

Incorrect revenue recognition policy of a contract

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Introduction

Company recognizes revenue under the categories of supply sale, Installation sale, and transport income. But company has been following incorrect revenue recognition policy for material value of the job. Company recognized total material value of the job as a revenue before commencement of the job. Due to the fact that materials are subject to further installation process, it is a violation of LKAS 18. There are some sub issues also attached with this issue. They are,

- Company does not concern the Materials which are already sent to the work place (customer) and still not utilized.
- Cut-off of the revenue shown in financial statements is incorrect.

Discussion of Issue

When the material (granite) sending to the site (work place) from factory company recognize supply sale revenue by adding profit margin to the cost of granite. After transporting material (granite) to site company recognize transport income. Installation revenue recognize after the job complete or after the completion of a stage of the job. Installation revenue represents around 40% of revenue from particular job.

Company recognize the supply sale revenue when material sending to the particular site. But the job they have undertaken is not yet fully completed or a stage completed

by at that time. Issue is company already recognize part of the revenue (supply Sale) before the job or a stage of job completed.

Conclusions& Recommendations

Before the fully finished or stage finished company recognize part of revenue. Risks and rewards attached with materials still retaining with the company due to that materials are subject to further installation process. Due to this issue Companies revenue overstated and financial position & financial performance of the company represent in wrong figures. So revenue recognition of company not complies with LKAS 18 Revenue.

According to LKAS 18 Revenue paragraph 16 (c),

"When the goods are shipped subject to the installation and installation is a significant part of the contract which has not yet been completed by the entity."

This is a situation where company retains significant risks & Rewards of the contract. So then Recommendation is recognize supply sale after the risks and rewards transferred to the customer. When the job company have undertaken is going long period subject to installation recognize revenue according to the Stage of completion which is described in LKAS 18 Revenue ,LKAS 11 Construction Contracts

Issue creates another 2 sub issues

Sub Issue 01 - Company did not concern about Goods in Transit (inventory).

At the beginning of the job company decreased its inventory (increasing cost of sales) and increased its revenue. Issue is

Company not utilized all materials at once which were issued from the factory to the work place at the beginning of the job. But the company have taken that all material as cost of sales when recognizing the supply sale revenue. Implication is Underestimate the inventory value of the company, Recommendation is Company should recognize goods in transit (inventory) for the materials which are not yet utilized at the work place.

Sub Issue 02 - Company overstated its Revenue at the Cut-Off.

At the cut-off company by sending more material (granite) to several work places overstated its revenue at the cut-off significantly by Using Company's present revenue Policy. Recommendation is revenue should be recognize by reference to the stage of completion of the contract accordance with IAS 18 & IAS 11 and Cut-off of the revenue should be presented by considering stage of completion of the job