

Query No. 19

Subject: Accounting for sales returns.¹

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') has been in the business of manufacture of readymade garments for the last 5 to 6 years. It sells its products to franchisees located across the country.

2. The querist has stated that the sale is said to be completed at the time when risks and rewards of ownership of goods are transferred to the franchisees. Readymade garment industry is subject to change in trends of fashion and as such, some of the goods are returned and the company accepts them back as sales returns. According to the querist, sales returns are said to be completed when the goods have been physically received back in the factory premises and all the risks and rewards of ownership have been transferred to the company. Hence, the company records the sales returns in its books of account on their physical receipt. On the basis of the past trend, sales returns work out to be approximately 20 to 22% of the sales for the year.

3. The querist has further stated that the company has accounted for the sales returns received during the financial year upto the balance sheet date but has not reversed the sales returns likely to be received after the balance sheet date, on the basis of the past trend.

4. During the course of audit for the financial year 2010-11, the auditors have raised an objection regarding booking of revenue from sales. The auditors are of the opinion that since there is a past trend indicating the return of goods sold to franchisees, the company should effect the reversal of sales on 31st March, 2011 to the extent that the goods sold in the year

¹ Opinion finalised by the Expert Advisory Committee on 10.10.2011.

2010-11 are likely to be returned by the franchisees in the year 2011-12 and subsequent years. Though the company has accounted for sales returns upto the date of the balance sheet, the auditors are of the view that the company should also account for sales returns likely to be received after the balance sheet date on the basis of past trend.

5. The querist has also stated that the auditor proposes to make the following qualification:

“Though the actual sales returns after 31st March, 2011 upto the conclusion of the financial statements have been recognised, the impact of further sales returns, likely to happen based on the past trend of such returns, has not been estimated and recognised in these financial statements. This is not in accordance with Accounting Standard (AS) 9, ‘Revenue Recognition’. In the absence of the above estimation and recognition, we are unable to comment in the matter and the consequential effect on the financial statements.”

6. The company is of the view that the stand of the auditors is not correct because of the following reasons:

(a) Paragraph 11 of Accounting Standard (AS) 9, ‘Revenue Recognition’ is reproduced below:

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

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

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

The querist is of the view that the company has complied with both the above conditions necessary to recognise revenue from the sale of goods in the year. Although there is a probability of some goods being returned by the franchisees, there is no significant uncertainty regarding the amount of consideration that will be derived from the sale of goods. Since the goods are not in the possession of the company and risks and rewards of ownership still lie with the franchisee and he is the one who is responsible for the goods, the company cannot record the sales returns in its books of account in respect of goods likely to be received back after the date of the balance sheet.

(b) As per the querist, the case of the company is also not covered by paragraph A(2)(c) of the Appendix to AS 9, issued by the Institute of Chartered Accountants of India, which, inter alia, states as below:

“In the case of retail sales offering a guarantee of “money back if not completely satisfied” it may be appropriate to recognise the sale but to make a suitable provision for returns based on previous experience.”

Although in the company’s case, the franchisee has a right to return the goods, the return of goods by the franchisees in subsequent years is entirely contingent upon the situation prevailing in the market at that time.

B. Query

7. On the basis of the above, the querist seeks the opinion of the Expert Advisory Committee on the following issues:

- (i) Whether the present policy of the company regarding recognition of sales returns after the date of the balance sheet in the books of account only upon the physical receipt of goods from the franchisees is correct.
- (ii) If the company records the sales returns received after the date of the balance sheet on estimated basis taking into account the past trend, whether it will be proper accounting to prepare financial statements of the company on estimation basis.

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to accounting for sales returns that occur after the date of balance sheet in a situation where the customers (franchisees) have a right to return the goods. The Committee has, therefore, considered only this issue and has not considered any other issue that may arise from the Facts of the Case, such as, recognition of revenue as per the principles of AS 9, etc. The Committee presumes from the Facts of the Case that franchisee is neither acting as an agent of the company nor as a consignee as covered under paragraph A(2)(c) of the Appendix to AS 9 which states as given below:

“(c) guaranteed sales i.e. delivery is made giving the buyer an unlimited right of return

Recognition of revenue in such circumstances will depend on the substance of the agreement. In the case of retail sales offering a guarantee of “money back if not completely satisfied” it may be appropriate to recognise the sale but to make a suitable provision for returns based on previous experience. In other cases, the substance of the agreement may amount to a sale on consignment...”

9. The Committee notes from paragraph 5 of the Facts of the Case that the auditor proposes to make the qualification that “though the actual sales returns after 31st March, 2011 *upto the conclusion* of the financial statements have been recognised, the impact of further sales returns, likely to happen based on the past trend of such returns, has not been estimated and recognised in these financial statements”, whereas it is also stated in the Facts of the Case that the company has accounted for sales returns *upto the date of the balance sheet*. Thus, there is an apparent contradiction in the Facts of the Case, although, that does not affect the accounting for the basic issue raised.

10. The Committee notes from the Facts of the Case that the querist has stated in paragraph 6 above that the company has complied with the conditions of paragraph 11 of AS 9 relating to conditions of recognition of revenue in the case of sale of goods. Accordingly, the Committee presumes that the requirements of AS 9 relating to recognition of revenue are fulfilled. The Committee is of the view that in case conditions relating to recognition of revenue are fulfilled at the time of making sale, it would be correct to recognise revenue in respect of sale of goods at the time of sale itself. However, the Committee notes from the Facts of the Case that in the extant case, there is a right of return by the franchisees (refer paragraph 6 above). The existence of such right would give rise to a present obligation on the company. In this context, the Committee notes the definition of the term ‘provision’ as defined in paragraph 10 of Accounting Standard (AS) 29, Provisions, Contingent liabilities and Contingent Assets, notified under Companies (Accounting Standard) Rules, which provides as follows:

“ A provision is a liability which can be measured only by using a substantial degree of estimation.

A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.”

The Committee is of the view that since obligation in respect of sales return can be estimated reliably on the basis of past experience and other relevant factors, such as, fashion trends, etc., in the extant case, a provision in respect of sales returns should be recognised. The provision should be measured as the best estimate of the loss expected to be incurred by the company in respect of such returns including any estimated incremental cost that would be necessary to resell the goods expected to be returned. The Committee is also of the view that as per paragraph 52 of AS 29, provisions should be reviewed at each balance sheet date and if necessary, should be adjusted to reflect the current best estimate. As far as actual sales returns that occur between the balance sheet date and the date of approval of financial statements are concerned, the Committee is of the view that necessary adjustments should be made in this regard to the amount of the provision.

D. Opinion

11. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 7 above:

- (i) No, the present policy of the company regarding recognising sales returns after the date of the balance sheet in the books of account upon the physical receipt of goods from the franchisees is not correct. The company should recognise a provision in respect of sales returns at the best estimate of the loss expected to be incurred by the company in respect of such returns including any estimated incremental cost that would be necessary to resell the goods expected to be returned, on the basis of past experience and other relevant factors as discussed in paragraph 10 above. Necessary adjustments to the provision should be made for

actual sales return after the balance sheet date upto the date of approval of financial statements. Such provision should also be reviewed at each balance sheet date and if necessary, should be adjusted to reflect the current best estimate.

- (ii) If the treatment prescribed in (i) above is followed, it will be appropriate accounting treatment for preparing the financial statements of the company.
