

Tracking IFRS Exposure draft on revenue recognition

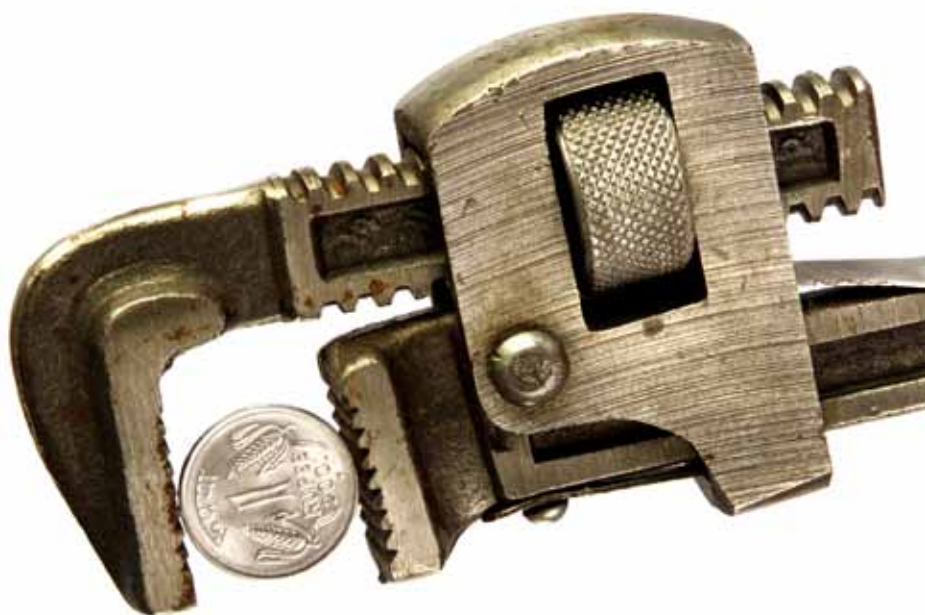
1. Why is it important for you?

The Exposure Draft (ED) proposes fundamental changes to the principles of revenue recognition. The ED proposes that the new standard would be applied retrospectively, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The ED does not specify an effective date for the new standard but proposes to permit first-time adopters to early adopt the new standard; however, early adoption may not be permitted for existing IFRS users. Entities in India will transition to the Indian accounting standards converged with the IFRSs from 2012 onwards. If the effective date is shortly after the final standard is issued or close to convergence date, it may be useful to evaluate the proposals in this ED and assess the implications. The first-time adopters may find it more beneficial to early adopt the standard to adapt systems and processes to the new requirements and avoid significant changes soon after transition to IFRS.

2. Scope of the new standard

The ED defines revenue as income arising in the course of an entity's ordinary activities. The new standard will apply to all contracts with customers except:

- lease contracts within the scope of IAS 17 *Leases*
- contractual rights and obligations within the scope of IFRS 9 *Financial Instruments* or IAS 39 *Financial Instruments: Recognition and Measurement*
- insurance contracts within the scope of IFRS 4 *Insurance Contracts*
- non-monetary exchanges between entities in the same line of business to facilitate sales to customers other than the party to exchange



This document contains only preliminary understanding and observations on the ED and should not be relied upon for complete knowledge of the subject; kindly visit www.iasb.org for full text of the ED.

IASB-FASB joint ED on 'revenue'

- The International Accounting Standards Board (IASB) and U.S. Financial Accounting Standards Board (FASB), in their commitment to convergence of accounting standards and a single set of high quality global accounting standards, have taken various joint projects to improve and issue new accounting standards.
- One of them, and inarguably one of the most important, is the joint project on 'revenue'.
- On 24 June 2010, the boards have published an exposure draft of the jointly developed standard on 'Revenue from Contracts with Customers' and propose amendments to the IFRSs and the FASB Accounting Standards Codification.
- The ED issued by the IASB proposes that the new standard will supersede IAS 11 *Construction Contracts*, IAS 18 *Revenue*, IFRIC 13 *Customer Loyalty Programmes*, IFRIC 15 *Agreements for the Construction of Real Estate*, IFRIC 18 *Transfers of Assets from Customers*, and SIC 31 *Revenue - Barter Transactions Involving Advertising Services*.
- The ED issued by the IASB is open for comments by 22 October 2010.
- The standard is expected to be finalized in 2011.
- This paper seeks to highlight the summary of the ED issued by the IASB and preliminary observations with respect to the current practices being followed in India.

Sale of assets within the scope of IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* or IAS 40 *Investment Property* shall be measured and recognised in accordance with the principles of the ED.

