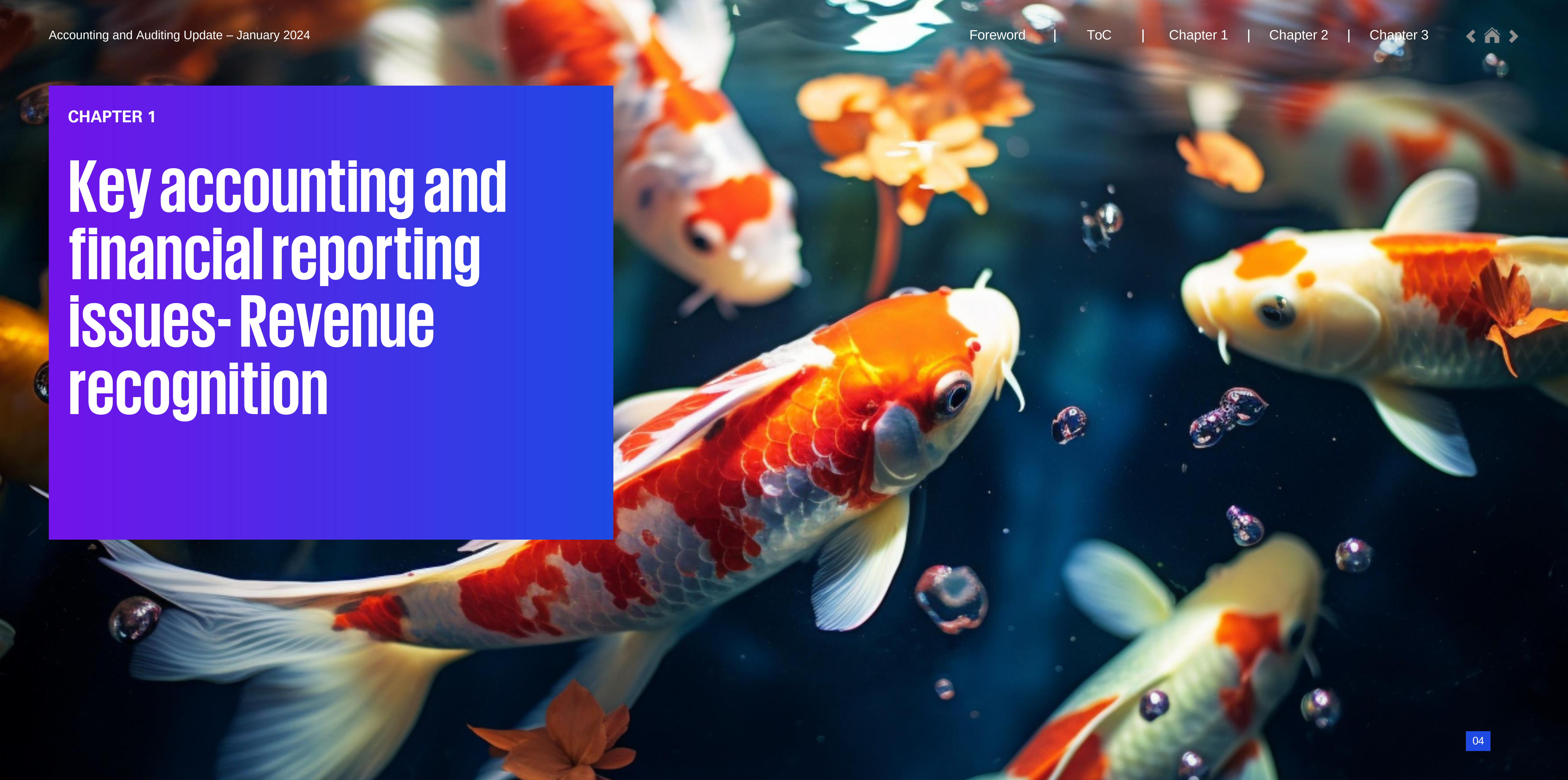


CHAPTER 1

Key accounting and financial reporting issues- Revenue recognition

Background

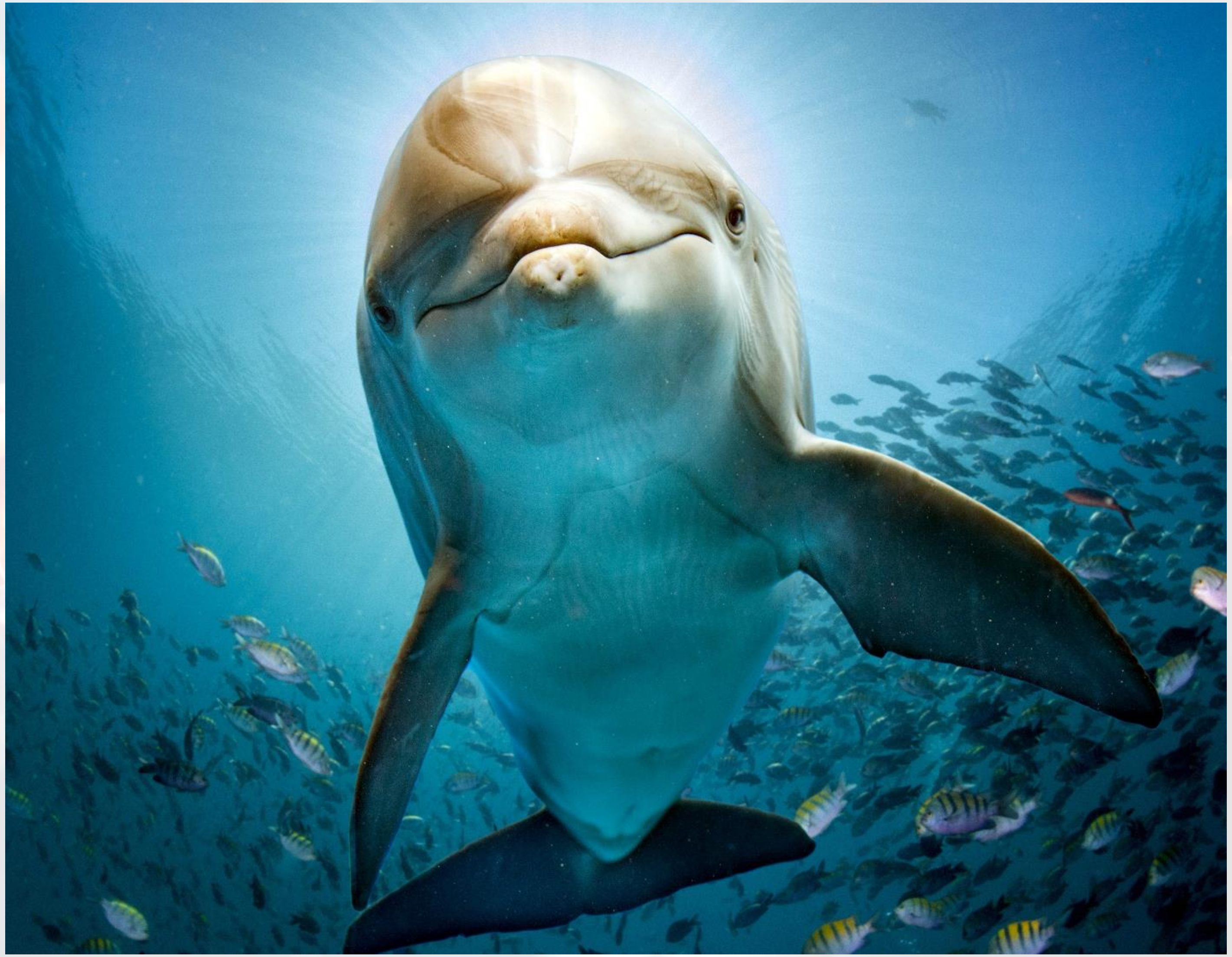
Ind AS 115, *Revenue from Contracts with Customers*, is designed to deal with a wide range of transactions and to accommodate changes in the global economy. This includes an extraordinary expansion in digital and intangible goods and services, the rapid growth of subscription services and the creation of new online platforms with innovative incentives, etc. But changes can bring challenges in interpreting the requirements of the standards or providing additional disclosures which would be useful to investors for understanding the contracts.

