# Revenue Recognition – Paradigm Shift

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**Introduction**

The Ministry of Corporate Affairs has notified Indian Accounting Standard 115 titled, "Revenue from Contracts with Customers" on 28th March 2018. This Ind AS is effective for accounting periods, beginning on or after 1st April 2018, replacing the following authoritative pronouncements:

- Ind AS 18 – Revenue
- Ind AS 11 – Construction Contracts
- Guidance Note issued by the ICAI on Accounting for Real Estate Transactions for Ind AS entities.

Ind AS 115 also modifies, among others, Ind AS 16, "Property, Plant and Equipment" in regard to determination of sale of PPE. For evaluation of disposal, the "transfer of control" in accordance with Ind AS 115 is to be referred to.

**Scope**

Ind AS 115 applies to contracts with customers for delivery of goods and services, other than:

- Lease Contracts under Ind AS 17
- Insurance Contracts under Ind AS 104
- Rights and Obligations associated with Financial Instruments covered under Ind AS 109, Ind 110, Ind AS 111, Ind AS 27 and Ind AS 28
- Non-monetary exchanges between companies in the similar line of business to facilitate sale to customers

**Transfer of Control – Core Principle**

The paradigm shift from "transfer of risk and rewards" model to "transfer of control" is the key change envisaged in the new standard. In evaluation of transfer of control of goods or services, a five step model is prescribed in Ind AS 115. This five step model involves:

- Identification of Contract with the Customer
- Identification of Performance Obligation in the Contract
- Determination of Transaction Price
- Allocation of Transaction Price to the Performance Obligation
- Recognition of Revenue when (or as) the entity satisfies the Performance Obligation

**STEP 1 - Identification of Contract with the Customer**

This standard defines a "Contract" as an agreement between two or more parties that creates enforceable rights and obligations. The entity shall account for a contract with customer, within the scope of this standard only if:

- The parties have a contract agreed (in writing, orally or in accordance with other customary business practices)
- Parties are committed to perform their respective obligations
- Rights of parties towards goods and services to be transferred can be identified
- Payment terms for the goods and services to be transferred can be identified
- Contract has commercial substance
- it is probable that the entity will collect the consideration to which it is entitled

**STEP 2 - Identification of Performance Obligation in the Contract**

This standard requires the entity to identify the performance obligation at the inception of the contract. Performance Obligation (PO) constitutes a PROMISE to deliver a good or provide a service. Such PO may be "distinctly identifiable" in the contract or may be in combination with other goods and services. The PO is considered distinct if it meets the following criteria:

- It is capable of being distinct and the customer can benefit from the good of services on its own.
- The Promise to transfer goods or services is separately identifiable from other promises in the contract.

If promises under the contract do not qualify to be a separately identifiable PO, the entity should combine various promises the until the bundled arrangement qualifies to be a PO. STEP 2 involves significant judgement and detailed assessment of promises under the contract.

Some examples / sectors which would have significant impact in identifying a performance obligation in the contract would include:

- Real Estate Sector involving undivided share of land, amenities and common areas.
- Engineering, Procurement and Construction (EPC) involving turn key contracts
- Media Sector involving multiple rights for distribution and marketing
- Information Technology Sector for licensing and after sale customer support and future updates
- Telecom Sector for sale of sim cards, handsets, devices along with network / data activation

**STEP 3 – Determination of Transaction Price**

Transaction Price is the amount of consideration an entity expects to be entitled towards transfer of goods or services to a customer as per the contract and excludes amounts collected on behalf of third parties, like, taxes. In determining the transaction price, the entity shall carefully assess the following elements as part of consideration:

- Variable consideration
- Non cash consideration
- Consideration payable to a customer
- Existence of a significant financing component in the contract.

Some examples / sectors which would have significant impact in determining the transaction price would include:

- Engineering, Procurement and Construction (EPC) involving turn key contracts with escalation clauses for cost incurred over a period of time
- EPC Contracts involving payment of substantial mobilisation advance and payment of retention on conclusion of the Contract
- Telecommunication involving quantity discounts and usage free tariff plans
- Club memberships, concessional fee, point redemption schemes in hospitality and travel sectors.

**STEP 4 – Allocation of Transaction Price to the Performance Obligation**

This new standard requires entities to allocate the transaction price identified to **each separate performance obligation** in proportion to its standalone price. Standalone price can be identified as the price at which the entity would sell the promised good or services **separately** to a customer. If the standalone price cannot be determined, then the following methods could be used:

- Adjusted market assessment approach
- Expected cost plus margin approach
- Residual approach

Some examples / sectors which would have significant impact in allocating the transaction price to the performance obligation would include:

- Telecommunication contracts
- IT contract for sale of licences with upgrades
- After sale services in multiple sectors

**STEP 5 – Recognition of Revenue**

Revenue can be recognised either:

- At a point in time – when customer obtains control over the promised good or services
- Over a period of time – as the customer obtains control over the promised good or services

This standard defines "Control" as the entity's ability to direct the use of and obtain necessary benefits from the asset.

The entity should assess whether the performance obligation is satisfied "at a point in time" or "over a period of time", at the inception of the contact. If the performance obligation is satisfied "over a period of time", the entity shall recognise revenue by measuring the progress towards complete satisfaction of performance obligation at end of each reporting period. This standard identifies two approaches, input and output method for measuring progress.

Some examples / sectors which would have significant impact in arriving at the methodology for recognising revenue would include:

- Real Estate and Construction Contracts
- Joint Development and Arrangements
- Defense Sector involving product development
- Contract manufacturing
- Allowing usage of Intellectual Property and Licences

**Other additional guidance**

Ind AS 115 provides additional guidance concerning the following areas:

- Determination of Contract Cost
- Contract modifications
- Sale with right to return basis
- Consignment arrangements
- Warranties
- Principal and Agent relationship
- Customer acceptance
- Non-refundable upfront fees
- Repurchase arrangements
- Customers rights and options

**Conclusion**

Ind AS 115 having been notified, the listed entities have very limited time to analyse the impact and provide the appropriate disclosures on the results for Q1 of 2018-19. With various complexities involved in the five step approach, it is even more important to maintain adequate records to reconcile the books with the tax books, be it for the purpose of GST or Income Tax. The integration of various books would take a longer period of time with the notification of Ind AS 115. However, India will evidence the impact along with the entire world which has jointly converged to the new standard on revenue. Adequate guidance would also be required from the Institute of Chartered Accountants of India concerning specific sectors.

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