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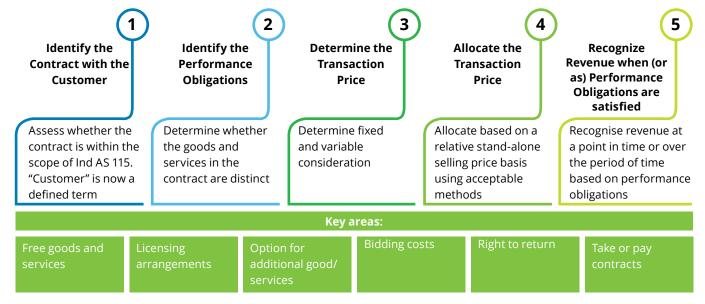
Ind AS 115 - Revenue from contracts with customers



# Ind AS 115 - Revenue from contracts with customers

The Ministry of Corporate Affairs (MCA) notified 39 Indian accounting standards (Ind AS) on 16 February 2015. These standards include Ind AS 115, which was converged with the International Financial Reporting Standards (IFRS) 15. Following the deferral of IFRS 15 to 1 January 2018, the MCA also deferred the application of Ind AS 115 on 30 March 2016, and issued Ind AS 11 (construction contract) and Ind AS 18

(revenue recognition). On 28 March 2018, the MCA notified Ind AS 115, a new revenue recognition standard that replaces existing Ind AS 11 and Ind AS 18. The new standard also replaces guidance notes on real estate revenue recognition. Ind AS 115 is applicable from 1 April 2018, i.e., FY 2018–19. The core principle of Ind AS 115 is that revenue needs to be recognised when an entity transfers the control of goods and services to customers at an amount that the entity expects to be entitled. Ind AS 115 is based on a five-step model shown below:



### **Transition to Ind AS 115**

Any impact of transition to Ind AS 115 needs to be given in opening retained earnings, as on 1 April 2018. The entity would compare the revenue recognised as per Ind AS 18 / Ind AS 11 / IGAAP / Guidance Note for each arrangement (in respect of open contracts, as on 31 March 2018) with amount that would have been recognised as per Ind AS 115. The difference between these two amounts would be accounted as a cumulative catch up adjustment and recognised on 1 April 2018 in opening retained earnings. Modified retrospective and retrospective are two transition approaches available that the entity may adopt for transitioning to Ind AS 115.

Modified Retrospective Approach Year ending 31 March 2019 Initial Application Year		Cumulative Catch up  31 March 2018 Prior Year				
				New contracts	Ind AS 115	-
				Existing contracts	Ind AS 115 + cumulative catch up	Legacy GAAP
Completed contracts	-	Legacy GAAP				

Retrospective Approach		Cumulative Catch up	
Year ending 31 March 2019		31 March 2018	
<b>Initial Application Year</b>		Prior Year	
New contracts	Ind AS 115	-	
Existing contracts	Ind AS 115	Ind AS 115 + cumulative catch up	
Completed contracts	-	Ind AS 115* + cumulative catch up	

<sup>\*</sup> Practical expedient available for completed contracts – an entity is not required to restate contracts that begin and end within the same annual reporting period

### **Key Transition Considerations**

Based on transition options followed globally<sup>1</sup>, nearly 58% of the industries (including technology, pharmaceutical, automotive, engineering and construction, fast moving consumer goods, media, and telecom) have adopted the modified retrospective approach. About 20% industries, including aviation, media and metal and mining, have adopted the full retrospective approach. The remaining 22% industries are under assessment or have not made disclosures.

However, in India<sup>2</sup>, nearly 34% of the industries (such as real estate, retail, life sciences and healthcare, shipping, logistics, construction, and engineering, procurement, and

commencement) have adopted the modified retrospective approach. Only 2% industries, including retail and real estate, have adopted the full retrospective approach, while the remaining 64% industries have not published their disclosures or have not made disclosures.

Regardless of the transition method companies choose, many companies will have to apply the standard to contracts entered into earlier. The number of contracts will be higher under the full retrospective approach. However, under the modified retrospective approach, companies will at least have to apply Ind AS 115 to all contracts that are not completed as on the date of initial application.

