IFRS Notes

ICAI issues exposure draft on clarifications to Ind AS 115

9 May 2017

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Background

The Ministry of Corporate Affairs (MCA), through its notification dated 16 February 2015, issued 39 Indian Accounting Standards (Ind AS), which are converged with the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). On 22 July 2015, IASB deferred the applicability of IFRS 15, *Revenue from Contracts with Customers* by one year to 2018. Consequently, the regulators in India such as MCA and the Institute of Chartered Accountants of India (ICAI) deferred Ind AS 115, *Revenue from Contracts with Customers*, which is based on IFRS 15 and notified two standards - Ind AS 11, *Construction Contracts* and Ind AS 18, *Revenue* that became applicable to entities transitioning to Ind AS from 1 April 2016 onwards.

New development

As a result of the discussions of the Transition Resource Group (TRG) which was set up jointly by the IASB and the U.S. Financial Accounting Standards Board (FASB), on 12 April 2016, the IASB issued amendments to IFRS 15. These amendments did not change the underlying principles of IFRS 15 but clarified some requirements and provided additional transitional relief to companies that were implementing IFRS 15.

To keep Ind AS updated with revisions made to IFRS, in order to maintain convergence, similar amendments were required in the Indian context. Accordingly, on 26 April 2017, the ICAI issued an Exposure Draft on Clarifications to Ind AS 115 (Exposure Draft). This Exposure Draft also proposes that Ind AS 115 would be applicable for accounting periods beginning on or after 1 April 2018.

The last date for comments on the Exposure Draft is 16 May 2017.

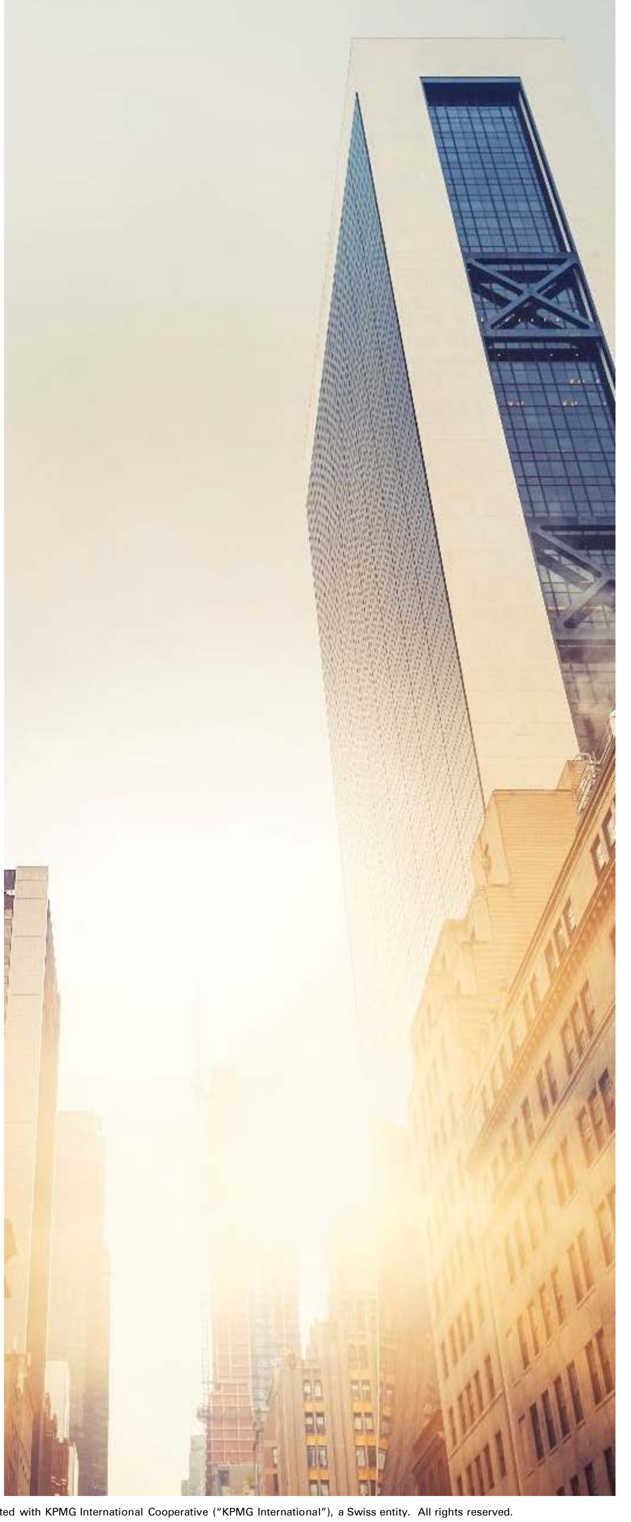
This issue of IFRS notes provides an overview of the amendments proposed in the Exposure Draft by the ICAI.

