Illustrative Guide to Ind AS 115

CONTAINS

1. In-depth explanation of the standard written in a user-friendly language
2. More than 100 practical examples
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4. Journal entries, paragraph references and effect on FS illustrated in detail
5. 8 case studies based on industry-specific scenarios

e-Book

Edition 3rd

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Ultimate Guide

in understanding and applying Ind AS 115

Ind AS 115 e-Book

Illustrative Guide to Ind AS 115

Preview

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Ind AS 115

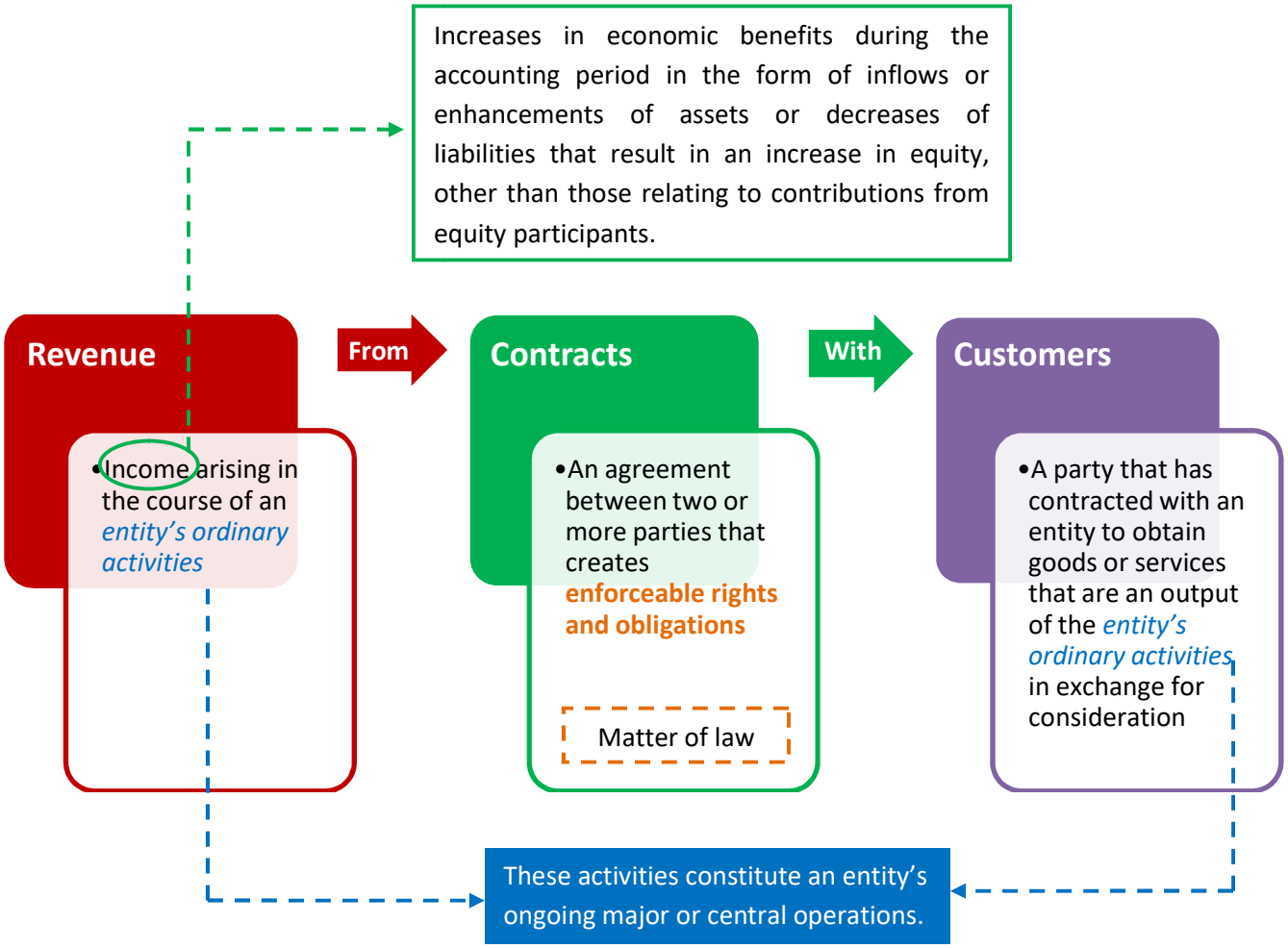
REVENUE FROM CONTRACTS WITH CUSTOMERS

CHAPTER 0

Introduction 0

This Standard provides principles that an entity applies to report useful information about the –

- nature;
- amount;
- timing and uncertainty of revenue; and
- cash flows arising from a contract with a customer.

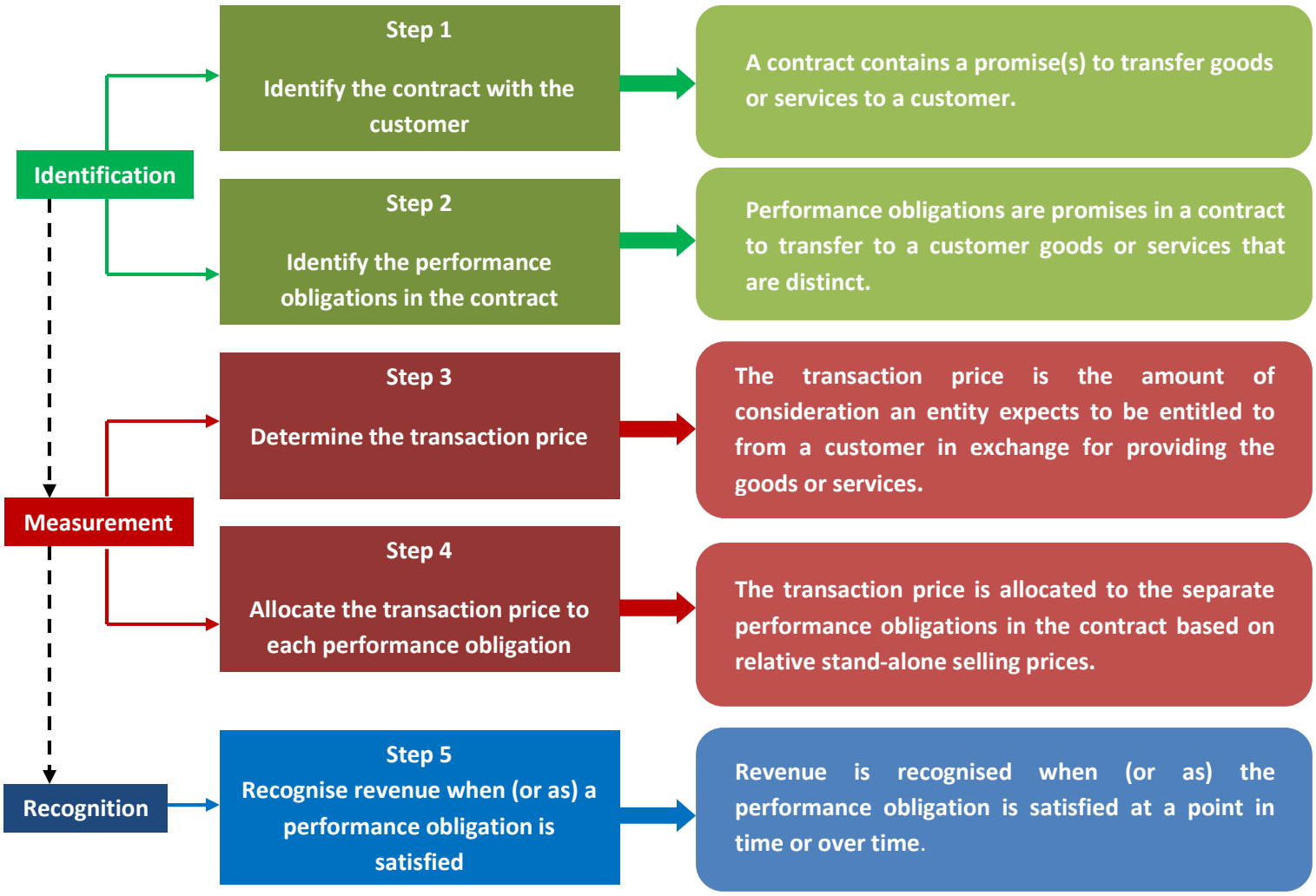


The 5-Step Model 0.2

Ind AS 115 provides a new comprehensive framework for revenue recognition and measurement using the following 5-step model –

