

REVENUE RECOGNITION

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Objective of the article

The article makes an effort at understanding the basic concepts IAS 18 which gives guidance in determining the revenue / expense of the entity for a particular period. One of the aims of the article is to get familiarized with terms and language used by IASB, which would help in IFRS implementation and debate.

What is "Income" ?

Income 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.

Note that IAS refers to "inflow of economic benefits" which is wider than "cash, receivables or other consideration" used by AS 9.

The primary issue in accounting for revenue is determining when to recognise revenue.

Amounts collected on behalf of third parties such as sales taxes, goods and services taxes / value added taxes and amounts collected on behalf of principal are not economic benefits which flow to the entity and do not result in increases in equity.

When is IAS 18 applied?

Applied for revenue arising from following transactions and events:

- Sale of goods;
- Rendering of services (performance by the entity of a contractually agreed task over an agreed period of time); and
- Use by others of entity assets yielding interest, royalties and dividends.

How to measure revenue?

Revenue shall be measured at the fair value of the consideration received or receivable.

Note that IAS refers to "fair value" which is a wider concept and primary concept referred to in every IFRS.

What is "Fair value" ?

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

What if cash flow from revenue is deferred?

If the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable. For example, an entity may provide interest free credit to the buyer or accept a note receivable bearing a below-market interest rate from the buyer as consideration for the sale of goods. When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest.

What if transaction is barter?

Only when goods are sold or services are rendered in exchange for **dissimilar** goods or services, the exchange is regarded as a transaction which generates revenue.

What if revenue is having more than one component?

Recognition criteria are applied to the separately identifiable

components of a single transaction in order to reflect the substance of the transaction. Example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period during which the service is performed. Conversely, the recognition criteria are applied to two or more transactions together. For example, an entity may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction; in such a case, the two transactions are dealt with together.

When is revenue from the sale of goods recognized?

All below conditions have been satisfied:

- Entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
- Entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
- Amount of revenue can be measured reliably;
- It is probable that the economic benefits associated with the transaction will flow to the entity; and
- Costs incurred or to be incurred in respect of the transaction can be measured reliably.

Note that definition is more specific and wider than that given in AS 9.

When does entity retain significant risks and rewards of ownership?

- Entity retains an obligation for unsatisfactory performance not covered by normal warranty provisions;
- Receipt of the revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of the goods;
- Goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the entity; and
- Buyer has the right to rescind the purchase for a reason specified in the sales contract and the entity is uncertain about the probability of return.

When is revenue from rendering of services recognized?

- Amount of revenue can be measured reliably;
- It is probable that the economic benefits associated with the transaction will flow to the entity;
- Stage of completion of the transaction at the end of the reporting period can be measured reliably; and
- Costs incurred for the transaction and the costs to complete the transaction can be measured reliably.
- Revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the end of the reporting period.

How is stage of completion determined?

An entity uses the method that measures reliably the services performed. Depending on the nature of the transaction, the methods may include:

- Surveys of work performed;

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- Services performed to date as a percentage of total services to be performed; or
- Proportion that costs incurred to date bear to the estimated total costs of the transaction.
- If services are performed by an indeterminate number of acts over a specified period of time, revenue is recognised on a straight-line basis over the specified period unless there is evidence that some other method better represents the stage of completion.

What if uncertainty arises on collectibles?

If an amount is already included in revenue, the uncollectible amount, or the amount in respect of which recovery has ceased to be probable, is recognised as an expense.

When can reliable estimates be made?

If the parties to the transaction agree to:

- Each party's enforceable rights regarding the service to be provided and received by the parties;
- Consideration to be exchanged; and
- Manner and terms of settlement.

What is revenue is from interest, royalties and dividends?

Revenue arising from the use by others of entity assets yielding interest, royalties and dividends shall be recognised when:

- It is probable that the economic benefits associated with the transaction will flow to the entity; and
- Amount of the revenue can be measured reliably.

Basis for recognition of revenue is:

- Interest shall be recognised using the effective interest method;
- Royalties shall be recognised on an accrual basis in accordance with the substance of the relevant agreement; and
- Dividends shall be recognised when the shareholder's right to receive payment is established.
- In an interest-bearing investment only the post- acquisition portion is recognised as revenue.

What have to be disclosed?

An entity shall disclose:

- Accounting policies adopted for the recognition of revenue, including the methods adopted to determine the stage of completion of transactions involving the rendering of services;
- Amount of each significant category of revenue recognised during the period, including revenue arising from:
 - Sale of goods;
 - Rendering of services;
 - Interest;
 - Royalties;
 - Dividends; and
- Revenue arising from exchanges of goods or services included in each significant category of revenue. ■