

UNIVERSITY OF NAIROBI



**REVENUE RECOGNITION AND MOBILE PHONE
SERVICE PROVIDERS IN KENYA //**

BY

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SUPERVISOR

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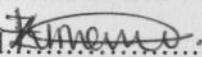
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DECLARATION

I hereby declare that this research project is my original work and has not been presented for a degree by myself or any other person from any other institution known and unknown to me

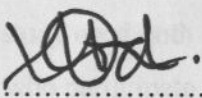
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ABSTRACT

The study examined practices adopted by mobile phone service providers in Kenya in recognition of revenue. The study intended to highlight whether there is any difference in the manner in which the mobile phone service providers recognize their revenue for the different categories of services offered to their customers. The study also intended to determine the extent to which mobile phone service providers comply with the requirements of IAS 18. The study covered the period ending December 2006.

I extend my thanks to my mother, my brother Peter and sister Martha who supported my
The study was exploratory in nature. A survey was conducted to establish the manner in which mobile phone service providers in Kenya recognize their revenue. The study intended to use census approach in examining three organizations namely Safaricom, Celtel and Telkom, but this was not achieved since Telkom failed to respond to the questionnaire. Data collected from Safaricom and Celtel amounted to 67% which made it possible to generalize the manner in which the mobile phone service providers recognize their revenue.

Data was collected through a comprehensive questionnaire which was administered to respondents. The study used both structured and closed-ended questions. The respondents were accountants who participate in preparation of financial statements in the two mobile phone service providers in Kenya which include Safaricom and Celtel.

In general, the accountants interviewed expressed similar views, suggesting that there are minimal differences in the way mobile phone service providers recognize their revenue. To the accountants, particular issues of relevance to the revenue recognition are heavily borrowed from IFRSs in particular IAS 18. Revenue recognition by mobile phone service providers was not seen as deserving a unique treatment but was treated in the same way as other service industries.

ACKNOWLEDGMENT

I want to sincerely thank my supervisor Mr. Abdullatif Essajee for his support and encouragement throughout the study. He gave me insight and corrected me where I went wrong. Without his support this would have been a task impossible. Secondly, I thank all the people who contributed to the success of this study in particular my colleagues who made their contributions to the study.

I extend my thanks to my mother, my brother Peter and sister Martha who supported my education from primary level to this level. They are my source of inspiration and I will always remember them for their support and encouragement.

To you all, I am most grateful.

DEDICATION

I dedicate the study to my dear wife Agatha Gathoni Kimemia, who endured the long hours she spent alone when I was working on the study. She also contributed a lot by her support and encouragement.

Revenue, the most important business, is the gross inflow of economic benefits (cash, receivables and other assets) arising from the ordinary activities of an enterprise such as sales of goods, sales of services, interest, royalties and dividends (IAS 18.7). The inflows result in increases in equity and it has been argued that revenue is the cornerstone of all businesses since it results an increase in equity.

The primary issue in accounting for revenue is determining when to recognize revenue. Revenue is earned throughout the process as value, in the form of time, place and form utility. Carwood, Flaherty and O'Connor (1998) observed that even though revenue may be earned continuously, recognizing it on a continuous basis is impractical and associating portions of it with each revenue-generating activity is not feasible. Accountants, therefore, select a point or points in the earning process at which to recognize revenue. There are many points at which revenue could be recognized. Depending on the circumstances, revenue could be recognized during production, at the completion of production, while the completed product is awaiting sale, at the point of sale, or when cash is collected.

The two International Financial Reporting Standards (IFRS) that deal with revenue recognition are IAS 18 "Revenue" and IAS 11 "Construction Contracts". Under IAS 18 revenue is defined as "the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an enterprise when those inflows result in increases in equity, other than increases relating to contributions from equity participants". The different sources of revenue described in IAS 18 and IAS 11 reveal that revenue primarily results from exchange transactions with customers in which the enterprise exchanges goods or services against cash, a claim to cash or other assets. The assessment of when an enterprise has transferred the significant risks and rewards of

CHAPTER ONE

1.0 INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Revenue, the heart beat of any business, is the gross inflow of economic benefits (cash, receivables and other assets) arising from the ordinary activities of an enterprise such as sales of goods, sales of services, interest, royalties and dividends (IAS 18.7) . The inflows result in increases in equity and it has been argued that revenue is the cornerstone of all businesses since it causes an increase in equity.

The primary issue in accounting for revenue is determining when to recognize revenue. Revenue is earned throughout the process as value, in the form of time, place and form utility. Chasteen, Flaherty and O'Connor (1998) observed that even though revenue may be earned continuously, recognizing it on a continuous basis is impractical and associating portions of it with each revenue-generating activity is not feasible. Accountants, therefore, select a point or points in the earning process at which to recognize revenue. There are many points at which revenue could be recognized. Depending on the circumstances, revenue could be recognized during production, at the completion of production, while the completed product is awaiting sale, at the point of sale, or when cash is collected.

The two International Financial Reporting Standards (IFRS) that deal with revenue recognition are IAS 18 "*Revenue*" and IAS 11 "*Construction Contracts*". Under IAS 18 revenue is defined as 'the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an enterprise when those inflows result in increases in equity, other than increases relating in contributions from equity participants'. The different sources of revenue described in IAS 18 and IAS 11 reveal that revenue primarily results from exchange transactions with customers in which the enterprise exchanges goods or services against cash, a claim to cash or other assets. The assessment of when an enterprise has transferred the significant risks and rewards of

ownership to the buyer requires an examination of the circumstances of the transaction (IAS 18).

