Ind AS 115, *Revenue from Contracts with Customers* has introduced a single comprehensive guidance – a ‘five step model’ for analysing revenue transactions. The model specifies that revenue should be recognised 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. It is applicable to Indian companies (who follow Ind AS) from 1 April 2018.

Revenue is a key performance metric for many entities and the new revenue model has an impact across sectors and to all types of revenue generating transactions. However, the requirements affect different sectors in different ways. Some companies may have witnessed little change in the timing and amount of revenue recognised. We found that not all five steps may be significant for all the sectors, for example, in certain sectors determination of performance obligations may be a critical area when multiple goods or services are in a contract while in others determination of transaction price would be an area of judgement when contract involves variable consideration or has financing component. The standard also provides detailed guidance on licences and royalty arrangements and accounting for costs to obtain or fulfil a contract, which has had an impact on some sectors.

Importantly, all companies across sectors will also be subject to extensive new disclosure requirements as they prepare their annual financial statements for year ending 31 March 2019.

We have worked with many companies across sectors in implementation of Ind AS 115 as they reported their quarterly financial results for the current financial year. Leveraging this experience, our publication ‘Unravelling revenue accounting – An analysis of sector impacts’ captures the significant impact of Ind AS 115 on various sectors. We have also explained the five step model in a practical way, with the help of flowcharts and examples.
## Table of contents

1. New principles of revenue recognition 01
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Revenue is one of the most important measures of performance for both preparers and users of financial statements. Revenue is generally used to measure and evaluate an entity’s financial performance, and future prospects. Therefore, revenue recognition is considered as one of the crucial aspects examined by the investors, analysts and regulators.

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. 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. Ind AS 115 provides a comprehensive framework for recognising revenue from contracts with customers and would apply to all revenue contracts with customers including construction contracts.

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 accounting change has brought 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 risks 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 recognise 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.

The new standard is likely to throw challenges from accounting perspective on different sectors, therefore in the publication we have highlighted some of the key challenges specific to different sectors.

**Scope of Ind AS 115**

The new standard applies to contracts with customers to deliver goods or services, except when those contracts are for:

- Lease contracts under Ind AS 17, Leases
- Insurance contracts under Ind AS 104, Insurance Contracts
- Rights or obligations that are in the scope of certain financial instruments guidance (such as Ind AS 109, Financial Instruments) e.g. derivative contracts
- Non-monetary exchanges between entities in the same line of business that facilitate sales to customers other than the parties to the exchange.
Overview of the five-step model

Step 1: Identify the contract with the customer

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.

A contract with a customer exists when it meets all of the mentioned criteria:

Step 2: Identify the performance obligations in the contract

The standard requires an entity to identify the performance obligations, i.e. the unit of account for revenue recognition. A promise to deliver a good or provide a service in a contract with a customer constitutes a performance obligation if the promised good or service is distinct.

A promised good or service is distinct from other goods and services in the contract if it meets two criteria:

Criterion 1: Capable of being distinct
Customer can benefit from the good or service on its own or together with other readily available resources

Criterion 2: Distinct within the context of contract
Promise to transfer good or service is separately identifiable from other promises in the contract

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

<table>
<thead>
<tr>
<th>Description of scenario</th>
<th>Conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entity provides a significant integration service for a building construction and delivers a single output to the customer</td>
<td>Single performance obligation</td>
</tr>
<tr>
<td>Entity provides a customer with equipment and a separately identifiable installation service</td>
<td>Multiple performance obligation</td>
</tr>
<tr>
<td>Entity provides the customer with equipment and proprietary consumable that are separately identifiable</td>
<td>Multiple performance obligation</td>
</tr>
<tr>
<td>Entity provides the customer with good and an implicit promise to provide a service to the customer’s customer who purchase the good</td>
<td>Multiple performance obligation</td>
</tr>
</tbody>
</table>

Source: Revenue Issues In-Depth, KPMG IFRG Limited’s publication, May 2016
If a promised good or service under the contract does not qualify to be a separate performance obligation, then 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).

**Step 3: Determine the transaction price**

Ind AS 115 requires an entity to consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration that an entity expects to be entitled in exchange for transferring goods or services to a customer.

The entity should consider the following when determining transaction price:

- **Variable consideration and the constraint:** If the consideration includes a variable amount, an entity should estimate the amount of consideration to which it will be entitled in exchange for transferring the promised goods or services to a customer. Items such as discounts, credits, price concessions, returns and performance bonuses may result in a variable consideration.

- **The existence of a significant financing component in the contract:** In determining the transaction price, an entity should adjust the promised amount of consideration for the time value of money if significant financing components exist.

- **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.

- **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.

**Step 4: Allocating the transaction price**

Under Ind AS 115, entities are required to allocate the transaction price to each performance obligation (or distinct good or service) in proportion to its stand-alone selling price i.e. the price at which an entity would sell the promised good or service separately to a customer.

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 then the entity should estimate the stand-alone selling price using the following methods:

- **Adjusted market assessment approach:** The entity needs to estimate the price that a customer would be willing to pay for the goods or services being offered, based on evaluation of the market in which goods or services are being sold.

- **Expected cost plus margin approach:** The expected costs of meeting a performance obligation are forecasted and an appropriate margin for such goods or service are added.

- **Residual approach (only in limited circumstances):** The stand-alone selling price is estimated by taking reference of the total transaction price less the sum of observable stand-alone selling prices of other goods or services promised in the contract. The residual approach is appropriate only if the stand-alone selling price of one or more goods or services is highly variable or uncertain, and observable stand-alone selling prices can be established for other goods or services promised in the contract.

If the stated contract price for any of the performance obligations in the arrangement is not an appropriate estimate of stand-alone selling price, then it will be necessary for the entity to perform a relative selling price allocation of the transaction price.

**Step 5: Recognise revenue**

As per the new standard, revenue may be recognised either at a point in time (when a customer obtains control over the promised service) or over a period of time (as the customer obtains control over the promised service). For the purposes of the standard, control refers to the customer’s ability to direct the use of and obtain necessary benefits from the asset, i.e. the promised services. The new standard includes certain indicators of transfer of control such as the customer has:

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

An entity would have to determine at contract inception whether it satisfies the performance obligation over time or at a point in time.
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.

If a performance obligation is not satisfied over time, then an entity recognises revenue at the point in time at which it transfers control of the good or service to the customer. The new standard provides indicators to be considered when the transfer of control occurs.

**Effective date**

The new standard notified by MCA is effective for accounting periods beginning on or after 1 April 2018. Early adoption is not permitted. Further, an entity can elect to adopt the new standard in a variety of ways, including retrospectively with or without optional practical expedient or through a cumulative effect adjustment as of the start of the first period for which it applies the new standard.

### Transition

Ind AS 115 provides two methods of accounting for transition i.e. the retrospective method (with or without one or more of four practical expedients) and the cumulative effect method.

#### Retrospective method

Under the retrospective method, an entity is required to restate each period before the date of initial application that is presented in the financial statements. The date of initial application is the start of the reporting period in which an entity first applies the new standard. For example, if an entity first applies the new standard in its financial statements for the year ended 31 March 2018, then the date of initial application is 1 April 2018.

The entity recognises the cumulative effect of applying the new standard in equity at the start of the earliest comparative period presented.

An entity that elects to apply the new standard using the retrospective method can choose to do so on a full retrospective basis or with one or more practical expedients. The practical expedients provide relief from applying the requirement of the new standard to certain types of contracts in the comparative periods presented.

### Approach

<table>
<thead>
<tr>
<th></th>
<th>1 April 2017</th>
<th>1 April 2018</th>
<th>Date of equity adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full retrospective – no practical expedients</td>
<td>Ind AS 115</td>
<td>Ind AS 115</td>
<td>1 April 2017</td>
</tr>
<tr>
<td>Full retrospective – practical expedients</td>
<td>Mixed requirements</td>
<td>Ind AS 115</td>
<td>1 April 2017</td>
</tr>
<tr>
<td>Cumulative effect</td>
<td>Ind AS 11/Ind AS 18</td>
<td>Ind AS 115</td>
<td>1 April 2018</td>
</tr>
</tbody>
</table>

Source: Revenue Issues In-Depth, KPMG IFRG Limited’s publication, May 2016
The following section explains practical expedients:

**Practical expedient 1 – Contracts that are started and completed in the same annual reporting period:** Under this expedient, an entity need not restate completed contracts that begin and end within the same annual reporting period.

**Practical expedient 2 – Exemption from applying variable consideration requirements:** Under this expedient, an entity may use the transaction price at the date on which the contract was completed, rather than estimating the variable consideration amounts in each comparative reporting period.

**Practical expedient 3 – Contract modifications before the earliest period presented:** Under this expedient, an entity need not separately evaluate the effects of contract modifications before the beginning of the earliest reporting period presented using the contract modifications requirement in the new standard. Instead, an entity may reflect the aggregate effect of all of the modifications that occur before the beginning of the earliest period presented in:
- Identifying the satisfied and unsatisfied performance obligations
- Determining the transaction price
- Allocating the transaction price to the satisfied and unsatisfied performance obligations

**Practical expedient 4 – Disclosure exemption:** Under this expedient, an entity need not disclose for reporting periods before the date of initial application:
- The amount of the transaction price allocated to the remaining performance obligations; or
- An explanation of when the entity expects to recognise that amount as revenue.

**Cumulative effect method (with optional practical expedients)**

Under the cumulative effect method, an entity applies the new standard as of the date of initial application, without restatement of comparative period amounts. The entity records the cumulative effect of initially applying the new standard as an adjustment to the opening balance of equity at the date of initial application.

Under the cumulative effect method, an entity can choose to apply the requirements of the new standard to:
- Only contracts that are not completed contracts at the date of initial application; or
- All contracts at the date of initial application.

An entity that applies the cumulative effect method may also use the contract modifications practical expedient.
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 as explained in the diagram below:

Disaggregation of revenue

Ind AS 115 requires the disclosure of revenue into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. The entity is also required to disclose sufficient information to enable users to understand the relationship between the disclosure of disaggregated revenue and revenue information that is disclosed for each reportable segment.

In determining these categories, an entity considers how revenue is disaggregated in:

- Disclosures presented outside the financial statements – e.g. earnings release, annual reports or investor presentations
- Information reviewed by the chief operating decision maker for evaluating the financial performance of operating segments
- Other information similar to the above that is used by the entity or users of the entity’s financial statements to evaluate performance or make resource allocation decisions.

Examples of disaggregation include type of good or service, geography, market, type of customer and type of contract. Further, the disaggregation of revenue disclosures is also required to be included in the entity’s interim financial statements and the optional practical expedients that it has elected to use.

Source: Revenue Issues In-Depth, KPMG IFRG Limited’s publication, May 2016
The following chart provides an overview of the detailed disclosure requirements and also highlights similarities and differences from the existing disclosure requirements.

<table>
<thead>
<tr>
<th>Disclosure requirements</th>
<th>What’s new</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Contract balances</strong></td>
<td></td>
</tr>
<tr>
<td>Ind AS 115 requires entities to provide narrative disclosure to describe changes in contract balances such as:</td>
<td></td>
</tr>
<tr>
<td>• The opening and closing balances related to contracts with customers (if not otherwise separately presented or disclosed) for:</td>
<td></td>
</tr>
<tr>
<td>- Contract assets</td>
<td></td>
</tr>
<tr>
<td>- Contract liabilities</td>
<td></td>
</tr>
<tr>
<td>- Receivables from contracts with customers</td>
<td></td>
</tr>
<tr>
<td>• The amount of revenue recognised in the current period that was included in the opening contract liability balance</td>
<td></td>
</tr>
<tr>
<td>• The amount of revenue recognised in the current period from performance obligations satisfied (or partially satisfied) in previous periods – e.g. changes in transaction price</td>
<td></td>
</tr>
<tr>
<td>• An explanation of how the timing of satisfaction of the entity’s performance obligations relates to the typical payment terms and how these two factors will affect the contract asset and contract liability balances</td>
<td></td>
</tr>
<tr>
<td>• An explanation of the significant changes in the balances of contract assets and contract liabilities, including both qualitative and quantitative information.</td>
<td></td>
</tr>
<tr>
<td><strong>Performance obligations</strong></td>
<td></td>
</tr>
<tr>
<td>Ind AS 115 requires an entity to disclose information about its performance obligations in its contracts with customers, including a description of all of the following:</td>
<td></td>
</tr>
<tr>
<td>• When the entity typically satisfies its performance obligations – e.g. on shipment, on delivery, as services are rendered or on completion of service</td>
<td></td>
</tr>
<tr>
<td>• Significant payment terms – e.g. whether the contract has a significant financing component, the consideration is variable and the variable consideration is constrained</td>
<td></td>
</tr>
<tr>
<td>• The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (if the entity is acting as an agent)</td>
<td></td>
</tr>
<tr>
<td>• Obligations for returns, refunds and other similar obligations</td>
<td></td>
</tr>
<tr>
<td>• Types of warranties and related obligations</td>
<td></td>
</tr>
<tr>
<td>• The aggregate amount of the transaction price allocated to performance obligations that are unsatisfied (or partially unsatisfied) at the reporting date. A quantitative (using time bands) or a qualitative explanation of when an entity expects that amount to be recognised as revenue is also required.</td>
<td></td>
</tr>
</tbody>
</table>
### Significant judgements when applying Ind AS 115

The entity is also required to disclose significant judgements made in accounting for customer contracts, including judgements related to the following:

- Methods used to recognise revenue over time (output method or input method).
- Explanation of why the ‘over time’ method(s) faithfully depicts the transfer of goods or services.
- Transfer of control of goods or services for performance obligations that are satisfied at a point in time.
- Methods used to determine the transaction price and its allocation to performance obligations.
- Estimates of stand-alone selling prices.
- Measurement of obligations for returns and refunds.

### Costs to obtain or fulfil a contract

Ind AS 115 requires an entity to disclose information about the assets recognised from the costs incurred to obtain or fulfil a contract with the customer. An entity discloses the following items that are recognised from the costs incurred to obtain or fulfil a contract with a customer:

- The amount of amortisation.
- Any impairment losses recognised in the reporting period.

These items are separated by their main category – e.g. acquisition costs, pre-contract costs, set-up costs and other fulfilment costs.

**Source:** IFRS 15 Revenue Supplement, KPMG IFRG Ltd’s publication, October 2017
Summary

- Determination of separate performance obligations is a key step e.g. for free goods and services and warranty.
- Variability in transaction price may be explicit or implicit, arising from customary business practices e.g. bonus, incentives, price concessions.
- When estimating stand-alone selling prices, it may be acceptable to select from a range of prices, particularly when stand-alone selling prices would be expected to vary from similar types for customers.
- For principal versus agent evaluation there is no specific hierarchy for the indicators, and all of the indicators are considered in making the assessment.

Introduction

The significance of the automotive sector as a critical growth engine for an economy cannot be over emphasised. The integral players of the value chain in automotive sector are the Original Equipment Manufacturers (OEMs) and component supplier units (who engage in production of components, parts and ancillary products used in vehicles and dealer network).

Revenue is considered as one of the key benchmarks for performance of these players in the industry. The new revenue standard, Ind AS 115 is likely to throw up multifaceted challenges from an accounting perspective in the automotive sector, this chapter provides insights on specific issues confronting the companies in this sector.

Therefore, entities should involve their legal departments to evaluate whether a specific document or a set of documents has legal binding and creates a contract with a customer in the scope of Ind AS 115, for example, in the case of master service agreement and subsequent purchase orders.

The following section highlights the steps in the five–step model that are likely to impact the automotive sector.

