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Voices on Reporting

Impact on the technology sector

19 November 2018

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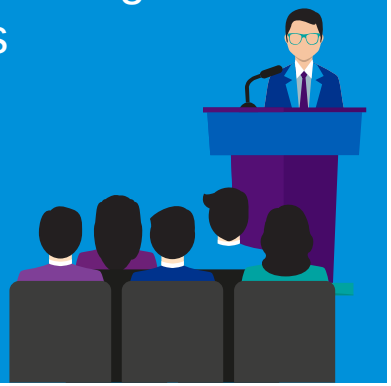
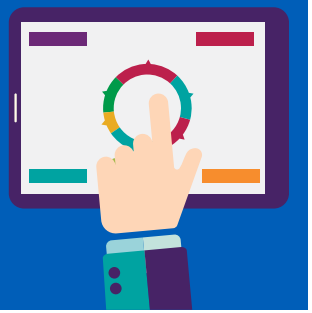
Welcome

01 Series of knowledge sharing calls



02 Covering current and emerging reporting issues



03 Scheduled towards the end of each month

04 Look out for our Accounting and Auditing Update, IFRS Notes and First Notes publications

Speaker for the call

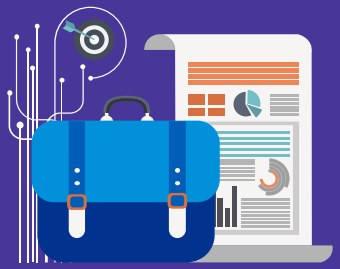
Ruchi Rastogi

Partner

Assurance
KPMG in India

Agenda

Ind AS 115,
Revenue from Contracts with Customers



Ind AS 103,
Business Combinations

Ind AS 115 – Quick recap

Ind AS 115 - Quick recap

Core principle of Ind AS 115, *Revenue from Contracts with Customers*

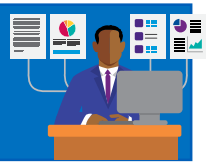
……'is that an entity recognises ***revenue*** to depict the transfer of ***promised goods and services*** to customers in an amount that reflects the consideration to which the entity expects to be entitled ***in exchange*** for those goods or services'.

Customer is…
….. 'a party that has ***contracted*** with an entity to ***obtain goods or services*** that are an output of the entity's ordinary activities ***in exchange for consideration***'.

The new revenue standard is applicable to Indian companies following the Ind AS road map framework from 1 April 2018.

Recap of the five-step model

STEP	
1	Identify the contract with the customer (One or multiple)
2	Identify the performance obligations in the contract (One obligation or multiple)
3	Determine the transaction price (Total consideration for contract)
4	Allocate the transaction price to the performance obligation (Allocate to various performance obligations identified)
5	Recognise revenue (At a point-in-time or over-time)



Common industry issues

Identify the contract

STEP
1

Question: Whether a ‘contract’ exist if an arrangement between the parties is not executed as a written document?

Key considerations

- A contract exists if rights and obligations are enforceable.
- Significant judgement may be required in some jurisdictions or for some arrangements to assess if a contract exists.
- An oral contract may constitute as an enforceable contract but key considerations to be factored in are:
  - Customary practices
  - Communications made by sales teams
  - Quotes
  - Purchase orders
  - Side agreement.

  The above assessment would depend on the facts and circumstances of each case.
- Consider involvement of the legal department while identifying a contract.

Identify the performance obligations in the contract

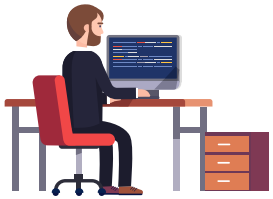
STEP
2

Illustration

IT service company

A contract to render:

- Transition and support services
- Over a period of 10 years



Customer

According to the contract:

- Transition services would require obtaining a detailed understanding of the existing systems of the customer and the way in which in-scope support services are to be rendered by it.
- Industry standard deliverables are signed-off between the customer and the company at the end of transition. The transition deliverables are likely to enable another unrelated IT services company to provide the support service.
- Support services involve end to end maintenance of the customer's IT applications and infrastructure.

