Revenue recognition (AS 7&9 + IAS 11&18)

Introduction:

Financial statements are the windows through which outsiders see what is happening inside the company. All the Accounting Standards do impact the bottom line by increasing the costs or impacting the revenue.

Any business looks on maximizing profit through maximizing revenue or reducing costs. Increasing the revenues is the only organic mode of growth, for any enterprise in long run.

Hence, the Revenue Recognition standards become pivotal as they lay down the principles for measuring and recognizing revenue.

In Indian GAAP, the two key standards for revenue recognition are:

1. AS – 7(IAS 11)
2. AS – 9(IAS 18)

AS-7 Construction Contracts:

Being a contract of long term nature, Revenue is recognized even before completion of sale. It is an exception to the rule that revenue is recognized when sale is complete.

History of the Standard: It was originally issued in December 1983 and subsequently revised in 2002.

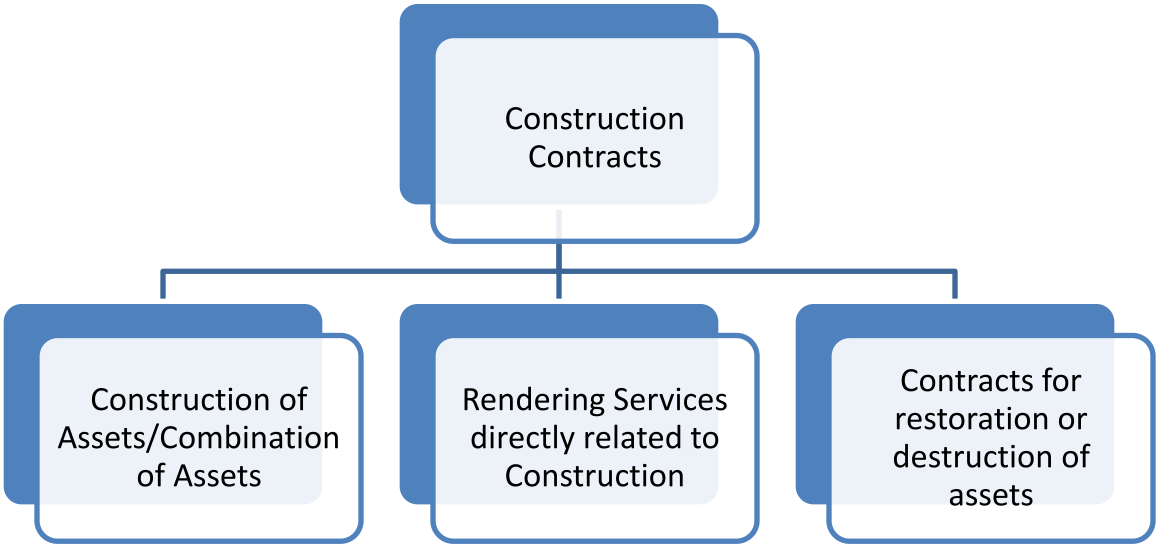
Applicability: The Standard is applicable for Accounting for Construction Contracts in statements of contractors.

This does not apply to commercial projects undertaken by the enterprise as a commercial venture in nature of production activities.

Definition of Construction Contract:

