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INTERNATIONAL FINANCIAL REPORTING STANDARD (IFRS) 15 REVENUE FROM CONTRACTS WITH CUSTOMER

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OBJECTIVE

Prescribe the accounting treatment for generating revenue from certain types of transaction and events.

INTRODUCTION

IAS 18 which provides guidance for revenue recognition to all companies, it's a quite

broad method of recognition of revenue, many companies apply as per their judgement. On other hand some of the companies (especially American based Companies) follow the US GAAP [1].

US GAAP is more detailed guidance and strict regulations for many areas other than revenue recognition compared to IFRS but there is some conflicts between IFRS and US GAAP. To reduce such gap between two different methodologies, International Accounting Standard Board (IASB) the independent accounting standard-setting body introduced new IFRS on replacement of IAS 18 named IFRS 15 revenue from contracts with customers [2].

THEORETICAL FRAMEWORK

International Accounting Standard 18 – Revenue

This standard applies in accounting for revenue arising from the following transactions and events [2]:

(a) The sale goods;

(b) The rendering of services; and

(c) The use of assets of entity by others to receive interest, royalties and dividends.

Recognition criteria: Revenue is economic benefit that is arising on trade of ordinary activities of an organization and in results the equity of an organization effects (increase), ultimately the increase relates with the principles who contributed in equity.

Fair value (i.e. market value) is the amount for which an asset can be exchanged, or a liability settled, between knowledgeable, willing parties in at arm's length transaction (at open market price).

Revenue shall be measured at the fair value of the consideration received or receivable: The amount paid or received is usually mutually decided in an

agreement between seller and user of the asset. This consideration is based on fair value of the asset i.e. market value and also taking into account if any trade discounts and order of 'quantity in bulk' offered by the entity.

Identification of the transaction: The recognition criteria in this Standard are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognized as revenue over the period during which the service is performed. Conversely, the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole. The recognition criteria of this standard applied distinctly to every transaction. However, in certain circumstances

Sale of goods: In case of sale of goods following criteria must be fulfilled:
Revenue from the sale of goods shall be recognized when all the following conditions have been satisfied:

- The entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
- The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
- The amount of revenue can be measured reliably;
- It is probable that the economic benefits associated with the transaction will flow to the entity; and
- The costs incurred or to be incurred in respect of the transaction can be measured reliably.

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 end of the reporting period.

The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:

- The amount of revenue can be measured reliably;
- It is probable that the economic benefits associated with the transaction will flow to the entity;
- The stage of completion of the transaction at the end of the reporting period can be measured reliably;
- The costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

The stage of completion of a transaction may be determined by a variety of methods. An entity uses the method that measures reliably the services performed.
Depending on the nature of the transaction, the methods may include:

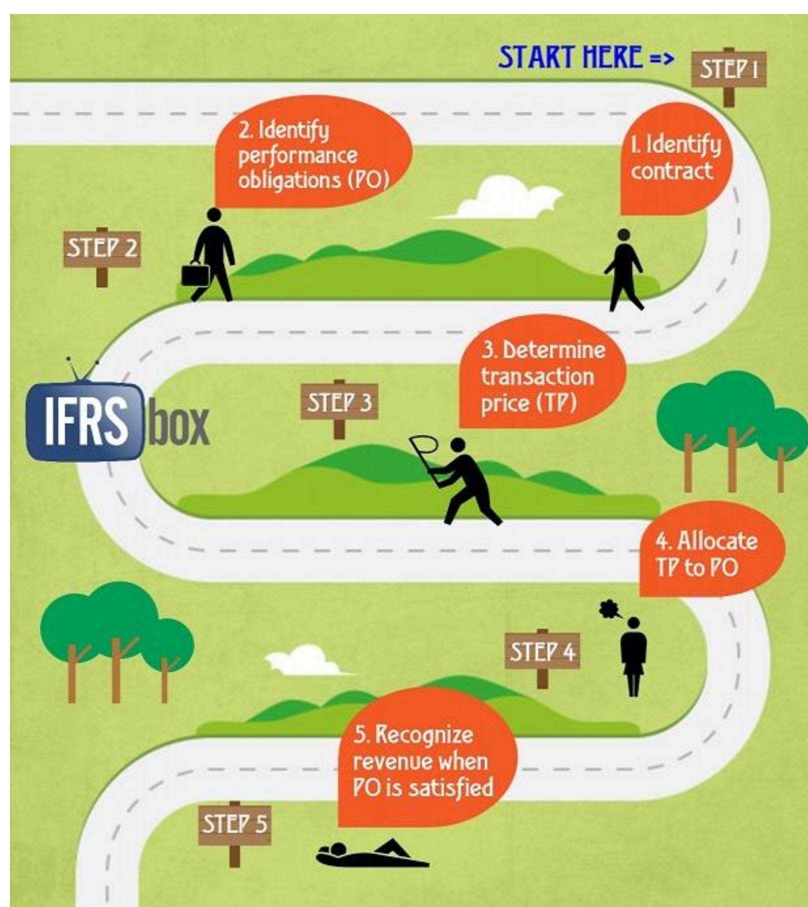
- Surveys of work performed;
- Services performed to date as a percentage of total services to be performed; or
- The proportion that costs incurred to date bear to the estimated total costs of the transaction. Only costs that reflect services performed to date are included in costs incurred to date. Only costs that reflect services performed or to be performed are included in the estimated total costs of the transaction.