Overview of guidance in Ind AS 115

Ind AS 115 provides a single model that applies to contracts with customers, to determine how revenue should be recognised. This is a five step model used to determine whether revenue should be recognised at a point in time or over time, and at what amount. The following is an overview of the 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 to the performance obligations
- Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation.

This model leads to revenue being recognised when, or as, an entity transfers control of goods or services to a customer at the amount to which the entity expects to be entitled.



Overview of clarifications provided in the Exposure Draft

The Exposure Draft clarifies how an entity should apply this model in terms of:

- Identifying a performance obligation
- Determining whether the entity is acting in the capacity of a principal or an agent, and
- Determining whether revenue from granting a licence should be recognised at a point in time or over time.

In addition, the Exposure Draft sets out transition provisions, including practical expedients available on transition to Ind AS 115.

The Exposure Draft is open for comments in general and has specifically invited comments on a question relating to the applicability of Ind AS 115 to entities engaged in real estate businesses. It has sought comments on whether such entities should be provided an exemption to continue applying the Guidance Note on accounting for real estate transactions (issued by ICAI in May 2016) instead of Ind AS 115.

The following is an overview of the clarifications and transition provisions in the Exposure Draft.

Identifying a performance obligation

Ind AS 115 states that a promise to deliver a good or provide a service in a contract with a customer constitutes a performance obligation if the promised good or service is distinct. A promised good or service is 'distinct' if it meets both the following criteria:

- The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer; **and**
- The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

The Exposure Draft clarifies that in assessing the criteria above, the objective is to determine whether the nature of the entity's promise, within the context of the contract, is to transfer individual goods or services to the customer or a combined item(s) to which the goods and/or services are inputs.

The Exposure Draft illustrates some of the factors that indicate that promises to transfer goods or services are not separately identifiable, to align them with the core principle. These factors are given below:

- The entity provides a significant service of integrating the goods or services with other goods or services promised in the contract
- One or more of the goods or services significantly modifies or customises, or is significantly modified or customised by, one or more other goods or services promised in the contract
- The goods or services are highly interdependent or highly inter-related with other goods or services promised in the contract.

Points to consider

The determination of whether an entity's promise to transfer a good or service is separately identifiable from other promises in the contract is a new concept that will require entities to think differently about promised goods or services. Compared with current practice, it may result in more goods or services being unbundled from others in a contract. Alternatively, an entity might bundle together promised goods or services that have stand-alone value to the customer because they are highly inter-related with the other promised goods or services in the contract.[1]

(Source: First Impressions, 2016 edition on IFRS 15, Revenue, KPMG IFRG Limited's publication)

Determining whether the entity is acting in the capacity of a principal or an agent

Ind AS 115 states that an entity needs to determine whether the nature of its promise is:

- A performance obligation to provide the distinct goods or services/distinct bundle of goods or services (goods or services) itself (i.e. the entity is a principal) or
- A performance obligation to arrange the goods or services, which would be provided by another party (i.e. the entity is an agent).

