately if they are distinct.
- If they are not distinct, they should be combined with other goods or services untill you have created a bundle that is distinct
- Judgment around whether or not two things ought to be put together or whether you can account for them separately

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5 step model for recognizing revenue

Step 3: Determine the Price

- Significant judgments' and estimates needs to be made in determining the transaction price – most likely amount or expected value when there is variable consideration.
- Include an estimate of variable consideration in the transaction price to the extent that it is "highly probable" that a significant reversal will not occur.
- Discounting is required if a contract has a significant financing component

Step4:- Allocate the transaction price

- Transaction price must be allocated to each separate performance obligation
- This is based on the relative standalone selling price. If this price is not observable, it should be estimated
- 'Adjusted market assessment approach', 'expected-cost-plus-a-margin approach' and residual approach may be used to estimate the standalone selling prices.

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5 step model for recognizing revenue

Step5:- Recognize revenue when or as performance obligations are satisfied

- This is where the standard's core principle of 'transfer of control' – which replaces the old concept of 'transferring risks and rewards of ownership' - comes into play.
- Performance obligations are considered and revenue should be recognized - when or as transfer of control occurs.
- Revenue should be recognized over time if one of the following 3 criteria is met:- a) The customer simultaneously receives and consumes benefits b) The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced c) the entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

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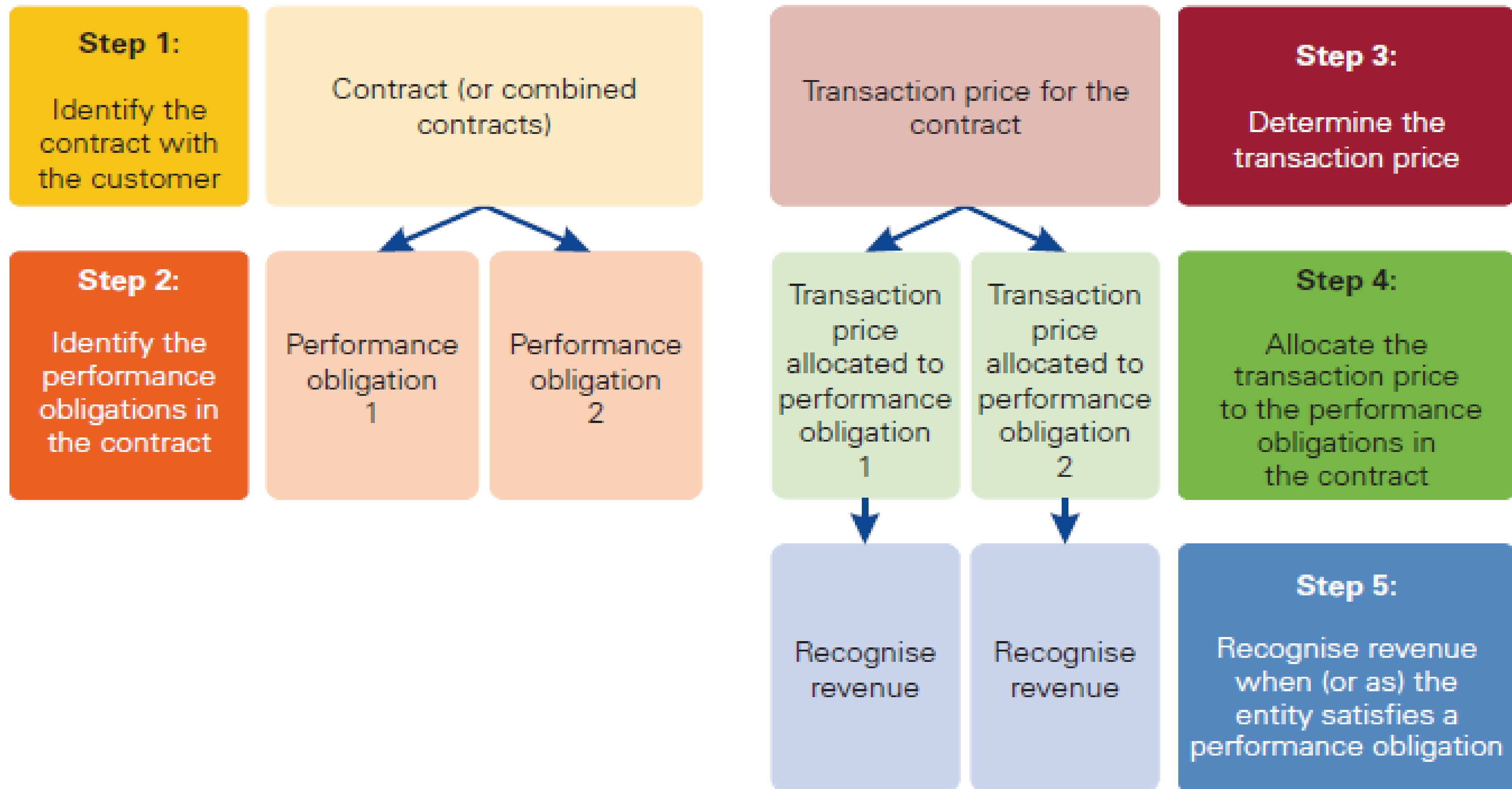
Ind AS 115 – Revenue from contracts with Customers

How to apply the 5 step model

The core principle of the new standard's five-step model is that entities should recognise revenue to depict the transfer of promised goods or services to customers – and the amount of revenue should reflect the consideration to which they expect to be entitled in exchange for those goods or services.



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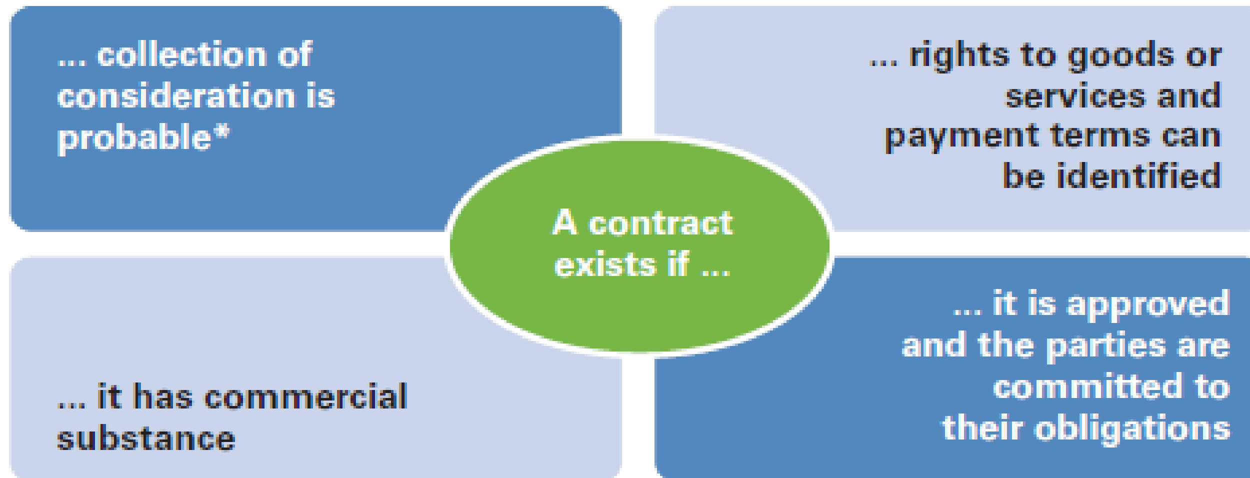
Ind AS115 – Revenue from contracts with Customers

Step 1 – Identify the contract with customer

Sectors likely to be significantly affected: Aerospace and defence, health care (US), life sciences, real estate

The new standard defines a contract as an agreement between two or more parties that creates enforceable rights and obligations and specifies that enforceability is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. In some instances, two or more contracts are combined and accounted for as a single contract with a customer. A contract with a customer also needs to meet all of the following criteria.



* The threshold differs under IFRS and US GAAP due to different meanings of the term 'probable'.

Collectability of an amount of consideration is probable = an entity shall consider only the customer's ability and intention to pay

Probable = More likely than not

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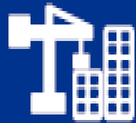
Ind AS115 – Revenue from contracts with Customers

Step 1 – Identify the contract with customer

Sectors likely to be significantly affected

The new requirements are expected to affect different sectors in different ways. The following section highlights the areas of accounting for relevant sectors that may have an impact due to revised requirements specific to identification of contract:

Construction/ real estate



- Claims and variation
- Collectability assessments

Software and technology

- Renewal of contracts

Aerospace and defense

- Government approvals
- Termination clauses

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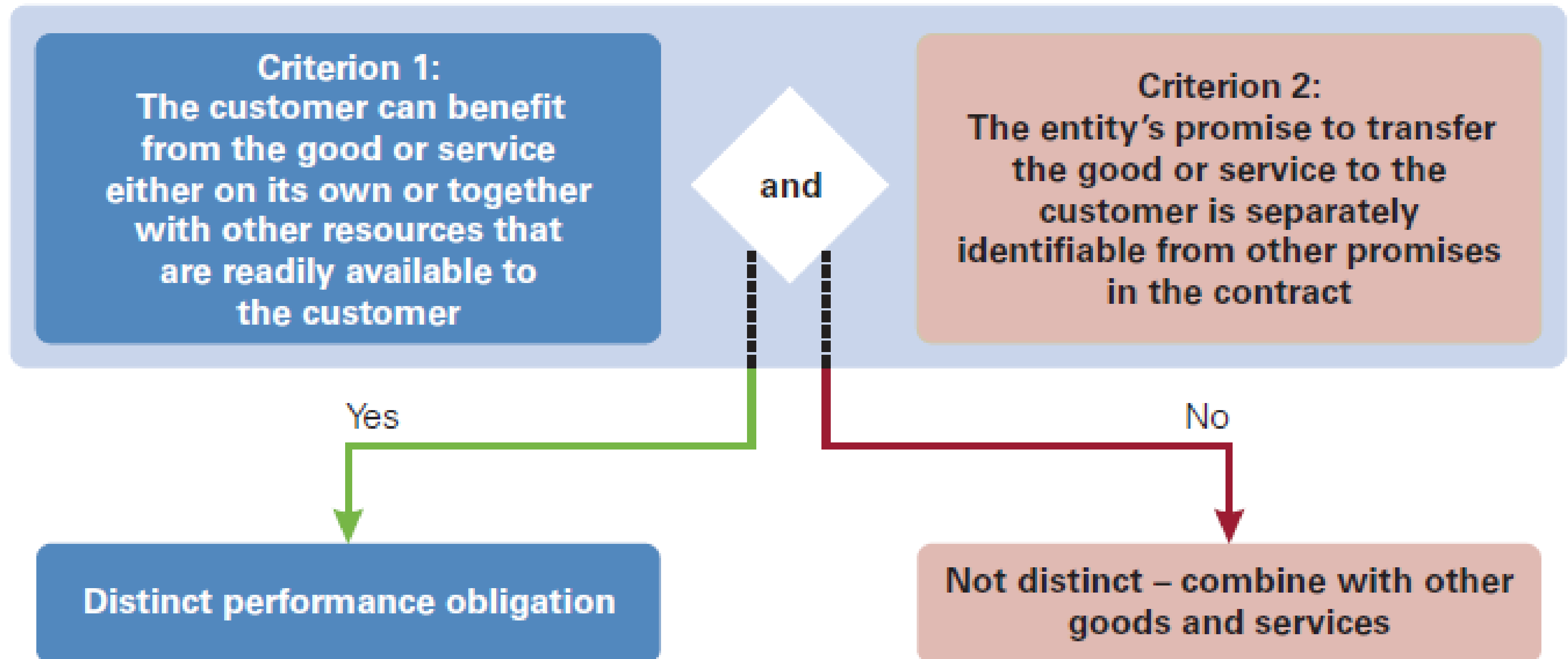
Step 2 – Identify the performance obligations in the contract

Entities identify each promise to deliver a good or provide a service in a contract with a customer. A promise constitutes a performance obligation if the promised good or service is distinct. A promised good or service is distinct if it meets *both* of the following criteria.



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Step 2 – Identify the performance obligations in the contract

The following table highlights few examples of scenarios of single and multiple performance obligations:

Description of scenario	Conclusion
Entity provides a significant integration service for a building construction and delivers a single output to the customer	Single performance obligation
Entity provides a customer with equipment and a separately identifiable installation service	Multiple performance obligation
Entity provides the customer with equipment and proprietary consumable that are separately identifiable	Multiple performance obligation
Entity provides the customer with good and an implicit promise to provide a service to the customer's customer who purchase the good	Multiple performance obligation

If a promised good or service under the contract does not qualify to be a separate performance obligation, the entity would need to combine such good or service with other goods or services until the bundled arrangement qualifies to be a performance obligation. Identification of a performance obligation requires significant judgement and entails an assessment of the promised goods and services under the contract (including implied and customary promises).

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Ind AS 115 – Revenue from contracts with Customers

Step 2 – Identify the performance obligations in the contract

Sectors likely to be significantly affected

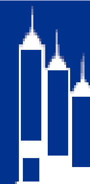
Telecommunication

- Devices and handsets
- Activation and installation
- Telecom services (voice data and SMS)

Technology

- Licences
- Customisation
- Customer Support
- Updates

Real estate



- Common areas
- Amenities (e.g. car park, club membership)

Pharmaceuticals

- Licence for compound combined with research and development and manufacturing services

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Step 3 – Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer. To determine this amount, an entity considers multiple factors.

Variable consideration (and the constraint)

Entities consider the risk of revenue reversal when determining how much variable consideration to include in the transaction price.

Consideration payable to a customer

Entities need to determine whether consideration payable to a customer represents a reduction of the transaction price, a payment for a distinct good or service, or a combination of the two.

Transaction price

Non-cash consideration

Non-cash consideration is measured at fair value, if that can be reasonably estimated. If not, an entity uses the stand-alone selling price of the good or service that was promised in exchange for non-cash consideration.

Significant financing component

For contracts with a significant financing component, entities adjust the promised amount of consideration to reflect the time value of money.

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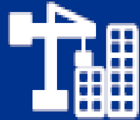
Step 3 – Determine the transaction price

Sectors likely to be significantly affected

Construction/ real estate

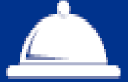


- Cost escalations
- Completion and performance bonus
- Deferred and advance payments

Telecommunication

- Quantity related discounts
- Enterprise service contract with usage fee
- Wireless instalment plan with service contract

Hospitality



- Club memberships

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Step 3 – Determine the transaction price

- Customer Credit risk is not considered when determining the amount to which an entity expects to be entitled
- instead, Credit risk is considered when **assessing the existence of a contract.**
- However, if a contract **includes a significant financing component** to the customer, then the entity considers credit risk in determining the **appropriate discount rate to use.**
- An entity **recognizes a refund liability** for consideration received or receivable if it expects to refund some or all of the consideration to the customer

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Step 3 – Determine the transaction price

- The promised consideration may be variable if **an entity's customary business practices and relevant facts and circumstances** indicate that the entity may accept a price lower than what is stated in the contract.

