

Comments of The Institute of Chartered Accountants of India on IASB Exposure Draft on “Revenue from Contracts from Customers”

Questions for respondents

Recognition of revenue (paragraphs 8–33)

Question 1: Paragraphs 12–19 propose a principle (price interdependence) to help an entity determine whether:

- (a) to combine two or more contracts and account for them as a single contract;
- (b) to segment a single contract and account for it as two or more contracts; and
- (c) to account for a contract modification as a separate contract or as part of the original contract.

Do you agree with that principle? If not, what principle would you recommend, and why, for determining whether (a) to combine or segment contracts and (b) to account for a contract modification as a separate contract?

Response

- (a) (i) W.r.t. paragraph 13, it is not clear whether the condition of a single commercial objective is in line with overall profit margin as envisaged in Paragraph 9 (b) of IAS 11. Is this change likely to have any implication? If yes, we suggest that guidance may be given on the same.

(ii) Since the indicators given in paragraph 13 with regard to price interdependence are inclusive, there may be other indicators as well.

It is not clear whether these three indicators need to be satisfied cumulatively (since at the end of paragraph 13 (d) the word ‘and’ is mentioned) or whether these are mutually exclusive. It is suggested guidance may be issued in this regard

- (b) We are in agreement with the principles.

- (c) (i) Example 2 scenario 2 seems to be contradictory with Paragraph 14 of the ED. In this example, we feel that the customer is getting a discount due to the existing relationship. Hence, it should not be treated as a contract modification. Therefore, the revenue that should be recognized in Year 3 to 6 should be CU 70,000 per annum (280,000/4).

Further, in this example, these are different products. Each year service is different. Hence, the revenue already recognized in Year 1 & 2 should not be reversed.

- (ii) The contract modification impact should be given prospective effect unless
 - it is explicitly stated in the contract ;or

- if one can demonstrate retrospective revision and other wise there is an obligation to refund if the contract is not continued in future

Question 2: The boards propose that an entity should identify the performance obligations to be accounted for separately on the basis of whether the promised good or service is distinct. Paragraph 23 proposes a principle for determining when a good or service is distinct. Do you agree with that principle? If not, what principle would you specify for identifying separate performance obligations and why?

RESPONSE

We agree with the principle.

Question 3: Do you think that the proposed guidance in paragraphs 25–31 and related application guidance are sufficient for determining when control of a promised good or service has been transferred to a customer? If not, why? What additional guidance would you propose and why?

RESPONSE

- (i) It is felt that the existing criteria regarding transfer of significant risks and rewards incidental to ownership may be specifically retained as a separate criterion or as part of the criterion of control.
- (ii) In paragraph 30, the indicators that give guidance on when the customer has obtained control over a good or service need to be strengthened, e.g., to identify whether revenue should be recognised for goods in transit, the indicators are not sufficient. Thus, paragraph 30 may be amended to include indicators such as managerial involvement, ability to direct the use of the goods. Also the Board should give negative indicators, i.e., indicators where control is not passed.
- (iii) Paragraph 30 (d) read with paragraph B 68 would result in same position as that in IFRIC 15 regarding recognition of revenue in case of real estate. In our view, this indicator in itself should not result into recognition of revenue on real estate on completion as it results in measurement of performance of real estate entity only in the year of completion of real estate property. In case of long term real estate contracts, percentage of completion would be an appropriate measure of performance of the entity.

Measurement of revenue (paragraphs 34–53)

Question 4: The boards propose that if the amount of consideration is variable, an entity should recognise revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 38 proposes criteria that an entity should meet to be able to reasonably estimate the transaction price.

Do you agree that an entity should recognise revenue on the basis of an estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach do you suggest for recognising revenue when the transaction price is variable and why?

RESPONSE

Yes, we agree that an entity should recognise revenue on the basis of an estimated transaction price.

However, for the purpose of measuring the estimated transaction price, one should not use probability weighted expected amount rather it should be based on best estimate. Recognising revenue based on probability weighted expected amount would render the revenue recognition process as a statistical exercise. It will also be very cumbersome for the auditor to satisfy himself on the fairness of management estimates regarding revenue recognised based on probability weighted expected amount.