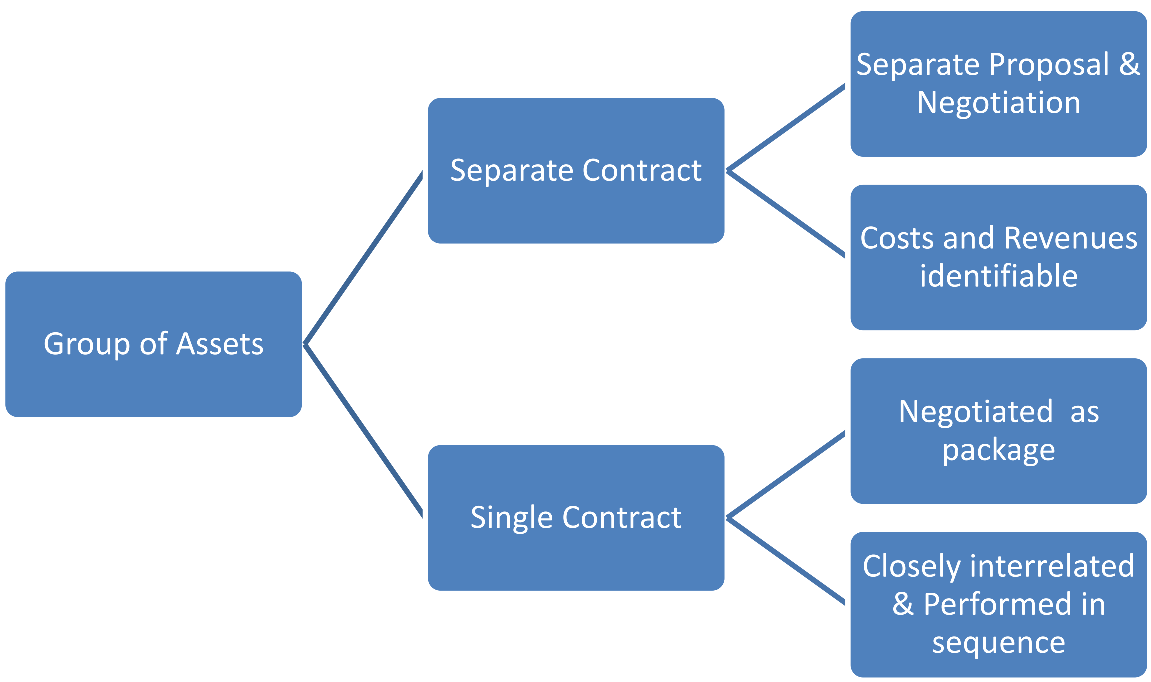
Contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

Inclusions in a Construction Contract:



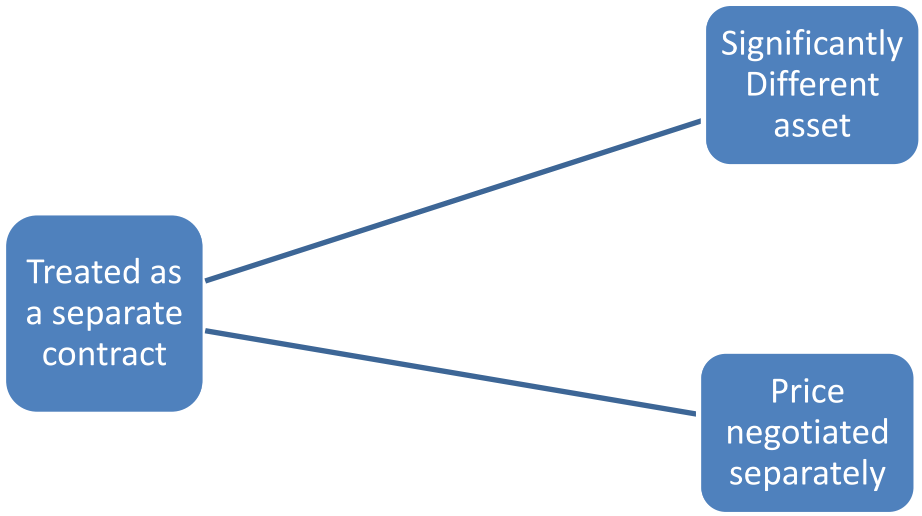
Construction of Group of Assets: Revenue Recognition

Generally, each construction contract should be viewed separately. The Standard in some special cases permits the combining and segmenting of assets:

