

Ind AS 115

(Revenue from contracts with customers)

Presented by
CA Manoj Pati
Partner
SGJ & Co,
Chartered Accountants

Contents

- ▶ Background
- ▶ 5 step model of revenue recognition
- ▶ Recognition & Measurement – over time or at a point in time

Background

- ▶ IASB adopted IAS 18 “Revenue” in 2001 revised in 1993 by the IASC Revenue standard originally issued in 1982.
- ▶ IFRS 15 issued In May 2014 as part of a joint effort by the IASB and the FASB
- ▶ From Indian perspective it is applicable for accounting years beginning April 1, 2018.
- ▶ 2 methods of transitional provisions:
 - full retrospective application, i.e. standard would be applicable from April 1, 2017
 - apply effect only to the opening balance of retained earnings on April 1, 2018

Background

- ▶ In addition to IAS 18, it replaces the following standards/interpretations
 - IAS 11 : Accounting for Construction Contracts
 - SIC 31 : Revenue – Barter Transactions Involving Advertising Services
 - IFRIC 13 : Customer Loyalty Programmes
 - IFRIC 15 : Agreements for the Constructions of Real Estate
 - IFRIC 18 : Transfer of Assets from Customers
- ▶ The revised standard has been issued because
 - US GAAP and IFRS had different revenue recognition criteria
 - Needed improvement. Deemed to be difficult to apply in complex transactions
 - Provided limited guidance on certain topics (multiple element arrangements in IFRS, US GAAP had guidance for specific transactions & industries leading to application differences)

Scope

- ▶ Ind AS 115 specifically excludes from its scope certain type of transactions:
 - Leases in the scope of Ind AS 17 / Ind AS 116
 - Insurance contracts in the scope of Ind AS 104
 - Financial instruments and other contractual rights and obligations in the scope of Ind AS 109, Ind AS 110, Ind AS 111, Ind AS 27 and Ind AS 28
 - Non-monetary exchanges between entities in the same line of business to facilitate sales to current or future customers
- ▶ The revised standard has been issued because
 - US GAAP and IFRS had different revenue recognition criteria
 - Needed improvement. Deemed to be difficult to apply in complex transactions
 - Provided limited guidance on certain topics (multiple element arrangements in IFRS, US GAAP had guidance for specific transactions & industries leading to application differences)

Areas of impact

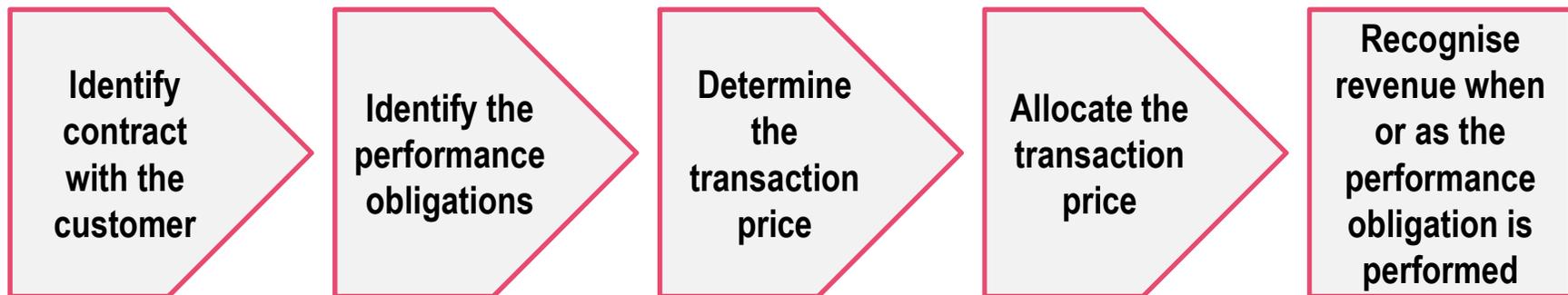
The biggest areas of impact are mainly:

- ▶ Shift from “Significant risk and reward” to “Control”
- ▶ Is the revenue recognized **over time** (spread between the periods during contract duration) or **at the point of time** (upon completion)?
- ▶ If the revenue is to be recognized over time, how should the company **measure the progress towards completion** (previously “stage of completion”)?
- ▶ How shall companies account for **revenue from bundled offers** (with multiple deliverables)? Should they **split the contract** into several components?
- ▶ How shall companies deal with **contract modifications**?
- ▶ How shall companies treat the **contract costs**, including cost of obtaining the contract? Shall they expense these costs in profit or loss, or capitalize and defer?
- ▶ Are there any **financing components** in the contract? If yes, how to deal with the **time value of money**?
- ▶ What **disclosures** do companies need to make? Do they have all the appropriate and relevant information?

5 step model for revenue recognition

Core Principle

A company 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 company expects to be entitled in exchange for those goods or services



1. Identify contract with customers

- ❑ Who is the customer? *Contracts that are not with **customers** are outside the scope of the revenue standard.*

A customer is the party that contracts with an entity to purchase goods or services that are the **output of the entity's ordinary activities**, in exchange for **consideration**.

- ❑ Examples of income that does not arise from a contract with customer:
 - ✓ Dividends;
 - ✓ Non-exchange transactions like donations and contributions;
 - ✓ Sale or transfer of non-financial assets like PPE, IP, etc.
 - ✓ Relationship in collaboration or partnership agreement (joint operations)
- ❑ Determining the contract term:
 - ✓ Contract term is the period during which the parties to the contract have present and enforceable rights and obligations;
 - ✓ It impacts determination and allocation of the transaction price, and recognition of revenue
 - ✓ Termination clause in a contract is the key while assessing contract term

1. Identify contract with customers

□ Determining the contract term (few examples)

- ✓ A service provider enters into a contract with a customer to provide monthly services for a three year period. Each party can terminate the contract at the end of the any month for any reason without compensating the party.
- ✓ Is there any change if the customer can only terminate without the penalty?
- ✓ Is there any change in contract term, if customer shall be required to pay a termination penalty when customer terminates the contract during the first 12 months.