With this background, in this issue we will touch upon some of the key areas that regulators have highlighted and provided improvement points in the area of **revenue recognition.** We have also provided illustrations of disclosures from thematic reviews performed by the Financial Reporting Council (FRC) and illustrative disclosures issued by KPMG IFRG Limited in 2023 and by KPMG in India in 2023.

Source

While preparing this article, we have referred to:

- The recent observations of the National Financial Reporting Authority (NFRA),
- The Report on Audit Quality Review issued by the Quality Review Board issued in October 2023,
- The Ind AS observations of the Financial Reporting Review Board (FRRB) of the Institute of Chartered Accountants of India (ICAI),
- The report- Annual Review of Corporate Reporting (2022/23) issued by the Financial Reporting Council, and
- Recent ESMA[1] enforcement directions.



1. European Securities and Markets Authority.

Key issues and recommendations pertaining to revenue recognition

Some of the key issues and recommendations pertaining to revenue recognition is given below:

Accounting policies

Comprehensive accounting policies are essential for an appropriate understanding of the revenue recognised. In this regard, some of the key observations of the regulators were:

- **Returns, refunds and similar obligations:** Ind AS 115 requires companies to disclose information about its performance obligations in contracts with customers. It has been reiterated that such a disclosure should *inter alia* include a description of the obligations for returns, refunds and other similar obligations. Additionally, significant judgements made by companies in application of this standard, including the methods, inputs and assumptions used in measuring such obligations should be disclosed[2]. Companies are also required to disclose the significant payment terms of the contract.

Accounting policy on revenue recognition (including obligations for returns, etc.)

Nature and timing of satisfaction of performance obligations, including significant payment terms	Revenue recognition policies
Customers obtain control of standard paper products when the goods are delivered to and have been accepted at their premises. Some contracts permit the customer to return an item. Returned goods are exchanged only for new goods – i.e. no cash refunds are offered.	Revenue is recognised when the goods are delivered and have been accepted by the customers at their premises. For contracts that permit the customer to return an item, revenue is recognised to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur. Therefore, the amount of revenue recognised is adjusted for expected returns, which are estimated based on the historical data for specific types of paper, size, finish, etc. In these circumstances, a refund liability and a right to recover returned goods asset are recognised. The right to recover returned goods asset is measured at the former carrying amount of the inventory less any expected costs to recover goods. The refund liability is included in other payables (see Note 29) and the right to recover returned goods is included in inventory (see Note 17). The Group reviews its estimate of expected returns at each reporting date and updates the amounts of the asset and liability accordingly.

(Source: Illustrative disclosures: KPMG in India's analysis 2024 read with guide to annual financial statements issued by KPMG IFRG Limited, in September 2023)

2. Refer paragraphs Ind AS 115.119

- **Policy for recognition of interest income:** Interest income on financial assets is recognised in accordance with Ind AS 109, *Financial Instruments.* Accordingly, for non-financial service companies, the policy on interest income should be disclosed separately from the policy on contracts with customers. An example disclosure is given below:

Accounting policy on recognition of interest income

Dividend income is recognised in profit or loss on the date on which the group's right to receive payment is established.

Interest income or expense is recognised using the effective interest method

The effective interest rate is a rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to:

- The gross carrying amount of the financial asset or
- The amortised cost of the financial liability.

In calculating interest income and expense, the effective interest rate is applied to the gross carrying amount of the asset (when the asset is not credit-impaired) or to the amortised cost of the liability. However, for financial assets that have become credit-impaired subsequent to initial recognition, interest income is calculated by applying the effective interest rate to the amortised cost of the financial asset. If the asset is no longer credit-impaired, then the calculation of interest income reverts to the gross basis.