Framework agreements

A contract should create 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. Under Ind AS 115, a contract should meet all the following criteria:

- ... collection of consideration is considered probable
- ... rights to goods or services and payment terms can be identified
- ... it has commercial substance
- ... it is approved and the parties are committed to their obligations
A contract does not exist when each party has the unilateral right to terminate a wholly unperformed contract without compensation.

Determining whether a contract exists is important because generally an automotive supplier cannot recognise revenue from an arrangement before all the criteria mentioned in Ind AS 115 are met.

Therefore, entities should involve their legal departments to evaluate whether a specific document or a set of documents has legal binding and creates a contract with a customer in the scope of Ind AS 115, for example, in the case of master service agreement and subsequent purchase orders.

**Performance obligations**

An OEM needs to identify the performance obligations to determine whether it has promised transfer of goods or services that are distinct, or a series of distinct goods or services that meet certain conditions. These promises may not be limited to those explicitly included within contracts.

An OEM may have a history of offering free goods/maintenance services to its dealer’s customer. These services may not be explicitly stated in the contract between the manufacturer and dealers. If the automobile manufacturer has a customary business practice, this may then be treated as an implicit promise and maintenance, free spares and accessories would be treated as a separate performance obligation.

Another example of separate obligation is the warranty provided in connection with the sale of automobiles.

The nature and type of warranty could depend on the contract, law or the entity’s customary business practices. Under Ind AS 115, a warranty is considered as a performance obligation if the customer has an option to purchase the good or service with or without the warranty. The standard identifies assurance-type warranties (an assurance that the related product will function as the parties intended because it complies with agreed upon specifications) and service warranties (which provides the customer with a service in addition to the assurance that the product complies with the agreed-upon specifications).

The standard has envisaged two situations in relation to accounting for warranty costs:

- **The customer has an option to purchase a warranty separately (for example, the warranty is priced or negotiated separately):** The warranty is a distinct service because the OEM promises to provide the service to the customer in addition to the product that has the functionality described in the contract.

  In those circumstances, the OEM would account for the promised warranty as a performance obligation and allocate a portion of the transaction price to that performance obligation.

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*Source: KPMG in India’s analysis, 2019*
• **Customer gets additional services as part of the warranty:** When a warranty is not sold separately, (e.g. extended warranty) the warranty or part of the warranty may still be a performance obligation, but only if the warranty or part of it provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications. A warranty that only covers the compliance of a product with agreed-upon specifications (an ‘assurance warranty’) is accounted for under other relevant guidance e.g. Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets.

The assessment of whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications is a matter of judgement which requires a consideration of factors such as:

• **Whether the warranty is required by law:** If an entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation because such requirements typically exist to protect customers from the risk of purchasing defective products.

• **The length of the warranty coverage period:** The longer the coverage period, the more likely it is that the promised warranty is a performance obligation because it is more likely to provide a service in addition to assurance that the product complies with agreed-upon specifications.

• **The nature of the tasks that the entity promises to perform:** If it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (for example, a return shipping service for a defective product), then those tasks are unlikely to give rise to a performance obligation.

**Sales incentive offered by a seller – variable consideration**

Sale contracts between OEMs and dealers often include incentives such as cash rebates, bonuses, price concessions or credits which are contingent upon specific milestones such as the number of vehicles sold in a period. The incentives could also include reimbursement of free maintenance services (to dealers) given to customers. These incentive may result in variable consideration. Since automotive entities develop various sale promotion schemes in order to increase their sales, careful consideration and judgement is required to ensure appropriate accounting.

When estimating the transaction price for a contract with variable consideration, an entity’s initial measurement objective is to determine which of the following methods best predicts the consideration to which the entity will be entitled. (see the table below)

<table>
<thead>
<tr>
<th>Method</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Expected value</strong></td>
</tr>
<tr>
<td>The entity considers the sum of probability-weighted amounts for a range of possible consideration amounts. This may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Method</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Most likely amount</strong></td>
</tr>
<tr>
<td>The entity considers that single most likely amount from a range of possible consideration amounts. This may be an appropriate estimate of the amount of variable consideration if the contract has only two (or perhaps a few) possible outcomes.</td>
</tr>
</tbody>
</table>

The method selected is applied consistently throughout the contract and to similar types of contracts when estimating the effect of uncertainty on the amount of variable consideration to which the entity will be entitled.

**Financial assistance by OEMs – Significant financing component**

In some arrangements, OEMs provide advances to automotive suppliers for parts before delivery. Payments made at an early stage of the project may provide the suppliers with financial assistance. Also other instances of significant financing components include cases where a taxi company may pay in advance for a fleet of cars, or a courier company may pay OEMs for a fleet of vehicles suitable for its purpose, etc.

Under Ind AS 18, Revenue, an entity discounts consideration to present value if payment is deferred and the arrangement effectively constitutes a finance transaction – e.g. a customer paying the agreed sales price two years after it takes ownership of the product.
However, Ind AS 18 is silent on whether an entity adjusts consideration if payment is received in advance. OEMs may support their component and parts suppliers by providing them financial assistance through advance payments at an early stage of the project. Under the new revenue recognition standard Ind AS 115, suppliers need to consider whether these payment terms (i.e. deferred or advance) indicate that such contracts contain a significant financing component that adjusts the transaction price.

Suppliers may need to recognise interest expense on such prepayments made by OEMS. The interest expense recognised also causes an increase in transaction price.

The objective when adjusting 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 reflects the credit characteristics of the party receiving the credit.

Ind AS 115 notes that a contract does not include a significant financing component in some specific circumstances—e.g. when a customer pays for goods in advance and the timing of the transfer of the goods is at the customer’s discretion.

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.

Source: Revenue Issues In-Depth, KPMG IFRG Limited’s publication, May 2016
Allocation of transaction price

Under Ind AS 18, consideration to be received could be allocated to components of a revenue transaction using the following methods:

- Components with reference to the relative fair values of the different components (relative fair value method) or
- The undelivered components measured at their fair value, with the remainder of the balance allocated to components that were delivered up-front (residual method).

Ind AS 115 provides detailed guidance on allocation of transaction price. In this step, an entity is required to allocate the transaction price at the contract inception to each performance obligation on the basis of relative stand-alone selling prices (unlike earlier Ind AS 18 where fair value of consideration was to be considered). The best evidence of such a price is the observable price from stand-alone sales of the goods or service to similarly-situated customers. If observable price is not available, then price need to be estimated by using:

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

In the automotive sector, the key impact would be with respect to determination of stand-alone selling prices of extended warranties and free goods and services.

In case of sale of vehicle, a contractually stated price or list price could be the stand-alone selling price, but it could not be presumed to be the case. In practice, the OEM may provide certain price concessions, hence, the entity would need to consider the observable price.

Estimated stand-alone selling prices for a particular good or service may change over time due to changes in market conditions and entity specific factors. Although the estimated stand-alone selling prices for previously allocated arrangements are not revised, new arrangements should reflect current reasonably available information, including shifts in pricing, customer base, or product offerings.

Principal versus agent

OEMs usually sell through a network of dealers. This entails movement of the vehicles from the manufacturer’s premises to the dealer premises/showrooms. The nature of terms/arrangement between the OEM and the dealer to ship the vehicles from one location to the other could be different and need to be analysed carefully to determine whether a separate performance obligation exist.

If the scope of the contract is to supply the vehicles at the location of the dealer at a lump sum price, it may indicate that there is a single performance obligation and revenue should be recognised once the performance obligation is met i.e. the vehicles are delivered at the location of the dealer.

If the scope of the contract is to only supply the vehicles and arrange for shipping services (at the request of the dealer) to deliver the vehicles at the location of the dealer and the price is negotiated separately, it may indicate that there are two performance obligations – one for the supply of goods (vehicle) and other for rendering of services (shipping).

In such an arrangement which involves two parties (OEM and dealer), management will need to determine whether the entity has promised to provide the services of shipping itself (as a principal) or to arrange for the specified service to be provided by another party (as an agent).

If the OEM is acting as a principal for shipping services:

- Revenue will be recognised at gross amount paid by the customer for supply of vehicle and rendering of shipping service
- Amount paid to the party providing shipping service will be recorded as an expense
- Any other cost incurred in satisfying the performance obligation of shipping service will be recorded as an expense

Revenue for sale of vehicles will be recognised only once all performance obligations are met i.e. once the control in goods is passed on to the dealer.

If the OEM is acting as an agent for shipping services:

- Any commission or service charge paid to the entity will also be recognised as revenue.
Timing of revenue recognition

Ind AS 115 provides a control-based approach to be applied to all transactions i.e. at the contract inception, an entity need to evaluate whether it transfers control of the good or service over-time or at a point in time.

Under Ind AS 18, revenue from the sale of goods is recognised when, amongst the other criteria, the entity has transferred to the buyer significant risks and rewards of ownership. However, under Ind AS 115 revenue is recognised at a point in time at which control of the good or service is transferred to the customer.

The new standard includes certain indicators of transfer of control such as the customer has:
- A present obligation to pay
- Physical possession
- Legal title
- Risks and rewards of ownership
- Accepted the asset.

It emphasises on transfer of ‘control’ as against transfer of ‘risks and rewards’. Under Ind AS 115, revenue would be recognised as and when the ‘control’ over vehicles is transferred to the customer. The standard requires entities to determine whether the control is passed on over a period of time or at a point in time for the purposes of recognising revenue.
Summary

- Assessment of collectability is important as entities cannot recognise revenue from a contract until collection is probable.
- When applying ‘distinct test’, think about land, building, common areas, car parks, management services, golf memberships.
- When recognising revenue over-time, assessment is required whether sales contracts meet one of the three criterias.
- Significant financing element could lead to complex calculations for contracts recognised over-time.

The companies in the real estate sector in India applying the Ind AS were recognising revenue using the principles of the Guidance Note on Accounting for Real Estate Transactions issued by the Council of the Institute of Chartered Accountants of India (ICAI) (GN on Real Estate) before the implementation of Ind AS 115.

This new standard superseded all the existing guidance available under Ind AS with respect to revenue recognition i.e. Ind AS 18, Revenue, Ind AS 11, Construction Contracts and GN on Real Estate. Consequently, ICAI withdrew this GN.

The GN on Real Estate provided guidance on:
- Application of the principles of Ind AS 18 in respect of sale of goods to a real estate project when the revenue recognition process is completed
- Application of the percentage of completion method based on the methodology as per Ind AS 11, where the economic substance of the transaction is similar to construction contracts.

Ind AS 115 changes the way in which many real estate developers account for their sales contracts.

For the purpose of this chapter, real estate sector includes entities that
i. Own, operate and sell real estate
ii. Provide property management services, and
iii. Construct and sell residential property - property can include sale of land, sale of plotted development, or sale of residential apartments.

The key impact areas for real estate sector on transition to Ind AS 115 are discussed below.

Assessing collectability

Generally, when relevant, one of the most difficult criteria to assess for real estate developers is whether the consideration is collectible. This is due to the fact that there could be certain conditions that would be outside an entity’s control, both during the construction phase and subsequently e.g. economic conditions that result in increases or decreases in property prices.

In making the collectability assessment, an entity would consider the customer’s ability and intention (which includes assessment of its credit worthiness) to pay the consideration when it falls due. All other relevant facts and circumstances are considered – for example:

- The buyer’s rights to cancel the contract for no penalty
- Any prior experience with the buyer
- Historical data on buyers with similar characteristics
- The importance of the property to the buyer’s operations
- Contractual terms (e.g. small down payment without sufficient collateral)
• Whether the seller is providing non-recourse finance (i.e. seller only has a right to the property in the event of default) to the buyer.

**Example**

Developer D entered into a contract to sell a building to buyer B for INR1 lakh and provided long-term, non-recourse financing (i.e. seller only has a right to the property in the event of default) for 95 per cent of the sales price. B expects to repay the loan using income derived from its restaurant business. B’s business faces significant risks due to high competition in the industry and B’s limited experience. B lacks other income or assets that could be used to repay the loan.

If developer D concludes that it is not probable that it will collect the amount to which it expects to be entitled, then a contract to transfer control of the building does not exist. D should apply the guidance under Ind AS 115 related to consideration received before concluding that a contract exists.

**Identification of performance obligations**

As per the new standard, once a contract has been identified, an entity has to evaluate the contractual terms and the general business practice to identify whether the entity has promised one or several distinct goods or services to its customer. These distinct goods or services are identified as performance obligation(s).

The standard provides the following criteria to identify performance obligations:

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

- **Criterion 2: Distinct within the context of the contract**
  - Is the promise to transfer the good or service separately identifiable from other promises in the contract?

If these criteria are not met, the entity would need to combine promised good or service with other promised goods or services until a distinct bundled goods or services has been identified. While assessing distinct goods and services, it is important to analyse these from the customer’s perspective.

In the case of a real estate developer, a key consideration would be whether land and building elements are separate performance obligations. This assessment is critical as different performance obligations may have different patterns over which the control is transferred and as a consequence the timing of revenue recognition would have a significant impact.

**Example**

In the case of residential apartments, the customers also receive the Undivided Share (commonly referred to as UDS) of the land on which the apartment blocks are constructed. In such a case, since the title to the UDS of land is transferred to the customer separately, it would need to be evaluated if the land would be considered as highly inter-related with the apartment constructed and hence, both together would constitute a single performance obligation, or, will the UDS of land and the apartment constructed cost be considered as separate performance obligations.

Issues on identification of separate performance obligations would also arise with respect to common areas/amenities that are provided by the developers to its customers such as car parks, recreational centers, etc.

In certain other cases, identification of separate performance obligations would be straightforward such as property management services, golf memberships, etc. since these services are not significantly customised, integrated with, or dependent on the underlying property.

To summarise, the identification of performance obligations would require an in-depth understanding and analysis of the terms of the contract and the property laws which are different across the different states in India.
Variable consideration

For entities in the real estate sector, variable consideration includes price concessions, incentives, performance bonuses, claims, variations, discounts, refunds, right of return, credits, or other similar items. However, the variable consideration would be included in the transaction price only to the extent that it is highly probable that significant revenue reversal will not subsequently occur (the constraint).

Under Ind AS 115, an entity is required to determine the transaction price and reassess the same at each reporting date. The transaction price may vary depending upon the variable consideration included in the contract. The approach and accounting of the variable consideration is significantly different from the existing requirements.

It is important for the entity to consider all facts and circumstances while applying the constraint as it might result in understatement or overstatement of revenue. And, the assessment of the estimate has to be updated at each reporting date.

For any claims or variations to be accounted by an entity as part of transaction price, they need to give rise to enforceable rights and obligations. This threshold could be different from what was applied earlier by entities resulting in acceleration or deferment of revenue recognition from these claims and variations.

Timing and measurement of revenue

Timing of revenue recognition

For the purpose of revenue recognition, an entity must determine whether the performance obligation is satisfied over time or at a point in time.

The new standard requires an entity to recognise revenue progressively over time if any of the following criteria are met:

1. Customer simultaneously receives and consumes the benefits as the entity performs.
2. The customer controls the asset as the entity creates or enhances it.
3. The entity’s performance does not create an asset for which the entity has an alternate use and there is a right to payment for performance to date.

The most relevant indicator to analyse for real estate developers would be criterion no. 3. This includes assessment of two parts (i). No alternative use of asset and (ii) Right to payment.

When applying the first part of the test – ‘no alternative use’ – is generally met when a real estate developer enters into a contract with a customer that includes a clause that the property cannot be sold to another party. These types of clauses are sufficient for the asset to be considered as having no alternative use to the entity.