Question

Would 'transition services' qualify to be a separate performance obligation?

Key considerations

- A promised service qualifies to be a separate performance obligation if the service is **'capable of being distinct'** and is **'distinct within the context of the contract'**.
- The evaluation requires **'significant management judgement'** and entails a comprehensive assessment of the promised goods and services under the contract (including implied and customary promises).

Identify the performance obligations (cont.)

STEP
2

Indicative factors that could be considered to evaluate whether transition qualifies to be a separate performance obligation:

- Are the transition deliverables owned by the customer?
- Are the deliverables robust enough to enable a new service provider to gain an in-depth understanding of the customer's IT environment?
- Does the company render similar services on a standalone basis to customers in the normal course of business?
- Is rendering of the service independent of the other services to be rendered under the scope of the contract?

Identify the performance obligations (cont.)

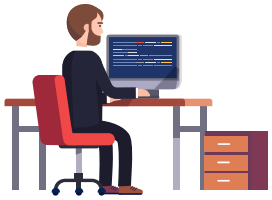
STEP
2

Illustration

Software company

A contract to:

- Sell proprietary software
- Render professional services
- Significantly customise or modify the licensed software



Customer

Question: Would the 'professional services' qualify to be a separate performance obligation?

Key considerations

Professional services provided in a software licensing arrangement can vary from contract to contract. Therefore, the contract-specific facts and circumstances would need to be considered.

The key element to consider if professional services would qualify as a separate performance obligation would be:

- Whether the customisation/modification to the licence/software is significant (that in effect is a new product itself) or
- The customisation/modification is simple and not significant in the context of the contract.

Identify the performance obligations (cont.)

STEP
2

Benefit on its own?

The software licence and professional service could be used on its own or together with another readily available resource

Software licence separable from services?

Company is providing a significant customisation/ modification service.

In the context of the contract, licence is not separable from the professional service

In general, a software licence and professional services to significantly modify or customise that software for a customer's use is likely to comprise a single performance obligation.

Determine the transaction price

STEP
3

Question: How would a company determine the transaction price when the consideration is variable?

Is the consideration fixed or variable?

Fixed

Include in transaction price

Variable

Identify all forms of variable considerations

- Discounts
- Rebates
- Refunds
- Right of return
- Credits
- Price concessions
- Incentives
- Performance bonuses
- Penalties or other similar items

For each form estimate by most likely method or expected value method

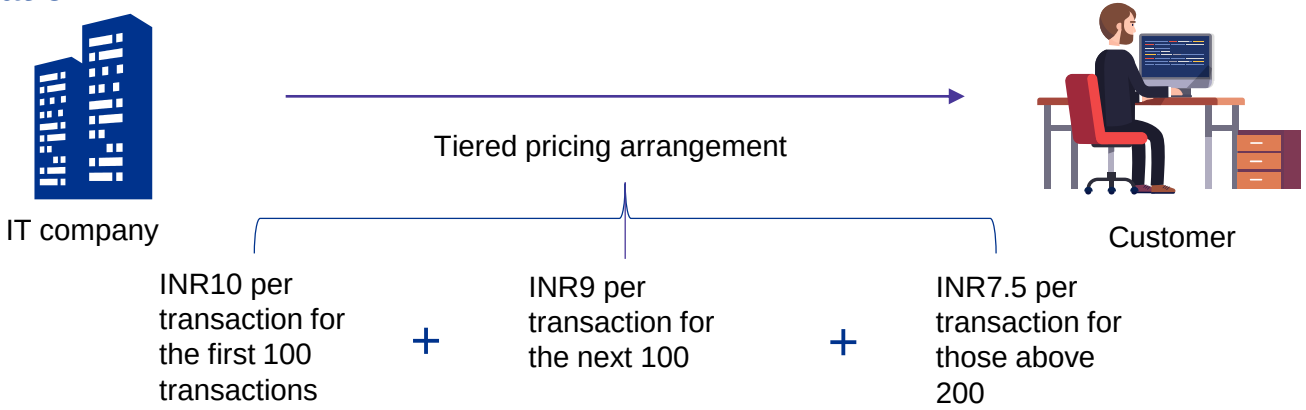
- Most likely amount – suitable when there are few possible outcomes.
- Expected value – suitable for high number of homogenous transactions or outcomes with similar probability expectations.

