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IMPACT OF IFRS ON REVENUE RECOGNITION: A CASE OF INDIA

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ABSTRACT

The globalization has brought a lot of changes in doing business across the world. Multinational companies are extending and establishing their business in various countries with emerging economies. The companies are entering into foreign markets to fulfill their capital needs by getting their securities listed on the stock exchanges outside the country. The use of different accounting frameworks in different countries creates confusion for users of financial statements resulting into inefficiency in capital markets across the world. The increasing complexity of business transactions and globalization of capital markets call the regulators, multi-national companies, auditing firm and investors to see the need for common standards in all areas of financial reporting to ensure integrity of different country's business together in the world market. Thus, the case for a single set of globally accepted accounting standards has prompted many countries to pursue convergence of national accounting standards with IFRS. More than 100 countries have converged or recognized the police of convergence with the IFRS. An upcoming economy on world economic map, India, too, decided to converge to International Financial Reporting Standards (IFRS). Revenue is one of the most important items in financial statements and that revenue recognition is one of the most difficult issues that standard-setters and accountants have to deal with. The paper examines the impact and implications of revenue recognition on financial reporting in different sectors. And also the difference between IFRS and AS on revenue recognition is highlighted.

KEYWORDS

Indian accounting standards (IAS), fair value, international financial reporting standards (IFRS), revenue recognition.

INTRODUCTION

A lot of change has taken place in doing business across world due to globalization. Multinational companies are extending and establishing their business in various countries with emerging economies. The companies are entering into foreign markets to fulfill their capital needs by getting their securities listed on the stock exchanges outside the country. The use of different accounting frameworks in different countries creates confusion for users of financial statements resulting into inefficiency in capital markets across the world.

These different circumstances have led to the use of a variety of definitions of the elements of financial statements: for example, assets, liabilities, equity, income and expenses. They have also resulted in the use of different criteria for the recognition of items in the financial statements and in a preference for different bases of measurement. The scopes of the financial statements and the disclosures made in them have also been affected.

However, the diversity of accounting standards among the nations of the world has been a problem for the globalization of the business environment. In India, the Accounting Standards Board (ASB) was constituted by the Institute of Chartered Accountants of India (ICAI) on 21st April 1977, which performs the function of formulating accounting standards. Generally, accepted accounting principles (GAAP) are diverse in nature but based on a few basic principles as advocated by all GAAP rules. These principles include consistency, relevance, reliability and comparability. Generally Accepted Accounting Principles (GAAP) ensures that all companies are on a level playing field and that the information they present is consistent, relevant, reliable and comparable. Thus, these moves by India will help in harmonizing its accounting standards with the internationally accepted accounting standards, which will lead to a globally accepted accounting system for the companies in India.

BENEFITS OF IFRS

1. BETTER ACCESS TO GLOBAL CAPITAL MARKETS

To meet the regulatory requirements of these markets, Indian Companies should report their financials as per IFRS. Thus adoption of IFRS not only helps Indian Firms in accessing global Capital Markets for funds but also accessibility of funds at cheaper cost.

2. EASIER GLOBAL COMPARABILITY

Firms are using IFRS to report their financial results. The comparison of the two firms have become easier with the adoption of IFRS by Indian Firms. Stakeholders including Investors, Bankers and Lenders also find it easy to compare the two financial statements following same reporting procedure. Indian companies in the process of raising funds from overseas capital markets have to provide financial results to interested parties. Since majority of Indian Firms are accessing European capital markets, preparation and presentation of financial statements on the basis of IFRS helps firms in getting easy accessibility to these capital markets.

3. EASY CROSS BORDER LISTING

Funds are required by the Indian Firms for their expansion plans which are not limited to the economic and political boundaries of India. Indian Firms are acquiring firms outside India also. They are also getting listed in European and American Capital Markets through raising funds from these markets. One of the major pre-requisites of getting listed on European Markets is preparation of Accounts as per IFRS requirements. Some Indian companies have started preparing their financial statements as per IFRS especially which have raised funds through the European Capital Markets.

4. BETTER QUALITY OF FINANCIAL REPORTING

The quality of financial reporting is expected to increase due to consistent application of Accounting Principles and improvement in reliability of financial statements. Among various latest trends-based concepts, IFRS follows a concept of fair value which can help Indian firms to reflect their true worth of Assets held in the financial statements.

