Certification Course in IFRS Pune

IAS 18 : Revenue Recognition

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Revenue Recognition IAS 18

- **1.1** The *Framework for the Preparation and Presentation of Financial Statements defines "income"* as "increases in economic benefits during the accounting period in the form of inflows or
- enhancements of assets or decreases of liabilities that result in increases in equity, other than those
- relating to contributions from equity participants." Income encompasses *both revenue and gains.*
- **1.2 "Revenue" should be distinguished from "gains." Revenue arises from an entity's ordinary activities**. Gains, however, include such items as the profit on disposal of non-current assets, or on retranslating balances in foreign currencies, or fair value adjustments to financial and non-financial assets.

Scope

- **2.1 The requirements of IAS 18 are to be applied in accounting for revenue arising from**
- • Sale of goods
- • Rendering of services
- • The use by others of the entity's assets thus yielding interest, royalties, or dividends

Scope Continued

- **2.2 The Standard does not deal with revenue arising from the following items, as they are dealt**
- with by other Standards:
- • Leases (IAS 17)
- • Dividends from investments accounted under the equity method (IAS 28)
- • Insurance contracts (IFRS 4)
- • Changes in fair values of financial instruments (IAS 39)
- • Changes in the values of current assets
- • Initial recognition and changes in value of biological assets (IAS 41)
- • Initial recognition of agricultural produce (IAS 41)
- • Extraction of minerals

3. DEFINITIONS OF KEY TERMS (in accordance with IAS 18)

- **Revenue. The gross inflow of economic benefits *during a period arising in the course of ordinary***
- activities when those inflows result in increases in equity, other than increases relating to
- contributions from equity participants.
- **Fair value. The amount for which an asset can be exchanged, or a liability settled, between**
- knowledgeable, willing parties in an arm's-length transaction.

Practical Insight

- “Revenue” refers only to those amounts received or receivable by an entity on its own account.
- Amounts received or receivable for the accounts of others are not classified as income as there is no increase in equity; such items are liabilities. Examples include sales taxes (amounts owed to the government), insurance premiums collected by an agent (revenue in this case would be the commission), and the like.

4. MEASUREMENT OF REVENUE

- **4.1 Revenue is to be measured at the fair value of the consideration received or receivable.** In most cases, the value is easily determined by the sales contract after taking into account trade discounts or rebates.

5. IDENTIFICATION OF A TRANSACTION

- Usually when applying the recognition criteria of the Standard, one applies it to each transaction.
- However, occasions arise with more complex transactions when the criteria need to be applied to *components of a transaction.*
- **For Example :**
- ***Facts***
- Good Service Co. sells some equipment, the cash price of which is Rs. 100,000, for Rs. 140,000 with a commitment to service the equipment for a period of two years, with no further charge.
- ***Solution***
- Good Service Co. would recognize revenue on sale of goods of Rs. 100,000. The balance of Rs. 40,000 would be recognized over two years as service revenue.

6. SALE OF GOODS

- **The Standard prescribes that revenue from the sale of goods should be recognized when *all of***
- the following criteria are satisfied:
- • The significant risks and rewards of ownership of the goods have been transferred to the buyer.
- • The seller retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold.
- • The amount of the revenue can be reliably measured.
- • It is probable that economic benefits associated with the transaction will flow to the seller.
- • The costs incurred or to be incurred in respect of the transaction can be measured reliably.

Example of Ashok Leyland

- OEM Supplier removes goods from Factory on 31st March
- Raises Excise sales invoice
- Place of delivery still uncertain on date of sale
  - Stores material at OWN warehouse
  - Stores material at warehouse of Ashok Leyland
  - Stores material at TRANSPORTER'S warehouse

Goods are insured by seller / Ashok Leyland

Sale of Gift Coupon

- In Orbit Mall sells Gift Coupons
- Gift Coupons can be redeemed against merchandise offered by In Orbit Mall

When is revenue recognised ?

When Gift Coupon is sold ?