The Exposure Draft clarifies that if the entity obtains control of a specified good or service before it transfers control to the customer, then the entity is acting as a principal for that good or service, otherwise it is acting as an agent (hence, an entity could be a principal for some goods or services and an agent for others). This is irrespective of whether the entity or another party is involved in providing the goods or services to a customer.

The Exposure Draft provides a list of indicators (although there may be others) that entities need to evaluate to determine whether the entity obtains control of the goods or services before they are transferred to a customer:

- The entity is primarily responsible for fulfilling the promise to provide the specified goods or services as per the customer's specifications

[1] *First Impressions, 2016 edition on IFRS 15, Revenue, KPMG IFRG Limited's publication*

Overview of clarifications provided in the Exposure Draft (*cont…*)

- The entity has inventory risk before the specified good or service has been transferred to a customer, or after transfer of control to the customer (where the customer has a right of return)
- The entity has the discretion in establishing the price for the specified good or service. While evaluating this indicator, entities need to gauge whether they are acting as an agent to arrange specified goods or services and have the flexibility in setting prices in order to generate additional revenue for themselves.

Revenue recognition

The Exposure Draft clarifies that:

- When a principal satisfies a performance obligation, it should recognise revenue as the gross amount of consideration to which it expects to be entitled in exchange for the specified good or service transferred
- When an agent satisfies a performance obligation, it should recognise revenue as the amount of fee or commission to which it expects to be entitled in exchange for arranging for the specified goods or services to be provided by the other party. This may be the net amount of consideration that an entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

Determining whether revenue from granting a licence should be recognised at a point in time or over time

A licence establishes a customer's right to intellectual property of an entity. Entities may, while entering into contracts promising the grant of a licence, additionally promise to transfer other goods or services to the customer. Ind AS 115 requires entities to determine whether the promise to grant a licence is distinct from the promise to provide other goods or services.

*Licences **not** distinct from other promises in the contract*

Where the licence is not distinct from other promises in the contract, then the entity recognises revenue for the promise to grant a licence and the other promised goods or services together as a single performance obligation. Thus the entity will recognise revenue when (or as) it satisfies a performance obligation by transferring control of a good or service to a customer. Control may be transferred either at a point in time or over time.[1]

Licences distinct from other promises in the contract

When licences are distinct from other promises in the contract, the entity should assess whether the nature of the entity's promise in granting the licence to a customer is to provide the customer with either:

What is provided by the licence	When revenue is recognised
A right to use the intellectual property as it exists at the time the licence is granted	Point in time
A right to access the intellectual property as it exists through the licence period	Over time

(Source: First Impressions, 2016 edition on IFRS 15, Revenue, KPMG IFRG Limited's publication)

Right to access intellectual property

If the underlying intellectual property licensed to the customer changes throughout the licence period because the entity continues to be involved with its intellectual property and undertakes activities that significantly affect the intellectual property, then the licence transfers to the customer over time. If the intellectual property does not change, then the customer obtains control at the point in time at which the licence is granted.[1]

The Exposure Draft clarifies that an entity's activities significantly affect the intellectual property to which the customer has rights if:

- Those activities are expected to significantly change the form or functionality of the intellectual property or
- The customer's ability to obtain benefit from the intellectual property is substantially derived from, or dependent on, those activities.

Points to consider

The requirement to assess whether a licence provides a right to use intellectual property or access to it is a new concept. Entities may need to think differently about which features of the licence they focus on when determining the appropriate pattern of revenue recognition. Assessing the criteria could be highly judgemental - and the outcome may result in revenue that is currently recognised over time being recognised at a point in time, or vice-versa.

The Exposure Draft clarifies that to determine whether licence revenue is recognised over time or a point in time, focus should be on activities that change the form or functionality of the intellectual property.

