IAS 18 Revenue - A Closer Look

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IAS 18,
Revenue
– A Closer Look

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International Accounting Standard (IAS) 18, *Revenue,* prescribes the accounting treatment of Revenue arising from certain types of transactions and events. In April 1981, the International Accounting Standards Committee (IASC) issued the Exposure Draft E20, *Revenue Recognition*. In December 1982, the IASC issued IAS 18, *Revenue Recognition,* effective from January 1, 1984. In May 1992, the IASC issued Exposure Draft E41, *Revenue Recognition.* In December 1993, the IASC issued revised IAS 18, *Revenue Recognition,* as part of the 'Comparability of Financial Statements' project based on E32. IAS 18 (1993) becomes operative for financial statements covering periods beginning on or after January 1, 1995. In December 1998, IAS 18 was amended by IAS 39, *Financial Instruments: Recognition and Measurement*, effective from January 1, 2001.

Objective

The objective of IAS 18 is to prescribe the accounting treatment of revenue arising from certain types of transactions and events, namely the sale of goods, the rendering of services yielding fees and the use by others of entity assets yielding interest or rental income. The primary issue in accounting for revenue is determining when to recognise revenue. Revenue is recognised when it is probable that future economic benefits will flow to the entity and these benefits can be measured reliably. This standard identifies the circumstances in which these criteria will be met and, therefore, revenue will be recognised.

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Scope and Application

IAS 18 shall be applied in accounting for revenue from sale of goods, services provided and use by others of the entity assets thereby yielding a form of income.
The use by others of entity assets gives rise to revenue in the form of:
(a) interest — charges for the use of cash or cash equivalents or amounts due to the entity;
(b) royalties — charges for the use of long-term assets of the entity, for example, patents, trademarks, copyrights and computer software; and
(c) dividends — distributions of profits to holders of equity investments in proportion to their holdings of a particular class of capital.

However, IAS 18 does not deal with revenue arising from:
• lease agreements (covered by IAS 17, *Leases*)
• dividends arising from investments that are accounted for under the equity method (refer to IAS 28, *Investments in Associates*)
• insurance contracts within the scope of IFRS 4, *Insurance Contracts*
• changes in the fair value of financial assets and financial liabilities or their disposal (IAS 39)
• changes in the value of other current assets
• initial recognition and from changes in the fair value of biological assets related to agricultural activity (IAS 41, *Agriculture*)
• initial recognition of agricultural produce (IAS 41)
• the extraction of mineral ores

Key Definitions

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Revenue is the gross inflow of economic benefits (cash, receivables, other assets) during the period arising in the course of the ordinary activities of an entity (such as sales of goods, sales of services, interest, royalties, and dividends) when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

Measurement of Revenue

Revenue includes only the gross inflows of economic benefits received and receivable by the entity on its own account. Amounts collected on behalf of third parties such as sales taxes, goods and services taxes and value added taxes are not economic benefits which flow to the entity and do not result in increases in equity. Therefore, they are excluded from revenue. Similarly, in an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity for the entity. The amounts collected on behalf of the principal are not revenue. Instead, revenue is the amount of commission.

Revenue shall be measured at the fair value of the consideration received or receivable taking into account the amount of any trade discounts and volume rebates allowed by the entity.

An exchange for goods or services of a similar nature and value is not regarded as a transaction that generates revenue. However, exchanges for dissimilar items are regarded as generating revenue.

The amount of revenue arising on a transaction is usually determined by agreement between the entity and the buyer or user of the asset. In most cases, the consideration is in the form of cash or cash equivalents and the amount of revenue is the amount of cash or cash equivalents received or receivable. However, when the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable. This would occur, for instance, if the seller is providing interest-free credit to the buyer or is charging a below-market rate of interest. Interest must be imputed based on market rates. When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest.

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 recognised 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. For example, an entity may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction; in such a case, the two transactions are dealt with together.

Sale of Goods

When goods or services are exchanged or swapped for goods or services which are of a similar nature and value, the exchange is not regarded as a transaction which generates revenue. For example, an arrangement to exchange grapes with another producer to meet the requirements of each producer. When goods are sold or services are rendered in exchange for dissimilar goods or services, the exchange is regarded as a transaction which generates revenue. This is usually a regular commercial transaction (i.e. cash for service or products) rather than a barter arrangement between suppliers.

