Ind AS 115: Impact on transport, logistics and leisure sector

Background

Accounting for contracts in the transportation, logistics and leisure sector is undergoing a change due to the application of the new revenue recognition standard. In this edition of Accounting and Auditing Update (AAU), we focus on the transportation, logistics and leisure sector. Our article highlights the significant areas (e.g. determination of performance obligations, variable consideration, contract manufacturing arrangements, etc.) where old guidance in Ind ASs is expected to change due to implementation of Ind AS 115.

Therefore, there is a need for a deeper understanding of the impact of requirements of the new standard and determine the sector specific impact, both on the business operations and financial reporting. For transportation, logistics and leisure sector, which is one of the largest and fastest growing sectors in the country, certain Ind AS 115 impacts affect the heart of business performance i.e. sales and timing of recognising revenue, customer incentives and other performance obligations, which may be embedded in the sale of products made to customers.

The transportation, logistics and leisure sector includes companies associated with shipping, railways, airlines, ports, container freight station, leisure and logistics. Customers generally pay a fee for the movement of cargo or passengers between two or more specified points, or for use of hotel/recreation space for a particular duration of time. While arrangements with customers are not too complex, the same have the ability to be modified to increase/reduce the extent of services. The industry also offers rewards/incentives to its customers in the form of volume discounts/rebates, loyalty programmes, etc.
From 1 April 2018, new revenue standard, Ind AS 115, *Revenue from Contracts with Customers* is applicable for companies following the Ind AS road map framework. This new standard replaces the existing revenue recognition principles set out by Ind ASs i.e. Ind AS 11, *Construction Contracts* and Ind AS 18, *Revenue*. The new standard comes with a concept of recognising revenue at a point in time or over time, provides more guidance on separating goods and services (in case of bundled contracts) and also provides guidance on measuring the transaction price.

Ind AS 115 follows a core principle 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. As per the standard, a 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’.

### 1. Identify the contract

The assessment of whether a contract with a customer exists under the new revenue guidance is less driven by the form of the arrangement, but whether an agreement between two parties (either written, oral, or implied) creates legally enforceable rights and obligations between them. The purpose of the collectibility assessment under the new guidance is to determine whether there is a substantive contract between the company and the customer. This differs from the guidance given in Ind AS 18 in which collectability is a constraint on revenue recognition.

Companies should consider any history of entering into amendments or side agreements to a contract that either change the terms of, or add to, the rights and obligations of a contract. These can be verbal or written, and could include cancellation, termination, or other provisions. They could also provide customers with options or discounts, or change the substance of the arrangement. All of these have implications for revenue recognition. Therefore, understanding the entire contract, including any amendments, is important to the accounting conclusion.

It is quite common in this sector to enter into ‘Master Service Agreements’ (‘MSAs’), which defines broadly the general scope of services to be provided and the timelines over which the same are to be provided.

However, without explicit underlying details of the exact scope of services, these MSAs by themselves may not qualify to be a contract under this standard.

The new guidance also eliminates the cash-basis method of revenue recognition that is often applied today if collectibility is not reasonably assured or probable. Any cash received is recognised as a contract liability until either collectibility of the transaction price is probable or one of the criteria for recognition is met. This could result in revenue being recorded later than under current guidance in some situations.

Further, this sector experiences various modifications to existing contracts (e.g. upgradation of class of travel in railway/airlines, upgradation of rooms in hotels, inclusion of additional services like last mile travel, etc.) Ind AS 115 has specific guidance on when a modification should be treated as part of original contract or when it should be treated as termination of existing contract and creation of a new contract. The examples given above of upgradation of class of travel would normally fall under the former eventuality whereas change in date of travel/availing additional services are likely to result in creation of a new contract.

### 2. Identify performance obligations

Many entities in this sector provide multiple products or services to their customers as part of a single arrangement. Management must identify the separate performance obligations in an arrangement based on the terms of the contract and the company’s customary business practices. A bundle of goods and services might be accounted for as a single performance obligation in certain situations.