Constrain the estimate of variable consideration to an amount that is highly probable i.e. significant revenue reversal will not subsequently occur

Determine the transaction price (cont.)

STEP
3

Illustration



Key considerations:

The company would be required to estimate the consideration, possibly through most likely method. The standard also offers guidance in two scenarios:

‘As-invoiced’ practical expedient	‘Series’ of distinct performance obligations
Company is able to apply the ‘as-invoice’ practical expedient and recognise revenue from items like transaction-based fees if it has a right to invoice the customer, at an amount that corresponds directly with its performance to date.	The service performance obligation is determined to be a series of distinct service periods (e.g. a series of distinct daily, monthly or annual periods of service), and allocation of the fees earned to each distinct service period based on the customer's usage each period would reasonably reflect the fees to which the entity expects to be entitled for providing the service for that period.

Recognise revenue as performance obligations are satisfied

STEP
5

Illustration

Contract

=

Sell proprietary software licence

+

Professional services to customise or modify the licensed software

Question: How should revenue be recognised for sale of distinct licence?

Key considerations

As per the new standard, to determine whether the performance obligation for licensing Intellectual Property (IP) is satisfied at a point in time or over time, the company would need to consider whether the nature of its promise is to provide the customer with a right to:

- Access the company's IP through the licence period (right to access the company's IP), or
- Use the company's IP as it exists at a point in time at which the licence is granted (right to use the company's IP).

Recognise revenue (cont.)

STEP
5

Are all the following criteria met?

Criterion 1
Entity expects to undertake activities that significantly affect the IP

+

Criterion 2
Rights directly expose the customer to positive or negative effects of the entity's activities

+

Criterion 3
Activities do not result in the transfer of a good or service to the customer entity's activities

Yes → Right to access the entity's IP

No → Right to use the entity's IP

Generally, in the case of IP such as software, given that the IP has significant stand-alone functionality (unless the functionality is changed), the company's ongoing activities would not significantly affect the IP.

In the above scenario, the sale is of the right to use the IP. Hence, it would be appropriate for the company to recognise revenue at a point in time at which the licence is transferred.

Costs to fulfil a contract

Are the costs incurred in fulfilling the contract in the scope of other guidance?

Yes → Apply that other guidance

No ↓

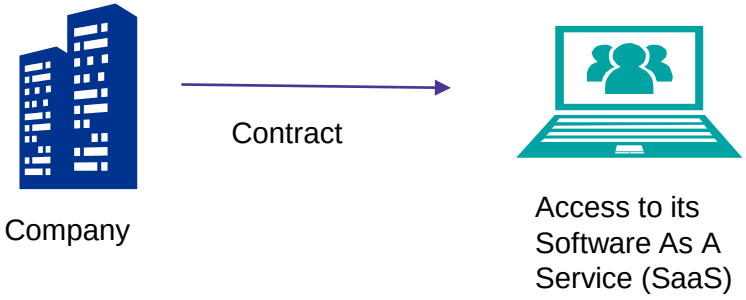
Do they meet the criteria to be capitalised as fulfillment costs

Yes → Capitalise cost

No ↓

Expense costs as they are incurred

Illustration



Contract involves

- Company will set up the user interface that the customer will need to access the online application.
- Undertake data conversion and migration activities for the customer to configure and move its relevant, existing data from the customer's current on premise solution to the company's hosted environment.
- Training to be imparted to relevant customer personnel regarding best practices for efficient use of the company's hosted application.

Costs to fulfil a contract (cont.)

Question: How should these contract costs be accounted for?

