CHAPTER 1

Gross vs. net presentation of revenue under Ind AS 115

This article aims to:

Discuss the key considerations for recognition of revenue on gross or net basis.

Background

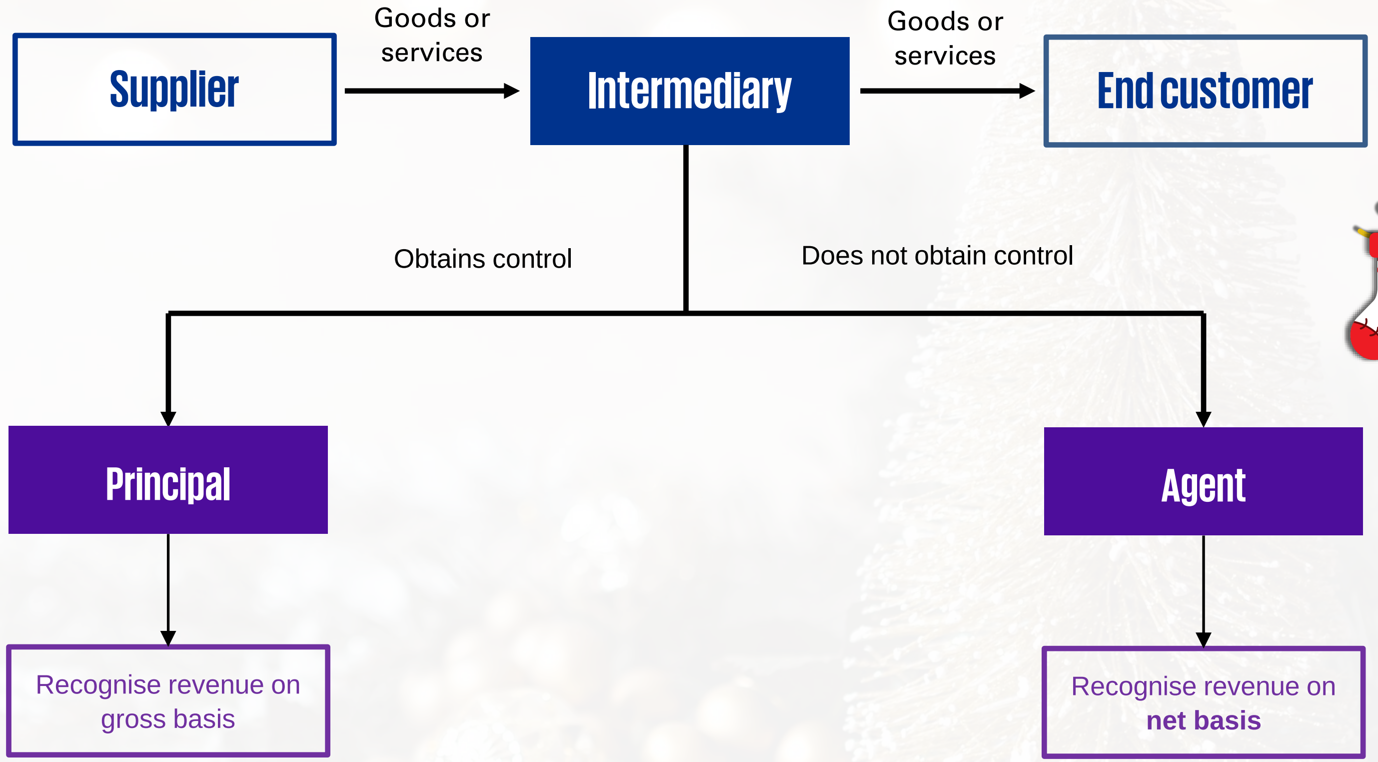
An entity recognises revenue on sale of goods and/or of services. Such transactions generally involve two parties i.e. a customer and a seller (Entity). However, a critical challenge in revenue recognition emerges when another party is involved in providing goods or services to a customer – i.e. should entities recognise the gross amount of revenues and the related cost of sales, or should they report revenue on net basis? Determination of this aspect could have significant implications on financial reporting and decision-making.