3. Core principle of the new standard

The core principle in the ED is that an entity shall recognise revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration the entity receives, or expects to receive, in exchange for those goods and services.

To apply the core principle, an entity shall:

1. identify the contract(s) with a customer;
2. identify the separate performance obligations in the contract;
3. determine the transaction price;
4. allocate the transaction price to the separate performance obligations; and
5. recognise revenue when the entity satisfies each performance obligation.

3.1 Identify the contract(s) with a customer

The ED states that the new standard shall be applied to a contract, which can be oral or written or implied by the entity's customary practice, and must have a commercial substance, and creates enforceable rights and obligations of the entity and the customer.

Combination and segmentation of contracts

The principle of price interdependence - Where two or more contracts are interdependent in terms of pricing of goods and services, they should be combined and accounted for as one contract. Such contracts, for example, may be entered into at or near the same time, may be negotiated as a package, or, may be performed concurrently or consecutively.

Conversely, a single contract shall be segmented and accounted for as more than one contract if price of some goods or services is independent of other goods or services.

Contract modifications

A change in the scope or price of a contract should be accounted for together with the existing contract if the price of the modification and the existing contract are interdependent.

Indian context

Presently, under the Indian GAAP, there is no guidance on identification of contracts for revenue arrangements. This is a significant requirement in contrast with the current prevailing practices and would require contract documentation practices, and controls and processes over the same, to be more robust, in the absence of which, applying the requirements of the new standard may prove challenging.

Further, the guidance on bundling or unbundling of contracts does not presently exist under the Indian GAAP. Consequently, this requirement of the proposed standard may impact a large number of revenue arrangements across various industries.

3.2 Identify the separate performance obligations in the contract (multiple element arrangements)

A performance obligation is an enforceable promise (whether explicit or implicit) in a contract. The entity shall account for each promised good or service as a separate performance obligation only if it is distinct. A good or service, or a bundle of goods or services is distinct if an identical or similar good or service is sold separately by the entity or another entity; or it has a distinct utility to the customer and distinct profit margin to the entity. Performance obligations need not be separated if accounting them together results in same amount and timing of revenue recognition.

For example, an entity typically sells product A and B on a stand-alone basis for Rs.100 and Rs.50 respectively. Entity offers a discount of Rs.30 if a customer enters into

Under the current practice, generally only the elements identified in the contract, with a specified contracted price, are accounted for separately based on specified prices; elements in a contract for which no price has been specified are not accounted for separately. Such practices will be required to be evaluated under the new standard.

a single contract to buy product A and B, for Rs.120. Product A and B are to be delivered at different times and are generally, also, sold separately. Under the proposed model, product A and B will be identified as separate performance obligations. Revenue of Rs.120 shall be allocated in the proportion of 100 and 50 i.e. Rs.80 and Rs.40 for product A and B respectively.

Also, refer section 3.5 below on guidance for allocation of transaction price to identified separate performance obligations.

Indian context

Under the Indian GAAP, the guidance on unbundling of multiple element arrangements does not exist except in case of accounting by dot-com companies. With the issue of the new standard, identifying a separate performance obligation will be a significant change from the prevailing accounting practice in case of multiple element arrangements. This will not only require significant resources, efforts and judgement, but will also impact the timing and pattern of revenue recognition. Entities in sectors like telecommunications, manufacturing, healthcare and technology may be affected.

3.3 Recognise revenue when the entity satisfies each performance obligation (the recognition principle)

An entity shall recognise revenue when it satisfies a performance obligation by transferring a promised good or service. A good or service is transferred when the customer obtains control of that good or service.

Control is the ability to direct the use of, and receive the benefit from, a good or service. The ability to direct the use refers to the right to use the asset for the remaining economic life or to consume the asset. The ability to receive the benefit refers to the right to obtain substantially all of the potential cash flows from the asset.

Indicators that the customer has obtained control are that if the customer has the legal title, if the customer has physical possession, if the customer has an unconditional obligation to pay, or if the design or function of good or service is specific to the customer or the customer has the ability to specify major changes to design or function.

None of these indicators, however, are individually or collectively conclusive and other facts and circumstances may have to be considered.

Continuous transfer of control

In case of continuous transfer of goods or services, an entity shall apply a suitable method of revenue

Indian context

The recognition criteria of transfer of control to the customer may result in delayed revenue recognition in long-term construction-type, production-type and software development contracts.