(Source: Illustrative disclosures: Illustrative Ind AS consolidated financial statements issued by KPMG in India, issued in March 2023)

Reconciliations of amounts recognised in the financial statements

Considering the adjustments required to be made by Ind AS 115 while computing revenue, contract assets and liabilities, reconciliations of these amounts are required to be made for a better understanding of the contracts with customers. Few of the observations include:

- **Reconciliation of contract liabilities:** With regard to contract liabilities, Ind AS 115 requires entities to *inter alia* disclose the opening and closing balances and an explanation of significant changes in these balances during the reporting periods (i.e. a reconciliation)[3]. It has been clarified, that while providing such reconciliation, details of both, the deferred revenue and advances from customers should be provided. Such a reconciliation could be in a tabular form or in the form of a paragraph. An example disclosure is given below:

Reconciliation of contract liabilities

The contract liabilities primarily relate to the advance consideration received from customers for construction of storage units and warehouses, for which revenue is recognised over time, and to the unredeemed customer loyalty points. The amount of unredeemed customer loyalty points is INR50 lakhs (31 March 2022: INR22 lakhs).
This will be recognised as revenue when the points are redeemed by customers which is expected to occur over the next two years.
The amount of INR166 lakhs included in contract liabilities at 31 March 2022 has been recognised as revenue during the year ended 31 March 23 (31 March 22: INR140 lakhs).

(Source: Illustrative disclosures: Illustrative Ind AS consolidated financial statements issued by KPMG in India, issued in March 2023)

3. Para 116 read with para 118 of Ind AS 115.

- **Reconciliation of revenue recognised in the statement of profit and loss:** As per Ind AS 115, a reconciliation of the amount of revenue recognised in the statement of profit and loss with the contracted price should be provided. It has been reiterated that such a reconciliation should separately show the adjustments made to the contract price, and specify the nature and amount of such adjustments. For example, adjustments on account of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, etc. An example disclosure is given below.

Reconciliation of revenue recognised with the contracted price

In lakhs of INR	**Year ended 31 March 2023**	Year ended 31 March 2022
Revenue as per contracted price	**103,430**	97,346
Adjuststments for:		
Contract liabilities - Loyalty programme	(48)	(42)
Refund liabilities	(988)	(883)
Total revenue from contract with customers	**102,394**	**96,421**

(Source: Illustrative disclosures: Illustrative Ind AS consolidated financial statements issued by KPMG in India, issued in March 2023)

Variable consideration

Where a contract includes a variable consideration, the amount of consideration to which an entity will be entitled needs to be estimated. However, the estimation will be constrained to the extent that it is highly probable that a significant reversal in revenue does not occur when the uncertainty is subsequently resolved. To determine the extent to which the estimation of variable consideration should be constrained, entities should consider both, the likelihood and magnitude of revenue reversal[4]. It has been observed that when material variable consideration exists, sufficient company-specific information should be provided to explain how it arises and how it is estimated and constrained. Below are two examples of computing how variable consideration is constrained.

Example 1: Constraint to variable consideration is based on a computation

Variable consideration, such as price or scope amendments, is included based on the expected value or most likely amount. **A constraint is included unless it is highly probable that the revenue will not significantly reverse in the future. This constraint is calculated based on a cautious expectation of the life of certain Risk and Revenue Sharing Partnerships and by assessing the impact of a 10 per cent reduction in expected spares sales.** Variations in contract work, claims and incentive payments are included in revenue from construction contracts based on an estimate of the expected value the Group expects to receive. Variations are included when the customer has agreed to the variation or acknowledged liability for the variation in principle.

(Source: IFRS 15 Thematic Review: Review of Disclosures in the First Year of Application issued by the Financial Reporting Council in October 2019)

4. Para 56 and 57 of Ind AS 115

Example 2: Constraint to variable consideration is based on milestones defined

Variable consideration includes the estimate of payments in the form of contingent development-related and regulatory approval milestones. **These milestones are included in the transaction price when the most likely outcome is that they will be received. Once this is established, the entire transaction price is constrained to the extent that it is highly probable that a significant reversal of revenue will not occur in future periods. The estimate is reassessed for each reporting period.** The initial transaction price for the development of the generic ABC portfolio with XYZ has been assessed as $20.0m, which includes a second $5.0m milestone due on completion of the device development services. **The second milestone is being constrained (i.e. not recognised) until completion is considered highly probable.** If this $5.0m milestone had not been constrained, additional revenue of £3.1m (2018: £2.2m) would have been recognised in 2019.

