

Unit-2 Determination of Business Income

Meaning of Revenue and 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. Revenue is typically recognized when a critical event has occurred, when a product or service has been delivered to a customer, and the dollar amount is easily measurable to the company.

Revenue is at the heart of all business performance. 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.

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.

There are five steps needed to satisfy the updated revenue recognition principle:

- Identify the contract with the customer. This involves agreeing on the terms of the contract, including payment, the delivery of goods and services, and consequences if any obligations aren't met. Contracts may come in written form or may begin as verbal agreements.
- Identify contractual performance obligations. In this case, it's important to outline the specific goods or services behind the agreement.
- Determine the amount of consideration/price for the transaction. This isn't just about the price of goods and services but also includes other factors, such as discounts, return policies, and additional fees.
- Allocate the determined amount of consideration/price to the contractual obligations. This step involves any specific selling price to every single obligation.
- Recognize revenue when the performing party satisfies the performance obligation. This should only be done once the transaction is complete and your obligation is fulfilled. Revenue can only be recognized once this is done.

Inventory Valuation (IND AS 2)

Objective of IND AS 2

The objective of IND AS 2 is to provide guidance on the determination of the cost of inventory and its subsequent recognition as an expense in the income statement. This standard aims to ensure that inventories are valued correctly and reported in a consistent and appropriate manner in the financial statements of companies following the Indian Accounting Standards. Additionally, IND AS 2 provides guidance on the measurement of inventory at the lower of cost or net realizable value and the treatment of write-downs and reversals. By following the provisions of IND AS 2, entities can ensure that their inventory is valued accurately, providing users of the financial statements with reliable and relevant information. Scope of IND AS 2: The scope of IND AS 2 applies to all inventories, including raw materials, work-in-progress, finished goods, and goods held for resale. The standard also applies to entities that prepare their financial statements in accordance with the Indian Accounting Standards (Ind AS). However, IND AS 2 does not apply to the following types of inventories

1. Work in progress arising under construction contracts, including directly related service contracts (Ind AS 11, Construction Contracts)
2. Financial instruments (Ind AS 39, Financial Instruments: Recognition and Measurement and Ind AS 32, Financial Instruments: Presentation)
3. Biological assets (i.e., living animals or plants) related to agricultural activity and agricultural produce at the point of harvest (Ind AS 41, Agriculture 1)

The standard provides guidance on the measurement and recognition of inventory, including the determination of cost, the treatment of write-downs, and the disclosure requirements for inventory in the financial statements. This Standard does not apply to the measurement of inventories held by:

(a) producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at net realisable value in accordance with well-established practices in those industries. When such inventories are measured at net realisable value, changes in that value are recognised in profit or loss in the period of the change.

(b) commodity broker-traders who measure their inventories at fair value less costs to sell. When such inventories are measured at fair value less costs to sell, changes in fair value less costs to sell are recognised in profit or loss in the period of the change.

Key Provisions of IND AS 2

The key provisions of IND AS 2 include:

1. Measurement of inventories: IND AS 2 requires entities to measure inventories at the lower of cost and net realizable value. Cost includes all costs of purchase, costs of conversion, and other costs incurred to bring the inventories to their present location and Net realizable value is the estimated selling price in the ordinary course of business, less estimated costs of completion and estimated costs necessary to make the sale.
2. Write-downs and reversals: When the net realizable value of inventories falls below their cost, the standard requires entities to recognize a write-down in the income statement. When the circumstances that previously caused the write-down no longer exist, the standard allows entities to reverse the write-down.
3. Methods of inventory valuation: IND AS 2 allows entities to use any one of the following methods to value their inventory: First-In, First-Out (FIFO), Last-In, First-Out (LIFO), or Weighted Average Cost (WAC). The choice of method should be applied consistently and disclosed in the financial statements.
4. Disclosure requirements: IND AS 2 requires entities to disclose the accounting policies adopted for the valuation of inventory, the carrying amount of inventories classified into appropriate categories, the amount of any write-down of inventories recognized as an expense in the income statement, the amount of any reversal of a write-down of inventories, and the carrying amount of inventories pledged as security for liabilities.

Methods of Inventory Valuation

IND AS 2 provides three methods for the valuation of inventory, which are:

1. First-In, First-Out (FIFO): Under this method, the first inventory purchased or produced is considered the first to be sold. The cost of the oldest inventory is matched with the revenue earned from the sale of the oldest inventory. This method assumes that the

inventory that remains at the end of the period is the most recent inventory and reflects current market prices.

2. Last-In, First-Out (LIFO): Under this method, the most recent inventory purchased or produced is considered the first to be sold. The cost of the newest inventory is matched with the revenue earned from the sale of the newest inventory. This method assumes that the inventory that remains at the end of the period is the oldest inventory and reflects the historical cost.
3. Weighted Average Cost (WAC): Under this method, the cost of inventory is calculated as the weighted average of the cost of all units of inventory available for sale during the period. The weighted average cost is calculated by dividing the total cost of inventory available for sale by the total number of units of inventory available for sale.