1. Identify contract with customers

Contact with customers – required criteria

A **Contract** is an agreement between two parties that creates enforceable rights and obligations and have the following attributes:

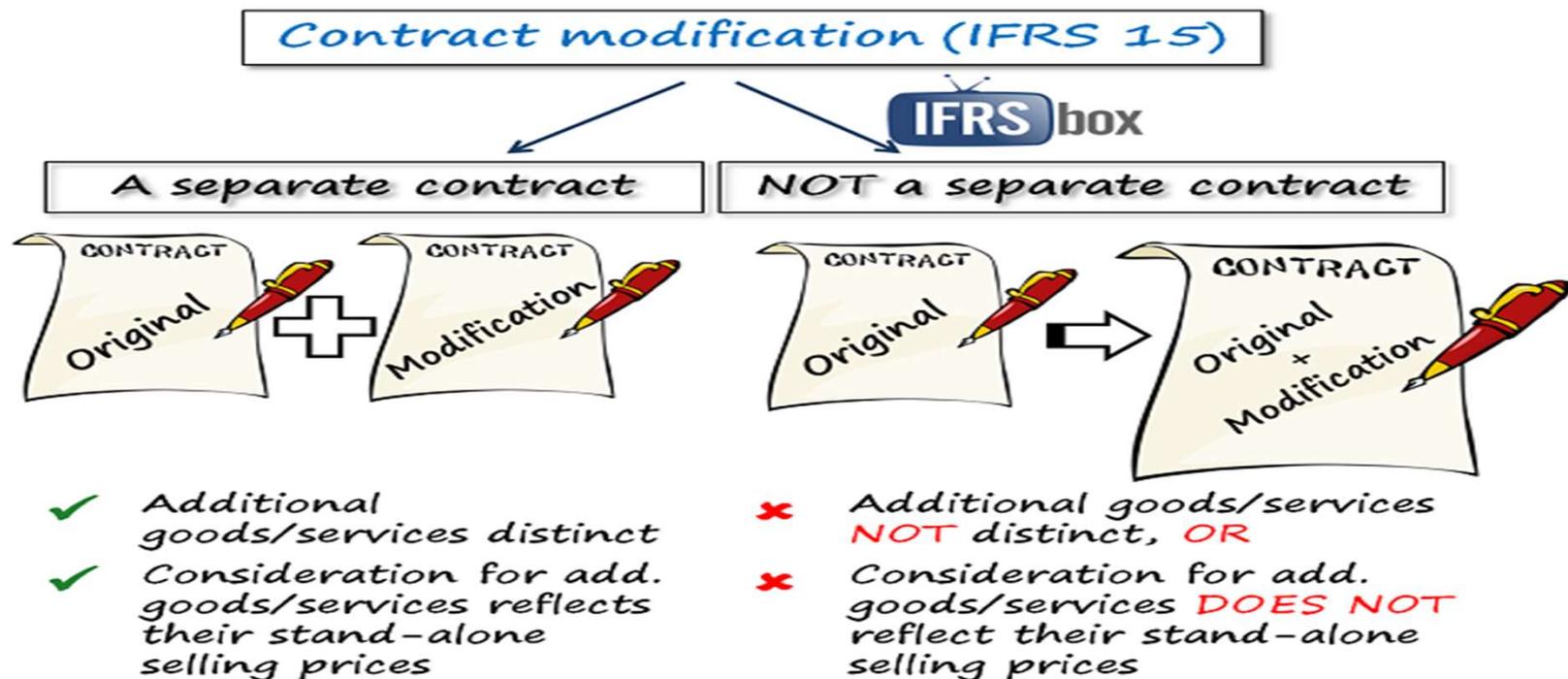
- ▶ Parties to the contract have **approved** the contract and are committed to **perform their respective obligation**; (It may be written, verbal, or implied by customary business practice)
- ▶ Each party's rights to the goods/services transferred are identified;
- ▶ The payment terms are identified;
- ▶ A contract must have commercial substance
- ▶ It must be more likely than not that an entity will collect consideration from the customer (here, you need to evaluate the customer's ability and intention to pay)
 - Price concession Vs. customer credit risk
 - Reassessment of the above criteria are not required to be done unless there are indications of significant changes in circumstances.

1. Identify contract with customers

- ▶ It may be necessary to combine two or more contracts entered into at or near the same time with the same customer and account for them as a single contract
 - The contracts are negotiated as a single package with a **single commercial objective**
 - The amount of consideration to be paid in one contract depends on the price or performance of the other contract
 - The goods or services promised in the contracts are a single performance obligation

Contract modification

- ▶ **Contract modification** is the change in the contract's scope, price or both. In other words, when you add certain goods or services, or you provide some additional discount, you are effectively dealing with the contract modification.



Contract modification

▶ **Contract modification is a separate contract**

Contract modification is accounted for as for a separate contract (meaning that the original contract is left as it is), when **2 criteria are fulfilled**:

- Additional goods and services in the modification must be **distinct** from the goods or services in the original contract.
- Amount of consideration expected for the additional goods/services must **reflect the stand-alone selling price** of these goods/services.

▶ **Contract modification is not a separate contract**

If the above criteria are not fulfilled (or one of them is not met), then the contract modification is **not a separate contract** and the accounting depends on further analysis.

- accounts for a modification prospectively if the remaining goods or services are distinct but the consideration does not reflect standalone selling prices.
- accounts for a modification through a cumulative catch-up adjustment if the remaining goods or services are not distinct and are part of single performance obligation.

Contract modification - Example

Ball PC, computer manufacturer, enters into contract with Forward University to deliver **300 computers for total price of CU 600 000 (CU 2 000 per computer)**.

Due to necessary preparation works, Forward University agrees to deliver computers in **3 separate deliveries** during the forthcoming 3 months (100 computers in each delivery). Forward University takes control over the computers at delivery.

After the first delivery is made, Forward University and Ball PC **amend the contract**. Ball PC will supply **200 additional computers** (500 in total).

How should Ball PC account for the revenue from this contract for the year ended 31 March 2019 if:

- Scenario 1:** The price for additional 200 computers was agreed at **CU 388 000**, being CU 1 940 per computer. Ball PC provided a **volume discount of 3%** for additional delivery which reflects the normal volume discounts provided in similar contracts with other customers.
- Scenario 2:** The price for additional 200 computers was agreed at **CU 280 000**, being CU 1 400 per computer. Ball PC provided a **discount of 30%** for additional delivery because it hopes for the future cooperation with Forward University (nothing even discussed yet).

As of **31 March 2019, Ball PC delivered 400 computers** (300 as agreed initially and 100 under the contract amendment).

