Revenue Recognition

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What is Revenue & its Importance

- Revenue means gross inflow of cash, receivable, or other consideration arising in the ordinary activities of enterprise such as;
  - Sale of goods
  - Rendering the services
  - Use of enterprises resources by others yielding interest, dividend and royalties
- In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.
- Importance
  - largest item in financial statements
  - top the list of reasons for financial reporting restatements
  - pre-qualification norm for tendering opportunities
  - Parameter to measure the size of the company & for valuation

Revenue Recognition (AS-9)

- All of the following conditions to be satisfied;
  - All Significant risks and rewards of ownership have been transferred to buyer for a price.
  - Seller doesn’t retain any effective control of ownership over the goods.
  - There is no significant uncertainty in collection of the amount of consideration.
  - There is a reliable measurement of revenue consideration.

- Rendering of Services
  - Completed service contract method; or
  - Proportionate completion method

Special Transactions

- Sale on Approval
- Guaranteed Sales
- Warranty Sales
- Consignment Sales
- Revenue Swaps (IAS-18)
- Repo Arrangements
- DEPB Credit
- Installment Sales
- Advertising

Accounting for Construction Contracts (AS-7)

- Applicable in accounting of contracts in the books of the contractor.
- Not applicable for construction project undertaken by the entity on behalf of its own.
- What is Construction Contract.
- Contract includes
  - Services directly related to construction contract. For ex. Architect services.
  - Destruction or restoration of asset and restoration of environment.
- What is Contract Cost
- What is Contract Revenue

Contract Revenue Recognition

- **Recognition** : Percentage of Completion Method
- Determining Stage of Completion;
  - Cost to Cost Method
  - By survey of work performed
  - Completion of physical proportion of the contract work
- Types of Construction Contracts
  - Fixed Price Contract
  - Cost Plus Contract
  - Mix of the both
- Where contract revenue or stage of completion cannot be determined reliably (Preliminary Stage).
- Provision for expected future losses

Non-Applicability

AS-9 Revenue Recognition

- Construction Contracts
- Insurance Contracts in case of insurance companies
- Realised and unrealised gains
- Government grants
- Hire purchase/Lease agreements

AS-7 Construction Contracts

- Accounting by Contractee (Customer).
- Construction projects undertaken by enterprise on its own account
- Contracts in substance similar to sale of goods and services
- Government grants
- Hire purchase/Lease agreements

Recognition of Government Grants (AS-12)

- What is Government Grants
- Recognition of Government Grants
  - Compliance with conditions attached to them
  - Grant can be valued reasonably
  - The grant will be received
- Types of Government Grants
  - Non Monetary Grants
  - Monetary Grants
    - Revenue Grants
    - Capital Grants

Revenue Grants

- Accounted on accrual basis.
- Matching principle to be adopted.
- To be shown under the head "Other Income" - More appropriate to treat it as other operating income.
- Can be credited to expense head where relevant.
- Appropriate disclosure of method of accounting essential.

Revenue in Foreign Exchange (AS-11)

- Revenue Recognition as per AS – 9 or AS-7
- Converted in to INR at the prevailing rate on the date of transaction. Option available for average rate.
- Currency remittance restriction to be taken in to account while recognising revenue.
- Subsequent change in value on realisation cannot be treated as Revenue from operations

Real Estate Transactions

- Applicability of guidance note
- Project Revenue
- Revenue Recognition;
  - Where economic substance is similar to construction contracts i.e. Long Term Contracts (AS-7).
  - Where economic substance is similar to delivery of goods and services (AS-9).
- Project Cost
  - Cost of Land & Developing Rights
  - Construction & Development Cost
  - Borrowing Cost (AS-16)

Criteria for Real Estate's Revenue Recognition

- All following conditions to be satisfied
  - Availability of all critical approvals for commencement of project.
  - 25 per cent cost of construction and development (excluding land cost, cost of development rights and rehabilitation costs) to be incurred.
  - Sale of at least 25 per cent of the saleable area.
  - Collection of 10 per cent or more at the reporting date, at the individual contract level.
- Broadly, this resulted in deferral of revenue recognition for most companies in respect of new projects launched in FY 2012-13 onwards, as the incurrence of 25 per cent construction and development costs typically takes 12-15 months.

