CHAPTER 1

Accounting for online gaming sector

This article aims to:

Discuss practical aspects of revenue recognition by an online gaming sector.

Introduction

The online gaming sector in India indeed presents a remarkable story of growth, shaped by advancements in technology, the entertainment industry, and the entrepreneurial landscape. The factors such as the widespread adoption of smartphones, affordable data plans, and a young, tech-savvy population, have all contributed to this surge.

The rise of e-sports in India and financial reporting of this growth requires compliance with financial regulations and transparency in accounting practices. The complexities of accounting in this sector are significant, given the various monetisation strategies and the need for compliance with financial regulations.

In this article, we will delve into few of the common revenue recognition issues faced by the gaming sector. Therefore, it is essential to consider these insights and the need for a strategic approach to navigate the financial complexities.

Ecosystem of the online gaming sector

The online gaming ecosystem is indeed a complex network of various participants, each playing a crucial role in delivering an immersive gaming experience to the end-users. The ecosystem is supported by a range of devices and platforms, including smartphones, tablets, gaming PCs, and social networks, all of which are integral to the digital data consumption driven by the gaming industry. Additionally, the roles and responsibilities of these participants become increasingly complex, often overlapping as some entities take on multiple functions. This complexity requires careful management and a deep understanding of the technical and business aspects of the gaming world.

Participants in this sector can be divided into contributors and orchestrators.

Contributors within this ecosystem include

- **Game developers**, who are responsible for programming the game from concept to final product. They handle a wide array of tasks such as coding, testing gameplay, dictating virtual character behavior using AI, game upgrades, bug fixes, and collaborating with designers and artists. While many gaming companies have in-house development teams, the sector's growth has led to the emergence of specialised gaming studios focussed solely on game development.
- **Publishers** are companies that publish video games developed either internally or by external game developers. They often handle distribution, though some may partner with distribution companies or other publishers for this task. Publishers are also involved in licensing, localisation, user manual creation, and the design of graphic elements like the box design. Some large publishers with vertical structures own publishing subsidiaries, further integrating the publishing process within their operations.
- **Payment intermediaries** such as credit card agencies, pre-paid card distributors, UPI, online banking, wallet companies, etc.
- **Cloud service providers and online gaming servers.**

Orchestrators

- **Digital marketplaces** such as the App Stores serve as intermediaries between mobile gaming companies and gamers. They provide a platform for downloading mobile games, facilitate payment transactions, and share detailed transaction reports with the gaming companies.
- **Social media platforms and websites** offer alternative avenues for gamers to engage with games, either by playing online directly on the websites or by downloading games onto mobile devices, bypassing traditional digital marketplaces.

Beneficiaries

- The end-users, who are the **gamers** themselves, range from hardcore enthusiasts to regular players. They are the primary consumers of the gaming content, driving demand and influencing the development and monetisation strategies of the gaming industry.

Each participant in this ecosystem plays a vital role in the overall experience and success of the gaming industry. The developers and publishers create and distribute the content, the digital marketplaces and social platforms facilitate access and transactions, and the gamers drive the industry's growth through their engagement and purchases.

Game category segmentation

Following is an overview of the game categories:

- **Casual Gaming:** These games are designed to be easy to pick up and play on various devices. They do not involve wagering real money or earning monetary rewards. Instead, they are often played for entertainment.
- **Real Money Gaming (RMG):** This category includes games that are played online where players wager real money on the outcome. The winners receive monetary prizes.
- **Real Money Gaming – Online Fantasy Sports (OFS):** In these games, players create virtual teams. The rewards are distributed from an overall prize pool, and the amount a player wins is based on the points they accrue during the game.

Monetisation models

The monetisation model in gaming can be understood through various revenue streams:

- **Ad spends revenue:** Predominantly present in casual games, this revenue is generated by displaying ads in various forms within the games. The revenue depends on the number of impressions and click-through rates. Incentivised ads, which offer rewards like a level-up, additional coins, or new lives, have seen increased deployment recently, enhancing user engagement and allowing more ads to be pushed during each play session.
- **In-app purchases:** This stream is common in mid-core and hardcore games, and to some extent in casual games. Revenue is derived from the purchase of virtual goods, upgrades to an ad-free model, battle passes, virtual currency, power-ups, and more.
- **Subscription:** Players pay an initial fixed fee for a subscription that can range from a few months to a lifetime pass. This model provides access to multiple games or platforms throughout the subscription period.
- **Commission:** This model is typical in RMG and OFS segments. Users pay a fee to participate in a game or contest and receive monetary rewards upon winning. The platforms retain a portion of the entry fee pool as their primary source of income (in the form of commission).

Each model caters to different types of games and player engagement, offering a variety of ways for companies to generate revenue from their gaming platforms.

