IAS 18 - Revenue
IFRIC 12,13,15,18 & SIC 27,29,31

CA Rajkumar S Adukia
B.Com (Hons), FCA, ACS, ACWA, LLB, DIPR, DLL &LP, IFRS(UK), MBA
email id: rajkumarradukia@caaa.in
Mob: 09820061049/09323061049

To receive regular updates kindly send test email to : rajkumarfca-subscribe@yahoogroups.com & rajkumarfca+subscribe@googlegroups.com

Objective

- To prescribe the accounting treatment for revenue arising from certain types of transactions and events.

Scope

- Accounting for revenue arising from
  - sale of goods
  - services
  - Interest, royalties, dividends

Scope Exclusions

- **Lease income**
- **Dividends** from equity method investments
- **Insurance contracts**
- **Changes in fair value** of financial assets and liabilities or their disposal
- Initial recognition and changes in fair value on **biological assets**
- The extraction of **mineral ores**
- Initial recognition of **agricultural produce**
- Changes in the value of other **current assets**

What is Revenue?

- 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.

Key Issues in Revenue Recognition

- Identification of Transaction
- Timing of Recognition
- Measurement of Revenue
- Multiple Elements
- Measurement of Revenue

Identification of Transaction

- The recognition criteria in this Standard are usually applied ***separately to each transaction***.
- However, in certain circumstances, it is necessary to apply the recognition criteria
  - ***to the separately identifiable components of a single transaction*** in order to reflect the substance of the transaction.
  - to ***two or more transactions together*** when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole.

Timing of Recognition of Revenue

(A) **Sale of Goods**

Revenue to be recognised when ***all the following conditions*** have been satisfied:

(a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;

(b) the entity ***retains neither continuing managerial involvement*** to the degree usually associated with ownership nor effective control over the goods sold;

(c) the amount of revenue can be ***measured reliably***;

(d) it is probable that the economic benefits associated with the transaction will flow to the entity; and

(e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.

Sale of Goods

(a) Risk - Reward Transfer

a) It coincides with the transfer of the legal title or the passing of possession to the buyer.

b) In other cases, it occurs at a different time from the transfer of legal title or the passing of possession

c) If the entity retains significant risks of ownership, the transaction is NOT a sale and revenue is not recognised

d) If an entity retains only an insignificant risk of ownership, the transaction is a sale and revenue is recognised

Examples: Retention of Risk/Reward

1. The entity retains an obligation for unsatisfactory performance not covered by normal warranty provisions;
2. The receipt of the revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of the goods;
3. The 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
4. The 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.

In all above cases transaction is not a sale and hence revenue not recognised

However, a seller may retain the legal title to the goods solely to protect the collectability of the amount due. In such a case, if the entity has transferred the significant risks and rewards of ownership, the transaction is a sale and revenue is recognised.

Case Study

John Ltd. manufactures and sells complex bottling machines. Installation is a standard process, consisting of principally of uncrating, calibrating and testing the equipment. The process is not complex but other vendors do not provide the service. Installation is included in overall sale price and entity does not sell the equipment for less if the customer installs it themselves. The sale of each bottling machine is conditional on the equipment working as designed when the installation is complete.

When to recognise revenue by John Ltd.

Ans.:

Sale of equipment is conditional upon successful installation

A ltd to recognise revenue only after successful installation

Sale of Goods

(b) Continuing Managerial Involvement

- Indicators of Continuing Managerial Involvement:
  - Control over future price of the item.
  - Responsible for the management of the goods subsequent to the sale.
  - Transaction allows the buyer to compel the seller, or give an option to the seller, to repurchase the item.
  - Guarantees the return of the buyer's investment or a return on that investment for a limited or extended period

In all above cases, there is no sale and hence no revenue is recognised

Sale of Goods

(c) Reliability of Revenue Measurement

- An entity can make reliable estimates after it has agreed with the other parties to the transaction on the following:
  - each party's enforceable rights regarding the service to be provided and received by the parties;
  - the consideration to be exchanged; and
  - the manner and terms of settlement.
  - The entity reviews and, when necessary, revises the estimates of revenue as the service is performed. The need for such revisions does not necessarily indicate that the outcome of the transaction cannot be estimated reliably