Contract modification - Solution

Revenue under previous rules (Ind AS 18)

As per Ind AS 18, you are not required to examine whether this additional delivery reflects stand-alone selling prices or not.

The revenue for the year ended 31 March 2019:

Scenario 1: CU 600 000 (the first 300 computers) + CU 194 000 (additional 100 computers delivered) = **CU 794 000** (for all 400 computers already delivered).

Scenario 2: CU 600 000 (the first 300 computers) + CU 140 000 (additional 100 computers) = **CU 740 000** (for all 400 computers already delivered)

Is it the same under IFRS 15?

Contract modification - Solution

Whether additional goods are distinct goods?

In both scenarios, this is met, as additional computers are quite distinct from the original computers.

Whether the additional consideration reflects their stand-alone selling prices?

Scenario 1: 3% discount agreed on additional delivery

The price for additional computers indeed *reflects their stand-alone selling prices*, because Ball PC normally provides 3% volume discount.

Therefore, this contract modification is accounted for *as a separate contract* and revenue for the year 2019 (400 computers delivered) is:

CU 600 000 from the original contract for 300 computers;

CU 194 000 from the contract modification for additional 100 computers delivered.

Total revenue in the year 20X1 is therefore **CU 794 000** – exactly as under Ind AS 18.

Contract modification - Solution

Scenario 2: 30% discount agreed on additional delivery

Here, it's clear that the price for additional computers **does not reflect their stand-alone selling prices**, because 30% discount is exceptional.

As a result, the contract modification is **NOT a separate contract, but it is bundled** with the original contract.

In this case, as additional goods are distinct, you need to account as **you would terminate the original contract and start the new one**.

You simply recognize the revenue from the delivery already made before contract modification under the original contract. For the remaining goods from the original contract and additional goods, you recognize total revenue amounting to:

- That part of consideration in the original contract that hasn't been recognized as revenue yet (in other words, price for goods yet to be delivered); PLUS
- The consideration agreed in the contract modification.

In the scenario 2, contract modification was **made after the first delivery**, so Ball PC needs to recognize revenue for the first 100 computers in line with the original contract:

100 computers x CU 2 000 per computer = CU 200 000

Total transaction price to allocate **after the contract modification** is:

CU 400 000, being the part of original consideration related to undelivered 200 computers;

CU 280 000, being total consideration for additional 200 computers;

Total: **CU 680 000**, We need to **allocate CU 680 000 to 400 computers CU 1 700 to one computer**

So what's the **total revenue recognized in 2019** during which 400 computers were delivered?

2. Identify the performance obligations



- ▶ A contract may contain one or more performance obligations i.e.,
 - promises to transfer what are known as 'distinct' goods or services to a customer
 - a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer
- ▶ Performance obligation can be both explicit (e.g. written in the contract) and Implicit (e.g. implied by some customary practices)
- ▶ It is often necessary to break individual contracts down into a series of 'distinct' goods and services

2. Identify the performance obligation

Case Study 1:

A manufacturer enters into a contract with a customer to sell five televisions. The customer requests the manufacturer arrange for delivery of the televisions for nil consideration. The delivery terms state that legal title and risk of loss pass to the customer when the televisions are given to the carrier.

Question:

- How many performance obligations are in the arrangement?
- whether any revenue to be allocated for shipping services?
- whether the same should be recorded Gross or net?

Case Study 2:

Entity A operates health clubs. Entity A enters into contracts with customers for one year of access to any of its health club for Rs 300. Entity A also charges Rs 50 non-refundable joining fee to compensate, in part, for the initial activities of registering the customer.

Question:

How many performance obligations are in the contract?

2. Identify the performance obligation

Case Study 3:

A manufacturer enters into a contract with a customer to sell a custom tool and replacement parts manufactured for the custom tool. The Manufacturer only sells custom tools and replacement parts together, and no other entity sells either product. The customer can use the tool without the replacement parts, but the replacement parts have no use without the custom tool.

#1: How many performance obligations are in the contract?

Distinct or not distinct under Ind AS 115?

What is distinct?

[IFRS 15.27](#) says that a good or a service is distinct if both of the following are met:

- ▶ The good or service is **capable of being distinct**.
It means that the customer can benefit from it either on its own or together with other available resources.
- ▶ The good or service is distinct **within the context of the contract**.
It means that the good or a service is **separately identifiable** from other promises in the contract.

Sometimes, you will have a bunch of individual items, like you sell a car, and you provide 2-years of free repair service as a bonus. These are 2 separate components – distinct goods (car) and services (repairs).

Sometimes, it may seem that the goods and services are distinct, but they are not in fact. For example, The client gets the overnight stay and breakfast in a hotel – two components but they might not be distinct because you cannot get breakfast without the room.

Distinct or not distinct under Ind AS 115?

A software company develops software and sell it to clients. Clients can buy the installation services from the software company. Also, the software company provides 1-year of support services after the purchase. Support services cover both unspecified future upgrades and telephone support.

#1: Is the good or service capable of being distinct?

An entity sells software, installation services and 1-year support. Are these services capable of being distinct?

- ▶ Can the customer install the software himself? Does the installation significantly modify software? Can the customer use the software also without 1-year support? It seems yes. Software seems to be capable of being distinct in this case.
- ▶ Installation services seem capable of being distinct, too, because the question said that the customer could buy the installation from the software vendor. It implies that it was not obligatory. And even if it was obligatory, then still the customer can benefit from the installation services with readily available resources – software.
- ▶ The same applies to 1-year support and also future unspecified upgrades and telephone support can be two separate performance obligation.

In this case we can conclude that yes, the first criterion is met and the software, installation service and 1-year support are capable of being distinct.

Distinct or not distinct under Ind AS 115?

#2: Is the good or service distinct within the context of the contract?

- ▶ Here we need to assess whether the goods or services are separately identifiable in the contract.
- ▶ Or, in other words, whether the nature of the promise in the contract is to transfer each of those goods or services **individually or a combined item**.

IFRS 15 lists a few **situations** when two or more goods or services are NOT separately identifiable and thus not distinct:

- ▶ You provide a significant service of **integrating** the goods or services with other goods or services in the contract into a bundle and you are in fact delivering **combined output**.
- ▶ One or more of the goods or services significantly **modifies or customizes** the other goods or services in the contract. As an example, you sell software, but before it is functional and customer can use it, you need to customize it to the customer's environment.
- ▶ The goods or services are **highly depended or highly interrelated** and the entity or a supplier cannot fulfil the contract by transferring each of them independently.

