NEW APPROACHES ON REVENUE RECOGNITION AND MEASUREMENT

Cristina-Aurora, Bunea-Bontaş[1]

Abstract:
Revenue is an important indicator to users of financial statements in assessing an entity's financial performance and position. International Financial Reporting Standard 15 Revenue from Contracts with Customers (IFRS 15) issued in May 2014 provides a robust framework for addressing revenue issues. The standard establishes principles for reporting useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers. This article outlines the basic principles that an entity should must apply to measure and recognise revenue and the related cash flows.

Keywords: *IFRS 15, revenue, contract with customer, performance obligation, satisfaction of performance obligations, allocating the transaction price*

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1. Introduction

In May 2014, the International Accounting Standards Board (IASB) has published IFRS 15 *Revenue from Contracts with Customers*, the product of a major joint project between the IASB and FASB, the US Financial Accounting Standards Board. The previous requirements of IFRS and US GAAP on revenue recognition were not harmonized and often resulted in different accounting treatments for economically similar transactions (Grant Thornton, 2014, pp. 1). Therefore, IASB and FASB have developed new, fully converged requirements for the recognition of revenue under both IFRS and US GAAP.

Currently, existing IFRS guidance on revenue recognition and measurement is set out in two standards (IAS 18 *Revenue* and IAS 11 *Construction Contracts*) which are accompanied by a number of Interpretations.

The objective of the new standard is to establish the principles that an entity will apply to report useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from a contract with a customer (IFRS 15, par. 1). In order to meet this objective, IFRS 15:

- sets out a new control-based revenue recognition model,
- changes the basis for deciding whether revenue is to be recognised over time or at a point in time,
- includes comprehensive application guidance and illustrative examples,
- provides new and more detailed guidance on specific topics,
- expands and improves disclosures about revenue.

The new standard will be applied to all the contracts with customers to provide goods or services, including construction contracts and licensing of intellectual property. It will not apply to certain contracts within the scope of other IFRSs such as lease contracts, insurance contracts, financing arrangements, financial instruments, guarantees other than product warranties, and non-monetary exchanges between entities in the same line of business to facilitate sales to third-party customers.

IFRS 15 is effective for annual reporting periods beginning on or after 1 January 2017, with earlier application permitted and it supersedes: IAS 11 *Construction Contracts*, IAS 18 *Revenue*, IFRIC 13 *Customer Loyalty Programmes*, IFRIC 15 *Agreements for the*

[1] Lecturer PhD., Constantin Brancoveanu University of Pitesti, Faculty of Management Marketing in Economic Affairs of Braila, bontasc@yahoo.com

Construction of Real Estate, IFRIC 18 *Transfers of Assets from Customers*, and SIC-31 *Revenue - Barter Transactions Involving Advertising Services*.

2. The five-step approach on revenue recognition and measurement under IFRS 15

IFRS 15 establishes a single and comprehensive framework which sets out how much revenue is to be recognised, and when. The core principle of the standard is that the entities should recognise revenue to depict the transfer of promised goods or services to customers – and the amount of revenue should reflect the consideration to which they expect to be entitled in exchange for those goods or services (IFRS 15, par. 2).

Revenue will be recognised by a vendor when control over the goods or services is transferred to the customer. In contrast, IAS 18 bases revenue recognition around an analysis of the transfer of risks and rewards; now this is one of the criteria that are assessed in determining whether control has been transferred (BDO, 2014b, pp. 6).

The application of the core principle in IFRS 15 is carried out in five steps:

- Step 1: Identify the contract(s) with the customer
- Step 2: Identify the performance obligations in the contract
- Step 3: Determine the transaction price
- Step 4: Allocate the transaction price to the performance obligations in the contract
- Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation.

Step 1: Identify the contract(s) with a customer

An entity will apply the revenue standard to each contract with a customer when all of the following criteria are met:

- the parties have approved the contract and intend to perform their respective obligations;

- each party's rights regarding the goods or services to be transferred can be identified;

- the payment terms can be identified;

- the contract has commercial substance: the risk, timing or amount of the entity's future cash flows are expected to change;

- it is probable that the entity will collect the consideration to which it will be entitled in exchange for goods or services transferred. In evaluating whether collection is probable, the entity would consider only the customer's ability and intention to pay the consideration when due.

An entity will reassess whether the criteria are met each reporting period to determine if the criteria are subsequently met if they are not met at contract inception.

A contract is an agreement between two or more parties that creates enforceable rights and obligations. (IFRS 15 par. 10) Contracts may be written, verbal or implied by customary business practices, but must be enforceable and have commercial substance. The model applies to each contract with a customer once it is probable the entity will collect the consideration to which it will be entitled.