Sale of Goods

(d) Probable Inflow of Benefits

- Recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity.
- ***This may not be probable until the consideration is received or an uncertainty is removed.***
- *For e.g. it may be uncertain that a foreign governmental authority will grant permission to remit the consideration from a sale in a foreign country. When the permission is granted, the uncertainty is removed and revenue is recognised.*
- When an uncertainty arises -the uncollectible amount included in revenue
  - recognised as an expense,
  - not an adjustment of revenue already recognised.

Case Study: Cash Volume Discount

A paint manufacturers with 31 December year end offers several large customers stepped rebates on sales based on following volumes:

Upto 100,000 liters – no discounts

Between 100,000 liters and 250,000 liters – 5 % discount on all sales

Over 250,000 liters – 10% discount on all sales

All rebates are paid to the customers after the end of the customer's contract year.

At 31 December 2006, a particular customer has purchased 140,000 liters of paint. That customer has a history of purchasing over 250,000 liters of paint each year, spread evenly during the year. The customer's contract year runs from July to June.

Determine revenue recognition.

Ans.: As per existing volume, the customer is eligible for 5% discount but as per history, the customer will be eligible for 10% rebate. Hence, revenue to be recognised based on 10% discount.

Sale of Goods

(e) Outcome of a Transaction Estimated Reliably

- Outcome be estimated reliably if:
  - revenue measured reliably;
  - probable that economic benefits flow to the entity;
  - the stage of completion measured reliably;
  - the costs incurred for the transaction and the costs to complete the transaction can be measured reliably

RENDERING OF SERVICES

a) ***by reference to the stage of completion of the transaction at the statement of financial position date*** (the percentage-of-completion method): [IAS 18.20]

- the amount of revenue can be measured reliably;
- it is probable that the economic benefits will flow to the seller;
- the stage of completion at the statement of financial position date can be measured reliably; and
- the costs incurred, or to be incurred, in respect of the transaction can be measured reliably.

b) ***If above not met,*** revenue arising from the rendering of services should be **recognised only to the extent of the expenses recognised that are recoverable** (a "cost-recovery approach". [IAS 18.26]

Rendering of services: Chart

Outcome cannot be estimated reliably

↓

revenue recognised = recoverable expenses

During the early stages of a transaction, it is often the case that the outcome of the transaction cannot be estimated reliably.

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Is it probable that the entity will recover the transaction costs incurred?

YES

- Revenue is recognised only to the extent of costs incurred that are expected to be recoverable.
- No profit is recognised.

NO

- Revenue is not recognised
- The costs incurred are recognised as an expense.

↓

When the uncertainties that prevented reliable estimation no longer exist, revenue is recognised

Measurement of revenue

- Measured at

  Fair value of consideration received or receivable

- Where consideration is deferred
  - present value – calculated using imputed rate of interest