A performance obligation is a promise in a contract to transfer to a customer either:

- A good or service (or a bundle of goods or services) that is distinct, or
- A series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer.
A promised good or service is distinct from other goods and services in the contract if meets two criteria:

**Criterion 1: Capable of being distinct**
Customer can benefit from the good or service on its own or together with other readily available resources

**Criterion 2: Distinct within the context of contract**
Promise to transfer good or service is separately identifiable from other promises in the contract

Assessing whether goods and services are capable of being distinct is similar to determining if deliverables have stand-alone value or are separate components, although the definitions are not identical. Under the new guidance, management will assess if the customer can benefit from the good or service with ‘resources that are readily available to the customer’ which could be a good or service sold separately by the entity or another entity, or a good or service the customer has already obtained.

**Examples**

**Customer loyalty programmes - Airline and hospitality**
Many airlines and hotels operate customer loyalty programmes in which customers can earn loyalty points, either by travelling with the airline/staying in a hotel, or making qualifying purchases with an airline partner. Customers can use the points to buy future travels or stays, upgrade to a higher travel class or purchase goods from the issuing airline/hotel and/or its redemption partners. A customer loyalty programme that provides a customer with a material right is accounted for as a separate performance obligation under the new standard.

**Turnkey projects - Logistics**
In the Third-party logistics (3PL) or Fourth-party logistics (4PL) business, an entity takes over the end-to-end responsibility of transport goods from origination to destination. This service includes multiple distinct services viz. land transport, custom and port services, ocean transport, installation, etc. As per the new standard, some of these segments will be treated as a distinct performance obligation.
Seaside and offshore services - Port sector

A typical port operator provides core services like wharfage, pilotage, stevedoring and loading/unloading of cargo. In addition, they also provide additional services like storage, transshipment, internal shifting, etc. Management will need to assess whether these services are separate performance obligations based on the facts of the customers’ arrangement.

Import/export services - Container Freight Stations (CFS)

CFSs provide both import and export related services, in addition to stuffing and de-stuffing cargo and storing the same as well. Historically, all the CFS services were considered as one performance obligation. However, it is likely that the core CFS operation of storage and stuffing/de-stuffing and the non-core operation of transportation of cargo could be considered as distinct performance obligations.

3. Determine transaction price

The transaction price is the consideration to which the entity expects to be entitled in exchange for goods or services. Determination of the transaction price may be simple when the contract price is fixed and paid at the time services are provided. However, it may require more judgement if the consideration contains an element of variable or contingent consideration. Common forms of variable consideration in the transportation and logistics sector include discounts, volume rebates and performance bonuses.

Variable consideration (e.g. discounts and rebates) included in the transaction price is normally subject to a constraint. Management will need to determine if there is a portion of the variable consideration (that is, a minimum amount) that would not result in a significant revenue reversal and include that amount in the transaction price.

The revenue standard provides factors to consider when assessing whether a variable consideration should be constrained. Management should reassess the estimate of variable consideration at each reporting period.

Additionally, customers may not exercise all of their contractual rights related to a contract, such as rebates and other incentive offers. These unexercised rights are often referred to as breakage. Management should adjust for changes in expectations when updating the estimated amount of consideration to which an entity expects to be entitled.

Management might need to put into place new processes to monitor estimates on an ongoing basis as more experience is obtained.
Demurrage claims - Shipping

A shipping company enters into a voyage charter contract with a customer to transport goods from point A to point B. The shipping company may experience delays in loading and unloading the cargo (referred to as demurrage), which are not the responsibility of the shipping company. The additional amount to be paid to the shipping company is calculated in accordance with the terms of the contract. Demurrage claims are often negotiated, resulting in adjustments to the contract price, and can take a long time to resolve. The amount of demurrage claims might be difficult to estimate and are likely to vary depending on the counterparty and the type of delay. Based on past experience, the entity would be required to include in the transaction price any portion of the claim that meets the probable threshold. The time taken to resolve claims or the external factors involved are not factors that would allow the entity to avoid including in the transaction price a minimum amount that meets the threshold.

Volume rebates - Rail/road transport, CFS, freight forwarders, etc.

