

ON RECOGNITION AND MEASUREMENT OF THE REVENUES ACCORDING TO IFRS 15

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Abstract

In May 2014, the Board of the International Financial Reporting Standards accepted IFRS 15 – “Revenues from Contracts”. This Standard will change radically the established methods of recognition and measurement of the revenues gained by the entities of various fields, that will have a material effect on determination of a total revenue.

The requirements set forth in IFRS 15, create the common conceptual grounds, that will improve reflection in the financial statements of the information regarding volume, nature, distribution in time, uncertainties and cash turnover of the revenues received from the contracts with clients, as well as comparability of these indicators for the enterprises of different levels and branches.

The Article provides discussions on separate provisions of the Standard and, analyzes their approaches to the terms and methods of recognition of the revenues. An emphasis is made on the issues of accounting and reflection of the contractual assets and liabilities in the financial reporting and also on a common model of recognition of the revenues a basic element of which is the contracts concluded with clients. A detailed analysis of 5 steps of recognition of the revenue is provided, as IFRS requires for the recognition.

Key words: revenue recognition, identification of contract, contractual assets, contractual liabilities, contractual price

1. INTRODUCTION

The operating standards related to the revenues did not discuss some of the circumstances that could emerge in practice, and thus, did not provide a reasonable answer to the question when and how should the revenues be recognized. Adaptation of IAS 18 - "Revenue" and IAS 11 - "Construction Contracts" with the complex operation was very difficult. At the same time, their provisions differed from the US Generally Accepted Accounting Principles – (US GAAP) and both of them needed improvement.

IFRS 15 was issued in May, 2014. This Standard identifies 5-stage model of recognition of the revenues from the contract executed with clients. A new standard of recognition of the revenue will spread all over the entities and substitute the currently adopted rules of recognition of the revenues according to IFRS, except for the revenues received from other financial instruments and contractual rights covered within the scope of operation of IAS 17 “Leases”, IFRS 4 “Insurance Contracts”, and IAS 39 “Financial Instruments: Recognition and Measurement”, which are accounted according to relevant standards.

As expected, the new standard, with its more structural approaches and introduction of universal criteria for different contracts, will avoid all misunderstandings conditioned by previous standards. If, in the past, for selling the goods, and delivering the services and construction works as per the subject of the contracts, various models of accounting existed, the new standard provides more detailed and unified mechanism for the accounting.

2. RECOGNITION OF REVENUES

According to the basic principle of IFRS 15, recognition of the revenues will take place by size of the compensation the entity expects to receive in exchange of the goods and services delivered to its client. To determine a recognition of the revenue, the Standard includes numerous provisions. Namely, the 5-step analysis of the contractual terms and conditions provides an opportunity to resolve this issues on the basis of the professional discussions.

Contract is an agreement between two or more parties, which creates legal rights and responsibilities despite a form of composing thereof.

According to the Standard, we can say that a contract is a legal document, which contains the information that must to be subordinated to the recognition and measurement in the accounting practice. For example, the information regarding the contractual obligation or the asset covered by the contract.

For recognizing the revenue from a specific contract, a company must use the 5-step model of the analysis:

Step 1: Identify the contract with the customer. Here an emphasis is made on determination and formation of the contract.

The contract concluded with the client will be considered within the scopes of IFRS 15 and become an object of observation in terms of the accounting if provided by the relevant legal norms and all the following criteria are met:

- The contract has been approved by the parties to the contract;
- Each party's rights in relation to the goods or services to be transferred can be identified;
- The payment terms for the goods or services to be transferred can be identified;
- The contract has commercial substance; and
- It is probable that the consideration to which the entity is entitled to in exchange for the goods or services will be collected (IFRS 15).

The contract concluded despite the fact that the Standard considers both the written and verbal forms of the contract, we think that the criteria, which should be met by the contract, require a written form thereof, because otherwise a transparency of the accounted will not be provided.

In some cases, the Standard requires integration of several contracts and accounting thereof as one contract. Besides, the Standard defines, how the accounting process should be implemented in cases of changes in the contracts.

