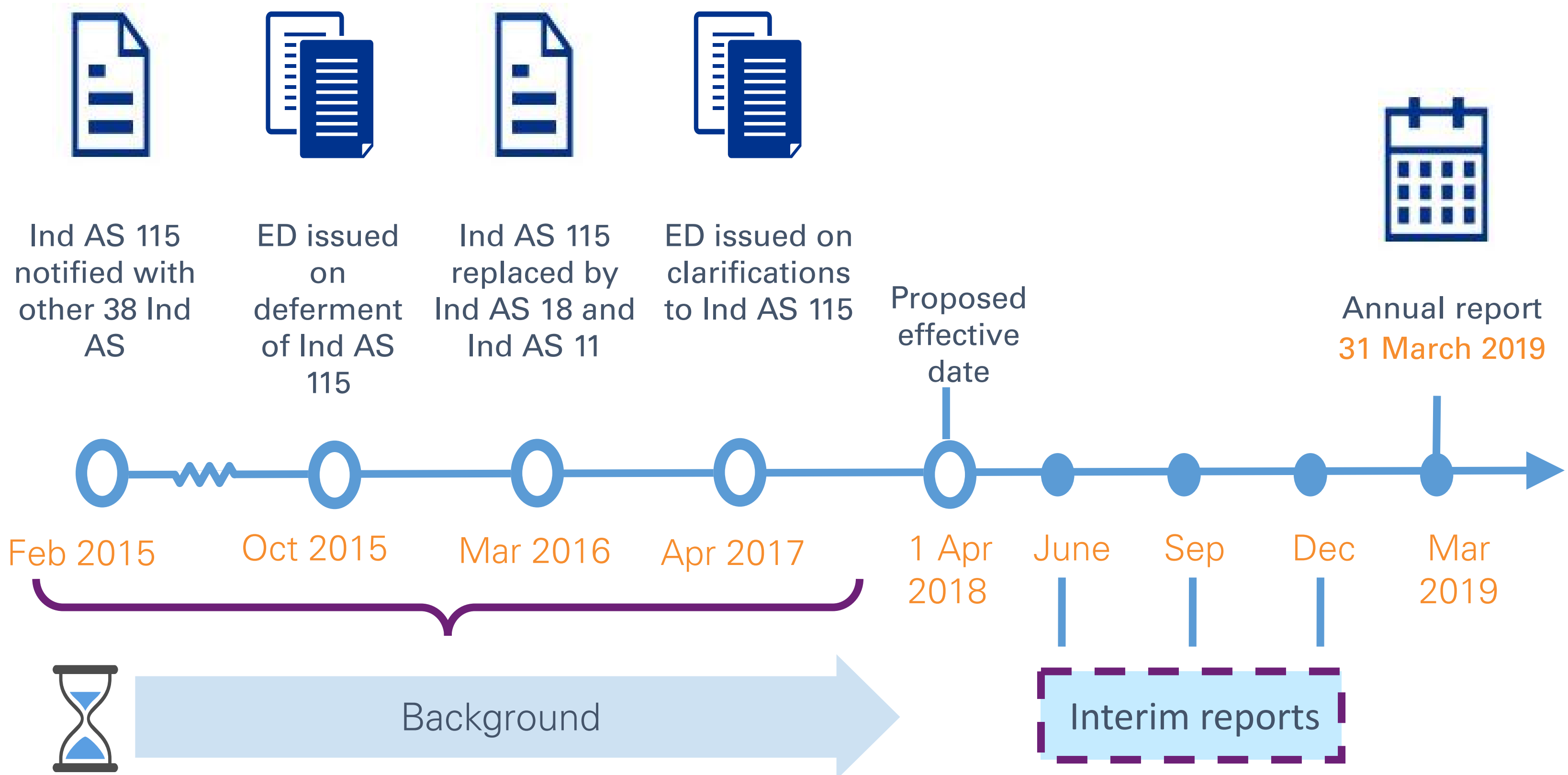
Ind AS 115, *Revenue from Contract with Customers*