When it is exchanged against merchandise ?

How long do I wait for gift coupon to be redeemed ?

Revenue Recognition- Case Study

- Walchandnagar Industries has manufactured a machine specifically to the design of its customer. The machine could not be used by any other party. WIL has never manufactured this type of machine before and expects a number of faults to materialize in its operation during its first year of use, which WIL is contractually bound to rectify at no further cost to the customer. The nature of these faults could well be significant. As of WIL's year-end, the machine had been delivered and installed, the customer invoiced for Rs. 1 crore (the contract price), and the costs incurred by WIL up to that date amounted to Rs. 65 lakhs.

- ***Required***
- How should Bespoke Inc. recognize this transaction?
- ***Solution***
- As WIL has not manufactured this type of machine earlier, it is not in a position to reliably measure the cost of rectification of any faults that may materialize. Consequently, the cost to WIL of the transaction cannot be reliably measured and no sale should be recognized. Identified costs to accrue till end of year 1 from sale date.

Matching of Cost

- **Revenues recognized and the costs (expenses) associated with them should be matched and** recognized simultaneously—this is essential because if costs cannot be measured reliably, then the related revenue should not be recognized. In such a situation, any consideration received from such transactions is booked as a liability.

Recognition criteria : Services

Revenue on rendering services to be recognised when *all* the foll. criteria have been met :

- Performance has been achieved
- Revenue is measurable
- It is not unreasonable to expect the ultimate collection

Recognition criteria : Services

- Completed service contract is not permitted under IFRS
- IAS 18 mandates the use of the % of completion method ONLY when accounting for revenue from rendering of services

Recognition criteria : Services : Guidance under IAS 18

Conditions for the outcome of a transaction to be estimated reliably :

- The amount of revenue can be measured reliably
- It is probable that the economic benefits associated with the transaction will flow to the entity
- The stage of completion of the transaction at the end of the reporting period can be measured reliably
- The costs incurred / to be incurred can be measured reliably

Reliable estimates : Services : Guidance under IAS 18

An entity is usually able to make reliable estimates if :

- Each party's enforceable rights regarding the service to be provided / received are well defined
- There is clarity on consideration to be exchanged
- There is clarity regarding the manner and terms of settlement
- The entity has an effective internal budgeting / reporting system to make reliable estimates and ascertain actual costs incurred

IFRIC 13, Customer Loyalty Programs

- **This Interpretation applies to customer loyalty award credits that**
- (a) An entity grants to its customers as part of a sales transaction (i.e., a sale of goods, rendering of services or use by a customer of entity assets); and
- (b) Subject to meeting any further qualifying conditions, the customers can redeem in the future for free or discounted goods or services.

This Interpretation addresses accounting by the entity that grants award credits to its customers as incentive to buy their goods and services.

- **According to the consensus in IFRIC 13**
- An entity shall apply IAS 18 and account for award credits as a separately identifiable component of the sales transaction(s) in which they are granted (the 'initial sale');

- The fair value of the consideration received or receivable in respect of the initial sale shall be allocated between the award credits and the other components of the sale; and

- The consideration allocated to the award credits shall be measured by reference to their fair value, (i.e., the amount for which the award credits could be sold separately).

Self Assessment

1. “Bill and hold” sales, in which delivery is delayed at the buyer’s request but the buyer assumes title and accepts invoicing, should be recognized when:

- (a) The buyer makes an order.
- (b) The seller starts manufacturing the goods.
- (c) The title has been transferred but the goods are kept on the seller’s premises.
- (d) It is probable that the delivery will be made, payment terms have been established, and the buyer has acknowledged the delivery instructions.

2. ABC Inc. is a large manufacturer of machines.

XYZ Ltd., a major customer of ABC Inc., has placed an order for a special machine for which it has given a deposit of 112,500 to ABC Inc. The parties have agreed on a price for the machine of 150,000. As per the terms of the sales agreement, it is an FOB (free on board) contract and the title passes to the buyer when goods are loaded onto the ship at the port. When should the revenue be recognized by ABC Inc.?