(Source: First Impressions, 2016 edition on IFRS 15, Revenue, KPMG IFRG Limited's publication)

Overview of clarifications provided in the Exposure Draft (*cont…*)

Exceptions to variable rate considerations - sale or usage based royalties

Items such as discounts, credits, price concessions, returns and performance bonuses/penalties may result in variable consideration. Depending on the facts and circumstances, entities estimate the amount of variable consideration to be included in the transaction price using either the expected value or the most likely amount.[1]

An exception exists for sales and usage-based fees – e.g. royalties – arising from licences of intellectual property. Revenue is recognised for sale/usage based royalties promised in exchange for a licence of intellectual property only when (or as) the subsequent sale or usage occurs, or the performance obligation to which such royalty has been allocated has been satisfied, whichever is later.

The Exposure Draft clarifies that the requirement above applies when the royalty relates only to a licence of intellectual property or when such licence is the predominant item to which the royalty relates. If this criteria is not met then the requirements on variable consideration in Ind AS 115 would apply to the sales or usage based royalty.

Points to consider

Judgement is required to assess when the exception for sales or usage based royalties applies – i.e. whether a licence is the predominant item to which the fee relates. Additional complexities can arise when a fee is combined with other contractual terms – e.g. sales-based royalty is subject to a guaranteed minimum or a cap.[1]

(Source: First Impressions, 2016 edition on IFRS 15, Revenue, KPMG IFRG Limited's publication)

Transition provisions

The Exposure Draft provides the following transition provisions, including certain practical expedients:

Approach 1- Retrospective approach:

Entities may choose to apply Ind AS 115 retrospectively, and may elect to use any of the below practical expedients:

- An entity need not restate contracts that begin and end within the same accounting period or contracts that are completed before the beginning of the earliest period presented (i.e. 1 April 2017)
- For contracts with variable consideration that are completed on or before the initial application date (i.e. 1 April 2018), an entity may use the transaction price at the date the contract was completed, rather than estimating the variable consideration
- For contracts that were modified before the beginning of the earliest period presented, an entity may reflect the aggregate effect of all contract modifications when identifying separate performance obligations and determining and allocating the transaction price on transition
- For periods presented before the initial application date, an entity can elect not to disclose the amount of transaction price allocated to the remaining performance obligations or an explanation of when that revenue will be recognised.

An entity is required to consistently apply the practical expedient it has elected, for all reporting periods presented. Further, the entity should disclose the option it has selected and provide a qualitative assessment of the estimated effect of applying each of those expedients.

Approach 2- Cumulative effect approach:

An entity may choose not to retrospectively adjust comparative periods, and instead adopt the new standard as of the application date. The cumulative effect of initially applying this standard would be recognised as an adjustment to the opening balance of retained earnings (or another component of equity, as appropriate). In this case, it would have to adjust retained earnings for only those contracts that are open on the initial application date of this standard (i.e. 1 April 2018). An entity electing this approach may also apply the practical expedient for contract modifications, either as at the beginning of the earliest period presented or as at the date of initial application.

Where an entity selects this approach, it shall disclose the amount by which each financial statement line item is affected in the year of adoption as a result of applying the new standard, along with an explanation for significant changes.

Our comments

Ind AS 115 will be applicable for accounting periods commencing on or after 1 April 2018 once the revised standard is notified by the Ministry of Corporate Affairs (MCA). It is expected to have a significant impact on how and when companies recognise revenue and will require significant use of judgements and estimates. The Exposure Draft introduces amendments/clarifications that are in line with international requirements and also aligns the date of applicability with that of IFRS 15.

Companies that have complex transactions with multiple components or variable amounts of consideration, specifically those in sectors such as telecom, software, engineering and construction, etc. should commence assessing the extent of impact of this standard and its wider business implications.

