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Revenue recognition – The change is here

March 2018

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Revenue recognition - the future is here

In May 2014, the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) issued their long-awaited converged standard on revenue recognition. These standards are required to be adopted by the IFRS and US GAAP reporters from 1 January 2018. The Ministry of Corporate Affairs (MCA) has notified Ind AS 115, 'Revenue from Contracts with Customers', on 28 March 2018, which is effective for accounting periods beginning on or after 1 April 2018.

Ind AS 115 is largely converged with IFRS 15 and ASC 606 issued by the IASB and FASB. The standard contains principles that an entity will apply to determine the timing and amount of revenue to be recognised. The underlying principle is that an entity will recognise revenue to depict the transfer of goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. The standard could significantly change how many entities recognise revenue. The standard will also result in a significant increase in the volume of disclosures related to revenue recognition.

Impact of the new revenue standard

Revenue is one of the most important financial statement measures for both preparers and users of financial statements. The standard will require entities to apply judgement and use estimates in a number of areas. Depending on the nature of the industry and past practices, the new revenue standard may impact identification of performance obligations to be delivered, accounting for contract costs, accounting for right of return, and evaluation of principal-agent relations. The new standard may have an impact on an entity's budgeting and reporting process, IT systems, internal control systems, employee KPIs and bonuses. It may also have tax implications in many circumstances. Hence, early identification of the implications of the new standard is imperative.

Conceptual change - transfer of control vs risks and rewards

Under Ind AS 115, revenue is recognised when a customer obtains control of a good or service, while under existing principles of Ind AS, revenue is recognised when there is a transfer of risk and rewards. A customer obtains control when it has the ability to direct the use of and obtain the benefits from the good or service. Transfer of control is neither the same as transfer of risks and rewards nor similar to the culmination of an earnings process as understood today.

Entities will be required to apply the new guidance to determine whether revenue should be recognised 'over time' or 'at a point in time'. So, as the first step, a company will have to first determine whether control is transferred over time. If the answer to this question is negative, only then revenue will be recognised at a point in time, or else it will be recognised over time.

The difference between transfer of control vis-a-vis transfer of risk and reward can sometimes be subtle and at other times be stark, requiring a detailed understanding of the accounting standard and customer contractual arrangements.

The five-step control model

The core principle of Ind AS 115 is that an entity will recognise revenue to depict the transfer of goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. This core principle is described in a five-step model framework:

- Step 1: Identify the contract with the customer.
- Step 2: Identify the separate performance obligations in the contract.
- Step 3: Determine the transaction price.
- Step 4: Allocate the transaction price to separate performance obligations.
- Step 5: Recognise revenue when (or as) each performance obligation is satisfied.

What is changing from the current GAAP?

Ind AS 115 provides extensive practical guidance in contrast with the extant accounting standard on revenue. Some of the more significant areas where the new standard is different from the existing GAAP are discussed below:

Performance obligation	Entities will have to determine whether there are multiple promises in a contract and whether those promises are distinct. Identification of performance obligation requires understanding what a customer expects to receive as a final product to assess whether goods or services should be combined and accounted as a single performance obligation or separate elements. It is also to be noted that separate performance obligations may be identified based on promises in a contract which may be explicit or implicit, including based on past customary business practices. The consideration will then be allocated to multiple components and revenue recognised when those distinct goods or services are delivered, i.e. when control is transferred.
Variable consideration	There is a diversity in practice in accounting for variable consideration. Under Ind AS 115, if the consideration is variable, then a company will need to estimate this variability at the inception of the contract subject to a constraint, i.e. that is there should not be a significant revenue reversal in the future, which will be reassessed at each reporting period.
Allocation of transaction price based on relative standalone selling price	Entities first evaluate if a contract contains a single performance obligation or separate performance obligations. If separate performance obligations are identified, entities should allocate the consideration to each distinct performance obligation based on their relative standalone selling price. This allocation is based on the price an entity will charge a customer on a standalone basis for each good or service sold separately. Entities will first consider observable data to determine the standalone selling price. Entities will need to estimate the standalone selling price if such data does not exist.
Licenses	Entities that license their IP to customers will need to determine whether the licence transfers to the customer 'over time' or 'at a point in time'. A licence that is transferred over time allows a customer access to the entity's IP as it exists throughout the license period – such revenue is recognised over time. Licences transferred at a point in time allow the customer the right to use the entity's IP as it exists when the licence is granted. The customer must be able to direct the use and obtain substantially all of the remaining benefits from the licensed IP to recognise revenue when the license is granted.
Time value of money	Under the new standard, entities will have to adjust the transaction price for the time value of money if the contract includes a significant financing component. The standard provides certain exceptions to applying this guidance and a practical expedient which allows entities to ignore time value of money if the time between transfer of goods or services and payment is less than one year.

Contract costs	Entities sometimes incur costs (such as sales commissions or mobilisation activities) to obtain or fulfil a customer contract. Contract costs that meet certain criteria will be capitalised as an asset and get amortised as revenue is recognised upon adoption of the new standard. If the contract period is a year or less, then as a practical expedient, such capitalisation may not be required. Under the current standard, such costs are generally expensed as incurred.
Principal versus agent considerations	Extensive guidance is available in the new standard to help entities with the evaluation of principal-agent relationships. In general, an entity is a principal if it obtains control of the specified goods and services before they are transferred to the customer. Determination of whether an entity is a principal or an agent is required to be performed separately for each specified good or service promised to a customer. Determining whether an entity is the principal or an agent is not a policy choice.
Disclosures requirements	Extensive disclosures are required for revenue that has been recognised and revenue that is expected to be recognised in the future from existing customer contracts. Quantitative and qualitative information will have to be provided about significant judgments and changes in those judgments made while recording revenue.