Revenue and income recognition is and has always been one of the most controversial issues in accounting. Many companies have experienced difficulties and often bankruptcy and lawsuits from “premature” recognition of revenue and income. In the 1980s many retail land sales companies experienced losses and cash flow problems that arose from premature recognition of revenue from credit sales transactions. Purchasers made only token down payments and were given many years to pay for the land. Additionally, the sellers had not fulfilled their obligations to the purchasers, evidence that the revenue had not been earned on the revenue recognition date. (Chasteen, Flaherty and O’Connor, 1998).

Revenue recognition is the point at which a firm recognizes and records the impact of revenue for the purpose of reporting its effects in the financial statements. The point at which revenue is to be recognized is theoretically and empirically unclear. This poses challenges to industries that are peculiar in nature. Examples include agricultural industry, hire purchase industry and construction industry. Mobile phone service providers may be peculiar in that, they face difficulties in measuring the value of the right to consideration in exchange for the substantive fulfillment of its performance obligation to both the pre-paid and post-paid customers. This is due to the time taken by the pre-paid customer from the time he purchases air-time to the time he uses that airtime. On the other hand, there is a time lag between the time the post-paid customer uses the airtime and when he pays for the service. The industry also sells airtime through dealers, who act as agents of the service providers. The question to be posed then is, should the agency sales theory as a method of recognizing revenue be applied or should revenue be recognized during sale? The lack of clarity in revenue recognition can have repercussions in the preparation and interpretation of financial statements. The study will therefore examine the revenue recognition practices adopted by mobile phone service providers in Kenya.

1.2 STATEMENT OF THE PROBLEM

International Accounting Standard (IAS) 18 “Revenue” states, “Conflicts abound as to when revenue should be recognized”. The International Accounting Standards Board and International Financial Reporting Interpretation Committee provide guidance on this matter. Under IAS 18 “revenues should be recognized when they are ‘realized or realizable’ and earned. Revenues are ‘realized or realizable’ when products are exchanged for assets (such as cash) or claims to assets (such as promises to pay). Revenues are ‘earned’ when the entity has performed all duties necessary to the purchaser”.

Certain aspects of the earning process may be generalized across companies and types of businesses. A manufacturing company acquires the components of production, manufactures the product, sells it and then collects cash from the sale. The period between the sale and the collection of cash may be of zero duration, as in a cash sale, or quite long, as in a sale in exchange for a long-term receivable. The earning process of a merchandising company differs slightly. The merchandise company acquires inventory from a manufacturer and then holds it until the time of sale. In a service company, the production period is replaced by the period of providing services. The point of sale is the point at which performance of the service is complete.

Mobile phone service providers do not deal with merchandise products for which revenue recognition is usually at the point when the seller has transferred all the risks and rewards to the buyer. They offer services which are both pre-paid and post paid. The industry sells airtime through dealers, who act as the agent of the service providers. Should the agency sales theory as a method of recognizing revenue be applied or should revenue be recognized during sale?

The question that arises is, which is the critical event that mobile phone service providers await to happen for them to recognize revenue arising from provision of services to pre-paid customers, post paid customers and the sale of sim-cards? Is it at the point of sale of sim-cards or activation of sim-cards? Is revenue recognized for pre-paid customers at the

point of sale of credit time to the dealer, or at the point the dealer sells credit time to the subscriber, or is it when the subscriber uses the airtime? What about post-paid customers; is revenue recognized at the point of provision of airtime, on billing the customer or at the point of payment? Unused credit at the end of the period is a matter of concern, is it recognized as a liability or as revenue?

1.3 OBJECTIVES OF THE STUDY

The objectives of the study were:

1. To identify the revenue recognition practices adopted by mobile phone service providers in Kenya and determine whether there is a difference in the manner in which mobile phone service providers recognize revenue for the different categories of services offered to their customers.
2. To determine the extent to which mobile phone service providers comply with the requirements of IAS 18.

1.4 IMPORTANCE OF THE STUDY

The study sought to examine the revenue recognition practices adopted by mobile phone service providers in Kenya.

The study will find value among the users of financial statements who will have an understanding of the method used by mobile phone service providers in recognizing revenue. This will enable them to assess the financial performance of the mobile phone service providers.

The study also provides accountants with an insight as to the approaches used by the mobile phone service provider companies in recognizing revenue.

Regulators will also have an understanding of the level of compliance exhibited by such companies to the International Financial Reporting Standards. This may provide information to the regulators that may be useful in the development of ways and means of ensuring compliance.

1.5 DEFINITION OF TERMS

1.5.1 Revenue

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants (IAS 18.7).

1.5.2 Recognition

Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition set out below

- a. It is probable that any future economic benefit associated with the item will flow to or from the entity, and
- b. The item has a cost or value that can be measured with reliability.

(IASB framework)

1.5.3 Revenue recognition in rendering of services

When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognized by reference to the stage of completion of the transaction at the balance sheet date. (IAS 18.20)

1.5.4 Earned revenue

Earned revenue is the income from which the buyer has accepted the products and the entity has performed all duties necessary to the purchaser. (IASB framework)

1.5.5 Unearned revenue

Unearned revenue means the situations when assets are received before revenue is earned (Nzomo, 1992). This is when either the buyer has not accepted the products or the entity has not performed all duties necessary to the purchaser.

1.5.6 Income

Income encompasses both revenue and gains (IASB framework).

1.5.7 Accounting policies

Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements (IAS 8.5).

