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Ind AS 18 – Revenue Recognition and Ind AS 11 – Construction Contracts

Revenue recognition is arguably the most important pillar on which modern day accrual accounting is based on. Recognising revenue in the appropriate accounting period is vital to ensure accuracy in financial reporting. Revenue recognition under Indian Generally Accepted Accounting Principles (GAAP) is divided into two segments, namely:

a) Revenue recognition from the sale of goods and services, interest, royalties and dividend which is governed by Accounting Standard 9 (AS 9): Revenue Recognition; and
b) Revenue recognition from construction contracts which is governed by Accounting Standard 7 (AS 7): Construction Contracts.

Internationally, revenue recognition continues to be a much-debated subject. A joint project between the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) led to the pronouncement of International Financial Reporting Standards (IFRS) 15, the globally accepted standard for revenue recognition. The Ministry of Corporate Affairs (MCA) pronounced Indian Accounting Standard (Ind AS) 115, the Indian replica of IFRS 15 for revenue recognition. However, challenges in the interpretation and implementation led to IFRS 15 being deferred. In India, Ind AS 115 was also deferred on the recommendation of the National Advisory Committee on Accounting Standards (NACAS). As on 30 March 2016, the MCA notified two new Ind AS for revenue recognition, namely:

a) Ind AS 18: Revenue, which will be the Ind AS counterpart of AS 9. Internationally, Ind AS 18 shall be the Indian equivalent of International Accounting Standard (IAS) 18, International Financial Reporting Interpretations Committee (IFRIC) 13 and Standing Interpretations Committee (SIC) 31; and
b) Ind AS 11: Construction Contracts, which will be the Ind AS counterpart of AS 7. Internationally, Ind AS 11 shall be the Indian equivalent of IAS 11, IFRIC 12 and SIC 29.

Ind AS 18 may be considered to be more progressive than AS 9 owing to its comprehensive nature. Three major areas – barter transactions, transfer of assets from customers and customer loyalty programmes find guidance in Ind AS 18 which were earlier absent under the principles of the Indian GAAP. Ind AS 11 and AS 7 have no conceptual deviation from one another. However, Ind AS 11 addresses service concession arrangements, a concept which was not specially dealt with under the Indian GAAP. In this month's edition, we bring you a brief update on Ind AS 18 and Ind AS 11 along with a summary of the key changes between the new standards and their Indian GAAP precursors.

In this issue, we discuss:

a) Revenue - The broadened definition
b) Rendering of services
c) Interest and royalties
d) Measurement of revenue
e) Revenue recognition in special cases:
   (i) Barter transactions;
   (ii) Barter transactions involving advertising services;
   (iii) Transfer of assets from customers;
   (iv) Customers loyalty programmes; and
   (v) Service concession arrangements.

Revenue – The broadened definition

The definition of revenue under Ind AS 18 has been comprehensively broadened as compared to AS 9.

As per Ind AS 9, 'revenue' is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

- As per Ind AS 18, 'revenue' is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.
- Any inflow in the ordinary course of activities which generates economic benefits with a resultant increase in equity is termed as revenue.
- Ind AS focuses on generating economic benefits and the corresponding increase in equity rather than the mere form in which the income is derived. Shareholder's contribution which results in an increase in equity is not considered a source of revenue.

Scope Exclusion

Revenue arising from agreements of real estate development is specifically excluded from the scope of Ind AS 18 and Ind AS 11. There is no scope exclusion in AS 9 for revenue from real estate development contracts. A guidance note on accounting for real estate transactions, both under Indian GAAP and Ind AS, has been issued by the Institute of Chartered Accountants of India (ICAI).