- When an entity enters into a contract with a customer **for an undefined quantity of output at a fixed contractual rate per unit of output**, the consideration may be variable. Unknown quantities could also represent **customer options for which the entity will need to consider** a material right exists.

- Different outcomes and disclosure requirements can arise depending on whether an entity concludes that purchases of additional goods or services by a customer **are exercises of customer options or variable consideration. Future purchases that are options will be evaluated to determine whether they include a material right. Future purchases that are variable consideration are included in the initial identification of performance obligations, and determination of the transaction price, and may lead to additional estimation and disclosure requirements.**

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Step 3 – Determine the transaction price

Customer options for additional goods or services

Overview

An entity accounts for a customer option to acquire additional goods or services as a performance obligation if the option provides the customer with a material right. The new standard provides guidance on calculating the stand-alone selling price of a customer option when it is a material right.

General requirements

Requirements of the new standard

When an entity grants the customer an option to acquire additional goods or services, that option is a performance obligation under the contract if it provides a material right that the customer would not receive without entering into that contract.

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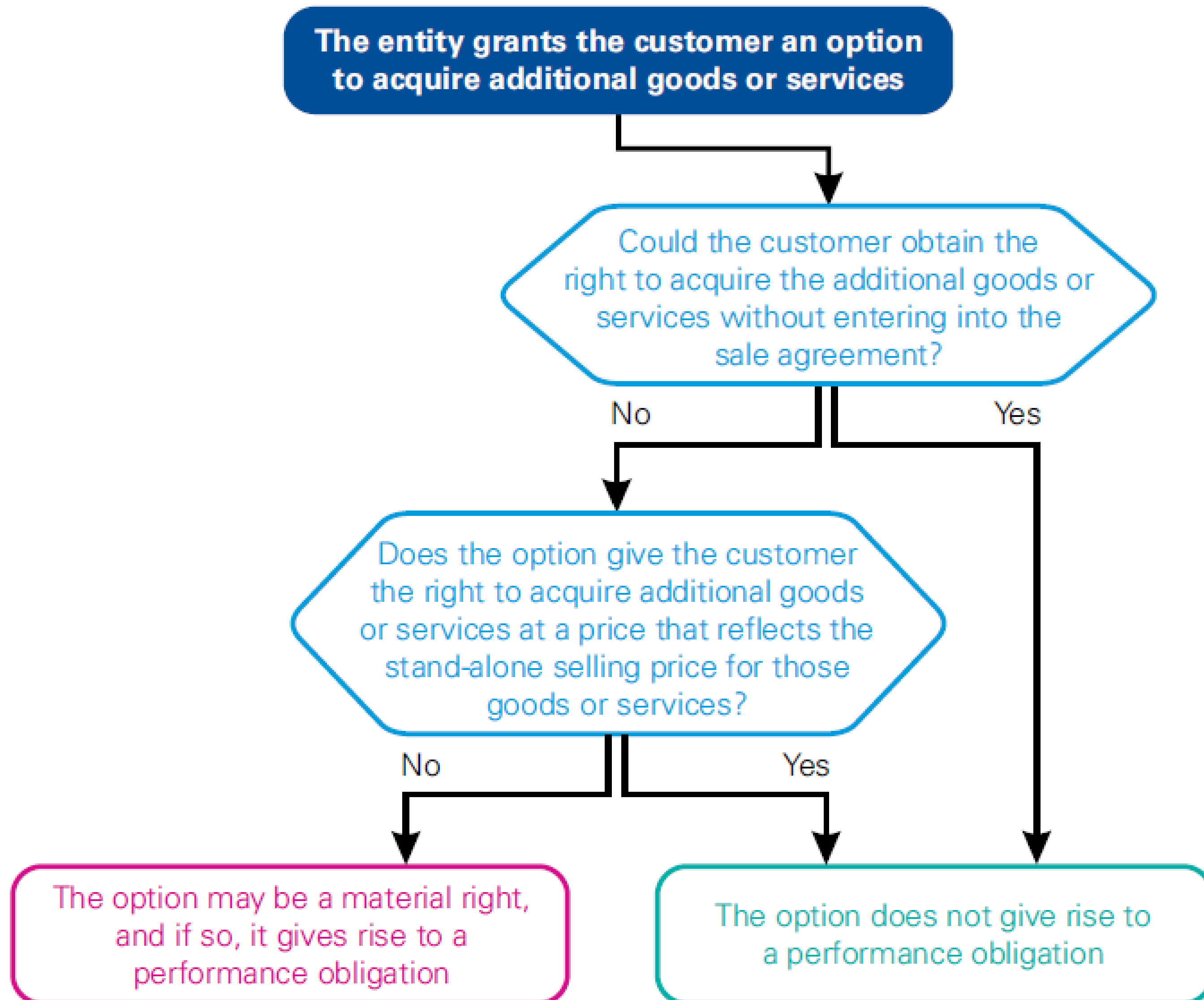
Step 3 – Determine the transaction price

The following flow chart helps analyze whether a customer option is a performance obligation.



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Step 3 – Determine the transaction price

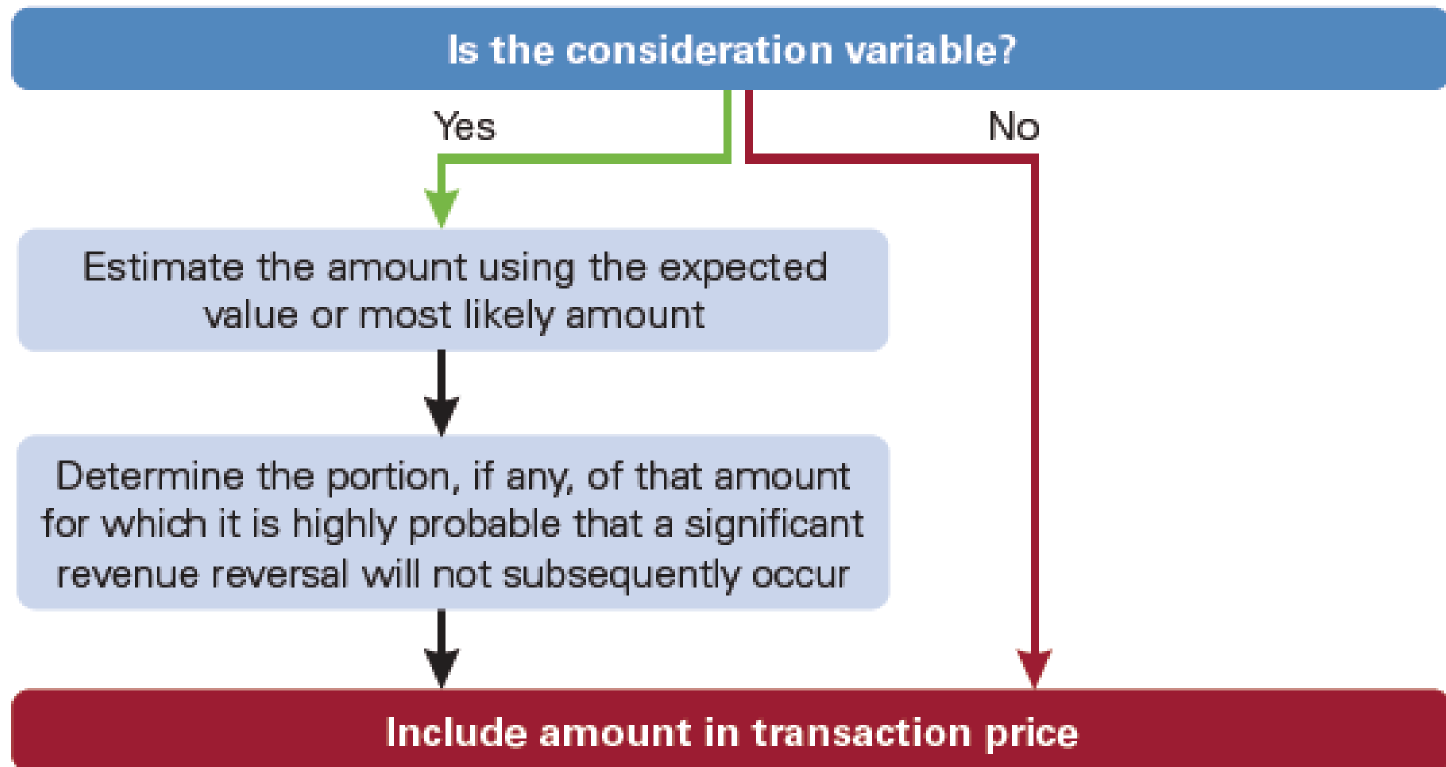
Distinguishing Options Vs variable consideration. Significant judgement required

Options for additional goods or services	Variable consideration
Customer has a present contractual right to purchase additional distinct goods or services.	Future event that results in additional consideration occurs as performance obligation is being satisfied (i.e. when control of goods or services is transferred to the customer).
Each exercise of an option is a separate purchase decision and transfer of control of additional goods and services by the entity if the customer is not currently obligated under the contract to do so	Contract with customer obligated the vendor to stand ready to transfer the promised goods or services, and the customer does not make a separate purchase decision for additional goods or services to be provided by the vendor.
If a tiered pricing structure provides discounts for future purchases only after volume thresholds are met, then the entity evaluates to determine whether arrangement conveys a material right to customer – in such case it is a separate performance obligation and entity allocates a portion of the transaction price.	If discount applies retrospectively to all purchases under a contract once the threshold is achieved, the discount represents variable consideration. In this case, the entity estimates the volumes to be purchased and the resulting discount in determining the transaction price and updates that estimate throughout the term of the contract.

Ind AS 115 – Revenue from contracts with Customers

Step 3 – Determine the transaction price

This assessment needs to be updated at each reporting date. The flow chart below sets out how entities will determine the amount of variable consideration to be included in the transaction price, except for sales- or usage-based royalties from distinct licences of intellectual property.



Items such as discounts, rebates, refunds, right to return, credits, price concessions, incentives, performance bonuses, penalties or similar items may result in variable consideration.

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Step 3 – Determine the transaction price

51AA In some contracts, penalties are specified. In such cases, penalties shall be accounted for as per the substance of the contract. Where the penalty is inherent in determination of transaction price, it shall form part of variable consideration. For example, where an entity agrees to transfer control of a good or service in a contact with customer at the end of 30 days for Rs. 1,00,000 and if it exceeds 30 days, the entity is entitled to receive only Rs. 95,000, the reduction of Rs. 5,000 shall be regarded as variable consideration. In other cases, the transaction price shall be considered as fixed.

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Step 3 – Determine the transaction price

Significant financing component

Requirements of the new standard

To estimate the transaction price in a contract, an entity adjusts the promised amount of consideration for the time value of money if that contract contains a significant financing component.

The objective when adjusting the promised amount of consideration for a significant financing component is to recognize revenue at an amount that reflects what the cash selling price of the promised good or service would have been if the customer had paid cash at the same time as control of that good or service transferred to the customer. The discount rate used is the rate that would be reflected in a separate financing transaction between the entity and the customer at contract inception.

To make this assessment, an entity considers all relevant factors – in particular the:

- difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services;
- combined effect of the expected length of time between the entity transferring the promised goods or services to the customer and the customer paying for those goods or services; and
- prevailing interest rates in the relevant market.

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Ind AS 115 – Revenue from contracts with Customers

Step 3 – Determine the transaction price

A contract does not have a significant financing component if any of the following factors exists.

Factor	Example
An entity receives an advance payment, and the timing of the transfer of goods or services to a customer is at the discretion of the customer	A prepaid phone card or customer loyalty points
A substantial portion of the consideration is variable, and the amount or timing of the consideration is outside the customer's or entity's control	A transaction whose consideration is a sales-based royalty
The difference between the amount of promised consideration and the cash selling price of the promised goods or services arises for non-finance reasons	Protection against the counterparty not completing its obligations under the contract

The new standard indicates that:

– an entity should determine the discount rate at contract inception, reflecting the credit characteristics of the party receiving credit; and

– the discount rate should not generally be updated for a change in circumstances.

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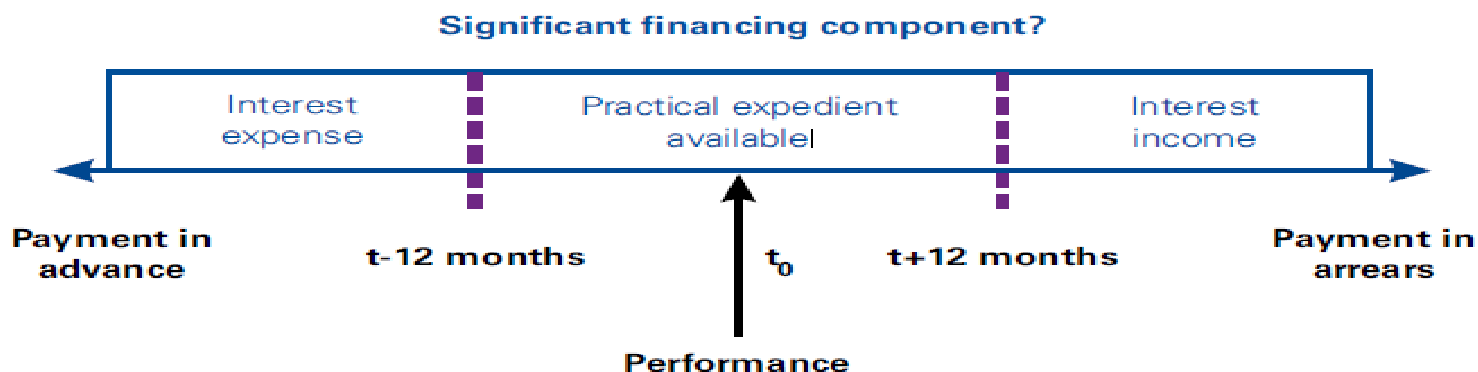
Step 3 – Determine the transaction price

As a practical expedient, an entity is not required to adjust the transaction price for the effects of a significant financing component if, at contract inception, the entity expects the period between customer payment and the transfer of goods or services to be one year or less.