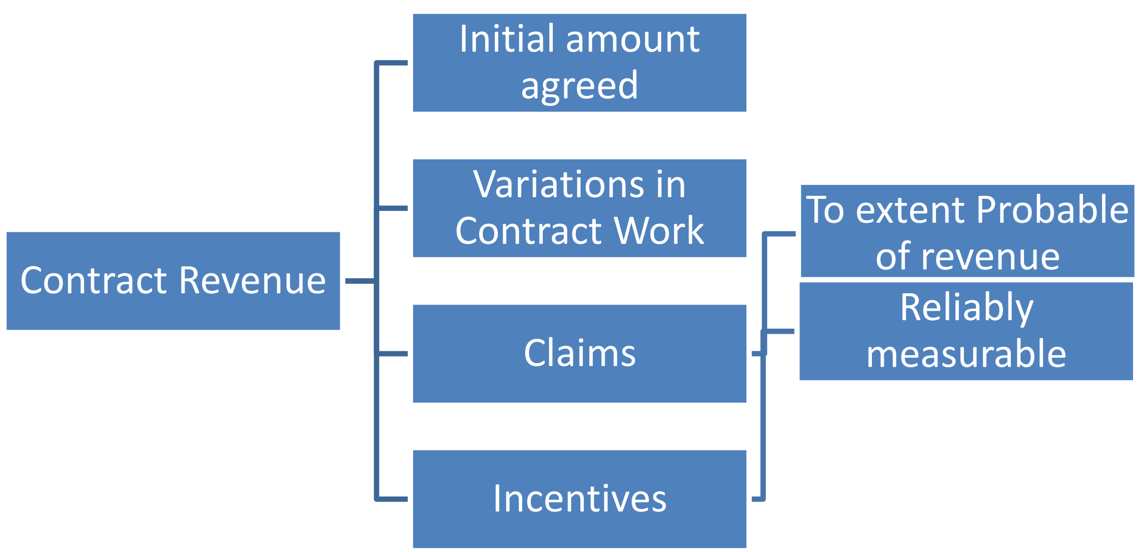


Construction of an additional asset:

Sometimes the contractor could be given the option to construct an additional asset, it could be treated as follows:



Components of Contract Revenue:



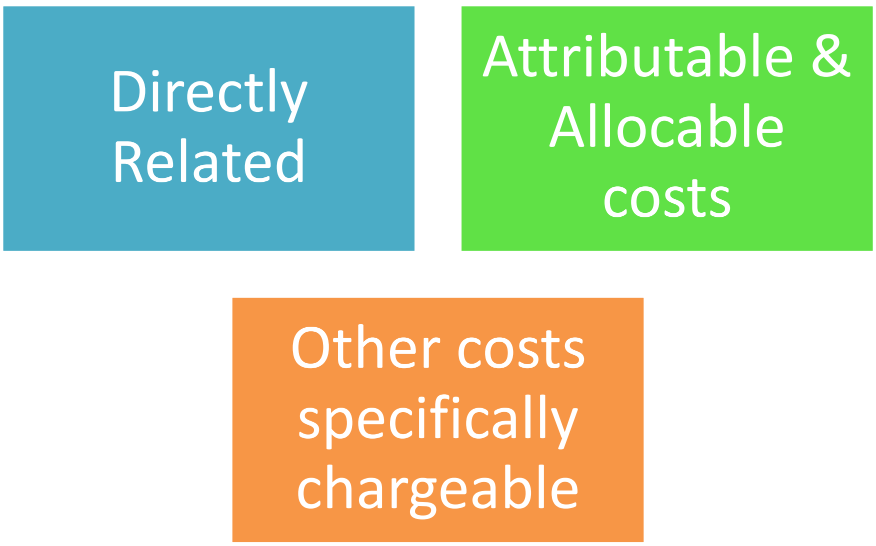
A variation is a change in scope of work on request of customer. A variation can cause increase or decrease in revenue. It arises from customer.

A claim is an amount that the contractor looks to collect from customer as it is not included in contract price.

Incentive payments are additional amounts payable to the contractor if specified performance standards are met or exceeded

Components of Contract Cost:

Costs of contract can contain the following:



Special Issues to Consider:

