Revenue Recognition

Revenue is usually the largest single item in financial statements, and the issues involving revenue recognition are among the most important and difficult ones that standard-setters and accountants face. In recent years, concerns related to the recognition of revenue in accordance with Accounting Standards have heightened significantly. Quite often, companies end up tweaking the Revenue numbers, besides some other reasons. Recording revenue improperly is also a commonly used 'earnings management technique'. The ever evolving business models and the growing online economy have only compounded the issue. Earnings Management/Issues with revenue recognition have been the subject of headlines in the United States and in the other parts of the world in the last few years.

-Shrikant Sortur

The author is a member of the Institute as well as AICPA, working with Lason Systems Inc, MI, USA. He can be reached at shrikant_sortur@yahoo.com

International Accounting Standards (IAS) are drafted on a 'Principles-based' approach. The same is the case with Indian Accounting Standards, which adopts the IAS framework. The United States Generally Accepted Accounting Principles (US GAAP) are more along the lines of a 'Rules-based' framework. The more complex the business, the more specialised the industry, the more difficult the decision becomes for that business as to when to recognise earnings. This article attempts to understand the Revenue recognition literature that exists today in US GAAP, International Accounting Standards and Indian Accounting Standards.

Revenue Recognition Under US GAAP

It is estimated that Revenue Recognition related aspects appear in close to two hundred different pieces of accounting literature; of course these pieces of literature include many nuances, some of which are unique to particular transactions.

Since no comprehensive standard on revenue recognition exists, there is a significant gap between the broad conceptual guidance in the Financial Accounting Standards Board's (FASB) Concepts Statements and the detailed guidance in the authoritative literature. Most of the authoritative literature provides industry or transaction-specific implementation guidance, and it has been developed largely on an ad-hoc basis and issued in numerous pronouncements with differing degrees of authority. Those pronouncements include Accounting Principles Board (APB) Opinions, FASB Statements, American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guides, AICPA Statements of Position (SOPs), FASB Interpretations, Emerging Issues Task Force (EITF) Issues, Securities and Exchange Commission (SEC) Staff Accounting Bulletins (SAB), and the like. Each focuses on a specific practice problem and has a narrow scope, and the guidance is not always consistent across pronouncements.

As can be seen from the above paragraph, regulation comes from three bodies:

1. Securities Exchange Commission (SEC)
2. Financial Accounting Standards Board (FASB)
3. American Institute of Certified Public Accountants (AICPA)

Sarbanes Oxley Act, 2002 also contains clauses related to Revenue.

a. Revenue: The broad guidance for revenue recognition

Important Pronouncements Containing topics on Revenue Recognition	
Pronouncement	**Topic**
SFAC 5	Recognition and Measurement in Financial Statements of Business Enterprises
SAB 101	Revenue Recognition in Financial Statements (Dec 1999 Superseded by SAB 104)
SAB 104	Revenue Recognition
SOP 81-1	Accounting for Performance of construction type and certain production type contracts
SOP 97-2	Software Revenue Recognition amended by SOP 98-9
EITF 00-21	Accounting for Revenue Arrangements with Multiple Deliverables
EITF 99-17	Accounting for Advertising Barter Transactions
EITF 99-19	Reporting Revenue Gross versus Net
FTB 90-1	Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts
FASB 48	Revenue Recognition when a right of return exists
	Other topics (not being discussed in this article)
FASB 45	Accounting for Franchise Fee Revenue
FASB 116	Accounting for Contributions Received and Contributions Made
FASB Interpretation 42	Accounting for Transfer of assets in which a not for profit organisation is granted variance power

is set forth in the (FASB) Conceptual Framework which defines the objectives of financial reporting in the U.S., qualitative characteristics of accounting, elements of financial statements and recognition and measurement criteria.

Two essential characteristics of revenues are:

1. They arise from the company's principal business activities (as opposed to investment activities and sale of assets, which generate "gains").
2. They are recurring.

b. Recognition: FASB Statement of Financial Accounting Concepts No. 5 defines "recognition" as the process of recording and reporting an item as an element of financial statements. In order to be recognised in the financial statements, an item must satisfy all four of the following criteria:

1. Meet the definition of an element of financial statements
2. Can be reliably measured (historical cost, current cost, market value, net present value or net realisable value)
3. Is relevant to a user of financial statements
4. Is reliable, which means it can be verified and is free of bias

c. The Revenue Recognition Principle: Once an item qualifies as revenue to be recognised, the question is when to recognise it. Conceptually, in order to be relevant to a user, it should be recorded as soon as possible. However, in order to be reliable, it is preferable to record it as late as possible when all uncertainties have been resolved and measurement is certain.