Ind AS 115 evolution



Role of Ind AS 115 in Ind AS Implementation roadmap

<table>
<tr><th></th><th>Phase I</th><th>Phase II</th><th>Voluntary adoption</th></tr>
<tr><td>Year of adoption</td><td>FY 2016 - 17</td><td>FY 2017 - 18</td><td>FY 2015 -16 or thereafter</td></tr>
<tr><td>Comparative year</td><td>FY 2015 – 16</td><td>FY 2016 - 17</td><td>FY 2014 -15 or thereafter</td></tr>
<tr><td colspan="4">Covered companies</td></tr>
<tr><td>a) Listed companies</td><td>All companies with net worth >= INR 500 crore</td><td>All companies listed or in the process of being listed</td><td rowspan="2">Any company could voluntarily adopt Ind AS</td></tr>
<tr><td>b) Unlisted companies</td><td>All companies with net worth >= INR 500 crore</td><td>Companies having a net worth >= INR 250 crore</td></tr>
<tr><td>c) Group companies</td><td colspan="3">Applicable to holding, subsidiaries, joint ventures, or associates of companies covered in a) and b) above.</td></tr>
<tr><td>Ind AS 115 compliance</td><td colspan="3">1. Adoption date would be 1 April 2018;
2. FY 2018-19 being the first full year of reporting under Ind AS 115;
3. FY 2017-18 being the comparative period.</td></tr>
<tr><td>Ind AS 115 transition</td><td colspan="3">There are various transition approaches and practical expedients available. Refer following slides for the same.</td></tr>
</table>

Ind AS 115: Global perspective

Ind AS 115 is required to be applied for annual periods beginning on or after 1 April 2018 (as per exposure draft).

Remove inconsistencies and weaknesses in existing requirements to improve comparability

Provide a more robust framework for addressing revenue issues

IASB / FASB Converged Standard

Provide more useful information through improved disclosure requirements

Simplify the preparation of financial statements by reducing the number of requirements by having one revenue framework

Introduction to Ind AS 115

Core principle of Ind AS 115

……is that an entity recognises ***revenue*** to depict the transfer ***promised goods and services*** customers in an amount that reflects the ***consideration*** which the entity ***expects*** entitled ***in exchange*** for those goods or services.

Customer is…

….. "a party that has ***contracted*** with an entity to ***obtain goods or services*** that are an output of the entity's ordinary activities ***in exchange for consideration***".

The new revenue standard is expected to be applicable to Indian companies following the Ind AS road map framework from 1 April 2018.

Ind AS 115 applicability

Out of scope

- AS 17, *Leases*
- Ind AS 104, *Insurance Contracts*
- Rights or obligations that are in the scope of certain financial instruments guidance – 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.

In scope

Contract with a customer

Part of a contract

- Ind AS 115
- Other Ind AS

Portfolio of contracts

- Contract 1
- Contract 2
- Contract 3
- Contract 4

Ind AS 115: Five step model

STEP 1	Identify the contract with the customer
STEP 2	Identify the performance obligations in the contract
STEP 3	Determine the transaction price
STEP 4	Allocate the transaction price Allocate the transaction price to the performance obligation
STEP 5	Recognise revenue when (or as) the entity satisfies a performance obligation

Identify the contract with the customer

STEP 1

- Ind AS 115 defines contract "as an agreement between two or more parties that creates enforceable rights and obligations", which can be written, oral or implied by customary business practices.
- A contract with customer needs to meet all of the following criteria.

A contract exists if legally enforceable and …

- **… 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.**

Combining contracts in Ind AS 115

STEP
1

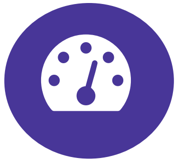
Contracts may be combined and accounted for as a single contract…

… if

Entered into at or near the same time with the same customer ***and*** one or more of the following criteria are met:

Negotiated as package with a single commercial objective.

Consideration in one contract depends on the other contract.



Goods and services are a single performance obligation.

Step 2: Identify the performance obligations

STEP 1	Identify the contract with the customer
STEP 2	Identify the performance obligations in the contract
STEP 3	Determine the transaction price
STEP 4	Allocate the transaction price Allocate the transaction price to the performance obligation
STEP 5	Recognise revenue when (or as) the entity satisfies a performance obligation

Identify performance obligations

STEP

2

Performance obligation ... is an implicit or explicit promise within a contract to transfer distinct goods or services to the customer.