Ind AS 115, *Revenue from Contracts with Customers*, lays down the principles for recognition, measurement and disclosure of revenue from contracts with customers thereby enabling users of the financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from such revenues. The core principle for revenue recognition is – "*an entity recognises revenue to depict the transfer of promised goods or services to the customer in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services*". Accordingly, the standard is based on principle on 'transfer of control'. It further introduces a five-step model to support the core principle.

Therefore, when another party is involved in providing the goods or services to a customer, the entity is required to evaluate the nature of the promise to the customer. As part of the five-step model, an assessment is required to be made in determining whether the nature of the entity's promise is to provide the specified good or service itself (in which case the entity is a principal) or to arrange for it to be provided to the customer by another party(ies) (in which case the entity is an agent).

In this article, we aim to discuss the guidance laid down in Ind AS 115 to help entities determine whether they are acting as a principal or an agent for the purpose of recognising revenue on a gross or net basis.

Below is a diagrammatic representation to help determine whether the entity is a 'principal' or an 'agent':



(Source: KPMG in India's analysis read with KPMG IFRG Limited's IFRS 15 Handbook, November 2022)

Case studies[1]

Let's discuss the evaluation of principal vs agent with the help of following case studies:

Case study 1

Fact Pattern

- Entity ABC negotiates with major airlines to purchase tickets at reduced rates compared to public prices. ABC commits to buying a specific number of tickets and must pay for them regardless of resale. The reduced rate is negotiated and agreed upon in advance.
- ABC sets the prices for airline tickets it sells. It collects the payment from customers at the time of purchase.
- ABC also assists the customers in resolving complaints with the service provided by the airlines. However, each airline is responsible for fulfilling obligations associated with the ticket, including remedies to a customer for dissatisfaction with the service.

Step 1 - Identification of specified goods and/or service

A 'specified good or service' means a distinct item or a distinct bundle of items in the customer contract. If individual goods and services are not distinct, the entity evaluates whether it acts as a principal or an agent for the combined promise that includes these items. Once an entity identifies each specified good or service in the contract, it then evaluates whether it obtains control of each specified good or service from the third-party provider before the good or service is transferred to the customer.

In the given case study, ABC purchases tickets to fly on a specified flight from the airline. Therefore, the specified good or service provided to the customer is the right to a seat on that specific airline. Accordingly, any other goods or services are not promised to the customer.

Step 2 - Determination of control and assessment of other indicators

If the entity obtains control of goods or services before transferring those goods or services to a customer, then the entity is a principal. However, if the entity does not obtain control before it is transferred and further arranges for such goods or services to be provided by another entity then the entity is acting as an agent. To determine whether entity controls goods or services before it is transferred to the customer, the entity should consider the general guidance on transfer of control as provided under Ind AS 115 and specific indicators relating to determination of principal vs agent guidance. Some of the specific indicators enumerated in the standard are as follows:

- The entity has primary responsibility for providing the specified goods or service e.g. the entity is responsible for accepting or rejecting the orders, for developing the sales strategy, etc.
- The entity has inventory risk, for instance – the entity is liable for customer returns or is liable for any damage to the inventory in its possession before sale to the end customer
- The entity has discretion in establishing prices for the specified goods or services e.g. the amount paid to the supplier is fixed price per unit.

In the given case study, the entity has evaluated following points to determine whether it is acting as a principal or an agent in the current fact pattern:

- ABC controls the right to each ticket before it transfers that specified right to one of its customers because ABC has the ability to direct the use of that right by deciding whether to use the ticket to fulfil a contract with a customer and, if so, which contract it will fulfil. ABC also has the ability to obtain the remaining benefits from that right by either reselling the ticket and obtaining all

1. Clarifications to IFRS 15, *Revenue from Contracts with Customers* issued by International Accounting Standards Board (IASB) in 2016

of the proceeds from the sale or, alternatively, using the ticket itself. This is further evidenced by:

– ABC has inventory risk with respect to the ticket because ABC has committed itself to obtain the ticket from the airline before obtaining a contract with a customer to purchase the ticket. This is because the ABC is obliged to pay the airline for that right regardless of whether it is able to obtain a customer to resell the ticket to or whether it can obtain a favourable price for the ticket.

