Accounting for revenue is changing, are you ready?

This article aims to:

- Highlight the key changes that Indian companies can expect on application of Ind AS 115, *Revenue from Contracts with Customers.*

In April 2017, the Institute of Chartered Accountants of India (ICAI) issued an Exposure Draft (ED) on clarifications to Ind AS 115, *Revenue from Contracts with Customers,* the new accounting standard on revenue recognition. This Exposure Draft proposed that Ind AS 115 be applicable for accounting periods beginning on or after 1 April 2018. Although there is no formal announcement yet on the applicability of the standard by the regulators in India, it is expected that the standard may become effective, as planned from Financial Year (FY) 2018-19. This would be one of the first key changes to the Ind AS framework since its implementation in India in two phases commencing from 1 April 2016. Companies covered in both phase I and II of Ind AS convergence are likely to implement Ind AS 115 from the same date, i.e. 1 April 2018.

The original plan of the Ministry of Corporate Affairs (MCA) was to implement Ind AS 115 before its global roll-out, as part of the overall Ind AS convergence in India, i.e. from 1 April 2016 for phase I companies. However, with the deferral of an equivalent standard by the International Accounting Standard Board (IASB) and the U.S. Financial Accounting Standard Board (FASB) by a year, the regulators in India also decided to defer the standard until 2018.

This accounting change will bring about significant changes in the way companies recognise, present and disclose their revenue. The new revenue standard is a paradigm shift from the present 'transfer of risk and rewards model' to a 'five step model' which mainly focusses on transfer of control of goods and services by an entity under a contract with its customers. The core principle in Ind AS 115 is that an entity should recognises revenue to depict the transfer of promised goods or services to the customer in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

While this accounting change may impact almost all companies with revenue, the impact may particularly be severe for companies in sectors such as telecommunications, technology, real estate, aerospace and defense, building and construction and contract manufacturing. Listed below are some of the key changes likely to be faced by companies in India as they plan for convergence with Ind AS 115:

1. Bundled contracts

Ind AS 115 requires an entity to identify the performance obligations in a contract whereas current accounting standards contain limited guidance on identifying whether a transaction contains separately identifiable components. At contract inception, an entity evaluates the promised goods or services to determine which goods or services (or bundle of goods or services) are distinct and therefore, constitute performance obligations.

A good or service is distinct from other goods or services, and so is a performance obligation if it satisfies both of the following criteria:

1. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer, and
2. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

Example

Telco T enters into a contract with customer R that includes the delivery of a handset and 24 months of voice and data services for a monthly consideration of INR5,000. The contract does not require any payment of consideration upfront as long as the customer commits to a 24 months contract. Customer R obtains title to the handset. The handset can be used by customer R to perform certain functions – e.g. calendar, contacts list, email, internet access, accessing applications via Wi-Fi, and to play music or games.

There is evidence of customers reselling the handset on an online auction site and recapturing a portion of the selling price of the handset. Telco T regularly sells its voice and data services separately to customers, through renewals or sales to customers who acquire their handset from an alternative vendor – e.g. a retailer.

Telco T concludes that the handset and the wireless services are two separate performance obligations based on the evaluation that the customer can benefit from the handset on its own and both handset and wireless services are also separate in the context of the contract as a whole.

2. Non-refundable upfront fees

An upfront non-refundable fee is a regular feature in certain industries such as joining fees for health club membership, activation fees for telecommunication contracts, and set-up fees for outsourcing contracts. There exists a varied practice currently with regard to recognition of such revenue, while some companies defer such a fee income over the contract period, some others record that upfront.

Under Ind AS 115, an entity assesses whether the non-refundable upfront fee relates to the transfer of a promised good or service to the customer. In many cases, though a non-refundable upfront fee relates to an activity that the entity is required to undertake to fulfil the contract, that activity does not result in the transfer of a promised good or service to the customer. Instead, it is an administrative task.

