Revenue Recognition Method-Overview

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Abstract— **Accounting standards such as the International Financial Reporting Standards (IFRS) and the Generally Accepted Accounting Principles (GAAP) have a set of principles and guidelines to recognize and report revenues in financial statements which need to be adhered by all companies. In this regard, adopting these guidelines to configure the system to comply to these set of rules has become evident.**

Keywords—**SAP Sales & Distribution, SAP SD, Revenue Recognition Methods.**

➢ INTRODUCTION

In Industries, there are instances where revenues must be realized in the posting Period in which services are carried out, instead of realizing in the Posting period of billing. It ensures that income is recorded in the period in which it is earned, rather than when cash is received, thus providing a more accurate picture of a company's financial health. This process is critical for adhering to accounting standards such as the International Financial Reporting Standards (IFRS) and the Generally Accepted Accounting Principles (GAAP), which require specific criteria for recognizing revenue.

E.g. When a company sells a yearly subscription for $12,000 and customer pays 12,000 upon billing, then at the end of first month the revenue should be stated as $1000 and at the end of second month the revenue should be stated as $2000 and not 12,000. The values ($12,000) are accrued in a deferred account upon billing and later posted to Revenue Account($1000/month) when a service is provided.

Deferred Accounts: G/L Account that accrues the Invoice amount until the values are released to Revenue accounting. For service-related items, the amount is generally released to Revenue accounts once the service was provided.

Revenue Accounts: G/L Account in which the final revenues are posted. The Amount posted to this Account may refer to the Company's Revenue for that transaction.

➢ REVENUE RECOGNITION TYPE

SAP Offers the Below revenue Recognition Models:

a. Standard Revenue Recognition:

In this Revenue recognition method, the Invoice amount is posted into the Revenue accounts or Revenue is realized as soon as the Invoice is created. No Amount is posted to the deferred account.

At the time of invoice, Customer G/L Account is debited and Revenue account is credited. Short Term Subscription Items, Software Sales, one time service /training follows th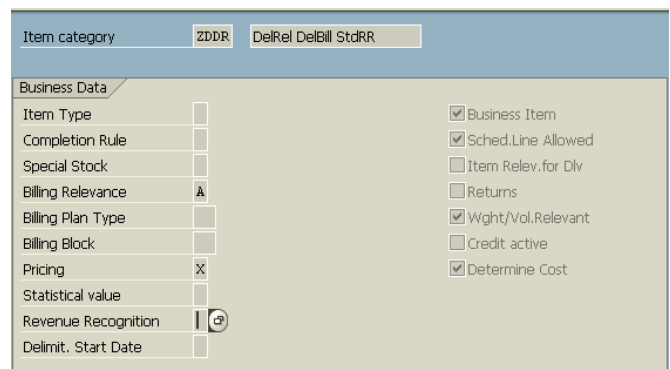e Standard Revenue Recognition Method. No Contract agreement would be created for one-time sales. In this method a sales order is created followed by delivery. When delivery is invoiced, the transaction amount is posted into Revenue accounts.

Standard Revenue Recognition Process Flow--
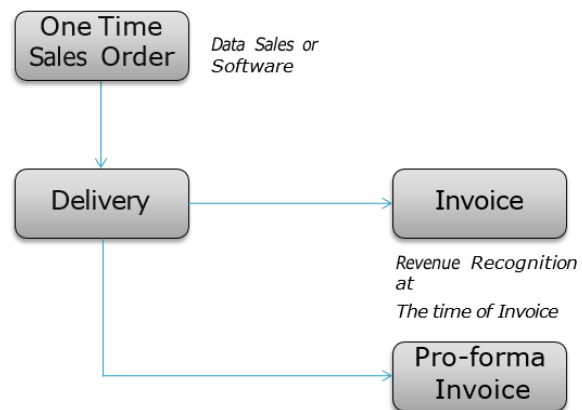
Standard Revenue Recognition Configuration- Item Category: By default, all the items follow the Standard Revenue Recognition Method if the revenue recognition functionality is used.

