Reporting revenue right

Changes to accounting rules will ensure that the public will get a true picture of a company’s health

By CS Choong and John N Williams

N December 2002, an amendment was passed by the Companies Accounting Standards Board (CASB) empowering section 20A (1) of the Companies Act. This amendment requires that the accounting standard applicable to companies be adopted from International Accounting Standards (IAS 18 Revenue (Revised 1993) as now known as the Financial Reporting Standard (FRS 18) Revenue. This change legally requires Singapore companies to follow FRS 18 Revenue and IAS 18 Revenue, which also makes them consistent with the new standards now prevailing in the UK. These new standards determine what an account should do in the following examples:

Consider the management of a company, faced with the task of preparing a financial statement to report how much revenue the company has earned. Suppose that the following events have already occurred:

**Time 1**: The company signs a contract to sell 100 bananas to a buyer, B, for $100,000 in exchange for 500 shares of banana. The company gives 30 bananas for 30 days.

**Time 2**: The company delivers 80 bananas to banana. ItSuppose that at this point in time, it is probable, in the light of information available to the company, that it will receive the $100,000 from the buyer. Note, however, that this is not necessarily the same as reporting revenue in the financial statement.

But now suppose that two further events occur:

**Time 3**: The date expires.

**Time 4**: It pays $80,000. So the company has earned $80,000.

Suppose that at this point in time, it has not paid the full $100,000 yet or after the due date. In the absence of any relevant information that it will not be able to collect or to pay the overdue amount of $12,000, this amount of $12,000 is material to how much revenue the company should report in its financial statements.

Suppose that at this point in time, it is probable that the company will receive the $12,000. This would be reported as a receivable in the financial statements.

The management should then, in accordance with the new revenue standard, adjust this amount by deducting the unrealised revenue of $12,000.

The management must then report the new receivable to sales of $80,000. If not, it would disclose the outstanding and overdue $12,000 as a loan or note in the financial statements.

This is what the management should do if it is to follow IAS 18 Revenue and FRS 18 Revenue.

**Artificial inflation**

To report the $12,000 as revenue would be premature. Moreover, it would artificially inflate the paper profits of the company, thus giving a misleading picture of that company to its stakeholders.

In other words, the management is legally required to refrain from recognising revenue from sales that are not received on or after the due date and before the date of finalising the accounts.

But companies do not always do what is legally required of them. One source of misunderstanding is a failure to grasp the meaning of paragraph 14 of IAS 18 Revenue (Revised 1993).

This says that revenue from the sale of goods or services may only be recognised when all of the following conditions have been satisfied:

(a) The enterprise has transferred to the buyer the significant risks and rewards of ownership of the goods.
(b) The enterprise has no continuing involvement with the goods, unless control over the goods sold is negligible.
(c) The enterprise operates either in the capacity of an agent or principal in the transaction at the time the transaction is carried out.
(d) The transaction is properly accounted for in the financial statements.
(e) The amount of revenue can be measured reliably.
(f) It is probable that the economic benefits associated with the transaction will flow to the enterprise, and
(g) The costs incurred or to be incurred in respect of the transaction can be measured reliably.

The crucial condition here is (d).

What does mean is to say that the condition has been satisfied? One answer is that the probability of economic benefits flowing from the sale of goods is $12,000, and is no less than the probability of the management being satisfied that that condition has been satisfied.

One might ask whether it is possible to distinguish between being satisfied that condition (d) exists and being satisfied that condition (d) is unlikely to exist. Or, put it another way, since the probability that the economic benefits will flow to the enterprise is no more than the probability that the management is satisfied that condition (d) exists. But this is not enough to satisfy the management.

A second answer is that the probability of flowing of economic benefits from the sale of goods is $12,000, and in other words, since the probability of payment is nothing more than the degree to which the buyer is willing and able to pay, then to fail to flow it is to fail to measure the ability to pay.

In short, the cost is on the buyer to discharge his obligation to pay. This can only be done by actual payment, including the receipt of money in the form of credit terms being made in a contract.

But clearly it is the second and not the first answer that is correct.

**Event of lightning strikes**

For the management was satisfied with the buyer’s new willingness to pay then it should recognise revenue from the sale even if the buyer never pays. The buyer may be willing and able to pay today, yet get struck by lightning tomorrow. In that case, the first answer tells us to recognise revenue for reporting from the sale, despite the fact that the revenue will never be received.

What prompts us to confuse the correct answer with the incorrect one is to fail to distinguish between being satisfied that condition (d) exists and being satisfied that condition (d) is unlikely to exist. Or, put it another way, since the probability that the economic benefits will flow to the enterprise is no more than the probability that the management is satisfied that condition (d) exists.

The conclusion is that it is better to distinguish between being satisfied that condition (d) exists and being satisfied that condition (d) is unlikely to exist.

Clearly a condition must be established before it can be satisfied, to say that it has been established does not mean that it has already been satisfied.

It is crucial to note that the amendment to the Companies Act requires compliance with FRS 18 Revenue, in particular the satisfaction of paragraph 13, as opposed to its mere establishment.

This eventuality is similarly, the giving of a cash discount by a company to its UK and the recent scandal involving Parmalat that some have called Europe’s Enron.

We would not want to see similar scandals in Singapore, our future generation.

An artificial “profit” — merely accruals revenue or very that may never be recovered — is of course a cause of worry, not merely an aggravating factor. Does the general practice of declaring non-existent profits to the public increase the general likelihood of bankruptcy and economic crisis?

Moreover, the main reason that it is difficult to answer such questions is that given the current practices of declaring unrealised revenue, it is impossible to know how much money companies have really earned.

However, the new standards require that declaring accruals revenue must ultimately lie in the discretion of a company. Ultimately it must pay its way with money, or something that is an asset. The temporary, artificial accruals revenue on a balance sheet cannot ultimately be turned into money.

Singapore companies are legally bound by statute to satisfy, not merely establish, condition (d) of paragraph 13 of FRS 18 Revenue in Singapore. Doing so ensures that the true picture of the economic health of a company is disclosed to the public. It will also assure companies that they will remain on the right side of the law.

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