Revenue Recognition

Sale of goods and services (AS-9)

and

Construction contracts (AS-7)

WIP

Contents

Revenue from sale of goods and rendering of services

Definition of Revenue

- **AS-9 definition**
- Revenue is the **gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities** of an enterprise from the **sale of goods**, from the **rendering of services**, and from the **use by others of enterprise resources** yielding interest, royalties and dividends
- [AS-9.4.1]

- Revenues arising from the following sources are not covered by AS-9:
  - Construction contracts (AS-7)
  - Hire-purchase, lease agreements (AS-19);
  - Government grants (AS-12);
  - Insurance companies arising from insurance contracts (IRDA regulations).

Definition of Revenue - Revenue v. Gains

Income = Revenue + Gains

- Increase 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.

Revenue

- Gross inflow of cash, receivables or other consideration **arising in the course of the ordinary activities** of an enterprise from the **sale of goods**, from the **rendering of services**, and from the **use by others of enterprise resources** yielding interest, royalties and dividends

Gains

- Gains represent **other items** that meet the definition of income and **may, or may not, arise in the course of the ordinary activities of an enterprise**. Gains represent increases in economic benefits and include, for example, those arising on the disposal of fixed assets [Also see exclusions in AS-9.3]

Definition of Revenue - other frameworks

- **IFRS**
- Revenue is the **gross inflow of economic benefits** during the period **arising in the course of the ordinary activities** of an entity **when those inflows result in increases in equity**, other than increases relating to contributions from equity participants
- [IAS 18.7]

- **US GAAP**
- “Revenues are **inflows or other enhancements of assets** of an entity **or settlements of its liabilities** (or a combination of both) from **delivering or producing goods, rendering services, or other activities** that **constitute the entity's ongoing major or central operations**
- [Paragraph 78 of FASB Concepts Statement No. 6, Elements of Financial Statements]

Definition of Revenue - Illustration

- Proceeds from the sale of a building may be classified as
  - **Revenue** by a real estate company;
  - **Gain** by a automobile manufacturer

Measurement

- Revenue is measured by the **charges made to customers or clients** for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them [AS-9.4.1]

- **Trade discounts**
  - Revenue recognised at the **net amount**
- **Cash discounts**
  - Revenue is recognised at the **net amount**
- **Deferred consideration**
  - Revenue attributable to the **sales price exclusive of interest** is recognised.
  - The **interest element may also be recognised as revenue**, proportionately over the period of recovery of the instalments
  - [IAS 18:12]

- **Exchange of goods**
  - If goods are of a similar nature and value no revenue is recognised
  - Where exchanged goods are dissimilar revenue is measured at the fair value of goods and services received adjusted for cash payments by either the buyer or the seller
    - If the fair value of goods received cannot be measured reliably, revenue is recognised at the fair value of the goods given up
  - [IAS 18:12]
- **Barter transactions involving advertisement services**
  - It is very unlikely that revenue from a barter transaction involving advertisement services can be reliably measured at the fair value of advertising services received
  - [SIC-31]

Recognition criteria – Sale of goods

- In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:
  - the **seller of goods has transferred to the buyer the property in the goods** for **a price or all significant risks and rewards of ownership have been transferred** to the buyer and the **seller retains no effective control** of the goods transferred to a degree usually associated with ownership; and
  - **no significant uncertainty exists regarding the amount of the consideration that will be derived** from the sale of the goods.
- [AS-9 .11]

- At certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases when
  - sale is assured under a forward contract; or
  - a government guarantee or where market exists;
  - and there is a negligible risk of failure to sell,

  the **goods involved are often valued at net realisable value.**
- Such amounts, **while not revenue** are sometimes recognised in the statement of profit and loss and appropriately described.
- [AS-9.6.2]

Recognition criteria – sale of goods – other frameworks

- **IFRS**
- Revenue from the sale of goods shall be recognised when all the following conditions have been satisfied:
  - the entity has **transferred to the buyer the significant risks and rewards of ownership** of the goods;
  - the entity **retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control** over the goods sold;
  - the **amount of revenue can be measured reliably**;
  - it is **probable that the economic benefits associated with the transaction will flow to the entity**; and
  - the **costs incurred or to be incurred in respect of the transaction can be measured reliably**."
- [IAS18.14]

- **US GAAP**
- Revenue from the sale of goods or products should not be recognized **until it is earned and realized, or realizable**. Revenue is generally earned and realized, or realizable, when all of the following conditions have been satisfied:
  - There is **persuasive evidence of an arrangement**.
  - **Delivery has occurred** (e.g., an exchange has taken place).
  - The **sales price is fixed or determinable**.
  - **Collectibility is reasonably assured**.
- [SAB Topic 13]
- In addition, ASC 605-15 provides guidance on product transactions that include a right of return.
- Furthermore, other U.S. GAAP provide industry- and transaction-specific guidance.