5. ELIMINATION OF MULTIPLE REPORTING

The Adoption of IFRS has eliminated the problem of multiple financial reporting standards by these firms

In spite of these benefits, adoption of IFRS in India is not that easy and faces many challenges. Adoption of IFRS means a complete set of different reporting standards have to bring in. The awareness of these reporting standards should be created among the stakeholders like Firms, Banks, Stock Exchanges, and Commodity Exchanges etc. Professional Accountants are looked upon to ensure successful implementation of IFRS. It has been observed that India does not have enough number of fully trained professionals to carry out this task of adoption of IFRS in India.

LITERATURE REVIEW

Anderson and Yohn (2002) concluded through their research that more than any other issue, investors are more concerned about revenue recognition at the time of problems in a company's financial statement.

T Colwyn Jones and Robert Luther (2005) examined the possible impact on manufacturing companies drawing upon perceptions and expectations of managers in three Bavarian companies and two management consultancy firms and found out that, at this juncture in the development of their information systems, German managers face an important choice between integrating external and internal reporting in ways that might fundamentally change established Controlling practices, or of continuing to operate dual accounting systems in much the same way as in the past so that adoption of IFRS is restricted to external reporting.

Daske et al. (2008) examined the impact of mandatory IFRS adoption on cost of capital around the world, including EU countries and stated that first time mandatory adopters experience a modest decrease in the cost of capital. They observed that the capital market benefits of IFRS adoption are most pronounced for countries with strict enforcement regimes. Their effects are stronger for countries where local GAAP differs more from IFRS.

Karthik Ramanna and Ewa Sletten (2009) while studying the need for adopting IFRS taking 102 non- European Union Countries found out that a country is more likely to adopt IFRS if its trade partners or countries within in its geographical region are IFRS adopters. Also, more powerful countries are less likely to adopt IFRS, consistent with more powerful countries being less willing to surrender standard-setting authority to an international body.

Md Humayun, Fawzi and Md Ainul (2010) *examined the impact of the adoption of International Financial Reporting Standards (IFRS) on the accounts and the quality of earnings of New Zealand firms. Their analysis of IFRS adjustments revealed that total assets, total liabilities and net profit were significantly higher under IFRS than under pre-IFRS GAAP. Profit and equity under IFRS were increased by adjustments for goodwill and other intangibles and investment property, and decreased by adjustments for employee benefits and share-based payments.*

Cai, Francis and Hannal (2010) found out that capital markets of the countries that have adopted IFRS have high degree of integration among them after their IFRS adoption as compared to the period before the adoption.

Most of the previous studies on IFRS in India have addressed the issued related to the problems and challenges in the implementation of IFRS.

Kaushik datta (2009), Pawan Jain (2011), Srivastava, Anubha; Bhutani, Prerna, (2012) Mahender k. Sharma (2013), Gurpreet kaur and Amit kumar (2014), Meenu Sambaru and Dr. N. V. Kavitha (2014), Dr. Preeti shrivastava, D.S Rawat and Deepti Maheswari (2015). Have analyzed the information available on IFRS adoption process and the problems faced by the stakeholders (Regulators, Accountants, Firms etc.) in the process of adoption of IFRS in India and suggested that on effective Control & Enforcement Mechanism are required in order to ensure a high quality corporate financial reporting environment and creating an awareness is mandatory for successful implementation of IFRS in India.

Rakesh and Shilpa R (2013) found out that there is a significant relationship between IFRS adoption by companies and FDI in India and the adoption of standard accounting format will increase the level of confidence of global investors and investment analysts in the financial statements of companies in India. IFRS is an effective tool for enhancing the uniformity and comparability of financial statements of companies which have adopted it in India.

Besides, few research has been done on the impact of IFRS in the banking sector and not much has been done on revenue recognition. Azira Abdul Aziz (2012), examined the impact of IFRS on banking industry and stated that IFRS adoption leads to a reduction in income smoothing activities through loan loss provisions for IFRS adopters.

Firoz and Abdul Aziz Ansari (2011) critically analyzed the financial statements of the Indian Banking Industry and found out that implementation of IFRS has a great effect over advances, financial instruments and investments and banking industry needs more detailed analysis and valuation of existing advances and all other instruments in order to comply with IFRS.

Sankar Thappa (2012) studied the various phases of implementation of IFRS in India and suggested that challenges in the implementation of IFRS can be addressed by creating awareness on importance of compliance with accounting and auditing standards and by giving training to the staff.