Key considerations

- User interface is a set-up activity, rather than a promised service to customer. It provides no incremental benefit to customers i.e. it only provides access to the hosted application.
- If the set-up activities are directly identifiable to the contract with the customer and are expected to be recoverable, the company can capitalise such costs as a contract cost asset.
- The data conversion, migration and training activities are services that are likely to provide the customer with incremental benefits beyond just access to the hosted application.
- The data conversion and migration activities, and the training of customer's personnel are promised services, and assuming that both of those services are satisfied over time, the costs of fulfilling those services do not qualify for capitalisation as contract cost assets. These costs would be expensed as incurred.

Ind AS 103 – Quick recap

Ind AS 103 - Quick recap

Ind AS 103, *Business Combinations* provides guidance on accounting for business combinations under the acquisition method (acquisition accounting), with limited exceptions.

A business combination is a transaction or other event in which an acquirer obtains control of one or more business.

A 'business' is an integrated set of activities and assets that is capable of being conducted and managed to provide a return to investors by way of dividends, lower costs or other economic benefits.

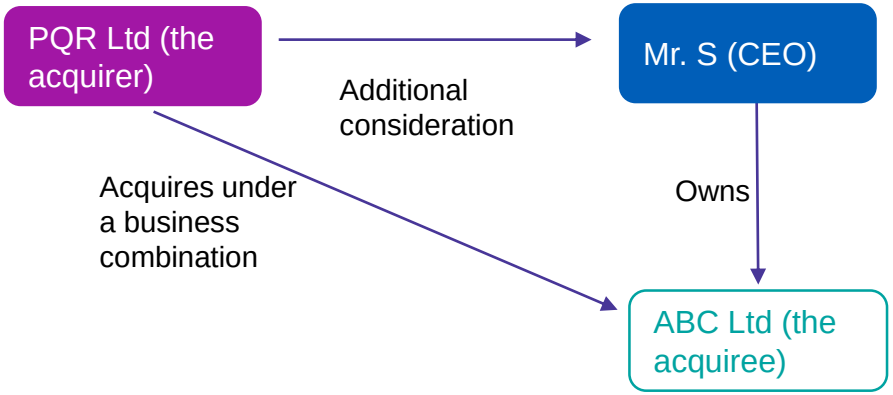
The acquirer in a business combination is the combining entity that obtains control of the other combining business or businesses. The date of acquisition is the date on which the acquirer obtains control of the acquiree.

The acquirer in a business combination can elect, on a transaction-by-transaction basis, to measure 'ordinary' Non-Controlling Interests (NCI) at fair value, or at their proportionate interest in the net assets of the acquiree, at the date of acquisition.

All other components of NCI (such as equity components of convertible bonds and options under share based payments arrangements) shall be measured at fair value or in accordance with other relevant Ind ASs.

Case studies

Case study 1 - Contingent consideration linked to continuing employment



Conditions for additional consideration:

- On achieving specific EBITDA (Earnings Before Interest, Tax, Depreciation and Amortisation) levels over the two-year period following the acquisition
- Continuation of Mr. S is critical for transition of ABC Ltd's on-going business upto two years
- Right to additional consideration will be forfeited in case Mr. S resigns before the end of two years.

Issue

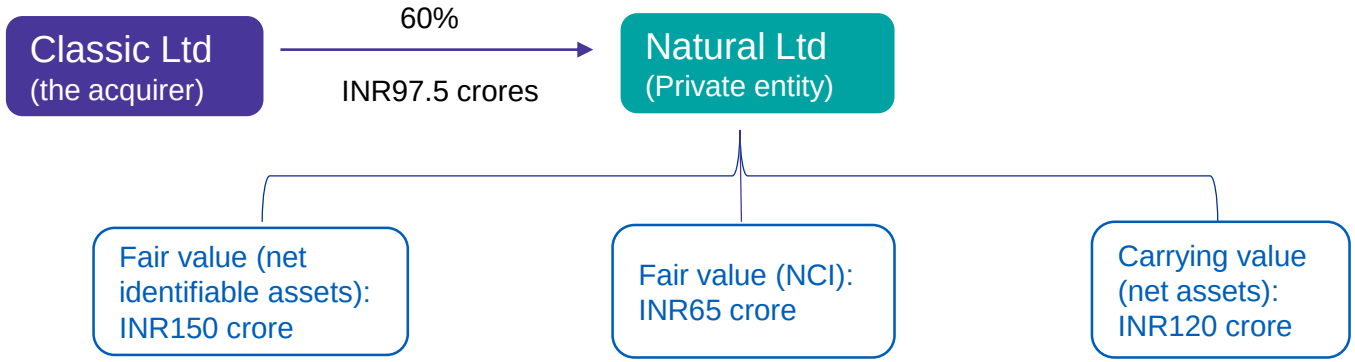
Would the above contingent consideration for acquisition of ABC Ltd, represent adjustment to purchase price or employee compensation?