Risk and rewards – not transferred to the buyer

Seller retains an obligation for unsatisfactory performance not covered by normal warranty provisions

Receipt of revenue is contingent on derivation of revenue by the buyer

Goods shipped are subject to installation and installation is a significant part of the contract which has not yet been completed by the seller

Buyer has the right to rescind the purchase and the seller is uncertain about the probability of return

Risk and rewards – not transferred – some other indicators

- Risk of physical damage to the product is retained by the seller
- Ability of the buyer or the buyer's intention to take delivery of the goods is suspect
- Seller has a repurchase option at a fixed price
- Buyer lacks economic substance apart from that provided by the seller
- Seller shares in the revenues to be realised from onward sales

Risks and rewards – sale of goods - illustrations

- Goods shipped free on board (FOB) shipping point
  - Title passes on shipment and buyer is responsible for transit losses
- Goods shipped FOB destination
  - Title passes on delivery to the seller and the buyer is responsible for transit losses
- Goods shipped FOB destination but shipping co. assumes the risk of loss
  - Title has not passed to the buyer on shipment. The seller has only managed his risk
- Reseller arranges for the manufacturer to ship directly to the buyer
  - Reseller needs to evaluate whether he is acting as the principal or as an agent
  - The resellers should evaluate the revenue recognition point as if it had shipped the products itself
- Retention of title until receipt of consideration
  - If this condition is inserted as a matter of policy, goods are delivered and there is no credit risk foreseen, revenue can be recognised
  - Transfer of title is not a required condition

- Written sales agreement has expired but shipments continue
  - A legal evaluation of the seller's and buyer's rights is necessary. As a result of the agreement expiring.
    - It may be the case that:
    - The seller has retained the significant risks of ownership
    - The amount of revenue cannot be measured reliably
    - It is no longer probable that the amounts due from the buyer would be recovered
- Unlimited right of return
  - The buyers would have assumed the rights of ownership as they have an unrestricted right to resell
  - The seller needs to evaluate whether on the basis of experience, it is able to estimate the amount of returns
  - Assuming that a reliable estimate of the returns can be made, the extent to which the buyer has assumed risks can be measured.
  - Revenue can be recognised at an amount that reflects a reduction for estimates
- Shipping and handling changes under a CIF contract
  - Amounts collected on behalf of 3rd parties do not constitute Revenue
  - Where the seller is able to determine the additional margin or the additional cost there is an indicator that the entity is not acting as an agent

Risks and rewards – sale of goods – illustrations …2

- **Bill and hold sales**
- Normally revenue is recognised only when all performance criteria have been satisfied including delivery of goods to the customer
- Under bill-and-hold arrangements, a customer obtains title to goods, but requests the vendor to hold these until the customer collects goods or requests delivery

- **AS-9**
- Revenue should be recognised notwithstanding that physical delivery has not been completed so long as:
  - there is every expectation that delivery will be made.
  - the item must be on hand, identified and ready for delivery to the buyer at the time the sale is recognised
- Revenue is not recognised when there is simply an intention to acquire or manufacture the goods in time for delivery.

- **Guidance Appendix A of IAS 18**
- Revenue is recognised when the buyer takes title, provided:
  - it is probable that delivery will be made;
  - the item is on hand, identified and ready for delivery to the buyer at the time the sale is recognised;
  - the buyer specifically acknowledges the deferred delivery instructions; and
  - the usual payment terms apply.
- Revenue is not recognised when there is simply an intention to acquire or manufacture the goods in time for delivery.
- **US GAAP**
- The SEC provides specific criteria that must be met for revenue to be recognised in bill-and-hold arrangements before delivery of the product.