Current IFRS does not provide specific application guidance on oral contracts. However, entities are required to consider the underlying substance and economic reality of an arrangement and not merely its legal form. *The Conceptual Framework for Financial Reporting* states that representing a legal form that differs from the economic substance of the underlying economic phenomenon may not result in a faithful representation (Ernst & Young, 2014b, pp. 22).

For example, Company XYZ provides online technology support for customers remotely via the internet. For a flat fee, XYZ will scan the customer's personal computer for viruses, optimise the PC's performance and solve any connectivity problems. When the customer calls to obtain the scan services, the company describes the services it can provide and states the price for those services. When the customer agrees to the terms stated by the representative, payment is made over the telephone. The company then gives the customer the information it needs to obtain the scan services (e.g., an access code for the website). It provides the services when the customer connects to the internet and logs onto the entity's website (which may be that day or a future date).

In this example, Company XYZ and its customer are entering into an oral agreement, which is legally enforceable in their jurisdiction, for XYZ to repair the customer's computer and for the customer to provide consideration by transmitting a valid credit card number and authorisation over the telephone. The required criteria for the contract with the customer are all met. This agreement would be within the scope of IFRS 15 at the time of the telephone conversation, even if the entity has not yet performed the scanning services (Ernst & Young, 2014b, pp. 20)

An entity may combine two or more contracts that are entered into at or near the same time with the same customer, and account for them as a single contract, provided they meet specified criteria. The standard provides detailed requirements for contract modifications. Depending on the specific facts and circumstances, a modification may be accounted for as a separate contract or a modification of the original contract.

Step 2: Identify the performance obligations in the contract

Once the contract has been identified, an entity will evaluate the terms and customary business practices to identify which promised goods or services, or a bundle of promised goods or services, should be accounted for as separate performance obligations (Ernst & Young, 2014a, pp. 2)

The key determinant for identifying a separate performance obligation is whether a good or service, or a bundle of goods and services, is distinct. According to IFRS 15 (par. 27), a good or service is distinct if (a) the customer can benefit from the good or service on its own or together with other readily available resources, and (b) the promise to transfer the good or service to the customer is separately identifiable from other promises in the contract. Each distinct good or service will be a separate performance obligation.

Whilst a version of the first criterion is widely used today, the second criterion is a new concept that will require entities to think differently about promised goods and services. Compared to current practice, it may result in more goods and services being unbundled from others in a contract. Alternatively, an entity might bundle together promised goods and services that have stand-alone value to the customer today because they are highly inter-related with other promised goods and services in the contract (KPMG, 2014, pp. 9).

For example, Company XYZ has a contract to build a house, a process that requires a number of different goods and services. Generally, those goods and services would meet the first criterion because the customer could benefit from each individual brick or window in conjunction with other readily available resources. The second criterion is not met for each brick and window, because the company provides a service of integrating those goods into a combined output. Therefore the goods and services used to build the house are combined and accounted for as one performance obligation.

By contrast, Company ABC is a software developer and it enters into a contract with a customer to transfer a software licence, perform an installation service and provide unspecified software updates and technical support for a specified period. The company will identify four separate performance obligations of: (a) the software licence, (b) the installation service, (c) the software updates services, and (d) technical support (Tong, 2014, pp. 5).

Step 3: Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled. To determine this amount, en entity considers multiple factors:

- an estimate of any variable consideration (e.g., it may vary due to rebates or bonuses), using either a probability-weighted expected value or the most likely amount, whichever better predicts the amount of consideration to which the entity will be entitled;

- the effect of the time value of money, if there is a financing component that is significant to the contract;

- the fair value of any non-cash consideration;

- the effect of any consideration payable to the customer, such as vouchers and coupons.

Two of these are important factors to be considered for the purpose of determining the transaction price: variable consideration and the existence of a significant financing component.

Variable consideration

Items such discounts, price concessions, returns or performance bonuses/penalties may result in variable consideration. Depending on the facts and circumstances, entities estimate the amount of variable consideration using either the expected value or the most likely amount.

The expected value approach represents the sum of probability-weighted amounts for various possible outcomes. The most likely amount represents the most likely amount in a range of possible amounts. Management should use the approach that it expects will best predict the amount of consideration to which the entity will be entitled based on the terms of the contract and taking into account all reasonably available information. The approach used should also be applied consistently throughout the contract.

A constraining estimate of variable consideration included in the transaction price is that an entity should recognise revenue as performance obligations are satisfied only if it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved. This assessment will often require judgment (PWC, 2014, pp. 7).

