E-Commerce Accounting: Finding Method in the Muddle

E-commerce has redefined the way business gets conducted and has swept the conventional norms and metrics of doing business. E-commerce transactions have reaffirmed the accounting fraternity that accountancy is an evolving discipline. These have rekindled the belief that accountants need to be equipped with thinking caps. E-commerce businesses have brought with them accounting challenges of their own, where every transaction can have multiple interpretations. The business owners and the accountants might see an e-commerce transaction in different light, akin to the proverbial six blindfolded people trying to define an elephant through whichever body-part of the elephant they touch. The importance of an accounting policy to take care of peculiar transactions, in this context, can hardly be over-emphasised. At the same time, applicability and continuity of an accounting policy must be judged in the context of its relevance. In this article, the author helps us understand the accounting treatment of peculiar e-commerce transactions and the best practices which must be etched thereto. He argues, in accounting for these transactions, there cannot be one clear answer and that there can only be opinions, not sacrosanct conclusions. Read on…

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Introduction

"There's no accounting for taste" is an idiom often attributed to the medieval age, if we sight its etymological roots. Perhaps, an astute predecessor would have coined this sentence in trying to come to terms with the harsh frailties of life or attempting

to gauge why some people do what they do. Or perhaps, this ancestor would have been a large advocate of subjectivity over objectivity.

Little would have he known, that centuries later, accountants of the e-commerce space would take respite in reading this idiom. E-commerce has redefined the way business gets conducted and has swept the conventional norms and metrics of doing business. It has kept eyeballs glued and eyebrows raised. E-commerce transactions have reaffirmed the accounting fraternity that accountancy is an evolving discipline. It is not a theology capable to be zeroed down to straight-jacketed evergreen equations. Capturing the essence of e-commerce transactions through journal entries is akin to nailing a jelly to a tree. E-commerce transactions have rekindled the belief that accountants need to be equipped with thinking caps. Subjectivity is a by-product of e-commerce, and by extension, accountants too must leave a room for factoring in subjectivity into their objectivity-wired grey cells. True, there's no accounting for taste. Yet, there have to be journal entries.

E-commerce businesses have brought with them accounting challenges of their own, where every transaction can have multiple interpretations. The business owners and the accountants might see an e-commerce transaction in different light, akin to the proverbial six blindfolded people trying to define an elephant through whichever body-part of the elephant they touch. For instance, how do you account for the discount coupon-codes outstanding as at the reporting date? Or in the first place, taking a step back, is there even a need to account for these?

It is only ironic to realise that the importance of objectivity is felt the most when subjectivity thrives unbridled. The importance of an accounting policy to take care of peculiar transactions, in this context, can hardly be over-emphasised. Consistency must prevail. At the same time, the applicability and continuity of an accounting policy must be judged in the context of its relevance.

The Indian GAAP, it seems, laid down too little text and hence, too many interpretations. Standards had to be read between the lines, more than reading them through the lines. Ind-AS, however, was a definite improvement. However, it is a characteristic feature of principle-based accounting frameworks that the management's perception of a transaction holds a close-to-equal footing with that of the standard itself. More so, when the entities involved are e-commerce companies.

Operating Revenue

The top-line of e-commerce companies is a topic which often prevents purists and contemporaries from looking eye-to-eye. A major chunk of this debate rests on the fact that the 'revenue-multiple' is a very integral component of valuing e-commerce companies. Hence, the revenue figure has to be solemnized on the altar of fairness and truth.

The first major debate lies on the measurement component of revenue; as to what exactly constitutes the revenue.

AS 9 on revenue recognition states "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."*

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Ind AS 115 defines revenue as "Income arising in the course of an entity's ordinary activities."

Ind AS 115 on Revenue states "When (or as) a performance obligation is satisfied, an entity shall recognise as revenue the amount of the transaction price that is allocated to that performance obligation. An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a

customer, *excluding amounts collected on behalf of third parties*."