Accounting considerations

Revenue recognition is a judgemental and complex area of accounting. The accounting complexities in this ecosystem arise from the diverse revenue streams. Under Ind AS framework, Ind AS 115, *Revenue from Contracts with Customers* lays down the principles for revenue recognition. Let us look at few of the complex areas:

Principal vs agent revenue: From the perspective of a game publisher, it needs to be evaluated whether the revenue generated would be recognised at gross or net value. Let us take two examples.

Example 1

ABC Limited, a gaming company with a portfolio of word games, offers a crossword game where virtual coins are sold to customers. Hosted on an App Store (host), the game allows end customers to make in-app purchases of these coins. At the end of each month, the hosts provide ABC with a transaction report, deduct a 30 per cent commission, and remit the balance. For instance, if the total in-app purchases amount to INR1,000, the hosts would remit INR700 to ABC.

In this scenario, the game publisher would need to apply the principles of revenue recognition given under Ind AS 115 and evaluate whether it is acting as an agent or principal.

When assessing the role in delivering goods or services to a customer, an entity must consider the nature of its promise. If the entity takes control of the goods or services from another party before they are transferred to the customer, it is acting as a principal, fulfilling the promise to provide the goods or services itself. Conversely, if the entity does not gain control of the goods or services before they reach the customer, it is acting as an agent, responsible for arranging the provision of goods or services by another party. It is crucial for an entity to identify each specified good or service promised to the customer and determine its role as a principal or agent for each transaction. In contracts involving multiple goods or services, an entity may serve as a principal for some and as an agent for others.

This assessment would require ABC company to evaluate certain indicators:

- Whether it is primarily responsible for providing specified goods or services
- Whether it has the inventory risk
- Whether it has discretion in establishing prices for specified goods or services.

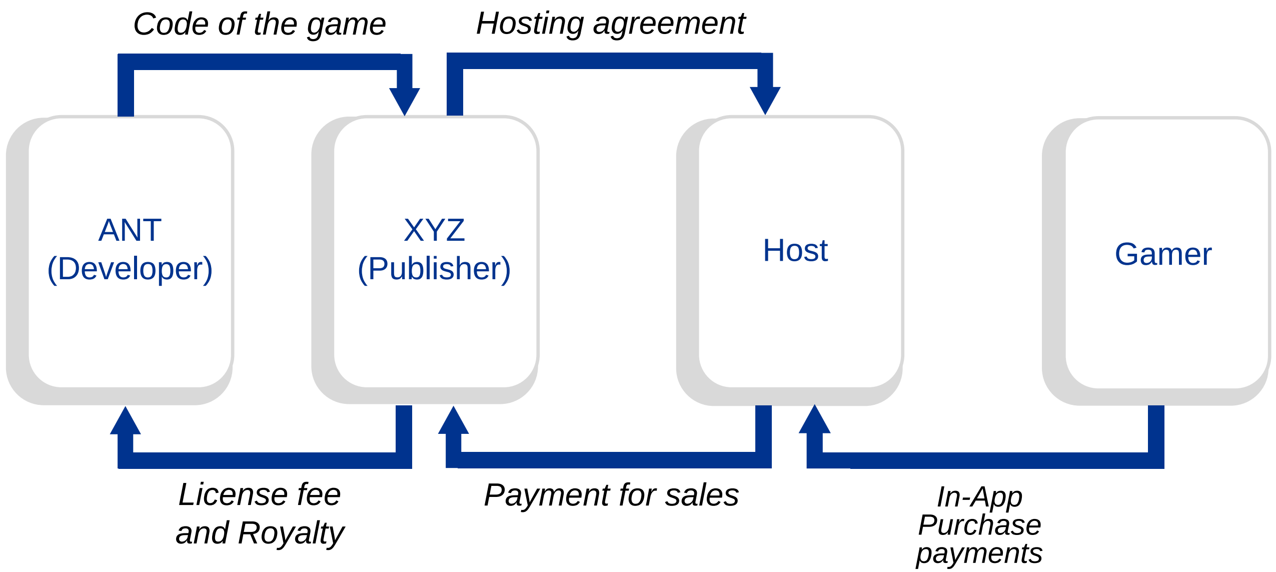
Based on the evaluation, if ABC considers itself the principal in the transaction, as it is responsible for issuing the virtual currency directly to the gamer's wallet, while the hosts merely provide a platform for collection. ABC, would record the total In-App purchases of INR1,000 as its gross revenue from operations and recognise INR300 as an expense, reflecting its role as the principal in this arrangement.

Example 2

XYZ Limited, a gaming company with an array of word games, holds an exclusive ten-year license to operate the game ‘Alpha’ developed by ANT Limited. As the publisher, XYZ pays an upfront license fee and a sales-based royalty to ANT.

XYZ's responsibilities include selecting hosting platforms, requesting game modifications from ANT based on market feedback or internal decisions at no extra cost, investing in IT infrastructure, setting prices for the game and in-app purchases, and providing customer service. XYZ markets itself as the game's operator and forms agreements with platforms and end-users accordingly.