However, one of the most challenging areas would be assessing the right to payment criteria in cases where the contract is terminated for reasons other than non-performance by the developer. As per Ind AS 115, the right to payment needs to be enforceable and should approximate the selling price of goods or services transferred i.e. should at least cover performance to date including a reasonable profit margin. A mere reimbursement of cost would not qualify for over-time satisfaction of performance obligation. Hence, this is likely to be an area of significant debate and would require careful evaluation of whether the developer is entitled as per the contract to recover his/her costs of performance plus margin from the customer and would also need an assessment of the local property laws to check on the legal precedent on enforceability of rights and the past practice with respect to enforcing these rights. The general practice of repossessing the property in case of default in payment will not again meet this criteria since a right to repossess a property will not qualify as a right to payment for performance.

As per the new standard, if the above criteria for recognising revenue over time are not met, then the revenue has to be recognised at a point in time i.e. when the customer obtains the control of the asset. This guidance under Ind AS 115 is in contrast to the guidance that was provided by GN on Real Estate that permits real estate developers to recognise revenue using the percentage of completion method.

Example

Assume that in addition to the fixed transaction price of INR100 lakh, the real estate developer will also be eligible for a bonus of INR5 lakh for each month of early completion of the project. Under the existing standard, an entity would either include the bonus as part of total contract revenue or exclude it in entirety. Under Ind AS 115, an entity would estimate the variable consideration using the most likely amount and include the same in the transaction price to the extent that significant reversal will not subsequently occur.
Example

P Ltd. is developing a multi-unit residential complex. A customer enters into a binding sales contract with P Ltd. for a specified unit that is under construction. Each unit has a similar floor plan and is of a similar size, but other attributes of the units are different (for example, the location of the unit within the complex). The customer pays a deposit (10 per cent) upon entering into the contract and promises to make progress payments during construction of the unit. The deposit is refundable, only if, the entity fails to complete construction of the unit in accordance with the contract. P Ltd. retains legal title to the real estate unit construction is complete. The customer can resell or pledge the right as the real estate unit is being constructed. P Ltd. cannot direct the unit to another customer as per terms of the contract. In addition, the customer does not have the right to terminate the contract unless P Ltd. fails to perform as promised.

Recognition of revenue is based on facts and circumstances and is explained with the help of following three scenarios:

Scenario 1

In case the customer defaults on its obligations by failing to make the promised progress payments as and when they are due, the entity would have a right to all of the consideration promised in the contract, if it completes the construction of the unit. The courts have previously upheld similar rights that entitle developers to require the customer to perform, subject to the entity meeting its obligations under the contract.

In this scenario, P cannot change or substitute the real estate unit specified in the contract with the customer, and thus the customer could enforce its rights to the unit if the entity sought to direct the asset for another use. Accordingly, the contractual restriction is substantive and the real estate unit does not have an alternative use to P.

Also P has a right to payment for performance completed to date. This is because if the customer were to default on its obligations, P would have an enforceable right to all of the consideration promised under the contract if it continues to perform as promised. Therefore, the terms of the contract and the legal precedent indicate that there is a right to payment for performance completed to date. Consequently, the criteria mentioned under Ind AS 115 are met, and P has a performance obligation that it satisfies over time. To recognise revenue for that performance obligation satisfied over time, P should measure its progress toward complete satisfaction of its performance obligation as per guidance under Ind AS 115.

Scenario 2

In situations where customer defaults on the contract before completion of the unit, P Ltd. only has the right to retain the deposit. As mentioned earlier, the real estate unit does not have an alternative use to P. P also does not have an enforceable right to payment for performance completed to date - until construction of the unit is complete, P only has a right to the deposit paid by the customer. Because P does not have a right to payment for work completed to date, P’s performance obligation is not a performance obligation satisfied over time. Instead, P would account for the sale of the unit as a performance obligation satisfied at a point in time as per the guidance under Ind AS 115.

Scenario 3

In this situation if the customer defaults, P Ltd. would serve the customer with a notice period to perform/pay. P Ltd. has two options

- Can require the customer to perform as required under the contract or
- Can cancel the contract in exchange for the asset under construction and be entitled to a penalty of a proportion of the contract price.

In case of such cancellation, the P Ltd. would be entitled to sell the unit to any other person if the customer does not fulfil his/her obligation within the notice period given by P Ltd.

Since P Ltd has a right to payment for performance completed to date as entity P has the option to enforce its rights to proportionate payment under the contract. Consequently, the criterion specified under Ind AS 115 relating to enforceable right has been met, thus the entity has a performance obligation that it satisfies over time. The fact that P Ltd. may choose to cancel the contract in the event the customer defaults on its obligations would not affect that assessment, provided that P Ltd.’s rights to require the customer to continue to perform as required under the contract (i.e., pay the promised consideration) are enforceable.

Source: Educational material on Ind AS 115, issued by ICAI, August 2018
Measuring progress

Under the current requirements, some entities recognise work in progress balances that may include both amounts related to uninstalled materials and amounts that may be deferred until the next milestone is reached. Under Ind AS 115, these practices are no longer appropriate because when control of the property is transferred over time, it is assumed that the transfer is continuous such that no material amounts of work in progress are recorded. As a result, the recognition of work in progress as a balance sheet ‘true up’ to ensure a smooth margin is no longer permitted. Ind AS 115 provides specific guidance on the treatment of uninstalled materials which requires revenue recognition at a zero margin when control of these materials is passed to the customer. Under the current guidance, materials that have not yet been installed are excluded from contract costs when determining the stage of completion of a contract and are recognised as part of work in progress.

Thereby under the new standard an entity can capitalise only the following costs:

- Cost of inventory for which the control has not been passed on to the customer
- Cost of obtaining a contract (discussed subsequently)
- Cost of fulfilling a contract i.e. set up costs.

Significant financing element

Currently Ind AS 18 requires revenue to be recognised at fair value for arrangements with deferred credit that provide a financing arrangement for a customer. Under Ind AS 115, the concept of significant financing element needs to be looked at from both deferred credit and receipt of advance basis and would result in recognition of interest income and interest expense respectively over the period of the contract with a corresponding adjustment to revenue (reduction in case of deferred credit and gross up in case of advance). While the computations of these can be straight-forward in cases where revenue is recognised at a point in time, in case of real estate where the revenue recognition would be over-time, the computations could get complex and would require exercise of judgement.

Example

Developer D has entered into contract for sale of property for INR10 lakh with buyer B, for property which will be delivered at the end of 2 years. Buyer B has agreed to schedule of payments as below:

10 per cent on signing the contract
50 per cent at end of Year 1
40 per cent on completion of contract.

Developer D concludes that contract consists of significant financing component, since the property will be delivered to B at point in time on completion i.e. at the end of year 2.

Considering the guidance discussed above, management would need to consider whether a financing component exists for the contract. If there is a financing component, it needs to be further assessed whether it is significant. For this, the management would need to consider the time period between payment and the completion of the related performance where developer D is performing over time rather than at a specific point in time to assess whether there is a significant financing component taking into account the 12-month practical expedient offered by the standard.

Costs of obtaining a contract

There is no specific guidance under current Ind AS on accounting for the costs to obtain a contract. Ind AS 11 states that costs that relate directly to a contract and are incurred in securing the contract are included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained.

Ind AS 115 provides specific guidance on accounting for costs incurred for obtaining the contract. An entity can capitalise costs that are directly attributable and incremental in nature for obtaining a contract and are expected to be recovered. Costs are considered as incremental in nature if they are incurred only as a result of obtaining the contract.

The asset recognised based on the above guidance shall be amortised on a systematic basis over the contract period in a pattern matching the transfer of promised goods or services. The standard provides a practical expedient by allowing to recognise such costs as expenses when they are incurred if the amortisation period would be less than 12 months.

As there is now specific guidance under Ind AS 115, it could result in fewer or more costs being capitalised as compared to the current practice. In the real estate sector, many entities incur significant costs as sales commission, bonus paid to staff on targets, etc.

Therefore, such entities would need to assess if such costs would qualify for capitalisation under Ind AS 115.
Impact of Ind AS 115 on construction companies

The issues discussed above for real estate developers would also be relevant for construction contractors to a large extent. The determination of whether recognition of revenue should be at a point in time or over-time would be less of a challenge for construction companies since such contracts are likely to meet criteria 2 discussed above under the heading ‘timing and measurement of revenue’.

A couple of topics more specific to the construction industry for which there could be an impact under Ind AS 115 are discussed below:

**Contract modifications**

A contract modification can happen either because of a change in price or scope and/or of both. Ind AS 115 would require a contract modification to be accounted only if the same has been approved i.e. when it creates legally enforceable rights and obligations on parties to the contract.

A contract modification could be accounted as:

1. A separate contract
2. A part of the original contract
3. As termination of existing contract and creation of a new contract.

These would require analysis to determine whether any distinct goods or services are being delivered to the customer and whether the same are priced at their stand-alone selling prices.

In case of construction contracts that are considered initially to include a single performance obligation for which revenue is recognised over time, a contract modification is not distinct from the existing goods and services in the contract. For example a modification to the design of the asset being constructed. The modifications to construction contracts are generally accounted for as part of the original contract with a cumulative catch-up adjustment recorded at the date of the modification.

These contract modifications could get complex and involve significant administrative efforts, if these occur frequently. Further since the assessment focusses on enforceability, this would require significant judgement particularly in cases where the parties to the contract could dispute the scope or the price.

**Loss making contracts**

As per the new standard there is no specific guidance on loss making contracts. Therefore, the same has to be accounted based on the general guidance provided for onerous contracts under Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets.

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**Source:** Revenue Issues In-Depth, KPMG IFRG Limited’s publication, May 2016
Summary

- Process followed to establish a contract with a customer could require reassessment to be compliant with the new requirements.
- Determination of performance obligation is a key step as contracts may explicitly or implicitly include additional promises e.g. customer loyalty programmes.
- Contract terms should be examined to determine whether all variable consideration elements have been identified appropriately.
- When determining stand-alone selling price, the warranties accounted for as a separate performance obligation need to comply with the requirements of the new standard.

The consumer market sector is one of the largest and fastest growing sectors in the country. Certain new requirements under Ind AS 115 affect the heart of business performance i.e. sales and the timing of recognising revenue, warranties and any other performance obligation which may be embedded in the sale of products made to customers.

This chapter focusses on the consumer market and retail sectors’ companies and highlights significant areas where current guidance in Ind AS is expected to change due to implementation of Ind AS 115.

Contract with customers

A contract should create enforceable rights and obligations and the standard specifies that enforceability is a matter of law. Contracts can be written, oral or implied by an entity’s customary business practices.

Under Ind AS 115, a contract should meet all of the following criteria:

- Collection of consideration is considered probable
- Rights to goods or services and payment terms can be identified
- It has commercial substance
- It is approved and the parties are committed to their obligations

Source: Revenue Issues In-Depth, KPMG IFRG Limited’s publication, May 2016
One can note here that in comparison to Ind AS 18, step number 1 and 3 are additions in this standard and to that extent provide explicit new requirements while an entity recognises revenue.

For companies in the consumer market and retail sectors, existing practices and the policies followed for establishing a contract with their customers, could require a reassessment in order to be compliant with the requirements of the standard.

**Performance obligation and the customer taking control**

A ‘performance obligation’ is the unit of account for revenue recognition. An entity assesses the goods or services promised in a contract with a customer and identifies a performance obligation either as:

- A good or service (or a bundle of goods or services) that is distinct; or
- A series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer – i.e. each distinct good or service in the series is satisfied over time and the same method is used to measure progress.

In order for a promised good or service to be distinct and therefore, constitute as a performance obligation, at contract inception, it should meet the following two conditions as described in the diagram below:

Many contracts entered into by companies in the consumer market and retail sectors may include only a single promise, being the promise to transfer the specified goods to the customer. However, in some cases, contracts may explicitly or implicitly include additional promises e.g. customer options, customer loyalty programmes, shipping and handling services, warranties and training.

Apart from determining the obligations towards customers, the standard also requires that the satisfaction of a performance obligation is determined on transfer of a promised good or service (i.e. an asset) to a customer and that such a transfer occurs when or as the customer obtains control of that asset. On export sales at Cost, Insurance and Freight (CIF) terms, an entity would need to evaluate legal and commercial aspects (such as incoterms and an insurance policy terms) before concluding that control of goods is transferred when bill of lading is submitted to a shipper and a copy is given to the customer.

**Principal versus agent**

As mentioned above, a promise to transfer a good or a service can be stated explicitly in a contract or implicitly, based on established business practices that create a valid expectation that the entity will transfer the good or service. These could have a significant impact, especially in sales through distributor network model, where the contracts with customers may or may not specify the point of transfer of control.

Arrangements like freight and insurance are usually managed by the seller. Therefore, in such situations, the role of the seller would have to be distinguished between being either as a principal or as an agent. In the case of the former, revenue can be recognised only once the goods have been received by the customer and there is sufficient evidence of control being transferred to the customer. In the case of the latter, the seller acts as an agent and thus, while the seller can recognise revenue on dispatch of goods, (in practice it coincides with the transfer of control) it should reduce recoveries made towards arranging for freight and insurance for its customers from the gross revenue charged to customers. These recoveries would have to be adjusted with the costs incurred for providing these facilities to the customers.

**Visibility and promotion spends**

Companies often make payments to their distributors and retailers, for example, towards placement of products in the stores (slotting fees), promotion events or co-branded advertising. The existing practice under Ind AS warrants to reduce such payouts from sales or book as an expense basis the nature of the expense.
Ind AS 115 provides greater clarity in this regard and warrants companies to evaluate whether they received a distinct good or service against such payouts. In case a separate good or service is being received and consumed, then such payouts need to be treated as costs/expense by the company. In absence of a distinct product or service being received, these payouts are reduced from the revenues of the company.

**Product warranties**

Product warranties are commonly supplied with the sale of a products (e.g. warranties given with white goods). The new standard, Ind AS 115, requires to distinguish such warranties in two types.

**Type I:** Where a customer can purchase the warranty separately to the purchase of the product. In such case, providing warranty forms a distinct service which the company is providing and thus, needs to account for a separate performance obligation. Thus, it would have to allocate the transaction price to the product and the warranty service given. Revenue in respect of the warranty is recognised over the period over which the warranty is valid.

**Type II:** Where buying a warranty separately is not given as an option to a customer. The customer only gets the standard warranty along with the product, which is typically called as an ‘assurance warranty’. In such a situation, the accounting is as per Ind AS 37, Provisions, Contingent Liabilities and Contingent Assets, where a cost accrual is made for such a liability. To that extent the treatment is similar to the current requirements.

**Determining the transaction price**

An entity should consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both items such as price concessions, incentives, performance bonuses, completion bonuses, price adjustment clauses, penalties, discounts, and refunds, rights of return, credits, or similar items may result in variable consideration. The chart (below) sets out how an entity accounts for variable consideration.

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**Diagram:**

[Diagram showing the process of determining the transaction price]

**Source:** Revenue Issues In-Depth, KPMG IFRG Limited’s publication, May 2016
Volume discounts or rebates may be variable consideration or may convey a material right. Companies in this sector may have different structures of rebates and discounts, which could lead to different effects on the transaction price. For instance, certain agreements provide for a discount or rebate that applies to all purchases made, whereby discounts or rebates are applicable on a retrospective basis once a certain volume mark has been achieved. In other instances, discounts in the purchase price may apply only after a minimum volume has been achieved and to all future purchases thereafter.

If a discount is applied with a retrospective effect, the discount is representative of a variable consideration. In such instances, the entity estimates volumes that could be purchased and the consequent discount that is expected to be given, which in turn determines the transaction price. This estimate would be updated throughout the term of the contract.

However, in the second instance mentioned above, the entity would typically evaluate the agreement to decide whether the agreement provides a material right to the customer. If it is so determined, then such a commitment becomes a separate performance obligation and a portion on the transaction price needs to be allocated to this element. If a material right does not exist, then there are no accounting implications for the transactions completed before the volumes have been achieved and all purchases that happen after the volume mark has been achieved are accounted at the discounted price as committed.