According to IFRS 15, the following indicators suggest that including an estimate of variable consideration in the transaction price could result in a significant reversal of cumulative revenue:

- the amount of consideration is highly susceptible to factors outside the entity's influence;

- the uncertainty about the amount of consideration is not expected to be solved for a long period of time;

- the entity has limited experience with similar types of contracts;

- the entity has a practice of offering a broad range of price concessions or changing payment terms and conditions in similar circumstances for similar contracts;

- there is a large number and broad range of possible outcomes.

The assessment needs to be updated at each reporting date.

Estimating the amount of variable consideration may affect the timing of revenue recognition (KPMG, 2014, pp. 11). Currently, entities determine whether the amount of consideration can be measured reliably, or is fixed or determinable. By contrast, the new standard sets a ceiling, which limits rather than precludes revenue recognition. As a result, estimating variable consideration and applying the constraint may lead to earlier revenue recognition for some entities.

For example, Company XYZ has a contract to sell products through a distributor. According to the contract, the distributor has a right of return if it cannot sell the product. Currently, revenue is recognised by Company XYZ when the distributor resells the products to end users, based on IAS 18. Under IFRS 15, revenue may be recognised by the company earlier on the sale to the distributor, based on historical experience of the number of products for which it is highly probable that they will not be returned.

Significant financing component

Management will need to evaluate arrangements with customers to determine whether they include a significant financing component. The guidance related to a significant financing component is different than current guidance related to applying the time value of money. In some cases it will be clear that a significant financing component exists due to the terms of the arrangement. In other cases it could be challenging to determine whether a significant financing component exists, especially in some long-term arrangements with multiple performance obligations if goods or services are delivered and cash payments received throughout the arrangement (PWC, 2014, pp. 10). The standard allows for some level of judgment by requiring entities to assess whether the substance of the payment arrangement is a financing.

In assessing whether a contract contains a significant financing component, an entity should consider various factors, including:

- the length of time between when the entity transfers the goods or services to the customer and when the customer pays for them;
- whether the amount of consideration would substantially differ if the customer paid cash when the goods or services were transferred;
- the interest rate in the contract and prevailing interest rates in the relevant market.

For example, Company XYZ is a software entity that agrees to provide two years of post-contract customer support for CU500, which the customer pays upfront and can renew for CU250 annually after the initial two-year period. The entity needs to consider whether there is a significant financing component because the customer paid CU500 in advance, but there is no discount for paying upfront as compared to the annual pricing (CU250 per year). If the advance payment is required for reasons other than obtaining financing, such as for business purposes to obtain a longer-term contract, then the entity would conclude that a significant financing obligation does not exist.

A practical expedient allows entities to disregard the time value of money if the period between transfer of the goods or services and payment is less than one year, even if the contract itself is for more than one year (IFRS 15, par. 63).

Step 4: Allocate the transaction price to the separate performance obligations

An entity has to allocate the transaction price to each separate performance obligation on a relative stand-alone selling price basis, with limited exceptions. When determining the stand-alone selling prices, an entity should use observable information, if it is available. If stand-alone selling prices are not directly observable, an entity will need to use estimates based on reasonably available information. Examples of reasonably available information include an adjusted market assessment approach or an expected cost plus a margin approach. A residual approach can be used only when the stand-alone selling price of a good or service is highly variable or uncertain.

In most instances, an entity will be able to make estimates of stand-alone selling prices that represent management's best estimate considering observable inputs. However, it could be more difficult if goods or services are not sold independently by the entity or others. Current IFRS does not explicitly address the accounting for multiple-element arrangements, which has resulted in diversity in practice. IFRS 15 provides detailed requirements for transactions with multiple elements, but does not eliminate the need to exercise judgement to determine the appropriate performance obligations and allocate the consideration to those performance obligations.

For example, Company XYZ sells a good that includes free after-sale services for three years and the consideration receivable is CU5,000. The stand-alone selling price of the good is CU4,000 and the stand-alone service price per year is CU500. The relative stand-alone selling price ratio is 0.73 for the good and 0.27 for the after-sale services. The entity allocates CU3,650 to the sale of the good component (that is CU5,000 x 0.73) and CU1,350 to the after-sale services component (that is CU5,000 x 0.27).

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

An entity satisfies a performance obligation by transferring control of a promised good or service to the customer, which could occur *over time* or *at a point in time*. A performance obligation is satisfied at a point in time unless it meets one of the following criteria, in which case, it is satisfied over time:

- the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;
- the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or
- 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.

Revenue is recognised in line with the pattern of transfer. Revenue that is allocated to performance obligations satisfied at a point in time will be recognised when control of the good or service underlying the performance obligation has transferred. If the performance obligation is satisfied over time, the revenue allocated to that performance obligation will be recognised over the period the performance obligation is satisfied, using a single method that best depicts the pattern of the transfer of control over time.