As against the current practice, under Indian GAAP, of recognising revenue generally on a percentage of completion method, revenue may have to be recognised only on completion of the contract. Under the proposed guidance, continuous revenue recognition will be possible only if the customer obtains the control of the asset as it is developed.

For example, consider an entity developing real estate enters into a contract with a customer for the sale of a specific apartment. The customer pays a deposit that is refundable only in case the entity fails to deliver the apartment. The customer is able to choose from a range of standardised options specified by the entity. In this example, the customer obtains title and physical possession of the apartment only on completion of the contract. Additionally, the customer cannot specify major structural changes to the design of the apartment. Consequently, the entity's performance obligation is to provide the customer with a completed apartment because the customer does not obtain control of the apartment until completion of the contract.

Accordingly the changes proposed by the ED may significantly affect the revenue recognition from contracts in large number of industries such as real estate and construction, infrastructure, aircraft manufacturing and software.

Under the new recognition principle, proposed in the ED, percentage of completion method will be restricted to fewer revenue arrangements. This may result in delayed revenue recognition in long-term construction-type contracts.

recognition, for example percentage of completion based on outputs, or inputs, or passage of time.

3.4 Determine the transaction price (the measurement principle)

Transaction price is the amount of consideration that an entity receives, or expects to receive, from a customer in exchange for transferring goods or services, excluding amounts collected on behalf of third parties (for example, taxes). Transaction price reflects the probability-weighted amount of consideration that an entity expects to receive from the customer i.e. the 'expected value' approach.

For example, if the entity expects to refund some or all of the consideration received, revenue should be deferred and refund liability recognised at the expected value.

When determining the transaction price, an entity shall consider the effects of

- collectibility (for example, an entity sells a product for Rs.100 and expects to realise only Rs.80 on account of credit risk; the amount of revenue shall only be Rs.80 and any difference in realisation shall be accounted for as a gain on the receivables. Say, in this case, if the entity realises Rs.70 or Rs.90, the loss or gain, respectively, of Rs.10 shall be recorded separately from revenue as expense or income)
- the time value of money,
- non-cash consideration, and
- consideration (cash or credit) payable to the customer.

Indian context

Under the Indian GAAP, when the ultimate collection cannot be assessed with reasonable certainty, revenue recognition is postponed. However, under the proposed standard, revenue will be recognised at the amount entity expects to realise from the customer.

Further, presently, under the Indian GAAP, there is no guidance with respect to accounting of time value of money. Under the proposed standard, time value of money especially in case of long term contracts, where payments are received in advance or are deferred beyond normal credit period, will have to be recognised as finance expense or income, respectively, if material.

Unlike the practice followed under Indian GAAP for recording non-monetary exchanges at carrying value, the same will have to be recognised at fair value.

Presently, there is no guidance under the Indian GAAP to account for consideration payable to the customer and mixed accounting practices prevail, like accounting for credit for volume discounts. Under the proposed standard, there is detailed guidance which may need to be evaluated.

Under the proposed standard, guidance on determination of transaction price will not only change certain accounting practices across all industries, it will also require significant judgement and estimates to apply these requirements, e.g. to determine the expected amount of recovery from the customer.



3.5 Allocate the transaction price to the separate performance obligations

An entity shall allocate the transaction price to all separate performance obligations in the proportion of underlying stand-alone selling price of good or service. The stand-alone selling price is the observable market price; however, where such price is not available, it can be estimated using methods like 'expected cost plus a margin approach' and 'adjusted market assessment approach'.

A change in the transaction price after the inception of the contract shall be allocated on the same basis as at the contract inception, amount allocated to satisfied performance obligations shall be recognised immediately.

Also, refer section 3.2 above for guidance on identification of separate performance obligations in a contract and an example on allocation of transaction price.

Indian context

Compared with the Indian GAAP, this proposal may have a significant impact on the timing and pattern of revenue recognition for multiple element arrangements. Both, the obligations identified and the allocation of transaction price to the various obligations could significantly vary from the current practices. Further, in applying the new model of revenue recognition, an entity will be required to make significant judgements and use estimates more extensively in determining the transaction price, not only where such prices are required to be estimated but also where such prices are to be observed from the market.

4. Other key aspects of the new model

Onerous performance obligation

An entity shall recognise a liability and a corresponding expense if a performance obligation is onerous. A performance obligation would be onerous if the direct costs that would be incurred to satisfy the obligation are greater than the allocated transaction price; a liability would be recognised for that individual performance obligation even if the contract as a whole is not onerous.