Applicability to real estate transactions

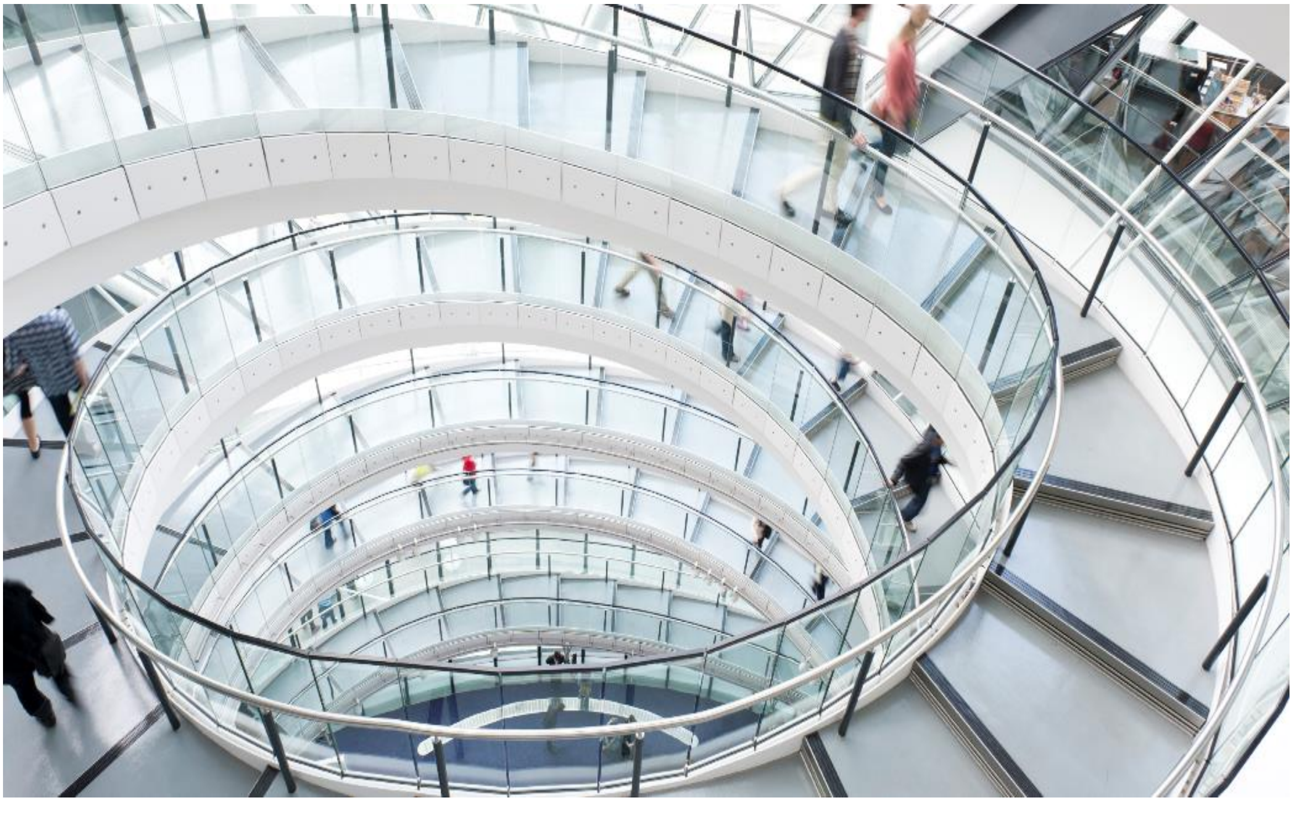
Companies that operate in the real estate sector are specifically required to consider their response to the question posed by the Exposure Draft. Ind AS 18, which currently provides guidance on revenue recognition for all entities, requires real estate developers to recognise revenue in accordance with the Guidance Note on *Accounting for Real Estate Transactions* (for entities to whom Ind AS is applicable) issued by the Institute of Chartered Accountants of India (ICAI) (the Guidance Note) in May 2016. In accordance with the Guidance Note, revenue on real estate transactions would generally be recognised by applying the stage of completion method (i.e. it eliminates the concept of the completed contract method).

Ind AS 115 read with the Exposure Draft, provides a different approach for revenue recognition to real estate developers. It now requires the real estate developers to refer to each contract while determining the timing and amount of revenue to be recognised.

