Revenue Recognition

What Is Revenue Recognition?

Revenue recognition is a generally accepted accounting principle (GAAP) that identifies the specific conditions in which revenue is recognized and determines how to account for it. Typically, revenue is recognized when a critical event has occurred, and the dollar amount is easily measurable to the company.

Important Points:

- Revenue recognition is a generally accepted accounting principle (GAAP) that stipulates how and when revenue is to be recognized.
- The revenue recognition principle using accrual accounting requires that revenues are recognized when realized and earned–not when cash is received.
- The revenue recognition standard, ASC 606, provides a uniform framework for recognizing revenue from contracts with customers.

Understanding Revenue Recognition

Revenue is at the heart of all business performance. Everything hinges on the sale. As such, regulators know how tempting it is for companies to push the limits on what qualifies as revenue, especially when not all revenue is collected when the work is complete. For example, attorneys charge their clients in billable hours and present the invoice after work is completed. Construction managers often bill clients on a percentage-of-completion method.

Revenue accounting is fairly straightforward when a product is sold, and the revenue is recognized when the customer pays for the product. However, accounting for revenue can get complicated when a company takes a long time to produce a product. As a result, there are several situations in which there can be exceptions to the revenue recognition principle.

Analysts, therefore, prefer that the revenue recognition policies for one company are also standard for the entire industry. Having a standard revenue recognition guideline helps to ensure that an apples-to-apples comparison can be made between companies when reviewing line items on the income statement. Revenue recognition principles within a company should remain constant over time as well, so historical financials can be analyzed and reviewed for seasonal trends or inconsistencies.

The revenue recognition principle of ASC 606 requires that revenue is recognized when the delivery of promised goods or services matches the amount expected by the company in exchange for the goods or services.

The revenue recognition principle, a feature of accrual accounting, requires that revenues are recognized on the income statement in the period when realized and earned—not necessarily when cash is received. Realizable means that goods or services have been received by the customer, but payment for the good or service is expected later. Earned revenue accounts for goods or services that have been provided or performed, respectively.

The revenue-generating activity must be fully or essentially complete for it to be included in revenue during the respective accounting period. Also, there must be a reasonable level of certainty that earned revenue payment will be received. Lastly, according to the matching principle, the revenue and its associated costs must be reported in the same accounting period.

Objective

1. The Standard explains when the revenue should be recognized in profit and loss account and also states the circumstances in which revenue recognition can be postponed. Revenue means gross inflow of cash, receivable or other consideration arising in the course of ordinary activities of an enterprise such as:—
   1. The sale of goods
   2. Rendering the services
   3. Use of the enterprises resources by others yielding interest, dividend and royalties.

In other words, revenue is charge made to customers/clients for goods supplied and services rendered.

1.1 *What is Revenue?* – As per AS-9, 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. 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. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

Timing of Revenue Recognition

2. Revenue from sale or rendering services should be recognized at the time of the sale or rendering of services. However, if at the time of rendering of services or sale there is significant uncertainty in ultimate collection of the revenue, then the revenue recognition is postponed and in such cases revenue should be recognized only when it becomes reasonably certain that ultimate collection will be made. It also applies to the revenue arising out of escalation of price; export incentive, interest, etc.

Applicability

3. This **Accounting Standard** is not applicable to following revenue or gain—
   1. Revenue arising from construction contracts
   2. Revenue arising from hire purchase, lease agreements
   3. Revenue arising from Govt. grants and subsidies
   4. Revenue of Insurance companies arising from insurance contracts
   5. Gain – realized or unrealized gain. Example: Profit on sale of fixed asset.

Revenue from sale of goods

4. It is recognized when all the following conditions are fulfilled:—

1. Seller has transferred the ownership of goods to buyer for a price. **Or**
2. All significant risks and rewards of ownership have been transferred to buyer
3. Seller does not retain any effective control of ownership of the transferred goods
4. There is no significant uncertainty in collection of the amount of consideration (*e.* cash, receivables etc.).

4.1 *Revenue Recognition when the delivery of goods is delayed at buyers request* – Delivery is delayed at buyer's request and buyer takes title and accepts billing. Revenue should be recognized immediately but goods must be in hand of seller, identified and ready for delivery at the time of recognition of Revenue.