Indian context

As a result of the proposed guidance, onerous arrangements will have to be assessed and accounted for on performance obligation basis, and a provision will have to be recognised for such onerous performance obligations even if the contract as a whole is profitable. Thus, if there is a loss on a portion (in relation to performance obligation identified separately as per section 3.2 above) of a contract, that will have to be recognised even before the profitable portions are delivered and accounted for. Entities evaluating contracts as a whole for onerous performance obligation liability will have to assess the impact and change the practice.

If a performance obligation in a contract is onerous, a provision for loss will have to be recognised even if the contract as a whole is profitable.

Contract costs

Contract costs, not eligible for capitalisation under other IFRSs, can be capitalised if they relate directly to the contract, relate to future performance and are expected to be recovered. Such costs shall be classified suitably, for example, intangible or work in progress.

Indian context

Under the Indian GAAP, there is no specific guidance on accounting for contract costs and divergent practices have been noted for the contract costs to be capitalized or expensed. The ED contains specific and detailed guidance on accounting for direct contract costs.

Sale of non-financial assets

The sale of assets that are not an output of the entity's ordinary activities are outside the scope of the proposed standard. However, the ED proposes that recognition and measurement principles of the ED apply to contracts for the sale of assets within the scope of IAS 16, IAS 38 or IAS 40. The ED proposes consequential amendments to these standards to align their derecognition principles to the principle of transfer of control proposed in the ED.

Product warranties and product liabilities

Product warranties to provide customers coverage for latent defects would not be separate performance obligations. The only amount of revenue not recognised will be for replacement of defective products, or for the portion of transaction price attributed to the repair of the products.

Under the current practice, under Indian GAAP, warranty obligations are provided for as expense and revenue is not deferred. Such practices will have to be changed under the new standard.

In case of warranties to provide coverage for faults that arise after the product has been transferred to the customer, the transaction price shall be allocated between the product and the warranty, warranty being a separate performance obligation.

Indian context

Under the current practice, under the Indian GAAP, warranty obligations are generally accounted for as expense and revenue is not deferred for the same. Further, the Indian GAAP does not require a distinction between warranties covering only latent defects and/or other defects.

The ED contains detailed guidance on accounting for product warranties. Under the principles contained in the ED, while accounting for warranty obligations, some portion of revenue shall be deferred in case of warranties containing only latent and/or other defects.

The proposed guidance will require review of existing warranty policies and setting up of system and processes to distinguish between the types of warranties specified under the proposed standard. This will significantly affect industries like manufacturing, automobile and consumer electronic goods.

For example, an entity sells 1,000 products for Rs.1,000 each. The entity is required by law to warrant its products for replacement for 90 days against defects existing at time of sale. The entity also gives an extended warranty for another 90 days and promises to repair the defects arising during the period. The entity expects 1% of products expected to be replaced. The products returned by the customers are scrapped. The extended warranty of 90 days can also be purchased separately for subsequent periods for Rs.100 which is its fair value. The fair value of the product without extended warranty is Rs.900 apiece.

Under the proposed guidance,

- the amount of revenue to be deferred for extended warranty shall be Rs.100,000 [$1,000 \times \text{Rs.}100$] (assuming it includes 1% replaced products also). Note that a warranty covering defects other than just the latent defect is identified as a separate performance obligation. The amount of Rs.100,000 represents contract liability on account of unfulfilled performance obligation to provide extended warranty and shall be recognised over the period of extended warranty.
- the amount of revenue to be deferred for legal warranty shall be Rs.9,000 [$1,000 \times \text{Rs.}900 \times 1\%$]. Note that warranty covering only latent defects is not considered a performance obligation separate from the obligation to transfer a defect free product. The amount of Rs.9,000 represents contract liability on account of unfulfilled performance obligation to transfer defect free product to the customer and shall be recognised when the products are replaced or at the end of 90 days, whichever is earlier.
- The amount of revenue recognised upfront shall be Rs.891,000.



Principal versus agent consideration

Under the proposed standard, specific guidance is provided to determine whether an entity is acting as a principal (wherein it would record gross revenues) or as an agent (wherein it would record only the agency fee/ commission) on behalf of another entity. The indicators include determination of party primarily responsible for fulfilment of the contract, entity carrying the inventory risk, entity carrying the credit risk, etc.

Indian context

Indian GAAP did not provide guidance on identifying the agency and principal relationships. Accordingly, many entities were not performing evaluation that whether they were principal or agent, especially in transactions where they were not clearly defined as agents. In such cases, revenues were recognized on a gross basis; however, under the new guidance some of such transaction may get concluded to be agency transactions and revenues will be limited to net amount (earned as for being an agent of another party). This guidance may impact the revenue amounts and will require processes and controls to be established to identify and appropriately classify contracts where the entity is acting as a principal or as an agent.