2.1 REVENUE

History shows that managers and auditors need guidance as to when to recognize revenue. To recognize means to record an event for the purpose of reporting its effects in the financial statements. In the case when revenue is recognized prematurely, the income statement reports income sooner than it should and the business looks more profitable than it really is. When revenue is not recognized on time, the income statement shows lower amount of revenue and net income than it should and the business looks less profitable than it really is.

There are two International Financial Reporting Standards (IFRS) that deal with revenue recognition and IAS 18 "Revenue" and IAS 11 "Construction Contracts".

The interaction of general concepts, specific principles and professional judgment can be demonstrated in the area of revenue recognition. The general recognition principle is the probability of the inflow of future economic benefits associated with an asset if the significant risks and rewards of ownership of the goods have been transferred to the buyer. The assessment of when an enterprise has transferred the significant risks and rewards of ownership to the buyer requires an evaluation of the circumstances of the transaction (IAS 18).

Revenue is defined as the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an enterprise when those inflows result in increases in equity, other than increases relating to contributions from equity participants. The different sources of revenue described in IAS 18 and IAS 11 reveal that revenue primarily results from exchange transactions with customers in which the enterprise exchanges goods or services against cash, a claim to cash or other assets. As long as there is a past amount that is likely to recur on a regular basis in future accounting periods, it represents a reliable predictor of the enterprise's ability to generate cash flows in the future (Moxier, 1982).

CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 REVENUE

History shows that managers and auditors need guidance as to when to recognize revenue. To recognize means to record an event for the purpose of reporting its effects in the financial statements. In the case when revenue is recognized pre-maturely, the income statement reports income sooner than it should and the business looks more profitable than it really is. When revenue is not recognized on time, the income statement shows lower amount of revenue and net income than it should and the business looks less profitable than it really is.

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Chasteen, Flaherty and O'Connor (1998) observe that revenue are periodic inflows of assets or settlement of liabilities, or both as a result of the production of goods, the rendering of services or other earning activities that constitute an entity major or primary operations.

Revenues are inflows of assets received in exchange for goods or services provided to customers as part of the major or central operations of the business (Miller, 1992). Miller adds, "Revenue is not only on the inflows of assets, but revenue can also occur as decreases in liabilities".

Nzomo (1992) observes, "Revenue represents actual or expected cash inflows or the equivalent as a result of the ongoing or central operations of the enterprise during the accounting period". Revenue is the price of goods sold and services rendered during a given accounting period, earning revenue causes owners' equity to increase (Meigs, Bettner and Whittington, 1996).

Wtjstemann and Kierzek (2005) observe that they are three different conceptual models to revenue recognition that are all based on the asset and liability view. The asset and liability fair revenue recognition under International Financial Reporting Standard (IFRS) value approach has been pursued by the Financial Accounting Standard Board (FASB) and the International Accounting Standard Board (IASB) between 2002 and 2004. The asset and liability performance approach that FASB and IASB have been exploring since 2005 and the asset and liability transaction approach. Due to conceptual and practical concerns as regards the measurement of performance obligations at their legal layoff amount (fair value), the FASB and the IASB recently rejected the legal layoff amount as the relevant measurement attribute for performance obligations in favour of the adoption of the allocated consideration amount.

From the above contributions it can be concluded that revenue is the measure of the entity's performance from the sale of goods, rendering of services or other earning

activities that constitute an entity's major or primary operations. It can also be concluded that revenues have the following two essential characteristics

- i) They arise from an enterprise primary earning activities and
- ii) They are recurring or continuing in nature.

2.2 RECOGNITION OF REVENUE

Eugene and Imhoff (1991) observe that before revenues are recorded, they must be earned. Revenues are generally considered to be earned when the business has provided the necessary goods and services that give rise to revenues. When a business delivers merchandise or provides services to customers, the business is generally considered to have earned revenue. As a result, the seller recognizes revenue normally at the time:

- i) The seller has performed the service or delivered the product.
- ii) The seller has received something of value that has been realized or is realizable.

Revenue from the sale of goods is recognized according to the realization principle when a critical event occurs that reduces the uncertainties about the receipt of consideration to an acceptable degree (Chasteen *et al.*, 1995). Following IAS 18.14(a) the enterprise obtains a justified expectation to receive consideration when it has transferred to the buyer the significant risks and rewards of ownership of the goods. This criterion highlights that the enterprise's accomplishment of the entire legal performance obligation and thus the obtainment of the legally enforceable right to consideration is not decisive for the timing of revenue recognition. When the enterprise retains the legal title of the delivered goods to protect the collectability of consideration, the enterprise does not obtain the legally enforceable right to consideration until it has transferred the legal title in the goods to the buyer. Nevertheless revenue should be recognized with delivery of the goods to the buyer as the remaining risks not to receive consideration are regarded to be insignificant (IAS 18.17).

Chasteen, Flahertyn and O'Connor (1998) add that some accounting theorists have proposed a critical event theory of revenue recognition. Under this theory, revenue should be recognized when the most critical (crucial) events in the earning process has been completed. In most industries, the sale is the critical event in the earning process. In some industries however production of the goods may be the most critical event in the earning process. They add that the two revenue criteria illustrate the need to balance relevance and reliability in order to meet the financial reporting objective of providing information that assists users in predicting, evaluating and assessing cash flows.

Chasteen, Flahertyn and O'Connor (1998) observe that even though revenue may be earned continuously, recognizing it on a continuous basis is impractical and associating portions of it with each revenue-generating activity is not feasible. Therefore accountants select a point or points in the earnings process at which to recognize revenue. There are many points at which revenue could be recognized.