If the activity does not result in the transfer of a promised good or service to the customer, then the upfront fee is an advance payment for performance obligations to be satisfied in the future and is recognised as revenue when those future goods or services are provided. This period would extend beyond the initial contract period only if the customer has been given an option to renew the contract which creates a material right for him.

Example

Cable company T enters into a one-year contract to provide cable television to customer A. In addition to a monthly service fee of INR500, T charges a one-time upfront fee of INR1,000. T has determined that its set-up activity does not transfer a promised good or service to customer A, but is instead an administrative task. Customer A will not be charged another fee upon renewal. The average customer life for customers entering into similar contracts is three years.

Since the activity does not result in the transfer of a promised good or service to the customer, the upfront fee is an advance payment for performance obligations to be satisfied in the future and is recognised as revenue when those future goods or services are provided. Hence, the upfront fee would be recognised over the contract period and may be deferred beyond one year if the decision of the customer to renew the contract is influenced by the payment of this fee.

3. Variable consideration

Consideration promised under a contract may vary due to items such as price concessions, incentives, performance bonuses, completion bonuses, price adjustment clauses, discounts, refunds, rights of return, credits.

Under Ind AS 115, an entity assesses whether, and to what extent, it can include an amount of variable consideration in the transaction price at contract inception. Under the current Ind AS, an entity recognises revenue only if it can estimate the amount reliably but there is no specific guidance on measurement of the variable consideration. Under Ind AS 115, an entity would estimate the transaction price using expected value (the sum of probability-weighted amounts for a range of possible consideration amounts) or most likely amount (the single most likely amount from a range of possible consideration amounts), whichever method best depicts the consideration to which the entity will be entitled. After estimating the variable consideration, an entity is required to exercise prudence by including variable consideration in the transaction price only to the extent that it is highly probable that there will not be significant revenue reversal in future.

Example

Electronics manufacturer M sells 1,000 televisions to retailer R for INR5,000,000 (5,000 per television). Manufacturer M provides price protection to R by agreeing to reimburse R for the difference between this price and the lowest price that it offers for that television during the following six months. Based on M's extensive experience with similar arrangements, it estimates the following outcomes.

Price reduction in next six months	Probability
0	70%
500	20%
1,000	10%

After considering all relevant facts and circumstances, M determines that the expected value method provides the best prediction of the amount of consideration to which it will be entitled. As a result, it estimates the transaction price to be INR4,800 per television – i.e. (5,000 × 70%) + (4,500 × 20%) + (4,000 × 10%) – before considering the constraint.

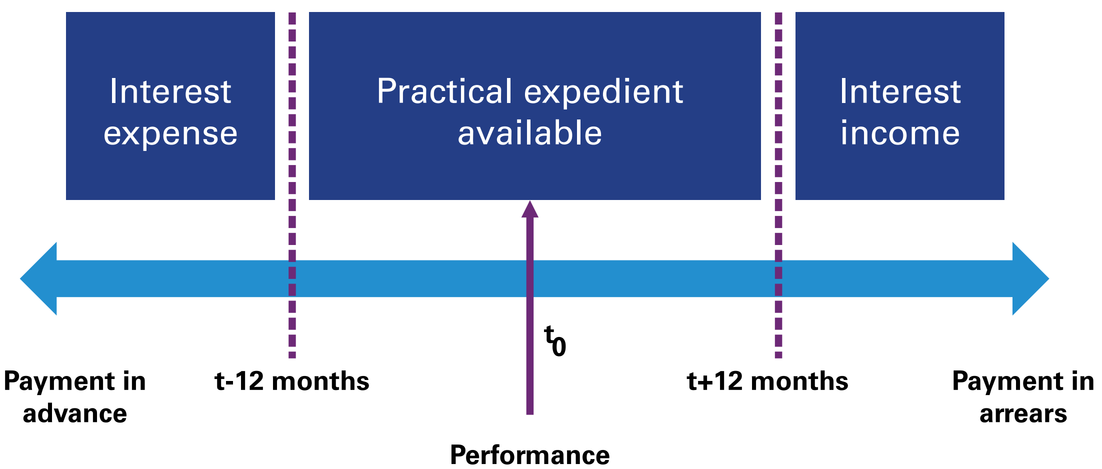
4. Significant financing component

To estimate the transaction price in a contract as per Ind AS 115, an entity would adjust the promised amount of consideration for the time value of money if that contract contains a significant financing component. Although under the current Ind AS, there is some guidance on discounting deferred consideration to present value, there is no guidance on treatment of consideration received in advance.