Core Principle

Revenue recognised to depict transfer of goods or services



For every contract, it may not be possible for an entity to apply all the five steps in sequential order. In effect, it may be necessary to consider a subsequent step (s) or concurrently with applying a preceding one. We consider the following situations –

Situation 1

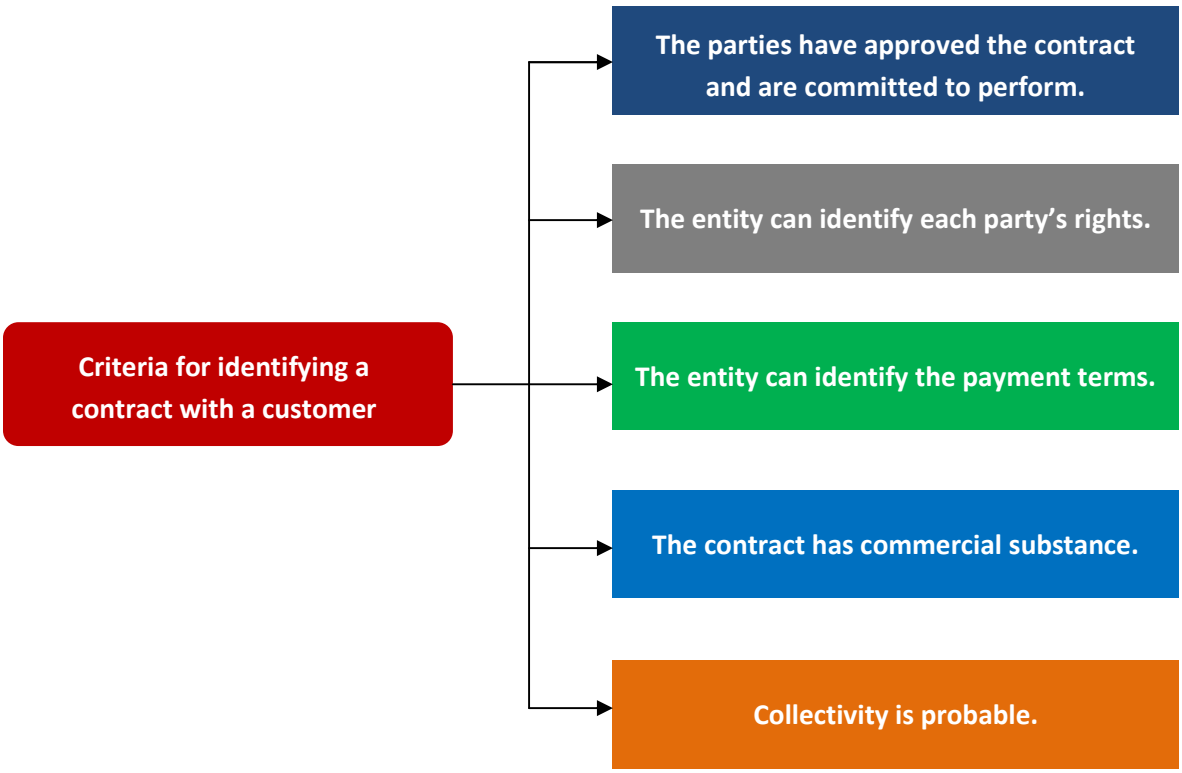
Under Step 1, to determine whether a contact exists, an entity will need to consider the amount of consideration to which it will be entitled to receive from a customer which may be *less* than the price

CHAPTER 1

STEP 1: IDENTIFY THE CONTRACT WITH THE CUSTOMER 1

Criteria for identifying a contract with a customer 1.1

The following diagram provides criteria that an entity has to evaluate to determine whether a contract with a customer is within the scope of this standard –



The above criteria are discussed further below.

- **The contract has been approved and the parties are committed**

For a contract to be accounted for, the parties must approve the contract and be committed to perform their respective obligations. Approval might be in writing, but it can also be oral or implied based on an entity's established practice(s). It is important to consider all facts and circumstances to determine if a contract has been approved.

Example 4

Entity A regularly sells goods to Entity B. As per the contract, Entity B is required to make a minimum weekly purchase of goods from Entity A. Despite the requirement, Entity B does not always make the

minimum weekly purchases. For this, Entity A does not force Entity B to comply with the requirements of the contract.

Entity A shall account for this as a contract with customer Entity B, because both the parties have demonstrated that they are substantially committed to the contract.

Example 5

It is the customary business practice of Entity A to obtain written and customer-signed sales agreements, before the performance obligation towards transfer of products is satisfied. On a request by Entity B, Entity A delivers a product to Entity B without a written and customer-signed sales agreement.

Though Entity A normally obtains written and customer-signed sales agreements, it does not necessarily mean that an oral agreement is not a contract. Entity A needs to determine whether the agreement creates enforceable rights and obligations that bind the parties to perform their respective obligations.

It might so happen that after a contract between two parties expires and before a new contract is executed, both the parties continue to perform under the terms of the expired contract. This indicates that even in the absence of a legally enforceable contract, a contract might exist since both the parties remain committed to perform, ie, the parties to the contract have present enforceable rights and obligations.

Example 6

Entity A, on 1 April 20x3, entered into a 6-month contract with Entity B to provide services in exchange for CU 500 per month. The contract did not include any automatic extension and, in effect, it expires on 30 September 20x3. The two parties signed a new contract on 1 January 20x4 that is retroactive to 1 October 20x3. The new contract requires Entity B to pay CU 600 per month.

Entity A's customary business practice is to continue providing services to a customer while negotiations for a new contract occur after the expiration of an existing contract. Accordingly, Entity A continued to provide services during October 20x3 to December 20x3 and Entity B continued to pay CU 500 per month during that period.

Aside from negotiation of rates under the new contract, all other contract attributes are the same between the expired contract and the new contract, and no disputes occurred during the interim period.

It appears that a contract existed during the interim period (ie, October 20x3 to December 20x3) because Entity A continued to provide services and Entity B continued to pay CU 500 per month according to the previous contract. It appears that both parties had enforceable rights and obligations during the interim period and, in effect, revenue recognition should not be deferred until the written contract is signed.

Worked Example 1 1.3

The reporting period of Entity A ends on 31 March every year. On 1 June 20x3, Entity A signed a contract to construct a machine for one of its customers for a total price of CU 5,000. The contract requires Entity A to subsequently provide servicing and warranty facilities (ie, the contract requires, in addition to servicing, Entity A to repair any defects found in the machine) for a period of 1 year from the date of delivery of the machine. The construction commenced on 1 July 20x3 and was completed on 30 September 20x3. On 1 October 20x3, the machine was delivered to the customer. Entity A reasonably estimated that servicing and warranty costs for 1 year will be CU 400. A reasonable mark-up on servicing and warranty facilities of such a machine is 25% of the cost of such servicing and warranty facilities. The customer paid the full contract price of CU 5,000 on 1 December 20x3. The following costs were incurred to complete the contract – Material: CU 2,000; Labour: CU 1,000; Allocated overheads: CU 500.