Distinct or not distinct under Ind AS 115?

How to account for the sales of software licenses with subsequent updates?

In general, a **software license and post-sale customer support will each be distinct** in most cases, even when the customer support and updates are not optional and customer must buy them. Why? Well, because the **software remains functional** also without the support. Most users can work without updates. So if this is the case, then the license is distinct.

However, **if the customer cannot continue working without updates** anymore, or the functionality of the product goes down, then the license is **NOT distinct**.

Similarly, if you sell software with significant customization and installation services, well, again – can the customer use the software without it? If not, then it is not distinct.

Analysis:

- ▶ The customers can buy the installation elsewhere or install the software themselves and it means that installation is separately identifiable. Even if the installation is obligatory per contract, the outcome would still be the same.
- ▶ The same applies for 1-year support services. Supplier can still transfer the software and customer can use it without the subsequent services.
- ▶ Therefore, software, installation and 1-year support are each distinct goods or services in this case and you need to account for them separately.

Distinct or not distinct under Ind AS 115?

Ind AS 115 provides the specific guidance for the licenses, but only ***if the license is distinct***.

It says that you can sell two types of licenses:

- ▶ ***Right to access*** the entity's intellectual property throughout the license period – in this case, the revenue is recognized ***over time*** based on the progress towards completion, and
- ▶ ***Right to use*** the entity's intellectual property as it exists at the point of time in which the license is granted – here, the revenue is recognized ***at the point of time***, when you make the software available to the client.

Ind AS 115 provides a clear guidance on whether you deal with one or another type.

I would say that for software licenses, you should ask:

- ▶ Are you, as a supplier or a seller, ***required to make changes*** in the software (except for future updates that are separate performance obligation)?
- ▶ Is your customer exposed to positive or negative effects resulting from these changes?
- ▶ If you sell technical software without customization, then well, in most cases, the answer would be NO to both questions and thus the license is the right to use, not the right to access.

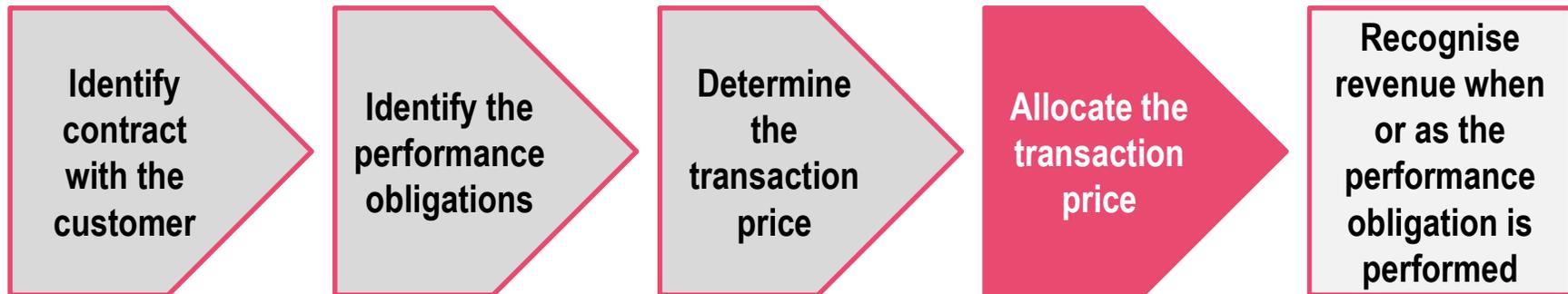
So, you would recognize the revenue at the point of time for that license.

3. Determine the transaction price



- ▶ An entity must consider the terms of the contract and its customary business practices to determine the transaction price
- ▶ In many cases it will simply be the price specified by the contract, excluding any amounts collected on behalf of third parties such as sales taxes
- ▶ While the transaction price will usually be easy to determine when it is a fixed amount at the time of sale, it will be more complicated in other cases, for example when the amount could vary in the future based on contract terms or if consideration is in forms other than cash
- ▶ The transaction price is adjusted for the time value of money when a contract contains a significant financing component
- ▶ The transaction price is not otherwise adjusted for collectability

4. Allocate the transaction price



- ▶ When a contract contains more than one performance obligation, it will be necessary to allocate the transaction price to each of these
- ▶ This is usually done in proportion to the relative stand-alone selling price of the goods or services underlying each performance obligation
- ▶ If a stand-alone selling price is not directly observable, it should be estimated by considering all information that is reasonably available
- ▶ The standard specifies that an entity should allocate a discount to all promised goods or services in the contract unless the entity has observable evidence that the discount relates to one or more, but not all, performance obligations in the contract

5. Recognise revenue



- ▶ Performance obligations are settled by transferring the goods or services to the customer
- ▶ This occurs when the customer obtains control of the goods or services ie, when the customer has the ability to direct the use of and obtain the benefits from the goods or services
- ▶ At the inception of the contract an entity will need to determine whether control is transferred – and revenue recognised – over time or at a point in time

Revenue recognition as performance obligation satisfied – at a point in time or over time

Over Time

if any one of the following criteria met

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

At a point in time

When control is transferred to the customer

- ▶ The entity has a present right to payment for the asset
- ▶ The customer has legal title to the asset
- ▶ The entity has transferred physical possession of the asset
- ▶ The customer has significant risks and rewards of ownership of the asset
- ▶ The customer has accepted the asset

Ind AS 115 Vs. Ind AS 18

Johnny enters into a 12-month telecom plan with the local mobile operator ABC. The terms of plan are as follows:

Johnny's monthly fixed fee is CU 100.

Johnny receives a free handset at the inception of the plan.

ABC sells the same handsets for CU 300 and the same monthly prepayment plans without handset for CU 80/month.

How should ABC recognize the revenues from this plan in line with Ind AS 18 and Ind AS 115?



