Ind AS
Case Study

Revenue Recognition:

Measurement of Refund Liability under Ind AS 115

Standards required:

12	Income Taxes
115	Revenue from Contracts with Customers

CASE STUDY

Revenue recognition: Measurement of Refund Liability under Ind AS 115

Learning outcome

This Case Study aims to describe how an entity determines the amount of consideration to which it expects to be entitled, when it transfers control of a product to a customer and also grants the customer the right to return the product within a specified period of time. It also considers the requirements on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration can be included in transaction price. Lastly, the treatment of right to recover products from customers on settling the refund liability has also been discussed.

Introduction

In regard to the goods, the core principle of Ind AS 115 is that an entity shall recognise revenue to depict the transfer of promised goods to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods.

In some contracts, an entity may sell goods to a customer against cash and also grants the customer the right to return the goods within a specified period and receive a full refund of any consideration paid. In such a case, the entity shall recognise a refund liability which is measured at the amount of consideration received for which the entity does not expect to be entitled. At the same time, an asset is recognised for right to recover products which is measured by reference to the former carrying amount of the product, eg, inventory. Therefore, an entity shall recognise the following –

- revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (ie, excluding revenue from the products expected to be returned);
- a refund liability (and a corresponding adjustment to revenue); and
- a right to recover products (and a corresponding adjustment to cost of sales); and
- deferred tax adjustments as per Ind AS 12 *Income Taxes.*

This Case Study relates to 2 Standards, namely –

1. Ind AS 115 *Revenue from Contracts with Customers*; and
2. Ind AS 12 *Income Taxes*

Case Study Example

KMC Ltd (year-end 31 March) is in a business where the custom of trade is that products are sold to customers in cash and unsold products can be returned within 90 days against full refund. For KMC Ltd, the costs of recovering the returned products are immaterial and they can be resold at the prevailing market prices.

In 20x1-x2, KMC Ltd sold 100 products @ CU 100 each. The cost of each product is CU 70. During the end of 20x1-x2, it is estimated that 3 products will be returned.

In 20x2-x3, none of the products sold out in 20x1-x2 were returned. KMC Ltd sold 120 products @ CU 120 each. The cost of each product is CU 75. During the end of 20x2-x3, it is estimated that 5 products will be returned.

In 20x3-x4, all the 5 products sold out in 20x2-x3 (which were anticipated to be returned) were returned. KMC Ltd sold 125 products @ CU 130 each (including the 5 returned products). The cost of each product (excluding the returned products) is CU 80. During the end of 20x3-x4, it is estimated that 7 products (other than 5 returned products) will be returned. The income tax rate is 40%.

KMC Ltd

Balance Sheet (Extract)

	NOTES	20x1-x2	20x2-x3	20x3-x4
Assets		**CU**	**CU**	**CU**
Non-current asset				
Deferred tax asset	**8**	36	90	140
Current assets				
Right to recover products [a]	**5**	210	375	560
Equity and Liabilities				
Current liabilities				
Refund liability [a]	**4**	300	600	910

[a] *Right to recover products is presented separately from refund liability (paragraph B 25 of Ind AS 115).*

Statement of Profit and Loss (Extract)

	NOTES	20x1-x2	20x2-x3	20x3-x4
		CU	**CU**	**CU**
Revenue	**2**	9,700	14,100	15,340
Cost of sales	**3**	6,790	8,835	9,415
Accounting profit		**2,910**	**5,265**	**5,925**
Tax Expense	**9**	1,164	2,106	2,370
Profit for the period		**1,746**	**3,159**	**3,555**

NOTES

(1) Journal

20x1-x2

o Cash (100 x CU 100)	10,000	
Revenue		10,000
o Cost of sales (100 x CU 70)	7,000	
Inventory		7,000
o Revenue	300	
Refund liability (3 x CU 100)		300
o Right to recover products (3 x CU 70)	210	
Cost of sales		210
o Revenue (CU 10,000 – CU 300)	9,700	
Profit or loss		9,700
o Profit or loss	6,790	
Cost of sales (CU 7,000 – CU 210)		6,790
o Deferred tax asset [1]	36	
Deferred tax income		36
o Deferred tax income	36	
Tax expense		36
o Tax expense	1,200	
Current tax expense		1,200
o Profit or loss	1,164	
Tax expense		1,164