In this context, identifying whether the e-commerce company is engaging itself as a principal or an agent is of prime importance, since it determines what amount can be recognised as revenue. Taking a step back, it may sound a little absurd to say that, at times, it is difficult to identify whether an e-commerce company is a *goods* company or a *services* company. For instance, when an e-commerce company serves as a platform or an intermediary for sellers to list their goods on its website and the buyers browse through them and buy them online *(an open-marketplace model)*, the e-commerce company isn't selling goods. It is only rendering a service of facilitating the sale of goods. Depending on the other pointers of the contract, if it is established that the e-commerce company serves only as an agent, the accounting norm suggests that the revenue for this company should be recognised only to the extent of commission it earns from merchants, and not the value of goods it is able to sell through its platform. The e-commerce company here is a commission-agent, nor a trader; thereby the revenue-recognition is restricted to the commission it earns, by whatever name it is called or referred to.

However, if this e-commerce company would have adopted the *managed marketplace model*, where the entity itself would have essayed the role of a principal and inter-alia, would have borne, the inventory and credit risk, it could have classified itself as a trader, and it would have been justified to measure revenue as the value of goods sold.

To quote para B35 of Ind-AS 115, "an entity is a principal if the entity controls a promised good or service before the entity transfers the good or service to a customer. However, an entity is not necessarily acting as a principal if the entity obtains legal title of a product only momentarily before legal title is transferred to a customer. An entity that is a principal in a contract may satisfy a performance obligation by itself or it may engage another party (for example, a subcontractor) to satisfy some or all of a performance obligation on its behalf. When an entity that is a principal satisfies a performance obligation, the entity recognises revenue in the gross amount of consideration to which it expects to be entitled in exchange for those goods or services transferred."

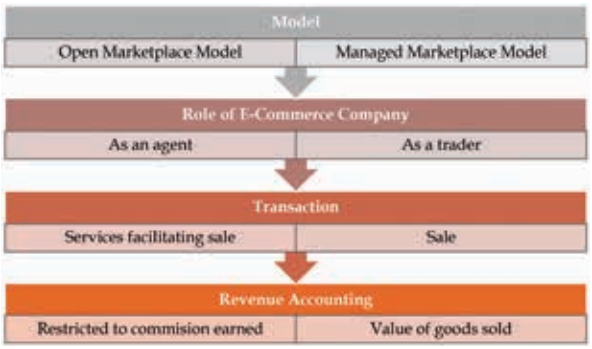

Figure 1: How to recognise revenue

An illustrative list of factors which point the compass towards the entity being a principal include that the entity bears or assumes the inventory risk, the entity bears or assumes the credit risk associated with the transaction, the entity is the primary obligor in the arrangement, the entity can influence the selling price to a large extent, the entity performs the part of the services provided or modifies the goods supplied or the entity bears the risks associated with the return of goods. The common caveat to these pointers is that every arrangement has to be analysed in its own light, before arriving at a conclusion.

An e-commerce platform which enables consumers to recharge their prepaid cell-phones may not be able to recognise the gross billing as its revenue, since it is not the primary obligor; it does not have to cater to providing telecommunications service, nor it assumes any inventory risk. Similarly, a hotel-room aggregator must recognise only the commission received as its revenue.

An e-commerce platform which enables consumers to recharge their prepaid cell-phones may not be able to recognise the gross billing as its revenue, since it is not the primary obligor; it does not have to cater to providing telecommunications service, nor it assumes any inventory risk. Similarly, a hotel-room aggregator must recognise only the commission received as its revenue. The transaction-facilitation fee or the commission is the reward, not the gross value of prepaid coupons or the value of accommodation of rooms. However, a contradicting view under both these examples would be, if the recharge-platform 'buys' the codes or recharge from telecommunication companies or the aggregator expands its scope and ventures out to buy the inventory of room-nights *(it wouldn't*

remain an aggregator in strict sense of the word), there may arise a possibility of recognising gross revenue, subject to the other underlying factors involved.