Transition

Entities can apply one of the two transition methods: retrospective or modified retrospective. Retrospective application requires applying the new guidance to each prior reporting period presented. However, the standard provides certain practical expedients in applying the full retrospective method. The modified retrospective transition approach is intended to be simpler than full retrospective application; however, there are still challenges associated with that approach, including additional disclosure requirements in the year of adoption. These additional disclosures effectively require an entity to apply both the new revenue standard and the previous revenue guidance in the year of initial application. Entities should consider the needs of investors and users of the financial statements in deciding which transition method to follow.

Our services

Workstream	*Typical procedures*
1. Impact Assessment	• Desktop review to identify key areas of potential impact by material revenue stream. • Hold workshops with key stakeholders from finance and commercial teams to review and refine listing of potential areas of difference. • Before position papers are created, prepare summary reports to communicate results of impact assessment to senior stakeholders. • Prepare roadmap for conversion to identify key workstreams and resources required to complete the implementation exercise.

Workstream	*Typical procedures*
2. Ind AS 115 accounting policies/ Position Papers	• Update existing revenue recognition policy. • Prepare position papers to provide additional guidance on key areas of judgment.
3. Contract reviews	• Develop tailored contract review checklist (or equivalent) to use in documenting contract reviews.
4. Quantification exercise	• Quantification of first-time adoption impact. Also, document details of which of the optional practical expedients management intends to apply in quantifying the impact.
5. Tax implications	• Any adjustments to underlying Ind AS 18 revenue will need to be adjusted for impact on current/deferred tax. • Identification of potential areas which may have significant impact on minimum alternate tax
6. Analysis of data Requirements	• For any material 'triggers' identified where adjustments are required to revenue or cost recognition, new data required to apply revised accounting models will need to be identified.
7. Changes to business processes	• In particular, will the new requirements of Ind AS 115 be embedded into systems and processes and the required information will therefore flow up through the accounting systems, or will the systems and processes remain unchanged and a manual top-side adjustment be made as part of year-end financial reporting?
8. Changes to systems	• The company will need to design, build and test an accounting engine to apply the requirements of Ind AS 115 to the relevant data captured. • The company will need to document and test the design and build to demonstrate that the calculation process is appropriate. • User acceptance testing will also be required to ensure the solution is working effectively.
9. Updates to controls and control framework	New controls may need to be designed and tested to make sure the financial information produced to meet the requirements of Ind AS 115 is robust and accurate.
10. Additional disclosures	New or revised disclosures will be needed in the following areas: • Accounting policies and significant judgements • Disaggregation of revenue by type • Contract asset and liability balances/roll forwards • Unsatisfied performance obligations for contracts in progress at the balance sheet date

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November 29, 2017

In depth IFRS 15 industry supplement – Technology

The technology sector and the accounting standards are both subject to constant change. One of the latest changes is the new IFRS 15 revenue recognition standard. Here you will find details of the potential impact, difference from previous IFRS and US GAAP and examples in areas such as intellectual property licences, variable consideration, warranties and much more.

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November 22, 2017

In depth IFRS 15 industry supplement – Software

Revenue recognition for software products and services is expected to be one of the areas most impacted by IFRS 15. Our latest insight explains the potential impact and difference from previous IFRS and US GAAP on areas such as intellectual property licences, post-contract customer support, sales or usage-based royalties, and much more.

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Dealing with revenue recognition in the industrial products industry? Some of the guidance has changed. This supplement includes the potential impact, differences with previous IFRS and US GAAP and examples in areas like identifying contracts, transfer of control, contract costs, principal versus agent and warranties.

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In depth IFRS 15 industry supplement – Engineering and construction

IFRS 15 introduces a single model for revenue recognition, sweeping away both IAS 18 and IAS 11. This supplement identifies the potential impacts, differences from previous IFRS and US GAAP and includes examples to address the challenging aspects of long-term contract accounting.

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Are you looking for remedies to understand IFRS 15? Here is the perfect medicine, a summary of potential impacts, differences from previous IFRS and US GAAP treatment and examples of how IFRS 15 affects the pharma and biotech industry, including among others, analysis of areas like variable consideration, sales to distributors and consignment stock.

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September 29, 2017

In depth IFRS 15 industry supplement – Aerospace and defence

Do you want to fly? Then fly through the new revenue recognition standard! This supplement includes the potential impact of the standard, differences with previous GAAPs and examples of the five step recognition model. It covers complex contractual arrangements like defence and commercial aviation equipment and long-term maintenance contracts as well as many more examples.

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February 23, 2018

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How might the banking industry be affected by IFRS 15? Take a look at our supplement that considers potential issues in areas such as credit cards, loyalty schemes, commissions, advisory contracts and bundled products.

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November 29, 2017

In depth IFRS 15 industry supplement – Transportation and logistics

Do you know how to get from IAS 18 to IFRS 15? Find the route with a summary of potential impact, differences with previous GAAPs and examples of industry specific areas like freight services, transportation costs, and many more.

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July 27, 2017

In depth IFRS 15 industry supplement – Communications

If you are in the communications industry you will have heard that your industry will be significantly affected by IFRS 15. But you might not know where or how. This supplement explains the potential impact, differences with previous GAAPs and examples covering areas such as how to identify performance obligations or how to determine and allocate the transaction price and much more.

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