In order to achieve a balance, two other factors must be considered to determine when revenue should be recognised:

1. It is realised or realisable.
2. It is earned.

Revenue from a transaction must meet both criteria in order to be recognised. Revenue is generally considered realised when cash is received for the sale of a product or performance of a service. Revenue generally becomes realisable when a promise to pay is received in exchange for the sale of a product or performance of a service. The promise to pay could be verbal (account receivable) or written (note receivable). Revenue is generally earned when a legally enforceable exchange takes place (e.g., consideration has been tendered and the buyer takes possession of the product or benefits from the performance of a service).

d. Securities Exchange Commission – Staff Accounting Bulletins: All public companies are regulated by the SEC. The SEC sought to fill the gap in the accounting literature with SAB No. 101, Revenue Recognition in Financial Statements, which was issued in December 1999 and the companion document, Revenue Recognition in Financial Statements— Frequently Asked Questions and Answers, which was issued in October 2000. SAB 101 was superceded by SAB 104, Revenue Recognition, in December 2003.

SAB 101 provides specific examples of applying revenue recognition principles and helps to clarify the concepts of realised

or realisable and earned.

SAB 104 states that if a transaction falls within the scope of specific authoritative literature on revenue recognition, that guidance should be followed; in the absence of such guidance, the revenue recognition criteria in Concepts Statement 5 (namely, that revenue should not be recognised until it is (a) realised or realisable and (b) earned), should be followed. However, SAB 104 is more specific, stating additional requirements for meeting those criteria, and reflects the SEC staff's view that the four basic criteria for revenue recognition in AICPA SOP 97-2, Software Revenue Recognition, should be a foundation for all basic revenue recognition principles. Those criteria are:

- Persuasive evidence of an arrangement exists.
- Delivery has occurred or services have been rendered.
- The seller's price to the buyer is fixed or determinable.
- Collectibility is reasonably assured.

SAB 104 provides further guidance on the interpretation and consideration of the criteria noted above. As additional questions arise, the SEC's Emerging Issues Task Force addresses them in updated SABs. The volume and detail of the examples provided in these documents further demonstrate the complexity of revenue recognition considerations. The topics covered by SAB 104 are:

A. Selected Revenue Recognition Issues

1. Revenue Recognition – General
2. Persuasive evidence of an arrangement
3. Delivery & Performance
   a) Bill and hold arrangements
   b) Customer acceptance
   c) Inconsequential or perfunctory performance obligations
   d) License fee revenue
   e) Layaway sales arrangements
   f) Non refundable upfront fees
   g) Deliverables within an arrangement
4. Fixed or determinable sales price
   a) Refundable fees for services
   b) Estimates and changes in estimates
   c) Contingent rental income
   d) Claims processing & billing services

B. Disclosures

e. Accounting for Performance of construction type and certain production type contracts:

Guidance is defined from the perspective of the contractor rather than the contract, as in IAS. Scope is not limited to construction type contracts; guidance is also applicable to unit-price and time-and-materials contracts.

Recognition Method: The percentage of completion method is preferred. However, in rare circumstances, when the extent of progress towards completion is not reasonably measurable, the completed should be used.

Applying the percentage of completion method: Two different approaches permitted.

1. The Revenue Cost approach (similar to IAS) multiplies the estimated percentage of completion by the estimated total revenues to determine estimated revenue, and multiplies the estimated percentage of completion by the estimated total contract cost to determine the cost of earned revenue; and
2. The Gross Profit approach multiplies the estimated percentage of completion by the estimated gross profit to determine the estimated gross profit earned to date.

Losses are recognised when incurred or when the expected contract costs exceed the expected contract revenue, regardless of which accounting method used.

Completed contract method:

Allowed only in rare circumstances where estimates of costs to completion and the extent of progress towards completion cannot be determined with enough certainty. Revenue is recognised only when the contract is completed or substantially completed. Losses are recognised when incurred or when the expected contract costs exceed the expected contract revenue.

f. SOP 97-2 - Software Revenue Recognition (Amended in part by SOP 98-9): SOP 97-2 applies to all entities that license, sell, lease, or market computer software. It also applies to "hosting" arrangements in which the customer has the option to take possession of the software. Hosting arrangements occur when end users do not take possession of the software but rather the software resides on the vendor's or a third party's hardware, and the customer accesses and uses the software on an as-needed ba-

sis over the Internet or some other connection. It does not, however, apply to revenue earned on products containing software incidental to the product as a whole or to hosting arrangements that do not give the customer the option of taking possession of the software.