The entity must combine two or more contract having similar specifications and, account them as one contract, if they meet one or more following criteria:

- a) The contracts are negotiated as a package with a single commercial objective;
- b) The amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
- c) The goods or services promised in the contracts (or some goods and services promised in each of the contracts) are a single performance.

Change (modification) of the contractual terms and conditions may be treated as modification in the original contract, and/or a new contract.

Modification implies changes in the contractual price and of the subject matter of the contract.

The contract shall be recognized as a new one, if:

- The scope of the contract increases because of the addition of the promised goods and services;
- Contractual price increases by amount of consideration of the additional promised goods and services.

The changes made in the contract, are to be accounted in pursuance of the two following models:

- Prospectively (with distribution of the price of deal over the remainder contractual obligations);
- Retrospectively (regarding the obligations, which are to be performed for a certain period of time and, are partly performed as at the date of modification of the contract, as a result of which the total revenues should be corrected with taking into account the date of modification).

One of the above two versions are to be selected with considering, whether the goods and services promised after the modification, differ from the ones promised before the modification. If differ, the retrospective model must be applied, while if no difference occurs - the prospective model.

Thus, the contract concluded with the customer, contains the information on the contractual obligations that is a subject of the accounting. That is why this document becomes the object of observation and analysis in terms of accounting.

Step 2: Identify the contractual obligations - this is aimed at identification of delivery of all promised goods and services. Promises are treated as a single obligation if related to those objects, which independently from each other meet the definition of element and has a value that may be measured reliably.

For determining whether the goods (services) can be identified and are separate from each other, the company must analyze:

- Whether the company can gain benefit from separate use of such goods and services of together with other available resources; and
- Whether the company's obligations for the delivery of the goods and services can be separated from its other contractual obligations and, identified correspondingly.

For example, the contract valued as 100 000 USD, envisages stage-by-stage performance of the works: projecting implementation, delivery, and technical service.

In this case, the goods and services envisaged by the contract, are separable because they are the components of each other and, each of them can be purchased separately. Proceeding from the above mentioned, each single stage of the contract is to be treated as a separate obligation, and, on these obligations a total price of the contract must be distributed at the initial stage.

By the example provided above, the obligations should be identified as follows:

Contractual obligations	Individual prices	% of total amount
Projecting	15 000	0.15
Implementation and delivery	80 000	0.80
Technical service	5 000	0.5
Total	100 000	100

Table 1. Identification of the contractual obligations

Let us consider a case where, for instance, a systemic integrator transfers the server to the buyer, and, a configuration of the server meets the client's requirements. The object includes both the hardware and the software adapted with the client's requirement. Since the technical device cannot be used without its installation, neither the server nor the software shall be considered as the separate obligations.

Thus, the identification of the contractual obligations imply a determination of the accounting units, on which the price of contract must be distributed and which should be recognized as the revenue. If the goods and services envisaged under the contract are different, i.e. separable, the company must identify all the arising obligations concerning their delivery.

Step 3: Determine the transaction price.

This envisages determination of the value of the deal, i.e. the amount the company expects to receive from the client in exchange of delivery of the goods and services.

At the same time, the transaction price may be fixed or variable, with taking into consideration variable, components, discounts, bonuses, and penalty sanctions.

When determining the amount of the revenue, the following factors should be foreseen:

- A value of the variable components of the Contract;
- Important component of funding;
- Non-cash compensation.

If the contracts contain variable components, the contract should indicate the expected change.

The company should evaluate variable components either by size of compensation of the expected value, or by the most likely value, depending upon a better availability of each of them for the company.

The Standard restricts recognition of the amount of variable components of the contractual price and, requires that the risk of chance (reduction) of the revenue be foreseen. A variable compensation will be included in the transaction price in case, if it is expected that this amount will be insignificant in total annual revenues and if exists a higher probability of recognition thereof.

An important component of funding, that may be foreseen under the contract, implies receive of the money from the client in advance of delivery of the goods or services.