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

Criterio1:

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

Yes

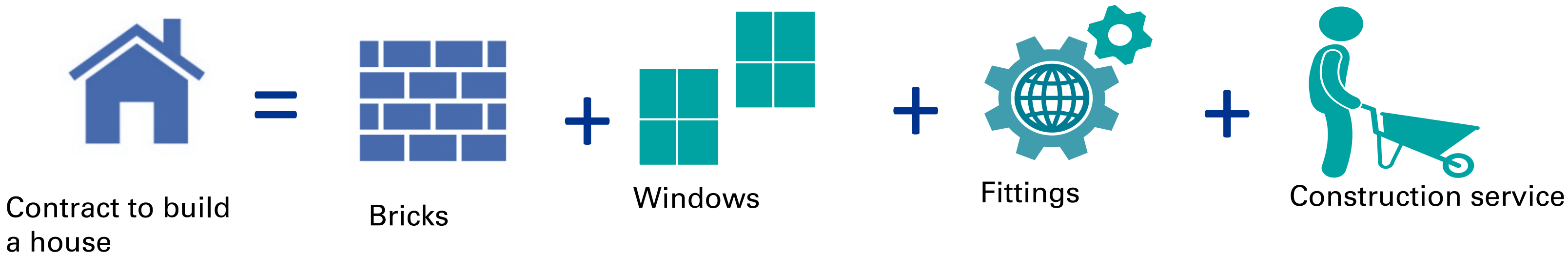
Distinct performance obligation

No

Not distinct – combine with other goods and services.

Single performance obligation - Example

STEP
2



Do the goods and services individually meet the ‘performance obligation’ criteria?

Criterion 1 – Benefit on its own or with other resources	**Criterion 2 – Good or service separately identifiable**
Each material could be used with another readily available item.	Entity is providing a significant integration service.

Multiple performance obligation - Example

STEP

2

Contract

Machine

\+

Standard installation

Installation services are also offered by third party providers.

Do the machine and the installation service meet the ‘performance obligation’ criteria?

Criterion 1 – Benefit on its own or with other resources

Machine and installation can be used with other available resources. ✓

Criterion 2 – Good or service separately identifiable

No significant integration service, installation is a standard service and installation and machine are not highly inter-related. ✓

Step 3: Determine the transaction price

STEP 1	Identify the contract with the customer
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STEP 5	Recognise revenue when (or as) the entity satisfies a performance obligation

Determine the transaction price

STEP 3

To determine transaction price, an entity considers multiple factors:

Variable consideration (and the constraint)

Consideration payable to a customer

… reduction to the transaction price unless it's a payment for a distinct good or service

Transaction price

Non-cash consideration

… measured at fair value unless it cannot be reliably measured.

Significant financing component

Key areas to be considered when determining transaction price: Variable consideration and existence of a significant financing component

Variable consideration

STEP
3

Variable consideration can be

- Discounts
- Credits
- Incentives
- Performance bonuses
- Many more....

Variable consideration is estimated using most appropriate method of either:

- Expected value
- Most likely amount

Estimating variable consideration

STEP
3

Transaction price

Contract to build a jet

Fixed amount: INR100

Completion bonus: INR100

Performance bonus: INR0 – INR100

How would the entity estimate variable consideration?