<sup>&</sup>lt;sup>1</sup> Source: Data compiled by Deloitte from sample of 113 Global Companies

<sup>&</sup>lt;sup>2</sup> Source: Data compiled by Deloitte from sample of 176 Indian Companies



Companies should appropriately evaluate the effectiveness of the approach considering all practical expedients, changes required in IT systems and processes to generate historical analysis, and impact on financial statements.

# Tax implications on transition to Ind AS 115 on MAT

- For the entities that adopted Ind AS on or after
   1 April 2018 The adjustment made to retained earnings will be a part of "transition amount" and book profit can be increased or decreased by 1/5th the amount in each year starting from convergence year and the subsequent four years, subject to certain exceptions.
- For the entities that adopted Ind AS before 1 April 2018 According to provisions in the Income Tax Act, 1961 (the Act), transition amount means the amount adjusted in the other

equity on the convergence date. Ind AS 101 defines "first Ind AS reporting period" as the latest reporting period covered by an entity's "first Ind AS financial statement". Thus, "convergence date" will occur only once in the lifetime of the company when it adopts Ind AS. The substitution of one Ind AS with another, pursuant to the notification of new Ind AS, is different from 'convergence date'. Hence, the adjustment made to retained earnings on the adoption of Ind AS 115 will not be a part of 'transition amount'. Accordingly, in the absence of specific provisions in the Act, based on the decision of the Supreme Court in case of Apollo Tyres, no adjustment can be made to book profit.

The above-mentioned implications may lead to double taxation or double non-taxation. Representation needs to be made to the Central Board of Direct Taxes to provide a clarification on this aspect.





### **Impact of Ind AS 115 - Examples**

#### 01. Real Estate

Key building blocks of change

# Timing of revenue recognition



- Guidance Note on Real Estate not carried over
- Careful evaluation of arrangements for continuing Percentage of completion method

## Variable consideration



- Significant financing component (e.g. subvention schemes)
- Bonus, rental guarantees and profit sharing

## Performance obligation (distinct or same)



- Parcel of land sold as part of a contract for the construction of a building
- Whether design phase distinct from construction and/ or operation phases of the contract
- Common amenities like gym, parking lot and swimming pool

Under Ind AS 115, revenue should be recognised over time if either of the following conditions is met:

- i. Buyers take all the benefits of the property as real estate developers construct the property.
- ii. Buyers obtain physical possession of the property.
- iii. The property unit to be delivered is specified in the contract and real estate entity does not have an alternative use of the unit; the buyer does not have the discretion to terminate the contract and the entity has right to payment for work completed to date.

In case none of these conditions is met, revenue would be recognised at a point in time when the control of the property is passed on to the customer.

<sup>3</sup> Source: Data compiled by Deloitte from sample of 16 real estate companies

#### Tax implications

For tax purposes, profits and gains arising from a construction contract needs to be determined using the percentage of completion method. There could be differences in the recognition of income under accounting and tax purposes.

Based on the analysis of quarterly results of real estate companies<sup>3</sup>, nearly 81% of the companies have made a disclosure regarding impact or no impact due to Ind AS 115 and about 19% of the companies have not provided any disclosures. Further, of the companies making disclosures, nearly 85% have been significantly affected by changing the method of revenue recognition as per

Ind AS 115. Only 15% of these real estate companies have not been materially affected.

Further, according to recent news report<sup>4</sup>, due to the adoption of Ind AS 115, real estate companies may take a write-back of profit of about INR 20,000 crore. This may have a significant impact on MAT computation for companies that have adopted Ind AS before 1 April 2018. This is because the adjustment made to retained earnings on the write-back of profit following the adoption of Ind AS 115 will not be a part of 'transition amount'. In the absence of specific provisions in the Act, companies may not be in a position to claim deduction for the write-back of profit while computing book profit under MAT. Such a situation may lead to double taxation as the same profit will be subject to tax twice (i) when the profit would have been credited to the profit and loss account in the past years before the adoption of Ind AS 115 and (ii) again when the profit will be credited to the profit and loss account in the year in which performance obligation is met.