International Financial Reporting Standard 15 – Revenue from Contracts with Customers

IFRS 15 establishes the principles that an entity can recognize its revenue to portray the promised goods or services to customer in an amount that describe the consideration to which the entity assumed to be contractually entitled against goods or services [3].

The new standard contains a single model that is applied when accounting for contracts with customers across all industries. The new standard replaces substantially all of the current revenue recognition guidance in both IFRS and US GAAP, excluding contracts that are out of scope – e.g. leases and insurance.
To implement/apply this principle, an entity needs to follow the five step model framework given below in Figure 1 [3].

Figure 1: IFRS 15 in 5 step model.



Step 1: Identify the contract with a customer: IFRS 15 explains the contract as an agreement between two or more parties that creates legally bounded rights and obligations and sets the criteria to meet the contract. Accordingly, following criteria have to be met to establish a contract;

- Both parties must approve contract and have intention to perform;
- And have to identify the rights and obligations of each party in the contract;

- Payment terms must be clearly decided, and contract has "commercial substance".

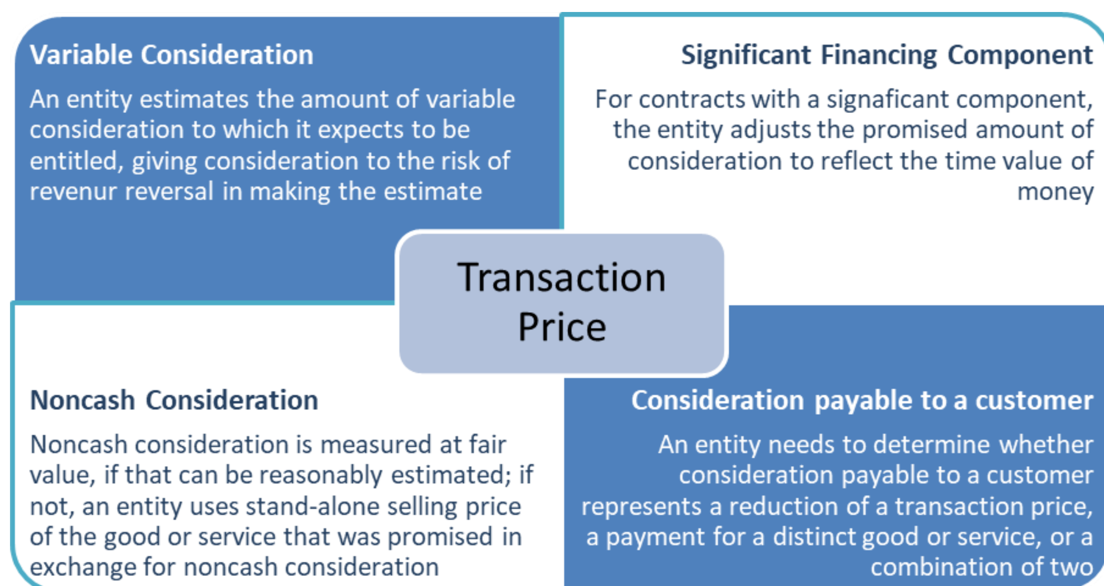
Step 2: Identify the performance obligations in the contract: A performance obligation is a promise with the buyer that goods or services will be delivered as per contract, and also unit of account for revenue recognition.