Similar would be the fate of e-commerce portals which sell mutual funds and insurance policies online. They would need to resort to recognition of revenue on a *net* basis.

Another deliberation lies on *when* should the revenue be recognised.

Under **AS 9**, revenue from sale of goods is recognised when the performance is achieved, that is, when 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 no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of goods. Revenue for services is recognised and measured either under the completed service contract method or under the proportionate completion method. Such performance should be regarded as being achieved when no significant uncertainty exists regarding the amount of consideration that will be derived from rendering the services.

Under **Ind AS 115**, an entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (that is, an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.

Again, to pinpoint with precision the exact time when the risks and rewards are passed, or the performance obligation has been fulfilled is a hard nut to crack. While AS-9 centred attention on "transfer of risk and rewards", the focal point of Ind AS 115 is the customer obtaining "control" of the asset. A customer obtains control when it has the ability to direct the use of and obtain the benefits from the good or service. The difference between transfer of *"risk and rewards"* and transfer of *"control" may not be as contrasting as black and white, yet can lead to major accounting implications.*

For instance, an e-commerce portal using the *managed marketplace model* may give an option of "cash-on-delivery" to its customers. However, if it employs a logistics player which bears the insurance cost and the risk of last mile delivery from the entity's warehouse, it may be a fair conclusion to draw that the revenue can be recognised **under AS-9** when the goods are dispatched from the entity's warehouse. However, under Ind-AS 115, the revenue recognition may have to be deferred until the customer actually receives the physical delivery of the goods, notwithstanding the contractual arrangement between the entity and the logistics player.

Recognising revenue from advertising is straightforward - account for revenue when the advertisement appears before public in the intended manner. However, layered contracts having minimum guarantee clauses or barter advertising does result in complications. Revenue cannot be recognised until the minimum guarantee obligations are met *(example: minimum number of displays, clicks or lead generation)*, though one may argue that management estimates based on historic trends may override this opinion.

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Gone are the days when contracts only had a legal impact. The new dawn of accounting suggests that the contracts will be scrutinised closely to suggest what their impact on books of accounts will be!

Revenue from Shipping Charges

One more significant issue which arises in an e-commerce setup is the accounting for income from shipping of goods. At times, e-commerce companies charge extra charges for shipping the goods, especially in scenarios where the invoice is below a certain threshold value. Some e-commerce companies charge an extra amount for express delivery of the shipment. Revenue arising from such transactions must be segregated in the income statement.

However, for transactions where the shipping charges are not expressly stated *(akin to "free shipping")*, there are certain aspects which need accounting ponderings.

Ind AS 115 introduces a five step framework on when and how to recognise revenue, briefly summarised as below:

1. Identify the contract with customers.
2. Identify the performance obligation of the Contract.
3. Determine the transaction price.
4. Allocate the transaction price to contract obligation, and
5. Recognise the revenue when the Company satisfies the performance obligation.

Figure 2: Five-step Framework on how & when to recognise revenue

The bottom-line *(or should we say top-line?)* of this approach is that no "performance obligation" can be termed as "free", as long as you are in the accounts' cubicle. Though some services can be marketed as being free, these aren't free in the real sense of the term.

Thus, when a transaction is undertaken by an e-commerce company which entails a home-delivery obligation, a portion of the revenue has to be deemed using a sound rationale, as being arisen by virtue of performing 'shipping' services. Thus, if the e-commerce company is availing the services of a logistics player willing to undertake the risks associated with transportation, the e-commerce company can recognise "goods" revenue when it dispatches goods to the logistics player (assuming a *managed marketplace model*), whereas the revenue arising from "shipping service" has to be deferred till the point wherein the goods are actually delivered to the customer, notwithstanding the fact that the logistics player takes responsibility for delivering the goods. The measurement and timing criteria, both, are affected by virtue of such an arrangement.

A similar approach could be followed even under AS 9.