For contracts with an overall duration greater than one year, the practical expedient applies if the period between performance and payment for that performance is one year or less.

The financing component is recognized as interest expense (when the customer pays in advance) or interest income (when the customer pays in arrears), and is presented separately from revenue from customers.



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Step 3 – Determine the transaction price

No significant financing component if the timing of transfer of goods or services is at the customer's discretion

Customers pay for some types of goods or services in advance – e.g. prepaid phone cards, gift cards, and customer loyalty points – and the transfer of the related goods or services to the customer is at the customer's discretion. In these cases, the contracts do not include a significant financing component, because the payment term does not relate to a financing arrangement. Also, the Boards believe that the costs of requiring an entity to account for the financing component in these situations would outweigh any perceived benefits, because the entity would not know – and would therefore have to continually estimate – when the goods or services will transfer to the customer.

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Step 3 – Determine the transaction price

Example 20 – Time value of money in a multiple-element arrangement

Product Company B enters into a contract with Customer C to deliver Product X and Product Y for 150,000 payable up-front. Product X will be delivered in two years and Product Y will be delivered in five years.

Product Company B determines that the contract contains two performance obligations that are satisfied at the points in time at which the products are delivered to Customer C. Product Company B allocates the 150,000 to Products X and Y at an amount of 37,500 and 112,500 respectively – i.e. based on their relative stand-alone selling prices. Product Company B concludes that the contract contains a significant financing component and that a financing rate of 6% is appropriate based on Product Company B's credit-standing at contract inception.

How should Product Company B account for the above contract ?

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Step 3 – Determine the transaction price

SOLUTION

Product Company B accounts for the contract as follows.

Contract inception	Recognize a contract liability for the payment of 150,000
Years 1 and 2	During the two years from contract inception until the transfer of Product X, recognize interest expense of 9,000 and 9,540[a] on 150,000 at 6% for Years 1 and 2, respectively, for a cumulative interest expense of 18,540
	Recognize revenue of 42,135[b] for the transfer of Product X
Years 3, 4 and 5	Recognize annual interest expense of 7,584, 8,039, 8,522[c] for Years 3, 4, and 5, respectively, based on the contract liability at the beginning of Year 3 of 126,405[d]
	Recognize revenue of 150,550[e] for the transfer of Product Y

Notes

a. Calculated as 150,000 ×.06 for Year 1 and 159.000 x.06 for Year 2.

b. Calculated as 37,500 + 4,635, being the initial allocation to Product X plus Product X's portion of the interest for Years 1 and 2 of the contract (37,500 ÷ 150,000 x 18,540).

c. Calculated as 126,405 ×.06 = 7,584; (126,405 + 7,584) x.06 = 8,039; and (126,405 + 7,584 + 8,039) x.06 = 8,522.

d. Calculated as 150,000 + 18,540 - 42,135, being the initial contract liability plus interest for two years less the amount derecognized from the transfer of Product X.

e. Calculated as 126,405 + 24,145, being the contract liability balance after two years plus interest for three years.

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Step 3 – Determine the transaction price

Example 21 – Determining whether an arrangement has a significant financing component – Payment in advance

Technology Company T signs a three-year, noncancellable agreement with Customer C to provide hosting services. Customer C may elect to either pay:

a. 140 per month (total payment is 5,040); or

b. 4,200 at the beginning of the contract term, with no additional monthly payments.

Does this contract include a financing component under option b ?

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Step 3 – Determine the transaction price

SOLUTION

The contract includes a financing component.

The difference in pricing between option (a) and option (b) indicates that the contractual payment terms under option (b) have the primary purpose of providing Technology Company T with financing. The cash-selling price is the monthly fee of 140 because it reflects the amount due when the monthly hosting services are provided to Customer C. A comparison of the payment terms between options (a) and (b) indicates the total cumulative interest of 840 and an implied discount rate of 13%.

Technology Company T considers if factors indicating that a significant financing component does not exist apply in this case and concludes that they do not. Technology Company T determines that the financing component is significant because the difference between the cumulative cash-selling price of 5,040 and the financed amounts of 4,200 is 840, or approximately 20% of the financed amount. Therefore, an adjustment to reflect the time value of money will be needed if the customer elects option (b) to pay at the beginning of the contract.

Technology Company T evaluates whether the implied discount rate of 13% is consistent with the market rate of interest for companies with the same credit rating as its own. Assuming that it is, Technology Company T recognizes revenue of 5,040 ratably over the contract term as the performance obligation is satisfied and interest expense of 840 using the effective interest method. The amount of interest expense to recognize each period is based on the projected contract liability, which decreases as services are provided and increases for the accrual of interest.

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Ind AS 115 – Revenue from contracts with Customers

Step 3 – Determine the transaction price

SOLUTION

Below is one example interest calculation under the effective interest method.

Period	Contract liability – Beginning of month	Transaction price/ Delivery of service	Interest expense at 1.083% (Monthly rate – 13% ÷ 12)	Contract liability – End of month
	A	B	(A - B) x 1.083% = C	A - B + C
1	4,200	140	44	4,104
2	4,104	140	43	4,007
3	4,007	140	42	3,909
4	3,909	140	41	3,810
5	3,810	140	40	3,710
		Continue for each period…		
36	140	140	0	0

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Ind AS 115 – Revenue from contracts with Customers

Step 3 – Determine the transaction price

Example 22 – Determining whether an arrangement has a significant financing component – Payment in arrears

Manufacturer A enters into a contract to provide equipment to Customer C priced at 2,000,000. Customer C is a start-up entity with limited cash and Manufacturer A agrees that Customer C would pay for the equipment over two years by monthly installments of 92,000.

Does this contract include a financing component ?

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Ind AS 115 – Revenue from contracts with Customers

Step 3 – Determine the transaction price

SOLUTION

The contract includes a financing component. The difference in pricing between the selling price of 2,000,000 and the total of the monthly payments of 2,208,000 (24 x 92,000) indicates that the contractual payment terms have the primary purpose of providing Customer C with financing. The cash-selling price is 2,000,000 because it reflects the amount due at the point the equipment is transferred to Customer C. A comparison of the cash selling price and the total payments to be received indicates the total cumulative interest of 208,000 and an implied interest rate of 9.7%.

Technology Company T considers if factors indicating that a significant financing component does not exist apply in this case and concludes that they do not. Manufacturer A determines that the financing component is significant because the difference between the cash-selling price of 2,000,000 and the total promised consideration of 2,208,000 is 208,000, or approximately 10% of the financed amount. Therefore, an adjustment to reflect the time value of money is needed.

Manufacturer A evaluates whether the implied interest rate of 9.7% is consistent with the market rate of interest for companies with the same credit-standing as Customer C. Assuming that it is, Manufacturer A recognizes revenue of 2,000,000 upon delivery of the equipment – i.e. as the performance obligation is satisfied – and interest income on a monthly basis using the effective interest method. The amount of interest income for each month is based on the balance of the receivable for equipment sold, which decreases as payments are received.

TOTAL Classificatio
TOTAL - All rights r

Ind AS 115 – Revenue from contracts with Customers

Step 3 – Determine the transaction price

SOLUTION

Below is one example interest calculation under the effective interest method.

Period	Receivable – Beginning of month	Monthly payment – End of month	Interest income at 0.81% (Monthly rate – 9.7% ÷ 12)	Receivable – End of month
	A	B	A x 0.81% = C	A - B + C
1	2,000,000	92,000	16,143	1,924,143
2	1,924,143	92,000	15,531	1,847,674
3	1,847,674	92,000	14,913	1,770,587
4	1,770,587	92,000	14,291	1,692,878
5	1,692,878	92,000	13,664	1,614,542
		Continue for each period...		
24	91,263	92,000	737	0

If, in the above example, the implied interest rate of 9.7% is determined to be a below-market rate, then the transaction price would be adjusted to reflect a market rate, based on Customer C's creditworthiness. The difference between the implied interest rate and the market rate would represent a discount granted to the customer for purposes other than financing.

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Ind AS 115 – Revenue from contracts with Customers

Step 4 – Allocate the transaction price to performance obligations

Entities will generally allocate the transaction price to each performance obligation in proportion to its stand-alone selling price.

The best evidence of the stand-alone selling price is an observable price from stand-alone sales of that good or service to similarly situated customers. However, if the stand-alone selling price is not directly observable, entities should estimate it by either:

- evaluating the market in which they sell goods or services and estimating the price customers would be willing to pay;
- forecasting expected costs plus an appropriate margin; or
- in limited circumstances, subtracting the sum of observable stand-alone selling prices of other goods or services in the contract from the total transaction price.

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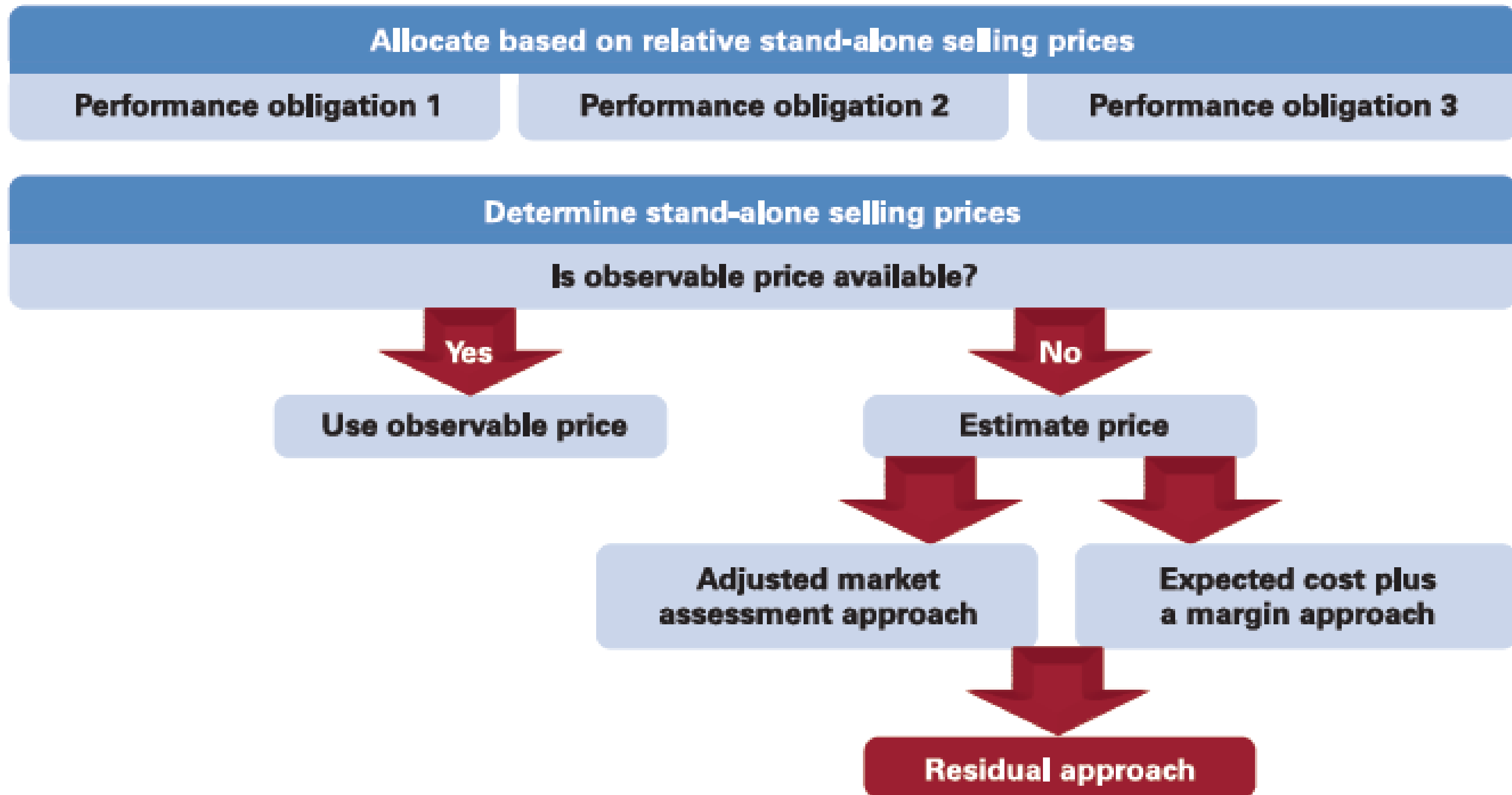
Ind AS 115 – Revenue from contracts with Customers

Step 4 – Allocate the transaction price to performance obligations



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Ind AS 115 – Revenue from contracts with Customers

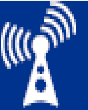
Step 4 – Allocate the transaction price to performance obligations

Sectors likely to be significantly affected

Technology

- Stand-alone selling prices of various performance obligations e.g. licences, upgrades, etc.
- Allocation of discounts and variable consideration

Telecommunication



- Complex telecommunication contracts
- Stand-alone selling prices to be reassessed frequently

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Ind AS 115 – Revenue from contracts with Customers

Step 5 – Recognize revenue when (or as) the entity satisfies a performance obligation

Sectors likely to be significantly affected: Aerospace and defence, building and construction, contract manufacturers, licensors, real estate, software

An entity recognises revenue when (or as) it satisfies a performance obligation by transferring control of a good or service to a customer. Control may be transferred either at a point in time or over time.

First, the entity assesses whether it transfers control over time, using the following criteria.

	Criterion	Example
1	The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.	Routine or recurring services.
2	The entity'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.
3	The entity's performance does not create an asset with an alternative use to the entity and the entity 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 order.

If one or more of these criteria is met, the entity recognises revenue over time, using a method that depicts its performance. This may be either an output method (e.g. units produced) or an input method (e.g. costs incurred or labour hours). The objective is to depict the entity's performance in transferring control of goods or services to the customer.

If an entity's performance has produced a material amount of work in progress or finished goods that are controlled by the customer, then output methods such as units of delivery or units produced will not faithfully depict progress. This is because not all of the work performed is included in measuring the output.

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Ind AS 115 – Revenue from contracts with Customers

Step 5 – Recognize revenue when (or as) the entity satisfies a performance obligation

If an entity uses an input method based on costs incurred, it considers the need to adjust for uninstalled goods and significant inefficiencies in the entity's performance that were not reflected in the price of the contract – e.g. wasted materials, labour or other resources. If the entity transfers to the customer control of a good that is significant to the contract but will be installed later, and if certain criteria are met, then the entity recognises the revenue on that good at zero margin.

If none of the three criteria for recognising revenue over time are met, then the entity recognises revenue at the point in time at which it transfers control of the good or service to the customer.

Indicators that control has passed include a customer having ...