Rendering of services

Revenue from service transactions is usually recognised as the service performed. The only condition to be fulfilled under AS 9 for recognising service contract revenue is the certainty of its collection. AS 9 prescribes two methods for revenue recognition, namely:

a) Proportionate completion method (also referred to as percentage completion method)
b) Completed service contract method

Ind AS 18 recognises that it is imperative to record revenue in the accounting period in which the services are rendered. If revenue is recognised on this basis, both the entity and the users of financial statements can best judge the extent of service activity and performance during a particular reporting period. Such clarity in recognising revenue from service contracts is provided by the percentage completion method which is the only method of revenue recognition for service contracts prescribed by Ind AS. In order to accurately determine the stage of completion of the service provision, Ind AS has suggested the following methods:

a) Surveys of work performed
b) Services performed to date as a percentage of total services to be performed
c) The proportion of costs incurred to date compared to the estimated total costs of the transaction. Only costs that reflect services performed to date are included in the costs incurred to date. Only costs that reflect services performed or to be performed are included in the estimated total costs of the transaction.

Interest

Under Ind AS 18, interest income is to be recognised using the effective interest rate method as prescribed under Ind AS 109: Financial Instruments.

Measurement of revenue

Ind AS 18 requires revenue to be recognised at the fair value of the consideration received or receivable as opposed to the nominal value as under the Indian GAAP. Although a more accurate method to report financial results, fair value is challenging to arrive upon in some circumstances.

The sale of goods or rendering of services may happen on a deferred payment basis. In such cases, the fair value of the consideration may be less than the nominal value. An imputed rate of interest may be applied in such cases wherein the interest element shall be accounted for separately as per Ind AS 109: Financial Instruments.

Revenue recognition in special cases

Barter transactions

The recognition and measurement of revenue arising from barter/exchange transactions are not covered by AS 9. Ind AS 18 prescribes guidelines for the recognition and measurement of revenue in the case of exchange of goods and services. Ind AS categorises these exchange transactions in the following categories:

Category	Impact	Measurement
Goods/services exchanged for goods/services which are ***similar in nature and value***	No revenue generated	Not applicable

Category	Impact	Measurement
Goods/services exchanged for goods/services which are ***dissimilar in nature and value***	Revenue generating	Fair value of goods/services received* (-) Cash/cash equivalents transferred

**In cases where the fair value of the goods/services cannot be reliably measured, revenue is measured at the fair value of the goods/services given up net off any cash/cash equivalents transferred.*

Barter transactions involving advertising services

AS 9 is silent on barter transactions and hence there is no specific guideline available in the Indian GAAP for barter transactions involving advertising services. Internationally, revenue recognition principles for these transactions are laid down in SIC 31. Ind AS 18 provides a brief guidance on this subject without conceptually differing from SIC 31. As per Ind AS 18, the need to recognise revenue in barter transactions involving advertising services shall arise when:

a) the advertisement services exchanged are of a dissimilar nature; and
b) the amount of revenue involved in the exchange can be reliably measured (as discussed earlier, the fair value of the service received/provided can be reliably measured).

Let us consider the following case to discuss this:

Company A produces tomato ketchup and Company B produces potato chips. Company A has remote access throughout region XYZ; an area Company B has not been able to penetrate owing to competition. Company B has remote access throughout region PQR; an area Company A has not been able to penetrate owing to competition. Both companies aim to penetrate into markets where their presence is minimal and enter into the following agreement:

10,00,000 units of ketchup bottles of Company A that will be sold across region XYZ will bear the graphics and logo of Company B's potato chip. In return, Company B will allow Company A to use 20% of its television advertising space to feature its mineral water advertisements for no charge.

Print advertisements are exchanged in return for television advertisements. Considering that services of a dissimilar nature are exchanged, the exchange is revenue generating.

The issue faced by the accounting teams of both entities shall be a fair valuation of the services received or provided in the said exchange.

The accounting principles laid down in Ind AS 18 state that a barter transaction involving advertising cannot be reliably measured at the fair value of the advertising services received. A selling entity can easily arrive upon the fair value of services rendered by it. This being considered, Ind AS 18 prescribes selling entities to reliably arrive upon the fair value of services they have **rendered** for advertising barters.