Other issue

Breakage

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

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

An entity considers the variable consideration guidance to determine whether and to what extent the constraint applies. It determines the amount of breakage to which it is entitled as the amount for which it is considered highly probable that a significant reversal will not occur in the future. The following chart explains the timing of revenue recognition related to breakage.

For example, the transaction price for a sale of a INR50 gift card is fixed at INR50, the possibility of breakage does not make the transaction price variable. However, the expected breakage affects the timing of revenue recognition.

Sales with a right of return

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 – e.g. exchanging a red sweater for a white sweater).

As per the Ind AS 115 requirement:

- Revenue should not be recognised for goods expected to be returned, and a liability should be recognised for expected refunds to customers as the cash is usually received upfront.
- An asset and corresponding adjustment to cost of sales should be recognised for the right to recover goods from customers on settling the refund liability.
- At the end of each reporting period, the refund liability and asset should be re-measured (if necessary) based on changes in expectations.

The entity should evaluate the history and make an estimate in case of goods which have been sold with a right to return towards damaged/expired goods and stock take backs and also provide for the same at the time of sale. The estimate should reflect the amount that the entity expects to repay or credit customers. The entity is required to use the variable consideration guidance given under Ind AS 115 in making its estimate.
Timing of revenue recognition

Under the standard Ind AS 18, revenue can be recognised on the sale of goods, amongst the other criteria, when the entity has transferred to the buyer significant risks and rewards of ownership.

However, under Ind AS 115, revenue is recognised at a point in time at which control of the good or service is transferred to the customer. The new standard includes certain indicators of transfer of control such as the customer has:

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

As highlighted, the new standard Ind AS 115, uses the word ‘control’ and thereby the approach for recognising revenue is explicitly a control-based transfer of goods or services sold over-time or at a point in time. Thus, under Ind AS 115, revenue would be recognised as and when the ‘control’ over goods is transferred to the customers. Entities are, therefore, required to evaluate whether the control has passed on over a period of time or at a point in time for the purpose of recognising revenue.

Contract manufacturing arrangements

Currently contract manufacturing arrangements in companies in the consumer market and retail sectors, would typically treat such arrangements as product sales and entities would recognise revenue once the manufactured goods are delivered to the customer.

However, under Ind AS 115, if the manufacturer so determines that it satisfies a performance obligation to manufacture goods over time, then it should recognise revenue over time, which could be as the manufacturing takes place over the contract period.

Thus, it could be a trigger for significant changes to arrangements between a contract manufacturer and a brand owning company. Currently, these arrangements call for manufacturing of goods to the precise specifications of the customer and could qualify for recognition of revenue over the time of manufacturing of units.
Summary

- Determination of separate performance obligations is a vital step due to different types of fees collected by education institutes e.g., tuition fees, application fees, hostel fees, etc.
- Cash awards offered to students should be accounted for as a reduction from the transactions price as they are not towards any distinct performance obligation.
- When determining stand-alone selling price, consider reductions in amounts charged for specific services.
- Evaluate commission paid to determine whether it should be capitalised as contract cost or recognised as expense.

Education sector in India is a mix of government-operated and privately operated educational institutions and allied education providers.

The new revenue standard is likely to throw up challenges from an accounting perspective in the education sector, out of which we have attempted to provide our insights on specific issues confronting the companies in this sector.

Existence of an enforceable contract

Under the new standard, a contract is an agreement between two or more parties that creates enforceable rights and obligations. Contracts can be written, oral or implied by an entity’s customary business practices.

Enforceability is a matter of law. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries, and entities. An entity is generally unable to recognise revenue if an enforceable contract does not exist. In accordance with Ind AS 115, institutions will need to consider such practices and processes (including those related to the admission and registration of students) in determining whether and when an agreement with a student creates enforceable rights and obligations between the institution and the student.

Generally, students enroll by signing a registration form which details the terms and conditions, types of coaching services available along with the fee structure for each course and the timing of instalments. The parties to the contract i.e., the institute and students, approve the contract in writing and are committed to perform their respective obligations and adhere to the terms and conditions in the document. On signing of the document, the student is obligated to pay tuition fees and therefore, ensuring regular flow of income for the institution during the entire duration of the contract. Thus, creating an enforceable contract.

Performance obligations

Fees collected by institutes may include, tuition fees, application fees, enrolment fees, hostel fees, and other tuition-related fees.
Tuition and hostel fees
Institutions will need to determine whether tuition and hostel services are distinct services promised by the institution or whether they need to be combined. In many cases, tuition and hostel are considered as distinct services and, therefore, separate performance obligations.

Enrollment fee
Depending on the terms and conditions relating to the enrolment fee, it is likely that such a fee does not relate to a separate performance obligation but is highly dependent on, or highly interrelated with, other goods or services promised in the contract (i.e., provision of tuition services over subsequent periods). In that case, the enrolment fee would represent an advance payment for future services and, therefore, would be recognised as revenue when those future goods or services are provided (that is, when the right is exercised). This may result in deferral of revenue in respect of that fee to later years.

Entrance fees
Generally, institutions conduct assessment exams to identify the students eligible for enrolling in a course. If entrance fee relates entirely to the assessment process then, a single obligation is identified in such services i.e. assessment conducted.

In certain situations entrance fees may relate to IT equipment (e.g. laptops, other IT infrastructure and servicing), excursions or other outdoor or off-site activities and class resources. These fees fall within the scope of Ind AS 115 and separately identify the relevant performance obligations.

Distance learning course
Students may enroll for distance learning wherein the learning material is sent to them by post. The institutes are obliged to only deliver the material to the student, and such courses would have a single performance obligation which shall be identified.

Sale of tablet with pre-loaded learning material
Students can purchase a tablet and view the pre-loaded content offline thereafter (the content has a pre-configured expiry up to which the student can view the content). After completion of the course, the student is free to use the tablet for his/her personal needs wherein the chip containing the content becomes non-useable. The students purchase the tablet in order to view the learning material and the institutes generally provide only a standard warranty for the entire tutor package. The performance obligations identified in such a scenario could be sale of tablet and sale of SD card (Secure Digital card) with pre-loaded learning material.

Transaction price
An entity estimates the transaction price at the inception of the contract, including any variable consideration.

Under the new guidance, the transaction price is the amount the institutes ‘expects to receive’.

Under the new standard, price concessions, discounts, etc. constitute ‘variable consideration’. Under Ind AS 18, Revenue education service providers recognised revenues for the amounts billed to students. Often, this resulted in recognition of an amount of revenue for which collectability was doubtful. In practice, this led to recognition of provision for doubtful debts or bad debt expense at a future date.

An implicit price concession does not have to be specifically communicated or offered by the education service provider. Institutes need to use judgement to determine whether they have implicitly provided price concession to their patients.
The new model is expected to lower the volume of bad debt expense which were historically reported in such situations, and also result in a corresponding reduction in revenues. The reduction in revenues are likely to occur due to ‘implicit price concession’ while ‘estimating the amount of variable consideration’.

In our experience, certain competitive institutions award high performing students with scholarships and cash rewards. Such education institutes may run various scholarship programmes wherein the students meeting the eligibility criteria are entitled for a refund of a part of the tuition fee. In other situations, fees could be refunded to students in case they wish to withdraw from the course, based on certain thresholds e.g. full refund before the start of the course, 80 per cent refund within 20 days from the commencement of the course. Such scholarships and cash rewards are likely to make the consideration variable. Accordingly, a detailed analysis of the terms and conditions and the customary practices would need to be performed to identify such variable amounts in the contract.

As per Ind AS 115, if the consideration promised in the contract includes a variable amount, then an entity is required to estimate the amount of consideration which will not be subject to reversal later considering the ‘expected value’ or ‘most likely’ method (see diagram below).

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**Expected value**

The sum of the probability-weighted amounts in a range of possible amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.

**Most likely amount**

The single most likely amount in a range of possible consideration amounts. The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes.

An institution may receive a nonrefundable deposit from a potential student to secure a spot for enrollment. Ind AS 115 states that upon receipt of a prepayment from a customer, an entity would recognise a contract liability as the amount of the prepayment for its performance obligation to transfer, or to stand ready to transfer, goods or services in the future.

**Allocating transaction price to performance obligations**

If tuition and hostel services are included in a single contract or combined contracts, institutions will need to consider the guidance in Ind AS 115 with respect to allocating the transaction price to the performance obligations in the contract.

Ind AS 115 indicates that the transaction price should be allocated to each performance obligation identified in the contract on a relative stand-alone selling price basis.

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**Consideration payable to customer:** Certain competition oriented institutes conduct examination and award cash grant to high performing students. Since these cash awards are not towards any distinct goods or services, they shall be accounted for as a reduction from the transaction price.
Regarding tuition and hostel services, institutions may sell tuition separately (for example, to day boarding students), but rarely would they sell hostel separately to a student not also enrolled in classes. As such, although the stand-alone selling price for tuition may be observable, this may not be the case for hostel.

Institutions may consider other similar hostel prices to estimate the Stand-alone Selling Price (SSP). When determining the transaction price, institutions will also need to consider whether any reductions in amounts charged for tuition and hostel (for example, financial aid awarded to the student) applies to tuition, hostel, or both.

For the sale of a tablet with preloaded learning material, the institutes would have to allocate the transaction price between the sale of the tablet and the chipset with loaded study material in proportion their SSP.

Recognising revenue

An entity would recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service to a customer. For each performance obligation identified, an entity needs to determine whether it satisfies the performance obligation over time or at a point in time. Ind AS 115 provides the criteria, one of which would need to be met, in order for revenue to be recognised over time. For example, if a customer simultaneously receives and consumes the benefits provided by the entity’s performance as the entity performs, the entity transfers control of the good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time.

Entrance fees

Revenue should be recognised once the exams are conducted.

Sale of tablet with preloaded learning material

Revenue from sale of tablet shall be recognised at the delivery to the student and for the learning material, revenue recognition shall be over the duration of the course as the students will continue to receive the benefits over the duration of the course.

Distance learning course

Revenue shall be recognised when performance obligation is fulfilled, i.e. when learning material is provided to the student.

Contract costs

Certain institutes may enter into arrangements with various schools for getting student referred to them as part of their marketing strategy. Such schools charge a pre-determined commission for every student referred. The contract cost paid i.e. sales commission paid to schools for every successful referral should be recognised as an asset since the service providers expect to recover that cost from students in form of coaching fees.

Accordingly, institutes shall recognise the commission paid to the schools as contract costs and amortise them over the period of the contract i.e. period from course start/receipt to end of course.

Tuition and hostel revenue

Generally, students simultaneously receive and consume all of the benefits provided by an institution’s performance because the institution provides instruction or hostel to the students throughout the academic period. It would be appropriate for institutions to recognise tuition and hostel revenues over time in these circumstances.
High level impact of Ind AS 115 on the Financial Services (FS) sector

Ind AS 115 has a pervasive impact on all industries. Entities in financial services sector like banks, non-banking financial services, investment management companies, fund houses, insurance companies, etc. need to assess the impact of Ind AS 115 on their financial statements. However, it is pertinent to initially assess if the contract is in the scope of Ind AS 115 or is governed by any other standard (e.g. Ind AS 109, Financial Instruments).

A contract with a customer may be partially in the scope of Ind AS 115 and partially in the scope of other accounting guidance. If the other accounting guidance specifies how to separate and/or initially measure one or more parts of a contract, then an entity first applies those requirements. Otherwise, the entity applies the new standard to separate and/or initially measure the separately identified parts of the contract.

For banks, many contracts with customers are financial instruments or are packaged together with a financial instrument. Examples of the latter include providing a free safety deposit service to bank’s customers that have deposits or credit cards with the bank, and investment management services provided to holders of investment products. In these cases, the new standard requires that a bank first applies the financial instruments guidance provided to holders of investment products. In these cases, the new standard requires that a bank first applies the financial instruments guidance, because it includes specific initial measurement guidance and applies Ind AS 115 to any residual amount.

The implementation issues likely to be faced by companies in the financial services sector have been discussed below:

A. Identification of performance obligations

A ‘performance obligation’ is the unit of account for revenue recognition. An entity assesses the goods or services promised in a contract with a customer and identifies as a performance obligation either:

- A good or service (or a bundle of goods or services) that is distinct or
- A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

Source: Banking IFRS 15 Revenue – Are you good to go? slide share, KPMG IFRG Limited’s publication, July 2017
Do any services promised in the contract meet the new ‘distinct’ test to be accounted for separately?

A good or service is distinct if it is...

- Capable of being distinct
- Distinct in the context of the contract

Investment management contracts between the investment manager and the customer may integrate different services into a single package – e.g. administrative services, asset management and custody services. Ind AS 115 includes new guidance for such arrangements, including:

- New separation criteria that may affect which service are bundled or unbundled; and
- New guidance on determining and allocating the transaction price for each performance obligation.

At contract inception, an entity assesses the goods or services explicitly or implicitly promised in a contract. Each promise to transfer a good or service shall be identified as a performance obligation if the goods or services are distinct. A good or service that is promised in a contract is ‘distinct’ if both of the following criteria are met.

**Criterion 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.

**Criterion 2:** The entity’s promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

Multiple services within an investment management contract like administrative services, asset management and custody services shall be identified as distinct performance obligations only if the investor can derive benefit from each of the services and the contract specifically identifies them as separate services. Additionally, revenue recognition for each performance obligation would be at a point in time or over the period depending upon the terms of the contract.

**B. Determination of transaction price**

When estimating the transaction price for a contract with variable consideration, an entity’s initial measurement objective is to determine if the ‘expected value’ or ‘most likely amount’ method best predicts the consideration to which the entity will be entitled.

After estimating the variable consideration, an entity may include some or all of it in the transaction price – but only to the extent that it is probable that a significant reversal in the amount of cumulative revenue will not occur when the uncertainty associated with the variable consideration is subsequently resolved. To assess whether – and to what extent – it should apply this ‘constraint’, an entity considers following factors:

- Likelihood of a revenue reversal arising from an uncertain future event; and
- Potential magnitude of the revenue reversal when the uncertainty related to the variable consideration has been resolved.
Investment manager M determines that the contract includes a single performance obligation (series of distinct services) that is satisfied over time, and identifies that both the management fee and the performance fee are variable consideration. Before including the estimates of consideration in the transaction price, investment manager M considers whether the constraint should be applied to either the management fee or the performance fee.

At contract inception, investment manager M determines that the cumulative amount of consideration is constrained because the promised consideration for both the management fee and the performance fee is highly susceptible to factors outside its own influence. At each subsequent reporting date, investment manager M makes the following assessment of whether any portion of the consideration continues to be constrained.

### Example

Investment manager M enters into a two-year contract to provide investment management services to its customer Fund N, a non-registered investment partnership. Fund N’s investment objective is to invest in equity instruments issued by large listed companies. Investment Manager M receives the following fees payable in cash for providing the investment management services.

#### Quarterly management fee

2 per cent per quarter, calculated on the basis of the fair value of the net assets at the end of the most recent quarter

#### Performance-based incentive fee

20 per cent of the fund’s return in excess of an observable market index over the contract period

Investment manager M determines that the contract includes a single performance obligation (series of distinct services) that is satisfied over time, and identifies that both the management fee and the performance fee are variable consideration. Before including the estimates of consideration in the transaction price, investment manager M considers whether the constraint should be applied to either the management fee or the performance fee.

At contract inception, investment manager M determines that the cumulative amount of consideration is constrained because the promised consideration for both the management fee and the performance fee is highly susceptible to factors outside its own influence. At each subsequent reporting date, investment manager M makes the following assessment of whether any portion of the consideration continues to be constrained.