(Source: IFRS 15 'Revenue from Contracts with Customers' A follow up thematic review issued by the Financial Reporting Council in September 2020)

Significant judgements

Significant judgements made when applying Ind AS 115 that affect the amount and timing of revenue recognition should be clearly explained and be company-specific. Any disclosures about significant judgements under Ind AS 115 are in addition to the requirements of Ind AS 1, *Presentation of Financial Statements,* and companies should note that a judgement that would not ordinarily qualify for disclosure under Ind AS 1 may still need to be disclosed under Ind AS 115. Some of the judgements made by companies, that need improvement, as per the observation of the regulators include the following:

- **Principal versus agent considerations:** When another party is involved in providing goods or services to a customer, the entity should determine whether the nature of its promise is aperformance obligation to provide the specified goods or services itself (i.e. the entity is a principal)[5] or to arrange for those goods or services to be provided by the other party (i.e. the entity is an agent) . This assessment is required to be done by the entity for each significant good or service provided, based on stipulated guidelines and requires the exercise of judgement.

5. Paragraphs B34-B38 of Ind AS 115 provide further guidance on this.

Below is a case study issued by ESMA pertaining to the assessment of whether an entity is a principal or agent in a contract

ESMA case study on principal vs agent*

Facts of the case:

- The issuer is an IT provider offering the sale of standard software licences as an authorised sales partner of software developers.
- The issuer was granted a non-exclusive right to resell software licenses to customers.
- The issuer is required to provide pre-sale advisory services to ensure that customers received a suitable software solution and purchased a sufficient number of licences.
- After receiving a purchase commitment from the customer, the issuer submitted orders for software licences to the developer, which the latter could accept or reject. The issuer had complete discretion to negotiate prices (except for some special discounts for particular customers that must be passed through).
- The software developer granted the customer the right to use the software and assured the functionality of the software.

Assessment:

- Ind AS 115 requires entities to:
  - Identify the specified goods or services to be provided to the customer, and
  - Assess whether an entity controls each specified good or service before it is transferred.
- Pre-sales advice the issuer provides is not an implicit promise in a contract with a customer. Accordingly, the software licenses are distinct goods provided to the customer
- Software manufacturer is responsible for the software's functionality as well as issuing and activating the licenses
- The issuer had only insignificant inventory risk
- The issuer is responsible for fulfilling the promise to provide the license to the customer
- The issuer had limited discretion in establishing prices (or negotiating prices)
- The issuer did not have the ability to direct the use of or substantially obtain all of the remaining benefits of the software.

Conclusion: Based on the above factors, the issuer acted as an agent of the software manufacturer.

* *A similar matter was discussed by the IFRS Interpretations Committee (IFRIC) in IFRS IFRIC Update in April 2022* [6]

(Source: 28th Extract from the FRWG (EECS)'s Database of Enforcement issued by the European Securities and Markets Authority on 9 October 2023)

6. IFRS - Tentative Agenda Decision and comment letters: Principal versus Agent: Software Reseller IFRS 15

Regulators have also reiterated the need to disclose the judgements made by the entity, basis which they determine whether they are acting as a principal or an agent in a contract.

- **Allocation of transaction price:** When a contract has multiple performance obligations, the transaction price should be allocated to each performance obligation in an amount that depicts the amount of consideration that an entity expects to receive in exchange for transferring the promised goods or services. Further guidance on these allocation has been prescribed in the standard[7]. The regulators remarked that these disclosures should convey significant judgements made in determining the amounts allocated such as the method used to estimate the stand-alone selling price and why this is suitable and (if relevant) why discounts have been allocated to certain performance obligations rather than proportionately across all performance obligations.
- **Timing of satisfaction of performance obligation:** The timing of satisfaction of performance obligation is a significant judgement that significantly affects the determination of the amount and timing of revenue from contracts with customers. Performance obligations could be satisfied over time or at a point in time. In both these cases, disclosures have been prescribed by the accounting standard. The regulators have indicated that though companies have made statements about a specific application of the standard, the judgements that led to the chosen accounting treatment should also be provided.