Other Real Estate Transactions

- Sale of plot of land without any development (AS-9)
- Sale of developed plots (AS-7)
- Transferable Development Rights (TDRs)
- Transactions with multiple elements

Dot Com Companies/ e-commerce

- Impressions are the number of times that an advertisement appears in pages viewed by users of the dot-com company's on-line sites.
- Revenue recognition on the basis of the number of impressions or 'click-throughs.
- To the extent the minimum guaranteed impressions or 'click-throughs are not met, recognition of the corresponding revenue should be postponed until the guaranteed impression levels are achieved.
- E-commerce revenue recognition is depend on nature of agreement and arrangement.

Accounting by Education Institutes

- Revenue Recognition in case of;
  - Tuition Fees
  - One Time Charges
  - Periodic Charges
  - Caution Money
  - Sale of prospectus
  - Canteen Income
  - School Premises given on Rent to outside parties
  - Hostel Fees
  - Revenue from provision of Transportation Facilities
  - Supply of books & Uniforms to Students
  - Sponsorship Fees
  - Advertisement for School Magazines
  - Board Fees

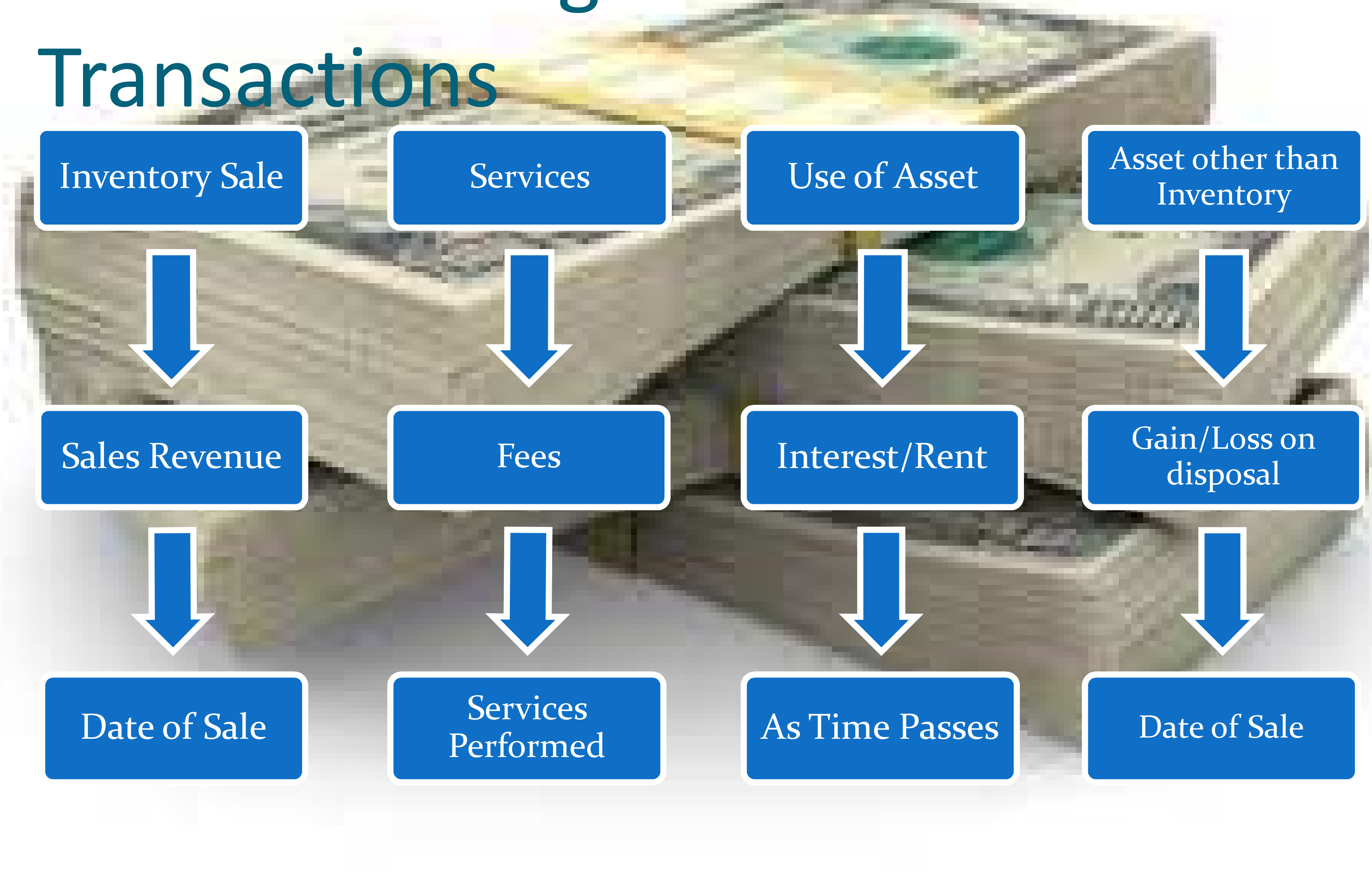
Incoterms

- The **Incoterms** rules or **International Commercial Terms** are a series of pre-defined commercial terms published by the International Chamber of Commerce (ICC) that are widely used in International commercial transactions or procurement processes. A series of three-letter trade terms related to common contractual sales practices, the Incoterms rules are intended primarily to clearly communicate the tasks, costs, and risks associated with the transportation and delivery of goods.
- The Incoterms rules are accepted by governments, legal authorities, and practitioners worldwide for the interpretation of most commonly used terms in international trade. They are regularly incorporated into sales contracts worldwide.
- Some popular Incoterms
  - EXW - Ex Works
  - FOB - Free on Board
  - CFR - Cost and Freight
  - CIF - Cost, Insurance and Freight
  - DAP - Delivered at Place
  - DDP - Delivered Duty Paid