4.2 *Revenue Recognition when delivery of goods sold subject to conditions*—

1.
    1.
        1. **Installation and inspection:** Revenue should be recognized when
        2. Goods are installed at the buyer's place to his satisfaction
        3. Goods are inspected and accepted by the buyer.

- **Sale on approval**

Revenue should be recognized when buyer confirms his desire to buy such goods by communication.

- **Guaranteed sales**

Revenue should be recognized as per the substance of the agreement of sale or after the reasonable period has expired.

- **Warranty Sales**

Sales should be recognized immediately but the provision should be made to cover unexpired warranty.

- **Consignment sales**

Revenue should be recognized only when the goods are sold to third party.

- **Special order and shipments**

Revenue from such sales should be recognized when the goods are identified and ready for delivery.

- **Subscriptions for publication**

1.
    1. Items delivered vary in value from period to period
    2. Revenue should be recognized on the basis of sales value of items delivered
    3. Items delivered do not vary in value from period to period

4. Revenue should be recognized on straight-line basis over time.

- **Instalment sales**

Revenue of sale price excluding interest should be recognized on the date of sale. Interest should be recognized proportionately to the unpaid balance.

- **Revenue Swaps**

IND AS-18 contains the provisions for revenue swaps no such corresponding provisions are in AS-9. Under IAS-18, when goods or services are exchanged or swapped for goods or services which are of a similar nature and value, the exchange is not regarded as a transaction which generates revenue. 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. The revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents transferred.

- **Repo Arrangements**

Under IND AS-18, the recognition criteria are applied 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. For example, an enterprise 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. AS-9 too in the case of repo arrangements requires that such transactions should be recorded as financing arrangements; the resulting cash inflow is not revenue and should therefore not be recognized as revenue. (refer Q. 9)

Revenue from rendering of the services

5. Revenue from service is generally recognized as the service is performed. The performance of service is measured by two methods as under:—

5.1 *Completed service contract method* – Revenue is recognized when service is about to be completed and no significant uncertainties exist about the collection of amount of service charges.

5.2 *Proportionate Completion Method* – Revenue is recognized by reference to the performance of each Act. The revenue recognized under this method would be determined on the basis of contract value, associated costs, number of Acts or other suitable basis. Further, no significant uncertainty exists about the collection of amount of service charges of performed Acts.

5.3 *Revenue Recognition Norms* – Revenue Recognition norms for rendering of service under special condition are as follows :

- **Installation fees**

It is recognized when the installation has been completed and accepted by the clients.

- **Advertising and Insurance agency commission**
    1. Advertising commission is recognized when the advertisement appears before public
    2. Insurance commission is recognized on the effective commencement/renewal date of the policies.
- **Financial service commission**

    Recognition of revenue depends upon:—

    1.
        1.
            1. Whether the service has been provided "once and for all" or is on a continuing basis
            2. The incidence of costs relating to the service
            3. When the payment for the service will be received.

Generally, commission charged for arranging or granting loan and other facilities should be recognized when a loan is sanctioned and accepted by borrower. Commitment facility or loan management fees which relate to continuing obligations or services should normally be recognized over the life of the loan.

- **Admission fee**

Revenue from artistic performance, banquets and other special events should be recognized when event takes place.

- **Tuition fees**

Revenue should be recognized over the period of instruction.

- **Entrance and Membership Fees**

Recognition depends upon the nature of service being provided against entrance and membership fees, however entrance fees are generally capitalized and membership fees should be recognized on systematic and rational basis having regard to timing and nature of service provided.

Revenue from Interest

6. Revenue from interest should be recognized on time proportion basis.

Revenue from royalties

7. On accrual basis as per terms of agreement.

Revenue from Dividend

8. When the declaring company declares dividend.

Effect of Uncertainties on Revenue Recognition

9. Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.

Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc. Revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments

9.1 *Subsequent uncertainty in collection* – When uncertainty of collection of revenue arises subsequently after the revenue recognition, it is better to make provision for the uncertainty in collection rather than adjustment in already recognized revenue.