Two or more contracts, that are entered into at (or near) the same time, and with the same customer, are accounted for as if they were a single contract for accounting purposes, if the contracts are negotiated as a package with a single commercial objective.

The total transaction price of the contract of CU 5,000 is to be allocated between "sale of the machine" and "provision of servicing and warranty facilities". The total anticipated costs of the service and warranty facilities are CU 400. Therefore, if a normal mark-up on servicing and warranty facilities is 25%, then the revenue that is allocated to the service and warranty elements is CU 500 (CU 400 + 25% of CU 400). In effect, revenue from the sale of machine is CU 4,500 (CU 5,000 – CU 500).

Again, revenue from servicing and warranty facilities of CU 500 is to be recognised evenly over the 1 year period, with the balance shown as contract liability.

For the reporting period ended 31 March 20x4

1.	Cash	CU 5,000	
	Contract liability		CU 5,000
2.	Contract liability	CU 4,750 (CU 4,500 + CU 250)	
	Revenue (Machine)		CU 4,500
	Revenue (Servicing and warranty facilities)		CU 250

Balance Sheet (Extract)

	CU
Equity	
Retained earnings	1,050
Liabilities	
Current Liabilities	
Contract liability (CU 5,000 – CU 4,750)	250

Statement of Profit and Loss (Extract)

		CU
Revenue from sale of machine		4,500
Cost of sales {CU 2,000 + CU 1,000 + CU 500]		(3,500)
		1,000
Revenue from servicing and warranty facilities	250	
Cost of sales	(200)	50
Accounting Profit		**1,050**

Contract modifications 1.4

A change to an existing contract is a modification. A contract modification could change the scope of the contract, the price of the contract, or both. This may be in practice be described as a *change order* (ie, modifications of an original contract that effectively change the provisions of the contract without adding new provisions), a *variation* (ie, an instruction by the customer for a change in the scope of the work to be performed under the contract, which may lead to an increase or a decrease in contract revenue), or an *amendment* (minor improvements in a contract). A contract modification exists when the parties to the contract approve the modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract, either by writing, orally, or based on party's customary business practices. If the parties to the contract have not approved contract modification, an entity shall continue to apply this Standard to the existing contract until the contract modification is approved.

If the parties to a contract have approved a change in scope, but have not yet determined the corresponding change in price, then the entity estimates the change to the transaction price by applying the guidance on estimating variable consideration and constraining estimates of variable consideration.

Accounting for a modification as a separate contract reflects the fact that there is no economic difference between the entity and the customer entering into a separate contract or agreeing to modify an existing contract. A contract modification is treated as a separate contract if the modification results in –

(a) a promise to deliver additional goods or services that are distinct; and
(b) an increase to the price of the contract by an amount of consideration that reflects the entity's stand-alone selling price of those goods or services adjusted to reflect the circumstances of the contract. For example, the renewal price that an entity charges a customer is sometimes lower than the initial price because the entity recognises that the expenses associated with obtaining a new customer can be excluded from the renewal price to provide a discount to the existing customer.

Worked Example 9 3.2

Entity A (year-end 31 March) enters into a contract with a customer on 1 April 20x4 to build a customised asset. The promise to transfer the asset is a single performance obligation that is to be satisfied over time. The promised consideration is CU 3,750 with a bonus of CU 250 if the asset is completed within two years. At the inception of the contract, Entity A expects the costs to complete the work to be CU 2,250. It also concludes that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will occur. At 31 March 20x5, Entity A estimates that it has satisfied 72% of the performance obligation on the basis of costs incurred to date, but concludes that the variable consideration is still constrained. However, on 15 April 20x5, the contract is modified and, in effect, the promised consideration and expected costs to complete the contract increase by CU 275 and CU 150 respectively. In addition, the time allowable for achieving the bonus is extended by four months. Entity A now concludes that it is highly probable that the bonus will be achieved.

According to **Para 35 of Ind AS 115** – "An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time if the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance obligation completed to date."

Entity A accounts for this transaction as a single performance obligation satisfied over time in accordance with the above.

According to **Para B 14** and **B 18 of Ind AS 115** – "Methods that can be used to measure an entity's progress towards complete satisfaction of a performance obligation satisfied over time include input methods which recognise revenue on the basis of the entity's efforts or input to the satisfaction of the performance obligation relative to the total expected inputs to the satisfaction of that performance obligation."

On the basis of the above, Entity A calculates the expected profit, as under –

Transaction Price	CU 3,750
Expected Cost	CU 2,250
Expected Profit	CU 1,500

Margin is (CU 1,500 ÷ CU 3,750) X 100 = 40%

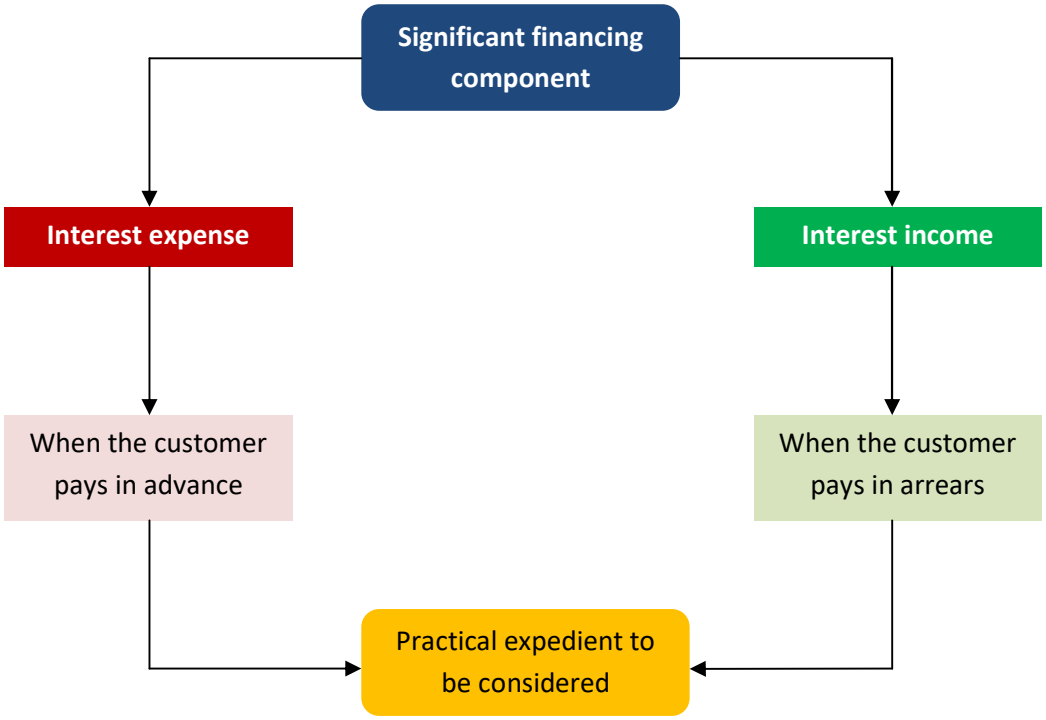
According to **Para 53 of Ind AS 115** – "An entity shall estimate an amount of variable consideration by using the most likely amount method which is the single most likely amount in a range of possible consideration amounts. The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (eg, an entity either achieves a performance bonus or does not)."

Para 56 of Ind AS 115 states – "An entity shall include in the transaction price some or all of the variable consideration estimated in accordance with para 53 only to the extent that it is highly probable that a

rate should reflect the credit characteristics of the party that receives financing, as well as any collateral or security provided by the customer or the entity, including assets transferred in the contract. The discount rate may be capable of being determined by identifying the rate that discounts the nominal amount of consideration to the cash selling price of goods or services. After contract inception, the discount rate is not updated, eg, for changes in interest rates or the customer's credit risk.