The objective for adjusting the promised amount of consideration for a significant financing component is to recognise 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.

Significant financing component?



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.

Example

Technology company T signs a three-year, non-cancellable agreement with customer C to provide hosting services. Customer C may elect to either pay:

a. INR140 per month (total payment is INR5,040); or

b. INR4,200 at the beginning of the contract term, with no additional monthly payments.

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 INR140 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 INR840 and an implied discount rate of 13 per cent.

Technology company T determines that the financing component is significant because the difference between the cumulative cash-selling price of INR5,040 and the financed amounts of INR4,200 is INR840, or approximately 20 per cent of the financed amount. Therefore, an adjustment to reflect the time value of money would be needed if the customer elects option (b) to pay at the beginning of the contract.

Technology company T would recognise revenue of INR5,040 (i.e. more than the actual transaction price) ratably over the contract term as the performance obligation is satisfied and interest expense of INR840 using the effective interest method. The amount of interest expense to recognise each period is based on the projected contract liability, which decreases as services are provided and increases for the accrual of interest.

5. Cost to obtain a contract

Under Ind AS 115, an entity would capitalise incremental costs to obtain a contract with a customer – e.g. sales commissions – if it expects to recover those costs. However, as a practical expedient, an entity is not required to capitalise the incremental costs to obtain a contract if the amortisation period for the asset is one year or less. There is no specific guidance under the current Ind AS framework in this area resulting into varied practices.

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 capitalised 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.

Example

Consulting company E provides consulting services to customers. Following a competitive tender process, E wins a contract to provide consulting services to a new customer. Company E incurs total cost of INR5,000 in this relation which includes INR1,500 towards external legal fees for due diligence, INR1,000 travel costs to deliver the proposal and INR2,500 commissions to sales employees and related payroll taxes.

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. Company E, therefore, would recognise an asset for the sales commissions of INR2,500, subject to recoverability.

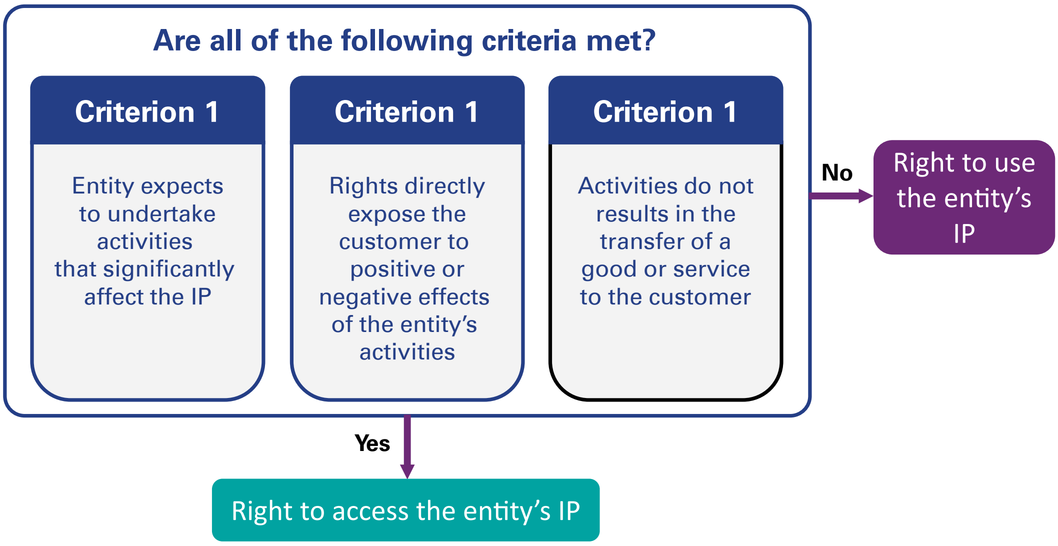
By contrast, although the external legal fees and travel costs are incremental costs, they are costs associated with trying to obtain the contract. Given that these costs are incurred even if the contract is not obtained, E expenses the legal fees and travel costs as they are incurred.