Transport companies enter into a contract to transport goods from point A to point B for INR1,000. The customer earns a rebate of INR100 for each load if the customer transports at least 10,000 loads annually. Based on past experience, management believes there is a 50 per cent likelihood that the customer will ship 10,000 loads and earn the rebate of INR100 per load. As per the new revenue standard, the transaction price is INR900 per load, which reflects the amount to which the transporter expects to be entitled based on its estimate of loads to be transported. There are only two possible outcomes regarding the variable consideration (e.g. the rebate). The customer will be entitled to either INR0 or an additional INR100 per load. Any amounts collected in excess of INR900 per load (that is, the additional INR100 per load prior to earning the rebate) would be recorded as a liability. These estimates should be monitored and adjusted, as necessary, using a cumulative catch-up approach. For instance, should circumstances change and it becomes probable that the customer will not be entitled to the rebate, the extra INR100 per load would be included in the transaction price for the loads previously shipped at that point.

Time value of money - all sectors

An entity needs to adjust the amount of promised consideration to reflect the time value of money if the contract includes a significant financing component. A significant financing component does not exist if the timing of delivery is at the customer’s discretion (for example, in the case of customer loyalty points) or the difference between the promised consideration and the cash selling price arises for reasons other than financing. As a practical expedient, a company need not assess whether a contract has a significant financing component if it expects at contract inception that the period between payment and the transfer of services will be one year or less. We do not expect a significant change to current practice for many entities in transportation, logistics and leisure sector in connection with the time value of money because payment terms do not often extend over more than one year from the time of contract performance.
4. Allocate transaction price

Transportation, logistics and leisure sector may provide multiple goods or services to their customers as part of a single arrangement. As we discussed above, the entities will have to identify different performance obligations and therefore, will need to allocate the transaction price to the separate performance obligations in one contract. This allocation should be based on the relative stand-alone selling price of each separate performance obligation. The standard recommends use of directly observable price in this respect, however, in its absence, the standard requires the entity to estimate the stand-alone selling price (viz. adjusted market price, cost plus margin or residual approach).

Examples

Customer loyalty programmes - Airline and hospitality

As discussed earlier, points/awards issued under customer loyalty programmes are separate performance obligations if they provide the customer with a material right that the customer would not receive without buying the initial product or service (for example, the original flight/hotel stay). The transaction price is allocated between the initial purchase and the award credits based on the actual or estimated stand-alone selling price of each performance obligation. The portion of the transaction price allocated to the award credits is not recognised as revenue until the credits are redeemed or expire.

The stand-alone selling price of the award credits is not usually directly observable and will, therefore, need to be estimated. The estimate should reflect the discount achieved by customers when spending award credits, adjusted for the likelihood that the credits will be forfeited (breakage). For example, an airline recognises revenue from the award credits on a gross basis when the customer redeems them for goods or services that the airline provides.

Adjustments for expected forfeitures (breakage) are likely to affect the timing of revenue recognition. The stand-alone selling price of award credits will be reduced to reflect the award credits not expected to be redeemed. This requirement could result in less revenue allocated to award credits as compared to Ind AS 18’s multiple-element model.

Further, an airline/hotel that operates a programme in which points can be redeemed with a third party needs to consider whether it is a principal or an agent in the arrangement. This requires management to first consider the nature of its performance obligation. The entity should recognise revenue for the net fee or commission retained in the exchange if it is an agent in the arrangement.
5. Recognise revenue and costs

Transportation or freight services are generally provided over a period of time ranging from one day to multiple months. The new standard requires that revenue be recognised as an entity satisfies a performance obligation by transferring control of a good or service. A performance obligation can be satisfied over time or at a point in time.

A performance obligation is satisfied over time if any one of the following criteria is met:

- The customer simultaneously receives and consumes the benefits as the entity performs
- The entity’s performance creates or enhances an asset that the customer controls, as the asset is created or enhanced
- The entity’s performance does not create an asset with an alternative use, and the entity has an enforceable right to payment for performance completed to date.

An entity should recognise revenue over time only if the entity can reasonably measure its progress towards complete satisfaction of the performance obligation. If a performance obligation is not satisfied over time, then the entity satisfies the performance obligation at a point in time.

Transportation services will likely meet the criteria for revenue recognition over time as the customer simultaneously receives and consumes the benefit as the entity performs. It is observed that the customer benefits from the entity’s performance as it occurs if another entity would not need to substantially re-perform the entity’s performance (for example, distance already travelled) to date. An entity should disregard any contractual or practical limitations when it assesses whether the customer simultaneously receives and consumes the benefits and whether another entity would need to substantially re-perform the performance completed to date. For example, the assessment would not consider contractual provisions that restrict an entity from transferring its obligations to another entity.