In this case, the standard requires adjustment of the expected amount of payments, taking into consideration the time value of the money. The effect of money-time value is not considered and the adjustment of the amount is not required when the receipt of the amount and the obligation undertaken by the counter involves are less than one year. The purpose of the adjustment is to evaluate the value of the returns, which would have to pay the buyer at the moment of receiving control of the assets. The Company must determine whether prepayments are an important component of funding, because in this case:

- Cash withdrawals are treated as cash loans from clients, which generate financial expenses and increase the amount of deferred revenues;
- Late funds will be considered as a cash loan for the client, which generates financial incomes and reduces the amount of revenues.

In non-cash payments, returns are measured at fair value. But if it cannot be adequately evaluated, then the enterprise will use the price at that the goods and services are sold as an independent object.

Step 4: Distribution of the transaction price over the contractual obligations. When a contract contains more than one obligation, the total price of the contract shall be distributed to individual contractual obligations, since they are treated as independent objects.

The best tool on observing the sales price of the goods and services if they are the independent objects, is the observation on prices at which the similar goods and services are sold in a similar situation. However, if observation on the sales prices of the goods and services (if independent objects) is impossible, then they must be assessed according to the following instruments:

- Adjustment of the market valuation - determination of the amount to be paid by the buyer in the goods or services;
- Predictable Expenses plus a rate of profit;
- In rare cases, using a residual method - the transaction price minus the observed price.

For example: According to the contract, the entity must supply to the client the equipment for the network service. A total value of the deal is 1800 USD of which 150 USD must be paid on a monthly basis. According to the Standard, the entity is obliged to distribute a total 1800 USD over each contractual obligation by the market price of valuation thereof.

Contractual obligation	Effective market price	A share in a total value	Revenue
Equipment	450	23. %	414
Service	1500	77%	1 386
Total	1950	100%	1800

Table 2. Distribution of the transaction price over the contractual obligations

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

The company should recognize income when performing contractual obligations through the transfer of goods and services. The standard contractual commitment is fulfilled when the customer is given control over these assets or services.

Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. The control includes also the ability to prevent other entities from directing the use of, and obtaining the benefits from an asset (IFRS 15).

Obligation may be performed at the specific moment (at the time of sale of goods) or during a period of time (mainly in service delivery).

That is why it is important to recognize the revenues when the buyer has the right to control. The client will obtain the right to control of the asset during the execution of the contract, if any of the following three criteria is met:

1. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;
2. The entity's performance creates or enhances (for example, work in progress) that the customer controls as the asset is created or enhanced;
3. The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date (IFRS 15).

For a certain period of time, the company must choose a method for measuring the liability process to determine exactly what part of the liability has already been fulfilled and to recognize the returns accordingly.

Although IFRS 15 defines accounting requirements for separate contracts, in some cases, the company may use the standard requirements for the contracts portfolio, instead of accounting each contract separately.

The identifiers of passing the control of assets to the customer are as follows:

- The entity has the right to payment the value of the asset;
- The client has a legal right to hold the asset;
- The client has a physical right to hold the asset transferred;
- Important risks and benefits associated with holding the assets transferred to the client;
- The client received the benefit (IFRS 15).

In all other cases the revenue must be recognized upon performance of the obligation.

3. RECOGNITION OF THE CONTRACTUAL ASSET

According to the Standard, the contract is an object of accounting and contains the information about the contractual asset and the contractual obligation. Therefore, companies should provide disclosure of more detailed information about the contracts.

If the Contracting Parties have fulfilled even one component of the contractual obligations, the company has to reflect in the financial statements the uncovered contract according to performance by the parties as the contractual asset or the contractual obligation.

According to the Standard, the supplier shall separate from each other the contractual assets and the accounts receivable.

Accounts receivable is an unconditional right to accept the price determined by the contract, which belongs to the entity in exchange of delivered the goods and services. In practice, however, we sometimes encounter such a deal when certain liabilities under the contract differ from each other. Performing at least one component of the contractual liability is part of the rest of the component parts, which means the seller's right to fulfill the obligations determined by the seller in the future and the transaction will be completed in the future. In this case the seller of the goods shall not be entitled to receive an unconditional right to receive the sum because it must perform (satisfy other additional obligations under the contract). For example, when the cost of the goods of one name will be paid in accordance with the contract only, when other services or other goods are delivered.