- ... a present obligation to pay
- ... physical possession
- ... legal title
- ... risks and rewards of ownership
- ... accepted the asset

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Ind AS 115 – Revenue from contracts with Customers

Step 5 – Recognize revenue when (or as) the entity satisfies a performance obligation

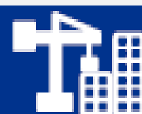
At the end of each reporting period, for each performance obligation satisfied over time, revenue should be recognised by measuring the progress towards complete satisfaction of that performance obligation. An entity should use a single method consistently for such measurement. Ind AS 115 specifies two types of methods: input method and output method, which an entity should consider based on the nature of the goods or services. The objective is to use a method that depicts the transfer of control of goods or services to the customer.

Sectors likely to be significantly affected

Aerospace, defense and construction

- Over time vs point in time
- Output vs input method to measure performance
- Uninstalled material

Real estate/ construction



- Over time vs point in time

Licences

- Licensing revenue based on right-to-use or right-to-access intellectual property

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Ind AS 115 – Revenue from contracts with Customers

Step 5 – Recognize revenue when (or as) the entity satisfies a performance obligation

Example 33 – Treatment of uninstalled materials

In November 2015, Contractor P enters into a lump-sum contract with Customer Q to refurbish a three-story building and install new elevators for total consideration of 5,000. The following facts are relevant.

- The refurbishment service, including the installation of elevators, is a single performance obligation that is satisfied over time.
- Contractor P is not involved in designing or manufacturing the elevators, but is acting as the principal. Customer C obtains control of the elevators when they are delivered to the site in December 2015.
- The elevators are not expected to be installed until June 2016.
- Contractor P uses an input method based on costs incurred to measure its progress toward complete satisfaction of the performance obligation.

The transaction price and expected costs are as follows.

Transaction price	**5,000**
Costs	
Elevators	1,500
Other costs	2,500
Total expected costs	**4,000**

How much revenue should be recognized as at 31.12.2015 ?

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Ind AS 115 – Revenue from contracts with Customers

Step 5 – Recognize revenue when (or as) the entity satisfies a performance obligation

Additional information and solution:

Contractor P concludes that including the costs of procuring the elevators in the measure of progress would overstate the extent of its performance. Consequently, it adjusts its measure of progress to exclude these costs from the costs incurred and from the transaction price, and recognizes revenue for the transfer of the elevators at a zero margin.

By December 31, 2015, other costs of 500 have been incurred (excluding the elevators) and Contractor P therefore determines that its performance is 20% complete (500 ÷ 2,500). Consequently, it recognizes revenue of 2,200 (20% x 3,500[a] + 1,500) and costs of 2,000 (500 + 1,500).

Note

a. Calculated as the transaction price of 5,000 less the cost of the elevators of 1,500.

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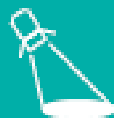
Ind AS 115 – Revenue from contracts with Customers

Step 5 – Recognize revenue when (or as) the entity satisfies a performance obligation



Observations

No guidance on the timing and pattern of the recognition of margin on uninstalled materials

An entity may be entitled to a margin on the uninstalled goods that is clearly identified in the contract terms or forms part of the overall transaction price. The new standard does not provide guidance on the timing of recognition for this margin – i.e. whether it is recognized when the materials are installed, or incorporated into the revenue recognition calculation for the remainder of the contract – or whether the costs are excluded when a measure of progress based on input costs is used.

The Boards believe that recognizing a contract-wide profit margin before the goods are installed could overstate the measure of the entity's performance and, therefore, revenue. However, requiring an entity to estimate a profit margin that is different from the contract-wide profit margin could be complex and could effectively create a performance obligation for goods that are not distinct (therefore bypassing the requirements on identifying performance obligations).

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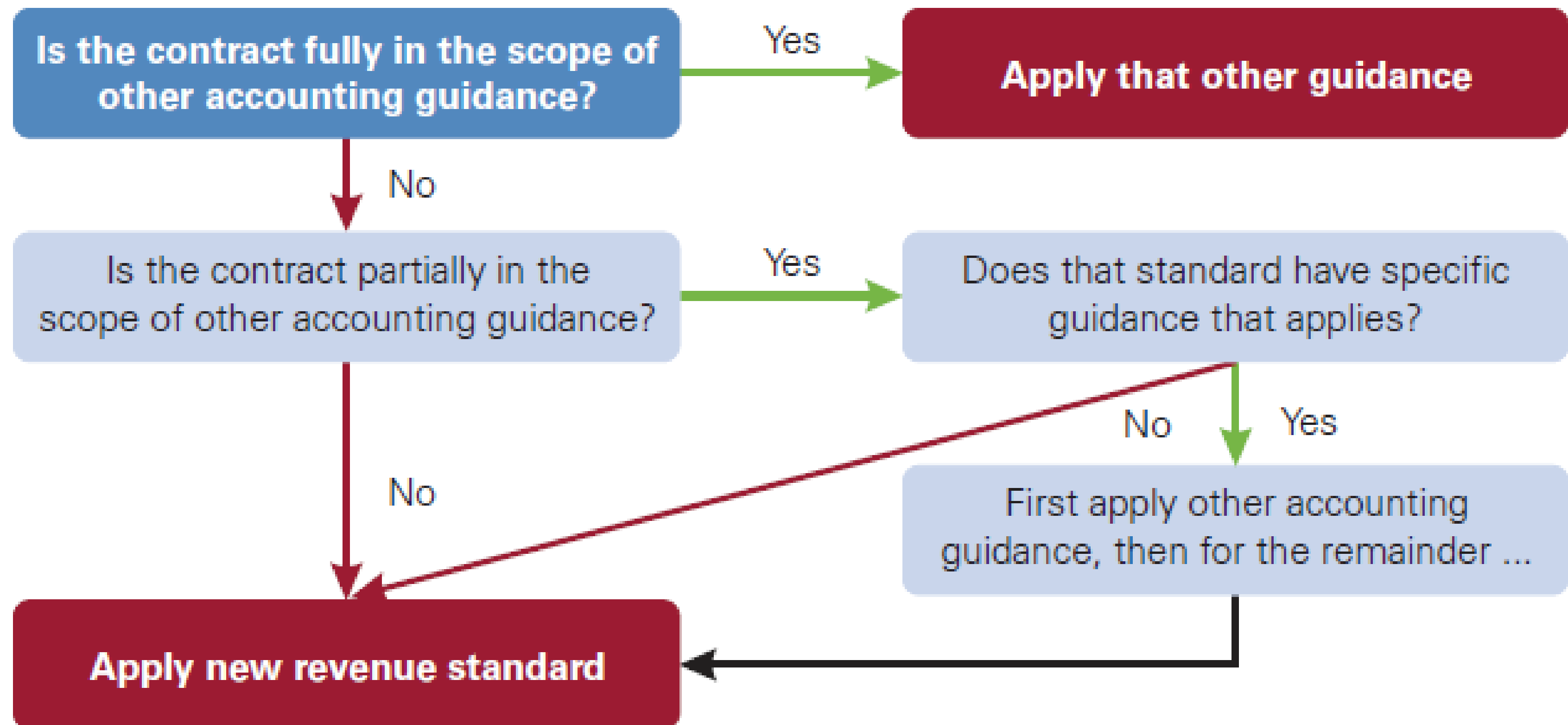
Ind AS 115 – Revenue from contracts with Customers

A contract with a customer may be partially in the scope of the new standard and partially in the scope of other accounting guidance – e.g. a contract for a lease of an asset and maintenance of the leased equipment or a financial services contract with a cash deposit and treasury services.



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Ind AS115 – Revenue from contracts with Customers

Key impacts of Ind AS115

- **Revenue may be recognised at a point in time or over time**
- **Revenue recognition may be accelerated or deferred**
- **Revisions may be needed to tax planning, covenant compliance and sales incentive plans**
- **Sales and contracting processes may need to be re-considered**
- **IT systems may need to be updated**
- **New estimates and judgments may be required**
- **Accounting processes and internal controls will need to be revised**
- **Extensive new disclosures will be required**
- **Entities will need to communicate with stakeholders**

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Ind AS115 – Revenue from contracts with Customers

Disclosure requirements

Ind AS 115 contains extensive disclosure requirements as compared to those under the current Ind AS. The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of the financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

Accordingly an entity should disclose following:

- Disaggregation of revenue
- Contract balances
- Performance obligations
- Significant judgements
- Costs to obtain or fulfil a contract.

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Contract costs

The new standard provides guidance on accounting for incremental costs of obtaining a contract and some costs to fulfil a contract.

Costs to obtain a contract

An entity capitalises incremental costs incurred only as a result of obtaining a contract – e.g. sales commissions – if the entity expects to recover these costs. However, a practical expedient allows an entity to expense such costs as incurred if the amortisation period of the asset is one year or less.

Costs to fulfil a contract

If the costs incurred in fulfilling a contract are not in the scope of other guidance – e.g. inventory, intangibles or property, plant and equipment – then an entity recognises an asset only if the fulfilment costs meet the following criteria:

- they relate directly to an existing contract or specific anticipated contract;
- they generate or enhance resources of the entity that will be used to satisfy the performance obligations in the future; and
- they are expected to be recovered.

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Ind AS115 – Revenue from contracts with Customers

The following are examples of costs that may and may not be capitalised when these criteria are met.

✓ 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**
Costs 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 of capitalised costs

Capitalised costs are amortised on a systematic basis, consistent with the pattern of transfer of the good or service to which the asset relates, and are subject to impairment testing. The amortisation period includes expected contract renewal periods.

Reversal of a previously impaired contract acquisition and contract fulfilment costs for a change in facts and circumstances = Required (limited to the carrying amount, net of amortization, that would have been determined if no impairment loss had been recognized)

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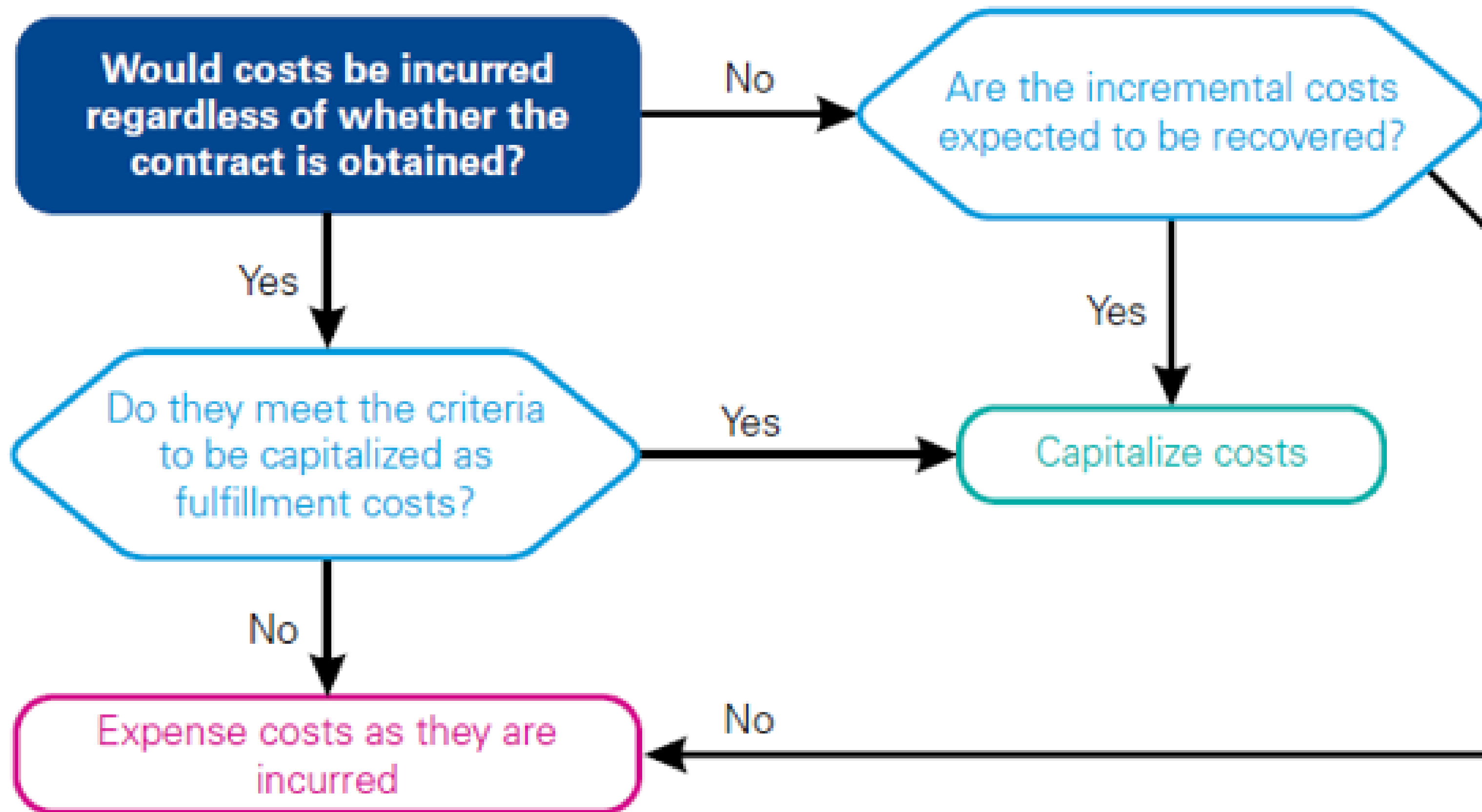
Ind AS115 – Revenue from contracts with Customers

Costs that will be incurred regardless of whether the contract is obtained – including costs that are incremental to *trying* to obtain a contract, are expensed as they are incurred, unless they meet the criteria to be capitalized as fulfillment costs
An example of such costs are costs to prepare a bid, which are incurred even if the entity does not obtain the contract.



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Ind AS115 – Revenue from contracts with Customers

Example 36 – Costs incurred to obtain a contract

Consulting Company E provides consulting services to customers. Following a competitive tender process, Consulting Company E wins a contract to provide consulting services to a new customer. Consulting Company E incurs the following costs to obtain the contract.

External legal fees for due diligence	15
Travel costs to deliver proposal	25
Commissions to sales employees and related payroll taxes	10
Total costs incurred	**50**

The commissions payable to sales employees and related payroll taxes are an incremental cost to obtain the contract, because they are payable only upon successfully obtaining the contract. Consulting Company E therefore recognizes an asset for the sales commissions of 10, subject to recoverability.

By contrast, although the external legal fees and travel costs are incremental costs, they are costs associated with *trying* to obtain the contract. Therefore, they are incurred even if the contract is not obtained. Consequently, Consulting Company E expenses the legal fees and travel costs as they are incurred.