The game ‘Alpha’ is available on few App stores (hosts), where end customers make in-app purchases. Monthly, the hosts issue a transaction report to XYZ, deduct a 30 per cent commission, and transfer the remaining balance to XYZ.



To accurately assess the relationship between the developer (ANT), and the publisher (XYZ), it's crucial to examine the agreement that outlines the service obligations of each party. Apart from the principal vs agent considerations, the arrangement may provide more factors for influencing this assessment. For example,

1. **Platform selection rights:** The publisher's authority to choose the hosting platforms is a significant factor in determining the ‘right to direct’.
2. **Change request rights:** The publisher's right to direct the developer to modify the game based on business needs is also important.

If XYZ has a comprehensive role and the rights in the operation and distribution of the game, then XYZ would be considered as the principal.

Sale of virtual items – point in time or over time

Under Ind AS 115, an entity recognises revenue when (or as) it satisfies a performance obligation by transferring a good or service to a customer. An entity 'transfers' a good or service to a customer when the customer obtains control of that good or service. Control may be transferred either at a point in time or over time. The analysis of when control transfers is performed primarily from the perspective of the customer.

The recognition of revenue for virtual items is a nuanced process, distinct from the sale of tangible goods. For instance, the sale of a physical item, such as a toy, typically ends the retailer's obligation to the customer. However, the sale of a virtual toy in a game requires the game publisher or developer to maintain the digital environment necessary for the item's use.

Game publishers are generally expected to uphold the digital environment for the gameplay, which is essential for the utility of virtual items. This expectation persists despite the non-refundable nature of the gamer's payment and the publisher's legal right to discontinue the game without repercussions. This duty reflects the publisher's commitment to sustaining its online gaming business and operations. Consequently, revenue recognition for virtual items must be evaluated whether at point in time or over the period of publisher’s obligation i.e. over the 'delivery period’.

Virtual items commonly found in games include:

1. **Consumables:** These are items like in-game currency, bonus health, or power-ups, frequently seen in mobile games. Consumables are used up upon utilisation and can be repurchased. Games often provide small quantities of these items to maintain gameplay continuity. For players seeking immediate access without delays, these in-app purchases are available for a fee.
2. **Permanent/non-consumables:** In the gaming industry, non-consumable items, once purchased, grant players permanent access, unlike consumables that are used up. These permanent items, often called unlockables, range from level access to bonus characters, toys, skins, cosmetic enhancements, and virtual pets. They enhance the gaming experience by allowing full exploration and enjoyment of all game features. For instance, buying a cow in a popular farming game grants unlimited life as long as the game is active.
3. **Period-based items:** These items include subscriptions or items consumed over time. A battle pass in a war game, valid for 30 days, or a subscription that eliminates advertisements for a year.

To ascertain the appropriate timing for revenue recognition of virtual items, an entity must comprehend its contractual obligations, payment terms, other contractual conditions, and the applicable local laws and regulations. The evaluation process involves consideration of following:

- The **inherent characteristics** of the virtual item
- The **specific terms of the contract**
- Information about the **infrastructure** and **delivery mechanisms**
- And **other pertinent facts and circumstances**.

This assessment helps determine if the customer immediately consumes the assets and benefits as the performance obligation is fulfilled. The assessment approach requires judgement that ensures the entity's revenue recognition practices align with the actual delivery and consumption of virtual goods.

Customer's unexercised rights

When a virtual item is sold, the publisher may receive non-refundable upfront payment but may have an obligation to provide future services. However, if the gamer does not utilise these items (customer may not exercise their rights to use the virtual item), then it raises the question of when should the publisher recognise the revenue. This scenario is not uncommon in the industry due to the high turnover of gamers, driven by the frequent release of new games or shifting preferences over time.

As per Ind AS 115, the publisher would need to recognise the prepayment received from a customer as a contract liability and recognise revenue when the promised goods or services are delivered in the future. However, if the customer is expected to not exercise their rights, then a portion of the contract liability recognised may relate to contractual rights that the entity does not expect to be exercised - i.e. a breakage amount.

The publisher would need to determine the amount of breakage to which it is entitled as the amount for which it is considered highly probable that a significant reversal will not occur in the future. This amount is recognised as revenue in proportion to the pattern of rights exercised by the customer (proportional method) when the entity expects to be entitled to breakage. Otherwise, the entity recognises breakage when the likelihood of the customer exercising its remaining rights becomes remote.

Conclusion

The accounting complexities in this ecosystem arise from the diverse revenue streams, the need for compliance with various financial regulations, and the intricate relationships between the different participants. As the industry continues to evolve, these complexities are likely to increase, requiring even more sophisticated accounting and financial management strategies.

Organisations are recommended to ensure transparency in operations while keeping long-term objectives in mind and framing their accounting policies as per the financial reporting standards.