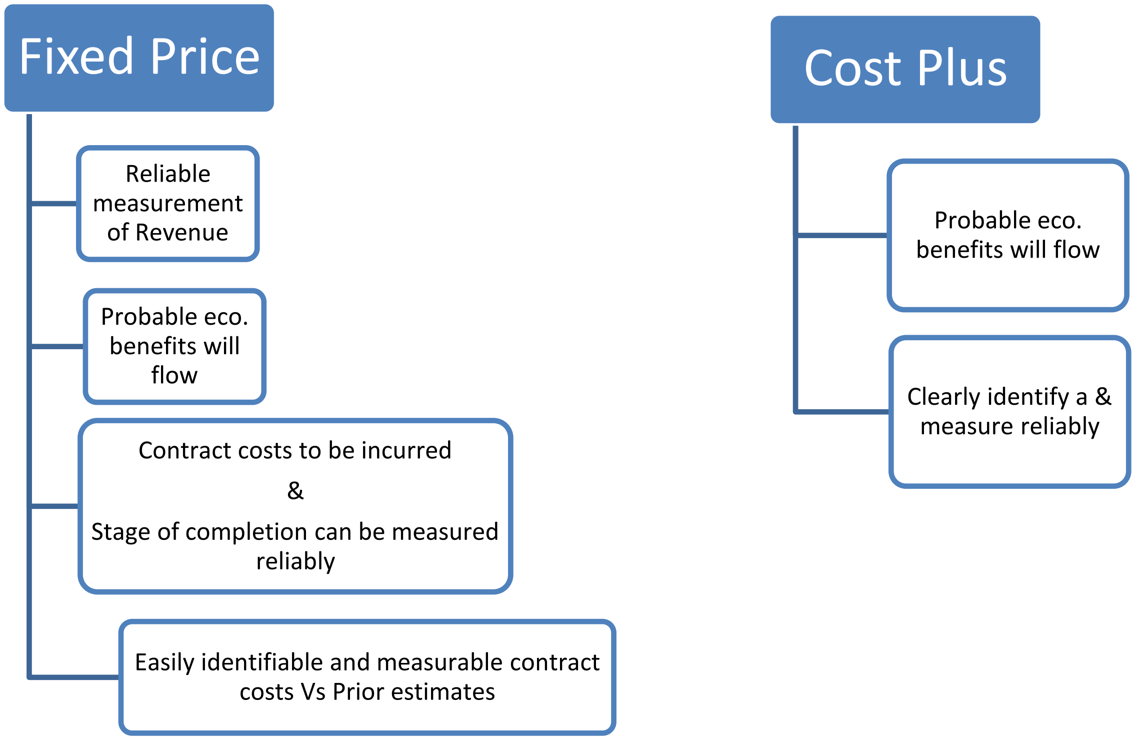
1. The allocation of costs is based on Normal level of activity.
2. Costs also include borrowing costs as per AS 16.
3. Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs could include:
   - general administration costs for which reimbursement is not specified in the contract;
   - selling costs
4. Contract costs include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract.

   However, costs that relate directly to a contract and which are incurred in securing the contract are also included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained.

Recognition of Contract Costs & Revenue:

Contract revenue and contract costs associated with the construction contract should be recognized as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date when outcome can be estimated reliably

When can outcome of a contract be estimated reliably?



The stage of completion of contract can be determined in various ways. The most reliable method should be employed by the organization. Some methods are:

a) Percentage of Contract costs up to reporting date to total contract costs
b) surveys of work performed;
c) Completion of a physical proportion of the contract work.

Under the percentage of completion method,

Contract Revenue and Contract costs are recognized in period in which work is performed

Contract Costs: Recognized as expense in period in which work is performed, Contract costs are recognized when the work to which they relate is performed.

When outcome of a customer contract cannot be estimated:

a. revenue should be recognized only to the extent of contract costs incurred of which recovery is probable; and
b. Contract costs should be recognized as an expense in the period in which they are incurred.

Subsequent uncertainty after recognition

When a subsequent uncertainty arises to an amount already recognized, the uncollectible amount should be recognized as an expense, rather than adjusting to the contract revenue.

Recognition of Losses Immediately:

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

Suppose X Ltd an construction company estimated total costs at 105 Crores for a 5 year project. The agreed contract revenue is 120 Crores. Say, X Ltd faces a technical miscalculation which pushes up the costs by 30 Crores. The company should immediately provide for loss of 15 crores immediately in first year.

Disclosures

Sample Disclosure from HCC Limited:

42. Disclosure in accordance with Accounting Standard - 7 (Revised) -

Amount due from / to customers on Construction Contracts.

	2013-14 (Rs Crore)	2012-13 (Rs Crore)
Contract Revenue for the period	3,889.75	3,649.41
Contract Costs incurred till date	22,741.92	19,551.95
Recognized Profits / Losses till date	3,056.59	2,356.80
Advances received from Customer	900.64	1,104.05
Retention Money	343.17	308.21
Gross amount due from Customer for Contract Work	3,297.94	3,641.06
Gross amount due to Customer for Contract Work	-	-

Note: - The above information is given only in respect of contracts entered into on or after 01.04.03.

Comparison with IFRS

The corresponding standard is IAS – 11 Construction Contracts. IFRIC 15 prescribes the accounting for real estate transactions. In India, Guidance note on Real Estate Contracts provides guidance for real estate accounting.

The differences are almost marginal. However US GAAP still allows completed contract method under certain circumstances.