### Performance-based incentive fee

Investment manager M determines that the full amount of the performance fee is constrained, and therefore, excluded from the transaction price. This is because of the following reasons:

- The performance fee has a high variability of possible consideration amounts, and the magnitude of any downward adjustment could be significant
- Although investment manager M has experience with similar contracts, that experience is not predictive of the outcome of the current contract because the amount of consideration is highly susceptible to volatility in the market based on the nature of the assets under management; and
- There are a large number of possible outcomes.

As a result, investment manager M determines that the revenue recognised during the reporting period is limited to the quarterly management fees for completed quarters. This determination is made at each reporting date and could change towards the end of the contract period.

### C. Allocating transaction price to performance obligations

The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation at an amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer. An entity generally allocates the transaction price to each performance obligation on a relative stand-alone selling price basis.

### Example

Bank R has a credit card rewards programme that rewards a customer with one customer loyalty point for every INR100 of purchases. Each point is redeemable for a INR0.1 on any future purchases of the products listed on bank R’s reward redemption website. During a reporting period, customer C earns 100 points that are redeemable on future purchases. The fees received from merchant by the bank is (say) INR1,200. Bank R expects 95 points to be redeemed. Bank R estimates a stand-alone selling price of INR0.1 per point totaling INR9.5 (i.e. 0.1 x 100 points x 95/100) on the basis of the likelihood of redemption.
The reward points provide a material right to customer C which it would not receive without entering into the contract for credit card. Therefore, Bank R concludes that the promise to provide the reward points is a performance obligation.

The sum of the stand-alone prices of INR1,209.5 (INR1,200 in commission income, and INR9.5 in loyalty points) exceeds the promised consideration of INR1,200. Bank R needs to determine whether to allocate the discount to all or only some of the performance obligations.

Bank R determines that the discount relates entirely to the service and reward points. Bank R allocates the transaction price to the services and reward points as follows.

<table>
<thead>
<tr>
<th>Performance obligation</th>
<th>Stand-alone selling price (INR)</th>
<th>Price allocation (INR)</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Services</td>
<td>1,200</td>
<td>1191</td>
<td>1,200 x (1,200 ÷ 1,209.5)</td>
</tr>
<tr>
<td>Reward points</td>
<td>9.5</td>
<td>9</td>
<td>9.5 x (9.5 ÷ 1,209.5)</td>
</tr>
<tr>
<td>Total</td>
<td>1,209.5</td>
<td>1,200</td>
<td></td>
</tr>
</tbody>
</table>

Taking this example further, an entity recognises a prepayment received from a customer as a contract liability, and recognises revenue when the promised goods or services are transferred in the future. However, a portion of the contract liability recognised may relate to contractual rights that the entity does not expect to be exercised — i.e. a breakage amount.

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 probable that recognising breakage will not result in a significant reversal of the cumulative revenue recognised.

In case of banks providing reward points on credit cards, it is also important to note whether the contract involves multiple parties.

If another party is involved in the customer reward programme, then an entity needs to assess whether it acts as an agent or as a principal with respect to:

a. The reward points and, if relevant,

b. The goods or services to be delivered in exchange for the points.

Reward programmes may be structured in different ways which impact this assessment some of which have been explained below:

**Points are issued by the entity and can be redeemed only for goods or services provided by the entity:** In such arrangements, an entity is usually a principal with respect to the loyalty points and the goods or services to be delivered in exchange for the points because it does not satisfy its performance obligation until the goods or services are transferred to the customer.

**Points are issued by the entity and can be redeemed for goods or services provided by the entity or by a third party at the customer’s discretion:** In such arrangements, an entity is usually a principal with respect to the loyalty points because it is obliged to ‘stand ready’ until the customer has made its choice. The entity satisfies its performance obligation and recognises revenue only when the customer redeems the points, either from the entity or from the third party. An entity assesses whether it acts as an agent or as a principal with respect to the goods or services to be delivered in exchange for the points.
D. Costs of obtaining a contract

Who is the customer in your contracts?

For a fund manager, is it….

- The fund
- The fund’s investors

Does your accounting policy for commission costs meet the requirements of Ind AS 115?

- If the fund is the customer…..

…..then commission paid for introducing new investors may not meet the criteria for capitalisation

An entity capitalises incremental costs incurred as a result of obtaining a contract - e.g. sales commissions - if the entity expects to recover these costs.

Costs that are 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 fulfilment costs. As a practical expedient, an entity is not required to capitalise the incremental costs to obtain a contract if the amortisation period of the resulting asset would not exceed one year.

Fund managers generally pay a commission/fee to sourcing agents for enrolling investors with the fund. There is a need to assess whether such brokerage/commission costs paid are eligible to capitalise as contract costs. If it is evaluated that the fund is the customer for the fund manager, the fund manager will not be eligible to capitalise and amortise such costs over the period.

Source: Investment management, IFRS 15 Revenue – Are you good to go? slide share, KPMG IFRG Limited’s publication, July 2017
Summary

- While assessing existence of an enforceable contract, specific facts and circumstances need to be evaluated to determine whether and when an agreement with a patient creates legally enforceable rights and obligations.
- For principal versus agent evaluation all the indicators are considered in making the assessment.

Variability in transaction price may be explicit or implicit, arising from customary business practices e.g. price concessions.

A healthcare provider likely transfers control of in-patient healthcare services over time.

Healthcare sector is facing major challenges due to technological change with vast disruptive potential, a constrained funding environment, changing population needs and consumer sentiment. All of these create drivers and opportunities for transformation in the industry and adjacent markets. Additionally, plethora of changes in the regulatory and reporting environment, including those related to Ind AS are creating new complexities for those operating in the healthcare sector.

Revenue recognition is one of the crucial accounting concept for this sector due to presence of complex transactions. Therefore, the new revenue standard is likely to throw up challenges from an accounting perspective in the healthcare sector, out of which we have attempted to provide our insights on specific issues confronting the companies in this sector.

Existence of an enforceable contract

Under the new standard, a contract is an agreement between two or more parties that creates enforceable rights and obligations. Contracts can be written, oral or implied by an entity’s customary business practices. Enforceability is a matter of law.

- Collection of consideration is considered probable
- Rights to goods or services and payment terms can be identified
- It is approved and the parties are committed to their obligations
- It has commercial substance.

Healthcare services generally involve multiple parties. In addition to the patient and the healthcare service provider, there is often a third-party. The third-party could be a government administered scheme or an insurer and they are involved in paying for some or all of the services on the patient's behalf to the healthcare service provider.

In such situations, there is a question as to whether the patient or the third-party payer is the ‘customer’. For the purposes of the new standard, the ‘contract with the customer’ refers to the arrangement between the healthcare service provider and the patient.
However, the healthcare service provider should also evaluate its contractual arrangement with the third-party payer. The terms of that arrangement may impact certain aspects of the contracts with patients covered by that health plan (this is explained further in the ‘transaction price’ section below).

A healthcare service provider should also consider specific facts and circumstances in determining whether and when an agreement with a patient creates legally enforceable rights and obligations. The agreement with a patient can be written, oral or implied by an entity’s customary business practices. An entity is generally unable to recognise revenue if an enforceable contract does not exist.

This issue is relevant when services are provided before obtaining information from the patient e.g. emergency services provided to an unconscious patient.

Transaction price

An entity estimates the transaction price at the inception of the contract, including any variable consideration.

Under the new standard, price concessions, discounts, etc. constitute ‘variable consideration’. The transaction price includes amounts that are not paid by the customer e.g. a healthcare service provider may include amounts to be received from the patient and third-party payer in determining the transaction price.

Under Ind AS 18, *Revenue* healthcare service providers recognised revenues for the amounts billed to patients. Often, this resulted in recognition of an amount of revenue for which collectability was doubtful. In practice, this led to recognition of provision for doubtful debts or bad debt expense at a future date.

The new model is expected to lower the volume of bad debt expense which were historically reported in such situations, and also result in a corresponding reduction in revenues. The reduction in revenues are likely to occur due to ‘implicit price concession’ while ‘estimating the amount of variable consideration’.

Implicit price concessions: An implicit price concession does not have to be specifically communicated or offered by the healthcare service provider to the patient. Healthcare service providers need to use judgement to determine whether they have implicitly provided price concession to their patients.

As per the new standard, implicit price concession is present if:

- The customer has a valid expectation arising from an entity’s customary business practices, published policies or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract; or
- Other facts and circumstances indicate that the entity’s intention, when entering into the contract with the customer, was to offer a price concession to the customer.

The new guidance uses a different model than the practice followed in the past that the transaction price is the amount billed to the patient. Under the new guidance, the transaction price is the amount the healthcare service provider ‘expects to receive’.

Where services are provided to uninsured patients, the transaction price for revenue recognition purposes is likely to be less than the amount billed. In certain cases, hospitals providing services to uninsured patients do so knowing that on an average, they will not collect a certain percentage of the amount billed.

As a result of the uncertainty, amounts earned from providing services to uninsured patients often represent a ‘variable consideration due to implicit price concessions’.

An implicit price concession may be estimated based on historical collection experience from similar patients. If on a subsequent reassessment of the estimated implicit price concession, a healthcare service provider expects to collect more than originally estimated, it recognises the additional amount as patient service revenue in the period the change is identified. If it expects to collect less than originally estimated, it recognises the shortfall as a reduction of patient service revenue. An exception would be if there is a specific event known to the healthcare service provider that suggests that the patient no longer has the ability and intent to pay the due amount e.g. patient is bankrupt. In that circumstance, the healthcare service provider recognises the change in the estimate as a bad debt expense and not as a reduction of patient service revenue.
Estimating the amount of variable consideration:

In our experience, the healthcare service providers in India have a huge amount of bad debts on the amounts billed under the government administered schemes e.g. Central Government Health Scheme (CGHS), Employees’ State Insurance Corporation (ESIC), etc. Under these schemes, payments for services provided to the patients are determined as per the arrangement entered into by CGHS/ESIC with the healthcare service provider (generally, the prices for services rendered under the aforementioned schemes are lower than that charged to other patients). Often, they may subject the healthcare service provider to retrospective adjustments on the revenue; thus, the amount ultimately earned may not be known with certainty for several months.

As a result of the uncertainty, a portion of the amounts earned from providing services to government administered scheme beneficiaries often represent ‘variable consideration’ under the new standard.

Currently, management makes its best estimate of the third-party settlement adjustment based on its knowledge and experience about past and current events. The new standard specifically provides guidance in relation to estimation of the consideration using either of the following methods:

**Expected value**

The sum of the probability-weighted amounts in a range of possible amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.

**Most likely amount**

The single most likely amount in a range of possible consideration amounts. The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes.

**Principal versus agent**

Ind AS 115 has introduced specific guidance on principal versus agent considerations, which represents a change in approach from Ind AS 18. While Ind AS 18 was based on the risks and reward approach, Ind AS 115 is based on the transfer of control approach. Further, credit risk is no longer an indicator that an entity is a principal.
Careful evaluation may be needed of certain contracts such as arrangements with consultant doctors and operation and maintenance arrangements of healthcare service providers with other persons.

For instance, the primary responsibility to provide necessary treatment to the patient in most of the cases is of the hospital and not the consultant doctors. If a particular consultant doctor who was treating the patient would not be available henceforth, then it is the responsibility of the hospital to ensure that another consultant doctor is identified to provide necessary treatment to the patient. In cases of professional negligence also, the hospital has to make good the losses to patients and not the consultant doctors. Further, if the pricing for services provided by the hospital, are also decided by the hospital then the hospital is acting as a principal.

Healthcare service providers should also evaluate the various operation and maintenance arrangements they have entered into with other persons. If the primary obligation to provide the services is of the hospital and the pricing for services are also decided by them, then hospital will become the principal.

### Example

A hospital treats a patient registered under a state government scheme (scheme). For the treatment given to patient, the price for the services is pre-agreed at INR180,000. This is price as per the arrangement between the scheme and the hospital. The pre-agreed price has cap on various services/goods that can be rendered/consumed for treating the patient. One such cap is on the number of visits of a consultant doctor (the cap is of one visit). However, due to complexity of the case the consultant doctor had to make two visits. The hospital bills of the patient amounted to INR190,000; increase of INR10,000 (INR190,000 less INR180,000) from the agreed price. This is on account of incremental visit of the consultant doctor. From the past experience, hospital expects to collect INR10,000 from the scheme in 60 per cent of the cases. Therefore, INR186,000 (INR180,000 plus INR6,000 (INR10,000 * 60 per cent)) is the transaction price.

### Timing of revenue recognition

Under Ind AS 115, an entity recognises revenue when or as it satisfies a performance obligation by transferring a good or service to a customer, either at a point in time (when) or over time. Certain criteria need to be met for a performance obligation to be satisfied over time.

A healthcare provider likely transfers control of in-patient healthcare services over time (i.e. over the in-patient stay) because the patient simultaneously receives and consumes the benefits provided by the healthcare provider’s performance as the provider performs (i.e. provides care).

Revenue for performance obligations satisfied over time is recognised based on a measure of progress that provides a faithful depiction of the transfer of services over the term of the performance obligation. A healthcare provider may consider an input method like actual charges incurred in relation to total expected (or actual) charges as a measure of progress to recognise revenue for in-patient healthcare services.
Summary

- Determination of separate performance obligations in an arrangement with multiple promises is a key step.
- While applying the distinct test, evaluate whether a licence is distinct from the other goods and services in a contract.
- Evaluate the criteria for assessing licence of an Intellectual Property (IP) as a predominant item in a contract to determine eligibility of royalty exception and ensure consistent application.
- When multiple goods and services are considered as a single performance obligation, determining whether the over-time criteria are met would involve judgement.

Life sciences sector commonly enters into complex transactions with other parties where revenue recognition is considered as one of the key accounting issue. The new standard on revenue recognition replaces all existing accounting guidance related to revenue recognition. The key concern for this sector is to determine how the new standard would apply to agreements with multiple arrangements, licenses of an intellectual property and arrangements involving variable consideration. Therefore, application of Ind AS 115 requires life sciences entities to use significant judgement as the new standard changes the way in which life sciences entities have been accounting for their sales transactions.

In this chapter, we cast our lens on the key implementation issues of Ind AS 115 to be considered by entities in the life sciences sector.

Performance obligations

Entities in the life sciences sector generally enter into arrangements which comprise multiple promises such as licences, Research and Development (R&D) services, manufacturing and distribution arrangements, etc. The new standard introduces detailed guidance on identifying separate components, which applies to all types of revenue generation transactions. This could result in goods or services being unbundled more frequently than under the current guidance.

Additionally, arrangements may also include terms related to goods and services that the customer has not yet committed to, such as option to renew or extend agreements and optional purchases of products. Therefore, determining which of the options in the contract give rise to a material right to customers to be considered as a separate performance obligation under the new standard would be crucial.

An entity would need to evaluate at the contract inception, the promised goods or services to determine which goods or services (or bundle of goods or services) are distinct and therefore, constitute a performance obligation.
A good or service that is promised to a customer, is distinct if both the following criteria are met:

**Criterion 1: Capable of being distinct**
Can the customer benefit from the good or service either on its own or together with other readily available resources?

- **Yes**: Distinct performance obligation
- **No**: Not distinct – combine with other goods and services.

**Criterion 2: Distinct within the context of contract**
Is the entity’s promise to transfer the good or service separately identifiable from other promises in the contract?

If the above mentioned criteria are not met, then the good or service would be combined with other promised goods or services in the contract until the entity identifies a bundle of goods or services that is distinct.