SOP 97-2 provides that revenue should be recognised in accordance with contract accounting when the arrangement requires significant production, modification, or customisation of the software. When the arrangement does not entail such requirements, revenue should be recognised when persuasive evidence of an agreement exists, delivery has occurred, the vendor's price is fixed or determinable, and collectibility is probable.

In the software industry, the largest part of revenues stems from vendors' license fees associated with software. Companies such as Microsoft and Computer Associates have recognised revenue from license fees when the software was shipped to the customer. The amount and timing of revenue recognition is complicated, however, by multiple-element arrangements that provide for multiple software deliverables [e.g., software products, upgrades or enhancements, post-contract customer support (PCS), or other services]. In hosting arrangements that are within the scope of SOP 97-2, multiple elements might include specified or unspecified upgrade rights, in addition to the software product and the hosting service. The software provider often charges a single fee that must be allocated to the products delivered in the present and in the future. If contract accounting is not required, SOP 97-2 requires that the vendor's fee be allocated to the various elements based on vendor-specific objective evidence (VSOE) of fair value for each element. VSOE is limited to the price charged by the vendor for each element when it is sold separately. This requires the deferral of revenue until VSOE can be established for all elements in the arrangement or until all elements have been delivered. If PCS is the only undelivered element in the arrangement, however, the entire fee can be recognised ratably over the term of the PCS contract. In addition, recognition of revenue must be deferred if undelivered elements are essential to the functionality of any delivered elements.

g. EITF 00-21 - Accounting for Revenue Arrangements with Multiple Deliverables: Multiple-element arrangements are not limited to the software industry. Common examples include the sale of computer networks, specialised equipment with installation and training, and cellular telephones with service contracts. EITF 00-21, Revenue Arrangements with Multiple Deliverables, identifies when separation of sales arrangements for revenue recognition purposes is appropriate.

In an arrangement with multiple deliverables, EITF 00-21 requires that the delivered items be considered a separate unit of accounting if the delivered items have value to the customer on a stand-alone basis, if there is objective and reliable evidence of the fair value of the undelivered items, and if the arrangement includes a general right of return for the delivered item, or if delivery or performance of the undelivered items is considered probable and substantially in the control of the vendor. EITF 00-21 requires allocation of the vendor's fee to the various elements based on each element's stand-alone value, and the deferral of revenue until the stand-alone value can be established. Stand-alone value can be determined on the basis of any vendor's sales price or on the basis of the customer's ability to resell the element on a stand-alone basis. This requirement is much less restrictive than the VSOE requirement of SOP 97-2, which limits stand-alone value to that established by the vendor only and does not allow the value to be determined by other vendors or by the customer's ability to resell the element. Additionally, the stringent "essential to the functionality" criterion of SOP 97-2 is not included in EITF 00-21, so such undelivered elements would not cause the deferral of revenue recognition on the delivered elements.

In general, both SOP 97-2 and EITF 00-21 require allocating revenue to all of the elements of a multiple-deliverable arrangement using the relative fair value method, where objective and reliable evidence of fair value is present for all the products contained in the group. If objective and reliable evidence is available only for the products that have not been delivered, the residual method should be used to value the products that have been delivered. If objective and reliable evidence is available only for the delivered products, no value should be assigned to

any products until all of them are delivered. Both SOP 97-2 and EITF 00-21 prohibit using the reverse residual method.