The choice of inventory valuation method depends on various factors such as the nature of the business, the type of inventory, and the market conditions. However, the selected method should be applied consistently and disclosed in the financial statements. The consistency of the inventory valuation method enables users of the financial statements to compare the financial performance of the entity across different periods.

Recognition as an expense:

As per Para 34 of IND AS 2, when inventories are sold, the carrying amount of those inventories shall be recognised as an expense in the period in which the related revenue is recognised. The amount of any write-down of inventories to net realisable value and all losses of inventories shall be recognised as an expense in the period the write-down or loss occurs. The amount of any reversal of any write-down of inventories, arising from an increase in net realisable value, shall be recognised as a reduction in the amount of inventories recognised as an expense in the period in which the reversal occurs. As per Para 35 of IND AS 2, Some inventories may be allocated to other asset accounts, for example, inventory used as a component of self-constructed property, plant or equipment. Inventories allocated to another asset in this way are recognised as an expense during the useful life of that asset.

Disclosure Requirements:

IND AS 2 requires entities to disclose the following information in the financial statements:

1. Accounting policies: Entities should disclose the accounting policies adopted for the measurement of inventory, including the method of inventory valuation used (FIFO, LIFO, and WAC), the cost formula used, and any change in the accounting policies.
2. Carrying amount: The carrying amount of inventory should be disclosed, classified into appropriate categories such as raw materials, work-in-progress, finished goods, and goods held for resale.
3. Write-down of inventories: The amount of any write-down of inventory that is recognized as an expense in the income statement should be.
4. Reversal of write-down of inventories: The amount of any reversal of a write-down of inventory that is recognized as a reduction in the cost of sales should be disclosed.
5. Carrying amount of inventories pledged as security: The carrying amount of inventory that is pledged as security for liabilities should be.
6. Net realizable value: The basis used for determining the net realizable value of inventory and the amount of any write-down to net realizable value should be disclosed.

The disclosure requirements of IND AS 2 aim to provide users of financial statements with relevant and reliable information about the entity's inventory, enabling them to make informed decisions. By providing complete and transparent disclosures, entities can improve the transparency and comparability of their financial statements.

Conclusion:

IND AS 2 plays an essential role in the financial reporting of inventory for companies following the Indian Accounting Standards. It provides guidance on the measurement and valuation of inventory and requires entities to disclose relevant information in their financial statements. Entities should ensure that they comply with the provisions of the standard and provide sufficient disclosure to enable users to understand the impact of inventory on the financial statements.

Accounting Concept of Depreciation

Depreciation is an accounting practice used to spread the cost of a tangible or physical asset over its useful life. Depreciation represents how much of the asset's value has been used up in any given time period. Companies depreciate assets for both tax and accounting purposes and has several different methods to choose from.

In accounting terms, depreciation is considered a non-cash charge because it doesn't represent an actual cash outflow. The entire cash outlay might be paid initially when an asset is purchased, but the expense is recorded incrementally for financial reporting purposes. That's because assets provide a benefit to the company over an extended period of time. But the depreciation charges still reduce a company's earnings, which is helpful for tax purposes.

The matching principle under generally accepted accounting principles (GAAP) is an accrual accounting concept that dictates that expenses must be matched to the same period in which the related revenue is generated. Depreciation helps to tie the cost of an asset with the benefit of its use over time. In other words, the incremental expense associated with using up the asset is also recorded for the asset that is put to use each year and generates revenue. The total amount depreciated each year, which is represented as a percentage, is called the depreciation rate.

Types of Depreciation

There are a number of methods that accountants can use to depreciate capital assets. They include straight-line, declining balance, double-declining balance, sum-of-the-years' digits, and unit of production. We've highlighted some of the basic principles of each method below, along with examples to show how they're calculated.

Straight-Line: The straight-line method is the most basic way to record depreciation. It reports an equal depreciation expense each year throughout the entire useful life of the asset until the asset is depreciated down to its salvage value.

Let's assume that a company buys a machine at a cost of Rs.5,000. The company decides that the machine has a useful life of five years and a salvage value of Rs.1,000. Based on these assumptions, the depreciable amount is Rs.4,000 (Rs.5,000 cost - Rs.1,000 salvage value).

The annual depreciation using the straight-line method is calculated by dividing the depreciable amount by the total number of years. In this case, it comes to Rs.800 per year (Rs.4,000 / 5 years). This results in an annual depreciation rate of 20% (Rs.800 / Rs.4,000).

Declining Balance: The declining balance method is an accelerated depreciation method that begins with the asset's book, rather than salvage, value. Because an asset's carrying value is higher in earlier years (before it has begun to be depreciated), the same percentage causes a larger depreciation expense amount in earlier years, then declines each year thereafter. This is the formula:

Declining Balance Depreciation = Book Value x (1/Useful Life)

Using the straight-line example above, the machine costs Rs.5,000 and has a useful life of five years. In year one, depreciation would be Rs.1,000 (Rs.5,000 x 1/5 =Rs.1,000).