The seller’s responsibilities based on Incoterms

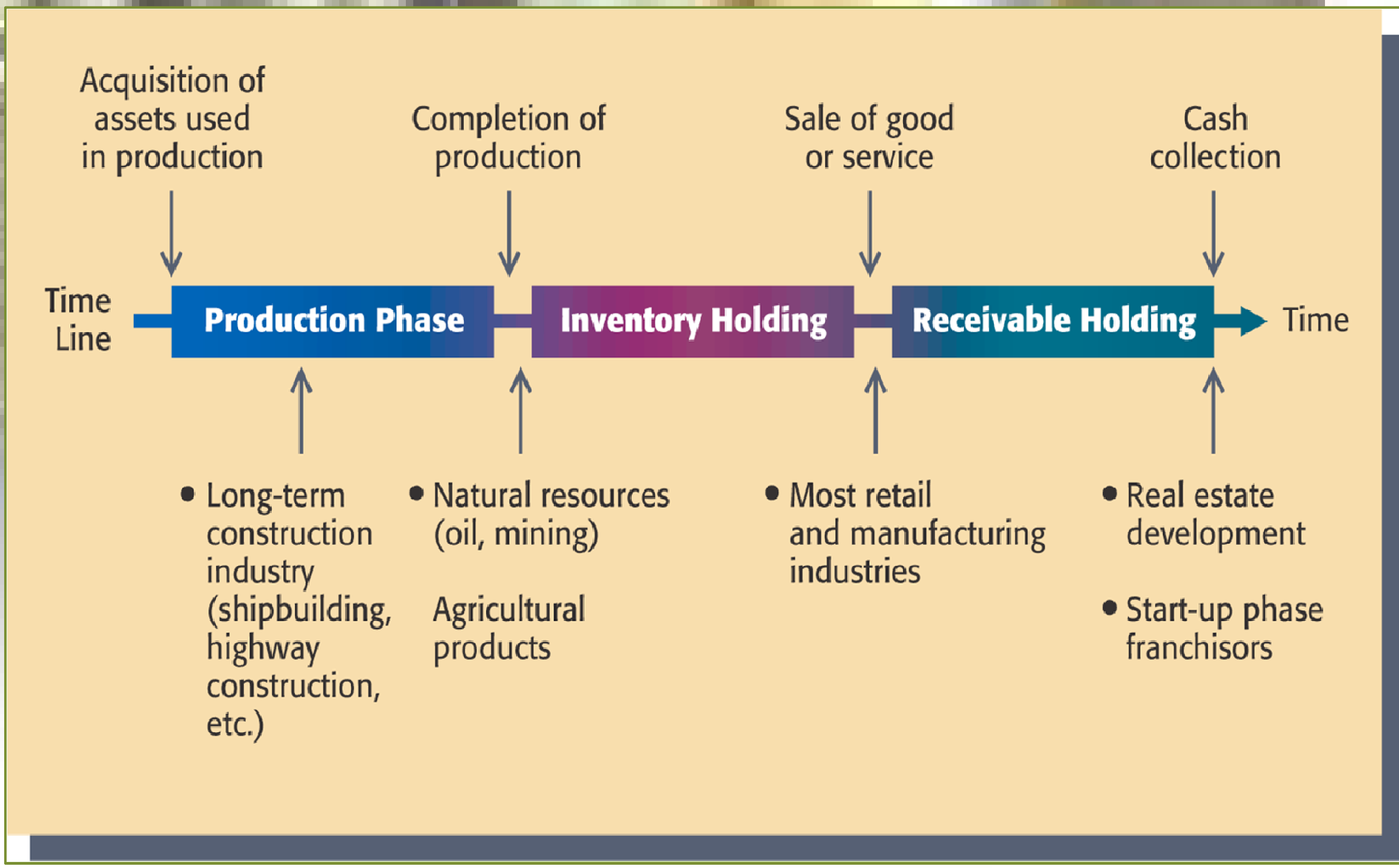
	Loading on Transport vehicle	export declaration	transport to the export port	unloading of the vehicle in the export port	loading fees in export port	transport to the import port	unloading fees in import port	loading to the transport vehicle in import port	transport to the delivery address	custom fees	tax fees	insurance
EXW	No	No	No	No	No	No	No	No	No	No	No	No
FOB	Yes	Yes	Yes	Yes	Yes	No	No	No	No	No	No	No
CFR	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No	No	No	No
CIF	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No	No	No	Yes
DAP	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No
DDP	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No

Revenue Recognition for Different Transactions



Inventory Sale	Services	Use of Asset	Asset other than Inventory
Sales Revenue	Fees	Interest/Rent	Gain/Loss on disposal
Date of Sale	Services Performed	As Time Passes	Date of Sale

Industries Recognizing Revenue at Indicated Phases



Hie…..Wait a Minute!

- This all sounds so incredibly easy!
- So . . . Why do we have so many problems with revenue recognition?

Case Study

- A Ltd manufactured goods as per customer's specifications which are ready for delivery lying at plant at a reporting date. Amount in respect of such goods has been received and billing has been done at a reporting date. However goods are lying at company's plant as instructed by buyer.
- A Ltd offers trade discounts and rebates through credit notes to its customers to promote sale. Such discounts and rebates are shown as expense.
- A Ltd is in sales of air conditioners. It sells air conditioners which includes a free twelve month replacement warranty on compressor.
- A Ltd accounted sales of Rs.10 Crs representing loyalty receivable for supply of know-how to a company in South-East Asia. As per the agreement the amount it to be received in US Dollars. However exchange permission was denied to the company in South-East Asia for remitting the same.