**Example**
An entity A entered into an arrangement with a customer under which the customer gets a licence for exclusive rights of a compound Z. Entity A undertakes to perform the R&D service to get the compound Z approved for commercial sale which primarily relate to testing and validating its efficacy. The R&D services required to develop compound Z further could be performed by another life sciences company. Entity A would need to consider whether the licence and the R&D services are distinct.

Accordingly, in this case, entity A determines that following factors are present:

- a. R&D services required to commercialise compound Z are not unique or specialised i.e. other entities could also perform them
- b. R&D services do not have a transformative effect on the licence and

**Licences of an Intellectual Property (IP)**
Unlike current accounting standards, Ind AS 115 provides specific guidance with respect to the licences of an IP. A contract to transfer a licence to a customer may include promises to deliver other goods or services in addition to the promised licence. These promises may be specified in the contract or implied by an entity’s customary business practices. An entity would need to apply step 2 of the revenue model to identify each of the performance obligations in a contract that includes a promise to grant a licence in addition to other promised goods or services.

A licence of IP that is distinct from other goods and services in the contract is a separate performance obligation. To determine whether the performance obligation is satisfied at a point in time or over-time, it requires an entity to consider the nature of the promise and ascertain whether the promise provides the customer with the right to:

- a. Access the entity’s IP throughout the licence period.
- b. Use the entity’s IP as it exists at the point in time at which the licence is granted.
For life sciences entities, determining whether the licence is distinct from the other goods and services in the contract is expected to be a more challenging step. If the licence is not distinct, then the entity should apply the general guidance of Ind AS 115 to determine the timing of revenue recognition. However, it may use the licence criteria (as given above) to evaluate the combined performance obligation.

Example
Licences of biological compounds and drug formulae are examples of right to use licences (i.e. point in time recognition) under Ind AS 115. In respect to such licences, it is generally being considered that the entity is not likely to undertake future activities that will significantly affect the underlying IP i.e. the underlying IP is complete. Assessment of future activities includes only those activities that do not transfer a separate good or service to the customer. For example, R&D services provided to a customer as a separate performance obligation under the contract does not consider these activities in making an assessment for the underlying IP. An example of a licence that is not considered as distinct would be a drug compound that requires proprietary R&D services from the entity.
Estimation of constraint in a variable consideration

In the life sciences sector, development of new products and obtaining approvals required for commercialisation involves significant risks and accordingly, a large portion of the consideration could be variable in many arrangements. For instance, arrangements may include payments contingent on development milestones being met, approvals being received or future production or sales levels. Similarly, distribution and manufacturing arrangements for approved drugs may include other forms of variable consideration such as volume rebates and rights of return.

As per Ind AS 115, these variable considerations would be included in the transaction price only to the extent that it is highly probable that significant revenue reversal will not subsequently occur (the constraint). Application of constraint is expected to be an area of key judgement for many life sciences entities when their contracts include large amounts of consideration that are dependent on highly uncertain future events. An entity may need to constraint the estimate of variable consideration to zero at the start of the contract for inherent uncertainty of events such as regulatory approval for a drug.

Therefore, such entities should consider all the facts and circumstances which could increase the likelihood or magnitude of a revenue reversal. This includes the risk of both under and over-statement of revenue based on all information available to management for each reporting period.

Sales and usage - based royalties

Ind AS 115 provides an exception from the general requirements of estimation of variable consideration in case of sale or usage-based royalties that are attributable to a licence of an IP (royalty exception).

Accordingly, these are to be recognised at the later of the following:

- When the subsequent sale or usage occurs and
- Satisfaction or partial satisfaction of the performance obligation to which some or all of the sales or usage- based royalty has been allocated.

In the life sciences sector, biotechnology and pharmaceutical licences are often sold with R&D services and/or a promise to manufacture the drug for the customer with all the consideration in the form of a sales-based royalty. In such cases, the royalty exception would be applied if an entity considers the licence to be the predominant item in the arrangement i.e. it ascribes significantly more value to the licence than to other goods or services to which the royalty relates.

However, assessment of predominant would be critical in the absence of any clear definition as different entities may ascribe different criteria for its assessment. For one entity, the licence which represents the major part of the value could be predominant, while for another, licence of IP comprising the largest item in a bundle of goods or services could be predominant and would be eligible for royalty exception.

Revenue recognition - point in time or over-time

Ind AS 115 provides a control-based approach to be applied to all transactions i.e. at the contract inception, an entity need to evaluate whether it transfers control of the good or service over-time or at a point in time.

Revenue is recognised over-time when any of the following criteria are met:

<table>
<thead>
<tr>
<th>Sr. no.</th>
<th>Criteria</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs</td>
<td>Routine or recurring services – e.g. R&amp;D services</td>
</tr>
<tr>
<td>2.</td>
<td>Entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced</td>
<td>Modifying a customer’s drug compound</td>
</tr>
<tr>
<td>3.</td>
<td>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</td>
<td>Developing a compound to a customer’s specifications</td>
</tr>
</tbody>
</table>

Source: Pharmaceuticals slide share “IFRS 15 Revenue – Are you good to go?”, published by KPMG IFRG Limited, 2017
If none of the above criteria are met, then control of the good or service transfers at a point in time.

In case of life sciences entities, the challenge lies in determining whether the over-time criteria is met when multiple goods and services are considered as a single performance obligation, for example, a licence and R&D service or a licence and manufacturing service in an arrangement. Therefore, determining the appropriate measure of progress of these types of arrangements could be another challenge. An entity would need to select an output or input method for measuring the progress of each performance obligation (satisfied over-time) that is consistent with the nature of the performance obligation or apply a method consistently to similar performance obligations in similar circumstances.

Similarly, life sciences entities which undertake contract manufacturing and have been using the units delivered or produced method to recognise revenue would need to reconsider the applicability of such methods as these methods have been specifically excluded under Ind AS 115 when there are material amounts of work in progress that are controlled by the customer.

Additionally, an entity needs to reconsider the conclusions reached for special arrangements such as repurchase agreements (forward, call and put options), consignment arrangements, bill-and-hold arrangements and customer acceptance in light of the change in the principle of revenue recognition from risks and rewards based approach (under current Ind AS i.e. Ind AS 18) to transfer of control under Ind AS 115.

**Allocating the transaction price**

Current Ind AS does not provide specific guidance on allocation of consideration to components of a transaction. Certain interpretations include guidance on allocation for service concession arrangements, and customer loyalty programmes and agreements for sale of real estate.

However, Ind AS 115 requires an entity to allocate the transaction price at the contract inception to each performance obligation on the basis of relative stand-alone selling prices. The best evidence of such a price is the observable price from stand-alone sales of the goods or services to similarly-situated customers. If observable price is not available, then price needs to be estimated by using any of the methods (as explained in the diagram in next column).

**Significant financing component**

Ind AS 18 requires an entity to discount consideration to present value if payment is being deferred and the arrangement effectively constitutes a finance transaction. For instance, an entity sells a product and allows the customer to pay the agreed price after two years when it takes ownership of the product. However, it does not provide any guidance with respect to adjustments to consideration in case payment is received in advance.

Ind AS 115 applies to both deferred and advance payments as well as both point in time and over-time contracts. Therefore, significant financing components are expected to be identified more frequently under it with more complex calculations in case of contract with over-time performance obligations.
The main considerations in determining significant financing component are the period between performance and payment for that performance and the discount rate that applies. However, a contract may not include significant financing component if a substantial portion of the consideration is variable and based on occurrence or non-occurrence of events outside the entity's control. For instance, a contract with consideration that comprises a fixed payment payable only on obtaining regulatory approval and a sales-based royalty would not include a significant financing component. However, a contract which involves a significant up-front payment would require further analysis, including consideration of when the performance obligations in the contract are satisfied.

Source: Pharmaceuticals slide share ‘IFRS 15 Revenue – Are you good to go?’, published by KPMG IFRG Limited, 2017
Summary

- Ind AS 115 introduces comprehensive guidance on identifying separate components which apply to all types of revenue generating transactions. Many contracts entered into by media companies include more than one promise to the customer.
- If the licence is distinct from other goods or services, then an entity would need to assess its nature whether to recognise revenue allocated to the licence at a point in time or over time.
- Variability in transaction price may be explicit or implicit, arising from customary business practices, published policies or specific statements or any other facts and circumstances that would create a valid expectation by the customer.
- The requirement to measure non-cash consideration at fair value is broadly similar to the current Ind AS requirements.

The media and entertainment sector is fairly diverse and includes radio and television broadcasters, print and online media, advertising agencies and content production companies. In this article, we look at the key implementation issues of Ind AS 115 to be considered by entities in this sector.

Performance obligations

The diversity of services offered by entities in this sector means that a single contract may often contain multiple promises or components. The new standard introduces detailed guidance on identifying separate components, which applies to all types of revenue generation transactions.

The standard provides following criteria to evaluate whether the contract contains a single performance obligation or multiple performance obligations:

- **Criterion 1:** Capable of being distinct. Customer can benefit from the good or service on its own or together with other readily available resources.
- **Criterion 2:** Distinct within the context of contract. Promise to transfer good or service is separately identifiable from other promises in the contract.

**Source:** Revenue Issues In-Depth, KPMG IFRG Limited’s publication, May 2016
A radio or television broadcaster may negotiate a single contract with a customer wherein the services offered could include a sponsorship deal for primetime programming, paid advertisement time slots, options to get additional slots for discounted pricing, bonus, or free advertising slots, content creation for television or radio, event hosting and so on. Such a contract contains multiple performance obligations as the elements are capable of being distinct, i.e. have separate value to the customer and would be distinct within the context of the contract (each promise is distinct within the overall proposition of the contract). Careful evaluation may also be required for options to get additional advertising slots at a discounted price in the future, which otherwise may not have been available to the customer, if the initial contract was not entered into, as these may constitute a ‘material right’ to the customer and therefore, require separation as a distinct performance obligation.

Similar examples can also be noted in the print media, where a magazine subscription includes access to both print and online editions for a single offer price. The fact that the customer is essentially buying the same magazine, albeit they have access to both print and online editions does not mean that there is a single performance obligation. Both editions are capable of being distinct as the customer benefits from each of the editions. The use of different platforms for the content would mean that the promise to deliver content is capable of being distinct in the context of the contract i.e. a customer is getting access separately to print and online editions.

On the other hand, if the contract was only for access to the online edition, the licence to access the content and the content itself cannot be considered as separable performance obligations as the licence to access on its own has no separate value to the customer and is, therefore, not capable of being distinct.

Revenue from licences to be recognised at a point in time or over time

The new standard brings in significant guidance on accounting for revenue attributable to licences that are distinct from other promises in a contract. To determine whether a licence is distinct, an entity applies guidance given in Step 2 of the revenue model - identifying separate performance obligations. Licences are identified as either ‘right of use’ or ‘right of access’. This distinction determines whether revenue attributable to the licence is recognised ‘at a point in time’ in case of a right of use licence or over time in case of a right of access licence.

Ind AS 115 lays out the following criteria to make the distinction:

Are all the following criteria met?

- **Criterion 1:** Entity expects to undertake activities that significantly affect the Intellectual Property (IP)
- **Criterion 2:** Rights directly expose the customer to positive or negative effects of the entity’s activities
- **Criterion 3:** Activities do not result in the transfer of a good or service to the customer

**Right to use the entity’s IP**

<table>
<thead>
<tr>
<th>Criterion 1</th>
<th>Criterion 2</th>
<th>Criterion 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entity expects to undertake activities that significantly affect the Intellectual Property (IP)</td>
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<td>Activities do not result in the transfer of a good or service to the customer</td>
</tr>
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**Right to access the entity’s IP**

Source: Revenue Issues In-Depth, KPMG IFRG Limited's publication, May 2016
A common ‘right of use’ licence is a film right, which a media company may grant to a broadcaster, which allows the broadcaster to show the film on their TV channel. The film and the underlying IP are complete and there are no activities that the media company licensing the right needs to undertake which may affect the IP. Therefore, revenue may be recognised at the point of time when the film right is transferred by the media company to the broadcaster and can be exploited for use by the broadcaster. It is pertinent to note that limiting factors such as restrictions of time, geography, or use of the licence do not determine the nature of the media company’s promise in granting the licence. These are merely attributes of the licence and do not preclude revenue recognition to take place at the point in time where the licence is exploitable by the licensee. Examples of limitations or restrictions on use could include right to exploit the licence in a single territory or geography, number of times that the film can be shown on the TV channel, etc.

Revenue from licences of brands or logos, however, require the entity licensing them to keep undertaking activities which could significantly affect the value of the brand or logo to the licensee. Similarly, the licensee is exposed to the positive or negative effect of the entity’s activities and there is no good or service which can be said to have been transferred to the licensee.

### Example

**Assessing nature of team name and logo licence – Active sports team**

Sports Team D enters into a three-year agreement with Apparel Maker M to allow them to use the team name and logo on its products, including display products, and in advertising and marketing materials.

The nature of Sports Team D’s promise in this contract is to provide Apparel Maker M with the right to access the sports team’s IP and, accordingly, revenue from the licence will be recognised over time. In reaching this conclusion, Sports Team D considers all of the following facts.

- Apparel Maker M reasonably expects Sports Team D to continue to undertake activities that support and maintain the value of the team name and logo by continuing to play games and field a competitive team throughout the licence period. These activities significantly affect the IP’s ability to provide benefit to Apparel Maker M because the value of the team name and logo is substantially derived from, or dependent upon those ongoing activities
- The activities directly expose Apparel Maker M to positive or negative effects (i.e., whether Sports Team D play games and fields a competitive team will have a direct effect on how successful Apparel Maker M is in selling clothing featuring the team’s name and logo).
- Sports Team D’s ongoing activities do not result in the transfer of a good or a service to Apparel Maker M as they occur (i.e., the team playing games does not transfer a good or service to Apparel Maker M).

**Source:** Revenue Issues In-Depth, KPMG IFRG Limited’s publication, May 2016
Thus, the new standard aims to harmonise practices of recognising revenue attributable to distinct licences by specifying criteria to recognise revenue at a point in time or over time.

**Sales or usage based royalty**

Contracts in this sector dealing with transfer of licences often have a sales or usage based royalty attached to the use of the licence. There is specific guidance in the new standard which requires that any sales and usage based royalty attributable to a licence of IP is to be recognised at the later of when the subsequent sale or usage occurs and the satisfaction or partial satisfaction of the performance obligation to which some or all of the sales or usage-based royalty have been allocated.

This is an exception to the general requirements and it applies when the royalty relates only to a licence of IP; or the licence is the predominant item to which the royalty relates e.g. when the customer would ascribe significantly more value to the licence than to the other goods or services to which the royalty relates.

Generally, in case of transfer of film rights by production houses to distributors there is a fixed guaranteed minimum payment by the distributor to the production house and a variable portion, consisting of royalty based on ticket sales at the box office. As per the above guidance, while the fixed component is recognised upfront at the time of transfer, the royalty on the licence can be recognised only as the ticket sales happen.

As mentioned above, this guidance relates only to licences of IP, and is an exception to the variable consideration guidance given in Ind AS 115, which requires an estimate of the variable consideration to be made while determining the transaction price, wherein a higher revenue may be recognised upfront, subject to the constraints to variable consideration.

**Estimation of constraint in a variable consideration**

Price concessions, incentives, performance bonuses, discounts, refunds constitute ‘variable consideration’ under the new standard. Due to innovation that media and entertainment companies undertake, there are associated risks of uncertainty in achieving the desired results like optimal viewership levels in case of programming, successful or positive perception ad campaigns, high quality online or published content, etc. Such arrangements may include variable consideration such as payment of bonus to a media agency on completion of a campaign within a certain time, or to a content producer by a broadcaster on reaching specified viewership levels or levying penalties in case of not achieving the desired outcomes. Other examples include offering discounts or price concessions on bulk buying of media space or advertising time.