Chasteen, Flahertyn and O'Connor (1998) observe that depending on the circumstances revenue could be recognized during production. IAS 11 paragraph 22 states that when the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract shall be recognized as revenue and expenses respectively by reference to the stage of completion of the contract activity at the balance sheet date.

The two methods commonly used to record profit from construction contracts are the percentage of completion method and the completed contract method for those contract which take less than one year to complete. The percentage of completion method recognizes profit in proportion to progress on a contract for each period in which construction occurs. The completed contract method recognizes profit only after all work on the contract is complete. Although both methods are in accordance with generally accepted accounting principles, their respective effects on a company's reported financial position and operating results can materially differ.

At the completion of production, while the completed product is awaiting sale, revenue may be recognized when production is completed. According to Chasteen, Flaherty and O'Connor (1998), the following are the circumstances that justify revenue recognition:

- i) The product is sold in the market with a reasonably assured selling price.
- ii) The costs of selling and distributing the product are insignificant and can be reasonably estimated.
- iii) Production rather than sale is considered as most critical event in the earnings process.

At the point of sale, most merchandising and manufacturing companies recognize revenue at the point of sale because for them the two recognition criteria are met at that point; the amount of revenue that is recognized is established by the exchange price at the time of sale (Chasteen, Flaherty and O'Connor, 1998).

For credit sales when cash is collected, under certain circumstances, uncertainty about the ultimate cash collection of a credit sale may be so great that revenue should not be recognized until the cash is collected. (Chasteen, Flaherty and O'Connor, 1998).

2.3 BASIS OF REVENUE RECOGNITION

Basis of revenue recognition can be seen as the principle to recognize revenue when goods or services are exchanged for cash or claims to cash (realization principle), to match costs with the associated revenues and the principle to recognize transactions and events in the period in which they occur and not in the periods in which cash is received or expensed (accrual basis assumption).

2.3.1 CONSERVATISM AS A BASIS FOR MEASURING REVENUE:

Anthony and Reece (1995) say that we should use the conservatism concept to recognize both revenue and expenses. In this case conservatism means prudent reporting based on a healthy skepticism which builds confidence in the results and in the long run, best serves

all of the divergent interests of financial statements users. They add that conservatism concept has two aspects which are as follows:

- i) Recognize revenues (increases in retained earnings) only when they are reasonably certain.
- ii) Recognize expenses (decreases in retained earnings) as soon as they are reasonably possible.

2.3.2 MATCHING CONCEPT AS A BASIS FOR REVENUE RECOGNITION

Nzomo (1992) states, “Matching periodic revenues against the expenses incurred in earning those revenues is the basic process of income determination. Expenses of the current period consist of those costs which are identified with the revenues of the current period and those costs which are identified with the current period on some basis other than revenue. In principle then, costs identifiable with future revenues or otherwise identifiable with future periods should be deferred to those future periods”.

The accrual basis is the principal conceptual framework for relating accomplishment (revenues) with efforts (expenses). They add that the measuring of income and financial position is anchored to the accrual basis of accounting, as distinguished from the cash basis. The accrual basis is the process whereby the impact of transaction on the income statement and balance sheet is recognized on the accounting records in the time periods when services are delivered or used instead of when cash is received or disbursed.

Eugene and Imhoff (1991) observe that the matching principle involves the process of relating the benefits from operations (revenues) with the efforts or costs of achieving those benefits (expenses) during an accounting period. They add that the matching process addresses the question of what net assets were given up (consumed) by the business to obtain the recorded revenues (benefits). Net income is the difference between the revenues and expenses from profit-seeking activities for a period.

2.4 EMPIRICAL STUDIES

2.4.1 Revenue recognition and real estate companies

Timothy Eccles, Andrew Holt and Wesley Fell-Smith carried out a study to evaluate the principle and practice of revenue recognition accounting and disclosure within the annual reports of UK quoted property companies. This research aimed at discovering whether revenue recognition is a problem in the UK in general, and for property companies in particular. Property values had been particularly affected due to the requirements enforced on certain companies by the regulators to restate published accounts. Moreover, since certain property companies had stock market capitalization that was below their net asset value, they were susceptible to concerns over the accuracy of their reported revenue and turnover.

The objectives of the study was to describe the issues surrounding revenue recognition and describe the basic theoretical models that underpin the various approaches by using empirical analysis of 25 property companies over two contiguous reporting periods.

The pilot study initially obtained the views and opinions of accounting practitioners. This research was carried out through unstructured, in-depth interviews with accountants. In order to provide a context for this interview data, an actual survey of published property company annual reports was conducted with the aim of ascertaining current levels of revenue recognition disclosure. Since this was a pilot study, only three interviews were carried out, and the findings were thus qualified by the size of the sample. In total 25 property company accounts were analyzed over a two-year period for the pilot study survey.

The findings of the study was that among the UK quoted property companies only 62 per cent of companies disclosed revenue recognition policy in 2003, which was an improvement from 43 per cent in 2002. Further the study showed that all respondents agreed that there were inconsistencies and there were differing opinions about the manner in which those concerns have been addressed. Accounting respondents also doubted the

independent interests of the property sector, while the analysis of the accounts showed widespread variation.