20x2-x3

o Cash (120 x CU 120)	14,400	
Revenue		14,400
o Refund liability (3 x CU 100)	300	
Revenue		300
o Revenue (5 x CU 120)	600	
Refund liability		600
o Cost of sales (120 x CU 75)	9,000	
Inventory		9,000
o Cost of sales (3 x CU 70)	210	
Right to recover products		210
o Right to recover products (5 x CU 75)	375	
Cost of sales		375
o Revenue CU (14,400 + 300 – 600)	14,100	
Profit or loss		14,100
o Profit or loss	8,835	

	Cost of sales CU (9,000 + 210 – 375)		8,835

o Tax expense	36	
Deferred tax asset		36
o Deferred tax asset [1]	90	
Deferred tax income		90
o Deferred tax income	90	
Tax expense		90
o Tax expense	2,160	
Current tax expense		2,160
o Profit or loss	2,106	
Tax expense		2,106

20x3-x4

o Cash (125 x CU 130)	16,250	
Revenue		16,250
o Refund liability (5 x CU 120)	600	
Cash		600
o Revenue (7 x CU 130)	910	
Refund liability		910
o Inventory (5 x CU 75)	375	
Right to recover products		375
o Cost of sales [(120 x CU 80) + (5 x CU 75)]	9,975	
Inventory		9,975
o Right to recover products (7 x CU 80)	560	
Cost of sales		560
o Revenue (CU 16,250 – CU 910)	15,340	
Profit or loss		15,340
o Profit or loss	9,415	
Cost of sales (CU 9,975 – CU 560)		9,415
o Tax expense	90	
Deferred tax asset		90
o Deferred tax asset [1]	140	
Deferred tax income		140
o Deferred tax income	140	
Tax expense		140
o Tax expense	2,420	
Current tax expense		2,420
o Profit or loss	2,370	
Tax expense		2,370

[1] Since the entire amount of refund liability has already been taxed in the form of revenue, the tax base of refund liability is *nil.*

A deductible temporary difference arises in profit or loss, and results on a deferred tax asset, when the carrying amount of refund liability exceeds its tax base. The amount of deferred tax asset is –

(Carrying amount – Tax base) x Income tax rate

20x1-x2 (CU 300 – 0) x 40% = CU 120

20x2-x3 (CU 600 – 0) x 40% = CU 240

20x3-x4 (CU 910 – 0) x 40% = CU 364

The tax base of right to recover products is nil, since the entire amount has been deducted for tax purposes in the form of cost of sales.

A taxable temporary difference arises in profit or loss, and results in a deferred tax liability, when the carrying amount of right to recover products exceeds its tax base. The amount of deferred tax liability is:

(Carrying amount – Tax base) x Income tax rate

20x1-x2 (CU 210 – 0) x 40% = CU 84

20x2-x3 (CU 375 – 0) x 40% = CU 150

20x3-x4 (CU 560 – 0) x 40% = CU 224

If we set off deferred tax liability from deferred tax asset, the net deferred tax asset is –

20x1-x2 CU 120 – CU 84 = CU 36

20x2-x3 CU 240 – CU 150 = CU 90

20x3-x4 CU 364 – CU 224 = CU 140

(2) Revenue

Date	Heads of Account	Dr	Cr	Balance
20x2				
Mar 31	Cash		10,000	10,000
	Refund liability	300		9,700
	Profit or loss	9,700		–
20x3				
Mar 31	Cash		14,400	14,400
	Refund liability	600	300	14,100
	Profit or loss	14,100		–
20x4				
Mar 31	Cash		16,250	16,250
	Refund liability	910		15,340
	Profit or loss	15,340		–

