Accounting for goods sold with a right to return

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Introduction

NOVA (Pvt) limited engages in importing of pharmaceutical products, warehousing, and distributing (wholesale activities). The company uses MYOB accounting package for accounting purpose. The company faced an issue relating to revenue recognition, that is how to recognize revenue when return goods that goods sold with a right of return in previous year.

Discussion of the Issue

Since the pharmaceutical products have different range of expiry periods the company use different due dates for sales returns. In this process some sales transactions are occurring in one financial year and returns of that sales are occurring in following financial year. The issue is how to get these returns in to accounts. The company considers this as current year sales return and used following journal entries.

When selling goods				When sales Return			
1. Debtor	Dr	xxx		1. Sales	Dr	xxx	
Sales	Cr		xxx	Vat output/Payable	Cr	xxx	
Vat Output/payable	Cr		xxx	Debtor	Cr		xxx
(being enter the sales)				(being Reverse the sales)			
2. Cost of sales	Dr	xxx		2. Inventory	Dr	xxx	
Inventory	Cr		xxx	Cost of sales	Cr		xxx
(being enter the sales cost)				(being Reverse the sales cost)			

The accountant expressed his views saying that the method carried up to now is usual and we cannot access and alter the previous data base and we have no authority to do changes to the retained earnings. Data entry operator entered the sales invoice and returns as they received. When the retunes on previous year sales are considered as current year sales return it affects the Sales, VAT payable and cost of sales accounts and are not reflect the correct values for current period. So in the statement of comprehensive income, sales were under stated. According to the framework for preparation and presentation of financial statements, it violates the matching concept. On the other hand there is no responsible person to record returns and alter the relevant accounts, due to poor internal control procedures.

Conclusion and recommendations

It is a common practice in the retail and consumer products industries to sell goods with a right of return. The company should not recognize revenue for sales that are expected to fail because the customer exercises its right to return the goods, therefore under LKAS 18, revenue is recognized when the shipment has been formally accepted by the buyer or the goods have been delivered and the time period for rejection has elapsed According to the current situation, if impacts on accounts are not material it is allowed to consider as current year sales return, but the impacts of the accounts are material it is recommended to do a prior year adjustment. i.e. make adjustment to retain earnings and should disclose the effects on EPS, tax and sales, nature of adjustment,

besides, from this year the company would record a liability on their balance sheets representing their obligation related to the expected returns, there after any changes in provision should be charged to the profit and loss account respectively. Accordingly, the company needs to estimate their expected returns and recognize revenue net of the expected returns. That is, the amount entity is reasonably assured to be entitled to at the end of the return period, taking into consideration the products expected to be returned. An estimate of its expected returns would be determined using either an expected value (probability-weighted) approach or the most likely amount to be received, Whichever better predicts the amount of revenue (net of returns) to which the entity will be entitled. If an entity is unable to estimate expected returns, revenue should not recognized until the end of the return period. Together, it would also record an asset for their right to recover the goods expected to be returned by the customer. Hence an amount equivalent to this asset is generally included in inventory, and need to be presentation the returned inventory separately from normal inventory, this returned inventory would be subject to impairment testing, by periodically evaluating the returned asset for impairment separately, as opposed to considering the asset as part of their overall evaluation of inventory for impairment. The company should implement proper internal control system to record sales and sales returns especially to approve the return and record them into relevant accounts.