2.4.2 Revenue recognition in the construction industry

Ken T. Trotman and Ian R. Zimmer, conducted a study to investigate the closely related questions of whether adjustments or transformations are made or attempted and whether alternative methods of reporting profit from long-term construction contracts affect lenders' predictions and decisions. The experiment used a within-subjects design in which loan officers evaluated four cases which varied according to (a) the method of recognizing long-term construction revenue, and (b) the expertise of management. During performance of the task, participants provided verbal protocols by 'thinking aloud'

Two sets of financial statements providing income statement, balance sheet and notes to the accounts for the one hypothetical construction company were initially developed. Comparative figures for three years were included. The two sets were identical except that (a) one set recognized revenue on a completed contract basis and the other on a percentage of completion basis, and (b) following Abdel-khalik and Keller (1979), the fact that otherwise the two sets of statements were identical was disguised by multiplying the numbers in the first set by 0.98." The method of revenue recognition was fully explained in the notes to the financial statements in each case and sufficient information was provided to enable adjustment from one method to the other. The statements were constructed so that the most recent net profit figure for the set which used the percentage of completion method materially exceeded interest; whereas the most recent net profit for the set which used completed contract was materially exceeded by interest.

The only material difference between the two sets of financial statements was the method of revenue recognition. However, this had considerable effect on the financial statements as the figures for total revenue, retained earnings and contracts in progress were substantially different, causing ratios such as debt to equity, gross cash flow to total debt and current assets to current liabilities to look 'riskier' in the completed contract statements than in the percentage of completion statements. In the absence of any adjustments, these differences, together with the other minor changes attributable to the

multiplication by 0.98, caused the two sets of financial statements to seem significantly different.

The results above suggested that lenders who had previously examined loan applications from companies in a particular industry that used unique revenue recognition procedures were unlikely to adjust financial statements. Out of the ten participants in the study only two made adjustment to the financial statements. The only apparent systematic difference was that the two adjusters had previous chartered accounting experience which may have resulted in them having greater accounting expertise.

2.5 SUMMARY

Revenue recognition is in a state of flux with a severe lack of consistency in accounting policies. The importance of revenue recognition cannot be understated as it is the vehicle that companies utilize to allow revenues to flow. Revenue is typically the single largest item reported in a company's financial statements and is the basis of investment decisions.

The two International Financial Reporting Standards (IFRS) that deal with revenue recognition are IAS 18 "*Revenue*" and IAS 11 "*Construction Contracts*". Revenue recognition in the mobile phone service providers is a great concern due to the peculiarities in the industry. It is evident that we have to know the critical point when the industry passes the risks and rewards to enable accountants recognize revenue. From the literature review the following can be summarized

- i) Revenue should be recognized when the enterprise obtains the right to consideration in exchange for the substantive fulfillment of its performance obligation.
- ii) Revenue should be measured at the value of the right to consideration that the enterprise obtains in exchange for the substantive fulfillment of its performance obligation.

CHAPTER THREE

3.0 METHODOLOGY

3.1 RESEARCH DESIGN

This study was exploratory in nature. A survey was conducted to establish the manner in which mobile phone service providers in Kenya recognize their revenues.

The interest of the study was to identify revenue recognition practices adopted by mobile phone service providers in Kenya. The study also sought to determine whether there is a difference in the manner mobile phone service providers recognize revenue. The study also explored the level of compliance to IAS 18 and the challenges faced by the mobile phone companies in compliance with the requirements of IAS 18.

3.2 POPULATION

The population of the study was the three mobile phone service providers in Kenya namely Safaricom, Celtel and Telkom. The study was carried out for the period ending December 2006. The study intended to use census approach in examining three organizations namely Safaricom, Celtel and Telkom, but this was not achieved since Telkom failed to respond to the questionnaire. Data collected from Safaricom and Celtel amounted to 67% which made it possible to generalize the manner in which the mobile phone service providers recognize their revenue. Data that was collected was mainly qualitative, although secondary quantitative data was also used.

3.3 DATA COLLECTION PROCEDURES

Data that was collected was both primary data and secondary data. Primary data was collected through a comprehensive questionnaire which was administered to respondents. The respondents were accountants who participate in preparation of financial statements in the two mobile phone service providers in Kenya which include Safaricom and Celtel. This method was complemented by brief interviews with the accountants.

The study used both structured and closed-ended questions. These are questions with a list of all possible alternatives from which respondents select the answer that best

describes their situation. Use of structured questionnaire was to ensure consistency of questions to and answers from the respondents. They were easier to analyze since they were in an immediate usable form. They were easier to administer because each item was followed by alternative answers and they were economical to use in terms of time and money. The questionnaire was divided into three sections, pre-paid services, post-paid services and the sales of sim-card since these were the possible revenue generating activities of the companies under the study.

Secondary data was collected through analyzing a variety of financial statements prepared by the enterprise. The financial statements were used to explore the recognition of revenue adopted by the companies by studying the notes accompanying the financial statements. More emphasis was laid on how the companies comply with IAS 18 in preparing the financial statements.

3.4 DATA ANALYSIS AND PRESENTATION

Data analysis was done through examination of both secondary data and primary data.

To achieve objective one, primary data was analyzed and summarized in tables to demonstrate the revenue recognition practices adopted by mobile phone service providers. Tabulation assisted in summarizing all the methods used to recognize revenue in the two mobile phone service providers in Kenya namely Safaricom and Celtel.

To achieve objective two, data analysis focused on how the disclosures presented in financial statements and how the figures were presented. A checklist derived from requirements of IAS 18 was used to assess the level of compliance demonstrated by the two mobile service providers which include Safaricom and Celtel.