Revenue arising from the sale of goods should be recognised when all of the following criteria have been satisfied:

the entity has transferred to the buyer the significant risks and rewards of ownership;
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 seller; and
the costs incurred or to be incurred in respect of the transaction can be measured reliably.

If the entity retains significant risks of ownership, the transaction is not a sale and revenue is not recognised. An entity may retain a significant risk of ownership in a number of ways. Examples of situations in which the entity may retain the significant risks and rewards of ownership are:
(a) when the entity retains an obligation for unsatisfactory performance not covered by normal warranty provisions;
(b) when the receipt of the revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of the goods;
(c) when the goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the entity; and
(d) when the buyer has the right to rescind the purchase for a reason specified in the sales contract and the entity is uncertain about the probability of return.

Rendering of Services

Revenue from a transaction involving the rendering of services shall be recognised by reference to the stage of completion of the transaction at the reporting date (the percentage-of-completion method). The outcome of a transaction can be estimated reliably when all of 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 reporting date can be measured reliably
• the costs incurred for the transaction and the costs to complete the transaction can be measured reliably
When the above criteria are not met, revenue arising from the rendering of services should be recognised only to the extent of the expenses recognised that are recoverable (a "cost-recovery approach").

An entity is generally able to make reliable estimates after it has agreed to the following with the other parties to the transaction:
(a) each party's enforceable rights regarding the service to be provided and received by the parties;

(b) the consideration to be exchanged; and
(c) the manner and terms of settlement.

It is also usually necessary for the entity to have an effective internal financial budgeting and reporting system. The entity reviews and, when necessary, revises the estimates of revenue as the service is performed. The need for such revisions does not necessarily indicate that the outcome of the transaction cannot be estimated 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:
(a) surveys of work performed;
(b) services performed to date as a percentage of total services to be performed; or
(c) 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. Progress payments and advances received from customers often do not reflect the services performed.

Interest, Royalties, and Dividends

When the outcome of a transaction involving the rendering of services cannot be estimated reliably, revenue is recognised only to the extent of the expenses recognised that are recoverable. Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity. Where uncertainty arises about the collectibility of an amount already included in revenue and correspondingly in the trade receivables, the probability test is subsequently not met. The potentially uncollectible amount or doubtful debt is recognised as an expense, and not as an adjustment of the amount of revenue originally recognised. However, the doubtful debts allowances on receivables are examples of a valuation allowance.

Revenue arising from the use by others of entity assets yielding interest, royalties and dividends shall be recognised when:
• it is probable that the economic benefits associated with the transaction will flow to the entity
• the amount of the revenue can be measured reliably

For interest, royalties and dividends, provided that it is probable that the economic benefits will flow to the enterprise and the amount of revenue can be measured reliably, revenue should be recognised as follows:

• interest shall be recognised using the effective interest method, as set out in IAS 39
• royalties shall be recognised on an accrual basis in accordance with the substance of the relevant agreement
• dividends shall be recognised when the shareholder’s right to receive the payment is established.

When unpaid interest has accrued before the acquisition of an interest-bearing investment, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; only the post-acquisition portion is recognised as revenue.

Royalties accrue in accordance with the terms of the relevant agreement and are usually recognised on that basis unless, having regard to the substance of the agreement, it is more appropriate to recognise revenue on some other systematic and rational basis.

When dividends on equity securities are declared from pre-acquisition profits, those dividends are deducted from the cost of the securities. If it is difficult to make such an allocation except on an arbitrary basis, dividends are recognised as revenue unless they clearly represent a recovery of part of the cost of the equity securities.

Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity. However, when an uncertainty arises about the collectability of an amount already included in revenue, the uncollectible amount, or the amount in respect of which recovery has ceased to be probable, is recognised as an expense, rather than as an adjustment of the amount of revenue originally recognised.