Completion bonus

Most likely amount

Performance bonus

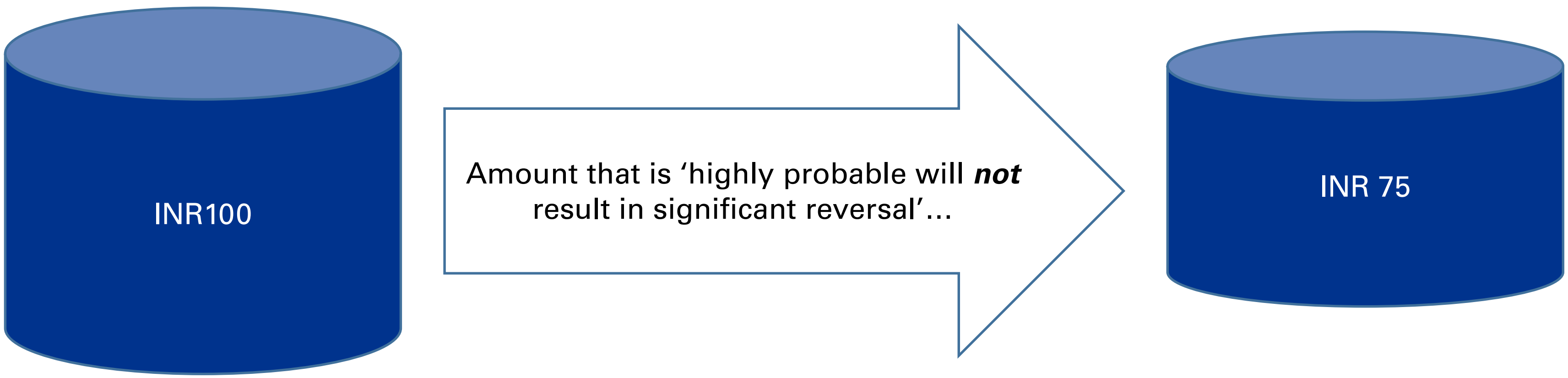
Expected value

Constraint on variable consideration

STEP 3

Estimate of variable consideration

... included in transaction price



Qualitative assessment	• The likelihood of a reversal arising from an uncertain future event. • The magnitude of the reversal if the uncertain event occurs.

Significant financing component

STEP 3

Indicators of a significant financing component

- Transaction price compared to cash selling price.
- Period between payment and delivery.
- Other reasons for payment terms.

Discount rate

- Rate that would be used in separate financing transaction between the entity and customer.

Practical Expedient

- No adjustment required if the period between performance and payment is 12 months or less.

Step 4: Allocate the transaction price to the performance obligation

STEP 1	Identify the contract with the customer
STEP 2	Identify the performance obligations in the contract
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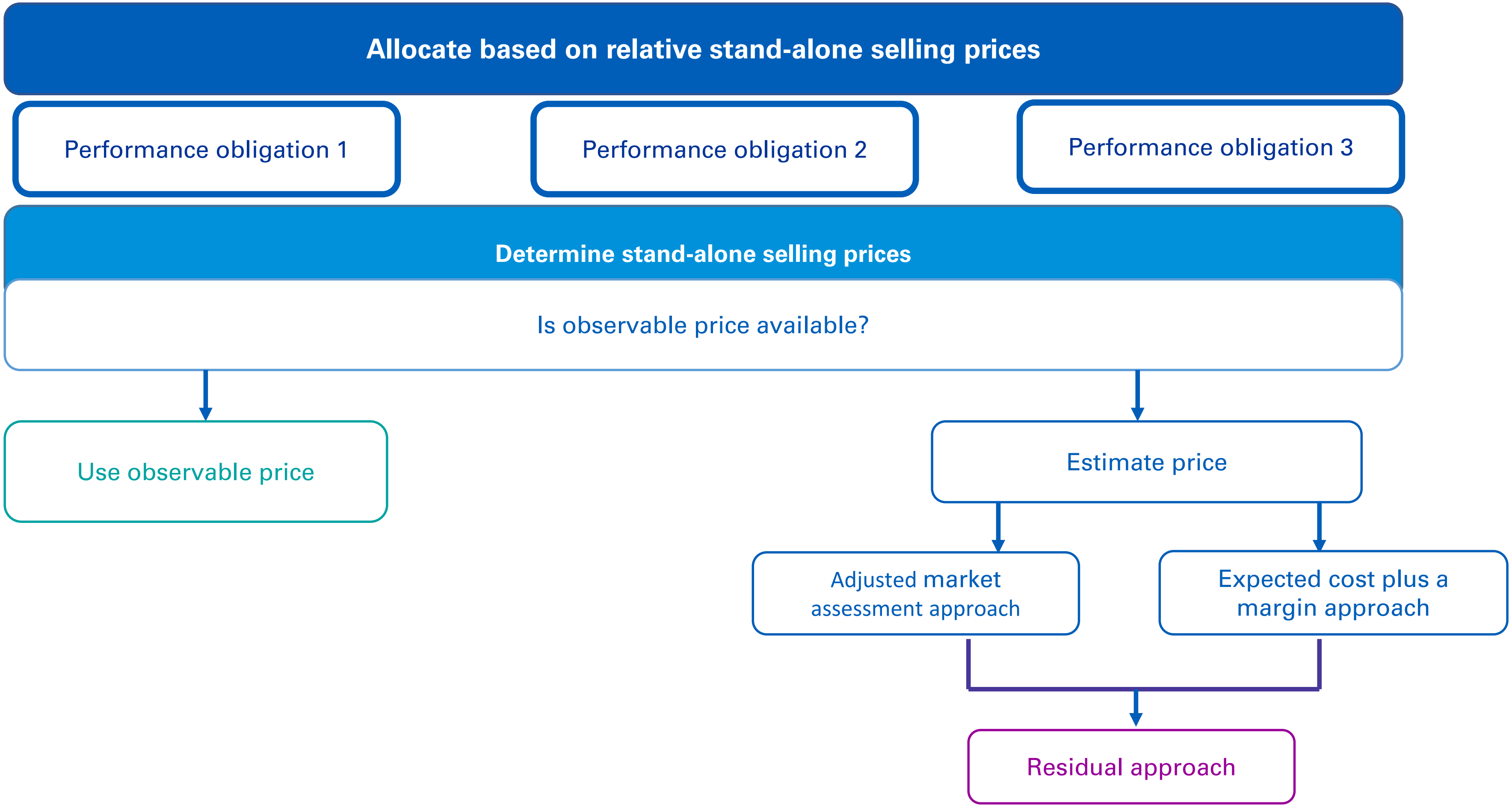
Allocate transaction price to performance obligations