CHAPTER FOUR

4.0 DATA ANALYSIS AND FINDINGS

The study was carried out to examine how mobile phone service providers in Kenya recognize their revenue from airtime (both pre-paid and post-paid) and revenue from sim-card. Revenue recognition in Safaricom and Celtel are based on International Financial Reporting Standards issued by the International Accounting Standards Board (IASB) and in particular IAS 18.

4.1 Revenue recognition in Safaricom

Revenue is shown excluding VAT and recognized at the time that the service is provided. It is shown gross of discounts to dealers and other selling costs that are accounted for as costs. For airtime, this is recognized on the basis of usage and for sim-cards at the date in which the subscriber activates the sim card. Revenue is deferred for those services billed in advance (e.g. fixed monthly charges) and is accrued for usage made during the period, but not billed (e.g. Interconnect income).

The critical point at which revenue is recognized by the company for the usage of air time is when the subscriber uses the air time for both pre-paid and post-paid. In the case of sim-cards, sale is made to the dealers or distributors at negotiated discount and the dealers can not return the sim-card incase of any eventuality. The critical point at which revenue is recognized for the sale of sim-card is when the subscriber activates the sim-card.

The company treats unused credit at the end of a financial year for pre-paid services as unearned revenue hence a liability. The amount received from the dealers is debited to the bank and credited to the deferred income account. In case of post-paid there is no unused credit since the subscriber pays the services on the usage.

The company recognizes inter company network connectivity income when a call is made to another network for both pre-paid and post-paid. The airtime given to the employees for both pre-paid and post-paid is treated as part of their salary package.

The company accounts for the unpaid air-time usage by post-paid subscribers as revenue earned but not received. This is accounted by debiting in the account receivables account and recognized as revenue by crediting it in revenue account. The deposit paid by the subscribers is treated as a liability and when the customer pulls out it is off-set against any pending bill of the customer and the balance refunded to the customer.

4.2 Revenue recognition in Celtel

Revenue is recognized excluding VAT at the time the service is provided. Revenue is realized when the subscriber use the airtime or activates the sim card, and is earned when the company performs it duties relating to the provision of the service. It is shown gross of discounts to dealers and other selling costs that are accounted for as costs.

Depending on the billing cycles of the operation, revenue is recognized on the basis of billed services plus an accrual for unbilled revenue in the case of different billing cycle dates per month-end. The accountants ensure that there is proper communication and transfer of information between the finance and billing department to ensure complete and timely recording of revenue on a monthly basis.

Recurring revenue is recognized when the related service is rendered which is the critical point. Unbilled revenues for airtime usage and subscription fees resulting from service provided from the billing cycle date to the end of each month is determined and recorded. Revenues from connection fees are recognized when the customer is connected and is able to use the service. Other revenues, which arise from service contracts, sales of telephones and accessories or other services, are recognized in the month during which the services or goods are provided.

Prepaid cards enable the forward purchase of a specified amount of airtime by customers. Direct costs associated with these cards which includes both the cost of purchasing the cards as well as dealer margins, are recognized when incurred, i.e. upfront while the airtime costs are recognized as and when the revenue is being recognized. Unused airtime

is carried in the balance sheet as deferred revenue. Deferred income represents payments made by subscribers in advance of the airtime used. It comprises two elements:

- Prepaid cards sold and not activated.
- The portion of the activated prepaid cards not used (i.e. unexpired balance left on the scratch card).

Specific customer acquisition costs are charged to marketing expenses or dealer commissions when the subscriber is activated.

The company recognizes inter company network connectivity charges when a call is made to the other network for both pre-paid and post-paid. The airtime given to the employees for both pre-paid and post-paid is adjusted against revenue. The unsold air time held by the dealers at the end of the year is treated as part of the deferred income.

In the case for the unpaid air-time usage by post-paid subscribers the company treats it as revenue earned but not received. This is recognized as revenue and amount owed by the subscriber is accounted by debiting in the account receivables. The deposit paid by the subscribers is treated as a liability and when the customer pulls out it is off-set against any pending bill of the customer and the balance refunded to the customer.

4.3 Comparison between the two companies

From the questionnaire answered by the accountants in both companies it is evident that the revenue recognition in Safaricom and Celtel are based on International Financial Reporting Standards issued by the International Accounting Standards Board (IASB) and in particular IAS 18. Secondly, there are no significant differences noted in the manner in which they recognized their revenue, although the two differences below were noted.

One of the differences was the treatment of the airtime given to the employees. Safaricom treat it as part of the salary package in form of benefits receivable. On the other hand Celtel adjust it in the revenue earned during the period. The difference can be significant depending on the magnitude of the airtime given to the employees.

The second difference was on the treatment on the unsold air-time held by the dealers at the end of the year. Safaricom negotiate its price with the dealers, and once the airtime is sold to the dealers it is recognized as revenue. Celtel on the other hand treat the airtime sold to the dealers as deferred income and recognized it once the subscriber makes a call.