Classification Issues of certain expenses

On many counts, classification of an expense under the appropriate head may present a challenge. For instance, consider an Over-the-top (OTT) entertainment platform, which streams movies or original content through its platform under a fixed-subscription model. If this e-commerce player, through an intention of making the platform popular among its target market, keeps the subscription of the first-month free, where would the content costs incurred on this first month be classified? Would it still be classified as "content expenses" or should it be attributed under "Promotion expenses"? Again, the intention of the management here has a major say in reaching to the appropriate head of classification.

Gift Vouchers

A very large number of e-commerce companies sell gift vouchers which can be redeemed against future purchases on their own platforms. Sale of gift vouchers cannot outrightly be regarded as revenue, and a distinct accounting policy for accounting for these transactions becomes a necessity.

The performance obligation against the sale of gift-vouchers is the eventual sale of merchandise. Hence, unless the gift vouchers are redeemed against actual merchandise, the performance obligation will not be deemed to be completed, and by extension, revenue cannot be recognised on the mere sale of gift vouchers.

If the sale of gift vouchers is an independent transaction, untied to any prior purchase whatsoever, such sale is akin to "advance against revenue". As and when the bearer of the voucher redeems it, the revenue can be recognised. If the gift voucher comes with an expiry period, revenue from unredeemed vouchers can be recognised on the expiry of such a time period.

Sales Returns

Under the e-commerce ecosystem, customer base is the undisputed currency. Customer centricity is the pivotal focus of e-commerce companies. Under this background, e-commerce companies offer a wide leeway to consumers with respect to 'returning' the goods to the vendor. So much so,

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'reverse logistics' is being regarded as the next big thing in the logistics space. Soft returning policies, to an extent, have made e-commerce platforms more trustworthy. Various apparel platforms even offer options like "Try on delivery", which entitles the customers to return goods there and then, if not found suitable to them.

A very conservative policy would be not recognising revenue till the time the option to return the goods expires. However, such a policy would not be indicative of the substance of the transaction, since cent percent returns cannot be a fair assumption to make.

Para B21 of Ind AS 115 states that to account for the transfer of products with a right of return, an entity shall recognise revenue for the transferred products to the extent of consideration to which the entity expects to be entitled. Thus, revenue would not be recognised for the products expected to be returned.

An ideal accounting policy would be to reduce the sales recognised by an estimate of the returns, dependent on *inter-alia*, historic trends, and recognising a current asset as a proxy to the inventory which may be returned. The cost of sales must also be reduced by the inventory so estimated to be returned. The estimates so made must be revised as and when the actual data becomes available, and the adjustments thereafter can be made to the revenue account. Again, the management estimates must be based on data-models and not merely arbitrary rules of thumb.

Loyalty Programmes

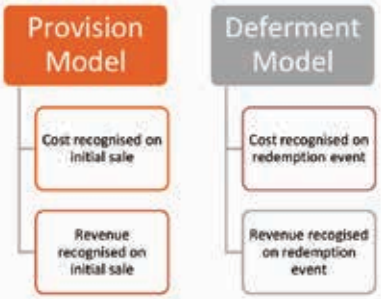
Nothing fascinates an e-commerce business as much as customer loyalty. Repeat purchases are one of the most authoritative and conclusive yardsticks of gauging the success of an e-commerce platform. The consumer is spoilt for choices since there is no dearth of competitors, who are ever-ready to capitalise on a minute lapse. This makes customer retention an important business function, since the customer is not only price-elastic but also experience-elastic. Loyalty programmes aimed at bringing the customer back to the platform birth out of a necessity than as a choice.