– ABC also establishes the price that the customer will pay for the specified ticket.

Conclusion

Based on the above facts, it is concluded that ABC is a principal and should recognise revenue on a gross basis. However, it is important to highlight that, the above-mentioned indicators and considerations are not exhaustive. They should not be evaluated in isolation as either a separate or an additional assessment from that of the control principle. Rather, the indicators should be considered in the context of the control principle, with more weight to those that best show the entity's ability to direct the use of and obtain benefits from the good or service before transfer to the customer. Therefore, assessment of control is not dependent on whether one or more of the indicators are met or on the majority evaluation of the indicators.

Let's consider another example with slightly different fact pattern:

Case study 2

Fact Pattern

XYZ sells vouchers that entitles the customers to future meals at specified restaurants. These vouchers are non-refundable and can be purchased from XYZ's website. Further, these vouchers provide the customer with a significant discount when compared with the normal selling prices of the meals (for example - A customer pays INR100 for a voucher to get a meal worth INR200 at a restaurant).

XYZ does not purchase or commit itself to purchase vouchers in advance of the sale of a voucher to a customer; instead, it purchases vouchers only when they are requested by the customers. Further the prices at which the vouchers are sold to customers is jointly determined by XYZ and the restaurant. On sale of the voucher, XYZ is entitled to 30 per cent of the voucher value on sale.

XYZ also assists the customers in resolving complaints about the meals and has a buyer satisfaction programme. However, the restaurant is responsible for fulfilling obligations associated with the voucher, including remedies to a customer for dissatisfaction with the service.

Step 1 - Identification of specified goods and/or service

The customer obtains a voucher for a restaurant that it selects. XYZ does not engage with the restaurants to provide meals to customers on the XYZ's behalf. Therefore, the specified good or service to be provided to the customer is the right to a meal (in the form of a voucher) at a specified restaurant, which the customer purchases. Accordingly, no other goods or services (other than the vouchers) are promised to the customers.

Step 2 - Determination of control and assessment of other indicators

In the present case:

- The vouchers are created only at the time that they are transferred to the customers and, thus, do not exist before that transfer. Therefore, the XYZ does not at any time have the ability to direct the use of the vouchers, or obtain substantially all of the remaining benefits from the vouchers, before they are transferred to customers.
- XYZ neither purchases, nor commits itself to purchase, vouchers before they are sold to customers. Further, XYZ has no responsibility to accept any returned vouchers. Therefore, it does not have any inventory risk with respect to the vouchers.

Conclusion

Based on the above assessment, it is concluded that XYZ is an agent and should recognise net amount of the consideration i.e. 30 per cent commission it is entitled to upon the sale of each voucher.

Bottom line

Determining whether an entity is a principal or an agent could have significant impact on the recognition of revenue in the financial statements and complexity of business structures and transactions pose challenges in making such assessment. This would be more prevalent in businesses such as advertising agencies, entities providing platform based services, software resellers, talent management companies, etc. In making this evaluation, a wholistic assessment needs to be done after considering all the relevant fact and circumstances for each case. Thus, significant judgement may be required to assess the role of the entity as a principal or an agent in a contractual arrangements where third parties are involved for goods or services. Where significant judgement is applied, an entity should ensure appropriate and adequate disclosures are provided in the financial statements in accordance with Ind AS 115 read with Ind AS 1, *Presentation of Financial Statements*.

With respect to entities preparing their financial statements under Accounting Standards (other than Ind AS), recognise revenue as per the principles laid down in AS 9, *Revenue Recognition*. As per AS 9, in case of an agency relationship, revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration. It is important to note that, unlike Ind AS 115, AS 9 does not provide detailed guidance to determine if an entity is acting as a principal or an agent while providing underlying goods or services. Therefore, entities should consider a holistic approach to assess their respective facts and circumstances and should also refer to various guidance issued by the Institute of Chartered Accountants of India (ICAI) such as technical guides on specific topics/industries, opinions issued by the Expert Advisory Committee (EAC) of ICAI, etc. in this regard.