Revenue Recognition = "Blank" (Standard revenue recognition).

G/L Account Determination:
Enter the Revenue Account under the field G/L Account and deferred Account under the field 'Provision Acc'.
Note: In case of Standard Revenue Recognition Method, no posting happens to deferred Account. However, Provision Acc. (Deferred Account) is entered as this field is mandatory.

Display View "Material Grp/Acct Key": Overview of Selected Set

App	CndTy.	ChAc	SOrg.	AAG	ActKy	G/L Account	Provision acc.
V	FI	IHS1	1012	04	ERL	400300	240020
V	KOFI	IHS1	1015	04	ERL	400300	240020
V	KOFI	IHS1	1020	04	ERL	400300	240020
V	KOFI	IHS1	1022	04	ERL	400300	240020
V	KOFI	IHS1	2004	04	ERL	400300	240020
V	KOFI	IHS1	2005	04	ERL	400300	240020

b. Time related Revenue Recognition:

In this recognition method, revenue is recognized at a particular period (E.g. Monthly) for the services or Item sold in that period. Subscription Item, Renewable Items follow the Time-Based Revenue Recognition Method.

For the Subscription Products, Customer either pays upfront for the whole subscription term (Annual) or on a monthly or Quarterly basis (Monthly or Quarterly billing). At the time of invoice the Customer G/L Account is debited and Deferred Account is Credited.

Revenue is recognized from the Invoice at the end of each month for the subscription or services that were rendered during that month.

Example: For an Annual Subscription, Customer pays $12,000 upfront for one year. During Invoice, Customer Account is Debited for 12,0000 and deferred account is credited for 12,000. At the end of the month when revenue is recognized, Deferred account is debited by $1000 and Revenue account is credited by $1000, thereby recognizing the Revenue.

Time Based Revenue Flow--
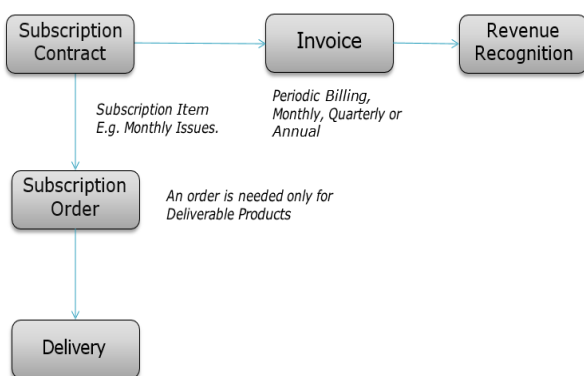
Time Based Revenue-Configuration--
Item Category: Assign a Value of "D" to the field Revenue Recognition for time-based Revenue Recognition. Revenue Recognition = "D" (Billing-related, time-related revenue recognition).

G/L Account Determination:
Enter the Revenue Account under the field G/L Account and deferred Account under the field 'Provision Acc'.

Display View "Material Grp/Acct Key": Overview of Selected Set

| App	CndTy.	ChAc	SOrg.	A...	ActKy	G/L Account	Provision acc.
V	FI	IHS1	1020	01	ERL	400000	240000
V	KOFI	IHS1	1020	02	ERL	400200	240060
V	KOFI	IHS1	1020	03	ERL	400100	240050
V	KOFI	IHS1	1020	04	ERL	400300	240020

c. Service-related Revenue Recognition:

Milestone contracts, Partial Milestone Contracts, Reimbursable Item and Service Items follow the Service Based Revenue Recognition Method.

In milestone contracts, a contract is set up for the agreed amount. When a service is requested by customer during the contract term, Release order is created for the contract with Service Items. These services are Invoiced and revenue is recognized from the release Order. Customer is billed as when the services are provided.

E.g. A contract is set up with the customer for an amount of $10,000. A release order is created for a service say training with a cost of $5,000. Customer is invoiced for $5,000 and the revenue is later recognized at the month end from the release order for the amount of 5000.