As per Ind AS 115, these variable considerations would be included in the transaction price only to the extent that it is highly probable that significant revenue reversal will not subsequently occur (the constraint). Application of constraint is expected to be an area of key judgement for entities in the sector when their contracts include significant amounts of consideration that are dependent on highly uncertain future events. In some cases, the entity may be able to predict expected rebate levels with sufficient accuracy that its estimate of variable consideration is not constrained at all. However, if the variable consideration is way into the future, e.g., a success payment related to a new TV show, it may be appropriate to constrain the estimate of variable consideration to zero at the start of the contract.

**Significant financing component**

Under Ind AS, an entity discounts consideration to a present value if payment is deferred and the arrangement effectively constitutes a finance transaction. However, Ind AS was silent on whether an entity adjusts consideration if payment is received in advance.

Ind AS 115 applies to both deferred and advance payments and point in time and over-time contracts. Therefore, significant financing components are expected to be identified more frequently under it, and may require complex calculations in case of contract with over-time performance obligations.

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**Significant financing components**

Do deferred payments terms in your contacts for point-in-time licenses give rise to a significant financing component?

- Interest income
- Control of licence transferred
- Deferred payments

Source: Media SlideShare 'IFRS 15 Revenue – Are you good to go?’ published by KPMG IFRG Limited, 2017
The main considerations in determining significant financing component are the period between performance and payment for that performance and the applicable discount rate. However, a contract may not include significant financing component if a substantial portion of the consideration is variable and is based on the occurrence or non-occurrence of events outside the entity’s control. For example, if the entire consideration relates to a sales-based royalty then the contract would not conclude significant financing component.

A contract which involves a significant up-front payment would require further analysis, including consideration of when the performance obligations in the contract are satisfied. In cases, where a significant financing component is determined for such upfront payments, interest cost needs to be recognised till the advance is adjusted against performance and revenue grossed up at the time when revenue is recognised upon satisfaction of the underlying performance obligation. This may lead to situations where interest cost is recognised in one period, while the revenue is grossed up in another.

**Non-cash consideration**

The new standard requires non-cash consideration received from a customer to be measured at fair value. If an entity cannot make a reasonable estimate of the fair value, then it refers to the estimated selling price of the promised goods or services.

At first glance, this requirement may look similar to existing standards, however under current standards, where the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by any cash transferred. By contrast, under the new standard, the entity measures the transaction price at the Stand-alone Selling Price (SSP) of the goods or services transferred. The SSP is not necessarily the ‘fair value’, thus results may differ under previous and new standards. For instance, in a transaction where a media agency providing content to a TV broadcaster, gets compensated a fixed amount of say INR100 and 10 advertising slots, the transaction price is determined to be the fixed price of INR100 plus the fair value of non-cash consideration received, i.e. the fair value of the 10 advertising slots. However, in cases where the fair value is not known or not reasonably determinable, the transaction price is measured at the SSP of the content provided by the media agency.

The SSP may be determined primarily through two approaches - the adjusted market assessment approach and the expected cost plus a margin approach. The adjusted marked assessment approach requires evaluation of the market in which goods or services are being sold and estimating the price that a customer would be willing to pay and the expected cost plus a margin approach, which is based on forecasting expected costs of satisfying a performance obligation and adding an appropriate margin for that good or service.

There is no specific guidance under the new standard on accounting for advertising barter transactions. Therefore, the general principles for measuring consideration apply.

**Principal versus agent considerations**

Ind AS 115 has introduced specific guidance on agent versus principal considerations, which represents a change in approach from Ind AS 18. While Ind AS 18 was based on the risks and rewards approach, Ind AS 115 is based on the transfer of control approach.

- **Primary responsibility to provide specified goods or services**
- **Inventory risk**
- **Discretion to establish prices for specified goods or services**
- **Control over specified goods or services in advance of transferring them to the customer**
- **Indicators that the entity is a principal in the transaction**
- **The entity is a principal in the transaction**

*Source: Revenue Issues In-Depth, KPMG IFRG Limited’s publication, May 2016*
Careful evaluation may be needed of certain contracts such as revenue sharing arrangements. For instance, a media content company provides content such as movies or music which is refreshed periodically to a telecom operator may also aggregate content from multiple media companies and make this content available to its subscribers for a fee. The telecom operator is also generally responsible for collections from customers and the media content company receives a share of such collections as revenue.

Whether the telecom operator and the media content company are in a principal-to-principal or agent-to-principal relationship needs to be evaluated. This will depend on factors such as whether the telecom operator obtains control over the content, even momentarily before transferring it to the customer, who has the discretion to establish prices to be charged to the subscriber, who has the primary obligation to provide the service, etc.

**Other potential areas**

The standard requires that a legally binding contract be put in place before revenue can be recognised. While the form of the contract is not prescribed by the standard, emphasis is laid on it being legally binding. Certain contracts may be structured as a high level Master Service Agreement (MSA) with subsequent Statement of Works (SOW), which lay out in detail the service to be rendered. At times such SOWs may be communicated in the form of emails, or through informal channels such as phone calls. The legally binding nature of all such communications must be evaluated to be able to recognise revenue and whether the existence of an MSA is enough evidence of a contract.

Ind AS 115 also lays out general guidance on recognising of revenue at a point in time and over a period of time. Revenue is recognised over time where certain criteria are met, such as the consumer simultaneously receiving and consuming the benefits provided by entity’s performance. For instance, in case of plain vanilla content subscription contracts, where there is a single performance obligation of the service provided and revenue is recognised over time of the subscription period. Revenue is also recognised over a period of time where an entity’s performance creates an asset that the customer controls as it is created. For example, creating specific or bespoke content for a customer or where the entity’s performance does not create an asset with alternative use to the entity and the entity has an enforceable right to payment for performance to date, for example, production arrangements. In all other cases revenue is recognised at a point in time.

Guidance on allocation of transaction price to different performance obligations now does not allow the use of residual method to allocate revenue except in limited cases. Instead transaction price must be allocated to each performance obligation based on the stand-alone selling price determined for such obligation using a market or cost based approach.
Companies in the technology sector have a varied range of products and services which could be bundled in many different ways. The existing accounting literature did not provide specific guidance on accounting for these bundled arrangements and companies typically used to follow the contractual terms to determine the accounting practice. With the application of Ind AS 115, additional guidance is now available for companies where revenue recognition is based on the substance of the arrangement and allocation of the contractual price linked to the stand-alone selling price of individual elements in a bundled arrangement.

The introduction of Ind AS 115 has resulted in the application of a single comprehensive model of accounting for revenue arising from contracts with customers and has superseded the current revenue recognition guidance under Ind AS 11 and 18. The new approach is expected to result in every company, including companies in the technology sector, a need to evaluate the impact of Ind AS 115. This impact goes beyond technical issues to cover significant understanding of the new rules, impact on operational processes including compensation and commission structures or sales methodologies, customer pricing and operating systems such as IT.

This chapter discusses some of the significant impacts areas related to the technology sector.

### Summary

- Identification of existence of enforceable contract require evaluation of specific facts and circumstances and application of significant judgement in case of renewals.
- Determination of separate performance obligations is crucial due to existence of inter related bundled offerings like hardware, software and services.
- Exercise significant judgement to determine what portion of variable consideration needs to be included in the transaction price.
- Evaluate licence of an Intellectual Property (IP) to determine it constitutes a right of access or use and account for revenue on this basis.

### Identification of the contract

In an Indian context, one of the key challenges in the technology sector is likely to be in terms of identification of the contract with the customer. Under Ind AS 115, a contract is deemed to exist when there is an agreement between two or more parties that creates enforceable rights and obligations – this is generally implied by the company’s customary business practices. This may require significant judgement for some arrangements, and may result in different assessments for similar contracts in different jurisdictions. For instance, given that oral contracts may constitute a contract, companies should evaluate all forms of arrangements with customers to determine if a contract within the meaning of Ind AS 115 exists. The key considerations to be looked at as follows:

- Customary practices
- Communications made by sales teams
- Quotes
- Purchase orders
- Any other agreement.

In the technology sector, the existence of contract can be established based on the availability of an approved purchase order or a signed statement of work. The challenge in application would be in respect of renewals of ongoing contracts – where such renewals are based on oral confirmations or emails, the company will have to assess the extent to which the contractual terms are enforceable and the timing of when such revenue recognition would be appropriate.
Identification of distinct performance obligations

In terms of the business model, companies in the technology sector are transitioning from selling products to selling solutions. This typically results in contracts that include bundled offerings containing hardware, software and services which are interrelated. One of the issues to be considered under Ind AS 115 is identifying the distinct performance obligations. A performance obligation is distinct when it meets two criteria, as provided in below diagram:

- **Criterion 1: Capable of being distinct**
  - Customer can benefit from the good or service on its own or together with other readily available resources

- **Criterion 2: Distinct within the context of contract**
  - Promise to transfer good or service is separately identifiable from other promises in the contract

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Distinct performance obligation</strong></td>
<td><strong>Not distinct – combine with other goods and services</strong></td>
</tr>
</tbody>
</table>

The guidance on identification of distinct performance obligation may require companies to apply judgements to evaluate bundled products containing licenses, customisation, installation, customer support, warranty and promised upgrades including transition services relating to outsourcing contracts. Companies will have to establish systems to assist with the identification of distinct performance obligations and document the rationale for their accounting decisions.

Example

Contracts in the technology sector often include multiple promises – e.g. a software licence, professional services, post-contract customer support, specified upgrades or additional product rights. Where a company M, a software provider enters into a contract with a customer to sell proprietary software and render professional services to significantly customise or modify the licensed software. In this case, company M would need to determine if professional services qualify as a separate performance obligation.

Professional services provided in the technology sector could vary from contract to contract, so a careful evaluation is required to determine whether the professional service provided in a contract provides a stand-alone value to the customer. Secondly, an entity would need to judge whether the amount of modification or customisation is essential to the performance of the professional software.

In the situations where the license is such that once the entity modifies or customises the software, the identity of the license is lost – in such scenarios the software and professional service would not be classified as separate performance obligation. Whereas, in situations where the entity supplies the software and the modification/customisation is not that essential to the software license then in such cases the license and the professional service are separate performance obligations as is able to benefit from the software together with readily available resources other than M’s customisation service.

Historically in outsourcing type arrangements, there has been a diversity in practice in the sector in relation to accounting of the transition phase and whether it can be treated as a separate element distinct from the steady state phase in a multiple element contract. Under Ind AS 115, companies will have to revisit the earlier conclusions in light of the new guidance and specifically, will have to assess whether the transition phase constitutes a performance obligation ‘distinct in the context of the contract’.

Source: Revenue Issues In-Depth, KPMG IFRG Limited’s publication, May 2016
Variable consideration

Owing to a shift in trend in the sector, companies in the technology sector are also moving from an input based pricing model to an outcome and consumption based pricing model.

This would result in an increased focus on the ability of companies to estimate outcomes and the related transaction price on the basis of which revenue would be accounted. With larger components of variable revenue in the transaction price, companies may need to start exercising significant judgement to determine what portion of variable consideration needs to be included in the transaction price. This is different from the current practice, where typically contingent revenue is recognised only once the contingency is resolved and therefore, may force companies to account for variable consideration earlier than current accounting requirements under Ind AS 18.

Allocation of transaction price

Another area of potential change is in respect of allocation of transaction price for identified performance obligations. Unlike the current practice under Ind AS 18, which allows the use of a residual method in allocating revenue, Ind AS 115 mandates allocation of transaction price to each performance obligation in proportion of its stand-alone selling price unless the selling price for a good or a service is highly variable and uncertain – which is expected to be very rare in practice. The use of a relative method ensures that any discounts provided on bundled arrangements is fairly divided between the different performance obligations unlike the residual method which would allocate all of the discount to the undelivered elements in a contract.

While this change may not have a significant impact on the total amount of revenue recognition, this is likely to impact the timing thereof and increase the documentation requirements on companies which would have to demonstrate the basis on which the transaction price has been allocated.

Example

XYZ Corp. provides a hosted software solution to customers for which customers pay a fixed up-front fee and subsequently variable amounts based on the number of transactions processed using XYZ’s solution. Customers are not permitted to take possession of XYZ’s software; therefore, this is a SaaS arrangement (i.e. there is no software license transferred to the customers).

XYZ enters into a contract with a customer to use XYZ’s solution for one year. The consideration consists of a fixed up-front fee of INR1,000 and INR5 per transaction processed. The number of transactions that will be processed is not known and will be billed on a monthly basis.

XYZ concludes that the contract consists of a single performance obligation satisfied over time of providing access to the hosted solution to the customer. XYZ also concludes that the performance obligation is a series of distinct days of service and that a time-based measure of progress is appropriate for the performance obligation.

Additionally, XYZ concludes that variable amounts per transaction should be allocated to the distinct service period (each day) in which the transaction is processed because:

- The variable amounts relate specifically to the customer’s usage of the SaaS that day.
- Allocating the transaction-based fees to each day is consistent with the allocation objective because each day has a similar pricing structure and when considering the fixed fee is allocated to all of the days in the contract the resulting allocation of potential variable amounts and fixed fees depicts what XYZ would expect to receive for each day of service.

The fixed fee is attributable to the entire performance obligation and recognised ratably over the contract period.

*Saas - Software-as-a-service

Source: Educational Material on Ind AS 115, issued by ICAI, August 2018
Timing of revenue recognition

Finally, the last step in revenue recognition is the determination of the timing of revenue – i.e. at a point in time vs over time. The timing of revenue recognition will now be based on an assessment of when the control over the performance obligation is transferred to the customer – this is a change from the current model which focused on risks and rewards. The change in emphasis from a ‘risks and rewards’ model to a ‘control model’ for revenue is consistent with changes that are happening in the accounting guidance under IFRS for multiple areas such as leases, consolidation, etc. which have also been incorporated in Ind AS.

For companies in the technology sector, this change in guidance is unlikely to have a significant impact where there are significant bespoke activities related to software development being carried out based on customer specifications and instructions as also for routine maintenance and other outcome-based activities. One area where this may have an impact is in the consulting space where typically companies used to follow the completed contract accounting based on established industry practices – this may no longer be possible under Ind AS 115.

Specifically, in the context of licence of intellectual property, companies will have to firstly determine whether the licence constitutes a distinct performance obligation. If it does constitute a distinct performance obligation, then the next step would be to determine whether the licence represents a ‘right of access’ or a ‘right of use’. This determination is important to establish whether revenue is required to be recognised over time or at a point in time. This guidance under Ind AS 115 is likely to change accounting for time-based software licences where revenue is typically spread over the period of the licence currently – now, companies need to evaluate whether the software licence constitutes a right of access or use and account for revenue on this basis irrespective of whether these are time-based.

Capitalisation of contract costs

In addition to detailed guidance on revenue recognition, Ind AS 115 also provides guidance in relation to capitalisation of contract costs. The standard allows capitalisation of both incremental costs to obtain a contract as also costs related to future performance. There was no guidance under Ind AS 18 in relation to these costs. Companies engaged in the outsourcing business are likely to find that a significant portion of their up-front costs (such as funding of retrenchment obligations, etc.) will likely meet the criteria for capitalisation under Ind AS 115. Other companies will also need to start looking at costs such as sales and renewal commissions, non-refundable upfront fees paid to the customer and customisation costs including licenses for potential capitalisation under Ind AS 115.

Principal versus agent

Ind AS 115 provides specific guidance on agent vs principal considerations. An entity is required to evaluate the nature of promise to the customer, when third party is involved in providing goods or services to the end customer. The entity determines whether the promise requires it to provide the goods or service itself or to arrange for them to be provided by another party i.e. whether it is acting as principal or agent.