Continuing managerial involvement

- **Indicators of continuing managerial involvement**
- The economics of the transaction deem it likely that the goods will be returned
- The seller can control the future onward sales price of the item or resale of the item
- The seller guarantees the return of the buyer’s investment or a return on that investment for a significant period
- The seller is responsible for the management of the goods subsequent to the sale

- **Warranty**
- A warranty is provided in conjunction with sale of goods and represent the sellers guarantee on performance of the item sold for a specified period of time
- It allows a customer to return the goods only if the product does not meet the specified performance criteria
- The expected future costs should not be recorded as a reduction from revenue but as a cost of sale as the warranty does not represent a return of a portion or the purchaser’s price

Recognition criteria – Sale of services

- Revenue from service transactions is usually recognised as the **service is performed**
- **No significant uncertainty exists regarding the amount of the consideration** that will be derived from rendering the service [AS9.7.1]

- **Proportionate completion method**
- Performance consists of the **execution of more than one act**. Revenue is recognised proportionately by reference to the performance of each act.
- The revenue recognised under this method would be determined on the basis of
  - contract value,
  - associated costs,
  - number of acts or other suitable basis.
- For practical purposes, when services are provided by an indeterminate number of acts over a specific period of time, revenue is recognised on a straight line basis over the specific period unless there is evidence that some other method better represents the pattern of performance

- **Completed service contract method**
- Performance consists of the **execution of a**
- **single act**.
- Alternatively, services are performed in more than a single act, and the services yet to be performed are **so significant in relation to the transaction taken as a whole** that performance cannot be deemed to have been completed until the execution of those acts.
- The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable.

Recognition criteria – Sale of services …2

- **Proportionate completion method**
- Franchisee fees – initial and subsequent
- Fees from development of software
- Milestone payments
  - Revenue recognition deferred until milestones are met
- Inception / membership fees
  - If the joining or membership fee entitles members to services or products during the membership period or to goods and services at concessional rates, revenue is recognised on a basis that reflects the timing, nature and value of benefits

- **Completed service contract method**
- Placement fees for arranging a loan between a borrower and an investor
- Insurance agency commissions
  - Revenue is recognised on the effective date of commencement or the renewal of the related policies , if the agent is not required to render further service

Revenue from use of an entity's resources

- Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends is recognised on the following bases provided no significant uncertainty as to measurability or collectability exists:
  - **Interest** : on a time proportion basis taking into account the amount outstanding and the rate applicable.
  - **Royalties** : on an accrual basis in accordance with the terms of the relevant agreement.
  - **Dividends** : when the owner's right to receive payment is established.
- [AS-9.8.1, 13]

Gross v. Net Presentation

- Revenue includes only gross inflows of economic benefits that are received or receivable by the entity on its own account.
- The use of the word 'gross' in the definition of revenue is not intended to include amounts collected on behalf of others.
- In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration
- [AS-9.4.1]

- **Shipping and handling changes under a CIF contract**
- No specific guidance has been provided by AS-9; however, amounts collected on behalf of 3rd parties are not Revenue
- Where the seller is able to determine the additional margin or the additional cost there is an indicator that the entity is not acting as an agent
- **Sales taxes** collected by the entity and remitted to a revenue authority will not be included as revenue.
- **Collection agency revenue** does not include the amounts actually collected on behalf of customers, but is restricted to the fee or commission relating to the collection

Disclosures

- The amount of revenue from sales transactions (turnover) should be disclosed in the following manner on the face of the statement of profit and loss:
  - Turnover (Gross) XX
  - Less: Excise Duty XX
  - Turnover (Net) XX
- The amount of excise duty to be deducted from the turnover should be the total excise duty for the year except the excise duty related to the difference between the closing stock and opening stock. The excise duty related to the difference between the closing stock and opening stock should be recognised separately in the statement of profit and loss, with an explanatory note in the notes to accounts to explain the nature of the two amounts of excise duty.
  [AS-9.10]
- Accounting Policies and disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.
  [AS-9.14]

Revenue from Construction Contracts

Types of construction contracts

A construction contract is a contract **specifically negotiated for the construction of an asset or a combination of assets** that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

Fixed price

Fixed contract price or fixed rate per unit

Cost plus

The contractor is reimbursed for allowable (or otherwise defined) costs plus a percentage or fixed fee

Hybrid

Contracts having characteristics of both fixed price and cost plus

- No minimum duration has been prescribed for the construction period
- No reference to 'long-term contracts'