Challenges in Revenue Recognition

- E-commerce
- Telecom services – Prepaid, Post paid, Free Talktime, Sms Packs etc. etc,
- Real Estate – point of transfer of risk and reward?
- Construction contracts – Variations and Claims
- Contract manufacturing – under customer supervision
- Discount coupons, payback points, Gift Vouchers
- Barter trasactions

Case Study

- A Ltd entered into an agreement with B Ltd for sale of goods at Rs.4 Crs. On the same day, A Ltd entered into another agreement with B Ltd for repurchasing the same goods at Rs.5 Crs after a year. What is the revenue to be recognised by A & B?
- A Ltd had fire in its factory in March 06 as a result of which finished goods worth Rs.5 Crs and plant & machinery worth Rs.10 Crs was gutted. The company lodged claim with insurance co. for Rs.6 Crs and Rs.11 Crs respectively. Can A Ltd book the claim as revenue.
- Revenue recognition Telecom industry – connection along with handset, packs, for lump sum Consideration . What is the revenue accrual at point of sale?
- Accounting for Non-Refundable Advances to be accounted as revenue?

Case Study

- A contractor not able to work for six months due to non-availability of land for construction of Highway. He claims compensation of Rs. 50 Crores as cost of idle time. Can he account this as revenue on filing claim?
- A telecom company agree to provide its facility of communication network to another service provider against other service provide proving similar facility to former in other region. What is the revenue each one can recognise for this arrangement?

Differences among Existing AS-7 & IND AS-11

Existing AS 7	IND AS 11
AS 7 includes Borrowing Cost (AS 16) attributable to contract activity.	IND AS 11 doesn't do so on the lines of IAS 11 ‘Construction Contracts”.
Existing AS 7 does not recognise fair value concept as contract revenue is measured at consideration received/receivable.	Ind AS 11 requires that contract revenue shall be measured at fair value of consideration received/receivable.
Existing AS 7 does not deal with accounting for Service Concession Arrangements.	Ind AS 11 deal with accounting and disclosure aspects involved in such arrangements.

Differences among Existing AS-9 & IND AS-18

Existing AS 9	IND AS 18
Revenue is recognised at the nominal amount of consideration receivable.	Ind AS 18 requires the revenue to be measured at fair value of the consideration received or receivable.
AS 9 doesn't deal with Barter Transactions.	Ind AS 18 specifically deals with Barter Transactions.
Existing AS 9 **doesn't** deal with recognition criteria of transactions involving separately identifiable components.	Ind AS 18 provides guidance for the same.
revenue in case of rendering of services, existing AS 9 permits the use of completed service contract method.	Ind AS 18 requires recognition of revenue using percentage of completion method only.
Existing AS 9 requires the recognition of revenue from interest on time proportion basis.	Ind AS 18 requires interest to be recognised using effective interest rate method.