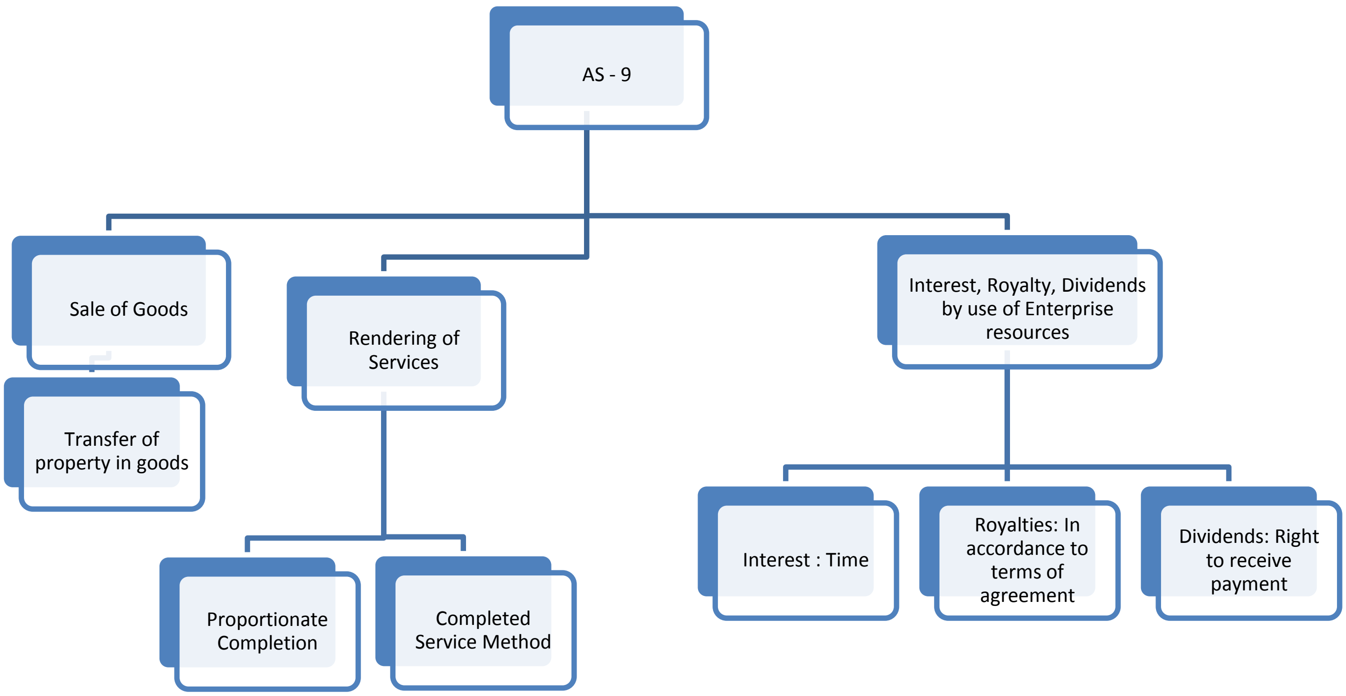
AS 9 Revenue Recognition

Accounting Standard 9 lays down the principles for recognition of revenue in different circumstances and different circumstances in which revenue can be postponed.

History of Standard: The Standard was issued in 1985.

Non-Applicability of the Standard:

- Construction Contracts
- Hire purchase or Lease agreements
- Government grants
- Income from insurance contracts for insurance companies

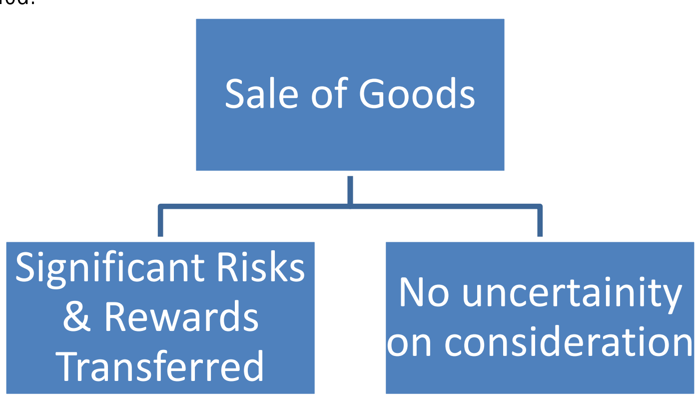


When interest, royalties and dividends from foreign countries require exchange permission and uncertainty in remittance is anticipated, revenue recognition may need to be postponed.