Question 5: Paragraph 43 proposes that the transaction price should reflect the customer's credit risk if its effects on the transaction price can be reasonably estimated. Do you agree that the customer's credit risk should affect *how much* revenue an entity recognises when it satisfies a performance obligation rather than *whether* the entity recognises revenue? If not, why?

RESPONSE

Customer's credit risk should impact *whether* an entity recognizes revenue and not *how much* of the revenue. The following arguments need consideration in this regard:

1. Recognition of contingent revenue based on probability can lead to preponment of revenue in certain cases, e.g., in cases where a substantial part of the revenue is based on success. Presently, generally no revenue is recognised in these cases till the time success is achieved. However, going by the exposure draft, it would be possible to recognise revenue in these cases even at early stages.
2. From a taxation perspective, separate set of books will be required as GST, income tax etc. will be assessed on actual revenue rather than probability weighted revenue. This will necessitate maintaining dual set of books.
3. Recognition of revenue will also lead to problem with recovery suits. Since full revenue will not be recognised, in most cases, in the books, it will be very difficult to establish in the court of law that the actual amount due from the customer is different than the revenue recognised in the books.
4. If credit risk will impact how much revenue an entity recognizes when it satisfy a performance obligation, then an entity would also need to have access to credit rating of the customer for the purpose of recognizing revenue. This will become a very cumbersome task.

Question 6: Paragraphs 44 and 45 propose that an entity should adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicit or implicit). Do you agree? If not, why?

RESPONSE

1. It may be useful if some guidance is included regarding when it should be considered that a contract includes a material financing component. .

2. Regarding the discounting rate, the exposure draft requires that the rate to be applied is the rate that would be applied in a separate financing transaction between the entity and the customer. This will be quite an onerous task. It will also require the entity to evaluate the credit rating of the customer. Instead a better approach should be to use WACC or incremental borrowing rate applicable to the entity.

Question 7: Paragraph 50 proposes that an entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the stand-alone selling price (estimated if necessary) of the good or service underlying each of those performance obligations. Do you agree? If not, when and why would that approach not be appropriate, and how should the transaction price be allocated in such cases?

RESPONSE

Principally we are in agreement with the suggestions.

However, we feel illustrative guidance may be added on implementation of allocation of transaction price in package deals, e.g., if a media company, has entered into a contract with a group of companies and the group has agreed to carry out 4 print ads, to run the ad on internet for 1 month and to give a stall in an event as a sponsor for a consolidated amount of say CU 10 lacs. The group has different legal entities who look after the print business (say A Ltd.), online business (say B Ltd.) and events business (say C Ltd.). In this case, how should the group allocate revenue of CU 10 lacs among the three different products. Since in the media business, inventory is a perishable item, allocation based on standalone selling price or based on costs may not be appropriate since the marginal cost of carrying additional ads is negligible. Further, since the inventory is perishable, stand alone selling prices may not have much relevance.

Contract costs (paragraphs 57–63)

Question 8: Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example, IAS 2 or ASC Topic 330; IAS 16 or ASC Topic 360; and IAS 38 *Intangible Assets* or ASC Topic 985 on software), an entity should recognise an asset only if those costs meet specified criteria.

Do you think that the proposed requirements on accounting for the costs of fulfilling a contract are operational and sufficient? If not, why?

Question 9: Paragraph 58 proposes the costs that relate directly to a contract for the purposes of (a) recognising an asset for resources that the entity would use to satisfy performance obligations in a contract and (b) any additional liability recognised for an onerous performance obligation.

Do you agree with the costs specified? If not, what costs would you include or exclude and why?

RESPONSE (for Q8 &9)

We feel that costs directly attributable to securing the contract (e.g., bid and proposal, should be included as part of the contract costs if they can be separately identified in

line with the existing requirements of IAS 11. We feel that an entity factors the cost of securing contract in the contract price and, hence, these costs should be part of contract costs.

We suggest that the inclusions and exclusions specified in IAS 11 should continue.

Disclosure (paragraphs 69–83)

Question 10: The objective of the boards' proposed disclosure requirements is to help users of financial statements understand the amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Do you think the proposed disclosure requirements will meet that objective? If not, why?