#### 02. Bundled contracts

Identifying performance obligations and allocation of transaction price



For example, in January 2018, customers A and B enter into a two-year contract with a wireless company (ABC). ABC offers two handsets, along with a two-year service contract. The first handset is a model that has been in the market for 18 months, and ABC gives it for free

(standalone selling price is INR 250). The second handset is the newest version of the phone with improved features and functionality. ABC offers this handset for INR 160 (standalone selling price is INR 380). Both the offers are under the subsidy model, where customers pay a lower price of a handset and sign a two-year service contract. Let us assume that ABC does not charge activation fee.

Over a two-year contract, ABC offers a 1 GB data plan with unlimited voice and text messages for INR 40 per month. Let us assume the standalone selling price of the plan is INR 40 per month. If more than 1 GB data is used, data usage is rounded up to the next GB and priced at INR 10 per extra GB. This is the standard price for all customers. The service plan is cancellable. However, the customer is subject to the early-termination penalty of INR 320, which decreases on a pro rata basis over the contract term.

Customer A selects the older model phone, while customer B selects the newer model. Both the customers select the 1 GB data plan (with unlimited voice and text messages).

#### **Evaluation**

Current AS 9 does not require revenue from contracts to be separately allocated to different elements. Ind AS 18 requires the recognition criteria to be applied to the separately identifiable components of a single transaction to reflect the substance of the transaction. However, there is no specific guidance on how to allocate transaction price.

Ind AS 115 provides the method to allocate transaction price among different performance obligations. In the current example, the customer can benefit from the handset and network service either on their own or

<sup>&</sup>lt;sup>4</sup> ET, 11 June 2018 – New Accounting Rules may give a INR 20,000 crore blow to builders

together with other resources that are readily available to the customer. In addition, the handset and network service are separately identifiable. The table below illustrates differences in the allocation of transaction price and revenue recognised between the likely current practice and Ind AS 115:

Performance obligation	Likely current practice (contract price )		Ind AS 115 (proportionate allocation)	
	Customer A	Customer B	Customer A	Customer B
Handset Revenue	0	160	198	317
Wireless Service Revenue	960	960	762	803
Total Revenue	960	1,120	960	1,120

Handset revenue for Customer A: [INR 250 / (INR 960 + INR 250) x INR 960]. For Customer B: [INR 380 / (INR 960 + INR 380) x INR 1,120] Wireless service revenue for Customers A: [INR 960 / (INR 960 + INR 250) x INR 960]. For customer B: [INR 960 / (INR 960 + INR 380) x INR 1,120]

#### Tax implications

What should be the approach for tax purposes to above accounting treatment vis-a-vis the current accounting practice that needs deliberation? Can revenue be offered to tax as per the agreement or in term of section 145 of the Act? Can revenue be offered as per the method of accounting employed by the assesse? These scenarios need to be analysed in details and appropriate position may be taken on a case-by-case basis.

Based on the analysis of the quarterly results of telecom companies<sup>5</sup>, all companies have made a disclosure stating that impact on the adoption of the standard is insignificant.

#### 03. Non-refundable upfront fee

In many transactions, customer may pay an upfront fee at the commencement of a contract. The fee may relate to the initiation, activation, or procurement of a good to be used or a service to be provided in the future. Ind AS 115 requires entities to determine whether an upfront fee is related to the transfer of a promised good or service. In addition, Ind AS 115 notes that non-refundable upfront fee is often related to activities an entity must undertake at or around the beginning of a contract. However, those activities may not result in the transfer of a good or service to the customer. In such circumstances, the upfront fee may represent an advance payment for goods or services to be provided in the future and would be recognised when those goods or services are transferred to the customer.

For example, a software entity enters into a contract with a customer to provide a software licence and one-year subscription to cloud services, wherein the consideration to be paid by the customer is a non-refundable upfront payment of INR 10,00,000 and an annual fee of INR

<sup>&</sup>lt;sup>5</sup> Source: Data compiled by Deloitte from a sample of two telecom companies



5,00,000. The customer has right to renew cloud services each year for INR 5,00,000.

The entity has assessed that the software licence and cloud services are a single performance obligation, as the software licence can only be used with the entity's cloud services.

The entity assesses that upfront fee is not associated with the transfer of any goods or services and represents a material renewal right because renewal price in subsequent years is lower than the amount paid (INR 15,00,000) in the first year.