OBJECTIVES OF THE STUDY

Revenue is one of the most important items in financial statements and that revenue recognition is one of the most difficult issues that standard-setters and accountants have to deal with. Following are the objectives of the study:

1. To highlight the difference between IFRS and AS on revenue recognition.
2. To examine the impact and implications of revenue recognition on financial reporting in different sectors.

DIFFERENCE BETWEEN AS9 AND IFRS 15

Revenue means gross inflow of cash, receivables or other consideration arising in the course of ordinary activities of an enterprise such as

- The sale of goods
- Rendering of the services
- Use of the enterprises resources by others yielding interest

Revenue manipulation is one of the most common ways of creative accounting. Enron and satyam are one of the recent examples. So the IFRS 15 on revenue recognition deals with when revenue should be recognize. However, the key difference between IFRS 15 and AS 9 are as follows:

- IFRS 15 Revenue from Contracts with Customers is a comprehensive standard that deals with revenue recognition. It has replaced AS 9 Revenue Recognition and AS 7 Construction Contracts.
- A five-step model with a single principle for recognizing revenue has been introduced that applies to all contracts under IFRS15.

This core principle is described in a five-step model framework:

Step 1: Identify the contract(s) with the customer

Step 2: Identify the separate performance obligations in the contract

Step 3: Determine the transaction price

Step 4: Allocate the transaction price to separate performance obligations

Step 5: Recognize revenue when (or as) each performance obligation is satisfied

1. Under AS 9 different recognition and measurement criteria for varying streams of revenue has been specified whereas under IRFS 15 Revenue Recognition requires revenue to be measured at the amount of consideration to which an entity expects to be entitled (rather than contractually specified) in exchange for transferring the promised goods or services.
2. The concept of variable consideration is introduced in IFRS 15. It takes various forms, including (but not limited to) volume discounts, price concessions, rebates, refunds, credits, incentives, performance bonuses and royalties. An entity's past business practices can cause consideration to be variable if there is a history of providing discounts or concessions after goods are sold whereas no guidance was there in AS 9 regarding this.
3. IFRS 15 requires that revenue should be recognized over time by measuring progress towards completion for recognizing revenue from service transactions. While an option was provided in AS 9 to use either the proportionate completion method or the completed service contract method for specified transactions

IMPACT ON AN ORGANISATION AND ON FINANCIAL REPORTING

IFRS 15's core principle is that an entity will recognize revenue when it transfers goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This will require entities to use more judgment and make more estimates than under current Indian GAAP. Unlike Indian GAAP, IFRS15 provides detailed guidance on the identification of separate performance obligations of a single transaction. It will be essential to apply the recognition criteria to the separate performance obligations of every transaction to reflect the substance of the transaction. Therefore, marketing strategies, such as free maintenance services for cars, loyalty points by hotels and supermarkets and free handsets by telecom operators, would need to be carefully evaluated to gauge their impact on revenue recognition. IFRS15 requires stand-alone selling prices to be determined for all of the identified performance obligations. Companies that do not currently estimate stand-alone selling prices will need to involve personnel beyond those in the accounting or finance departments. Personnel responsible for an entity's revenue recognition policies may need to consult with operating personnel involved in pricing decisions to determine estimated stand-alone selling prices, especially when there are limited or no observable input.

Contracts containing Multiple elements

Earlier in AS 9, revenue is measured by the charge made to customers or clients for goods supplied and services rendered and by the charges and rewards arising from the use of resources by them. But it sometimes becomes difficult to determine revenue for a contract that contains multiple elements such as sale of goods and rendering of services. IFRS 15 has come up with the fair value concept which states that the transaction price in such activities must be allocated to each separate performance obligation, so that revenue is recorded at the right time and in the right amount. Under Indian GAAP, an EAC opinion deals with accounting in the case of multiple element contracts in a limited way.

Control model

Control model in IFRS 15 has been introduced to determine the point of revenue recognition. Management has to determine, at contract inception, whether control of a good or service transfers to a customer over time or at a point in time or not. Arrangements where the performance obligations are satisfied over time are not limited to services arrangements. Complex assets or certain customized goods constructed for a customer, such as a complex refinery or specialized machinery, could also be transferred over time, depending on the terms of the arrangement. Revenue is said to be recognized over time if any of the following three criteria are satisfied:

- The customer all the while gets and devours the advantages provided by the substance's execution as the entity performs
- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced…
- The entity's performance does not create an asset with an alternative use to the entity…and the entity has an enforceable right to payment for performance completed to date

This model is very useful for the companies engaged in the business of construction or real estate.