STEP

4



Estimating the selling price

STEP 4

Two year contract – INR650

Phone

Data, calls and texts plan

Entity sells phone and plan separately

INR350

12 month plan for INR15 per month – INR360 (24XINR15)

Methods for estimating stand-alone selling price

Observable price

Observable price

Transaction price allocated to phone = INR650 x (INR350/INR710) = INR320
Transaction price allocated to plan = INR650 x (INR360/INR710) = INR330

Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation

STEP 1	Identify the contract with the customer
STEP 2	Identify the performance obligations in the contract
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STEP 5	Recognise revenue when (or as) the entity satisfies a performance obligation

Performance obligations satisfied over time

STEP 5

A performance obligation is satisfied over time if either:

1	Customer simultaneously receives and consumes the benefits as the entity performs.	Routine or recurring services.
2	Customer controls the asset as the entity creates or enhances it.	Asset built on customer's site.
3	The entity's performance does not create an asset with an alternate use and there is a right to payment for performance to date.	Asset built to order.

'Over time' criteria

STEP
5

Contract to build specialised equipment

Customer can cancel with 30 days' notice

Right to payment to cover costs incurred if contract cancelled

Quarterly payments arrangement

Do the terms meet the no alternate use and right to payment criteria?

No alternate use ✓

Right to payment ✗

Payment needs to approximate selling price of goods and services transferred to date (i.e. payment amount should include a profit margin).

Measuring performance over time

STEP 5

Objective - To depict the entity's performance in transferring control of goods or services promised to a customer

To meet the objective for each performance obligation an entity selects a method that depicts its performance

Output method

- Surveys
- Milestones reached
- Units delivered

Input method

- **Costs incurred**
- **Labour hours**
- **Machine hours**

When using input method consider:

- Uninstalled materials.
- Wastage and inefficiencies.

Performance obligations satisfied at a point in time

STEP
5

Recognise revenue when customer obtains control of the promised asset.