The financing component is recognised as interest expense (when the customer pays in advance) or interest income (when the customer pays in arrear) and is presented separately from revenue from customers in the Statement of Profit and Loss. Further, interest revenue or interest expense is recognised only to the extent that a contract asset (or receivable) or a contract liability is recognised with respect to the contract with the customers.

Accounting for significant financing component 3.8

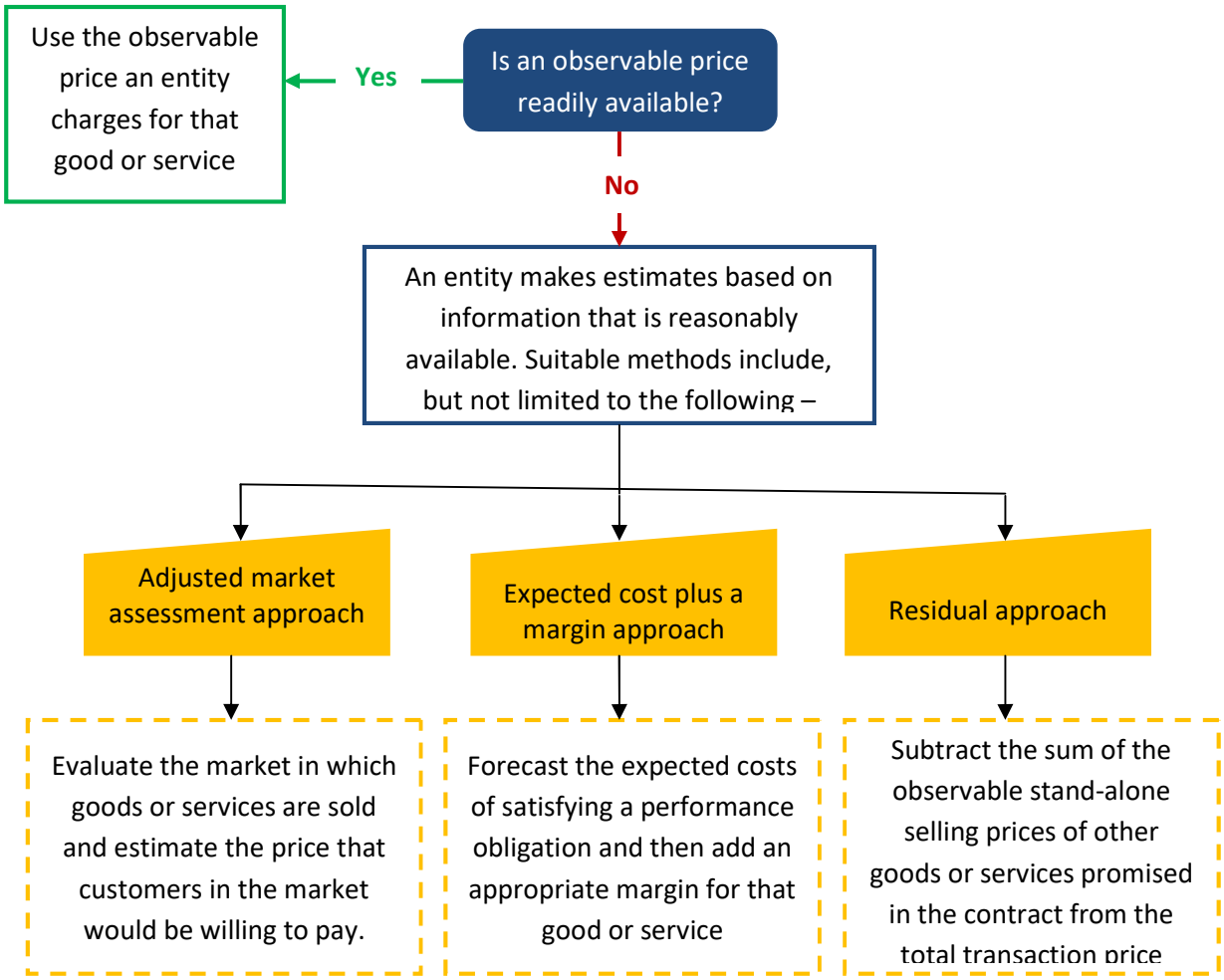


Worked Example 13 3.9

Entity A enters into a contract with a customer to sell an asset. Control of the asset rests with the customer in 2-years' time. The contract has two payment options; the customer can pay CU 2,800 when the contract is signed or CU 3,512 in 2 years time when the customer gains control of the asset. The customer elects to pay CU 2,800 when the contract is signed. The interest rate implicit in the contract is 12% in order to adjust the risk involved in the delay in payment. However, Entity A's incremental borrowing rate is 7.5%.

- ***Adjusted market assessment approach*** Evaluating the market in which the entity sells the goods or services and estimating the price that a customer in that market would be prepared to pay, which might include referring to prices charged by the entity's competitors for similar goods or services, and adjusting those prices as necessary to reflect the entity's costs and margins. For example, if an entity does not sell a particular product on a stand-alone basis, but its competitors do, that might provide data useful in estimating the stand-alone selling price.
- ***Expected cost plus a margin approach*** Forecast the expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.
- ***Residual approach*** This involves deducting from the total transaction price the sum of the estimated stand-alone selling prices of other goods or services in the contract to estimate a stand-alone selling price for the remaining goods or services. However, the use of this approach is restricted to those goods or services where price is highly variable (meaning that these cannot be observed from past transactions or other observable evidence) or not yet established (because they have not been previously sold).

Determination of stand-alone selling prices 4.1



Example 64

Entity A enters into a contract with a customer to sell Products A, B and C in exchange for CU 100. Entity A will satisfy the performance obligations for each of the products at different points in time. Entity A regularly sells Product A separately and, therefore, the stand-alone selling price is directly observable. The stand-alone selling prices of Products B and C are not directly observable.

Because the stand-alone selling prices for Products B and C are not directly observable, Entity A must estimate them. To estimate the stand-alone selling prices, Entity A uses the adjusted market assessment approach for Product B and the expected cost plus a margin approach for Product C. In making those estimates, Entity A maximises the use of observable inputs. Entity A estimates the stand-alone selling prices as follows:

Product	Stand-alone selling price	Method	Allocated transaction price
A	50	Directly observable	33 (CU50 ÷ CU150 × CU100)
B	25	Adjusted market assessment approach	17 (CU25 ÷ CU150 × CU100)
C	75	Expected cost plus a margin approach	50 (CU75 ÷ CU150 × CU100)
Total	**150**		**100**

Example 65

Entity A enters into a contract with a customer to sell three products A, B and C for a total transaction price of CU 500. The stand-alone selling prices of A and B are CU 125 and CU 225 respectively. Product C is a new product and there are no observable data exist to estimate the stand-alone selling price.

To determine the stand-alone selling price of C, Entity A cannot use the adjusted market assessment approach, because the product is new and even it is not sold by the competitors in the market. Entity A may be able to estimate a stand-alone selling price through expected cost plus a margin approach. Entity A can also use the residual approach since it has not previously sold or established a price for C. The total stand-alone selling price of A and B is CU 350 (CU 125 + CU 225). The residual approach results in an estimated stand-alone selling price of CU 150 (CU 500 – CU 350).

A combination of methods may need to be used to estimate the stand-alone selling price of the goods or services promised in the contract if two or more of those goods or services have highly variable or uncertain stand-alone selling prices. When a residual approach is used, an entity still needs to compare the results obtained to all reasonably available observable evidence to ensure the method meets the objective of allocating the transaction price based on stand-alone selling prices.