6. Licensing

Under Ind AS 115, for licences that are distinct from other goods or services, to determine whether the performance obligation is satisfied at a point in time or over time, an entity considers whether the nature of its promise is to provide the customer with a right to:

- access the entity's Intellectual Property (IP) throughout the licence period - i.e. over-time revenue recognition; or
- use the entity's IP as it exists at the point in time at which the license is granted - i.e. point-in-time revenue recognition.

The nature of an entity's promise in granting a license is a promise to provide a right to access the entity's IP if all of the following criteria are met:



A promise to provide the customer with a right to access the entity's IP is satisfied over time because the customer simultaneously consumes and receives benefit from the entity's performance of providing access to its IP as that performance occurs.

A promise to provide the customer with a right to use the entity's IP is satisfied at a point in time.

Example:

Software company X licenses its software application to customer Y. Under the agreement, X will provide updates on a when-and-if-available basis; Y can choose whether to install them.

Although the updates and upgrades that X performs will change the functionality of the software, they are not activities considered in determining the nature of the entity's promise in granting the license. This is because they transfer a promised good or service to Y. Therefore, X concludes that the software license provides a right to use the IP that is satisfied at a point in time.

This scenario is in contrast to the license for anti-virus software. Under the contract, X promises to provide Y with when-and-if-available updates to that software during the license period. The updates are critical to the continued use of the anti-virus software. The updates significantly modify the functionality of the software, since they protect Y from additional threats that the original software could not protect against. Therefore, X would account for the license and the updates as a single performance obligation and recognise revenue over time.

7. Contract modification

A contract modification is a change in the scope or price of a contract, or both. This may be described as a change order, a variation, or an amendment. When a contract modification is approved, it creates or changes the enforceable rights and obligations of the parties to the contract. Therefore, Ind AS 115 requires contract modifications to be approved before any revenue can be recognised from the modifications. If parties have not approved a contract modification, then the entity continues to apply the requirements of the new standard to the existing contract until approval is obtained.

There is currently a diversity in practice when it comes to recognition of revenue from contract modifications (such as claims and variations in the construction industry). Some companies wait until such modifications are approved but some do recognise before formal approvals.

Example

Construction company B enters into a contract with customer C to build a manufacturing plant on C's land for a fixed price of INR1,000,000. Company B has determined that revenue should be recognised over time.

Construction of the manufacturing plant commenced on 1 January 2016. In December 2016, C requests B to make major changes to the manufacturing plant's layout. However, the approval in writing and change of transaction price to INR1,250,000 is done only on 30 June 2017. Under local jurisdiction, only modifications agreed in writing are legally enforceable. As on 31 March 2017, the development is considered 20 per cent complete without modification whereas it is 17 per cent compete with modification included as part of the scope.

Company B would account for the contract modification on 30 June 2017, as this is the date on which the change becomes legally enforceable. The modification is accounted for as part of the original contract because the changes to the manufacturing plant's design are considered part of the original performance obligation – i.e. to deliver a completed manufacturing plant. The modification would be reflected through a cumulative catch-up adjustment.

While preparing their financial statements as at 31 March 2017, B would not consider the additional revenue from modifications. The costs incurred on additional scope would dilute the margin on the contract given that the modification was not approved as of 31 March 2017.