Response:

According to paragraph B55 (a) of Appendix B to Ind AS 103, an indication that a 'contingent consideration arrangement in which payments are automatically forfeited if employment terminates is remuneration for post-combination services'.

Therefore, in the given case, the arrangement would be treated as an employee remuneration for the post-combination services as the right to the additional consideration will be forfeited if Mr. S quits before the stipulated period of time.

Case study 2: Measurement of NCI



Issue

How will the non-controlling interest be measured?

Response:

In a business combination, the acquirer would measure at the acquisition date components of NCI in the acquiree at either:

a) Fair value (goodwill represents the difference between the fair value of Natural Ltd, and the fair value of its net identifiable assets i.e. INR12.5 crore) or

b) Proportionate share in the recognised amounts of the acquiree's identifiable net assets (goodwill represents the difference between the total of the consideration transferred less the fair value of the acquirer's share of net assets acquired and liabilities assumed i.e. INR7.5 crore).

An acquirer can elect on a transaction-by-transaction basis to measure NCI at either of the two approaches.

Case study 3: NCI puts/forwards

Continuing the example in case study 2, Classic Ltd has written cash settled put options on the NCI of 40 per cent:

- Exercisable after a period of three years from acquisition date
- At an exercise price which is based on an agreed EBIDTA multiple.

Issue

How should the liability for put options be accounted?

Response:

Under Ind AS 32, *Financial Instruments: Presentation,* the put option would be recognised as a financial liability at present value of the redemption amount.

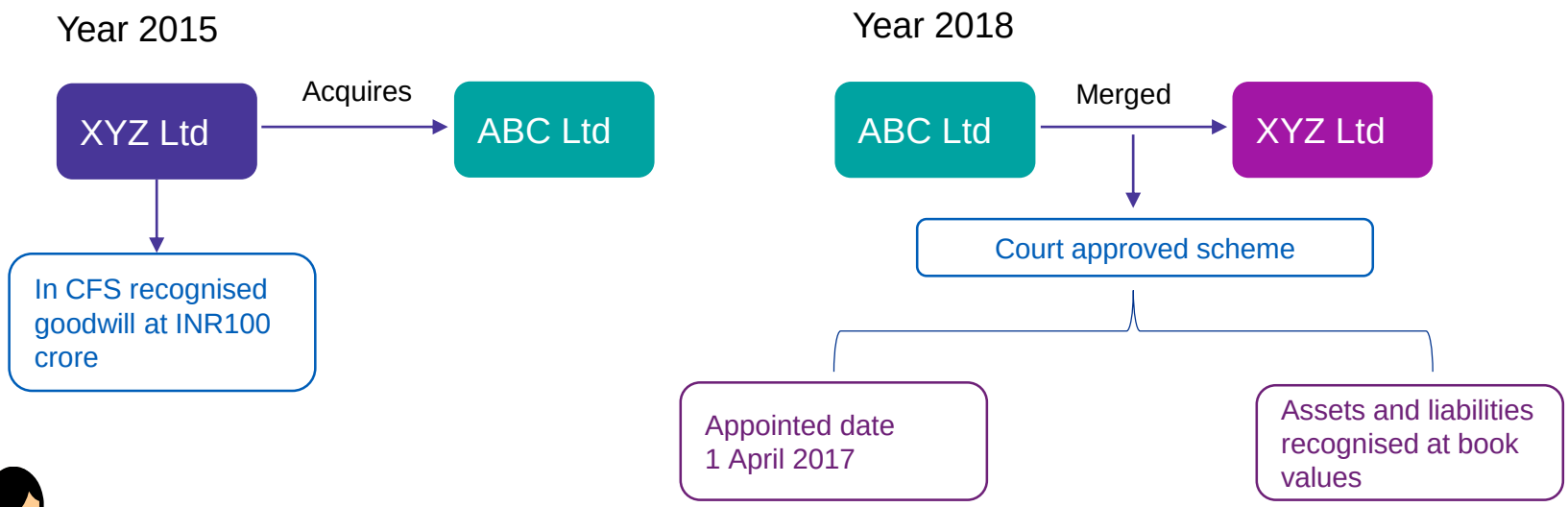
Subsequent to initial recognition, Classic Ltd could choose an accounting policy, to recognise changes in put liability in profit or loss or within equity (a careful consideration is required). However, this option is not available in case of forwards over NCI.