Worked Example 15 4.3

The reporting period of DKC Ltd ends on 31 March every year. DKC Ltd sells four products: A, B, C and D. The stand-alone selling prices are as follows –

Product	Stand-alone selling price
A	CU 36
B	CU 30
C	CU 24
D	CU 30
Total	**CU 120**

On 1 March 20x4, DKC Ltd enters into a contract with a customer to sell products A, B, C and D in exchange for CU 100. DKC Ltd will satisfy the performance obligations for each of the products by delivering the goods to the customer before 31 March 20x4. In addition, DKC Ltd gives the customer a 30% discount voucher for any future purchases up to CU 80 before April 20x4. DKC Ltd accounts for the promise to provide the 30% discount as a performance obligation for the sale of the products A, B, C and D. DKC Ltd makes the following estimates:

Likelyhood of redeeming the voucher	Average purchase price of additional products
10%	CU 80
20%	CU 60
30%	CU 40
40%	CU 20

The customer receives a discount for purchasing the bundle of goods because the sum of the stand-alone selling prices (CU 120) exceeds the promised consideration (CU 100). The discount and, therefore, the transaction price, is allocated as under –

Product	Stand-alone selling price	Allocated transaction price
A	CU 36	CU 30 (CU 36 ÷ CU 120 x CU 100)
B	CU 30	CU 25 (CU 30 ÷ CU 120 x CU 100)
C	CU 24	CU 20 (CU 24 ÷ CU 120 x CU 100)
D	CU 30	CU 25 (CU 30 ÷ CU 120 x CU 100)
Total	CU 120	CU 100

The following is DKC Ltd's estimated stand-alone selling price of the discount voucher –

Likelyhood of redeeming the voucher (A)	Average purchase price of additional products (B)	Total (C = A x B)	Discount rate (D)	Value of discount voucher (C x D)
10%	CU 80	CU 8	30%	CU 2.40
20%	CU 60	CU 12	30%	CU 3.60
30%	CU 40	CU 12	30%	CU 3.60
40%	CU 20	CU 8	30%	CU 2.40
			Total	**CU 12**

The sum of the stand-alone selling prices of the products A ,B, C and D and the discount voucher and the resulting allocation of CU 100 transaction price are as under –

Performance obligation	Stand-alone selling price	Allocated transaction price
Product: A, B, C and D	CU 100	CU 90 (CU 100 ÷ CU 112 x CU 100)
Discount voucher	CU 12	CU 10 (CU 12 ÷ CU 112 x CU 100)
Total	**CU 112**	**CU 100**

Therefore the rate of discount is – 10 ÷ CU 100 x CU 100 = **10%**

DKC Ltd should allocate CU 90 to the products A, B, C and D:

Product	Allocated transaction price after discount	Allocated transaction price after discount voucher
A	CU 30	CU 27 (CU 30 x 90%)
B	CU 25	CU 22.50 (CU 25 x 90%)
C	CU 20	CU 18 (CU 20 x 90%)
D	CU 25	CU 22.50 (CU 25 x 90%)
Total	**CU 100**	**CU 90**

For the reporting period ended 31 March 20x4, DKC Ltd should recognise revenue of CU 90 and contract liability of CU 10. This contract liability will be recognised as revenue when the customer redeems the voucher for goods or when it expires during April 20x4.

During the reporting period ended 31 March 20x4, DKC Ltd passes the following entries –

Journal

1.	Cash/Receivable	CU 100	
	Revenue		CU 90
	Contract liability		CU 10
2.	Deferred tax asset	CU 4 (CU 10 x 40%*)	* *Assumed income tax rate*
	Deferred tax income		CU 4

Worked Example 19 5.8

On 1 October 20x3, DKC Ltd. entered into a construction contract for a fixed price of CU 25,000, which was expected to be completed on 31 December 20x5. The estimated cost to complete the contract (excluding depreciation) was CU 11,000. An item of machinery was used in the contract from 1 January 20x4 and was expected to be used till the completion of the contract. The total depreciation of the item of machinery for this 2-year period was CU 8,000. DKC Ltd's accountants decided to allocate the depreciation using the straight line method (SLM). DKC Ltd decided that the percentage of completion was to be calculated as the agreed value of work completed as a percentage of the agreed contract price. The following information was provided for the reporting period ended on 31 March –

	20x4	20x5
	CU	CU
Agreed value of work certified	7,000	16,250
Costs incurred to-date (excluding depreciation)	5,000	9,600
Progress payment received	6,000	9,000
Estimation of work completed	35%	75%

	CU
Total value of the contract	25,000
Total expected costs to be incurred (CU 11,000 + CU 8,000)	19,000
Expected profit	**6,000**

Total depreciation for the contract period is CU 8,000. The allocation of depreciation under SLM will be as under –

For the reporting period ended 31 March 20x4 – CU 8,000 ÷ 2 x 3/12 = **CU 1,000**

For the reporting period ended 31 March 20x5 – CU 8,000 ÷ 2 = **CU 4,000**

For the reporting period ended 31 March 20x6 – CU 8,000 ÷ 2 x 9/12 = **CU 3,000**

For the reporting period ended 31 March 20x4

Under the output method, the percentage of completion of contract is 28% (CU 7,000 ÷ CU 25,000 x 100)

1.	Receivable	CU 7,000	
	Revenue		CU 7,000
2.	Cash	CU 6,000	
	Receivable		CU 6,000
3.	Contract asset	CU 1,750 [7% (35% – 28%) x CU 25,000]	
	Contract liability		CU 1,750

Balance Sheet (Extract)

Assets	**CU**
Current assets	
Contract asset	1,750
Receivable (CU 7,000 – CU 6,000)	1,000
Equity	
Retained earnings	1,680
Liabilities	
Contract liability	1,750

Statement of Profit and Loss (Extract)

	CU
Revenue	7,000
Cost of sales [28% of CU 19,000)	5,320
Accounting Profit	**1,680**

For the reporting period ended 31 March 20x5

Under the output method, the percentage of completion of contract is 65% (CU 16,250 ÷ CU 25,000 x 100)

1.	Receivable (CU 16,250 – CU 7,000)	CU 9,250	
	Revenue		CU 9,250
2.	Cash	CU 9,000	
	Receivable		CU 9,000
3.	Contract asset	CU 750 [{10% (75% - 65%) x CU 25,000} – CU 1,750	
	Contract liability		CU 750

Balance Sheet (Extract)

Assets	**CU**
Current assets	
Contract asset (CU 1,750 + CU 750)	2,500
Receivable (CU 1,000 + CU 9,250 – CU 9,000)	1,250
Equity	
Retained earnings	2,220
Liabilities	
Contract liability (CU 1,750 + CU 750)	2,500

Statement of Profit and Loss (Extract)

	CU
Revenue (CU 16,250 – CU 7,000)	9,250
Cost of sales [(65% of CU 19,000) – CU 5,320	7,030
Accounting Profit	**2,220**

Input methods 5.9

Input methods recognise revenue based on an entity's efforts or inputs towards satisfying a performance obligation, relative to the total expected inputs to the satisfaction of that performance obligation.

The examples are –

It may be appropriate for an entity to recognise revenue on a straight-line basis, when the entity's efforts or inputs are expended evenly throughout the performance period.

An entity shall exclude from an input method the effects of any inputs that do not depict the entity's performance in transferring control of goods or services to the customer. For instance, when using a cost-based input method, an adjustment to the measure of progress may be required in the following circumstances –

(a) when a cost incurred does not contribute to an entity's progress in satisfying the performance obligation, eg, the costs of unexpected amounts of wasted materials.
(b) When a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation. In those circumstances, the best depiction of the entity's performance may be to adjust the input method to recognise revenue only to the extent of that cost incurred. For example, a

faithful depiction of an entity's performance might be to recognise revenue at an amount equal to the cost of a good used to satisfy a performance obligation if the entity expects at contract inception that all of the following conditions would be met :

- the good is not distinct;
- the customer is expected to obtain control of the good significantly before receiving services related to the good;
- the cost of the transferred good is significant relative to the total expected cost to completely satisfy the performance obligation; and
- the entity procures the good from a third party and is not significantly involved in designing and manufacturing the good (but the entity is acting as a principal).