Revenue for real estate sales may be recognised progressively over the period of the contract only if any one or more of the following criteria are met:

- Customer simultaneously receives and consumes the benefits as the entity performs
- The customer controls the asset as the entity creates or enhances it or
- The entity’s performance:
  - Does not create an asset for which the entity has an alternative use; and
  - The entity has an enforceable right to payment for performance completed to date.

The application of Ind AS 115 may therefore result in delayed recognition of revenue for certain types of real estate transactions.



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KPMG in India's IFRS institute

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The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework.

Voices on Reporting

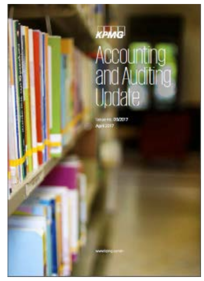
KPMG in India is pleased to present Voices on Reporting – a monthly series of knowledge sharing calls to discuss current and emerging issues relating to financial reporting.

In our recent call on Wednesday, 5 April 2017, we covered key financial reporting and regulatory matters that are expected to be relevant for stakeholders as they approach the quarter ending 31 March 2017.

Our call included updates from the Ministry of Corporate Affairs (MCA), the Securities and Exchange Board of India (SEBI), the Reserve Bank of India (RBI), etc.

In our VOR yearly updates, we have summarised key updates relating to the year ended 31 March 2017 from the MCA, the SEBI, the RBI, the Institute of Chartered Accountants of India (ICAI), the Insurance Regulatory and Development Authority of India (IRDA) and the Central Board of Direct Taxes (CBDT).

Missed an issue of our Accounting and Auditing Update or First Notes



Issue no. 9/2017 – April 2017

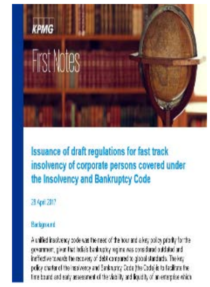
Continuing with our series of articles on the revised requirements of the Companies Act, 2013 (2013 Act), this month's edition of the Accounting and Auditing Update (AAU) carries an article highlighting the regulatory requirements with regard to acceptance of deposits.

This edition carries an article on accounting for prior period errors and explains the guidance with the help of illustrative examples. It also carries an article on accounting for changes in accounting policies, estimates and prior period errors.

Our article explains the accounting treatment of foreign currency translation reserve in various scenarios e.g. on first-time adoption of Ind AS, disposal, impairment, restructuring, etc. of a foreign operation.

The IFRS 8, Operating Segments standard under International Financial Reporting Standards (IFRS) focusses on segment disclosures based on the components of the entity that management monitors in making decisions about operating matters. The International Accounting Standards Board (IASB) conducted a Post Implementation Review (PIR) of IFRS 8 in July 2013. As a follow up of PIR, the IASB proposed certain amendments to IFRS 8. Our article summarises the amendments proposed by the IASB.

The publication also carries regular round up of regulatory updates in India and internationally.



Issuance of draft regulations for fast track insolvency of corporate persons covered under the Insolvency and Bankruptcy Code

28 April 2017

A unified insolvency code was the need of the hour and a key policy priority for the government, given that India's bankruptcy regime was considered outdated and ineffective towards the recovery of debt compared to global standards. The key policy charter of the Insolvency and Bankruptcy Code (the Code) is to facilitate the time bound and early assessment of the viability and liquidity of an enterprise which has been found unviable.

On 18 April 2017, the Insolvency and Bankruptcy Board of India has issued the below rules for public comments :

- Draft Insolvency and Bankruptcy Board of India (Fast Track Insolvency Resolution Process for Corporate Persons) Regulations, 2017 (draft Insolvency Regulations, 2017)
- Draft notification for eligible corporate debtors under Section 55(2) of the Code

This issue of First Notes provides an overview of the draft provisions.

Previous editions are available to download from: www.kpmg.com/in