Recognising revenue upon a transfer of control is a different approach from the 'risks and rewards' model that currently exists in IFRS. IFRS 15 (par. 33) states that control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. Control also means the ability to prevent others from directing the use of, and receiving the benefit from, a good or service.

Under IFRS 15, the transfer of control to the customer represents the transfer of the rights with regard to the good or service. The customer's ability to receive the benefit from the good or service is represented by its right to substantially all of the cash inflows, or the reduction of the cash outflows, generated by the goods or services. Upon transfer of control, the customer has sole possession of the right to use the good or service for the remainder of its economic life or to consume the good or service in its own operations (Ernst & Young, 2014b, pp. 99).

For example, Company XYZ, a local digital cable TV operator, enters into a 12-month plan with a customer. The terms of plan are as follows: the customer's monthly fixed fee is CU450, and he receives a free receiver at the inception of the plan. Company XYZ sells the same receiver for CU1,000 and the same monthly prepayment plans without receiver for CU400 per month.

Under current rules of IAS 18, the company *does not recognise revenue from the sale of receiver*, because it gives it away for free. The cost of receiver is recognised to profit or loss, as a cost of acquiring a new customer. Revenue from monthly plan is recognised on a monthly basis and the journal entry every month is:

Accounts receivable (or cash)CU450

Revenue CU450

Under new rules in IFRS 15, Company XYZ *identifies all performance obligations* from the contract with the customer, these being: (a) the obligation to deliver the receiver, and (b) the obligation to deliver cable TV services over 1 year. The *transaction price* is CU5,400, calculated as monthly fee of CU450 times 12 months.

The *allocation of the transaction price* of CU5,400 to individual performance obligations under the contract based on their relative stand-alone selling prices (or their estimates) is presented in table no. 1.

Table no. 1. The allocation of the transaction price to individual performance obligations

Performance obligation	Stand-alone selling price (CU)	% on total	Revenue (CU)
Receiver	1,000	17.24%	930.96**
Cable TV services	4,800*	82.76%	4.469.04**
Total	**5,800**	**100.00%**	**5,400.00**

* CU4,800 = CU400 x 12 months

** Revenue = CU5,400 x % on total

The revenue is recognised when Company XYZ *satisfies the performance obligations*. Therefore, it recognises the revenue of CU930.96 when it gives the receiver to the customer, and recognises the revenue of CU372.42 per month, when it provides cable TV services (the total revenue is CU4,469.04, that is CU372.42 times 12 months).

The journal entries are the following:

a. Sale of the receiver:

Unbilled revenue CU930.96

Revenue from sale of goodsCU930.96

When receiver is given to the customer

b. Cable TV services:

Accounts receivable CU450.00

Revenue from cable servicesCU372.42

Unbilled revenue (=CU930.96/12) CU77.58

When cable TV services are provided, on a monthly basis according to the contract with the customer

A major impact of the new standard is that the companies will report profits in a different way and profit reporting patterns will change. In the example presented above, the company reports loss at the beginning of the contract and then steady profits under IAS 18, because it recognises the revenue in line with the invoicing to the customer. Under IFRS 15, the reported profits are the same in total, but their pattern over time is different, as it can be seen in table no. 2.

Table no. 2. The revenue measurement under IAS 18 and IFRS 15

Performance obligation	Under IAS 18 (CU)	Under IFRS 15 (CU)
Sale of receiver	0.00	930.96
Cable TV services	5,400.00	4.469.04
Total	**5,400.00**	**5,400.00**

3. Conclusions

The new provisions of IFRS 15 will impact all entities in all industries, but the extent of the impact can vary significantly. For some entities whose customer arrangements consist of relatively straightforward contracts for the delivery of a single product or service, the timing and amount of revenue recognised may not change (Grant Thornton, 2014, pp. 1). Other entities may find the impacts to be more pervasive depending on the precise nature and complexity of their contractual arrangements with customers.

The application of the prescriptive and detailed implementation guidance contained within the new standard may result in a change in the timing and/or the amount of revenue recognition, primarily arising from:

- the number of goods or services in a contractual arrangement over which revenue needs to be allocated;
- the manner in which revenue is allocated to these goods and services; and

- the timing when an entity provides the goods or services to the customer (i.e. at a point in time or over a period of time).

Some of the areas that are likely to require more judgment in the application of the additional guidance and possibly result in accounting changes are: contract costs (expense vs. capitalisation), time value of money, contract modifications, warranties, licensing, option for additional goods or services at a discount (Delloitte, 2014b, pp. 2).

However, all entities should be prepared to reassess their revenue recognition policies and consider whether revisions are needed, as well as to look carefully at the new disclosure requirements which have been significantly expanded.

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