Worked Example 20 5.10

On 1 October 20x3, CPC Ltd commenced work on a construction contract for a fixed price of CU 40,000. The contract is estimated to be completed on 30 September 20x4. A plant is purchased for CU 12,000 for use in the contract, which will have an expected residual value of CU 2,000 after the contract is completed. The depreciation of the plant is allocated monthly under SLM over the period of the contract.

For the reporting period ended 31 March 20x4, the following costs are incurred –

Materials CU 8,000; Labour CU 2,500; Overheads CU 2,000

The following are the estimated costs to be incurred to complete the contract –

Materials CU 5,000; Labour CU 4,000; Overheads CU 3,500

On 31 March 20x4, the contract was certified as being 40% complete and the customer made a progress payment of CU 15,000.

Cost of contract

Costs	To-date(31 March 20x4)	Anticipated
Materials	CU 8,000	CU 13,000 (CU 8,000 + CU 5,000)
Labour	CU 2,500	CU 6,500 (CU 2,500 + CU 4,000)
Overheads	CU 2,000	CU 5,500 (CU 2,000 + CU 3,500)
Depreciation	CU 5,000[(12,000 – 2,000) ÷ 2]	CU 10,000 (CU 5,000 + CU 5,000)
Total	**CU 17,500**	**CU 35,000**

Percentage of completion is calculated on the basis of CPC Ltd's efforts or inputs to the satisfaction of a performance obligation (eg, resources consumed) relative to the total expected inputs to the satisfaction of that performance obligation.

Therefore, the percentage of completion of contract is – CU 17,500 ÷ CU 35,000 x 100 = 50%

For the reporting period ended 31 March 20x4

Journal

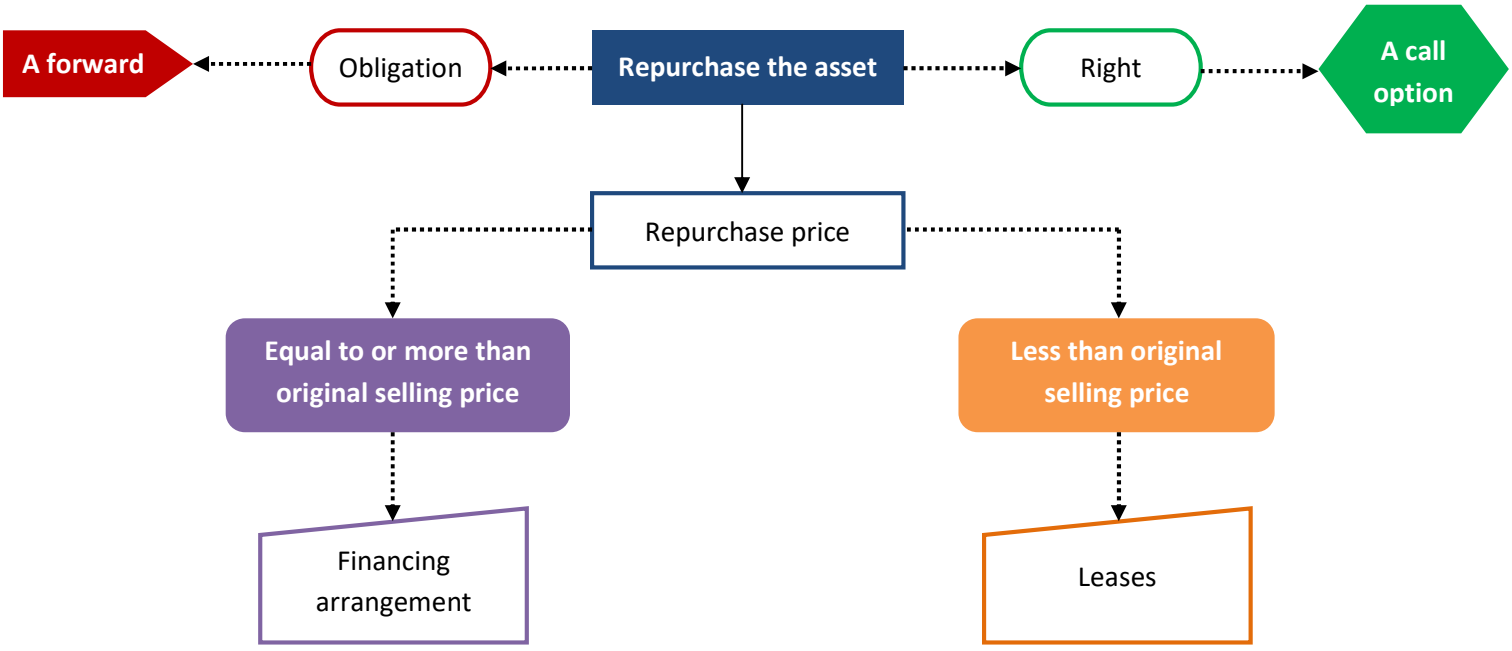
1.	Receivable		CU 16,000 (CU 40,000 x 40%)
		Revenue	CU 16,000
2.	Cash		CU 15,000
		Receivable	CU 15,000
3.	Contract asset		CU 4,000 [10% (50% - 40%) x CU 40,000]
		Contract liability	CU 4,000

Balance Sheet (Extract)

	CU
Assets	
Current assets	
Plant (CU 12,000 – CU 5,000)	7,000
Contract asset	4,000
Receivable (CU 16,000 – CU 15,000)	1,000
Equity	
Retained earnings	2,000
Liabilities	
Contract liability	4,000

Statement of Profit and Loss (Extract)

	CU
Revenue (CU 40,000 x 40%)	16,000
Cost of sales (CU 35,000 x 40%)	14,000
Accounting Profit	**2,000**



Example 78

Entity A sells a machine to a customer for CU 1,000. There is a repurchase agreement that includes a call option that gives Entity A the right (and not the obligation) to repurchase the machine in 3 years for CU 1,150. The effective interest rate is 10% p.a.

Entity A should account for the repurchase arrangement as a lease. The 3-year call period indicates that the customer does not obtain control of the machine because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the machine even though the customer has physical possession of the machine.

Including the effect of the time value of money might result in a repurchase price (ie, CU 1,150) that is less than the original sale price [CU 1,000 x 1.10^3 = CU 1,330 (approx.)], and the arrangement would be accounted for as a lease.