Question 11: The boards propose that an entity should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year.

Do you agree with that proposed disclosure requirement? If not, what, if any, information do you think an entity should disclose about its remaining performance obligations?

Question 12: Do you agree that an entity should disaggregate revenue into the categories that best depict how the amount, timing and uncertainty of revenue and cash flows are affected by economic factors? If not, why?

RESPONSE (Q 10 to Q12)

Principally, we are in agreement with the disclosure requirements. However, in case the disclosure requirements leads to dissemination of information on individual contracts then it will have confidentiality issues that can adversely affect a business (say ,e.g., disclosures required by paragraph 77 (c), (d) and (e). Accordingly, the Standard should exempt a company from disclosures in case there are confidentiality concerns.

Effective date and transition (paragraphs 84 and 85)

Question 13: Do you agree that an entity should apply the proposed requirements retrospectively (ie as if the entity had always applied the proposed requirements to all contracts in existence during any reporting periods presented)? If not, why?

Is there an alternative transition method that would preserve trend information about revenue but at a lower cost? If so, please explain the alternative and why you think it is better.

RESPONSE

No, we don't agree that the entity should apply the proposed requirements retrospectively because of the following reasons:

1. Invoices to the customers would have been already raised for the previous years' revenue and it may not be possible to raise invoices/debit notes for the adjustment arising on account of the ED. Further, in case hypothetically we assume that it would be possible raise such invoices/ debit notes, how would the customer adjust and accept these changes. Further, in case the customer would also be forced by virtue of this ED to accept such changes would that not result

- in changing the revenue recognition and expenditure across the board for most companies.
2. In case we recognize the revenue on the basis of the ED for the previous periods also then on account of the transitional provision whether the revenue for the current period would be debited/credited for this adjustment since reserves cannot be debited/credited in the absence of knowledge about the profit element in the revenue.
 3. It's not possible to change the revenue for the previous years as the company may have declared dividend & have paid the necessary taxes and filed the statutory returns (Income tax, Sales Tax, Service Tax etc).

In our view, the ED should apply prospectively.

Application guidance (paragraphs B1–B96)

Question 14: The proposed application guidance is intended to assist an entity in applying the principles in the proposed requirements. Do you think that the application guidance is sufficient to make the proposals operational? If not, what additional guidance do you suggest?

RESPONSE

1. There should be a guidance on what is commercial objective and how is it different from the concept of profit margin as envisaged in IAS 11.
2. Though the principles in the ED are of far reaching import, the examples given are very simplistic and do not consider the practical aspects and the possible problems which may be encountered across different industries. Certain instances are mentioned below:-
 - Paragraph B12- regarding probability estimation would be too onerous in practice not only for the managements but also for auditors. Thus, what in the example appears to be feasible may not be so when diverse situations are encountered in practice.
 - It becomes very difficult to determine the performance obligation. The test of distinct or not distinct practically whether feasible or not feasible is to be provided. Comparison with other entities is very subjective (Para B43 & B44).
 - ED prescribes to recognize revenue on the basis of performance obligation & to make best estimate of the cost incurred & subsequently deferred till the performance of obligation. It would have better to mention example for this particular case in Application Guidance.
 - Guidance should be provided on allocation of transaction price.

Question 15: The boards propose that an entity should distinguish between the following types of product warranties:

(a) a warranty that provides a customer with coverage for latent defects in the product. This does not give rise to a performance obligation but requires an evaluation of whether the entity has satisfied its performance obligation to transfer the product specified in the contract.

(b) a warranty that provides a customer with coverage for faults that arise after the product is transferred to the customer. This gives rise to a performance obligation in addition to the performance obligation to transfer the product specified in the contract.

Do you agree with the proposed distinction between the types of product warranties? Do you agree with the proposed accounting for each type of product warranty? If not, how do you think an entity should account for product warranties and why?

RESPONSE

The proposal will change the accounting for product warranties that are not separately priced, e.g., extended warranties as per the current practice.