Real estate transactions

Currently, real estate developers recognise revenue based on the revised guidance note of the Institute of Chartered Accountants of India (ICAI) on Accounting for Real Estate Transactions issued in 2012. The guidance note mandates the application of the percentage of completion method and gives certain 'bright-lines' for determining the eligibility of real estate transactions for revenue recognition. Under Ind AS 115, for recognising revenue over time for real estate transactions, the developers selling units must satisfy two criteria:

1. the entity's performance does not create an asset with an alternate use to the entity and
2. the entity has an enforceable right to payment for performance completed to date.

The first criterion is met if the entity is either restricted contractually or practically from readily directing the asset to another use (e.g. selling it to a different customer). The second criterion requires an entity to get at least compensated for the work performed, including a reasonable profit margin at any stage during the contract if there a termination of the contract.

In the Indian context, the second criterion may be difficult to meet if the termination clause in the contract requires the developer to refund the consideration after forfeiting part of the deposit. In such scenarios, the developer may not get compensated for the work performed resulting into point in time revenue recognition or completed contract type accounting.

Given that there is a carve-out for real estate revenue recognition currently under Ind AS, it is not very clear if the developers will adopt Ind AS 115 or continue to follow the guidance note of the ICAI. Therefore, one will have to observe the developments closely as far as applicability to the sector is concerned.

Effective date and transition

As discussed above, the regulators in India have not formally announced the date of application of Ind AS 115. Given that the global equivalent standard (IFRS 15) is becoming effective for annual periods beginning on or after 1 January 2018, the Indian regulars may want to coincide the effective date for Indian companies as well. Therefore, it is expected that Ind AS 115 may be effective from 1 April 2018.

As per Ind AS 115, an entity can elect to adopt the standard in a variety of ways, including retrospectively with or without optional practical expedients, or from the beginning of the year of initial application (1 April 2018), with no restatement of the comparative period.

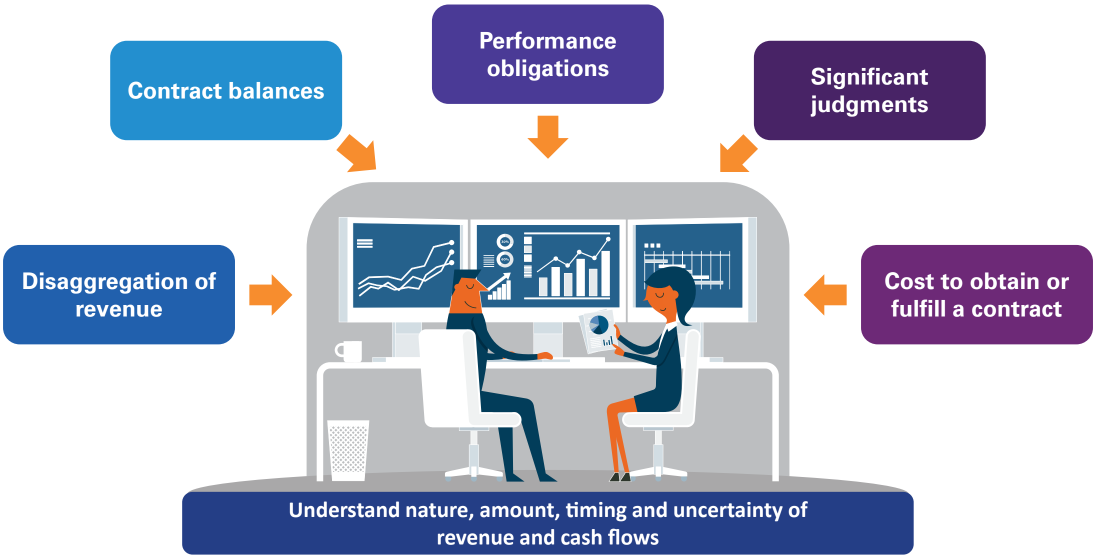
Retrospective adjustment (with optional practical expedients): Entities could recognise the cumulative effect of applying the new standard at the start of the earliest period presented. They can also elect to use one or more of the practical expedients available. The practical expedients are likely to help to simplify how contracts would be restated or reduce the number of contracts to be restated.