Suppose, in April 2015, the Company A concluded the 1500 USD valued contract with the Company B on delivery of X and Y goods, under the condition that delivery of X goods and the first payment depends on the delivery of Y goods, i.e. the seller will receive a total 1500 USD envisaged under the Contract only after delivery of the both goods therefore, the seller company will not receive an unconditional right on remuneration until both the goods will have been transferred according to the contract.

The supplying company has identified according to IFRS 15 the two obligations envisaged by the contract. A contractual value of X Goods and Y Goods separately are distributed as follows, based on their sales process: X Goods – 600 USD, and Y Goods, 900 USD.

Taking into account the given conditions, once the Company A transfers to the Company B the X goods and the right of control thereon, this will be reflected in the accounting book as follows:

Description of the operation	Debit	Credit	Amount (USD)
Delivery of X Goods	Contractual asset	Revenue from sale	600

Table 3. Record in the Accounting Book after transfer of the right of control on the Goods

The contractual asset is to be recognized by this record (Table 3).

Thereafter, when the Company A transfers to the Company B the right of control on Y Goods, the following record should be entered in the accounting book:

Description of the operation	Debit	Sum	Credit	Amount (USD)
Delivery of Y Goods	Account receivable	1500	Contractual asset	600
			Revenue from sale	900
Covering the Account receivable	Money	1500	Account receivable	1500

Table 4. Record in the Accounting Book after performance of the all contractual obligations

Thus, the seller receives an unconditional right to receive compensation only after it fulfills all obligations before the buyer. This right is a receivable debt and not a contractual asset. This unconditional right will be executed when the buyer will pay the value of the goods.

4. EXPENSES ASSOCIATED TO CONCLUSION OF THE CONTRACT

When concluding the contract, an entity may be faced to the additional costs, e.g. bonuses for participants in the contract, trade commission fee, etc. According to the standard, these types of expenses should be recognized as an asset if the enterprise's costs are reimbursed. Contracts may be paid in a separate item or reimbursement for the expenses at the expense of the contract.

Costs related to the conclusion of the contract which would have arisen regardless of the existence of the transaction, are the costs of the period of their origin, except where the obligation to pay the expenses is vested on the customer, regardless of whether or not the contract was concluded.

Expenses incurred to perform the contract the enterprise must recognize the asset if the expenses are not subject to the regulation of the other standard and all criteria below are fulfilled:

- Costs are directly related to a contract or future contract that can identify the enterprise;
- Costs to generate or increase the enterprise resources that will be later used to fulfill the obligations;
- Expense compensation is expected in the future.

If in these costs the period of amortization is less than one year, the entity will recognize them as the expenses upon origination thereof.

The new standard is also much more detailed and provides recommendations for recording issues related to returns such as guarantees, obligation to return money and so on.

5. DISCLOSURE OF THE INFORMATION

For the investors understand better the nature of the revenues, the number of uncertainties associated with the acquisition and the cash flows from contracts, the standard obliges the companies to report the quantitative and qualitative information on the following elements:

- Receipts generated from contracts, according to detailed categories;
- Contract-related balance, which includes expected revenues, contract assets and liabilities;
- The obligation to be fulfilled, in particular, when it is concluded and the value assigned to the specific part of the obligation stipulated by the contract;
- Important assessments and modifications in appraisal when using standard requirements;

- Assets from the expenses incurred in the maintenance or execution of the contract.

Delivering detailed information in the statement provides better determination of the expected revenues envisaged by the recognized returns and contracts.

6. CONCLUSION

Thus, unlike the applicable regulations, the IFRS 15, with introducing universal criteria for different contracts considers more widely and specifically all possible versions of recognition and measurement of the revenues.

Its main features are:

- Identify all liabilities;
- Individual prices on individual contract liabilities;
- Convert the variable values;
- Defining an important component of financing;
- Transfer of the Control;
- Recognition of the contractual asset;
- Costs related to conclusion;
- Licenses.

The introduction of IFRS 15 and new regulations for recognition of revenues will have a slight impact on some enterprises, but in many companies it significantly changes its rules of recognition and measurement. This refers to the companies that carry out licensing and software sales as well as enterprises operating in telecommunication, construction, defense industries, etc.

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