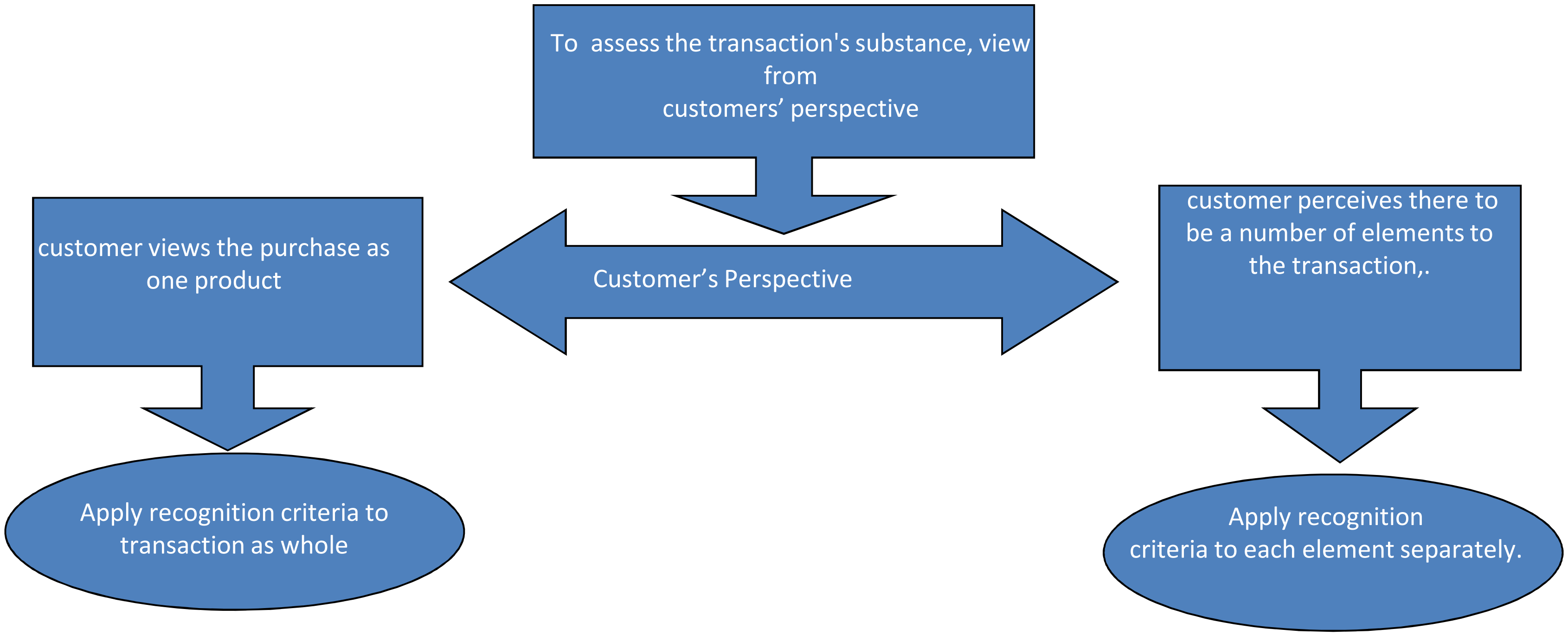
Multiple Element

In certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction to reflect substance.

Multiple Elements Transactions

1. Separation of Elements

- A transaction may contain separately identifiable components that should be accounted for separately.
- Apply the revenue recognition criteria to each separately identifiable component of a single transaction to reflect the transaction's substance.



Multiple Elements transactions

2. Allocation of Consideration

- Revenue in respect of each separable component of a transaction = its fair value.
- Fair value = price that is regularly charged for an item when sold separately

Case Study : Warranties

Electrical Appliances Ltd. is a retailer of domestic appliances and sells washing machines. Each of a particular model of washing machine is sold with an initial one year warranty and a 3 year extended warranty at no extra cost to the customer. Electrical Appliances Ltd. sells this washing machine for Rs.399 in its stores, while its competitor Red Elect Ltd. sells an identical washing machine with the 1-year initial warranty, but without an extended warranty for Rs. 379 and an unrelated insurer offers an equivalent extended warranty for Rs. 60.

Determine revenue recognition for Electrical Appliances Ltd.

Ans.: Fair value of washing machine – 344 (399* 379/379+ 60)

Fair value of extended warranty : 55 ; 399- 344 (399* 60/379 +60)

Exchanges of goods and services

- Dissimilar goods and services
  - fair value of goods and services received

- Similar good and services
  - no commercial substance

- Advertising barter transactions
  - fair value of services rendered by reference to non-barter transactions (SIC 31)

Interest, Royalties, and Dividends

- Interest:
  - on a time proportion basis that takes into account the effective yield;
- Royalties:
  - on an accruals basis in accordance with the substance of the relevant agreement; and
- Dividends:
  - when the shareholder's right to receive payment is established.