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Contract modifications

A contract modification is any change in the scope or price of a contract (or both). It exists when the parties to a contract approve a modification that creates new, or changes existing, enforceable rights and obligations of the parties to the contract.

Consistent with the identification of a contract, a contract modification has to be legally enforceable. A modification could be approved:

- in writing;
- by oral agreement; or
- as implied by customary business practices.

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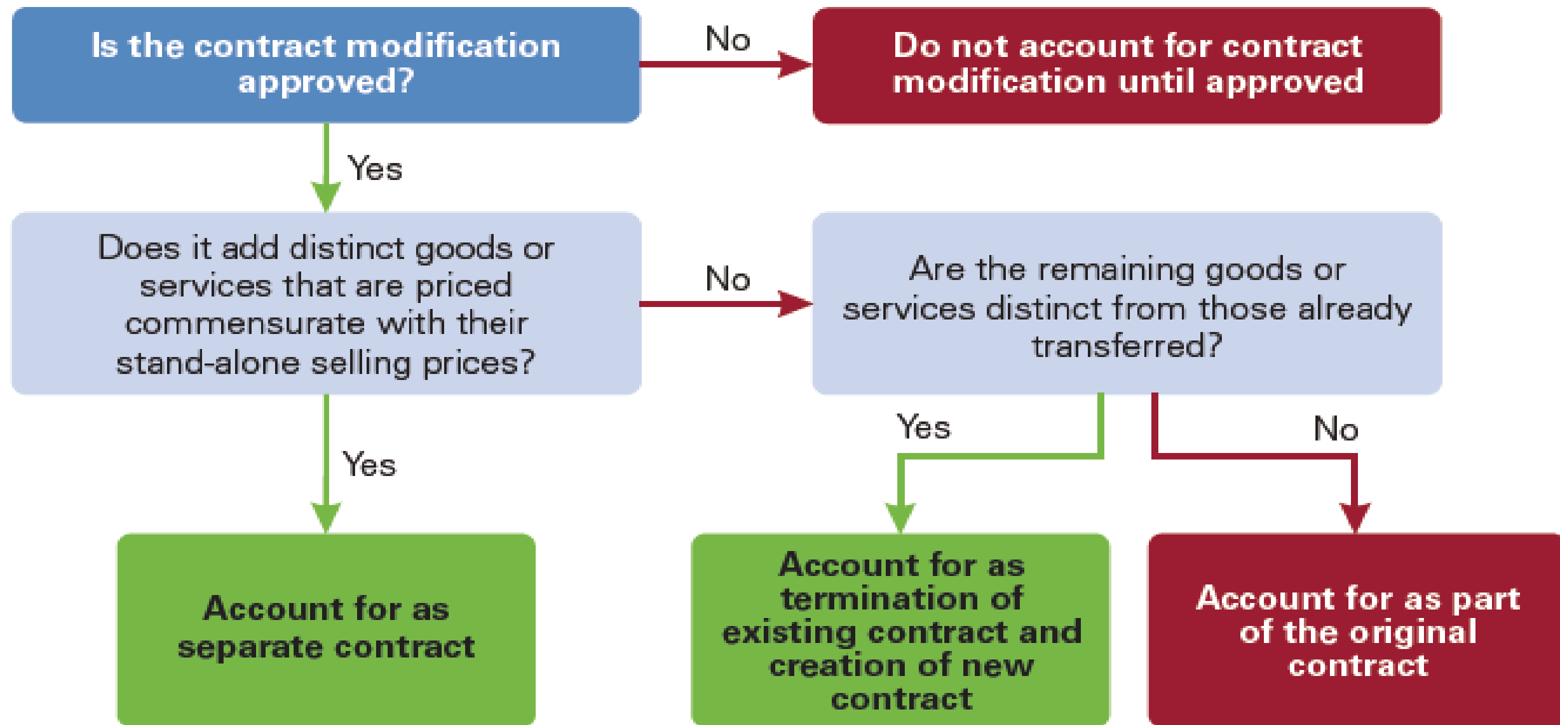
Ind AS115 – Revenue from contracts with Customers

The following flow chart illustrates how contract modifications are accounted for under the new standard.



What are the implications?

The timing of revenue recognition may change

Currently, guidance on contract modifications exists for construction-type and production-type contracts, but under the new standard the contract modification guidance applies to all contracts with customers. When modifications are made to existing contracts, all entities need to evaluate whether the modification is approved, and whether it is accounted for as a separate contract. Depending on this assessment, the timing of revenue recognition may be affected.

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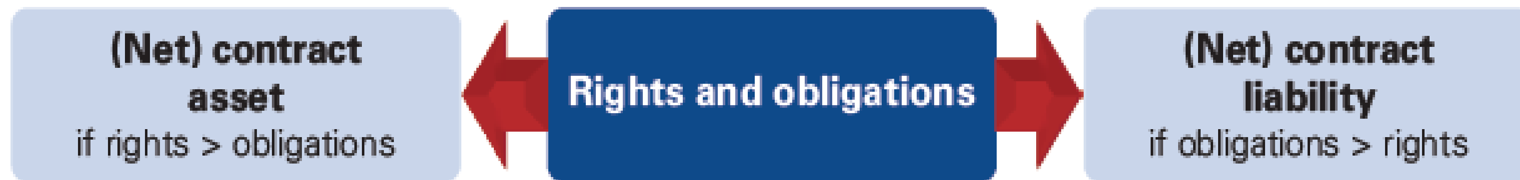
Ind AS115 – Revenue from contracts with Customers

Presentation and disclosures

Presentation of contract assets and liabilities

A contract asset or contract liability, respectively, is recognised when:

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



An unconditional right to consideration is presented as a receivable and accounted for as a financial instrument.

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Ind AS115 – Revenue from contracts with Customers

Disclosure requirements

At a high level, the objective of the disclosure requirements in the new standard is to enable users to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

The new standard requires both qualitative and quantitative disclosures that fall into the following categories:

- contracts with customers:
  - disaggregation of revenue;
  - changes in contract assets, liabilities and costs;
  - performance obligations; and
  - transaction price allocated to remaining performance obligations;
- significant judgements, and changes in judgements, in applying the requirements:
  - determining the timing of satisfaction of performance obligations; and
  - determining the transaction price and amounts allocated to performance obligations; and
- assets recognised from the costs to obtain or fulfil a contract with a customer.

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Ind AS115 – Revenue from contracts with Customers

Summary of transition approaches

Approach	Pre-adoption	Comparative year	Current year	Date of equity adjustment
Full retrospective – no practical expedients	Legacy GAAP	New GAAP	New GAAP	1 January 2016*
Partial retrospective – practical expedients	Legacy GAAP	Mixed requirements	New GAAP	1 January 2016*
Cumulative effect	Legacy GAAP	Legacy GAAP	New GAAP	1 January 2017

* If an entity with a calendar year end provides two years of comparatives, the date of equity adjustment will be 1 January 2015.

First-time adopters of IFRS

First-time adopters of IFRS may choose to apply the new standard either retrospectively, using the practical expedients available, or on a cumulative effect basis from the date of transition to IFRS.

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Ind AS115 – Revenue from contracts with Customers **[Case Studies – Licensing**

Licenses of intellectual property

Requirements of the new standard

A license establishes a customer's rights to the IP of another entity. Examples of IP licenses include:

- software[7] and technology;
- franchises;
- patents, trademarks, and copyrights;
- movies, music, and video games; and
- scientific compounds.

The accounting depends on the legal distinction of a sale or a license of IP. If a transaction is a legal sale of IP, then it is subject to the general model in the same way as the sale of any good or other nonfinancial asset. Sales- or usage-based royalties on a sale of IP are subject to the guidance on measuring variable consideration, including the constraint, and not the specific recognition guidance applicable to sales- or usage-based royalties from a license of IP.

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Determining whether a license is distinct

Requirements of the new standard

A contract to transfer a license to a customer may include promises to deliver other goods or services in addition to the promised license. These promises may be specified in the contract or implied by an entity's customary business practices.

Consistent with other types of contracts, an entity applies Step 2 of the model (see 5.2) to identify each of the performance obligations in a contract that includes a promise to grant a license in addition to other promised goods or services. This includes an assessment of whether the:

- customer can benefit from the license on its own or together with other resources that are readily available; and
- license is separately identifiable from other goods or services in the contract.

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Ind AS115 – Revenue from contracts with Customers **[Case Studies – Licensing**

The following are examples of licenses that are not distinct.

Type of license	Example
License that forms a component of a tangible good and is integral to the functionality of the good	– Software embedded in the operating system of a car
License from which the customer can benefit only in conjunction with a related service	– Media content that the customer can access only via an online service – Drug compound that requires proprietary research and development (R&D) services from the entity

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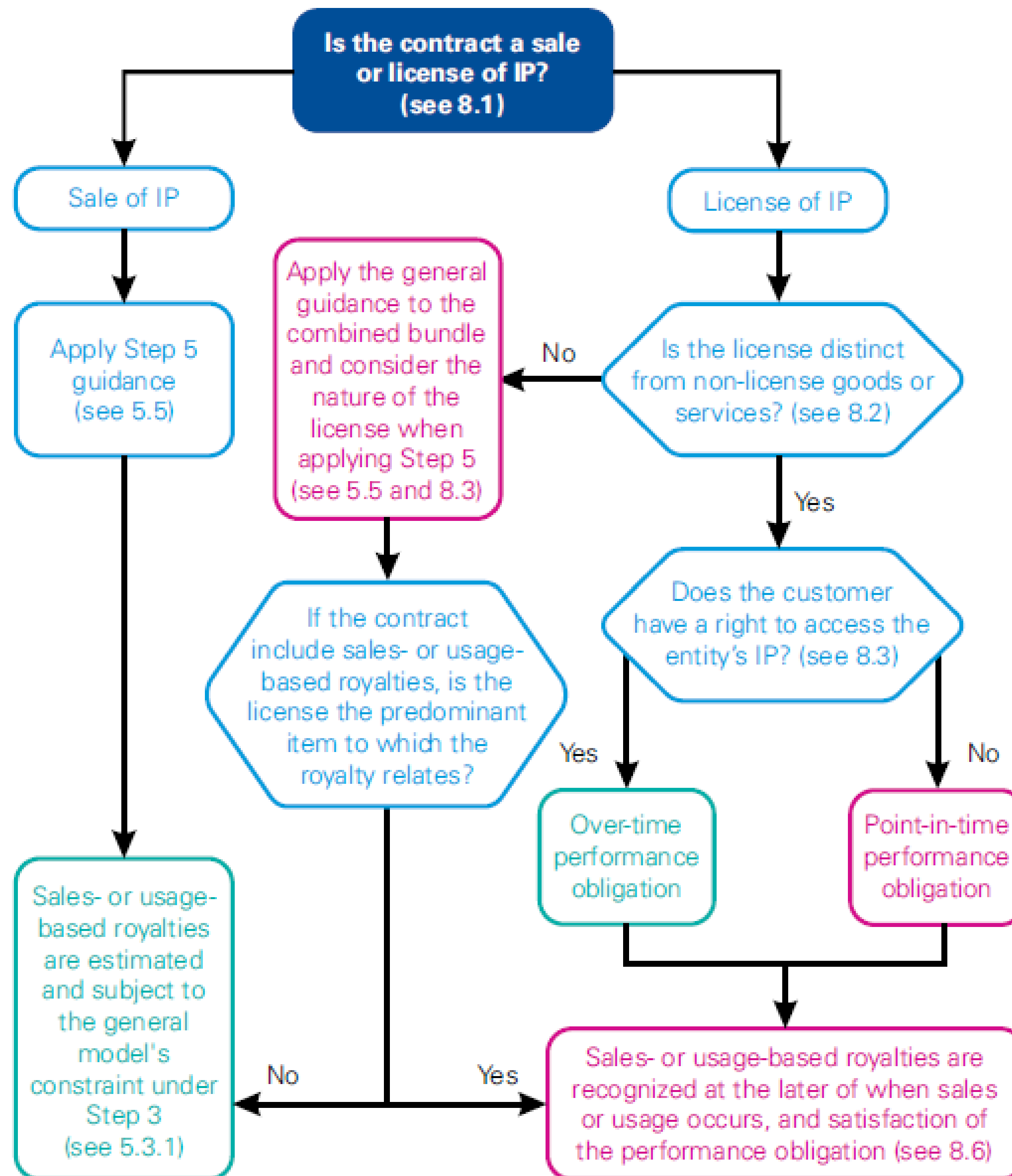
Ind AS115 – Revenue from contracts with Customers **[Case Studies – Licensing**



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Ind AS115 – Revenue from contracts with Customers **[Case Studies – Licensing**

Example 44 – Customer's option to purchase additional licenses

Software Vendor S enters into a five-year software arrangement with Customer C. As part of that arrangement, Software Vendor S provides access to download copies of the software from its website. Customer C pays a fixed fee of 300,000 for up to 200 software downloads. Each downloaded copy can have only a single user. Customer C pays an additional 1,000 per copy downloaded in addition to the 200, prorated based on the remaining license period at the time of download (e.g. 1,000 for copies downloaded in Year 1, 800 for copies downloaded in Year 2). Customer C has been given access codes for 200 downloads. Customer C has to request access codes for each additional download, which Software Vendor S will provide. The number of downloads is measured by Software Vendor S and any additional downloads are paid for each quarter.

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Ind AS115 – Revenue from contracts with Customers [Case Studies – Licensing

SOLUTION

The initial arrangement is generally a multiple license scenario (i.e. Customer C has been granted 200 software licenses) that can be accounted for as a single performance obligation because the licenses are transferred to Customer C at the same point in time. Therefore, the option for additional downloads represents an option to acquire additional user licenses to the software for 1,000 per license.

Because the 1,000 per copy option price is less than the initial per user license fee of 1,500 per license (300,000 ÷ 200 users), Software Vendor S needs to evaluate whether the option provides Customer C with a material right (see 10.4).

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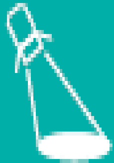
Ind AS115 – Revenue from contracts with Customers **[Case Studies – Licensing**



Observations

Assessing whether a license is distinct may require significant judgment

Licenses of IP are frequently included in arrangements that include promises for other goods or services. The evaluation of whether a license is distinct is often complex and requires assessment of the specific facts and circumstances of the contract. The new standard provides the following illustrative examples that may be helpful in evaluating different fact patterns.