Criteria for Multiple Deliverable Products		
Item	**SOP 97-2**	**EITF 00-21**
Software and software related products	Applicable	Not Applicable
Non software products	Not Applicable	Applicable
Basis for revenue recognition	Vendor specific objective evidence (VSOE) of fair value. Price must be available for each product provided by the seller	Stand alone value. VSOE is the best, but competitor prices and the customers ability to sell the product may be used
Residual method	Allowed	Allowed
Reverse residual method	Not allowed	Not allowed
Undelivered products essential to the functionality of any delivered product	Revenue deferred on the delivered product until the undelivered product is delivered	Revenue may be recognised for the delivered product

In an arrangement that includes software that is more than incidental to the products or services as a whole, software and software-related elements are included within the scope of SOP 97-2. Software-related elements include software products and services such as those listed in paragraph 9 of SOP 97-2 [i.e., software products, upgrades/enhancements, post-contract customer support, or services] as well as any non-software deliverable(s) for which a software deliverable is essential to its functionality. For example, in an arrangement that includes software, computer hardware that will contain the software, and additional unrelated equipment, if the software is essential to the functionality of the hardware, the hardware would be considered software-related and, therefore, included within the scope of SOP 97-2. However, because the software is not essential to the functionality of the unrelated equipment, the equipment would not be considered software-related and would, therefore, be excluded from the scope of SOP 97-2.

h. EITF 99-17 – Accounting for Advertising Barter Transactions: Revenue and expenses must be recognised at the fair value of the advertising given. Fair value must be based on the entity's own historical practice of receiving cash for similar advertising from unrelated entities. Similar transactions used as a guide to fair value must not be older than six months prior to the date of the barter transaction. If the fair value of the advertising given cannot be determined within these criteria, the carrying amount of the advertisement surrendered, which is likely to be zero, must be used.

i. EITF 99-19 – Reporting Revenue Gross versus Net:

Provides several indicators of whether revenue should be presented at gross or net:

The sale should be recorded at gross if the seller:

- Is the party responsible to the customer for satisfaction
- Has general inventory risk (before customer order is placed or upon customer return)
- Has reasonable latitude in establishing price
- Changes the product or performs part of the service
- Has discretion in supplier selection
- Is involved in determination of product or service specifications
- Has physical loss inventory risk (after order or during shipping); or
- Bears credit risk in the event of customer non payment

The sale should be recorded at net if:

- The supplier, not the company, is the primary obligator (responsible for fulfillment and customer satisfaction)
- The amount the company earns from the shipment is fixed; or
- The supplier, not the company, has the credit risk in event of customer non payment

j. FTB 90-1 – Accounting for Separately Priced Extended Warranty And Product Maintenance Contracts:

Revenue must be recognized on a straight-line basis unless the pattern of costs indicates otherwise. A loss must be recognised immediately if the expected cost to provide services during the warranty period exceeds unearned revenue

k. FAS 48 – Revenue Recognition when a right of return exists: When rights of return exist, or are likely to be accepted, FAS 48 dictates that it may be possible that a reasonable estimate can be made before revenue can be recognised from the transactions

In determining whether a reasonable estimate can be made, all factors that bear upon the quantity of products to be returned should be considered. These factors include competition, obsolescence and the length of time over which the product can be returned. The lack of reliable history regarding returns may preclude companies from recording product shipments with a right of return until that right expires or is terminated.

The Way Forward

With the increasing focus on Revenue Recognition issues and the need to for a comprehensive statement, FASB has undertaken a project on 'Revenue Recognition'

The objective of this project is to develop conceptual guidance for revenue recognition and a comprehensive Statement on revenue recognition that would be based on that guidance. In particular, the project is intended to improve financial reporting by:

1. Eliminating inconsistencies in the existing conceptual guidance on revenues in certain FASB Concepts Statements
2. Providing conceptual guidance that would be useful in addressing issues that may arise in the future
3. Eliminating inconsistencies in the existing authoritative literature and accepted practices
4. Filling voids that have emerged in revenue recognition guidance in recent years.

The comprehensive Statement that is expected to result from this project is initially planned to apply to business entities generally; however, the FASB may conclude that certain transactions or industries requiring additional study should be excluded from the scope of that Statement and be addressed separately.

Revenue Recognition Under International Accounting Standards

IAS framework contains specific standard on revenue recognition, IAS 18 – Revenue and IAS 11-Construction Contracts.

IAS 18: Revenue -- IAS 18 prescribes the accounting treatment for revenue arising from:

- The sale of goods;
- The rendering of services; and
- The use by others of entity assets yielding interest, royalties and dividends.

It does not deal with revenue arising from transactions covered by other Standards (e.g. revenue arising from lease agreements dealt with in IAS 17 leases).

Revenue is measured at the fair value of the consideration received or receivable. The consideration is usually cash. If the inflow of cash is significantly deferred, and there is no interest or a below-market rate of interest, the fair value of the consideration is determined by discounting expected future receipts. If dissimilar goods or services are exchanged (as in barter transactions), revenue is the fair value of the goods or services received or, if this is not reliably measurable, the fair value of the goods or services given up.