Cumulative effect method (with optional practical expedients): Entities could recognise the cumulative effect of applying the new standard at the date of initial application, with no restatement of the comparative periods presented – i.e. the comparative periods would be presented in accordance with current GAAP. Entities, who elect this method, are also required to disclose the quantitative effect and an explanation of the significant changes between the reported results under the new standard and those that would have been reported under current GAAP in the period of adoption.

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.

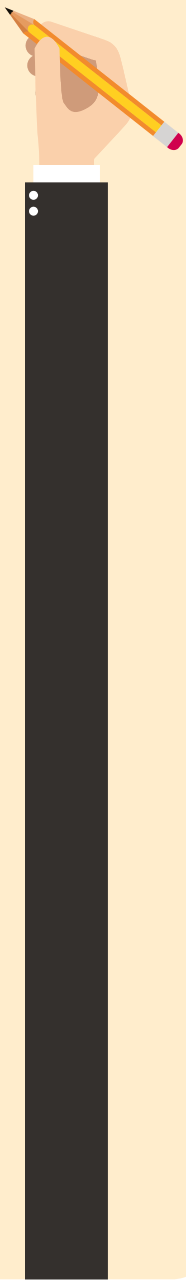
To meet the disclosure objective, the new standard has specific disclosure requirements in the following areas:



Under the new standard, an entity discloses more information about its contracts with customers than is currently required, including more disaggregated information about revenue and more information about its performance obligations remaining at the reporting date.

Consider this

- In summary, the new standard could have a significant bearing on revenues and margins with implications in the areas such as bundled contracts, timing of revenue recognition, contract costs and gross vs. net reporting of revenue. Companies will also need to carefully analyse the transition method that they want to adopt – from full retrospective method (without practical expedients), to cumulative effect method, the implications on retained earnings and future revenues and margins could be varied. For example, capitalisation of cost to obtain a contract could be double whammy for companies that have charged off such expenses as incurred thus far as the deferred costs would again be charged to profits in the future. There would also be extensive disclosure requirements which information systems will need to support.
- The impact of this accounting change may extend well beyond accounting, in areas such as systems and processes (including data collection), revenue based metrics, debt covenants, employee incentive schemes, forecasting and budgeting, etc. To that extent, the companies in India do need to factor in the time required for implementing the required changes.
- Another significant task for corporates would be to assess consequential impact on income taxes. While the recent amendment made to Section 115JB of Income-tax Act, 1961 by the Finance Act, 2017 specifies how to compute Minimum Alternate Tax (MAT) for first time Ind AS transition adjustments, it does not provide guidance on taxability of transition adjustments arising from any subsequent change in accounting standards. Although in July 2017 amendments have been proposed in Section 115JB, dealing with ongoing adjustments to equity items, those are pending notification. If notified, the cumulative adjustments made as at 1 April 2018 on adoption of Ind AS 115, may have to be considered for MAT computation. Further, the current Income Computation and Disclosure Standard (ICDS) on Revenue i.e. ICDS IV, is based on the revenue standard under Accounting Standards (Indian GAAP) (Indian GAAP is followed by companies not transitioned to Ind AS) and not even updated for the current revenue guidance under Ind AS. If the ICDS is not updated with Ind AS 115 changes, it may result in companies having to maintain another set of records effectively leading to parallel books of account for tax purposes. Hence, one will have to watch the developments under ICDS closely to evaluate the impact.
- Audit committee and other stakeholders would want to understand the impact of the new standard on the overall business – probably before it becomes effective. Areas of interest may include the effect on financial results, the costs of implementation, expected changes to business practices and the transition approach selected. Therefore, entities would need to carry out an extensive assessment of how their financial reporting, information systems, processes and controls are expected to be affected. Planning in advance will therefore be key to help ensure a smooth transition to this new, transformational standard.



Source: KPMG International Publication: Revenue Issues In-Depth, Second edition, May 2016