Given below is an example disclosure for the same:

Example of disclosure of why revenue is recognised over time

Revenue has been recognised over time, rather than at a point in time, following judgement made on the Group’s enforceable right to payment under certain contracts with the Ministry of Defence, where there is a right for the customer to terminate without cause and prior to contract completion under various versions of the contracts. Under these contacts there is no explicitly stated right of recovery of profit, however there is an implication that this is allowed for within such contract wording. **The revenue recognition determination under these contracts has taken this implied wording into account. This judgement is based on management’s understanding of the commercial reality underlying such contracts, and experience of similar contracts which do contain explicit rights to recover profit.**

(Source: IFRS 15 ‘Revenue from Contracts with Customers’ A follow up thematic review issued by the Financial Reporting Council in September 2020)

7. Para 73 of Ind AS 115

Disclosure tips

- Ensure completeness of disclosures about judgements - those that would not ordinarily qualify for disclosure under Ind AS 1 may still need to be disclosed under Ind AS 115.
- Ensure disclosures about significant judgements are consistent with information in other areas of the annual report such as the Audit Committee Report or the Independent Auditor's Report
- For companies in industries where readers might expect there to be significant judgements made in relation to revenue, it may be helpful to clarify when management has concluded that such judgements are not significant or are immaterial, rather than remaining silent.
- Where judgements also involve significant estimation uncertainty, ensure quantitative disclosures are also provided. Ind AS 1 provides examples of this information, such as sensitivities or ranges of potential outcomes.

(Source: IFRS 15 'Revenue from Contracts with Customers' A follow up thematic review issued by the Financial Reporting Council in September 2020)

Disaggregation of revenue

An entity should disaggregate revenue recognised from contracts with customers into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. Additionally, the relationship between the disclosure of disaggregated revenue and revenue for each reportable segment (under Ind AS 108, Operating Segments) should be provided. Ind AS 115 provides guidance on selecting the categories for disaggregation of revenue [8]. Below is a case study issued by ESMA on disaggregation of revenue.

ESMA case study on disaggregation of revenue

Facts of the case:

- The issuer operates in the animal health sector and sells both veterinary drugs and non-medicinal products. The issuer operates in a number of geographical regions.
- The issuer has provided a disaggregation of revenue according to its geographical operating segment. This is because
  a. the issuer believes it has only one significant type of activity, which is animal health,
  b. cash flows arising from its activities are affected by the same economic factors and
  c. disaggregation of revenue by markets does not provide useful information to the investors.