Revenue from the sale of goods is recognised when:

- Significant risks and rewards of ownership are transferred to the buyer;
- The seller has no continuing managerial involvement or control over the goods;
- The amount of revenue can be measured reliably;
- It is probable that economic benefits will flow to the seller; and
- The costs of the transaction (including future costs) can be measured reliably.

Revenue from rendering services is recognised by reference to the stage of completion if the following conditions are satisfied:

- The amount of revenue can be measured reliably;
- It is probable that economic benefits will flow to the service provider;
- The stage of completion of the transaction can be measured reliably; and
- The costs of the transaction (including future costs) can be measured reliably.
    - ❖ If the outcome cannot be measured reliably, revenue is recognised only to the extent of the expenses recognised that are recoverable.
    - ❖ Interest revenue is recognised on a time-proportion basis using the effective interest method.
    - ❖ Royalties are recognised on an accruals basis in accordance with the substance of the relevant agreement.
    - ❖ Dividend revenue is recognised when the shareholder's right to

receive the dividend is established.

- IAS 18 also specifies disclosures about revenue.

IAS 11: Construction Contracts – IAS 11 prescribes the accounting treatment of revenue and costs associated with construction contracts.

When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs are recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity ("percentage of completion method"). The outcome can be estimated reliably when the contract revenue, contacts costs to date and to completion, and the stage of completion can be measured reliably.

When the outcome of a construction contract cannot be estimated reliably, revenue is recognised only to the extent of contract costs incurred, that it is probable are recoverable. Contract costs are recognised as expenses when incurred. If the outcome of the contract subsequently can be estimated reliably, the percentage of completion method is used for recognition of revenue and expenses.

Any expected loss on a construction contract is recognised as an expense immediately.

IAS 11 also specifies disclosures about construction contracts.

Revenue Recognition Under Indian Accounting Standards

Indian Accounting Standards follow the framework of International Accounting Standards and are similar in nature. Accounting Standards for Revenue Recognition in India corresponding to IAS are found in AS 9- Revenue Recognition and AS 7 – Construction Contracts.

Key differences between IAS and Indian Accounting Standards

Revenue Recognition:

a) IAS 18 contains a clause that prohibits revenue to be recognised from sale of goods when the entity retains continuing managerial ownership or effective control over the goods sold. AS 9 does not specify this.

b) IAS 18 allows only 'Percentage of completion method' for recognising revenue from rendering of services. AS 9 allows 'Completed service contract method' or 'Proportionate completion method'

c) IAS 18 requires the effective interest method to be followed for revenue recognition of 'Interest' income whereas AS 9 requires interest income recognition on a time proportion basis

d) IAS 18 does not allow revenue to be recognised for payments received in advance for goods yet to be manufactured or third party sales until such goods are delivered to the buyer whereas AS 9 permits recognition when the goods are manufactured, identified and ready for delivery in such instances.

Construction Contracts: Contract revenue under IAS 11 is measured at the fair value of the consideration received or receivable whereas under AS 7 the contract revenue is measured at the consideration received or receivable (i.e. there is no fair value concept in AS 7)

Key Issues for Revenue Recognition

Revenue recognition is much more complex than it might seem to the average investor / user of financial statements. Much of the complexity is caused by the need to issue periodic reports, which requires that what is essentially a continuous earnings process be divided into discrete periods. Issues that must be considered include:

- When is delivery complete?
- When does the title to goods and the risk of loss transfer from the seller to the buyer?
- Does the buyer have the right to return the product?
- Has payment been received for a service to be provided in the future?
- Is any or all of a sales agreement contingent on a future event?

Principal Revenue Recognition Risk

The principal accounting risk is obviously the temptation to report higher revenues than were actually earned. This is typically done to make the organisation appear more attractive to existing and potential investors and can be accomplished through one of several means:

a. Moving revenues forward into a current period in order to meet the budget or forecast

b. Failing to fully meet the requirements for revenue to be both realised or realisable, and earned

c. Recording revenue when production is complete, but delivery, title transfer, and risk of loss transfer to the buyer have not yet occurred

d. Treating sales between different company business units as outside sales

e. Establishing contingencies or guarantees that may result in product returns

f. Failing to adequately consider collectibility at time of sale

g. Treating sales on consignment as outside sales ❐