Main Principles of Revenue Recognition:

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:



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.

Special Cases: Revenue Recognition

"Bill and Hold" Delivery is delayed at buyer's request and buyer takes title and accepts billing

Revenue should be recognized notwithstanding that physical delivery has not been completed so long as there is every expectation that delivery will be made. A mere intention to acquire or manufacture is not necessary, the item must be identified and ready for delivery.

Delivered Subject to Condition of Installation and Inspection:

Revenue should normally not be recognized until the customer accepts delivery and installation and inspection are complete. If the installation process is very simple, revenue can be recognized at sale.

Delivered Subject to approval:

Revenue should not be recognized until the buyer:

- formally accepts the goods
- Preforms an act adopting the transaction
- the time period for rejection or a reasonable time has elapsed

Sale of Goods as Guaranteed sales

Recognition of revenue in such circumstances will depend on the substance of the agreement. For retail sales offering money back, it may be appropriate to recognize the revenue but a suitable provision should be made.

Consignment sales

Revenue should not be recognized until the goods are sold to a third party.

Cash on delivery sales

Revenue should not be recognized until cash is received by the seller or his agent.

Installment Sales

Revenue is to be recognized to the extent of sales price exclusive of interest. Interest should be proportional to extent of unpaid balance.

"Lay Away "Sales where the purchaser makes a series of installment payments to the seller, and the seller delivers the goods only when the final payment is received:

Revenue should be recognized when goods are delivered on payment of last installment. But, when most of sales consummate, Revenue can be recognized on receipt of significant deposit.

Sale and Repurchase Agreement:

In substance it forms a financing agreement; the resulting cash inflow is not revenue as defined and should not be recognized as revenue.

Subscriptions for publications

Revenue received or billed should be deferred and recognized either on a straight line basis over time or, where the items delivered vary in value from period to period, revenue should be based on the sales value of the item delivered in relation to the total sales value of all items covered by the subscription.

Rendering of Services:

In a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished. Such performance should be regarded as being achieved when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service.

Special Scenarios: Rendering of Services

Installation services:

In cases where installation fees are other than incidental to the sale of a product, they should be recognized as revenue only when the equipment is installed and accepted by the customer.

Advertising Commissions:

For advertising agencies, media commissions will normally be recognized when the related advertisement or commercial appears before the public and the necessary intimation is received by the agency. Production commission will be recognized when the project is completed.

Insurance Commissions:

Insurance agency commissions should be recognized on the effective commencement or renewal dates of the related policies.

Admission fees

Revenue from artistic performances, banquets and other special events should be recognized when the event takes place. When a subscription to a number of events is sold, the fee should be allocated to each event on a systematic and rational basis.

Tuition fees

Revenue should be recognized over the period of instruction.

Entrance and membership fees

Entrance fee received is generally capitalized. If membership fees entitles services during the year, recognize systematic and rational basis. Else, recognize when received

Financial fees services:

The recognition of financial services depends on purposes for which fees are assessed and basis of accounting. Part B of IAS 18 classifies financial services:

- <u>Integral part of effective interest rate</u>: Such fees are treated as adjustment to interest rates
- <u>Fees for services provided:</u> Like for servicing a loan, investment management services should be recognized over the period

- **Fees for execution of a particular act:** On allotment of shares to a client, loan syndication fees : when the act has been finished

Fees from development of customized software:

Revenue could be recognized by stage of development, including completion of services for post-delivery report as mentioned in Part B of IAS 18.

Revenue arising due to use of enterprise resources:

i.	Interest :	On a time proportion basis taking into account the amount outstanding and the rate applicable.
ii.	Royalties	On an accrual basis in accordance with the terms of the relevant agreement
iii.	Dividends from investments in shares	When the owner's right to receive payment is established

Disclosure:

The circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

Differences between IFRS and US GAAP:

The corresponding standard is IAS 18. In IAS 18 for rendering of services, only percentage completion method can be followed. AS-9 also permits completed services method.

IAS 18 mentions that Revenue should be recognized at Fair value of consideration received or receivable. (AS-9 is silent about swap contracts)