An entity is a principal if it controls the specified goods or service that is promised to the customer before it is transferred to the customer. If an entity does not obtain control of the goods or the right to the services in advance or while transferring them to the customer, then it is an agent for that good or services. If an entity is a principal then the revenue would be recognised on a gross basis corresponding to the consideration to which the entity expects to be entitled. If the entity is an agent, then revenue would be recognised on a net basis corresponding to any fee or commission to which the entity expects to be entitled.

Example

Company V operates a website from which it sells company T’s products. Customers place orders directly on the website and provide credit card details for payment. V receives the order and authorisation from the credit card company, and passes the order on to T, which ships the product directly to the customer. V does not take title to the product and has no risk of loss or other responsibility for the function or delivery of the product. T is responsible for all product returns and defects. T sets the price of the product at INR175, from which V receives a commission of INR25.

V considers that it does not take title to the product, is not primarily responsible for providing the product, does not have an inventory risk, and does not have discretion in establishing prices. Therefore, V determines that it does not control the product before it is transferred to the customer and acts as an agent. As a result, V recognises its fee of INR25 as revenue when it passes the order to T.
Summary

- Understanding the entire contract, including any modifications, is important to establish the existence of contract.
- While applying the distinct test, consider the existence of multiple distinct products or services as part of a single arrangement such as customer loyalty programmes.
- Principal versus agent evaluation should be performed at each performance obligation level and not at contract level.
- Transportation services likely to meet over time criteria as the customer simultaneously receives and consumes the benefits.

The transportation, logistics and leisure sector includes companies associated with shipping, railways, airlines, ports, container freight station, leisure and logistics. Customers generally pay a fee for the movement of cargo or passengers between two or more specified points, or for use of hotel/recreation space for a particular duration of time. While arrangements with customers are not too complex, the same have the ability to be modified to increase/reduce the extent of services. The industry also offers rewards/incentives to its customers in the form of volume discounts/rebates, loyalty programmes, etc.

Accounting for contracts in the transportation, logistics and leisure sector is undergoing a change due to the application of the new revenue recognition standard. This chapter highlights the significant areas where old guidance in Ind ASs is expected to change due to implementation of Ind AS 115.

Identify the contract

The assessment of whether a contract with a customer exists under the new revenue guidance is less driven by the form of the arrangement, but whether an agreement between two parties (either written, oral, or implied) creates legally enforceable rights and obligations between them. The purpose of the collectibility assessment under the new guidance is to determine whether there is a substantive contract between the company and the customer. This differs from the guidance given in Ind AS 18 in which collectability is a constraint on revenue recognition.

Companies should consider any history of entering into amendments or side agreements to a contract that either change the terms of, or add to, the rights and obligations of a contract. These can be verbal or written, and could include cancellation, termination, or other provisions. They could also provide customers with options or discounts, or change the substance of the arrangement. All of these have implications for revenue recognition. Therefore, understanding the entire contract, including any amendments, is important to the accounting conclusion.

It is quite common in this sector to enter into ‘Master Service Agreements’ (MSA), which defines broadly the general scope of services to be provided and the timelines over which the same are to be provided.
However, without explicit underlying details of the exact scope of services, these MSAs by themselves may not qualify to be a contract under this standard. The new guidance also eliminates the cash-basis method of revenue recognition that is often applied today if collectibility is not reasonably assured or probable. Any cash received is recognised as a contract liability until either collectibility of the transaction price is probable or one of the criteria for recognition is met. This could result in revenue being recorded later than under current guidance in some situations.

Further, this sector experiences various modifications to existing contracts (e.g. upgradation of class of travel in railway/airlines, upgradation of rooms in hotels, inclusion of additional services like last mile travel, etc.)

Ind AS 115 has specific guidance on when a modification should be treated as part of original contract or when it should be treated as termination of existing contract and creation of a new contract. The examples given above of upgradation of class of travel would normally fall under the former eventuality whereas change in date of travel/ availing additional services are likely to result in creation of a new contract.

**Identify performance obligations**

Many entities in this sector provide multiple products or services to their customers as part of a single arrangement. Management must identify the separate performance obligations in an arrangement based on the terms of the contract and the company’s customary business practices. A bundle of goods and services might be accounted for as a single performance obligation in certain situations.

A performance obligation is a promise in a contract to transfer to a customer either:

- A good or service (or a bundle of goods or services) that is distinct, or
- A series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer.

A promised good or service is distinct from other goods and services in the contract if meets two criteria:

**Criterion 1: Capable of being distinct**
Customer can benefit from the good or service on its own or together with other readily available resources

**Criterion 2: Distinct within the context of contract**
Promise to transfer good or service is separately identifiable from other promises in the contract

Assessing whether goods and services are capable of being distinct is similar to determining if deliverables have stand-alone value or are separate components, although the definitions are not identical. Under the new guidance, management will assess if the customer can benefit from the good or service with ‘resources that are readily available to the customer’ which could be a good or service sold separately by the entity or another entity, or a good or service the customer has already obtained.

**Example**

**Customer loyalty programmes - Airline and hospitality**

Many airlines and hotels operate customer loyalty programmes in which customers can earn loyalty points, either by travelling with the airline/staying in a hotel, or making qualifying purchases with an airline partner. Customers can use the points to buy future travels or stays, upgrade to a higher travel class or purchase goods from the issuing airline/hotel and/or its redemption partners. A customer loyalty programme that provides a customer with a material right is accounted for as a separate performance obligation under the new standard.
Example

Turnkey projects - Logistics

In the Third-party logistics (3PL) or distinct services viz. land transport, Fourth-party logistics (4PL) business, custom and port services, ocean an entity takes over the end-to-end transport, installation, etc. As per responsibility of transport goods the new standard, some of these from origination to destination. segments will be treated as a distinct This service includes multiple performance obligation.

Determine transaction price

The transaction price is the consideration to which the entity expects to be entitled in exchange for goods or services. Determination of the transaction price may be simple when the contract price is fixed and paid at the time services are provided. However, it may require more judgement if the consideration contains an element of variable or contingent consideration.

Common forms of variable consideration in the transportation and logistics sector include discounts, volume rebates and performance bonuses.

Variable consideration (e.g. discounts and rebates) included in the transaction price is normally subject to a constraint. Management will need to determine if there is a portion of the variable consideration (that is, a minimum amount) that would not result in a significant revenue reversal and include that amount in the transaction price.

The revenue standard provides factors to consider when assessing whether a variable consideration should be constrained. Management should reassess the estimate of variable consideration at each reporting period.

Additionally, customers may not exercise all of their contractual rights related to a contract, such as rebates and other incentive offers. These unexercised rights are often referred to as breakage. Management should adjust for changes in expectations when updating the estimated amount of consideration to which an entity expects to be entitled.

Management might need to put into place new processes to monitor estimates on an ongoing basis as more experience is obtained.
Time value of money – all sectors

An entity needs to adjust the amount of promised consideration to reflect the time value of money if the contract includes a significant financing component. A significant financing component does not exist if the timing of delivery is at the customer’s discretion (for example, in the case of customer loyalty points) or the difference between the promised consideration and the cash selling price arises for reasons other than financing.

As a practical expedient, a company need not assess whether a contract has a significant financing component if it expects at contract inception that the period between payment and the transfer of services will be one year or less.

We do not expect a significant change to current practice for many entities in transportation, logistics and leisure sector in connection with the time value of money because payment terms do not often extend over more than one year from the time of contract performance.

Volume rebates – Rail/road transport, CFS, freight forwarders.

Transport companies enter into a contract to transport goods from point A to point B for INR1,000. The customer earns a rebate of INR100 for each load if the customer transports at least 10,000 loads annually. Based on past experience, management believes there is a 50 per cent likelihood that the customer will ship 10,000 loads and earn the rebate of INR100 per load.

As per the new revenue standard, the transaction price is INR900 per load, which reflects the amount to which the transporter expects to be entitled based on its estimate of loads to be transported. There are only two possible outcomes regarding the variable consideration (e.g. the rebate). The customer will be entitled to either INR0 or an additional INR100 per load.

Any amounts collected in excess of INR900 per load (that is, the additional INR100 per load prior to earning the rebate) would be recorded as a liability. These estimates should be monitored and adjusted, as necessary, using a cumulative catch-up approach.

For instance, should circumstances change and it becomes probable that the customer will not be entitled to the rebate, the extra INR100 per load would be included in the transaction price for the loads previously shipped at that point.

Allocate transaction price

Transportation, logistics and leisure sector may provide multiple goods or services to their customers as part of a single arrangement. As we discussed above, the entities will have to identify different performance obligations and therefore, will need to allocate the transaction price to the separate performance obligations in one contract. This allocation should be based on the relative stand-alone selling price of each separate performance obligation. The standard recommends use of directly observable price in this respect, however, in its absence, the standard requires the entity to estimate the stand-alone selling price (viz. adjusted market price, cost plus margin or residual approach).

Demurrage claims - Shipping

A shipping company enters into a voyage charter contract with a customer to transport goods from point A to point B. The shipping company may experience delays in loading and unloading the cargo (referred to as demurrage), which are not the responsibility of the shipping company. The additional amount to be paid to the shipping company is calculated in accordance with the terms of the contract. Demurrage claims are often negotiated, resulting in adjustments to the contract price, and can take a long time to resolve. The amount of demurrage claims might be difficult to estimate and are likely to vary depending on the counterparty and the type of delay. Based on past experience, the entity would be required to include in the transaction price any portion of the claim that meets the probable threshold. The time taken to resolve claims or the external factors involved are not factors that would allow the entity to avoid including in the transaction price a minimum amount that meets the threshold.
Example
Customer loyalty programmes - Airline and hospitality

As discussed earlier, points/awards issued under customer loyalty programmes are separate performance obligations if they provide the customer with a material right that the customer would not receive without buying the initial product or service (for example, the original flight/hotel stay). The transaction price is allocated between the initial purchase and the award credits based on the actual or estimated stand-alone selling price of each performance obligation. The portion of the transaction price allocated to the award credits is not recognised as revenue until the credits are redeemed or expire.

The stand-alone selling price of the award credits is not usually directly observable and will, therefore, need to be estimated. The estimate should reflect the discount achieved by customers when spending award credits, adjusted for the likelihood that the credits will be forfeited (breakage). For example, an airline recognises revenue from the award credits on a gross basis when the customer redeems them for goods or services that the airline provides.

Adjustments for expected forfeitures (breakage) are likely to affect the timing of revenue recognition. The stand-alone selling price of award credits will be reduced to reflect the award credits not expected to be redeemed. This requirement could result in less revenue allocated to award credits as compared to Ind AS 18’s multiple-element model.

Further, an airline/hotel that operates a programme in which points can be redeemed with a third party needs to consider whether it is a principal or an agent in the arrangement. This requires management to first consider the nature of its performance obligation. The entity should recognise revenue for the net fee or commission retained in the exchange if it is an agent in the arrangement.
Recognise revenue and costs

Transportation or freight services are generally provided over a period of time ranging from one day to multiple months. The new standard requires that revenue be recognised as an entity satisfies a performance obligation by transferring control of a good or service. A performance obligation can be satisfied over time or at a point in time.

A performance obligation is satisfied over time if any one of the following criteria is met:

- The customer simultaneously receives and consumes the benefits as the entity performs
- The entity’s performance creates or enhances an asset that the customer controls, as the asset is created or enhanced
- The entity’s performance does not create an asset with an alternative use, and the entity has an enforceable right to payment for performance completed to date.

An entity should recognise revenue over time only if the entity can reasonably measure its progress towards complete satisfaction of the performance obligation. If a performance obligation is not satisfied over time, then the entity satisfies the performance obligation at a point in time.

Transportation services will likely meet the criteria for revenue recognition over time as the customer simultaneously receives and consumes the benefits as the entity performs. It is observed that the customer benefits from the entity’s performance as it occurs if another entity would not need to substantially re-perform the entity’s performance (for example, distance already travelled) to date. An entity should disregard any contractual or practical limitations when it assesses whether the customer simultaneously receives and consumes the benefits and whether another entity would need to substantially re-perform the performance completed to date. For example, the assessment would not consider contractual provisions that restrict an entity from transferring its obligations to another entity.

Example

Transportation revenue

A trucking company enters into a contract with a customer to transport goods from Mumbai to Delhi. The customer has an unconditional obligation to pay for the service when the service has been completed, which is when the goods reach Delhi. These types of contracts will typically meet the criteria for revenue recognition over time. If the trucking company transports the goods midway to the destination, another transportation company could fulfil the remaining obligation to the customer without having to re-perform the services provided to date. The obligation to provide transportation services is therefore satisfied over time, and revenue should be recognised over the period of performance (generally the period from when transport of the goods begins from Mumbai through delivery to Delhi).

Example

Breakage revenue - Airlines

Airlines usually sell tickets in advance for full consideration. Some tickets are not used for travel and cannot be exchanged or refunded. Certain flexible air tickets include a right to re-schedule if the customer does not fly on the scheduled flight date, but the customer may decide not to travel. Those partially or wholly unused tickets are often referred to as ‘ticket breakage’. An entity considers the variable consideration guidance to determine whether - and to what extent - it recognises breakage. It determines the amount of breakage to which it is entitled as the amount for which it is considered highly probable that a significant reversal will not occur in the future. This amount is recognised as revenue in proportion to the pattern of rights exercised by the customer when the entity expects to be entitled to breakage. Otherwise, the entity recognises breakage when the likelihood of the customer exercising its remaining rights becomes remote.
Principal versus agent (gross versus net)

Certain arrangements involve two or more unrelated parties that contribute to providing a specified good or service to a customer. In these instances, management will need to determine whether the company has promised to provide the specified good or service itself (as a principal) or to arrange for those specified goods or services to be provided by another party (as an agent). This determination often requires judgement, and different conclusions can significantly impact the amount and timing of revenue recognition.

Management should first understand the relationships and contractual arrangements among the various parties. This includes identifying the specified good or service being provided to the end customer and determining whether the company controls that good or service before it is transferred to the end customer.

As per the new standard, an entity is the principal and should report revenue on a gross basis if it controls the specified good or service before it is transferred to the customer. Conversely, it is an agent and should report revenue on a net basis if its obligation is to arrange for another party to provide goods or services (i.e., the entity does not control the specified good or service before it is transferred to the customer).

The principal versus agent assessment is performed at the performance obligation level, not at the contract level. An entity may act as a principal with respect to certain performance obligations in the contract and an agent with respect to others.

Example

Principal versus agent assessment - Airlines

Airlines often sell tickets to customers that include flight segments to be flown by another airline, or enter into contracts for transporting cargo with another airline. In these cases, an airline determines whether it acts as principal or agent in the transaction and accounts for revenue accordingly, i.e. on a gross or a net basis. Airlines usually charge government- and airport-based passenger taxes and fees at the time of the ticket sale. Often, these are subsequently remitted to the relevant authorities. Airlines may also make discretionary fuel surcharges, which are not remitted to any authorities, and may or may not be explicitly stated in the airfare. Therefore, it is important to analyse all relevant facts and circumstances to evaluate whether an airline is acting as principal or agent in each case.

In general, passenger taxes and fees would not considered as part of gross revenue while discretionary fuel charges would be included in the gross revenue.

Example

Principal versus agent assessment – Freight forwarders/3PL/4PL

A freight forwarder, in addition to arrangement for transportation of cargo from point A to point B, also provides additional services of payment of statutory dues (viz. custom duty), custom clearance, etc. which is normally carried out on behalf of the customer. While custom clearance could classify as a separate performance obligation, and therefore be treated as an act of a principal, payment of custom duty to the authorities on behalf of the customer would be treated as an agency act, and therefore would not be considered as part of revenue.
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