(3) Cost of Sales

Date	Heads of Account	Dr	Cr	Balance
20x2				
Mar 31	Inventory	7,000		7,000
	Right to recover products		210	6,790
	Profit or loss		6,790	–
20x3				
Mar 31	Inventory	9,000		9,000
	Right to recover products	210	375	8,835
	Profit or loss		8,835	–
20x4				
Mar 31	Inventory	9,975		9,975
	Right to recover products		560	9,415
	Profit or loss		9,415	–

(4) Refund Liability

Date	Heads of Account	Dr	Cr	Balance
20x2				
Mar 31	Revenue		300	300
20x3				
Mar 31	Revenue	300	600	600
20x4				
Mar 31	Cash	600		–
	Revenue		910	910

An entity shall update the measurement of the refund liability at the end of each reporting period for changes in expectations about the amount of refunds. An entity shall recognise corresponding adjustments as revenue (or reductions of revenue) ***[Refer paragraph B 24 of Ind AS 115].***

(5) Right to Recover Products

Date	Heads of Account	Dr	Cr	Balance
20x2				
Mar 31	Cost of sales	210		210
20x3				
Mar 31	Cost of sales	375	210	375
20x4				
Mar 31	Inventory		375	–
	Cost of sales	560		560

An asset recognised for an entity's right to recover products from a customer on settling a refund liability shall initially be measured by reference to the former carrying amount of the product (eg, inventory) *less* any expected costs to recover those products (including potential decreases in the value to the entity of returned products). At the end of each reporting period, an entity shall update the measurement of the asset arising from changes in expectations about products to be returned ***[Refer paragraph B 25 of Ind AS 115].***

(6) Current Tax Expense

	20x1-x2	20x2-x3	20x3-x4
Revenue (CU)	10,000 (100 x CU 100)	14,400 (120 x CU 120)	15,650 [(120 x CU 130) + {5 x (CU 130 – CU 120)}]
Cost of sales (CU)	7,000 (100 x CU 70)	9,000 (120 x CU 75)	9,600 (120 x CU 80)
Taxable profit(CU)	3,000	5,400	6,050
Current tax at 40%	**CU 1,200**	**CU 2,160**	**CU 2,420**

(7) Deferred Tax Income

Date	Heads of Account	Dr	Cr	Balance
20x2				
Mar 31	Deferred tax asset		36	36
	Tax expense	36		–
20x3				
Mar 31	Deferred tax asset		90	90
	Tax expense	90		–
20x4				
Mar 31	Deferred tax asset		140	140
	Tax Expense	140		–

(8) Deferred Tax Asset

Date	Heads of Account	Dr	Cr	Balance
20x2				
Mar 31	Deferred tax income	36		36
20x3				
Mar 31	Tax expense		36	–
	Deferred tax income	90		90
20x4				
Mar 31	Tax expense		90	–
	Deferred tax income	140		140

(9) Tax Expense

Date	Heads of Account	NOTES	Dr	Cr	Balance
20x2					
Mar 31	Current tax expense	**6**	1,200		1,200
	Deferred tax income	**7**		36	1,164
	Profit or loss			1,164	–
20x3					
Mar 31	Current tax expense	**6**	2,160		2,160
	Deferred tax income	**7**		90	2,070
	Deferred tax asset	**8**	36		2,106
	Profit or loss			2,106	–
20x4					
Mar 31	Current tax expense	**6**	2,420		2,420
	Deferred tax income	**7**		140	2,280
	Deferred tax asset	**8**	90		2,370
	Profit or loss			2,370	–

Conclusion

Any consideration received from the sale of a product with a right of return is variable, since the consideration is contingent on the occurrence or non-occurrence of a future event, ie, the possibility of a return of the product. If the consideration received in a contract includes a variable amount, an entity should estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods to the customer. To estimate the variable consideration to which the entity will be entitled, the entity should use the *expected value method*, which is the sum of probability – weighted amounts in a range of possible consideration amounts. Using the expected value method, an entity can expect to better predict the amount of consideration to which it will be entitled.

Although the returns are outside the entity's influence, the entity should be able to conclude that it is highly probable that a significant reversal in the cumulative amount of revenue recognised will not occur as the uncertainty is resolved.