Disclosure [IAS 18.35]

- Accounting policy for recognising revenue
- Amount of each of the following types of revenue:
  - sale of goods
  - rendering of services
  - interest
  - royalties
  - dividends
  - within each of the above categories, the amount of revenue from exchanges of goods or services

IFRIC 12 – Service Concession Arrangements

- This Interpretation gives guidance on the accounting by operators for public-to-private service concession arrangements.
- Infrastructure for public services—such as roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunication networks—has traditionally been constructed, operated and maintained by private parties and transferred to public sector.
- This Interpretation applies to public-to-private service concession arrangements if:
  - (a) the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price; and

IFRIC 12 – Service Concession Arrangements

  - (b) the grantor controls—through ownership, beneficial entitlement or otherwise—any significant residual interest in the infrastructure at the end of the term of the arrangement. This
- Interpretation applies to both:
  - (a) infrastructure that the operator constructs or acquires from a third party for the purpose of the service arrangement; and
  - (b) existing infrastructure to which the grantor gives the operator access for the purpose of the service arrangement.
- The operator shall account for revenue and costs relating to construction or upgrade services in accordance with IAS 11.
- The operator shall account for revenue and costs relating to operation services in accordance with IAS 18.

SIC 29 – Service Concession Arrangement - Disclosure

- An operator and a grantor shall disclose the following in each period:

  (a) a description of the arrangement;

  (b) significant terms of the arrangement that may affect the amount, timing and certainty of future cash flows (eg the period of the concession, re-pricing dates and the basis upon which re-pricing or re-negotiation is determined);

  (c) the nature and extent (eg quantity, time period or amount as appropriate) of:

  (i) rights to use specified assets;

  (ii) obligations to provide or rights to expect provision of services;

  (iii) obligations to acquire or build items of property, plant and equipment;

  (iv) obligations to deliver or rights to receive specified assets at the end of the concession period;

  (v) renewal and termination options; and

  (vi) other rights and obligations (eg major overhauls);

  (d) changes in the arrangement occurring during the period; and

  (e) how the service arrangement has been classified.

SIC 29 – Service Concession Arrangement - Disclosure

- An operator shall disclose the amount of revenue and profits or losses recognized in the period on exchanging construction services for a financial asset or an intangible asset.
- The disclosures required under this Interpretation shall be provided individually for each service concession arrangement or in aggregate for each class of service concession arrangements. A class is a grouping of service concession arrangements involving services of a similar nature (eg toll collections, telecommunications and water treatment

IFRIC 13 Customer Loyalty Programmes

- An entity that grants loyalty award credits shall allocate some of the proceeds of the initial sale to the award credits as a liability (its obligation to provide the awards). In effect, the award is accounted for as a separate component of the sale transaction.
- It is necessary to apply the recognition criteria according to Para 13 of IAS 18 to the separately identifiable components of a single transaction in order to reflect the substance of the transaction(Para 5 of IFRIC 13)
- The amount of proceeds allocated to the award credits is measured by reference to their fair value, that is, the amount for which the award credits could have been sold separately.

IFRIC 13 Customer Loyalty Programmes

- The entity shall recognise the deferred portion of the proceeds as revenue only when it has fulfilled its obligations. It may fulfil its obligations either by supplying the awards itself or by engaging (and paying) a third party to do so.
- If at any time the expected costs of meeting the obligation exceed the consideration received, the entity has an onerous contract for which IAS 37 would require recognition of a liability.
- If IFRIC 13 causes an entity to change its accounting policy for customer loyalty awards, IAS 8 applies.