The entity will value the renewal right based on the average tenure of customer relationship. Consequently, upfront fee will be recognised over the customer contract or relationship period (after considering contract renewal).

Another exapmle could be of a bank or non-banking financial company which enters into a contract with a customer to provide a loan, wherein the customer is required to pay a non-refundable upfront processing fee and annual interest. The loan is for a period of five years. According to Ind AS, the processing fee will be amortised over the expected life of the loan based on the effective interest rate method.

Under the existing practice, these fees are recorded as income immediately on receipt whenever the agreement is signed.

#### Tax implications

For tax purposes, detailed analysis is required to determine whether non-refundable upfront fee needs to be offered for tax as income immediately on receipt in the first year or the fee can be spread over the contract period. The analysis is based on the terms of the agreement, rights of the customer, and available judicial precedents on the issue.

#### 04. Power and Utility

Certain long-term contracts often include significant variable elements, such as:

- Penalties
- Discounts

There are new specific requirements in respect of variable consideration. According to these requirements, variable consideration is only included in transaction price if it is highly probable that the revenue recognised would not be subject to significant future reversals as a result of subsequent re-estimation. In certain scenarios, a significant degree of judgement is required to estimate the amount of consideration that should be taken into account.

When transaction price includes a variable amount, an entity must estimate variable consideration using one of the following approaches (whichever gives an accurate prediction of the amount to which the entity expects to be entitled):

- An "expected value" (probability-weighted) approach
- A "most likely amount" approach

For example, an entity enters into an agreement to sell

10,000 units of electricity in a year at INR 5 per unit. However, if the entity is unable to supply the contracted electricity, the price per unit will be reduced to INR 3 per unit for deficit beyond 1,000 units.

In this situation, the company needs to estimate at the beginning of the year how many units it can supply. If the company estimates that it can only supply 8,000 units of electricity, revenue should be recognised for INR 3 per unit delivered (irrespective of the billing being made at INR 5 per until the final annual reconciliation).

By the end of 31 March 2019, only 5,000 units have been sold at INR 5. The revenue to be recognised will be at INR 15,000 (5,000\*INR 3) and the balance amount of INR 10,000 (5,000\*INR 2) would be recognised as advance.

#### Tax implications

According to the income computation and disclosure standards, revenue can be recognised when there is reasonable certainty of ultimate collection. Based on this, one can argue that certainty is lacking for the collection of INR 2. Hence, only INR 3 can be recognised and offered as income. The view needs detailed analysis and support to substantiate the argument.

Based on the analysis of the quarterly results of power and utility companies<sup>6</sup>, companies have made a disclosure regarding impact or no impact due to Ind AS 115. However, only 25% companies have been significantly affected by changing the method of revenue recognition. The remaining 75% power companies have not been materially affected or yet to assess the impact due to a change in accounting method.

<sup>&</sup>lt;sup>6</sup> Source: Data compiled by Deloitte from a sample of four power and utility companies



### **Summary**

Companies following Ind AS have started applying Ind AS 115 from 1 April 2018 onwards and published their June–September quarterly financial results using Ind AS 115 principles. Ind AS 115 requires revenue to be recognised when an entity transfers the control of goods or services to a customer at an amount to which the entity expects to be entitled following a five-step model.

Based on these quarterly results, we understand that companies preferred the modified retrospective approach over the retrospective approach for transition from Ind AS 18 and Ind AS 11 to Ind AS 115. Companies have started analysing contracts or agreements with customers to determine the impact of Ind AS 115 on their financials. They have also disclosed material impact in notes to these quarterly results. As per the reported data, amongst others sectors of the industry (such as retail, shipping and logistics, and fast moving consumer goods), real estate witnessed the highest impact. In the future, real estate developers will recognise revenue on the completed contract method in case of an under-construction property, as against the percentage of completion method.

This being the first year, companies are still evaluating the impact of the new accounting method and will make appropriate disclosures by year-end (March 2019 results). Thus, preparing for Ind AS 115 is more than an accounting change. Hence, we recommend that companies must evaluate the tax aspect of revenue recognition due to a change in the accounting method before the closing of account books for March 2019.



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