Indicators that control has passed include a customer having…

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

Transition approaches

Transition approaches

Approach	2017	2018	Date of equity adjustment
Full retrospective – no practical expedients	Ind AS 115	Ind AS 115	1 April 2017
Full retrospective – practical expedients	Mixed requirements	Ind AS 115	1 April 2017
Cumulative effect	Ind AS 11/ Ind AS 18	Ind AS 115	1 April 2018

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

Case studies - Real estate/ Construction

Over time v/s point in time

Issue:

- Developer D and the customer enter into a contract for the sale of a real estate unit before the entity constructs the unit.
- D retains legal title to the real estate unit until construction is complete.
- The customer can resell or pledge the right as the real estate unit is being constructed.
- The customer pays a deposit of 10% upon entering into the contract and promises to make progress payments during construction of the unit.
- As per terms of the contract, Developer D cannot direct the unit to another customer. In addition, the customer does not have the right to terminate the contract unless Developer D fails to perform as promised.

Question:

- Should D recognise revenue over time or at a point in time?

Work in progress (1/2)

Contractor P

Contractor P enters into a fixed price contract of 6,000 with Customer Q to refurbish a three-storey building including installation of new elevators

Customer Q

Relevant facts of the case:

- The consideration is payable at two milestones - on installation of the elevators and on completion of works.
- The refurbishment service, including the installation of elevators, is a single performance obligation satisfied over time.
- P is not involved in designing or manufacturing the elevators. but is acting as the principal. Q obtains control of the elevators when they are delivered to the site in December 2016. The elevators are not expected to be installed until June 2017.
- P also delivers a number of homogeneous building materials to the site in anticipation of future activity.
- Under the existing requirements, P uses the milestone method to recognise revenue.
- Under the new standard, P uses the cost-to-cost method (an input method) to measure its progress towards complete satisfaction of the performance obligation. The total costs estimated to be incurred are 4,500.

Work in progress (2/2)

Project costs of 3,000 were incurred up to 31 December 2016, comprising:

Elevator : 1,500

- Including the cost of the elevators in the measure of progress on the contract would overstate the extent of its performance. Hence, such cost is **excluded** from measure of progress with an adjustment to transaction price.
- As control of the elevators has been transferred, P recognises revenue towards elevators at zero margin

Construction Cost : 1,000

- the construct ion costs depict the entity's performance and are therefore **included** in the measure of progress

Materials not yet used : 500

- Materials are homogeneous in nature and could be deployed in another project. Hence, Hence, such cost is **excluded** from measure of progress.
- Control has therefore not yet transferred to Q. P recognises construction materials as inventory.

New approach:

Performance is 33% complete (1,000 ÷ 3,000*)
Revenue recognised: 3,000 (33% of 4,500** + 1,500)
Costs recognised: 2,500 (3,000 - 500)

** Calculated as total estimated costs of 4,500 less cost of elevators of 1,500*

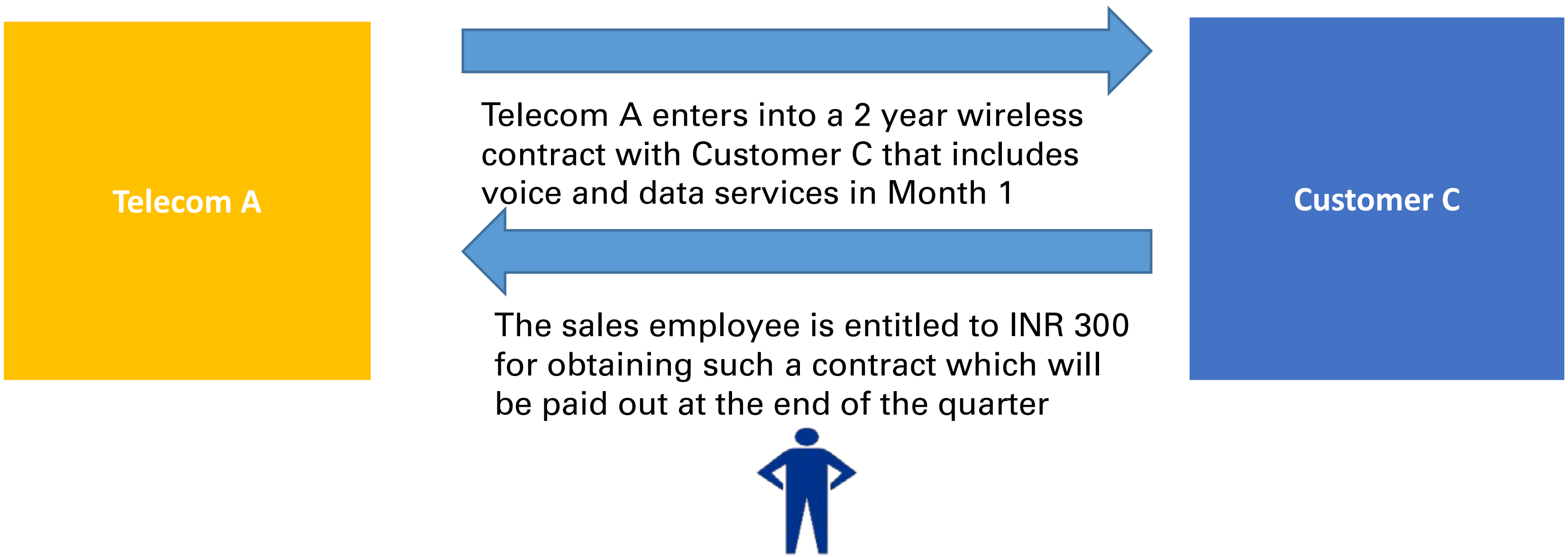
*** Calculated as transaction price of 6,000 less cost of elevators of 1,500*