Ind AS 18 lays down non-barter transactions from which reference can be drawn in arriving at the fair value of the advertising services bartered:

a) Advertising services similar to the one on the advertising barter transaction
b) Advertising services that occur frequently
c) Advertising services that represent a predominant number of transactions and amount when compared to all transactions to provide advertising that is similar to the advertising in the barter transaction
d) Advertising services that do not involve the same counterparty in barter transactions

Transfers of assets from customers

Let us consider the following case for our discussion.

Company AB acquires land at a remote location for setting up a manufacturing plant. The remote location does not have access to an electricity supply network. The closest electricity supply grid provides Company AB with options to resolve the supply crisis:

a) Company AB is to acquire/construct all the required support infrastructure such as conducting cables, poles, switches, etc. and provides the same to the grid which shall ensure that Company AB is within the network to receive electricity; or
b) Provide cash to the grid which shall set up all the infrastructure and ensure that Company AB is within the network and receives electricity.

On completion of construction, Company AB will be charged on a monthly basis for the electricity it consumes at the current prevalent power supply rates.

In industries such as power and utilities, telecommunication, outsourcing, etc., an entity may receive items of Property, Plant and Equipment (PPE) from its customers. These items of PPE are to be used by the entity to:

a) Connect their customers to a network to provide them services such as gas, water, electricity, etc.;
b) Provide the customer with an ongoing supply of services (e.g. payroll process, data entry, credit collection as is provided by BPOs); or
c) Provide the customer with an ongoing supply of goods.

In some cases, the entity may receive cash from the customer which must be used to construct or acquire the required item of PPE.

Transfers of assets under such conditions are made so that the customer receives the specified goods or services from the entity. Such transfers are considered to be that of dissimilar goods or services resulting in revenue. Internationally, IFRIC 18 provides guidance on these transactions. Under the Indian GAAP, no specific treatment for the same is prescribed. Ind AS 18 addressed the accounting issues that arise in transactions of this nature. The accounting issues at hand in these cases are:

a) Recognition and measurement of the items of PPE by the entity;
b) Revenue recognition of services rendered by the entity; and
c) Accounting for cash received from the customer.

Recognition and measurement of items of PPE by the entity

Recognition as an asset

From an accounting standpoint, the entity must first assess if the transferred item of PPE meets the definition of an asset. The *Framework for the Preparation and Presentation of Financial Statements* issued by the ICAI defines an asset as 'a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.'

The entity must assess if it has control over the item of PPE. If the entity is in a position to put the item of PPE to use as per its discretion, it is considered to be in control of the asset. Control also stems from the entity being in charge of decisions such as operation, maintenance and replacement of the item of PPE. If it is determined that the entity controls the item of PPE, it shall recognise the same as an asset in financial statements.

Measurement on initial recognition

The entity shall recognise the asset either at its cost or fair value. The recognition shall be as per the guidelines of Ind AS 16: Property, Plant and Equipment.

To know more about Ind AS 16, click here.

Revenue recognition of services rendered by an entity

Identifying separately identifiable services

The entity shall assess all components of the services that generate income for it. The entity shall then use the guidelines prescribed by Ind AS 18 to determine whether there is more than one revenue generating source in the agreement with the customer. Multiple revenue generating services if the following conditions are satisfied:

a) The service represents stand-alone value to the customer; and
b) A reliable fair value of the service can be arrived upon.

Revenue generated from each individual source shall be identified separately.

Ind AS 18 summarises revenue recognition on the transfer of assets from customers as:

Case	Revenue recognition
Single service is identified	Revenue is recognised as the fair value of service using the percentage completion method
More than one separately identifiable services are identified	Fair value of the total consideration shall be allocated to each recognised service
Ongoing service with a specified completion period is identified	Revenue is recognised at their fair value by the percentage completion method over the period agreed upon with the customer
Ongoing service without a specified completion period is identified	Revenue is recognised at their fair value by the percentage completion method over the useful life of the transferred asset

Accounting for cash received from the customer

If the constructed or acquired item of PPE meets the definition of an asset, it shall be recognised at cost. Any cash received for the construction or acquisition of the asset shall be recognised as revenue.