8. Para 114, 115 read with B87-B89 of Ind AS 115

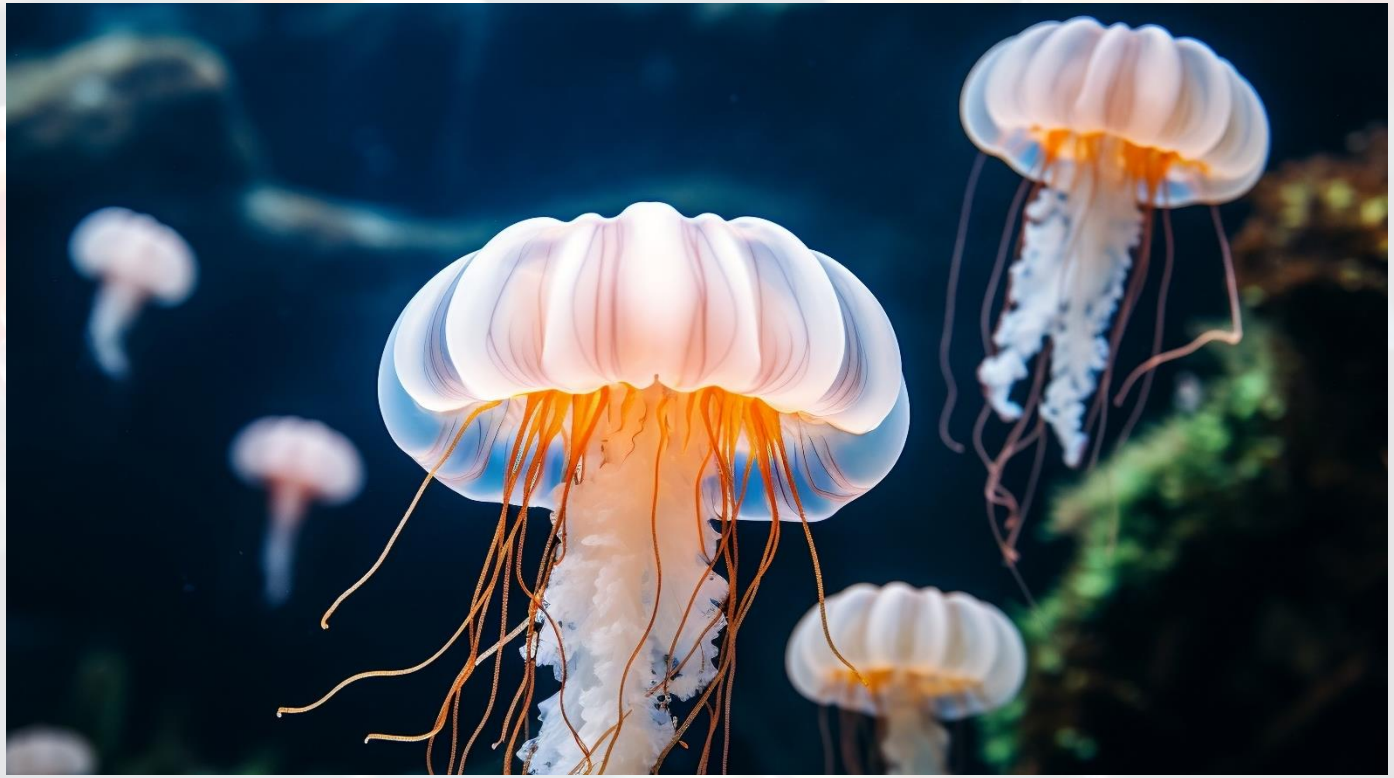
Assessment: The regulator assessed that:

- The economic factors that drive revenue in each market (livestock/pet) were not identical. Since revenue from livestock primarily depend on economics of livestock and agriculture[9] and revenue from pet products primarily depend on other factors[10].
- The issuer had disclosed in the prospectus that both the markets had evolved differently during the year.
- As per Ind AS 115, when selecting the type of category (or categories) to use to disaggregate revenue, an entity should *inter alia* consider how information about the entity's revenue has been presented for other purposes, including all of the following: (a) disclosures presented outside the financial statements (for example, in earnings releases, annual reports or investor presentations).'
- In the management report, the issuer separately discloses quantitative information on revenue arising from livestock products and pet products.

Conclusion: It was concluded that the disaggregation of revenue by main type of products (pets, livestock) disclosed by the issuer in the management report should have been included in the financial statements to comply with the requirements of Ind AS 115.

(Source: 27th Extract from the EECS's Database of Enforcement issued by the European Securities and Markets Authority on 29 March 2023)

With regard to disclosure of disaggregation of revenue, it was noted that the most common categories of disaggregation used by companies were geographical region or type of good or service. However, one company thoughtfully presented in its Chief Executive's review the proportion of revenue by size of order, explaining that smaller orders (<£100,000) generated three quarters of total revenue, while the largest orders (>£1m) just 5 per cent of revenue. This was important as it demonstrated that revenue was largely dependent on customers' operational, rather than capital, budgets. Changes in revenue composition could then be linked to underlying economic conditions. Regulators commented that where such relevant analysis has been done by management, it should be cross referred to in the financial statements.



9. Such as animal pandemics or changes in consumers' eating habits
10. Such as the purchasing power of pet owners

Inflationary features in contracts

Companies should note that considering the current volatile economic environment may include inflationary features. In such cases, inflationary features in contracts with customers and accounting for such clauses (that is, whether the feature is an embedded derivative or variable consideration) should be adequately disclosed and explained clearly.