Existing approach:

Revenue recognised: Nil
Cost recognised: 3,000 (as work-in-progress asset)

Case studies - Telecommunications

Sales commissions



Sales commissions

Solution:

- The sales commission is an incremental cost to obtain the contract with the customer because it is payable only on successfully obtaining the contract.
- Telecom A therefore capitalizes the sales commission of INR 300 as a cost of obtaining the contract in Month 1 and amortised over the contract period including anticipated contracts

Equipment as a separate PO or not

<u>Example:</u> Equipment provided by Telecom entity

2 years service contract for Wi-Fi provided by Telecom A

+

Modem & Router

(Customer X may purchase from Telco or from outside and there is a secondary market as well)

=

Home WiFi service to Customer X

Equipment as a separate PO or not

Solution:

Telco A concludes that the modem and router are each distinct and that the arrangement includes three performance obligations i.e. the modem, the router and the internet services as below:

Criterion 1: Capable of Being Distinct

- Customer C can benefit from the modem and router on their own as they can be resold for more than scrap value; and
- Customer C can benefit from the internet services in conjunction with readily available resources i.e. router and modem can be purchased from outside

Criterion 2: Distinct within the context

- There is no integration as such between the components
- The components do not modify or customize one another.
- The components are not highly dependent on, or highly interrelated with, each other

Case studies - Technology

Set up costs (1/2)

Managed services company M

- **Signs a contract with customer Y to manage its data centre for five years for a fixed monthly fee.**
- **Designs and builds a technology platform to migrate and test Y's data.**
- **The platform is not transferred and is not considered a separate performance obligation.**
- **The initial costs incurred to set up the platform are as follows**

Sales commission	20
Design service	40
Hardware and software	210
Migration and testing	100
Total	**370**

Set up costs (2/2)

- The set up costs relate primarily to activities to fulfil the contract but do not transfer goods or services to the customer. M accounts for them as follows.

Type of cost	Accounting treatment
Hardware	Accounted for under guidance for property, plant and equipment
Software	Accounted for under guidance for intangible assets.
Design, migration and testing of the data centre	Capitalised and amortised under the new standard because they: – relate directly to the contract – generate or enhance resources of the entity that will be used to satisfy performance obligations in the future; and – are expected to be recovered over the five-year contract period.

Software license and customisation (1/2)

- **Company M licences product P – asset management system software – to customers.**
- **P functions without any customisation or modification and can be implemented without M's assistance in its standard form.**

M signs a contract with Bank B

- To grant a licence of P and to provide customization services.
- Add certain off-the-shelf-settings – e.g. an option to access and value a portfolio in multiple foreign currencies.
- Modification and configuration of P is expected to take a long time and will significantly affect B's ability to use P

Software license and customisation (2/2)

Solution:

Company M concludes that there is only one performance obligations i.e. the customised software as below:

Criterion 1 : Capable of being distinct

- M determines that the software licence and the modification services are capable of being distinct, because:

– B could derive benefit from the licence for P on its own or with readily-available implementation services; and

– B can benefit from the modification services together with the licence to P that is transferred at contract inception.