Under IAS 18, a standard warranty clause in a sale contract that does not result in the retention of significant risks by the seller would not preclude the recognition of revenue at the date of sale. In such a case, at the time of sale, a warranty provision is recognised in accordance with IAS 37 for the best estimate of the costs to be incurred for repairing or replacing defective products while the amount of revenue related to the product is recognised in full provided all other criteria for revenue recognition have been met. However, an abnormal warranty obligation may indicate that the significant risks and rewards of ownership have not been passed to the buyer such that revenue recognition should be deferred.

Distinguishing latent defects from post-transfer defects would be extremely subjective. Even if it could be appropriately assessed, separate tracking of the information may be challenging. Judgement may be required to assess the nature of a particular form of warranty. Further challenges may arise in determining revenue attributable to a component in situations where the entity is required to repair or replace only a component of the goods delivered. Situations such as a major product recall or a significant change in estimate could result in reversal of previously recognised revenue. This would not only impact the assessment of the performance of the future years but also question the reliability of the revenue recognised for a year. Thus, the new approach would be too onerous without commensurate benefits.

As regards deferral of revenue for standard warranty, the challenge would be that usually a standalone fair value would not be available since the standard warranty would usually be bundled with the main product on a discounted basis. Hence, it appears appropriate to continue the current practice.

Unlike current IFRSs, the proposed standard does not envisage that the presence of a warranty would preclude recognition of all revenue associated with the sale. We understand that this reflects the change from a risks and rewards approach to a transfer of control approach in the model.

Question 16: The boards propose the following if a licence is not considered to be a sale of intellectual property:

(a) if an entity grants a customer an exclusive licence to use its intellectual property, it has a performance obligation to permit the use of its intellectual property and it satisfies that obligation over the term of the licence; and

(b) if an entity grants a customer a non-exclusive licence to use its intellectual property, it has a performance obligation to transfer the licence and it satisfies that obligation when the customer is able to use and benefit from the licence.

Do you agree that the pattern of revenue recognition should depend on whether the licence is exclusive? Do you agree with the patterns of revenue recognition proposed by the boards? Why or why not?

RESPONSE

As per the proposed standard, if an entity can grant similar rights to other customers under substantially the same terms, then the rights would not be exclusive. Rights could be exclusive during a certain period of time, or in a specified geographical area or distribution channel.

IAS 18 states that fees and royalties paid for the use of an entity's assets are recognised according to the substance of the arrangement; in some cases the fees will be recognised over time (perhaps on a straight-line basis) and in some cases the arrangement will be similar to a sale such that the fees will be recognised upfront. IAS 18 does not refer to exclusivity at all. Thus, the proposed standard is expected to result in changes in practice in some cases.

The standard does not clarify as to how exclusivity is linked to performance obligation. In other words, what is the rationale for considering that an exclusive license has more than one performance obligation while a non exclusive license is considered to have a single performance obligation.

Consider for example the information technology industry. Typically, certain term-based software licenses are granted to multiple customers. The rights granted under the contract terms in such cases are not exclusive. As per the exposure draft, revenue in such situations would be recognised when the customer is able to use and benefit from rights (i.e. at the beginning of the license period). Consider a case where a company develops interactive training courses and grants non-exclusive right to various customers to use the same software in concurrent periods. The company continues to own the intellectual property. The non-exclusive right to use the training software gives the customers only the right to use and benefit from the training software for a specified period. Thus, it would be logical to conclude that the company has a continuing performance obligation and should recognise the revenue over the contract term instead of recognising the entire contract amount from the sale of the non-exclusive right as soon as the customer is able to use the software.

Consequential amendments

Question 17: The boards propose that in accounting for the gain or loss on the sale of some non-financial assets (for example, intangible assets and property, plant and equipment), an entity should apply the recognition and measurement principles of the proposed revenue model. Do you agree? If not, why?

RESPONSE

Broadly recognition and measurement principles can be applied subject to comments discussed in Q 1 to 16 above.

Non-public entities

Question 18 [FASB only]: Should any of the proposed requirements be different for non-public entities (private companies and not-for-profit organisations)? If so, which requirement(s) and why?

RESPONSE

Revenue recognition for not-for-profit organizations may involve different considerations particularly where the amount of consideration received is not at fair value or goods are transferred free. In such situations, it may be more appropriate to follow IPSAS.