Customer loyalty programmes

In the Indian GAAP, there is no specific guidance on the accounting of customer loyalty programmes. There were majorly two practices prevalent in industries. Please read Assurance Insights – February 2016 to know more about these practices.

Under Ind AS 18, customer loyalty programmes are to be accounted as per the deferment model explained in the aforementioned Assurance Insights issue.

Service concession arrangements

Traditionally, public infrastructure services such as roads, bridges, tunnels, hospitals, airports, water distribution facilities, energy supply, telecommunication networks, etc., have been constructed, operated and maintained by the public sector. The government usually enters into a contractual service arrangement to encourage private sector entities to participate in the sphere of public infrastructure service. Under these arrangements, a contract is granted by a public sector entity or a government body (henceforth referred to as the grantor) to a private sector entity (henceforth referred to as the operator). Ind AS 11 typically applies to arrangements that require the operator to construct, operate and maintain the infrastructure needed to provide the public service.

- The operator entity acting in the capacity of a principal and not merely an agent of the grantor by being responsible for at least some management of the infrastructure and related services.
- The contract sets the initial prices to be levied by the operator and regulates price revisions over the period of the service arrangement.
- The operator is obliged to hand over the infrastructure to the grantor in a specified condition at the end of the period of the arrangement, for little or no incremental consideration, irrespective of which party initially financed it.

The issues addressed by Ind AS 11 are the same as IFRIC 12 and SIC 29, and there is a negligible conceptual deviation between the two guidelines. The key points with respect to such arrangements are given below:

- The operator is bound to provide public service on behalf of the grantor and hence has access to the infrastructure in question. The operator does not enjoy the right to control the use of the public service infrastructure under the arrangement. Hence, the operator entity cannot recognise the infrastructure that it constructs or substantially develops as PPE.
- The operator entity acts in the capacity of a service provider in such arrangements. The activities of constructing the infrastructure, operating and maintaining it are to be carried out for a specified period of time. The revenue recognition of this shall be carried out in accordance with a regular service contract as under Ind AS 18 by using the percentage completion method at the fair value.
- In certain cases (for construction/upgradation services), consideration may be in the form of:
  a) Financial assets – To be accounted for as per the principles of Ind AS 109: Financial Instruments; or
  b) Intangible assets – To be accounted for as per the principles of Ind AS 38: Intangible Assets.

To know more about Ind AS 38: Intangible Assets, click here.

- The subsequent treatment of financial assets and intangible assets finds guidelines in Ind AS 9 and Ind AS 38 respectively.
- In case there are any contractual obligations to restore the infrastructure to a specified level of activity, they are to be accounted for as per Ind AS 37.
- Any borrowing costs incurred by the operator shall be accounted for as per Ind AS 23.
- Any infrastructure to which the operator has been granted access to shall not be treated as PPE in its books. In case there are any assets that the grantor provides to the operator as consideration, they are not accounted for as government grants. Such assets that form a part of the consideration are recognised as assets in the books of the operator entity at their fair value. In case the operator fails to fulfil any contractual obligation assumed in the exchange of assets received as consideration, the same shall be recognised as a liability.

SKP's comments

Ind AS 18 and Ind AS 11 gives better guidance by bringing in specific issues such as barter transactions, customer loyalty programmes, etc. However, it is pertinent to note that when IFRS 15 becomes mandatorily applicable internationally by 2018, the MCA may also follow its footsteps and re-introduce Ind AS 115 to the Indian corporate sector. In that case, companies in India may have to make an effort to upgrade their systems to comply with the new Ind AS.

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