Ind AS 115 Vs. Ind AS 18

Revenue under Ind AS 18

- ▶ Current rules of Ind AS 18 say that ABC should apply the recognition criteria to the separately identifiable components of a single transaction (here: handset + monthly plan).
- ▶ However, **Ind AS 18 does not give any guidance** on how to identify these components and how to allocate selling price and as a result, there were different practices applied.
- ▶ For example, telecom companies recognized revenue from the sale of monthly plans in full as the service was provided, and no revenue for handset – they treated the cost of handset as the **cost of acquiring the customer**.
- ▶ Some companies identified these components, but then limited the revenue allocated to the sale of handset to the amount received from customer (zero in this case). This is a certain form of a **residual method** (based on US GAAP's cash cap method).
- ▶ For the simplicity, let's assume that ABC recognizes **no revenue from the sale of handset**, because ABC gives it away for free. The cost of handset is recognized to profit or loss and effectively, ABC treats that as a cost of acquiring new customer.
- ▶ Revenue from monthly plan is recognized on a monthly basis. The journal entry is to debit receivables or cash and credit revenues with CU 100.

Ind AS 115 Vs. Ind AS 18

Revenue under Ind AS 115

Under new rules in Ind AS 115, ABC needs to *identify the contract first (step 1)*, which is obvious here as there's a clear 12-month plan with Johnny.

Then, ABC needs to *identify all performance obligations* from the contract with Johnny (*step 2* in a 5-step model):

- Obligation to deliver a handset
- Obligation to deliver network services over 1 year

The *transaction price (step 3)* is CU 1 200, calculated as monthly fee of CU 100 times 12 months.

Now, ABC needs to *allocate that transaction price* of CU 1 200 to individual performance obligations under the contract based on their relative stand-alone selling prices (or their estimates) - this is *step 4*.

<i>Performance obligation</i>	<i>Stand-alone selling price</i>	<i>% on total</i>	<i>Revenue (=relative selling price = 1 200*%)</i>
Handset	300.00	23.8%	285.60
Network services	960.00 (=80*12)	76.2%	914.40
Total	1 260.00	100.0%	1 200.00

Manufacturing

What you should watch out:

- Should you recognize revenue ***over time or at the point of time***? If over time, how are you going to ***measure the progress*** towards completion?
- How should you account for ***contract modifications***, e.g. for delivering additional items of goods?
- Do you provide ***post-delivery rebates? Volume discounts? Year-end bonuses*** to customers based on total volume ordered during the year? Then you are probably affected by Ind AS 115.
- Should you ***split*** your contract into more performance obligations? This could be the case when you provide some ***warranty period*** for your products – should the warranty be accounted for separately? Are you providing any other services for your products?
- Do you incur certain costs for obtaining the contract, like ***bonuses to sales team***? Maybe you should capitalize them, and not expense them immediately as before.



Real Estate – Construction Companies and Property Developers

RE Construct, property developer, builds a residential complex consisting of 50 apartments. Apartments have a similar size and proportions – however, they can be customized to clients' needs.

RE Construct enters into 2 contracts with 2 different clients (A and B). Both clients want to buy almost identical apartments and agree with total price of **CU 100 000** per apartment. The payment schedule is as follows:

- Upon the signature of a contract, clients pay deposit of CU 10 000 each.
- Milestone: 1 year prior planned completion, RE Construct will deliver progress reports to clients and clients need to pay CU 50 000 each.
- Completion: Upon the completion of the construction, the legal ownership to apartments is transferred to clients and they pay the remaining amount of CU 40 000 each.

Assumed period of construction is **2 years** from the date of contract. RE Construct has the right to retain the payments from any client in the situation when that client defaults on the contract before its completion.

The contracts with clients A and B are NOT identical. Further contractual terms specify that:

- No other specific terms in the contract with client A.
- The contract with client B specifies that **RE Construct cannot transfer or direct** the apartment to another client and in return, the **client B cannot terminate** the contract. If the client B defaults on the contract before its completion (in other words, does not make payments in line with the schedule), RE Construct has the **right for all contractual price if RE Construct decides to complete the contract.**

Real Estate – Construction Companies and Property Developers

Revenue from contract with client A – at the point of time

The contract with client A **does NOT meet** the third criterion.

The reason is that RE Construct builds an apartment that can be **easily sold or transferred to another client** in case of default.

Even when this would be prevented (by writing specifically in the contract), RE Construct has **NO enforceable right to payment** for performance completed to date.

RE Construct will keep **ONLY the progress payments** in the case of client's default and they may not cover entity's cost for work completed to date.

As a result, RE Construct would recognize **revenue at the point of time** – that is when the apartment is transferred to the client A (upon the completion in the year 2).

Revenue from contract with client B – over time

The contract with client B **MEETS the third criterion**.

The reason is that RE Construct cannot direct the constructed asset for the alternative use, because the contract with client B **does not permit transfer of the apartment to another client**.

Also, RE Construct **has enforceable right to payment for performance completed to date**.

Construction contracts under Ind AS 115

Construction company ABC signs a contract in June 20X1 to refurbish a building and install new windows. Total contract price is CU 12 million.

Total expected contract costs are:

CU 6 mil. for windows (purchased from external suppliers);

CU 4 mil. for labor, materials and other costs related to the project.

As of 31 December 20X1:

ABC handed over windows to the client, although the installation has not been completed. However, the client obtained control of windows.

Other costs incurred to 31 December were CU 1 mil.

Just before the year-end, the client paid the first progress payment of CU 8 mil.

How should ABC account for this contract as of 31 December 20X1 in line with Ind AS 115?

Construction contracts under Ind AS 115

How to measure progress towards completion?

You can use either *input or output methods* to measure the progress towards completion. ABC uses input method, i.e. based on *costs incurred to date*.

There may be *no direct relationship between your inputs and the transfer of control of goods or services* to a customer. Therefore, you should exclude the effects of any inputs from input method that do not depict your performance in transferring control of goods or services to the customer (par. B19 of Ind AS 115).

ABC believes that costs of windows are significant item within total costs and including these costs to measure the progress to completion would not be appropriate, because it would certainly overstate ABC's performance.

The reason is that the windows are purchased from the third party and the transfer of windows to the customer has no direct relationship with the other ABC's work.

Therefore, progress towards completion will be measured *excluding the cost of windows*.

Let's measure the progress towards completion:

Total costs excluding windows: CU 4 mil.

Total incurred costs to date excluding windows: CU 1 mil.