Prescribed Disclosures

An entity shall disclose:

• the accounting policies adopted for the recognition of revenue including the methods adopted to determine the stage of completion of transactions involving the rendering of services
• the amount of each significant category of revenue recognised during the period including revenue arising from:
— the sale of goods
— the rendering of services
— interest
— royalties
— dividends
• the amount of revenue arising from exchanges of goods or services included in each significant category of revenue

An entity discloses any contingent liabilities and contingent assets in accordance with IAS 37 *Provisions, contingent liabilities and contingent assets*. Contingent liabilities and contingent assets may arise from items such as warranty costs, claims, penalties or possible losses.

SIC Interpretations

The International Financial Reporting Interpretations Committee (IFRIC) and the Standing Interpretation Committee (SIC) of the International Accounting Standards Board (IASB) has issued the following five Interpretations relating to IAS 18:

- IFRIC 12, *Service Concession Arrangements*
- IFRIC 13, *Customer Loyalty Programmes*
- IFRIC 15, *Agreements for the Construction of Real Estate*
- SIC 27, *Evaluating the Substance of Transactions in the Legal Form of a Lease*
- SIC 31, *Revenue - Barter Transactions Involving Advertising Services*

On November 30, 2006, the IFRIC issued IFRIC 12, with the objective to address how service concession operators should apply existing International Financial Reporting Standards (IFRSs) to account for the obligations they undertake and rights they receive in service concession arrangements. Service concession arrangements are arrangements whereby a government or other body grants contracts for the supply of public services—such as roads, energy distribution, prisons or hospitals—to private operators. The objective of this project of the IFRIC is to clarify how certain aspects of existing IASB literature are to be applied to service concession arrangements.

On June 28, 2007, the IFRIC issued IFRIC 13, which addresses how companies, that grant their customers loyalty award credits (often called 'points') when buying goods or services, should account for their obligation to provide free or discounted goods or services if and when the customers redeem the points. Until now, IFRSs have lacked detailed guidance in this area and practices vary. Some companies measure their obligation based on the value of the points to the customer. Others measure it at the (usually lower) cost to the entity of supplying the free or discounted goods or service. The Impact of IFRIC 13 is:

IFRIC 13 is based on a view that customers are implicitly paying for the points they receive when they buy other goods or services, and hence that some revenue should be allocated to the points.

IFRIC 13 requires companies to estimate the value of the points to the customer and defer this amount of revenue as a liability until they have fulfilled their obligations to supply awards.

IFRIC 13 will standardise practices and ensure that entities measure obligations for customer loyalty awards in the same way as they measure other obligations to customers, i.e. at the amount the customer has paid for them.

The IFRIC issued IFRIC 15 on July 2, 2008. The objectives of the Interpretation are to clarify the definition of a construction contract and the articulation between IAS 11, *Construction Contracts* and IAS 18 and to provide guidance on how to account for revenue when the agreement for the construction of real estate falls within the scope of IAS 18.Agreements for the construction of real estate are widespread and may relate to residential, commercial or industrial developments. Construction often spans more than one accounting period, may take place on land the buyer owns or leases before construction begins and agreements may require progress payments. The main area of divergence in practice concerns the identification of the applicable accounting standard. In some jurisdictions, the prevailing practice is to apply IAS 11 and to recognise revenue as construction progresses. In others, it is to apply the requirements for the sale of goods in IAS 18 and to recognise revenue only when the completed real estate is delivered to the buyer. The main expected change in practice is a shift from recognition of revenue using the percentage of completion method to recognition of revenue at a single time (e.g. at completion, upon or after delivery). Affected agreements will be mainly those accounted for in accordance with IAS 11 that do not meet the definition of a construction contract as interpreted by the IFRIC and do not result in a ‘continuous transfer’ (i.e. agreements in which the entity transfers to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses).