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Ind AS115 – Revenue from contracts with Customers [Case Studies – Licensing

Type of contract	Description	Observations
Example 10C – Technology		
Contract to transfer a three-year license for antivirus software and critical unspecified updates	The example illustrates the identification of a combined performance obligation when the promise to provide updates is an input to a combined item. It is an input because the software license would be of little value without the updates, and the updates significantly modify the functionality of the initial software. The example concludes that the license and the updates are not distinct and should be accounted as a single performance obligation.	Determining the degree to which updates are critical to the utility of a software license may require significant judgment for arrangements other than antivirus software arrangements. Some considerations may include: – the value that the customer would ascribe to the up-front deliverable versus the upgrades; – whether customers choose to delay or never install upgrades; and – the nature of the promise (e.g. a digital protection service versus a business application).

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Ind AS115 – Revenue from contracts with Customers [Case Studies - Warranties]

Warranties

Overview

Under the new standard, an entity accounts for a warranty (or part of a warranty) as a performance obligation if the warranty is distinct including:

- the customer has an option to purchase the warranty separately; or
- additional services are provided as part of the warranty.

Otherwise, warranties will generally continue to be accounted for under existing guidance.

A legal requirement to pay compensation or other damages if products cause damages is not a performance obligation, and is accounted for under other relevant guidance.

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Ind AS115 – Revenue from contracts with Customers **[Case Studies - Warranties]**

Example 59 – Sale of a product with a warranty

Manufacturer M grants its customers a standard warranty with the purchase of its product. Under the warranty, Manufacturer M:

- provides assurance that the product complies with agreed-upon specifications and will operate as promised for three years from the date of purchase; and
- agrees to provide up to 20 hours of training services to the customer.

The customer also chooses to purchase an extended warranty for two additional years.

HOW MANY PERFORMANCE OBLIGATIONS ARE THERE IN THIS CONTRACT ?

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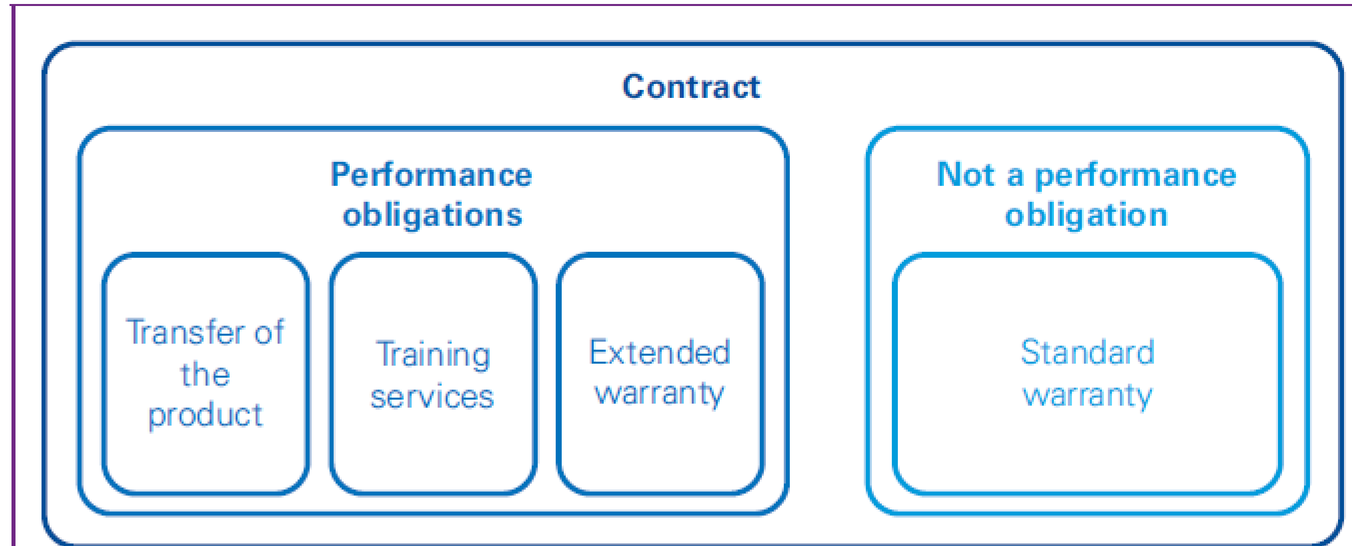
Ind AS115 – Revenue from contracts with Customers **[Case Studies - Warranties]**

Solution

In this example, Manufacturer M concludes that there are three performance obligations in the contract.



The training services are a performance obligation because they provide a distinct service in addition to ensuring that the product complies with specifications.

The extended warranty is a performance obligation because it can be purchased separately and is distinct based on the Step 2 criteria (see 5.2).

The component of the standard warranty that provides assurance that the product complies with stated specifications is an assurance-type warranty, and therefore is not a performance obligation. As a consequence, Manufacturer M accounts for it as a cost accrual under other relevant guidance when control of the product transfers to the customer.

TOTAL Classifica
TOTAL - All right

Ind AS115 – Revenue from contracts with Customers **[Case Studies – Sale with a right of return**

Sale with a right of return

Overview

Under the new standard, when an entity makes a sale with a right of return it recognizes revenue at the amount to which it expects to be entitled by applying the variable consideration and constraint guidance set out in Step 3 of the model

The entity also recognizes a refund liability and an asset for any goods or services that it expects to be returned.

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Ind AS115 – Revenue from contracts with Customers **[Case Studies – Sale with a right of return**

Requirements of the new standard

An entity applies the accounting guidance for a sale with a right of return when a customer has a right to:

– a full or partial refund of any consideration paid;

– a credit that can be applied against amounts owed, or that will be owed, to the entity; or

– another product in exchange (unless it is another product of the same type, quality, condition, and price such as exchanging a red sweater for a white sweater).

An entity does not account for its stand-ready obligation to accept returns as a performance obligation.

In addition to product returns, the guidance also applies to services that are provided subject to a refund.

The guidance does not apply to:

– exchanges by customers of one product for another of the same type, quality, condition, and price; and

– returns of faulty goods or replacements, which are instead evaluated under the guidance on warranties (see 10.2).

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Ind AS115 – Revenue from contracts with Customers [Case Studies – Sale with a right of return

When an entity makes a sale with a right of return, it initially recognizes the following.

Item	Measurement
Revenue	Measured at the gross transaction price, less the expected level of returns calculated using the guidance on estimating variable consideration and the constraint (see 5.3)
Refund liability	Measured at the expected level of returns – i.e. the difference between the cash or receivable amount and the revenue as measured above
Asset	Measured by reference to the carrying amount of the products expected to be returned, less the expected recovery costs
Cost of goods sold	Measured as the carrying amount of the products sold less the asset as measured above
Reduction of inventory	Measured as the carrying amount of the products transferred to the customer

The entity updates its measurement of the refund liability and asset at each reporting date for changes in expectations about the amount of the refunds. It recognizes adjustments to the:

– refund liability as revenue; and

– asset as an expense.

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Ind AS115 – Revenue from contracts with Customers **[Case Studies – Sale with a right of return**

Example 58 – Sale with a right of return

Retailer B sells 100 products at a price of 100 each and receives a payment of 10,000. The sales contract allows the customer to return any undamaged products within 30 days and receive a full refund in cash. The cost of each product is 60. Retailer B estimates that three products will be returned and a subsequent change in the estimate will not result in a significant revenue reversal.

Retailer B estimates that the costs of recovering the products will not be significant and expects that the products can be resold at a profit.

Within 30 days, two products are returned.

Record journal entries in the books of Retailer B based on the above information

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Ind AS115 – Revenue from contracts with Customers **[Case Studies – Sale with a right of return**

SOLUTION

Retailer B records the following entries on:

- transfer of the products to the customer to reflect its expectation that three products will be returned;
- return of the two products; and
- expiration of the right to return products.

	Debit	Credit
Sale		
Cash	10,000	
Refund liability		300[a]
Revenue		9,700
To recognize sale excluding revenue on products expected to be returned		
Asset	180[b]	
Cost of sales	5,820	
Inventory		6,000
To recognize cost of sales and right to recover products from customers		

TOTAL
TOTAL

Ind AS115 – Revenue from contracts with Customers [Case Studies – Sale with a right of return

SOLUTION

Two products returned		
Refund liability	200[c]	
Cash		200[c]
To recognize the refund for product returned		
Inventory	120[d]	
Asset		120[d]
To recognize product returned as inventory		
Right of return expires		
Refund liability	100	
Revenue		100
To recognize revenue on the expiration of the right of return		
Cost of sales	60	
Asset		60
To recognize cost of sales on the expiration of the right to recover products from customers		

Notes

a. 100 x 3 (the price of the products expected to be returned).

b. 60 x 3 (the cost of the products expected to be returned).

c. 100 x 2 (the price of the products returned).

d. 60 x 2 (the cost of the products returned).

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Ind AS115 – Revenue from contracts with Customers **[Case Studies – Principal versus Agent considerations**

Principal versus agent considerations

Overview

When another party is involved in providing goods or services to a customer, an entity evaluates the nature of its promise to the customer. If an entity obtains control of another party's goods or services before transferring control to the customer, then the entity's promise is to provide the goods or services itself. Therefore, the entity is acting as a principal.

However, if an entity does not control the good or service before it is transferred to the customer, then the entity is acting as an agent and arranges for that good or service to be provided by another party.

An entity identifies each specified good or service to be transferred to the customer and determines whether it is a principal or agent for each one. An entity may be a principal for some goods and services and an agent for others in a contract to transfer multiple goods or services.

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Ind AS115 – Revenue from contracts with Customers [Case Studies – Principal versus Agent considerations

Requirements of the new standard

When other parties are involved in providing goods or services to an entity's customer, the entity determines whether the nature of its promise is a performance obligation to provide the specified goods or services itself, or to arrange for them to be provided by another party – i.e. whether it is a principal or an agent. This determination is made by identifying each specified good or service promised to the customer in the contract and evaluating whether the entity obtains control of the specified good or service before it is transferred to the customer.

Because an entity evaluates whether it is a principal or an agent for each good or service to be transferred to the customer, it is possible for the entity to be a principal for one or more goods or services and an agent for others in the same contract.

An entity is a principal if it controls the specified good or service that is promised to the customer before it is transferred to the customer.

When another party is involved, an entity that is a principal obtains control of any one of the following:

- a good from another party that it then transfers to the customer;
- a right to a service that will be performed by another party, which gives the entity the ability to direct that party to provide the service on the entity's behalf; or
- a good or a service from another party that it combines with other goods or services to produce the specified good or service promised to the customer.

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Ind AS115 – Revenue from contracts with Customers [Case Studies – Principal versus Agent considerations

If the entity is a principal, then revenue is recognized on a gross basis – corresponding to the consideration to which the entity expects to be entitled. If the entity is an agent, then revenue is recognized on a net basis – corresponding to any fee or commission to which the entity expects to be entitled. An entity's fee or commission might be the net amount of consideration that the entity retains after paying other parties.

'Control' is the ability to direct the use of, and obtain substantially all of the remaining benefits from, the goods or services (or prevent others from doing so).

The new standard includes the indicators listed below to assist an entity in evaluating whether it controls a specified good or service before it is transferred to the customer.

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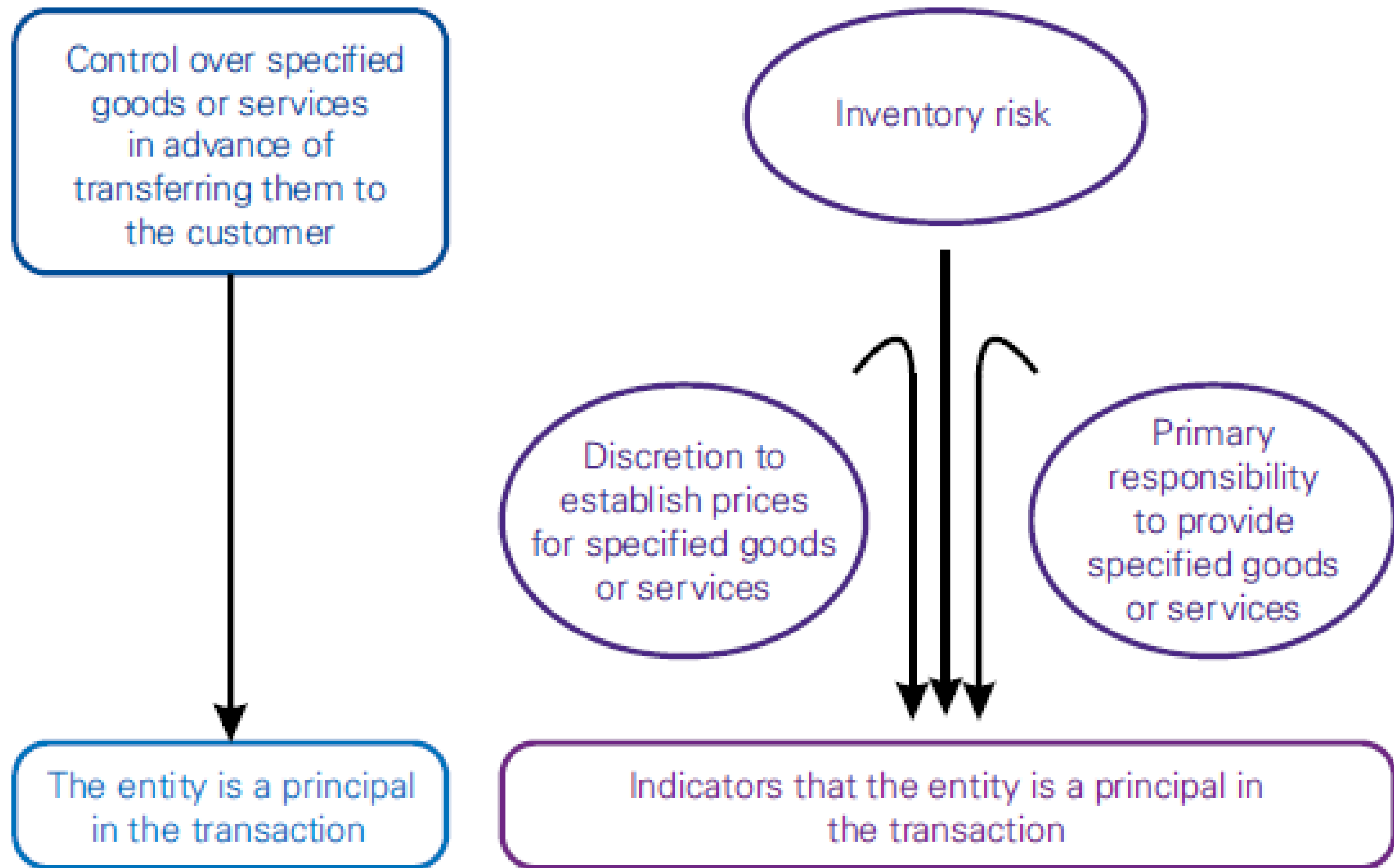
Ind AS115 – Revenue from contracts with Customers **[Case Studies – Principal versus Agent considerations**



If an entity does not obtain control of the goods or the right to the services in advance of transferring them to the customer, then it is an agent for that good or service.