Non-refundable upfront fee

Generally, upfront fee is in the nature of an advance payment for future goods and services, and it will be difficult to conclude that upfront fee is attributable to separate performance obligation. If upfront fee is concluded not to be a separate performance obligation, it cannot be recognized immediately. Facts and circumstances of every relevant case will have to be carefully examined.

Indian context

The proposed guidance with respect to non-refundable upfront fee will have to be carefully examined in order to recognise such amounts as revenue immediately. This may cover transactions such as activation fee charged by telecom companies, setup fees charged by IT and IT enabled services, lifetime fees charged by credit card companies and health clubs.

Licensing and rights to use

Contracts for grant of control of substantially all the rights associated with an intellectual property shall be accounted for as sale of intellectual property. If the customer does not obtain control, grant of exclusive

Under the proposed standard, it will be difficult to recognise non-refundable upfront fees as revenue immediately, as against the current practice under Indian GAAP.

rights shall be recognised during the period in which customer has the right to use the intellectual property. A contract, where a customer is granted non-exclusive rights, results in a performance obligation which is satisfied when the customer is able to use and benefit from the rights.

For example, revenue from a contract to grant exclusive rights to a franchisee to open and run a store anywhere in a specified region for a period of five years will be recognised over the period of five years, i.e. the period over which the customer has the right, even if the revenue amount is received upfront and there are no further/other obligations.



To meet the extensive new presentation and disclosure requirements, system and processes will have to be customised to be able to generate the required data in a timely manner.

Indian context

Under the Indian GAAP, there is no distinction between exclusive and non-exclusive rights, and, under the current practices, revenues are generally recognized upon grant of the license. The proposed guidance with respect to licensing and right to use may affect industries like entertainment and media, technology and franchisor-franchisee arrangements.

Customer loyalty programmes

A contract that rewards a customer with loyalty points which can be redeemed on future purchases gives rise to two separate performance obligations. The transaction price shall be allocated to the product and loyalty points on a relative stand-alone price basis.

Indian context

Presently, under the Indian GAAP, in the absence of specific guidance, certain entities are not accounting for such loyalty awards separately. However, under the proposed standard, entities will have to account loyalty awards as separate performance obligations and revenue attributable to the loyalty awards based on their fair value will have to be deferred. This will affect industries like airlines and retail.

Use of estimates

The proposed model requires use of estimates more extensively than presently under the Indian GAAP; for example in areas such as determining the transaction price (estimating variable consideration, time value of

money, fair value for non-monetary exchanges, estimating consideration payable to customers) and determining the stand-alone selling price. This would require establishing systems and processes around the estimation process.

Others

The other specific application issues that may be impacted are sale of products with a right of return, consignment arrangements, bill-and-hold arrangements, sale and repurchase of asset, etc. as the proposed standard contains detailed guidance in these areas.

5. Presentation and disclosures

The ED proposes extensive presentation and disclosure requirements. The ED requires presentation of contract as either a contract asset (for example unbilled revenue) or a contract liability (for example refund liability or deferred/ unearned revenue) depending on the satisfaction of performance obligations. The ED requires qualitative and quantitative information about contracts with customers and the significant judgements made in applying the new requirements.

Disclosures regarding contracts with customers include disaggregated revenue information, reconciliation of contract balances, information about performance obligations, and onerous performance obligations. Significant judgements will be required in determining timing of satisfaction of performance obligation and determining the transaction price and allocating it to performance obligations.

Contacts

For more information, please contact:

Ritesh Sanyal

Senior Director

Deloitte Touche Tohmastu India Private Limited

+91 80 6627 6111

rsanyal@deloitte.com

Yogesh Sharma

Director

Deloitte Touche Tohmastu India Private Limited

+91 80 6627 6120

yogsharma@deloitte.com

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

This material and the information contained herein prepared by Deloitte Touche Tohmastu India Private Limited (DTTIPL) is intended to provide general information on a particular subject or subjects and is not an exhaustive treatment of such subject(s) and accordingly is not intended to constitute professional advice or services. The information is not intended to be relied upon as the sole basis for any decision which may affect you or your business. Before making any decision or taking any action that might affect your personal finances or business, you should consult a qualified professional adviser. None of DTTIPL, Deloitte Touche Tohmastu Limited, its member firms, or its and their affiliates shall be responsible for any loss whatsoever sustained by any person who relies on this material."