IFRIC 15 Agreements for the Construction of Real Estate

- An agreement for the construction of real estate is a construction contract ***within the scope of IAS 11 only when the buyer is able to specify the major structural elements of the design*** of the real estate before construction begins and/or specify major structural changes once construction is in progress (whether it exercises that ability or not).
- If the buyer has that ability, IAS 11 applies.
- If the buyer does not have that ability, IAS 18 applies.
- The interpretation is effective for annual periods beginning on or after **1 January 2009** and is to be applied retrospectively

IFRIC 15 Agreements for the Construction of Real Estate

- The Agreement is a Construction Contract – Accounting for revenue under **IAS 11 – Construction Contracts**
- The Agreement is an agreement for Rendering of Services –

  Accounting for revenue under **Para 20 of IAS 18**
- The Agreement is an agreement for the Sale of Goods –

  Accounting for revenue under **Para 14 of IAS 18**

IFRIC 18 – Transfer of Assets from Customers

- An entity receiving an item of property, plant and equipment as a transfer from a customer concludes that the transferred item should be recognised and measured in accordance with paragraphs 9–11 of IFRIC 18
- If the entity concludes that the definition of an asset is met, it shall recognise the items in accordance with Para 7 of IAS 16 and measure it at fair value (Para 24 of IAS 16)

IFRIC 18 – Transfer of Assets from Customers

- 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.' – Para 12 of IAS 18
- An entity may agree to deliver one or more services in exchange for the transferred item of property, plant and equipment, such as connecting the customer to a network, providing the customer with ongoing access to a supply of goods or services, or both

IFRIC 18 – Transfer of Assets from Customers

- Where only one service is identified recognise revenue when the service is performed in accordance with paragraph 20 of IAS 18.
- If more than one separately identifiable service is identified, paragraph 13 of IAS 18 requires the fair value of the total consideration received or receivable for the agreement to be allocated to each service and the recognition criteria of IAS 18 are then applied to each service.
- If an ongoing service is identified as part of the agreement, the period over which revenue shall be recognised for that service is generally determined by the terms of the agreement with the customer.

IFRIC 18 – Transfer of Assets from Customers

- When an entity receives a transfer of cash from a customer that should be used only to construct or acquire an item of property, plant and equipment, where the definition of asset is not met then it is recognized as revenue under Para 13 to 20 of IAS 18.

IFRIC 18 – Transfer of Assets from Customers

It applies to the accounting for transfers of items of property, plant and equipment by entities that receive such transfers from their customers

It addresses the following issues:

(a) Is the definition of an asset met?

(b) If the definition of an asset is met, how should the transferred item of property, plant and equipment be measured on initial recognition?

(c) If the item of property, plant and equipment is measured at fair value on initial recognition, how should the resulting credit be accounted for?

(d) How should the entity account for a transfer of cash from its customer?

SIC 27 - Evaluating the Substance of Transactions Involving the Legal Form of a Lease

- When an arrangement with an Investor involves the legal form of a lease, the issues are:
- (a) how to determine whether a series of transactions is linked and should be accounted for as one transaction;
- (b) whether the arrangement meets the definition of a lease under IAS 17;

SIC 27 - Evaluating the Substance of Transactions Involving the Legal Form of a Lease

- IAS 17 applies when the substance of an arrangement includes the conveyance of the right to use an asset for an agreed period of time.
- Considerations to say IAS 17 does not apply are as follows
  - An Entity retains all the risks and rewards incident to ownership of an underlying asset and enjoys substantially the same rights to its use as before the arrangement;
  - The primary reason for the arrangement is to achieve a particular tax result, and not to convey the right to use an asset; and

SIC 27 - Evaluating the Substance of Transactions Involving the Legal Form of a Lease

- An option is included on terms that make its exercise almost certain (eg a put option that is exercisable at a price sufficiently higher than the expected fair value when it becomes exercisable)

- The criteria in paragraph 20 of IAS 18 shall be applied to the facts and circumstances of each arrangement in determining when to recognise a fee as income that an Entity might receive.

SIC 31 Revenue – Barter Transactions Involving Advertising Services

A seller can reliably measure revenue at the fair value of the advertising services it provides in a barter transaction by reference only to non-barter transactions that:

- involve advertising similar to the advertising in the barter transaction;
- occur frequently;
- represent a predominant number of transactions and amount when compared to all transactions to provide advertising that is similar to the advertising in the barter transaction;

SIC 31 Revenue – Barter Transactions Involving Advertising Services

- involve cash and/or another form of consideration (such as marketable securities, non-monetary assets, and other services) that has a reliably measurable fair value; and
- do not involve the same counterparty as in the barter transaction.