Progress to completion: $CU\ 1 / CU\ 4 = 25\%$

Total contract revenue excluding windows: CU 6 mil. (CU 12 – CU 6)

Total revenue to 31 December 20X1 excluding windows: $CU\ 6\ mil. \times 25\% = CU\ 1.5\ mil.$

ABC recognizes the revenue for windows at zero profit margin (equal to their cost – in line with par. B19(b) of Ind AS 115)

Technology and Software development

Technology sector, especially companies involved in a development of software, selling software licenses and providing various related services is famous for the ***diversity of its operations and long-term contracts***.

The main challenges are therefore:

Identification of the ***individual performance obligations*** (e.g. sale of license + customization + post-delivery support) and ***allocating transaction price*** to them

Assessment of the ***progress*** towards meeting the contract

Assessment of the ***licenses*** for the products sold by software vendors or developers.

Ind AS 115 recognizes ***2 types of licenses: license to use and license to access***. The accounting treatment is different for both of them and you should be able to identify which license is in question.

Other difficulties arise in areas common for every industry: dealing with ***contract modifications***, how to account for ***contract costs*** (e.g. commissions for getting the client), etc.



Technology and Software development

ManyBits is a software company who entered into contract with a client C on 1 July 20X1. Under the contract, ManyBits is obliged to:

Provide **professional services** consisting of implementation, customization and testing of software. Client C has bought software license from the third party.

Provide **post-implementation support** for 1 after the customized software is delivered.

Total contract price is CU 55 000.

ManyBits assessed its total cost for fulfilling the contract as follows:

Cost of developers and consultants for implementing and testing the existing software: CU 43 000;

Cost of consultants for post-delivery support: CU 2 000;

Total estimated cost of fulfilling the contract: **CU 45 000**.

As of **31 December 20X1**, ManyBits incurred the following costs of fulfilling the contract:

Cost of developers and consultants for development, implementation and testing the customized modules: CU 13 000.

How should ManyBits recognize revenue from this contract under Ind AS 18 and Ind AS 115?

Technology and Software development

Revenue under previous rules (Ind AS 18)

Here, ManyBits clearly provides professional services and the related revenue falls under the scope of Ind AS 18. Ind AS 18 requires recognizing revenue from similar services using the ***stage of completion including post-delivery services***.

It means that ManyBits treats software development and post-delivery services as ***one big service*** for the purpose of accounting the revenue.

Let's say that ManyBits calculates the stage of completion based on costs incurred for fulfilling the contract.

At the end of 20X1, total incurred cost was CU 13 000, which is **29%** of total estimated cost of CU 45 000.

Therefore, under Ind AS 18, ManyBits' revenue from this particular contract in the year 20X1 is 29% (stage of completion) x CU 55 000 (total contract price) = **CU 15 950**.

Is it the same under IFRS 15?

Technology and Software development

Revenue under the new rules (Ind AS 115)

Ind AS 115 states very precise and detailed guidance on ***whether the goods or services promised under the contract are distinct*** and whether they can be considered ***separate performance obligations or not***.

But here, let's say that software customization services and post-delivery support meet the definition of distinct performance obligations and as a result, they need to be treated separately. We need to look at them as at separate components, and allocate total transaction price of CU 55 000 to them ***based on their relative stand-alone selling prices***.

Let's say that ManyBits' normal charge for the support services is 10% of the package price.

That would imply that the relative split between customization service and post-delivery service is 100:10, which is:

CU 50 000 ($CU\ 55\ 000 / (100 + 10) * 100$) for software development or customization service, and
CU 5 000 ($CU\ 5\ 000 / (100 + 10) * 10$) for post-delivery support.

In the year 20X1, ManyBits ***measures the progress towards the completion of the performance obligation separately***, based on inputs for the fulfilling the contract (costs in this case).

Internal cost estimations show that ManyBits estimated total cost for the contract of **CU 45 000**, thereof CU 43 000 for the salaries of software developers and CU 2 000 for the salaries of consultants providing post-delivery support (based on man-days).

Technology and Software development

Let's measure the progress towards the completion of both individual performance obligations **as of 31 December 20X1**:

Software development services: CU 13 000 (incurred cost)/CU 43 000 (total estimated cost) = 30%

Post-delivery services: CU 0 (incurred cost)/CU 2 000 (total estimated cost) = 0%

As a result, **revenue recognized from this contract in the year 20X1** is:

Software development services: 30% (progress %) * CU 50 000 (revenue allocated to software development) = **CU 15 000**;

Post-delivery services: 0% (progress %) * CU 5 000 (revenue allocated to post-delivery service) = **CU 0**.

Total revenue from the same contract under Ind AS 115: **CU 15 000**.

Contract asset vs. account receivable

What do the rules say?

Contract asset is the term defined in [Ind AS 115](#) as an entity's **right to consideration in exchange for goods or services** that the entity has transferred to a customer, when that right is conditioned on something other than the passage of time, for example the entity's future performance.

Trade receivable or account receivable is a financial instrument defined by IAS 32 as a contractual right to receive cash or another financial asset from another entity.

As you can see, the main difference between the contract asset and a trade receivable is **conditionality**.

Contract asset is a conditional right, while a trade receivable is an unconditional right.

When should you account for a contract asset and when for a trade receivable?

A contract asset arises when you as a **supplier have already performed something** – deliver part of the services or goods as agreed – but under the contract, you still have something to do before you can bill the client.

Contract asset is NOT a financial instrument, so [Ind AS 109](#) does not apply here, with one exception: impairment. So, you have to assess the contract asset for any impairment, determine the expected credit loss and recognize a loss allowance – exactly as with any trade receivables you have.

Example:

You agreed to build a hotline center for your big client. The project will take 9 months and starts 1 July.

Total contract price is CU 100 000. In the contract you agreed that the customer would pay you for the whole project when the hotline is complete and handed over to the customer.

At the year-end, you have been working on the project for 6 months and under Ind AS 115, you need to recognize the revenue based on the progress towards completion. You assess that the project is 70% complete, so you book 70% of the total price – that is CU 70 000.

Agent or Principal

A real estate company, which rents out units to different tenants and charges its own rate on utilities like electricity to tenants, at the rates set by the company (not by utility provider). The company pays the electricity bill for all the property to the utility company based on invoices.

One could arguably say that it is a principal relationship – the real estate company sets own rates to the electricity charged to tenants and it bears the credit risk.