- *Reduction in the volatility of revenue recognition*

IFRS 15 requires revenue to be recognized over time by measuring progress toward completion. However, the entities whose revenue and deferred revenue is based on the completed service contract under AS 9 will have a significant impact on their income statement. The volatility of the income statement of such entities will be streamlined by the application of IFRS 15, and the profit or loss for the period will better represent the efforts put in by the entities during the period.

IMPLICATIONS OF IFRS IN DIFFERENT SECTORS

The adoption of IFRS 15 will have a significant impact on different sectors in some way or the other while recognizing revenue. Some of the impact of revenue recognition in different sectors has been discussed below:

- **TELECOMMUNICATION SECTOR**

All indirect taxes ("gross inflow") form part of the revenue under as per IAS-9 whereas these taxes (being 'pass through receipts') will not form part of revenue under IFRS 15. In case of an operator if total revenue collected is Rs. 100 million which includes service tax of Rs. 10 million and trade discount and rebates of Rs. 1 million then for the purpose of IFRS 15 the fair value of revenue is Rs. 89 million. In AS-9 it would have been the total amount i.e 100 million. In this case, revenue recognition will decrease significantly because of the adoption of IFRS. There would be an adverse impact on profit, net worth, EPS, and enterprise value, inter alia, since this would be a permanent change. However, extent of impact will differ from case to case basis.

There is no requirement of any adjustment of discounting to revenue items under AS 9 whereas IFRS 15 requires adjustment of discounting if cash flows are deferred. Both the methods- completed service method and proportionate completion method can be used us a recognition criteria under AS 9 while under IFRS 15, percentage completion method is compulsory.

Even the customer activation fees will now be accounted for amortization over the expected duration of the customer relationship'. The telecom operators provide both hardware and software products or combination of any two or more than two. E.g.: mobile handsets along with (bundled) services, set up boxes, internet connections etc. IFRS 15 requires that fair value of each component should be determined for the purpose of revenue recognition. However, determining fair value of each component requires complex estimates. One may have to refer to prices of individual component on standalone basis adjusted for volume discounts. For this purpose, to arrive at the value of each component separately, it should have a standalone value to customer and its fair value should be determinable.

- **AIRLINES**

The aircrafts are normally acquired by long-term lease arrangements. Due to differential pricing adopted by airlines the velocity with which revue comes differ from time to time. Under IAS 18/IFRS 15, Airlines entities have to identify contract with the customer, identify the separate performance obligations, ascertain the transaction price and allocate the transactions price to separate performance obligations and then recognize the revenue of the performance. Changes in the air tickets, cancellation of air tickets, defer their travel or change their route causes the separate charges for each contract have a significant change in the revenue.

- **AUTOMOTIVE**

The automotive industry is a capital sensitive industry having a long supply chain. Huge cost is incurred on research and development to keep bringing out new models of vehicles and their agreement with suppliers are even complicated. In automotive industry, Revenue would be recognized when the vehicle is handed over to the customer because with the physical delivery the risk and regards is also transferred. While determine the revenue, the manufacturer should look into the terms of the contract carefully.

- **FAST MOVING CONSUMER GOODS**

The word fast moving consumer goods are those products that are sold quickly and at relatively low cost. They are manufactured, traded and they are goods with short shelf lives. Revenues are realized quickly but also led to pile up of inventories or losses. A lot of careful consideration and judgment is involved while recognizing revenue. Like, new product launches, product returns rebates and discounts, sales incentive, and taxes levied.

CONCLUSION

The adoption of IFRS not only helps Indian Firms in accessing global Capital Markets for funds but also accessibility of funds at cheaper cost and has made the comparison of the two firms easier. Moreover, IFRS follows a concept of fair value which can help Indian firms to reflect their true worth of Assets held in the financial statements. The above discussion shows that revenue recognition is one of the most common ways of creative accounting and therefore revenue should be recognized carefully. IFRS15 provides detailed guidance on the identification of separate performance obligations of a single transaction. It will be essential to apply the recognition criteria to the separate performance obligations of every transaction to reflect the substance of the transaction. A five-step model with a single principle for recognizing revenue has been introduced that applies to all contracts under IFRS 15. The implementation of IFRS have the major impact on the revenue of the firms. However, the extent differs from sector to sector and from time to time.

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