

Subject: Accounting for maintenance spares supplied free of cost along with the main equipment.¹

A. Facts of the Case

1. A company is a leading engineering product company in public sector under the Ministry of Defence, catering to the vital sectors of the economy, such as, infrastructure, surface transportation, mining and defence. As per the querist, with a turnover of Rs. 2601.79 crore for the financial year 2006-07, the company is market leader in earthmoving and mining equipments and consistently making profits right from its inception. For the financial year 2006-07, the company earned a profit before tax of Rs. 316.04 crore registering a growth of 10.73% over previous year. The company is a fast growing engineering product company with export presence in as many as 42 countries spanning over Asia, Africa, and South American countries. For the financial year 2006-07, the export turnover was Rs. 110.73 crore and, according to the querist, it is expected to increase manifold in the future.

2. The company has three manufacturing units located at Kolar Gold Fields (KGF), Bangalore and Mysore. It has marketing and service centres spread all over India. The KGF unit manufactures dozers, excavators, loaders, walking draglines, rope shovels and sophisticated aggregates catering to the needs of mining and defence sectors. The Bangalore unit manufactures rail coaches, EMU's wagons, overhead inspection vehicles for Indian Railways and also logistics vehicles (tatra variants), mechanised pontoon bridges, ground support system for the integrated guided missiles for use by the Ministry of Defence. In addition, Bangalore unit is manufacturing for the first time in India, metro rail coaches under license from a company of Korea. The Mysore unit manufactures highly sophisticated dumpers, graders, aircraft towing tractors, the weapon loading systems and high powered internal combustion engines. All these products are highly technology intensive and call for an array of manufacturing technologies.

3. The querist has stated that one of the usual terms of sale is that the price of the equipment includes certain specified quantity of maintenance spares supplied free of cost. In other words, the company agrees to supply certain spares free of cost, i.e., without charging anything in excess of the agreed price of the equipment, purely as a marketing strategy.

4. The querist has illustrated the accounting treatment being followed by the company with the help of the accounting entries as follows:

- (i) Debit: Sundry Debtors/Customers
Credit: Sales Account-Equipment (value of equipment + value of spares to be supplied free of cost)
Credit: Sales Tax.
- (ii) The value of spares supplied/to be supplied free of cost as per the terms of the customer order is intimated through the issuance of a credit note, a copy of which is marked to the concerned sales office located at various states. The accounting entry passed is as follows:

¹ Opinion finalised by the Committee on 30.4.2008

- (a) Debit: Sales Account (Equipment) – To the extent of the value of free spares.
Debit: Depot Sales Tax Account – Pro-rata
Credit: Deposit – Customer Account
- (b) Thus, the equipment sold is recorded at a net value, i.e., value as per customer order as reduced by the value of free spares.
- (iii) The free spares may be supplied either from the production units located at Karnataka or from the concerned sales office(s) located at various places in India. To the extent the free spares are supplied from Karnataka, i.e., in case of inter-state sale, the accounting entry passed is as follows:

Debit: Deposit - Customer Account
Credit: Sales Account - Spare Parts
Credit: Sales Tax

To the extent free spares are supplied from the sales offices, i.e., intra state sales, the accounting entry passed is as follows:

Debit: Deposit - Customer Account
Credit: Sales Account - Spare Parts
Credit: Sales Tax at the appropriate rate as per the statute of the concerned State.

Thus, in the view of the querist, with the passing of the above accounting entries, the total sale value as per the customer order is restored.

5. According to the querist, this is done purely to reflect correctly the value of spare parts sold to customers (either at a price or free of charge or as a part of equipment), as the company has a strategic business unit for spare parts. Also, in the view of the querist, by doing this, the company is not violating Accounting Standard (AS) 9, 'Revenue Recognition', in any manner whatsoever. As per the querist, this method enables the company to fix the price of the equipment as per the market dynamics.

6. The querist has further stated that the statutory auditors of the company are of the opinion that raising invoice separately for spare parts supplied free of cost and accounting thereof by reducing the value of the equipment (to the extent of the value of spares supplied free of cost) is not in order.