An entity assesses the goods or services promised in a contract with a customer and identifies as a performance obligation either a:

- Good or service (or bundle of goods or services) that is distinct; or
- Series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

Step 3: Identify the transaction price: Transaction price is the amount an entity expects to be received from customer against the goods or services being delivered to a customer, excluding the amount being received on behalf of third parties- e.g. some sales tax. In determining the transaction price, an entity considers the components mentioned in Figure 2.

Figure 2: Components to be considered by entity while determining transaction price.



Step 4: Allocate the transaction price to the performance obligations in the contract: The transaction price is allocated to each performance obligation, generally each distinct good or service to represent the amount of consideration to which an entity expects to be entitled in exchange for transferring of promised goods or services to the customer.

If any contract has number of performance obligations, then entity should proportionate the transaction price into the performance obligations in proportion to its stand-alone selling price.

In this step of revenue model there are further two sub steps that an entity performs at contract establishment; i.e.

- **Determine stand-alone selling price:** The price at which an entity sell a promised goods or services separately to a customer. The best evidence of this is an observable price from stands alone sales of the good or service to similarly situated customers.
- **Allocate the transaction price:** At contract inception, the transaction price is generally allocated to each performance obligation on the basis of relative stands alone selling prices. However, when specified criteria are met, a discount or variable consideration is allocated to or more, but not all, of the performance obligations in the contract [4].

Step 5: Recognize the revenue when (or as) the entity satisfies a performance obligation: According to above five steps model an entity cannot recognize the revenue until they meet the mutually decided performance obligation. In this way the received amount will be reconsidered as advanced from customers as asset and an unearned income and will be recorded as liability in their Financial Statement.

Accordingly, when a good or service are transferred to the end customer and customer obtains the control of it then revenue will be recognized.

- **Transfer of control:** Transfer of control is basically the ability of customer to direct the use of, and obtain the all related benefits with the asset by the

customer and prevent other entities from directing the use of, and obtaining the other benefits from, an asset.

LIMITATIONS

There is some limitation that in Step 4 an entity must divide revenue in number of performance obligations (if more than one performance obligation) but no any reference or guidance being provided that on what basis it can be decide the percentage of transaction price can be allocate on single obligation [4].

What's the Impact of IFRS 15?

The big impact will be on the company's profit reporting activities as profits were recognized once goods or services were delivered. After introducing the new IFRS for recognition of revenue from contract with customer, on 1st January 2018, revenue must be recognized on the completion of performance obligation [5].

Which Sector Will More Affect by IFRS?

As per the report of experts, those organizations who involved in long term contracts with their customers will be more affected. Therefore, such organization needs more attention for revenue recognition as per new model such organizations will probably recognize revenue earlier than under preceding rules [5].

Comparison with Current IAS 18

IAS 18 includes specific scope exceptions relating to changes in the fair value of biological assets, the initial recognition of agricultural produce, the extraction of mineral ores, and changes in the value of other current assets. The new standard does not explicitly include these scope exemptions, but because these items do not arise from contracts with contracts, they are outside of scope [2].

Comparison with Current US GAAP

The new standard eliminates substantially all transaction- and industry-specific guidance and applies to all contracts with customers other than those scoped out. Therefore, some entities currently applying transaction- or industry specific guidance may find that their revenue recognition policies will change under the new standard [6].

CONCLUSION

The standard will be applied in the financial statements of an entity for annual reporting on or after 1st January 2018. The initial implication of this IFRS, the complete implication will be applicable in the beginning of that period.

The implication that is to recognition of revenue from customers must be recognized on the basis of completion of contract terms and conditions as the agreed obligations of contract have been rendered [7].

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