Disclosure

10. When revenue recognition is postponed, the disclosure of the circumstances necessitating the postponement should be made.
11. **Disclosure of Revenue from Sales Transactions**

Issue

- What should be the manner of disclosure of excise duty in the presentation of revenue from sales transactions (turnover) in the statement of profit and loss.

Consensus

- The amount of 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 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.

Guidance Note on Accounting for Real Estate Transactions (Revised 2012)

12. *Introduction* – Real Estate activities and transactions take diverse forms. While some are for sale of land (developed or undeveloped), others are for construction, development or sale of units that are not complete at the time of entering into agreements for construction, development or sale.

The Guidance Note primarily provides guidance on application of percentage of completion method prescribed in Accounting Standard (AS) 7, 'Construction Contracts' where it is appropriate to apply this method as such transactions and activities of real estate have the same economic substance as construction contracts. In respect of transactions of Real Estate which are in substance similar to delivery of goods the principles laid down in Accounting Standard (AS) 9, *Revenue Recognition*, are applied.

12.1 *Application of principles of AS 9 in respect of sale of goods to a Real Estate Project* – For recognition of revenue in case of Real Estate sales, it is necessary that all the conditions specified in Accounting Standard (AS) 9, *Revenue Recognition*, are satisfied Real Estate sale take place in a variety of ways and may be subject to different terms and conditions as specified in the agreement for sale. Accordingly, the point of time at which all significant risks and rewards of ownership can be considered as transferred, is required to be determined on the basis of the terms and conditions of the agreement for sale.

-
- This Guidance Note, thus, provides guidance in the application of :
- Principles of AS 9 in respect of sale of goods for recognizing revenue, costs and profits from transactions of Real Estate which are in substance similar to delivery of goods where the revenues, costs and profits are recognized when the revenue recognition process is completed; and
- Percentage completion method for recognizing revenue, costs and profits from transactions and activities of Real Estate which have the same economic substance as construction contracts.

The application of principles of AS 9 in respect of sale of goods requires recognition of revenues on completion of the transaction/activity when the revenue recognition process in respect of a Real Estate project is completed as explained below :

1.
    1. The seller has transferred to the buyer all significant risks and rewards of ownership and the seller retains no effective control of the Real Estate to a degree usually associated with ownership;
    2. The seller has effectively handed over possession of the Real Estate unit to the buyer forming part of the transaction;
    3. No significant uncertainty exists regarding the amount of consideration that will be derived from the Real Estate sales; and
    4. It is not unreasonable to expect ultimate collection of revenue from buyers.

Further, where individual contracts are part of a single project, although risks and rewards may have been transferred on signing of a legally enforceable individual contract but significant performance in respect of remaining components of the project is pending, revenue in respect of such an individual contract should not be recognized until the performance on the remaining components is considered to be completed on the basis of the aforesaid principles.

12.2 *Application of Percentage Completion Method (AS 7)* – The percentage completion method should be applied in the **accounting** of all Real Estate transactions/activities in the situations, where the economic substance is similar to construction contracts. Some further indicators of such transactions/activities are:

1.
    1. The duration of such projects is beyond 12 months and the project Commencement date and project completion date fall into different accounting periods.
    2. Most features of the project are common to construction contracts, , land development, structural engineering, architectural design, construction, etc.
    3. While individual units of the project are contracted to be delivered to different common activities and/or provision of common amenities.
    4. The construction or development activities form a significant proportion of the project activity.

In case of real estate sales, the seller usually enters into an agreement for sale with the buyer at initial stages of construction. This agreement for sale is also considered to have the effect of transferring all significant risks and rewards of ownership to the buyer provided the agreement is legally enforceable and subject to the satisfaction of conditions which signify transferring of significant risks and rewards even though the legal title is not transferred or the possession of the real estate is not given to the buyer.

Once the seller has transferred all the significant risks and rewards to the buyer, any acts on the real estate performed by the seller are, in substance, performed on behalf of the buyer in the manner similar to a contractor. Accordingly, revenue in such cases is recognized by applying the percentage of completion method on the basis of the methodology explained in AS 7, Construction Contracts.

There is a rebuttable presumption that the outcome of a real estate project can be estimated reliably and that revenue should be recognized under the percentage completion method only when the events in (*a*) to (*d*) below are completed.