The SIC issued Interpretation SIC 27 in December 2001, which addresses issues that may arise when an arrangement between an enterprise and an investor involves the legal form of a lease. Among the provisions of SIC 27:

- Accounting for arrangements between an enterprise and an investor should reflect the substance of the arrangement. All aspects of the arrangement should be evaluated to determine its substance, with weight given to those aspects and implications that have an economic effect. In this respect, SIC 27 includes a list of indicators that individually demonstrate that an arrangement may not, in substance, involve a lease under IAS 17.
- If an arrangement does not meet the definition of a lease, SIC 27 addresses whether a separate investment account and lease payment obligation that might exist represent assets and liabilities of the enterprise; how the enterprise should account for other obligations resulting from the arrangement; and how the enterprise should account for a fee it might receive from an Investor. SIC 27 includes a list of indicators that collectively demonstrate that, in substance, a separate investment account and lease payment obligations do not meet the definitions of an asset and a liability and should not be recognised by the enterprise. Other obligations of an arrangement, including any guarantees provided and obligations incurred upon early termination, should be accounted for under IAS 37 or IAS 39, depending on the terms. Further, it agreed that the criteria in IAS 18 should be applied to the facts and circumstances of each arrangement in determining when to recognise a fee as income that an Enterprise might receive.

The SIC issued Interpretation SIC 31 in December 2001. Under IAS 18, revenue cannot be recognised if the amount of revenue is not reliably measurable. SIC 31 deals with the circumstances in which a seller can reliably measure revenue at the fair value of advertising services received or provided in a barter transaction. Under SIC 31, revenue from a barter transaction involving advertising cannot be measured reliably at the fair value of advertising services received. However, a seller can reliably measure revenue at the fair value of the advertising services it provides in a barter transaction by reference only to non-barter transactions that:

- involve advertising similar to the advertising in the barter transaction;
- occur frequently;
- represent a predominant number of transactions and amount when compared to all transactions to provide advertising that is similar to the advertising in the barter transaction;
- involve cash and/or another form of consideration (such as marketable securities, non-monetary assets, and other services) that has a reliably measurable fair value; and do not involve the same counterparty as in the barter transaction.

IASB-FASB Joint Project on Revenue Recognition

Revenue recognition requirements in US generally accepted accounting principles (GAAP) differ from those in IFRSs and both are considered in need of improvement. The requirements in US GAAP comprise numerous standards—many are industry-specific and some can produce conflicting results for economically similar transactions. Although IFRSs contain fewer standards on revenue recognition, its two main standards have different principles and can be difficult to understand and apply beyond simple transactions.

On December 19, 2008, the IASB and the US Financial Accounting Standards Board (FASB) jointly published for public comment a discussion paper (DP) on recognition of revenue titled *Preliminary Views on Revenue Recognition in Contracts with Customers*, setting out a joint approach for the recognition of revenue. The boards' objective is to improve the existing guidance in both IFRSs and US GAAP by developing a single, contract-based revenue recognition model that can be applied consistently regardless of industry. The model would apply broadly to contracts with customers, although contracts in the areas of financial instruments, insurance, and leasing may be excluded.

Applying the underlying principle proposed by the boards, a company would recognize revenue when it satisfies a performance obligation by transferring goods and services to a customer as contractually agreed. That principle is similar to many existing requirements and the boards expect that many transactions would remain unaffected by the proposals. However, clarifying that principle and applying it consistently to all contracts with customers would improve the comparability and understandability of revenue for users of financial statements.

The boards intend to improve current revenue recognition guidance by:
• Enhancing consistency and comparability. The proposed model uses a recognition principle that can be applied consistently to various transactions in numerous industries. In addition, the proposed model provides more consistent guidance than currently exists on when an entity should recognize revenue.
• Simplifying US GAAP. Currently, there are more than 100 revenue recognition standards in US GAAP. Many of these standards are industry-specific, and some provide conflicting guidance. The proposed model eliminates conflicting guidance and reduces the number of revenue recognition standards.
• Providing guidance lacking in IFRSs. The two main IFRS revenue recognition standards are vague, inconsistent, and difficult to apply to complex transactions, such as revenue arrangements with multiple deliverables. The proposed model provides more comprehensive guidance than the current IFRS revenue recognition standards.

With regard to recognition of revenue, the DP states: In the proposed model, revenue is recognised when a contract asset increases or a contract liability decreases (or some combination of the two). That occurs when an entity performs by satisfying an obligation in the contract.

With regard to measurement of revenue, the DP states: The boards propose that performance obligations initially should be measured at the transaction price – the customer's promised consideration. If a contract comprises more than one performance obligation, an entity would allocate the transaction price to the performance obligations on the basis of the relative stand-alone selling prices of the goods and services underlying those performance obligations.