Someone else might say that it is the agent relationship – the main provider of the utility is the utility company and the utility company is responsible for interrupted supply of that utility, like electricity.

For example, electricity bill is \$50 from the electricity company and the real estate company charges \$65 to tenants. How do you recognize revenue and expense?

If it's a principal relationship, is the \$50 a utility expense? But clearly, this is not fair representation because it inflates the real estate company's utility expense. Or would this be cost of goods sold?

Or, is it an agent relationship and you only recognize the difference of 15 as revenue?

Agent or Principal

When are you a principal?

Ind AS 115 says that the entity is a principal **when it controls the good or service before it is transferred** to the customer.

And, Ind AS 115 lists **3 basic indicators** of entity controlling good before the transfer to the customer and thus being a principal:

- Primary responsibility for fulfilling the promises for goods and services,
- Inventory risk, and
- Discretion in establishing prices.

How to identify principal and agent in our present case?

Let's follow the 2 steps:

- What is a **distinct good or service** transferred to the customer? Well, it's just **rent of premises including** the water, electricity and other utilities.

Don't think that the utilities here are distinct, because the customer cannot buy the electricity without renting the apartment in most cases. It is just one bundle.

So, if this is the case, then you will need to assess the principal/agent relationship for the **rental service as a whole**.

Can entity **control the rent or an apartment before** it is transferred to the customer?

Well yes, a real estate company is clearly a principal here, because it is the owner of the apartments and takes care about them.

Thus in this case, utility bill will be just cost of sales and the rental income will be recognized gross, including the electricity charges.

Agent or Principal (in the case of services)

“There is a company whose main activity is selling artist songs through Internet (if you want to download an artist song you have to enter through their web site and you download).

The contract between an artist and Company is that when the end user downloads a song for INR 100, then an artist gets INR 60 and the company keeps INR 40.

How should Company record its revenue?”

Would the situation change if the Company paid to artists to compose and produce songs and music exclusively for the Company?

This is a very *classical issue for telecom operators*, too, because they sell lots of applications, music and other files together with their monthly pre-paid plans or on “pay-as-you-go” basis.

Accounting of warranties under Ind AS 115

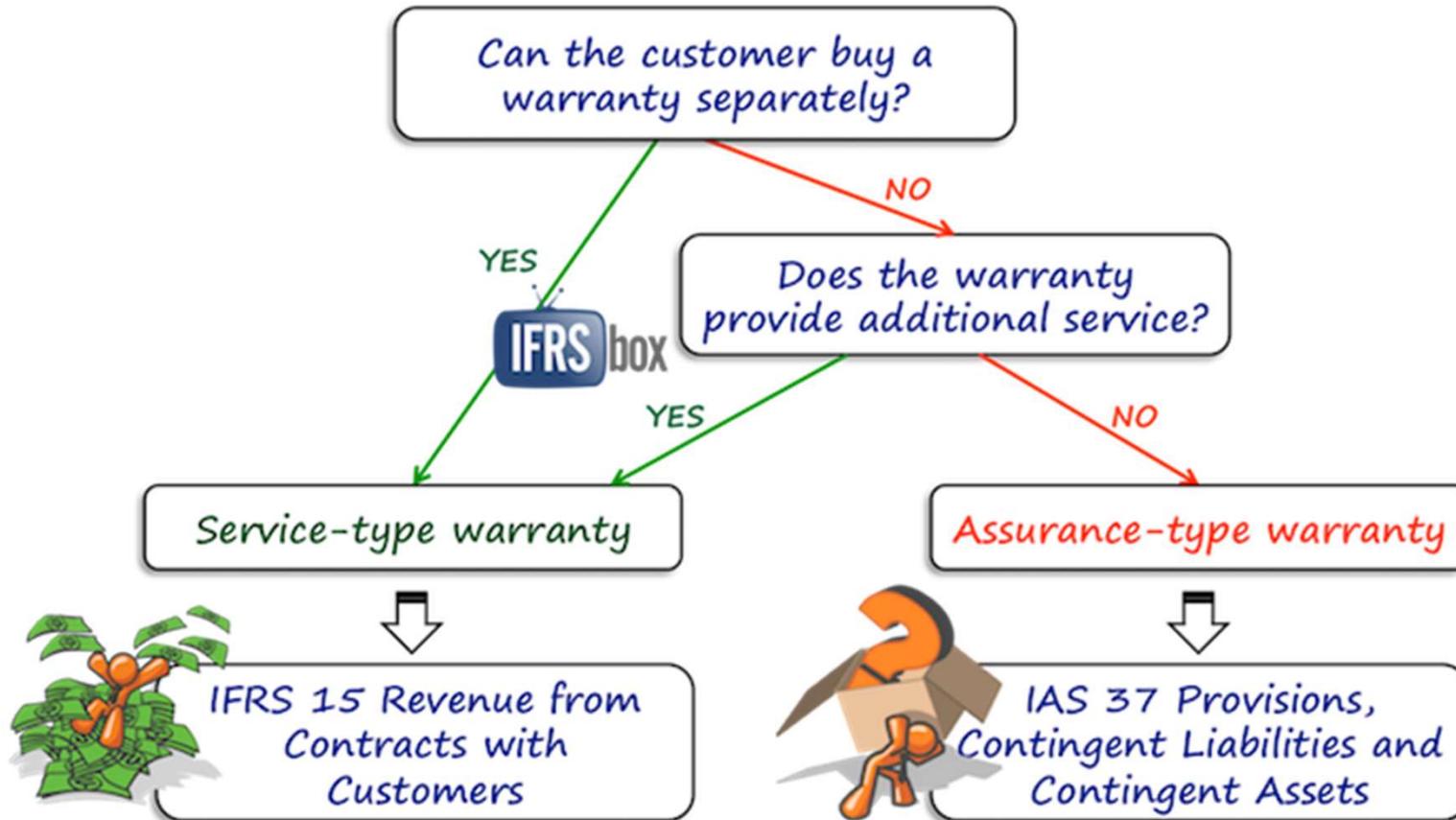
Types of warranties under Ind AS 115

Ind AS 115 contains quite a good guidance about warranties. It specifies that there are two basic types of warranties:

- **Assurance-type warranties** – those are warranties that promise to customer that the delivered product is as specified in the contract and will work as specified in the contract. These warranties **do NOT give rise to a separate performance obligation**, and you account just a provision for warranty repairs [under Ind AS 37](#).
- **Service-type warranties** – those are warranties that provide something additional to the mere assurance, for example – they provide some extra services. These warranties **give rise to a separate performance obligation**, because they provide additional service to the customer and they are [accounted for under Ind AS 115](#).