Examples

Transportation revenue

A trucking company enters into a contract with a customer to transport goods from Mumbai to Delhi. The customer has an unconditional obligation to pay for the service when the service has been completed, which is when the goods reach Delhi. These types of contracts will typically meet the criteria for revenue recognition over time. If the trucking company transports the goods midway to the destination, another transportation company could fulfil the remaining obligation to the customer without having to re-perform the services provided to date. The obligation to provide transportation services is therefore satisfied over time, and revenue should be recognised over the period of performance (generally the period from when transport of the goods begins from Mumbai through delivery to Delhi).

Breakage revenue - Airlines

Airlines usually sell tickets in advance for full consideration. Some tickets are not used for travel and cannot be exchanged or refunded. Certain flexible air tickets include a right to re-schedule if the customer does not fly on the scheduled flight date, but the customer may decide not to travel. Those partially or wholly unused tickets are often referred to as ‘ticket breakage’.

An entity considers the variable consideration guidance to determine whether - and to what extent - it recognises breakage. It determines the amount of breakage to which it is entitled as the amount for which it is considered highly probable that a significant reversal will not occur in the future. This amount is recognised as revenue in proportion to the pattern of rights exercised by the customer when the entity expects to be entitled to breakage. Otherwise, the entity recognises breakage when the likelihood of the customer exercising its remaining rights becomes remote.
6. Principal versus agent (gross versus net)

Certain arrangements involve two or more unrelated parties that contribute to providing a specified good or service to a customer. In these instances, management will need to determine whether the company has promised to provide the specified good or service itself (as a principal) or to arrange for those specified goods or services to be provided by another party (as an agent). This determination often requires judgement, and different conclusions can significantly impact the amount and timing of revenue recognition.

Management should first understand the relationships and contractual arrangements among the various parties. This includes identifying the specified good or service being provided to the end customer and determining whether the company controls that good or service before it is transferred to the end customer.

As per the new standard, an entity is the principal and should report revenue on a gross basis if it controls the specified good or service before it is transferred to the customer. Conversely, it is an agent and should report revenue on a net basis if its obligation is to arrange for another party to provide goods or services (i.e., the entity does not control the specified good or service before it is transferred to the customer).

The principal versus agent assessment is performed at the performance obligation level, not at the contract level. An entity may act as a principal with respect to certain performance obligations in the contract and an agent with respect to others.

Examples

**Principal versus agent assessment - Airlines**

Airlines often sell tickets to customers that include flight segments to be flown by another airline, or enter into contracts for transporting cargo with another airline. In these cases, an airline determines whether it acts as principal or agent in the transaction and accounts for revenue accordingly, i.e. on a gross or a net basis. Airlines usually charge government- and airport-based passenger taxes and fees at the time of the ticket sale. Often, these are subsequently remitted to the relevant authorities. Airlines may also make discretionary fuel surcharges, which are not remitted to any authorities, and may or may not be explicitly stated in the airfare. Therefore, it is important to analyse all relevant facts and circumstances to evaluate whether an airline is acting as principal or agent in each case.

**Principal versus agent assessment - Freight forwarders /3PL/4PL**

A freight forwarder, in addition to arrangement for transportation of cargo from point A to point B, also provides additional services of payment of statutory dues (viz. custom duty), custom clearance, etc. which is normally carried out on behalf of the customer. While custom clearance could classify as a separate performance obligation, and therefore be treated as an act of a principal, payment of custom duty to the authorities on behalf of the customer would be treated as an agency act, and therefore would not be considered as part of revenue.

Conclusion

Revenue is a key performance measure for companies operating across all the sectors and the transportation, logistics and leisure sector is no exception. Given the significant amount of judgement involved at each stage, companies, therefore, need to plan and invest time in effective implementation of the new standard. The standard is pervasive in nature and, in addition to the financial reporting impact, companies in the sector would also have to assess impact on business contracts, processes as well as the need to educate stakeholders such as investors and analysts.