In Partial milestone contracts, a contract is created for the agreed amount and the customer is invoiced for the complete contract amount. When a service is requested by a customer, Release orders are generated for the service and the revenue is recognized from the Contract for the amount of service provided. E.g. A contract is set up with the customer for an amount of $10,000. Customer is invoiced for $10,000 thereby debiting AR and crediting Deferred. A release Order is created for service Item for $5000 and the revenue is recognized from Contract. The Revenue recognition process debits the deferred by $5000 and credits the Revenue Account by $5000.

Service Based Revenue Flow—Milestone Contract
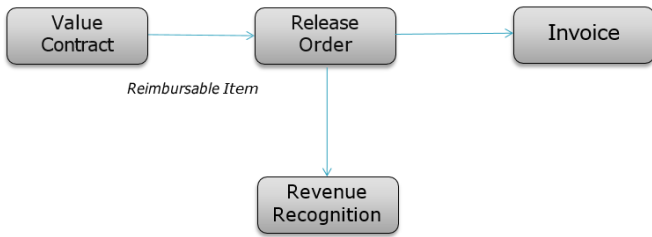
Service Based Revenue Flow—Partial Milestone Contract
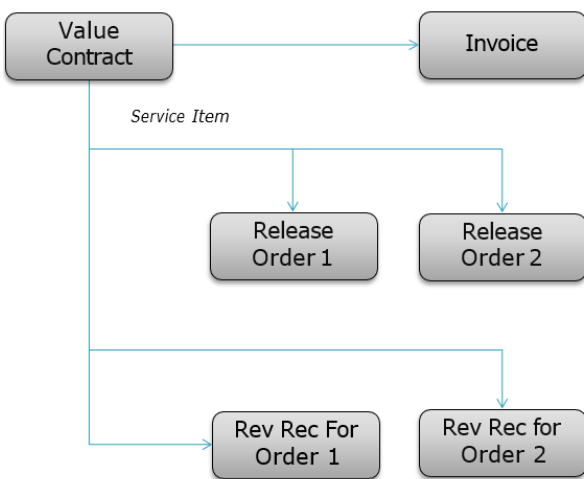
Service Based Revenue-Configuration--
Item Category: Assign a Value of "B" to the field Revenue Recognition for time-based Revenue Recognition.
Revenue Recognition = "B" (Service-related revenue recognition).

G/L Account Determination:
Enter the Revenue Account under the field G/L Account and deferred Account under the field 'Provision Acc.'.
When Invoice is created, the deferred account 240050 is credited. When Revenue recognition is executed at the month end, deferred account is debited and revenue is deferred in 400100.

➤ REVENUE RECOGNITION PROCESS

Standard SAP transaction VF44 is used to recognize the Revenue and VF46 is used to do the revenue reversal. Revenue Can be recognized from a Contract (Partial Milestone), Order (Milestone Contracts) or from an Invoice (Subscription Item) . In case of Non-Renewable or one-time Items the revenue is recognized directly upon billing and hence this process is not needed for those items. The Revenue recognition process debits the deferred account and credits the revenue account.

➤ REVENUE RECOGNITION EXAMPLES

A milestone contract has been created with a value of 15,000. A service was provided to Customer for $15,000 and hence a release order (20009345) has been created and invoiced. This debits the customer account and credits the deferred account (240050) for $15,000.

From Accounting Document:

Execute transaction VF44 to recognize the revenue. Enter the release order on Selection screen as shown and execute.

Sales Order Lines due for Revenue recognition will be displayed.

Select the line and Hit "Collective Processing". Revenue documents will be generated and revenue will be released.

From Revenue document:
Revenue Account (400100) has been credited.
Deferred Account (240050) has been debited.

> CONCLUSION

Revenue recognition is a critical process for ensuring that financial statements accurately reflect a company's earnings and performance. ERP systems like SAP help streamline this process, ensuring compliance with accounting standards while adapting to various business models.

> REFERENCES

[1] https://help.sap.com/docs/

[2] https://www.ifrs.org/

[3] https://blog.sap-press.com/revenue-accounting-and-reporting-with-sap-s4hana