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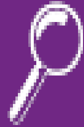
Ind AS115 – Revenue from contracts with Customers **[Case Studies – Principal versus Agent considerations**



Example 61 – Entity arranges for the provision of goods or services

Internet Retailer B operates a website that enables Customer E to buy goods from a range of suppliers that deliver the goods directly to Customer E. The website facilitates payment between the supplier and Customer E at prices set by the supplier, and Internet Retailer B is entitled to commission of 10% of the sales price. Customer E pays in advance and all orders are nonrefundable.

Can Internet Retailer B recognize revenue in respect of the products sold on its website ?

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Ind AS115 – Revenue from contracts with Customers [Case Studies – Principal versus Agent considerations

SOLUTION

Internet Retailer B observes that each supplier delivers its goods directly to Customer E, and that Internet Retailer B itself does not control the goods. In reaching the conclusion that it does not control the goods before they are transferred to Customer E, Internet Retailer B makes these observations.

- The supplier is primarily responsible for fulfilling the promise to provide the goods to Customer E (i.e. by shipping the goods to Customer E). Internet Retailer B is not obliged to provide the goods to Customer E if the supplier fails to deliver, and is also not responsible for the acceptability of the goods delivered by the supplier.
- Internet Retailer B does not take inventory risk at any time before or after the goods are transferred to Customer E (because the goods are shipped directly by the supplier to Customer E), Internet Retailer B does not commit to obtain the goods from the supplier before they are purchased by Customer E, and Internet Retailer B is not responsible for any damaged or returned goods.
- Internet Retailer B does not have discretion in establishing prices for the goods because the sales price is set by the supplier.

Consequently, Internet Retailer B concludes that it is an agent, and that its performance obligation is to arrange for the supplier to provide the goods. When Internet Retailer B satisfies its promise to arrange for the supplier to provide the goods to Customer E – which, in this example, is when the goods are purchased by Customer E – Internet Retailer B recognizes revenue at the amount of the commission to which it is entitled.

TOTAL Classif
TOTAL - All ri

Ind AS115 – Revenue from contracts with Customers **[Case Studies – Consignment arrangements**

Consignment arrangements

Requirements of the new standard

An entity may deliver goods to another party but retain control of the goods – e.g. it may deliver a product to a dealer or distributor for sale to an end customer. These types of arrangements are called 'consignment arrangements', and do not allow the entity to recognize revenue on delivery of the products to the intermediary.

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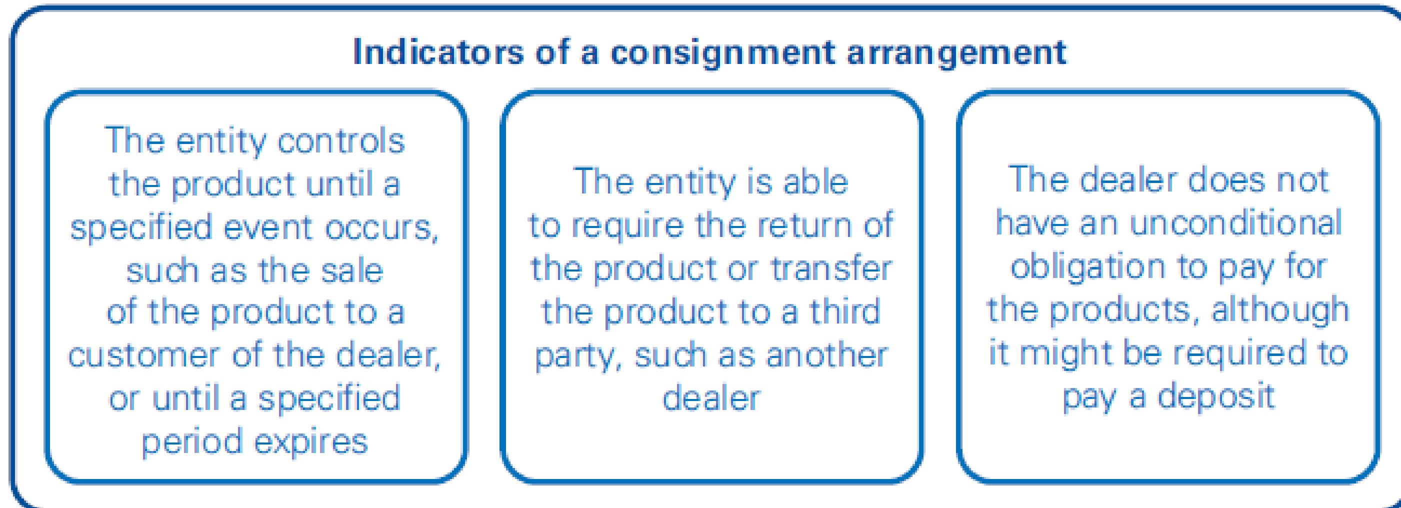
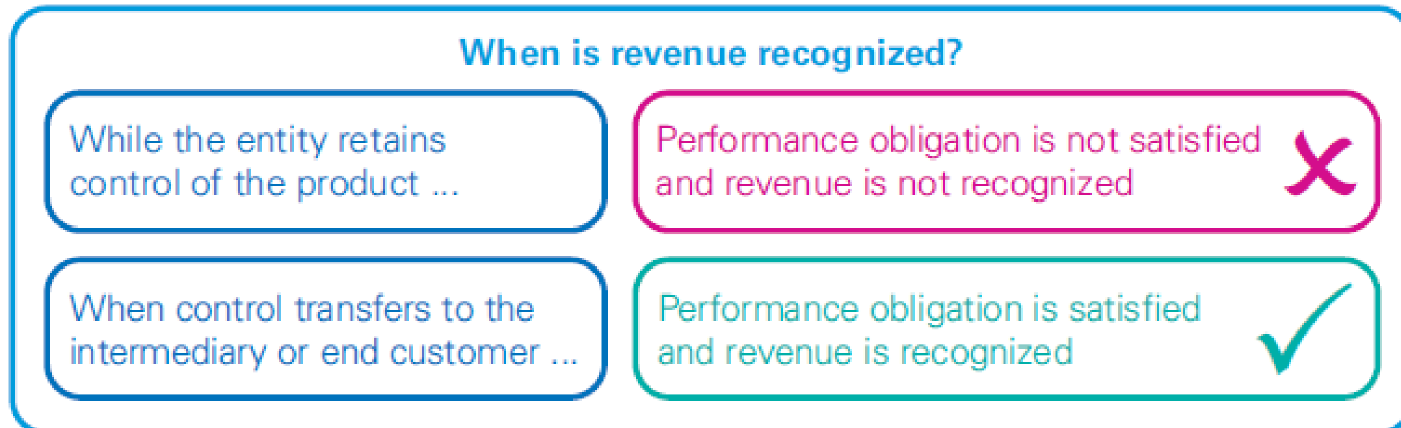
Ind AS115 – Revenue from contracts with Customers [Case Studies – Consignment arrangements

The new standard provides indicators that an arrangement is a consignment arrangement as follows.





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Ind AS115 – Revenue from contracts with Customers **[Case Studies – Consignment arrangements**

Example 34 – Consignment arrangement

Manufacturer M enters into a 60-day consignment contract to ship 1,000 dresses to Retailer A's stores. Retailer A is obligated to pay Manufacturer M 20 per dress when the dress is sold to an end customer. During the consignment period, Manufacturer M has the contractual right to require Retailer A to either return the dresses or transfer them to another retailer. Manufacturer M is also required to accept the return of the inventory.

When should Manufacturer M recognize revenue ? Has it transferred Control of the dresses ?

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Ind AS115 – Revenue from contracts with Customers **[Case Studies – Consignment arrangements**

SOLUTION

Manufacturer M determines that control has not transferred to Retailer A on delivery, for the following reasons:

- Retailer A does not have an unconditional obligation to pay for the dresses until they have been sold to an end customer;
- Manufacturer M is able to require that the dresses be transferred to another retailer at any time before Retailer A sells them to an end customer; and
- Manufacturer M is able to require the return of the dresses or transfer them to another retailer.

Manufacturer M determines that control of the dresses transfers when they are sold to an end customer – i.e. when Retailer A has an unconditional obligation to pay Manufacturer M and can no longer return or otherwise transfer the dresses. Manufacturer M recognizes revenue as the dresses are sold to the end customer.

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Ind AS115 – Revenue from contracts with Customers **[Case Studies – Bill and Hold arrangements]**

Bill and Hold arrangements occur when:-

- Entity bills a customer for a product that it transfers at a point in time
- But retains physical possession of product until it is transferred to customer
- At a future point in time

Examples:-

a) Accommodate a customers lack of available space for the product
b) Delays in production schedules

Revenue recognition criteria:-

- Determine when the customer obtains control of product – typically when shipment or delivery to customer depending on contract terms
- Apply criteria as per Flow chart in following slide

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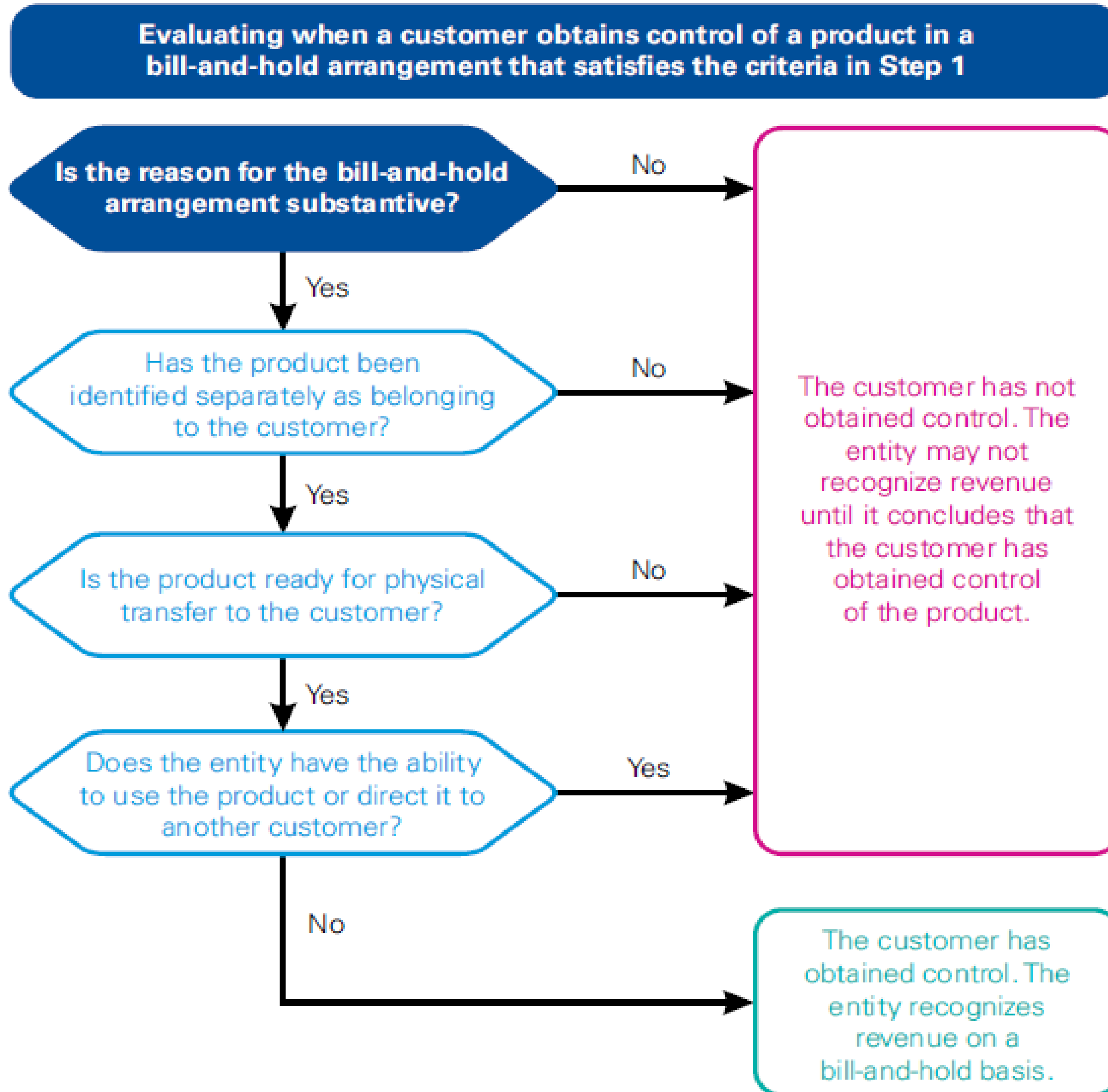
Ind AS115 – Revenue from contracts with Customers **[Case Studies – Bill and Hold arrangements]**



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Ind AS115 – Revenue from contracts with Customers **[Case Studies – Bill and Hold arrangements]**

Example 35 – Bill-and-hold arrangement

Company C enters into a contract to sell equipment to Customer A, who is awaiting completion of a manufacturing facility and requests that Company C hold the equipment until the manufacturing facility is completed.

Company C bills and collects the nonrefundable transaction price from Customer A and agrees to hold the equipment until Customer A requests delivery. The transaction price includes appropriate consideration for Company C to hold the equipment indefinitely. The equipment is complete and segregated from Company C's inventory and is ready for shipment. Company C cannot use the equipment or sell it to another customer. Customer A has requested that the delivery be delayed, with no specified delivery date.

Should Company C recognize revenue ? Has it transferred Control of the equipment ?

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Ind AS115 – Revenue from contracts with Customers **[Case Studies – Bill and Hold arrangements]**

SOLUTION

Company C concludes that Customer A's request for the bill-and-hold basis is substantive. It also concludes that control of the equipment has transferred to Customer A and that it will recognize revenue on a bill-and-hold basis even though Customer A has not specified a delivery date.

The obligation to warehouse the goods on behalf of Customer A represents a separate performance obligation. Company C needs to estimate the stand-alone selling price of the warehousing performance obligation based on its estimate of how long the warehousing service will be provided. The amount of the transaction price allocated to the warehousing obligation is deferred and then recognized over time as the warehousing services are provided.