**TABLE 1
SUMMARY OF FINDINGS**

	SAFARICOM		CELTEL		TOTAL	
	PRE PAID	POST PAID	PRE PAID	POST PAID	PRE PAID	POST PAID
1. What is the critical point at which revenue is recognized by your organization for the usage of air-time?						
when the subscriber uses the air time	√	√	√	√	2/2	2/2
2. How do you treat the un-used credit at the end of financial year?						
Unearned revenue hence liability	√	N/A	√	N/A	2/2	N/A
3. At what point does the company recognize inter company network connectivity charges?						
When a call is made to the other network	√	√	√	√	2/2	2/2
4. How does your company treat the air time that is given to employees?						
Part of salary package	√	√			1/2	1/2
Adjusted against revenue			√	√	1/2	1/2

5.4 Compliance to the requirements of IAS 18

	SAFARICOM	CELTEL	TOTAL
PRE-PAID			
5. What is the critical point for sale of air-time			
When the sale is made to dealers/distributors	√	√	2/2
6. How does your company treat the unsold air-time held by the dealers at the end of the year?	N/A		
Part of deferred income		√	1/2
SIM-CARD			
7. What is the critical point for the sale of sim-card?			
When the sale is made to the dealers/ distributors	√	√	2/2
8. When does the company recognize revenue for the sale of sim-card?			
When the subscriber activates the sim-card	√	√	2/2
POST-PAID			
9. How does your company account for the unpaid air-time usage by post-paid subscribers?			
Revenue earned but not received	√	√	2/2
10. How does your company treat the deposit paid by post paid subscribers?			
As liability to the company	√	√	2/2
11. What happens to the deposit when a post paid customer pulls out?			
Off-set against any pending bill of the customer	√		1/2
Refunded to the customer	√	√	2/2

4.4 Compliance to the requirements of IAS 18

IAS 18 requires the company to disclose the accounting policies adopted for the recognition of revenue, method adopted to determine the stage of completion of transactions involving the rendering of services, amount of each significant category of revenue during the period and the amount of revenue arising from exchanges of goods or services included in each significant category of revenue. The two companies had fully complied with requirements of IAS 18 as shown by the table below.

TABLE 2
CHECKLIST ON COMPLIANCE TO REQUIREMENTS OF IAS 18

REQUIREMENTS OF IAS 18	SAFARICOM	CELTEL	TELKOM	TOTAL
1. The accounting policies adopted for the recognition of revenue	√	√		2/2
2. Methods adopted to determine the stage of completion of transactions involving the rendering of services	√	√		2/2
3. Amount of each significant category of revenue during the period	√	√		2/2
4. The amount of revenue arising from exchanges of goods or services included in each significant category of revenue.	√	√		2/2

CHAPTER FIVE

5.0 CONCLUSION AND LIMITATIONS

5.1 CONCLUSION

This study analyzed the methods adopted by mobile phone service providers in Kenya in recognizing their revenue. The study examined whether there is any difference in the way the companies recognize their revenue. Through the questionnaires accompanied by brief interviews answered by respondents in Safaricom and Celtel the study made the following findings:

In general, the accountants interviewed expressed similar views, suggesting that there are minimal differences in the way the mobile phone service providers recognize their revenue. To the accountants, particular issues of relevance to the revenue recognition are heavily borrowed from IFRSs in particular IAS 18. Revenue recognition in mobile phone service providers were not seen as deserving of unique treatment but was treated as other service industries.

In both companies, revenue is recognized when the earnings process is complete and the revenue is measurable and realized or realizable. For airtime, this is recognized on the basis of usage and for other services at the date of delivery. Revenue from airtime is first recognized as deferred income and when the subscriber makes a call, it is debited in deferred income account and credited to revenue account. Deferred income balance that remains at the end of year is recognized as liability in the balance sheet.

In both companies, revenue is shown excluding VAT and recognized at the time that service is provided. It is shown gross of discounts to dealers and other selling costs that are accounted for as costs. Airtime revenue is also shown net of air time given to employees which is the case for Celtel but in Safaricom it recognizes as revenue and included as part of the employee salary package.

The only difference was the treatment of the airtime given to the employees. Safaricom treats it as part of the salary package in form of benefits receivable. On the other hand

Celtel adjusts it in the revenue earned during the period. The difference can be significant depending on the magnitude of the airtime given to the employees.

Both companies complied fully to the requirements of IAS 18. They disclose the accounting policies adopted for the recognition of revenue, method adopted to determine the stage of completion of transactions involving the rendering of services, amount of each significant category of revenue during the period and the amount of revenue arising from exchanges of goods or services included in each significant category of revenue.

5.2 LIMITATION OF THE STUDY

The population of the study was the three mobile phone service providers in Kenya namely Safaricom, Celtel and Telkom. The study was meant to be a census since data collection and analysis was supposed to be from every possible case or group member such as Safaricom, Celtel and Telkom. This was not achieved since it was hard to get information from Telkom. The employees mostly in accounting and finance department were not co-operative. This hindered the achievement of one of the objective i.e. whether there is difference in the manner in which the mobile phone service providers recognize their revenue.

Secondly it was difficult to receive financial statements prepared by the Safaricom and Celtel for the year ending December 2006. This hindered the achievement of second objective on the compliance of the requirements of IAS 18, and information received was through brief interview of the accountants who answered the questionnaire.

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APPENDICES

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APPENDICES

Appendix 1

QUESTIONNAIRE

Attached is a questionnaire that collects data on the revenue recognition practices adopted by mobile phone service providers in Kenya. You are kindly requested to provide the required information in the questionnaire. Any information and opinions obtained in connection to this questionnaire are important and will remain confidential. They will be used for academic purposes only.

A copy of the research project will be made available to your firm on request. Thank you for your co-operation.

COMPANY'S DETAILS

NAME OF CORPORATION:

YEAR OF INCORPORATION:

SERVICES OFFERED:

PERSONAL DETAILS

NAME OF RESPONDENT:

POSITION HELD:

YEARS WORKED:

ROLE IN THE PREPARATION OF THE FINANCIAL STATEMENTS:
.....