Significant Differences among AS-7, IFRS/IAS-11 and US GAAP

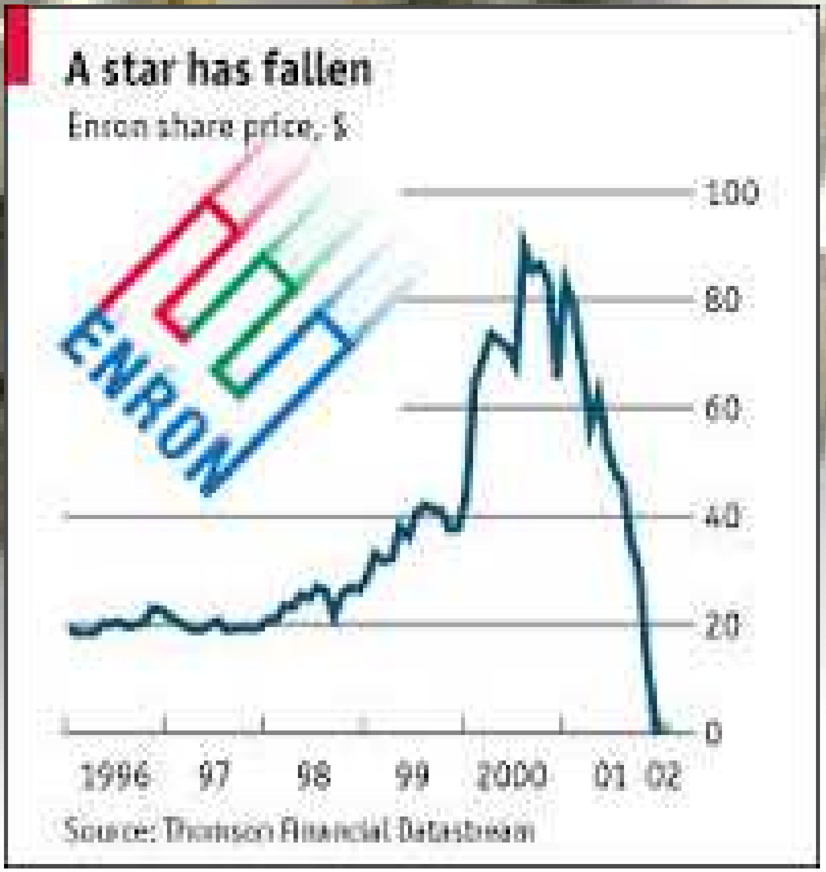
- After the issue of AS_7 (revised) in 2002 the only method prescribed is percentage completion method to recognise the contract revenue, which is the same as IAS-11. However, US GAAP in certain circumstances allows another method i.e completed contract method
- US GAAP provides detailed guidance on the use of estimate in accounting for construction contracts, however, no such guidance is provided under AS-7 and IAS-11.

Significant Differences among AS-9, IFRS/IAS-18 and US GAAP

- The definition of “Revenue” is almost same in AS-9 and IFRS/IAS-18; however there is no specific standard for recognising the revenue under US GAAP. There are several pronouncements in US having varying degree of authority (for example, APB opinions, FASB statements, AICPA Audit and Accounting Guides, AICPA Statement of Position, FASB Interpretations, EITF Issues, SEC Staff Accounting Bulletins and so forth) on an ad hoc basis. Each pronouncement generally has focused on particular practice problem and has been very limited in its scope. There are over 75 sources of accounting guidance for revenue recognition in the US.
- Under IFRS/IAS-18, revenue recognition from rendering of services is done on the basis of POC method where as AS-9 allows both methods.
- Under US GAAP/IAS-18 revenue from interest is recognised using the effective interest method.
- IFRS/IAS-18 contains the provisions for revenue swaps; however, no such corresponding provisions are in AS-9.

ENRON Revenue Recognition Scandal

- Used “Merchant Model” instead of “Agent Model” for recognising revenues.
- Between 1996 and 2000, Enron's revenues increased by more than 750%, rising from $13.3 billion in 1996 to $100.8 billion in 2000.
- Enron became the first non-financial company to use Mark-to-market accounting method to account for its complex long-term contracts.
- Mark-to-market accounting requires that once a long-term contract was signed, income is estimated as the present value of net future cash flow. Often, the viability of Enron’s business contracts and their related costs were difficult to estimate.



GE Revenue Recognition Scandal

- In the fourth quarters of 2002 and 2003, GE “improperly” booked revenue of $223 million and $158 million, respectively, for six locomotives reportedly sold to financial institutions, “with the understanding that the financial institutions would resell the locomotives to GE’s railroad customers in the first quarters of the subsequent fiscal years.
- Indeed, GE did not cede ownership of the trains to the financial institution.

- Worldcom – revenue inflation and capitalisation of revenue expenditure
- Satyam Scandal – Booking of fake revenue and fake realisation of cash against the same.

Thank You