(a) When the customer orders the machine.
(b) When the deposit is received.
(c) When the machine is loaded on the port.
(d) When the machine has been received by the customer.

3. M Ltd, a new company manufacturing and selling consumable products, has come out with an offer to refund the cost of purchase within one month of sale if the customer is not satisfied with the product.

When should M Ltd. recognize the revenue?

(a) When goods are sold to the customers.
(b) After one month of sale.
(c) Only if goods are not returned by the customers after the period of one month.
(d) At the time of sale along with an offset to revenue of the liability of the same amount for the possibility of the return.

ILLUSTRATION 1

A company sells goods to a customer for Rs. 2,500 on 5 July 2007. Although delivery will take place as soon as possible, the company has given the customer an interest-free credit period of twelve months.

The fair value of the consideration receivable is Rs. 2,294. In other words, If the company tried to sell this debt factoring company it would except to receive Rs. 2,294 rather than Rs. 2,500.

The balance of Rs. 206 represents interest revenue.

Therefore the company should split the Rs. 2,500 between revenue and interest.

Revenue of Rs. 2,294 should be recognized on 5 July 2007, with the balance of Rs. 206 being recognized as interest revenue over the twelve month credit period.

ILLUSTRATION 2

A motor car is sold for Rs. 20,000 on 1 March 2007, and includes a two-year manufacture's warranty As a special promotion a deferred payment option is being offered by the manufacturer buy now, pay in twelve months' time'. The dealer has a 31 December year end

The following steps are needed to account for the sale.

1 Split the Rs. 20,000 payments between the cash sale price and effective interest .

2. Recognize the cash sale price as revenue on 1 March.

3. Recognize interest income for the ten months' credit given in the accounting period in which the sale is recognized.

4.Recognise the remaining two months interest in the following period.

5. Production and selling costs will be recognized in the same period that the revenue relating to the sale of the motor car is recognized.

6.A warranty provision will be made in the period in which the revenue relating to the sale of the motor car is recognized for expected cost under the warranty provision (in accordance with IAS 37 Provisions, Contingent liabilities and contingent assets).

7. Costs incurred under the warranty provision will be charged to the warranty provision to the extent that the provision covers the costs. Any excess costs incurred will be recognized in profit or loss and any balance remaining on the provision at the end of the second year (at the end of the warranty period) will be released to profit or loss.

ILLUSTRATION 3

An entity enters into a Rs. 210,000 fixed price contract for the provision of services. At the end of 2007, the first accounting period, the contract is assessed as being one-third complete and costs incurred to date are Rs. 45,000.

If costs to complete can be estimated reliably at Rs. 90,000, the overall contract is profitable, as the total revenue of Rs. 210,000 exceeds total costs (Rs. 45,000 plus Rs. 90,000) Revenue to be recognized in the first accounting period will be Rs. 70,000 calculated as one-third of the total contract revenue. Costs of one-third of total estimated costs i.e. Rs. 45,000 would also be recognised and matched against the related revenue.

If the costs to complete cannot be estimated reliably, then the outcome of the total contract cannot be estimated reliably, and revenue is recognised to the extent that the costs incurred are believed to be recoverable from the client.

ILLUSTRATION : 4

An entity sells recorded music from emerging artists through a number of retail outlets. The outlets can return any unsold material within three months of receipt. The artists are unproven in a commercial market and it is unclear if the sale of the music will be successful.

There is uncertainty about the timing of receipts from the retailers. This uncertainty is only removed when the retailer sells the music or the three month period has expired. The risks and rewards of ownership do not pass until the retailer has sold the music.

Revenue should be recognised at the end of the three month return period or, when the retailer has sold the music if earlier (this could be based upon monthly return demanded from the retailer).