Loyalty programmes typically award "credits" to purchasers which can be redeemed on purchases undertaken at a later date. This can be viewed as a typical example of 'variable consideration', as stated by Para 50 of Ind AS 115. Para 51 of the same standard also states that the *'an amount of consideration can vary because of discounts, rebates, refunds,* ***credits****, price concessions, incentives, performance bonuses, or other similar items.'*

Now, there are two approaches to account for such programmes. One is the **"Provision model"** approach wherein the expected cost to the company on the redemption event of the points awarded on sale transactions are factored as a cost, while recognising the entire revenue arising on sale. The second approach, fondly known as **"Deferment model"** states that a part of the revenue attributable to the awards credit must be deferred up to the redemption event, and the associated costs must be recognised when such deferred revenue is ultimately recognised. Though the usage of the provision model is more prevalent, the Ind AS framework tilts more towards the adoption of the Deferment model, rightfully because subsequent servicing of the awards credit is a separate "performance obligation" arising out of initial sale transaction, as stated in Ind AS 115. The Deferment model finds a heads-up even under AS-9.

The revenue to be attributed to awards credit on the initial sale transaction must be based on the fair value to the holder and not on the cost of servicing the redemption to the issuing entity. The fair value of such awards credits, notwithstanding the subjectivity involved, *inter-alia*, must be based on the expected

percentage of redemption. Para 53 of Ind AS 115 advocates two methods of estimating the variable consideration – 'Expected value method' and 'Most likely amount method'. The 'expected value method' considers the sum of probability-weighted amounts in a range of possible consideration amounts. This is the most appropriate method if the entity has a large number of B2C transactions with similar characteristics. 'The most likely amount' is the single most likely amount in a range of possible consideration amounts – the single most likely outcome of the contract. The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, the loyalty milestones will be met or not). This method is appropriate for high-value B2B transactions, and may not be preferred for voluminous e-commerce retail transactions. All said and done, accounting for loyalty programmes, thus, will have to consider data analytics in its ambit.



Some merchants also outsource their loyalty plan maintenance and redemption function to third parties, whose prime business line is to service these loyalty plans. These merchants thus have to bifurcate the cash received from their consumers partly towards consideration for sale of goods or services and partly towards the loyalty benefits granted to consumers. As the loyalty plan obligation is transferred in entirety to third parties, no revenue arising on account on the loyalty plan account is recognised by the entity. However, the consequent expense or income, as the case may be, on account of transfer of liability to third-party administrator is recognised in the books of entity, based on the contractual arrangement with such a third party.

Discount Vouchers

The marketing department of an e-commerce organised always has to be on its feet. Promotional strategies need to be chalked out and executed, without disappointing both consumers and the Finance Department! What e-commerce has also done is that it has brought innovation even to the discount schemes. Discount schemes unheard of in the traditional business-setups have found both prevalence and acceptance in the e-commerce environment.

A contextual question that births logically is that whether the discount coupons must be regarded as marketing expenses *(akin to the 'provision model' discussed above)* or should revenue be attributed to such coupons and be deferred *('deferment model')*. This discussion depends on the linkage of the discount scheme with existing or future sales. For the former, marketing expenses are recognised, while for the latter, revenue is attributed and deferred. The rule of thumb while using the deferment model is that underlying sales constitute two or more different transactions at two or more distinct points in time. For onerous discounts, where discounts exceed the cost of goods, provision is mandated. Under the Ind AS framework, the discounts accounted using the former approach may have to be shown as a deduction from revenue.

Cashbacks, to the extent of which the incidence of cost is borne by the entity, are similar to discount coupons with respect to their accounting.

Conclusion

It comes as an absolute no-brainer that e-commerce has brought with it eccentricities and unconventionalities of its own, and the accounting breed has to go beyond the letter of the transactions to understand its spirit. The need of identifying the substance over form has never been this humongous. It comes with its own set of challenges. The accountants must understand the business technicalities very well to render justice to their depiction in books of accounts.

There cannot be one "accounting cubicle" in an e-commerce organisation, since accountants have to remain omnipresent throughout the value-chain! The narration of the journal entry, thus, becomes as important as the debits and credits! ■

Success isn't just about what you accomplish in your life; it's about what you inspire others to do. - Unknown