In year two it would be (Rs.5,000-Rs.1,000) x 1/5, or Rs.800. In year three, (Rs.5,000-Rs.1,000-Rs.800) x 1/5, or Rs.640, and so forth.

Depreciation allows businesses to spread the cost of physical assets over a period of time, which can have advantages from both an accounting and tax perspective. Businesses also have a variety of depreciation methods to choose from, allowing them to pick the one that works best for their purposes.

Provision for Depreciation

A provision for depreciation account is an improvement over the accounting treatment of depreciation. This account is used to accumulate depreciation that is provided against a fixed asset.

Entries in Provision for Depreciation Account

If a provision for depreciation account is used, the accounting entries are made as follows:

Entry 1

One provision for depreciation account is opened for every fixed asset account. For example, for a motor vehicle account, a "provision for depreciation on motor vehicle account" will also be opened.

Similarly, for plant and machinery, there will be a "plant and machinery account" and also one "provision for depreciation on plant and machinery account".

Entry 2

At the end of each financial year, debit the depreciation expense account and credit the provision for depreciation (on relevant fixed asset account) with the amount of depreciation calculated for the year.

Debit the depreciation expense account

Credit the provision for depreciation on the relevant fixed asset

Entry 3

The balance in depreciation expense account is transferred to the profit and loss account at the end of the year.

Entry 4

The balance of the provision for depreciation account is carried forward to the next year.

Note that the provision on depreciation account is not a nominal account, it is a part of the asset account. Also note that it will always show a credit balance that will increase each year.

At any given time, the balance on a provision for depreciation account represents the total accumulated depreciation that has been provided against a particular asset.

Entry 5

No entry relating to depreciation is made in a fixed asset account. This account will continue to show a debit equal to the cost of the fixed asset concerned.

The only entries that will be made in the fixed asset account will be in respect of fresh purchases or sales of the asset concerned.

Entry 6

The formula for the book value of a fixed asset is the following:

Book value = Cost (per fixed asset account) - Accumulated depreciation (per provision for depreciation account)

Entry 7

Although one depreciation account is enough to accommodate the depreciation expense on all fixed assets for the year, a separate provision for the depreciation account must be maintained for each fixed asset account.

Entry 8

If a fixed asset is recorded using the revaluation approach for calculating depreciation, it is usually not necessary (or beneficial) to maintain a separate provision for depreciation account for it.

For such assets, the treatment shown on the revaluation method is sufficient (i.e., depreciation may be directly credited to the fixed asset account).

Adjustment and Rectification Entries

When an error is made in the books of accounts, it should be fixed so that the financial statements display the proper amounts. If the issue is discovered quickly, it can be corrected by removing the incorrect entry and replacing it with the proper one. If the error is discovered later, the rectification should be done by submitting a proper journal entry; such entries used to rectify an accounting error are known as rectification entries.

What is Error Rectification?

Rectification of errors is the process of correcting errors in entries. These errors can be of two types: errors made on both sides of an entry that have no effect on the trial balance and can be corrected with a journal entry.

Another example is an error that occurs on one side of the trial balance and disrupts the trial balance, which cannot be rectified by simply forwarding journal entries but may be corrected by forming a suspense account. To comprehend error repair, it is necessary to first grasp the types of errors. The many types of errors are explained in detail below.

Types of Accounting Error

Accounting errors come in many forms, and some of the more prevalent are described here.

- Original Entry Error: When the incorrect amount is submitted to an account, this is referred to as an error of original entry. The error in posting the incorrect amount would likewise be reflected in any of the other accounts associated with the transaction. In other words, all of the accounts would be in balance except for the incorrect numbers.
- Duplication Error: When the accounting entry is being duplicated, that means it is either debited or credited twice for the same entry. Let us take an example, if a cost was debited two times for the same amount, it is considered as a duplication error.
- Omission Error: An omission error occurs when you neglect to record a transaction in the books. Omission errors are difficult to detect. One approach to detect them is to check your trial balance to see if your credits equal your debits. You may have typed a credit but not a debit for a transaction. Regular bank reconciliations will also assist you in double-checking the correctness of your records. It is preferable to be proactive and have a system in place to enter each transaction. When a corporation utilises petty cash to pay for expenditures, errors of omission are more likely to occur. Keep your receipts and documents, and schedule a weekly data entry time.

Errors of Principle

Principle Error occurs when a transaction wrongly applies an accounting concept. Principle errors do not conform to commonly recognised accounting standards (GAAP). It's sometimes referred to as a "input error" since, while the number is valid, it's stored in the incorrect account. Personal spending, for example, is mistakenly represented as corporate expenses in the books.

Compensating Error

When one error is balanced by an offsetting entry that is likewise wrong, this is referred to as compensating error. For example, if an incorrect quantity is recorded in inventory, it is balanced off by an incorrect amount being recorded in accounts payable to pay for that inventory.