Subsequent measurement of the performance obligations should depict the decrease in the entity's obligation to transfer goods and services to the customer. When a performance obligation is satisfied, the amount of revenue recognised is the amount of the transaction price that was allocated to the satisfied performance obligation at contract inception. Consequently, the total amount of revenue that an entity recognises over the life of the contract is equal to the transaction price.

The DP highlights the following differences from current practice:

> **Use of a contract-based revenue recognition principle.** An entity would recognise revenue only as a result of satisfying a performance obligation. Cash collection or production of inventory not transferred to a customer (whether under contract or not) would not trigger revenue recognition. For instance, revenue recognition for construction-type contracts would only occur during construction if the customer controls the item as it is constructed.
> **Identification of performance obligations.** Under the proposed model, entities would account for contractual promises as performance obligations and would

recognise revenue when these obligations are satisfied. For example, some warranties and other post delivery services accounted for as cost accruals under current guidance would be performance obligations of a contract.

Use of estimates. Estimates used to recognize revenue would not be as limited under the proposed model as they are under some existing standards. For example, in multiple-element arrangements, entities would estimate the price of the undelivered goods and services and recognise revenue when goods and services are delivered to the customer, regardless of whether objective and reliable evidence of the selling price of the undelivered item exists.

Capitalisation of costs. In the proposed model, costs are capitalised only if they qualify for capitalisation in accordance with other standards. For example, an entity would expense as incurred, rather than capitalise, commissions paid to a salesperson for obtaining a contract with a customer. These costs typically do not create an asset that qualifies for recognition in accordance with other standards.

Commenting on the DP, Sir David Tweedie, Chairman of the IASB, said: "We believe that a single revenue model, applied consistently across various industries and countries, would greatly improve comparability of a key number in the financial statements. We haven't got all the answers yet, but we need to know whether we're heading in the right direction. If you want to influence the outcome of the project, now is the time to get involved." Robert Herz, Chairman of the FASB, said: "Revenue recognition guidance has become increasingly complex with scores of authoritative literature in US GAAP. The boards' revenue recognition project aims to simplify existing guidance by providing clear principles for recognizing revenue across a variety of industries. This discussion paper is an important step toward achieving that aim."

The DP seeks views from interested parties by June 19, 2009 to assist the boards in further developing the proposed model into a draft standard for both IFRSs and US GAAP. (For a list of discussion questions asked by the boards, see the Appendix.)

Comparative Indian Standard

The Accounting Standard issued by the Institute of Chartered Accountants of India (ICAI) comparative to IAS 18 is AS 9, *Revenue Recognition.* AS 9 is based on the earlier IAS 18 (1993). AS 9 is presently under revision to converge with IAS 18.

Conclusion

Revenue is an important number to users of financial statements in assessing a company's performance and prospects. The primary issue in accounting for revenue is determining when to recognise revenue. Under the proposed model, revenue would be recognised on the basis of increases in an entity's net position in a contract with a customer.

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Appendix

Questionnaire of the Discussion Paper

The following are specific questions that the boards ask entities to consider when submitting comments on the Discussion Paper.

Question 1: Do you agree with the Boards' proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?

Question 2: Are there any types of contracts for which the Boards' proposed principle would not provide decision-useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?

Question 3: Do you agree with the Boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

Question 4: Do you think the Boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.

Question 5: Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?

Question 6: Do you think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation? Why or why not?

Question 7: Do you think that sales incentives (for example, discounts on future sales, customer loyalty points, and "free" goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

Question 8: Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.

Question 9: The Boards propose that an entity should recognize revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.

Question 10: In the Boards' proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.

(a) Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?

(b) Do you agree that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?

(c) Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.
(d) Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.
Question 11: The Boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (for example,
selling costs) are included in the initial measurement of the performance obligations. The Boards propose that an entity should recognize those costs as expenses unless they qualify for recognition as an asset in accordance with other standards.
(a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not?
(b) In what cases would recognizing contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.
Question 12: Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's standalone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?
Question 13: Do you agree that if an entity does not sell a good or service separately, it should estimate the standalone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

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