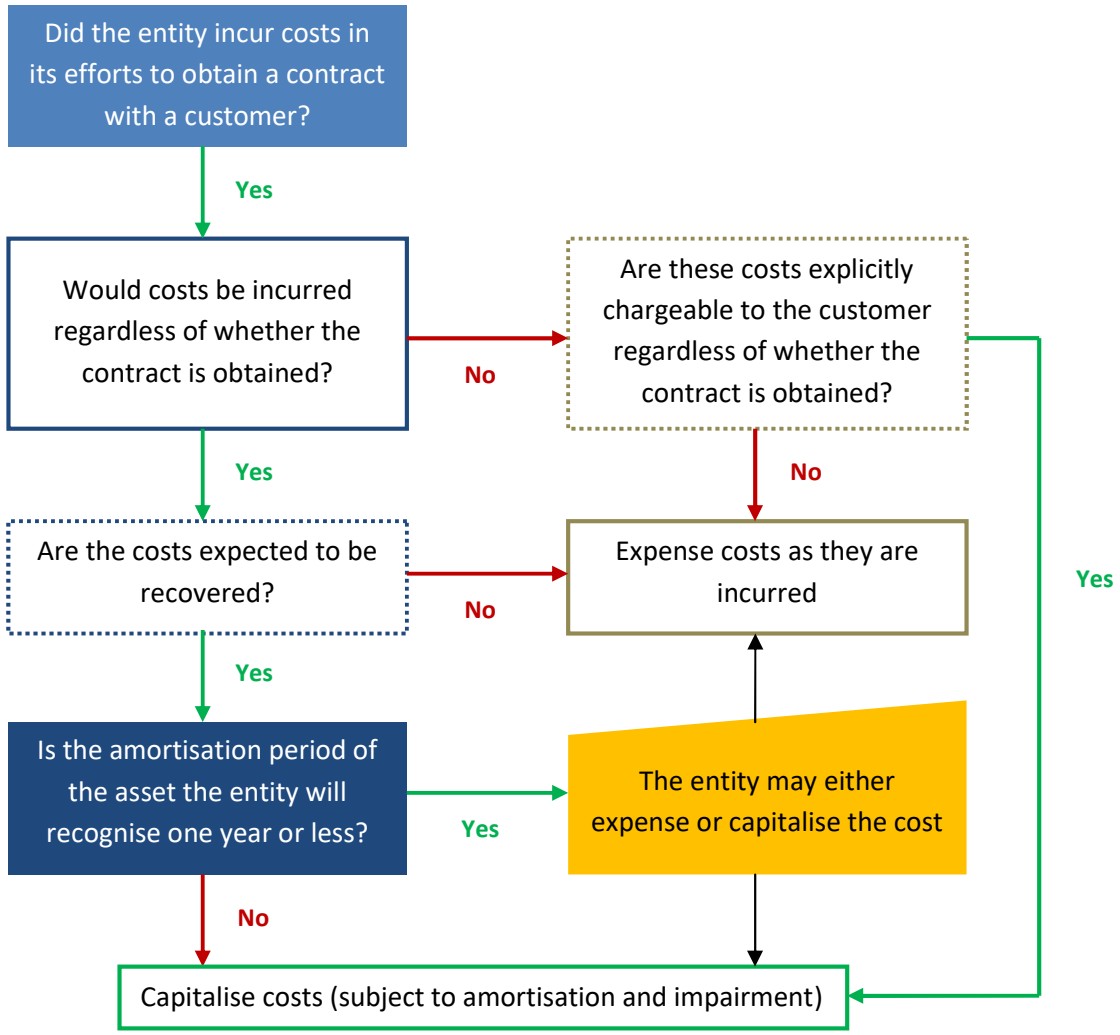
CHAPTER 6

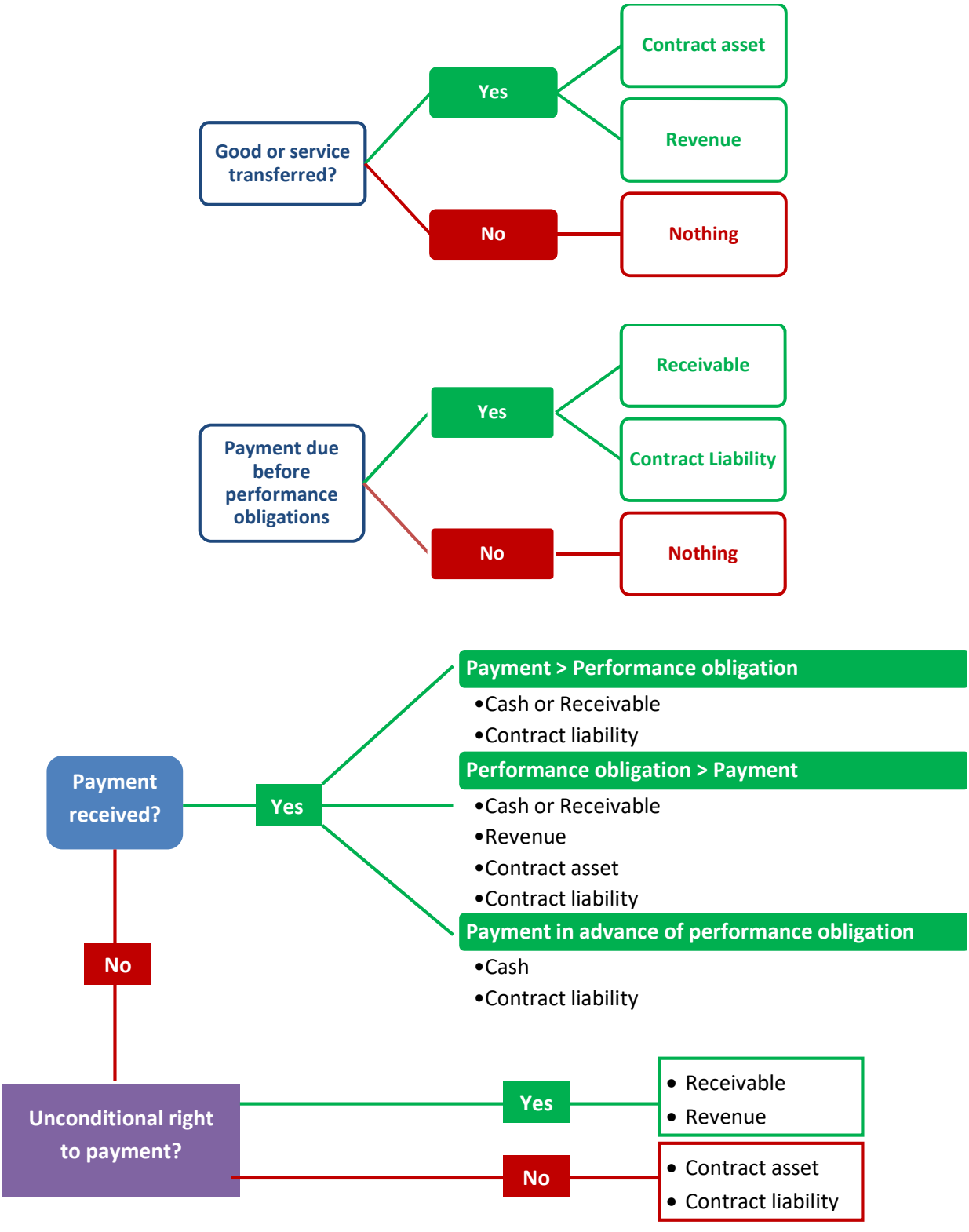
CONTRACT COSTS

Incremental costs of obtaining a contract

An entity shall recognise as an asset the incremental costs of obtaining a contract with a customer (ie, those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained, eg, a sales commission) if the entity would recover those costs. Costs of obtaining a contract that are not incremental should be expensed as incurred unless those costs are explicitly chargeable to the customer, even if the contract is not obtained. There is a practical expedient that permits an entity to expense the costs to obtain a contract as incurred when the expected amortisation period is one year or loss.

Treatment of incremental costs of obtaining a contract with a customer 6.1




Good or service transferred?
Yes
Contract asset
Revenue
No
Nothing
Payment due before performance obligations
Yes
Receivable
Contract Liability
No
Nothing
Payment received?
Yes
Payment > Performance obligation
•Cash or Receivable
•Contract liability
Performance obligation > Payment
•Cash or Receivable
•Revenue
•Contract asset
•Contract liability
Payment in advance of performance obligation
•Cash
•Contract liability
No
Unconditional right to payment?
Yes
• Receivable
• Revenue
No
• Contract asset
• Contract liability

Case Study 5 – Measurement of Refund Liability under Ind AS 115

Learning outcome

This Case Study aims to describe how an entity determines the amount of consideration to which it expects to be entitled, when it transfers control of a product to a customer and also grants the customer the right to return the product within a specified period of time. It also considers the requirements on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration can be included in transaction price. Lastly, the treatment of right to recover products from customers on settling the refund liability has also been discussed.