ILLUSTRATION 5
REVENUE RECOGNITION

On the last day of the current accounting period an entity completes the handover of a new system to a client at an agreed price of Rs. 800,000. The price includes after sales support for the next two years. The cost of providing the support estimated at Rs. 48,000 per annum, and the entity earns a gross profit of 20% on support contracts.

The after-sales support revenue should be deferred and recognised over the next two years and should include a reasonable element of profit. This is often computed by the reference to similar contracts. The revenue deferred on the after- sales contracts will Rs. 60,000 (cost and the 20% gross profit on selling price) per annum.

The revenue to be recognised on the handover of the system will be Rs. 680,000(Rs. 800,000-(2 x Rs. 60,000)).

ILLUSTRATION 6
REVENUE RECOGNITION

A supermarket awards loyalty points to customers who use the supermarket's own credit card to pay for purchases. The award is at rate of one point for every Rs. 250 charged to the card and each point entitles the customer to a certain credit against future purchases, without time limit. The supermarket estimates the fair value of each point at Rs. 5 and in one period Rs. 250 million is charged to the supermarket's credit card.

The number of points awarded in this period is 1 million (Rs. 250 million + Rs. 250) and at Rs. 5 per point their total fair value is Rs. 5 million.

The supermarket defers revenue of Rs. 5 million and recognises the other Rs. 245 million immediately. The deferred revenue of Rs. 5 million will be recognised as the award points are redeemed.

Case Study 1

Facts

Nice Guys Co. sells goods with a cost of $100,000 to Start-up Co. for $140,000 and a credit period of six months. Nice Guys Co.'s normal cash price would have been $125,000 with a credit period of one month or with a $5,000 discount for cash on delivery.

Required

How should Nice Guys Co. measure the income from the transaction?

Solution

Effectively, Nice Guys Co. is financing Start-up Co. for a period of six months. The normal price would have been $120,000 ($125,000 – the cash discount of $5,000). Therefore, revenue should be accounted at an amount that discounts the actual sale amount of $140,000 back to $120,000.

The difference between the nominal amount of $140,000 and the discounted value would be recognized as interest income over the period of finance of six months.

Facts

Full Service Co. sells some equipment, the cash price of which is $100,000, for $140,000 with a commitment to service the equipment for a period of two years, with no further charge.

Case Study 2

Solution

Full Service Co. would recognize revenue on sale of goods of $100,000. The balance of $40,000 would be recognized over two years as service revenue.

Case Study 3

- A machine is specifically manufactured to the design of its customer. The machine could be used by that Customer Only. This M/c was never manufactured before and number of faults are expected in its operation during its first year of use, which Manufacturer is contractually bound to rectify at no further cost to the customer. The nature of these faults could well be significant. The machine had been delivered and installed, the customer is invoiced for Rs. 2,50,000 (price of M/c), and the costs incurred by Manufacturer up to that date amounted to Rs. 65,000.
- ***Required***
- How should Manufacturer recognize this transaction on the Reporting Date?

Case Study 4

M Ltd, a new company manufacturing and selling Shirts, comes out with an offer to Return the Cost of Purchase or Replacement by Similar Shirt, *within one month of sale* if the customer is not satisfied with the Shirt.

When should M Ltd. recognize the revenue?

(a) When goods (Shirts) are sold to the customers.
(b) After one month of sale.
(c) Only if goods (Shirts) are not returned by the customers after the period of one month.
(d) At the time of sale along with an offset to revenue of the liability of the same amount for the possibility of the return.

Case Study 5

An entity enters into a Rs. 210,000 fixed price contract for the provision of Services. At the end of the first accounting period, the contract is assessed as being *One-Third* complete and costs incurred to date are Rs. 45,000.

Further costs to complete can be estimated reliably at Rs. 90,000, the overall contract is profitable. as the total revenue of Rs. 210,000 exceeds total costs (Rs. 45,000 plus Rs. 90,000).

Q : How the Revenue to be recognized

1. If Costs to Complete the Contract can be Estimated.

2. If Costs to Complete the Contract can Not be Estimated.

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