Please answer the following set of questions by ticking in the appropriate box

1. What is the critical point at which revenue is recognized by your organization for the usage of air-time (critical point is the point in which the entity transfers the significant risks and rewards of ownership pertaining to a sale transaction).

	PRE-PAID	POST-PAID
a. When the sale is made to dealers/distributors		
b. When the dealer/distributor sells the air time to		

the subscriber		
c. When the dealer orders for the air time		
d. when the subscriber uses the air time		
e. Any other point, specify		

2. How do you treat the un-used credit at the end of financial year?

	PRE-PAID	POST-PAID
a. Unearned revenue hence liability		
b. Earned revenue		
c. Not accounted for		
d. Other treatment, explain		

3. At what point does the company recognize inter company network connectivity charges?

	PRE-PAID	POST-PAID
a. When a call is made to the other network		
b. As a one-off transaction when the deal is made		
c. Other treatment, explain		

4. How does your company treat the air time that is given to employees?

	PRE-PAID	POST-PAID
a. Part of salary package		
b. Revenue and then offset against salary expense		
c. Not accounted for		
d. Other treatment, explain		

PRE-PAID

5. What is the critical point for sale of air-time (critical point is the point in which the entity transfer the significant risks and rewards of ownership pertaining to a sale transaction)?

- a. When the sale is made to dealers/distributors
 - b. When the dealer/distributor sell the air time to the subscriber
 - c. When the dealer order for the air time
 - d. Any other point, specify
6. How does your company treat the unsold air-time held by the dealers at the end of the year?
- a. Goods on consignment hence the inventory of the entity
 - b. Goods sold hence revenue
 - c. Not accounted for
 - d. Other treatment, explain

POST-PAID

7. How does your company account for the unpaid air-time usage by post-paid subscribers?
- a. Revenue earned but not received
 - b. Offset against existing deposit by customer
 - c. Other treatment, explain
8. How does your company treat the deposit paid by post paid subscribers?
- a. As revenue recognized
 - b. As liability to the company
 - c. Other treatment, explain
9. What happens to the deposit when a post paid customer pulls out?
- a. It is set aside as a provision “payable at a later date”
 - b. Off-set against any pending bill of the customer
 - c. Refunded to the customer
 - d. Other treatment, explain

SIM-CARD

10. What is the critical point for the sale of sim-card?
- a. When the sale is made to the dealers/distributors
 - b. When the subscriber buys from the dealer/distributor
 - c. When the dealer order for the sim-card
 - d. Any other point, specify
11. When does your company recognize revenue for the sale of sim-card?
- a. During the production
 - b. At the critical point
 - c. When the subscriber buys the sim-card
 - d. When the subscriber activates the sim-card
 - e. Other treatment, explain

Appendix 2

SUMMARY TABLE FOR THE QUESTIONNAIRE

	SAFARICOM		CELTEL		TELKOM		TOTAL	
	PRE PAID	POST PAID	PRE PAID	POST PAID	PRE PAID	POST PAID	PRE PAID	POST PAID
1. What is the critical point at which revenue is recognized by your organization for the usage of air-time?								
When the sale is made to dealers/distributors								
When the dealer/distributor sell the air time to the subscriber								
When the dealer order for the air time								
when the subscriber uses the air time								
Any other point, specify								
2. How do you treat the un-used credit at the end of financial year?								
Unearned revenue hence liability								
Earned revenue								
Not accounted for								
Other treatment, explain								
3. At what point does the company recognize inter company network connectivity charges?								
When a call is made to the other network								
As a one-off transaction when the deal is made								

Other treatment, explain								
4. How does your company treat the air time that is given to employees?								
Part of salary package								
Revenue and then offset against salary expense								
Not accounted for								
Other treatment, explain								

	SAFARICOM	CELTEL	TELKOM	TOTAL
PRE-PAID				
5. What is the critical point for sale of air-time				
When the sale is made to dealers/distributors				
When the dealer/distributor sell the air time to the subscriber				
When the dealer order for the air time				
Any other point				
6. How does your company treat the unsold air-time held by the dealers at the end of the year?				
Goods on consignment hence the inventory of the entity				
Goods sold hence revenue				
Not accounted for				
Other treatment				
SIM-CARD				
7. What is the critical point for the sale of sim-card?				
When the sale is made to the dealers/ distributors				
When the subscriber buys from the dealer/distributor				
When the dealer order for the sim-card				
Any other point				
8. When does the company recognize revenue for the sale of sim-card?				

During production				
At the critical point				
When the subscriber buys the sim-card				
When the subscriber activates the sim-card				
Other treatment				
POST-PAID				
10. How does your company account for the unpaid air-time usage by post-paid subscribers?				
Revenue earned but not received				
Offset against existing deposit by customer				
Other treatment				
11. How does your company treat the deposit paid by post paid subscribers?				
As revenue recognized				
As liability to the company				
Other treatment				
12. What happens to the deposit when a post paid customer pulls out?				
It is set aside as a provision "payable at a later date"				
Off-set against any pending bill of the customer				
Refunded to the customer				
Other treatment				

CHECKLIST ON COMPLIANCE TO REQUIREMENTS OF IAS 18

REQUIREMENTS OF IAS 18	SAFARICOM	CELTEL	TELKOM	TOTAL
1. The accounting policies adopted for the recognition of revenue				
2. Methods adopted to determine the stage of completion of transactions involving the rendering of services				
3. Amount of each significant category of revenue during the period				
4. The amount of revenue arising from exchanges of goods or services included in each significant category of revenue.				