Introduction

In regard to the goods, the core principle of Ind AS 115 is that an entity shall recognise revenue to depict the transfer of promised goods to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods.

In some contracts, an entity may sell goods to a customer against cash and also grants the customer the right to return the goods within a specified period and receive a full refund of any consideration paid. In such a case, the entity shall recognise a refund liability which is measured at the amount of consideration received for which the entity does not expect to be entitled. At the same time, an asset is recognised for right to recover products which is measured by reference to the former carrying amount of the product, eg, inventory. Therefore, an entity shall recognise the following –

- revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (ie, excluding revenue from the products expected to be returned);
- a refund liability (and a corresponding adjustment to revenue); and
- a right to recover products (and a corresponding adjustment to cost of sales); and
- deferred tax adjustments as per Ind AS 12 *Income Taxes.*

This Case Study relates to 2 Standards, namely –

1. Ind AS 115 *Revenue from Contracts with Customers*; and
2. Ind AS 12 *Income Taxes.*

Case Study Example

ABC Ltd (year-end 31 March) is in a business where the custom of trade is that products are sold to customers in cash and unsold products can be returned within 90 days against full refund. For ABC Ltd, the costs of recovering the returned products are immaterial and they can be resold at the prevailing market prices.

In 20x1-x2, ABC Ltd sold 100 products @ CU 100 each. The cost of each product is CU 70. During the end of 20x1-x2, it is estimated that 3 products will be returned.

In 20x2-x3, none of the products sold out in 20x1-x2 were returned. ABC Ltd sold 120 products @ CU 120 each. The cost of each product is CU 75. During the end of 20x2-x3, it is estimated that 5 products will be returned.

In 20x3-x4, all the 5 products sold out in 20x2-x3 (which were anticipated to be returned) were returned. ABC Ltd sold 125 products @ CU 130 each (including the 5 returned products). The cost of each product (excluding the returned products) is CU 80. During the end of 20x3-x4, it is estimated that 7 products (other than 5 returned products) will be returned. The income tax rate is 40%.

ABC Ltd

Balance Sheet (Extract)

	NOTES	20x1-x2	20x2-x3	20x3-x4
Assets		**CU**	**CU**	**CU**
Non-current asset				
Deferred tax asset	**8**	36	90	140
Current assets				
Right to recover products [a]	**5**	210	375	560
Equity and Liabilities				
Current liabilities				
Refund liability [a]	**4**	300	600	910

[a] Right to recover products is presented separately from refund liability (**paragraph B 25 of Ind AS 115**).

Statement of Profit and Loss (Extract)

	NOTES	20x1-x2	20x2-x3	20x3-x4
		CU	**CU**	**CU**
Revenue	**2**	9,700	14,100	15,340
Cost of sales	**3**	6,790	8,835	9,415
Accounting profit		**2,910**	**5,265**	**5,925**
Tax Expense	**9**	1,164	2,106	2,370
Profit for the year		**1,746**	**3,159**	**3,555**

[1]Since the entire amount of refund liability has already been taxed in the form of revenue, the tax base of refund liability is *nil.*

A deductible temporary difference arises in profit or loss, and results on a deferred tax asset, when the carrying amount of refund liability exceeds its tax base. The amount of deferred tax asset is –

(Carrying amount – Tax base) x Income tax rate

20x1-x2 (CU 300 – 0) x 40% = CU 120

20x2-x3 (CU600 – 0) x 40% = CU 240

20x3-x4 (CU 910 – 0) x 40% = CU 364

The tax base of right to recover products is nil, since the entire amount has been deducted for tax purposes in the form of cost of sales.

A taxable temporary difference arises in profit or loss, and results in a deferred tax liability, when the carrying amount of right to recover products exceeds its tax base. The amount of deferred tax liability is:

(Carrying amount – Tax base) x Income tax rate

20x1-x2 (CU 210 – 0) x 40% = CU 84

20x2-x3 (CU 375 – 0) x 40% = CU 150

20x3-x4 (CU 560 – 0) x 40% = CU 224

If we set off deferred tax liability from deferred tax asset, the net deferred tax asset is –

20x1-x2 CU 120 – CU 84 = CU 36

20x2-x3 CU 240 – CU 150 = CU 90

20x3-x4 CU 364 – CU 224 = CU 140

(2) Revenue

Date	Heads of Account	Dr	Cr	Balance
20x2				
Mar 31	Cash		10,000	10,000
	Refund liability	300		9,700
	Profit or loss	9,700		–
20x3				
Mar 31	Cash		14,400	14,400
	Refund liability	600	300	14,100
	Profit or loss	14,100		–
20x4				
Mar 31	Cash		16,250	16,250
	Refund liability	910		15,340
	Profit or loss	15,340		–

(3) Cost of Sales

Date	Heads of Account	Dr	Cr	Balance
20x2				
Mar 31	Inventory	7,000		7,000
	Right to recover products		210	6,790
	Profit or loss		6,790	–
20x3				
Mar 31	Inventory	9,000		9,000
	Right to recover products	210	375	8,835
	Profit or loss		8,835	–
20x4				
Mar 31	Inventory	9,975		9,975
	Right to recover products		560	9,415
	Profit or loss		9,415	–

(4) Refund Liability

Date	Heads of Account	Dr	Cr	Balance
20x2				
Mar 31	Revenue		300	300
20x3				
Mar 31	Revenue	300	600	600
20x4				
Mar 31	Cash	600		–
	Revenue		910	910

An entity shall update the measurement of the refund liability at the end of each reporting period for changes in expectations about the amount of refunds. An entity shall recognise corresponding adjustments as revenue (or reductions of revenue) ***[Refer paragraph B 24 of Ind AS 115]*.**

(5) Right to Recover Products

Date	Heads of Account	Dr	Cr	Balance
20x2				
Mar 31	Cost of sales	210		210
20x3				
Mar 31	Cost of sales	375	210	375
20x4				
Mar 31	Inventory		375	–
	Cost of sales	560		560

An asset recognised for an entity's right to recover products from a customer on settling a refund liability shall initially be measured by reference to the former carrying amount of the product (eg, inventory) less any expected costs to recover those products (including potential decreases in the value to the entity of returned products). At the end of each reporting period, an entity shall update the measurement of the asset arising from changes in expectations about products to be returned ***[Refer paragraph B 25 of Ind AS 115]*.**

(6) Current Tax Expense

	20x1-x2	20x2-x3	20x3-x4
Revenue (CU)	10,000 (100 x CU 100)	14,400 (120 x CU 120)	15,650 [(120 x CU 130) + {5 x (CU 130 – CU 120)}]
Cost of sales (CU)	7,000 (100 x CU 70)	9,000 (120 x CU 75)	9,600 (120 x CU 80)
Taxable profit(CU)	3,000	5,400	6,050
Current tax at 40%	**CU 1,200**	**CU 2,160**	**CU 2,420**

(7) Deferred Tax Income

Date	Heads of Account	Dr	Cr	Balance
20x2				
Mar 31	Deferred tax asset		36	36
	Tax expense	36		–
20x3				
Mar 31	Deferred tax asset		90	90
	Tax expense	90		–
20x4				
Mar 31	Deferred tax asset		140	140
	Tax Expense	140		–

(8) Deferred Tax Asset

Date	Heads of Account	Dr	Cr	Balance
20x2				
Mar 31	Deferred tax income	36		36
20x3				
Mar 31	Tax expense		36	–
	Deferred tax income	90		90
20x4				
Mar 31	Tax expense		90	–
	Deferred tax income	140		140