Criterion 2 : Distinct within the context

However, M determines that the licence and the modification services are not separately identifitable – i.e. there is a single performance obligation. This is because:

– the modification services significantly customise P; and

– P, in its off-the-shelf form, and the modification service, are inputs to the combined output the customer has contracted to receive – i.e. the customised software.

Case studies - Pharmaceutical

Licensing arrangement

- Company X has developed drug compounds, licenses for which are given to distributors for selling the product in their respective territories.
- In lieu of license, distributor typically agrees to make milestone payments upfront which is linked to product development.
- Linked to such licensing arrangements, a product supply agreement is also entered which requires the distributor to make product purchases only from company X.

Licensing arrangement

Solution:

- X determines that the upfront milestone payments linked to product development are not distinct within the context of the contract.
- This is because the distributor does not derive any separate benefit out of the product development, since the distributor is unable to use the license for anything apart from marketing of the product in future.
- The distributor has to mandatorily purchase the products from company X and accordingly, may not benefit from the product development activities carried out by company X other than purchasing the product from X.

Licence fee - separate PO or not and timing

- Pharma Company 'P' enters into an arrangement with Customer 'C'. Under the arrangement, C receives a licence for exclusive worldwide rights to Compound B.
- Compound B has shown promising results in early testing but still requires further research and development before it can be commercialised.
- P will perform the R&D services associated with seeking approval of B for commercial sale, which primarily relate to testing and validating its efficacy. The R&D services required to develop B further could be performed by another pharma company.

Licence fee - separate PO or not and timing

Contract includes two performance obligations

Licence

R&D Service

Rationale for separate POs:

P determines that the licence and the R&D services are distinct as:

- the R&D services required to take B through to commercialisation are not unique or specialised – i.e. other entities could perform them;
- the required R&D services do not have a transformative effect on the licence; and
- P's services do not change the nature of B.

Timing of revenue recognition:

- **P concludes that the nature of the licence is the right to use and will recognise revenue at a point in time.**
- **C consumes the benefits of the R&D services as they are being provided. Therefore P will recognise revenue from R&D services over time**

Sectoral impacts

Construction/ Real Estate

- Separate performance obligations (for ex: amenities, club house membership, etc.)
- Percentage completion method v/s completed contract accounting
- Evaluation of measure of progress (output method or input method) not a free choice
- Accounting for uninstalled materials
- Estimation of variable consideration (penalties, incentives, etc.)
- Timing of revenue recognition for claims and incentives may change
- Significant financing component for advance payment terms
- Capitalisation of costs of obtaining contracts
- Capitalisation of amounts related to future performance

Telecommunications

- Accounting for bundled contracts based on stand-alone selling prices
- Whether devices are a separate performance obligation
- Implicit price concessions if it becomes a customary practice
- Accounting for upfront fees in the nature of installation fee, connection fee
- Costs to obtain a contract – employee commissions, dealer commissions, initial set-up costs, etc.
- Significant financing component i.e. time value of money
- Contract modifications
- Portfolio accounting

Technology - IT/ ITES

- Assessment of separate performance obligations – licenses, customization, installation, cloud services, access keys, hosting customer support and updates
- Over time or point in time revenue recognition
- Allocation of discounts and using stand-alone selling prices
- Royalties – specific guidance (sales based) or general guidance
- Variable consideration and customer options for installation fee, upfront fee, price concessions, discounts and refunds
- Measure of progress for customized software, outsourcing, anti-virus
- Costs – sales commissions, renewal commissions, set-up costs, customization costs and license costs

Pharmaceuticals

- Identification of separate performance obligations – ex: license for compound with R&D and manufacturing services
- Over-time or point-in-time revenue recognition – ex: intellectual property licenses, milestones, R&D services and contract manufacturing
- Estimation of revenue for variable considerations in cases of milestone payments, volume discounts, bonuses and right of return
- Royalties – specific guidance (sales based) or general guidance
- Accounting of significant financing components in case of advance or deferred payment terms
- Accounting for Collaborative arrangements

Q&A

Thank you