This Interpretation only **applies to an exchange of dissimilar advertising services.** An exchange of similar advertising services is not a transaction that generates revenue under IAS 18

IFRS Exposure Draft – Revenue from Contracts with Customers

- The Exposure Draft aims at
  - Removing inconsistencies and weakness in existing revenue recognition standards
  - Provide more robust framework for addressing revenue recognition issues
  - Improve comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets
  - Simplify the preparation of financial statements by reducing the number of requirements to which the entities must refer

IFRS Exposure Draft – Revenue from Contracts with Customers

- This Standard applies to those contracts with customers to provide goods and services that are normally an output of the entity's activities and those which are not covered by other IFRS.
- The Amendments specified in this standard is said to supersede IAS 11 and IAS 18 and all related interpretations

IFRS Exposure Draft – Revenue from Contracts with Customers

- The main proposals of the draft includes
  - Specifying principles the entity would apply namely useful information about the amount, time, and uncertainties of revenue and cash flows
  - This is achieved by
    - Identifying the contract(s) with customers
    - Identifying the separate performance obligations in the contract
    - Determining the Transfer Price

IFRS Exposure Draft – Revenue from Contracts with Customers

- Determining the Transfer Price
- Allocating the transaction price to the Separate Performance Obligations
- Recognize revenue when a performance obligation is satisfied

Extract from ONGC Annual Report

12. Revenue Recognition

12.1 Revenue from sale of products is recognised on transfer of custody to customers. Any difference as of the reporting date between the entitlement quantity minus the quantities sold in respect of crude oil (including condensate), if positive is treated as inventory and, if negative, is adjusted to revenue by recording the same as liability.

12.2 Sale of crude oil and gas produced from exploratory wells in progress is deducted from expenditure on such wells.

12.3 Sales are inclusive of all statutory levies except Value Added Tax (VAT). Any retrospective revision in prices is accounted for in the year of such revision.

12.4 Revenue in respect of fixed price contracts is recognised for the quantum of work done on the basis of percentage of completion method. The quantum of work done is measured in proportion of cost incurred to date to the estimated total cost of the contract or based on reports of physical work done.

12.5 Finance income in respect of assets given on finance lease is recognised based on a pattern reflecting a constant periodic rate of return on the net investment outstanding in respect of the finance lease.

12.6 Revenue in respect of the following is recognised when there is reasonable certainty regarding ultimate collection:

a. Short lifted quantity of gas.

b. Gas pipeline transportation charges and statutory duties thereon.

c. Reimbursable subsidies and grants.

d. Interest on delayed realisation from customers.

e. Liquidated damages from contractors/suppliers.

About the Author

- *CA. Rajkumar S Adukia is an eminent business consultant, academician, writer, and speaker. He is the senior partner of Adukia & Associates.*
- *In addition to being a Chartered Accountant, Company Secretary, Cost Accountant, MBA, Dip IFR (UK), Mr. Adukia also holds a Degree in Law and Diploma in Labor Laws and IPR.*
- *Mr. Adukia, a rank holder from Bombay University completed the Chartered Accountancy examination with 1st Rank in Inter CA & 6th Rank in Final CA, and 3rd Rank in Final Cost Accountancy Course in 1983.*
- *He started his practice as a Chartered Accountant on 1st July 1983, in the three decades following which he left no stone unturned, be it academic expertise or professional development.*

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About the Author

- *He has been coordinating with various Professional Institutions, Associations, Universities, University Grants Commission and other Educational Institutions.*

- *Authored more than 50 books on a vast range of topics including Internal Audit, Bank Audit, SEZ, CARO, PMLA, Anti-dumping, Income Tax Search, Survey and Seizure, IFRS, LLP, Labour Laws, Real estate, ERM, Inbound and Outbound Investments, Green Audit etc.*

- *The author can be reached at* ***rajkumarradukia@caaa.in***
  Mob – 09820061049 / 09323061049

- *For more details log on to www.caaa.in*

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