Contract revenue

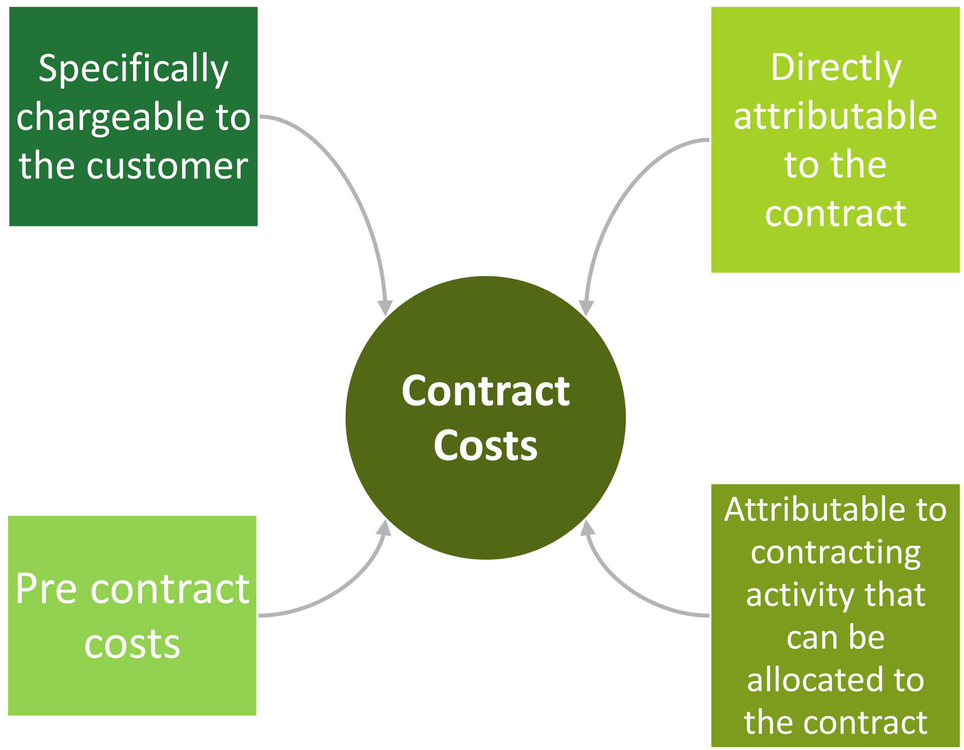
Revenue for a period is determined by **applying the estimated percentage of** completion at the end of the reporting period to the **total contract revenue**

If the outcome cannot be reliably estimated, revenue recognition is **restricted to the contract costs** incurred which are **likely to be recovered**

- It must be probable that the associated future economic benefits will flow to the entity; and
- The amount should be capable of being estimated reliably

Contract costs

Costs are generally charged to a contract only from the date of securing the contract. However, **direct costs** associated with securing a contract should be included in the cost of a contract if they can be **separately identified** and **measured reliably** and **it is probable that the contract will be obtained**



When it is probable that **contract costs will exceed contract revenue, the expected loss should be recognised immediately** as an expense.

Application of percentage of completion method

				Rs. crore
Contract	1	2	3	Total
Total revenue	300	500	200	1,000
Total costs	(200)	(350)	(300)	(850)
Expected profit / (loss)	**100**	**150**	**(100)**	**150**
Costs incurred upto 31 Mar 20X5	(100)	(245)	(180)	(525)
Stage of completion	50%	70%	60%	62%
If contracts are separated				
Revenue recognised upto 31 Mar 20X5	150	350	120	620
Profit / (loss) upto 31 Mar 20X5	50	105	(100)	**55**
If contracts were combined				
Revenue recognised upto 31 Mar 20X5				620
Profit / (loss) upto 31 Mar 20X5				**95**

Segregating contracts

Segregate contracts

Separate proposals have been submitted for each asset

Each asset has been subject to a separate negotiation and the customer and the contractor have been able to accept or reject that part of the contract relating to each asset

The costs and revenues from each asset can be identified separately

Combining contracts

Combine contracts

The group of contracts has been negotiated as a single package

The contracts are performed concurrently or in a continuous sequence

The contracts are so closely interrelated that they are, in effect, part of a single overall profit margin

Additional asset

- A contract with an option to construct an additional asset or an amendment to a contract to construct an additional asset is treated as a **separate contract** when
  - The **asset differs significantly** in design, technology or function from the asset or assets covered by the original contract;
    - or
  - The **price** of the asset **is negotiated without regard to the original contract price**

Contract revenue denominated in foreign currency

- When a construction contract is entered into that is denominated in a currency different from the presentation currency of the reporting entity, revenue recognised incrementally over the course of the contract will be the **incremental foreign currency revenue translated at the spot rate**.
- This treatment reflects the general requirement of AS 11 that foreign currency transactions should be recognised by applying to the foreign currency amount the spot exchange rate at the date of the transaction.
- In practice, if incremental revenue accrues fairly steadily over a period, it may be acceptable to translate it at an average rate for that period unless exchange rates for the period fluctuate significantly.

Disclosures on revenue from construction contracts

- An enterprise should disclose:
  - the amount of contract revenue recognised as revenue in the period;
  - the methods used to determine the contract revenue recognised in the period; and
  - the methods used to determine the stage of completion of contracts in progress.

Thank you