Before you start accounting for warranties, you need to **determine what type of warranty you have**.

Accounting of warranties under Ind AS 115



Accounting of warranties under Ind AS 115

Illustration: Assurance-type vs. service-type warranty

Let's say that you sell cars.

And, let's say that you have standard cars and luxury cars.

- For standard cars, you provide a warranty period of 2 years as required by the local legislation, but for luxury cars, you provide a warranty period of 3 years. The reason is that you think it may take longer time for hidden defects to show up.

Normally, this 1 year warranty on top of the regular warranty period required by the law would be assessed as the service-type warranty.

However – not here, because it is not considered as additional service due to the fact, that it's a luxury car of higher quality and the first hidden defects appear after longer time than in the standard cars.

Illustration : How to account for the individual warranties?

ABC sells refrigerators for CU 100 and the legal warranty period is 2 years. During these 2 years, ABC must remove all the defects that existed at the time of sale.

The customers can extend this warranty for a fee of CU 20 for another 2 years.

In this case, the first 2 years of warranty period are considered as **assurance-type warranty**, because the warranty cannot be purchased separately – it is guaranteed by the legislation.

So, you should account for this type of warranty **under Ind AS 37 and not as a separate performance obligation in line with Ind AS 115.**

Here, it is a **separate performance obligation, because the customer actually pays for it separately.**

Accounting of gift cards under Ind AS 115

A retail chain sell cloths, accessories and home decorations. They also sell gift cards of certain value for consideration and also provide a gift card for free as bonus with bigger purchases.

➤ **How to account for the gift card at the moment you sell them?**

Gift cards are in other words customer's unexercised rights that will be exercised in some future point. You have to recognize the amount attributable to that unexercised right as a contract liability. When the customer comes to your store, buys some clothes and pays with the gift card, this is the moment when you remove the contract liability and recognize revenue from sale.

➤ **How to recognize revenue from unexercised services?**

Well, this is called also breakage – prepaid, but unused service by the customers. You need to recognize it as revenue in proportion to the pattern of rights exercised by the customer.

➤ **What happens if no one comes to redeem the gift card?**

In this case, you should recognize revenue from breakage when the likelihood of the customer exercising its rights becomes remote.

For example, if the gift cards have some validity period, then you can recognize the revenue from breakage or unused service after the period lapses.

If the gift cards have no validity period and are valid forever, then you should have some past statistics to assess how much time needs to pass before the customer forget about unused gift cards and never come.

➤ **Providing gift cards as a bonus with bigger purchases**

We need to split the transaction price between the individual performance obligations based on the **relative stand-alone selling prices**.

Customer incentives under Ind AS 115

Is the incentive provided to your customer right at the inception of the contract (i.e. is it known before purchase)?

In general, if it's at the inception, then the customer incentive might be considered separate performance obligation because it's a material right and you might need to allocate the transaction price to it.

If it's not provided at the inception, then the customer incentive might be just a bonus to a good client and therefore no allocation of the transaction price to the performance obligation is necessary.

If you provide volume discounts, do you apply them prospectively for new purchases only?

If you apply discounts only prospectively, for new purchases only, this could be seen as a material right – a customer's option to get additional goods at discount.

However, if you apply discounts retrospectively, this is a variable consideration in determining the transaction price.

Do you offer prospective discounts to all customers for big bulk purchases?

If the discount is offered in connection with the specific contract while higher prices are charged to other customers, then you might have a material right.

If you offer the discount to all big bulk customers, then it's not a material right. Instead, you have a variable consideration.

What is a material right?

A **material right** is some benefit provided to a customer that it would NOT receive without entering into the contract.

You should answer 2 basic questions to find out whether there is or is NOT a material right:

➤ **Can your customer get an additional good or service *WITHOUT* entering into the contract?**

If yes, then there's no material right, because the customer can get the goods or services anyway.
If no, then go to question n.2.

➤ **Can the customer buy an additional good or service at the same price as the stand-alone selling price?**

If yes, then there is no material right, because the customer can buy the same at the same price anyway. If no, then yes, there is a material right and you **MUST** treat it as separate performance obligation.

Example 1: Additional services at discount

ABC is a provider of network services and to boost its sales, it offers to each customer who signs up for 12-month contract one month of free service after 12- month period of paid services is over. The price of 1-month service is CU 50.

How shall ABC account for this contract under Ind AS 115?

Example 2: Loyalty points

DEF, the supermarket chain, issues a loyalty card. For each purchase of CU 100, the customer gets 1 point. The customer can get a discount of CU 1 per 1 point on future purchases.

During the December 20X1, customers collected 80 000 points and based on past statistics, DEF assumes that 90% of customers will use these points for future discounts.

What is a material right?

Example 3: Discount coupons

Imagine you run an e-shop with books. To support your sales, you send a discount coupon for INR 50 that your customers can use with every purchase over INR 1000.

How should you account for the discount coupon?

In this particular example, you **don't recognize a provision** in your financial statements for a discount at the time of distributing a coupon. Why?

Because there's no past event. Remember, a customer would have to make a purchase over 1,000 and only then you have a liability to provide a discount of INR 50. Instead, you simply recognize revenue net of Rs 50 discount when a coupon is redeemed.

Example 4: Buy 1, get 1 free (or any free items)

Instead of giving discount coupons, you promise to deliver a book "India cuisine" for free with every purchase of "India travel guide" for INR 50. You normally sell India cuisine for INR 10, its cost in your inventory is INR 6 and the cost of India travel guide is INR 35.

Under Ind AS 18, you simply recognize revenue for both books of INR 50 and cost of sales of INR 41 (35+6).

Cost of free item is not a marketing or promotion cost in this case, because a free item increases revenues (supports spending).

Under Ind AS 115, the transaction price should be allocated based on relative standalone selling price.



Thank you

Head Office:

D-207, Times Square,
Near Marol Metro Station,
Andheri Kurla Road, Andheri East,
Mumbai - 400 072, India

Board Landline No: +91 22 28577990

S G J & Co
Chartered Accountants