Classic Ltd should evaluate whether the NCI by virtue of put options have present access to the returns associated with the underlying ownership interest.

In case the NCI has present access, then the entity should choose an accounting policy choice to be applied consistently based on one of the following methods:

- *The anticipated-acquisition method*: The contract is accounted for as an anticipated acquisition of the underlying NCI - i.e. as if the put option had been exercised already or the forward had been satisfied by the non-controlling shareholders.
- *The present-access method*: NCI continues to be recognised because the non-controlling shareholders still have present access to the returns associated with the underlying ownership interests; therefore, the debit entry is to 'other' equity.

Case study 4: Common control business combination



Issue

What should be the appointed date for accounting of the scheme?

Whether goodwill pertaining to acquisition of ABC limited will continue in financial statements of XYZ Ltd?

Response:

a) Appointed date of the scheme will be 1 April 2017 i.e. the date as per the court approved scheme. However, Appendix C of Ind AS 103 states that in common control business combinations, prior periods should be restated to give effect to the scheme from the beginning of the first day of the previous year i.e. 1 April 2016.

b) There will be no impact on the Consolidated Financials Statements (CFS) of XYZ Ltd due to the merger and goodwill will continue. In case ABC limited was the only subsidiary and XYZ limited would not prepare CFS post merger, goodwill will be carried in its individual financial statements.

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Q&A

Sources

1. Ind AS 115 notified by MCA
2. Revenue Issues In-Depth, KPMG IFRG Limited's publication, May 2016
3. Ind AS 103 notified by MCA
4. Education material on Ind AS 103, issued by ICAI
5. Bulletin 9 issued by Ind AS Transition Facilitation Group (ITFG) of ICAI

Links to previous recordings of VOR

Month	Topics	Link
June 2018 (special session)	• Ind AS implementation for NBFCs	Click here
July 2018	• Notification of sections of the Companies (Amendment) Act, 2017 and related rules under the Companies Act, 2013 • Amendments to SEBI Listing Regulations pursuant to Kotak Committee recommendations • Ind AS Transition Facilitation Group (ITFG) clarification - Bulletin 15	Click here
August 2018 (special session)	Ind AS 115 – Sector Series Automotive Sector	Click here
September 2018 (special session	Ind AS 115 – Sector Series Consumer and retail sector	Click here
October 2018	• Key clarifications on some Ind AS implementation issues provided in the Ind AS Transition Facilitation Group (ITFG) Bulletin 16. • An overview of the key amendments in the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018. • Notification of certain important sections of the Companies (Amendment) Act, 2017 such as amendments related to managerial remuneration, financial statements and board's report, Corporate Social Responsibility (CSR), etc. • Amendments to Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance.*	Click here

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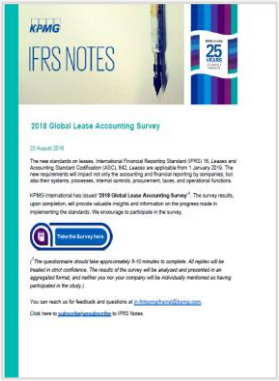

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