1. All critical approvals necessary for commencement of the project have been obtained. These include, wherever applicable:
    1. Environmental and other clearances.
    2. Approval of plans, designs, etc.
    3. Title to land or other rights to development/construction.
    4. Change in land use.
2. When the stage of completion of the project reaches a reasonable level of development. A reasonable level of development is not achieved if the expenditure incurred on construction and development costs is less than 25% of the total project cost.
3. Atleast 25% of the saleable project area is secured by contracts or agreements with buyers.
4. Atleast 10 % of the total revenue as per the agreements of sale or any other legally enforceable documents are realised at the reporting date in respect of each of the contracts and it is reasonable to expect that the parties to such contracts will comply with the payment terms as defined in the contracts.

12.3 *Transactions with multiple elements* – An enterprise may contract with a buyer to deliver goods or services in addition to the construction/development of real estate [*g.* property management services, sale of decorative fittings (excluding fittings which are an integral part of the unit to be delivered), rental in lieu of unoccupied premises, etc.]. In such cases, the contract consideration should be split into separately identifiable components including one for the construction and delivery of real estate units.

The consideration received or receivable for the contract should be allocated to each component on the basis of the fair market value of each component.

12.4 *Illustration on application of percentage completion method*

Total saleable area	20,000 Sq.ft.
Estimated Project Costs (This comprises land cost of ` 300  Lakhs and construction costs of ` 300 Lakhs)	` 600 lakhs
Cost incurred till end of reporting period (This includes land cost of ` 300 Lakhs and construction cost of ` 60 Lakhs)	` 360 Lakhs
Total area sold till the date of reporting period	5000 sq. ft.
Total Sale Consideration as per Agreements of Sale executed	` 200 Lakhs
Amount realised till the end of the reporting period	` 50 Lakhs
Percentage of completion of work	60% total project cost including land cost **or** 20% of total construction cost.

At the end of the reporting period the enterprise will not be able to recognise any revenue as reasonable level of construction, which is 25% of the total construction cost, has not been achieved, though 10% of the agreement amount has been realised.

Continuing the illustration

If the work completed till end of reporting period is (This includes land cost of ` 300 Lakhs and construction cost of ` 90 Lakhs)	` 390 Lakhs

Percentage of completion of work would be	65% of total project cost including l and cost **or** 30% of construction cos t

The enterprise would be able to recognise revenues at the end of the accounting period. The revenue recognition and profits would be as under:

Revenue recognized(65% of ` 200 Lakhs as per A greement of Sale)	` 130 Lakhs
Proportionate cost(5000 sq.ft./20,000 sq.ft.) ×390	` 97.50 Lakhs
Income from the project	` 32.50 Lakhs
Work in progress to be carried forward	` 292.50 Lakhs

Export related benefits such as DEPB

13. As per a recent ICAI opinion, the benefit of DEPB should be recognised in the year of export itself (provided no uncertainty exists). This is on the basis of matching concept. The activity of export results in an entitlement of DEPB credit and accordingly, this credit cannot be related to duty payable at the time of subsequent imports. At the time of subsequent imports, the full duty payable on such imports would form part of cost of purchase which is paid partly or fully by way of adjustment of DEPB credit. The export benefit should be booked separately as revenue by creating claim against it on the asset side. Accordingly, the cost of purchase of material subsequent to exports should be valued at full cost; including the import duty saved, *e.* full customs duty should be loaded irrespective of its payment in cash or payment by utilization of DEPB credit. In case DEPB credit is held for sale, the treatment of DEPB credit would be similar to the treatment when it is intended to be utilized for imports. However, significant uncertainty regarding the amount of consideration realisable and uncertainty regarding its ultimate collection would be taken into account.

Treatment of inter-divisional transfers

14. ICAI has announced that inter-divisional transfers/sales are not the revenue as per AS-9 “Revenue Recognition”.

Since in case of inter-divisional transfers, risks and rewards remain within the enterprise and also there is no consideration from the point of view of the enterprise as a whole, the recognition criteria for revenue recognition are also not fulfilled in respect of inter-divisional transfers.