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Ind AS115 – Revenue from contracts with Customers **[Case Studies – unexercised rights [Breakage]**

Customers' unexercised rights (breakage)

Overview

An entity may receive a nonrefundable prepayment from a customer that gives the customer the right to receive goods or services in the future. Common examples include gift cards, vouchers, and nonrefundable tickets. Typically, some customers do not exercise their right – this is referred to as 'breakage'.

Requirements of the new standard

An entity recognizes a prepayment received from a customer as a contract liability, and recognizes revenue when the promised goods or services are transferred in the future. However, a portion of the contract liability recognized may relate to contractual rights that the entity does not expect to be exercised – i.e. a breakage amount.

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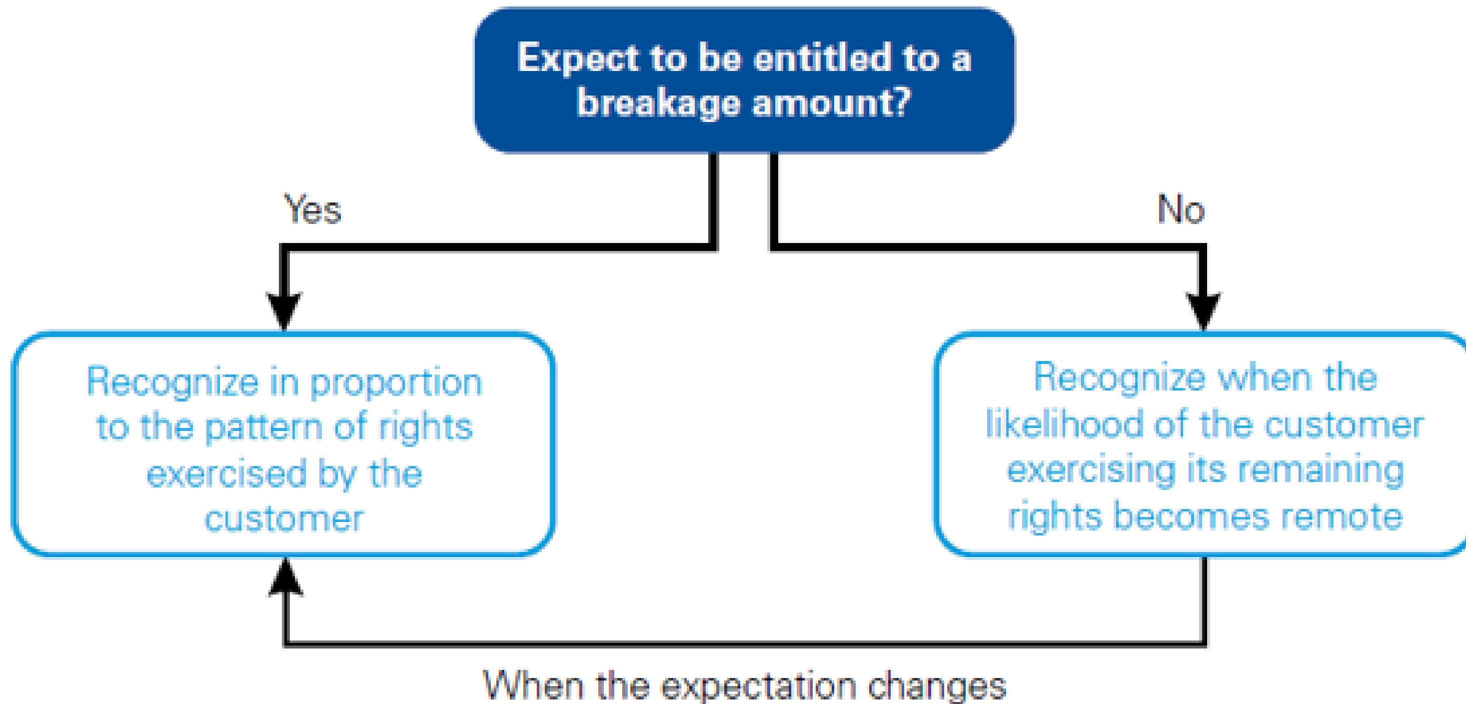
Ind AS115 – Revenue from contracts with Customers **[Case Studies – unexercised rights [Breakage]**

The timing of revenue recognition related to breakage depends on whether the entity expects to be entitled to a breakage amount – i.e. if it is (highly probable that recognizing breakage will not result in a significant reversal of the cumulative revenue recognized.



If an entity is required to remit to a government entity the amount that is attributable to customers' unexercised rights – e.g. under applicable unclaimed property or escheatment laws – then it recognizes a financial liability until the rights are extinguished, rather than revenue.

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Ind AS115 – Revenue from contracts with Customers [Case Studies – unexercised rights [Breakage]

Example 68 – Sale of a prepaid phone card – Entity expects to be entitled to breakage

Retailer R sells a prepaid phone card to Customer C for 100. On the basis of historical experience with similar prepaid phone cards, Retailer R estimates that 10% of the prepaid phone card balance will remain unredeemed and that the unredeemed amount will not be subject to escheatment. Because Retailer R can reasonably estimate the amount of breakage expected, and it is probable (highly probable for IFRS) that including the amount in the transaction price will not result in a significant revenue reversal, Retailer R recognizes the breakage revenue of 10 in proportion to the pattern of exercise of the customer's rights.

Specifically, when it sells the prepaid phone card, Retailer R recognizes a contract liability of 100, because Customer C prepaid for a nonrefundable card. No breakage revenue is recognized at this time.

If Customer C redeems an amount of 45 in 30 days, then half of the expected redemption has occurred (45 ÷ (100 - 10) = 50%). Therefore, half of the breakage – i.e. (10 x 50% = 5) – is also recognized.

On this initial prepaid phone card redemption, Retailer R recognizes revenue of 50 – i.e. revenue from transferring goods or services of 45 plus breakage of 5.

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Ind AS115 – Revenue from contracts with Customers **[Case Studies – unexercised rights [Breakage]**

Example 69 – Sale of a prepaid phone card – Entity does not expect to be entitled to breakage

Retailer C implements a new prepaid phone card program. Retailer C sells Customer D a prepaid phone card for 50. Retailer C does not have an obligation to remit the value of unredeemed cards to any government authority or other entity. The prepaid phone card expires two years from the date of issue.

Because this is a new program, Retailer C has very little historical information. Specifically, Retailer C does not have sufficient entity-specific information, nor does it have knowledge of the experience of other service providers. Therefore, Retailer C concludes that it does not have the ability to estimate the amount of breakage that, if it were included in the transaction price, would be (highly probable of not resulting in a significant revenue reversal.

Retailer C therefore recognizes the breakage when the likelihood of Customer D exercising its remaining rights becomes remote. This may occur at the expiration of the prepaid phone card, or earlier if there is evidence to indicate that the probability has become remote that Customer D will redeem any remaining amount on the prepaid phone card.

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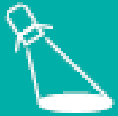
Ind AS115 – Revenue from contracts with Customers **[Case Studies – unexercised rights [Breakage]**



Observations

Constraint applies even though consideration amount is known

If an entity does not have a basis for estimating breakage – i.e. the estimate is fully constrained – then it recognizes the breakage as revenue only when the likelihood becomes remote that the customer will exercise its rights.

When the entity concludes that it is able to determine the amount of breakage to which it expects to be entitled, it estimates the breakage. To determine the breakage amount, the entity assesses whether it is probable (highly probable for IFRS) that including revenue for the unexercised rights in the transaction price will not result in a significant revenue reversal. Applying the guidance on the constraint in this context is unique – the amount of consideration is known and has already been received, but there is uncertainty over how much of the consideration the customer will redeem for the transfer of goods or services in the future. Conversely, in other situations to which the constraint applies, the total amount of consideration is unknown.

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Ind AS115 – Revenue from contracts with Customers [Case Studies – unexercised rights [Breakage]

Breakage does not constitute variable consideration

Although an entity considers the variable consideration guidance to determine the amount of breakage, breakage itself is not a form of variable consideration because it does not affect the transaction price. It is a recognition, rather than a measurement concept in the new standard. For example, the transaction price for a sale of a 50 gift card is fixed at 50; the possibility of breakage does not make the transaction price variable. However, the expected breakage affects the timing of revenue recognition.

Prepaid stored-value products may be financial liabilities

A prepaid stored-value product is a card with a monetary value stored on the card itself – e.g. a gift card. The guidance under the new standard on the recognition of breakage excludes prepaid stored-value products that meet the definition of financial liabilities.

These are instead accounted for using the applicable financial instruments guidance

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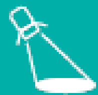
TC

Ind AS115 – Revenue from contracts with Customers **[Case Studies – Customer Loyalty programs**

Customer Loyalty Programs are often in the scope of the customer option guidance and the requirements already discussed. A customer loyalty program that provides the customer with a material right is accounted for as a separate performance obligation.



Observations

No significant financing component in most customer loyalty programs

Customer loyalty programs generally do not include a significant financing component even though the time period between when the customer loyalty points are earned and redeemed may be greater than one year. This is because the transfer of the related goods or services to the customer – i.e. use of the loyalty points – occurs at the discretion of the customer.

Cancellable customer loyalty programs may be implicit performance obligations

Many customer loyalty programs can be cancelled or changed by the issuer at any time. However, if the entity has a past practice that creates a valid expectation for its customers that it will fulfill its promises under the loyalty program, then it accounts for the customer loyalty program as a separate performance obligation. That is, the entity has made an implicit promise to operate the customer loyalty program.

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Ind AS115 – Revenue from contracts with Customers **[Case Studies – Customer Loyalty programs**

Example 67 – Customer loyalty points program

Retailer C offers a customer loyalty program at its store. Under the program, for every 10 that customers spend on goods, they are rewarded with one point. Each point is redeemable for a cash discount of 1 on future purchases. Retailer C expects 97% of customers' points to be redeemed. This estimate is based on Retailer C's historical experience, which is assessed as being predictive of the amount of consideration to which it will be entitled. During Year 1, customers purchase products for 100,000 and earn 10,000 points. The stand-alone selling price of the products to customers without points is 100,000.

Should the Customer Loyalty Program be accounted for as a separate performance obligation ?

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Ind AS115 – Revenue from contracts with Customers [Case Studies – Customer Loyalty programs

The customer loyalty program provides the customers with a material right, because the customers would not receive the discount on future purchases without making the original purchase. Additionally, the price that they will pay on exercise of the points on future purchases is not the stand-alone selling price of those items.

Because the points provide a material right to the customers, Retailer C concludes that the points are a performance obligation in each sales contract – i.e. the customers paid for the points when purchasing products. Retailer C determines the stand-alone selling price of the loyalty points based on the likelihood of redemption.

Retailer C allocates the transaction price between the products and the points on a relative selling price basis as follows.

Performance obligation	Stand-alone selling prices	Selling price ratio	Price allocation	Calculation
Products	100,000[a]	91%	91,000	(100,000 x 91%)
Points	9,700[b]	9%	9,000	(100,000 x 9%)
Total	**109,700**	**100%**	**100,000**	

Notes

a. Stand-alone selling price for the products.

b. Stand-alone selling price for the points (10,000 x 1 x 97%).

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Ind AS115 – Revenue from contracts with Customers [Case Studies – Customer Loyalty programs

During Year 2, 4,500 of the points are redeemed, and Retailer C continues to expect that 9,700 points will be redeemed in total. Retailer C calculates the revenue to be recognized and the corresponding reduction in the contract liability as follows.

4,175 = 9,000 x 4,500 ÷ 9,700 – i.e. price allocated to points multiplied by points redeemed in Year 2 divided by total points expected to be redeemed.

During Year 3, a further 4,000 points are redeemed. Retailer C updates its estimate, because it now expects 9,900 rather than 9,700 points to be redeemed. Retailer C calculates the revenue to be recognized and the corresponding reduction in the contract liability as follows.

3,552 = (9,000 x (4,500 + 4,000) ÷ 9,900) - 4,175 – i.e. price allocated to points multiplied by points redeemed in Year 2 and Year 3 divided by total points expected to be redeemed minus revenue recognized in Year 2.

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Differences between IND AS115 & IFRS15

Sl No	IND AS 115	Current IND AS requirements [Ind AS 18, Ind AS 11]
1.	Model: “Five step model” which mainly focuses on transfer of control of goods or services by an entity under a contract with its customers.	Model :- “Transfer of risks and rewards model”.
2.	Control based model. However, ‘risks and rewards’ retained as an indicator of control transfer for performance obligations satisfied at a point in time.	Risks and Rewards based model
3.	Includes separation of financing component in case of both Advance or deferred payments.	Includes separation of financing component only in case of deferred payments.
4.	Consideration measured at the amount the entity expects to be entitled to	Does not provide guidance based on expected value approach
5.	Detailed guidance on identifying performance obligations in a contract.	No guidance provided

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Differences between IND AS115 & IFRS15

Sl No	IND AS 115	Current IND AS requirements [Ind AS 18, Ind AS 11]
6.	Specific criteria provided to determine when a performance obligation is satisfied over time.	No specific criteria provided
7.	New guidance relating to software licence, cost of obtaining and fulfilling contracts, contract modifications etc	No such guidance

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Differences between IND AS115 & IFRS15

Sl No	IND AS 115	IFRS15
1.	Terminology:- Balance sheet and Statement of profit and loss	Terminology :- Statement of financial position' and Statement of comprehensive income'
2.	Transitional provisions:- not been given in Ind AS 115, since all transitional provisions related to Ind ASs, wherever considered appropriate, have been included in Ind AS 101, *First-time Adoption of Indian Accounting Standards.*	Transitional provisions given in IFRS15
3.	Excludes Penalties from the list of variable consideration. However, paragraph 51AA has been inserted to explain the accounting treatment of 'penalties'.	As per paragraph of 15 of IFRS 15, an amount of consideration, among other things, can vary because of penalties.

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Differences between IND AS115 & IFRS15

Sl No	IND AS 115	IFRS15
4.	Paragraph 109AA has been inserted to require an entity to present separately the amount of excise duty included in the revenue recognised in the statement of profit and loss.	No such requirement
5.	Additional disclosures:- Paragraph 126AA has been inserted to present reconciliation of the amount of revenue recognised in the statement of profit and loss with the contracted price showing separately each of the adjustments made to the contract price specifying the nature and amount of each such adjustment separately.	No such disclosure requirement
6.	In Appendix C – Application Guidance, paragraph B20AA has been inserted to explain the accounting treatment in case of transfers of control of a product to a customer with an	No such guidance

THANK YOU

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