B. Query

7. The querist has sought the opinion of the Expert Advisory Committee as to whether the accounting for sale of equipment duly reducing the value of free supply of spares and accounting as sale the value of spares at the time of supply is in line with Accounting Standard (AS) 9, 'Revenue Recognition'.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to whether or not the accounting of maintenance spares supplied free of cost by reducing the value of equipment (to the extent of the value of the spares) and recording the sale of spares at the time of supply thereof is in order. The Committee has, therefore, restricted its opinion to this issue and has not touched upon any other issue arising from the Facts of the Case, such as, the accounting and valuation of inventories of maintenance spares, accounting for sales tax, basis of measurement of the amount at which revenue from sale of spares should be booked, etc. Further, the opinion expressed by the Committee is purely from accounting point of view and the Committee has not gone into legal interpretation of various enactments, such as those relating to sales tax, etc.

9. The Committee notes on the perusal of the query that the entries passed by the company are not clear in respect of the values at which the entries are passed. Accordingly, the understanding of the Committee in this regard has been illustrated with the help of the following entries:

- (a) Assuming the value of sales order of equipment is Rs. 100, inclusive of the value of spares to be supplied along with the equipment Rs. 10; ignoring the effect of sales tax, the entry passed by the company is:

Sundry Debtors A/c	Dr.	100	
To Sales A/c (Equipment)			100

- (b) For issuing credit note to the concerned sales office:

Sales A/c (Equipment)	Dr.	10	
To Deposit – Customer A/c			10

(With passing of this entry, the equipment sold is recorded at the net value, i.e., value as per customer order as reduced by the value of free spares)

- (c) At the time of supply of free spares from the concerned sales office:

Deposit – Customer A/c	Dr.	10	
To Sales A/c (Spare parts)			10

(With the passing of this entry, the total sales value as per the customer order is restored)

10. The Committee notes from the Facts of the Case that though the company, in the instant case, is supplying spares free of cost, since the spares have a value which otherwise would have been recovered had these spares not been supplied under the agreement of selling of main equipment, in substance, in the view of the Committee, the company is selling two products under one composite selling arrangement. The Committee is, therefore, of the view that principles of revenue recognition, as enunciated in AS 9, should be applied separately to each element of the composite arrangement with a view to recognise revenue. In this context, the Committee notes paragraphs 6.1, 10 and 11 of AS 9, which provide as follows:

“6.1 A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer.

However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer. Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass at a time different from the time when ownership passes.”

“10. Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 11 and 12 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

11. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

- (i) 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***
- (ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.”***

11. The Committee further notes from paragraph 4(iii) above that free spares may be supplied either from the production units located at Karnataka or from the concerned sales offices located at various places. Thus, there can be a time lag between the recognition of revenue on account of sale of equipment and that for spares in case significant risks and rewards in respect thereof are transferred to the buyer on different dates, e.g., significant risks and rewards in respect of spares are transferred at the time of delivery thereof to the buyer whereas those of equipment are transferred at the time of the delivery of equipment which might have taken place at an earlier date. In such a situation, passing of a separate entry for spares would be justified.

12. The Committee notes from the above-reproduced paragraphs of AS 9 that the Standard requires recognition of revenue when the significant risks and rewards of ownership in respect of the goods have been transferred to the buyer. Thus, the Committee is of the view that in case the significant risks and rewards in respect of spares are transferred at a time different from the time of transfer of the risks and rewards of the concerned equipment, the revenue in respect of that equipment should not be recognised at a gross amount, inclusive of value of spares. The revenue in respect of spares should be separately recognised at the time of transfer of significant risks and rewards of ownership of the spares. Therefore, it is not appropriate to first pass the entry for sale of equipment at the gross amount and then to pass a reversal entry for recognising revenue from spares.

D. Opinion

13. On the basis of the above, the Committee is of the opinion that the accounting for sale of equipment duly reducing the value of free supply of spares would be in line with AS 9 provided

significant risks and rewards of ownership in respect of free spares are transferred at the time of the delivery of spares to the buyer. However, separate entries should be passed for (a) booking recognition of revenue from sale of equipment net of the amount related to revenue from spares when the risks and rewards of ownership of the equipment are transferred and (b) booking recognition of revenue from spares when the risks and rewards of ownership of spares are transferred.
