New Approaches to Revenue Recognition and Common Sense

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1 Introduction
The revenues are usually the greatest single item in the financial statements (FASB, 2002a, p. 1). Along with information on net income for period, revenues are the most scrutinised item of financial statements. The evaluation of company’s performance and financial health cannot be processed without investigating the source, nature, amount and timing of reported revenues. However, the complexity of business environment makes it difficult to determine when to recognise revenue and how much. Since there is no comprehensive standard on revenue recognition, there is a gap between conceptual basis in the FASB Financial Accounting Concepts and particular guidance in the specific authoritative literature. Despite quite huge authoritative literature on this topic within US GAAP (Sondhi, 2006, p. 1.02 or FASB, 2002b, p. 1), proper solution has not been found for many problems yet. No wonder that mistakes in revenue recognition are on the top of the “financial reporting errors” list (SEC, 2003, p. 6). IASB is challenging to similar revenue recognition conceptual issues. Both worldwide important standard-setters IASB and FASB are well aware of these lacks and they are currently working on a new standard for revenue recognition.¹ The main aim of this paper is to estimate future development in the sphere of revenue recognition and to evaluate the usefulness of suggested proposals for accounting practice. This evaluation will be based on personnel experience from accounting education.

2 Background
International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) are cooperating on new standards within the context of joint convergence project. Revenue Recognition Project is a fragment of this project (see IASB, 2006, p. 3). The main objective of the Revenue Recognition Project is to develop new and comprehensive concepts for revenue recognition within a general standard based on those concepts. The Revenue Recognition Project is probably the most complicated part of the convergence project for both Boards. FASB started project concerning revenue recognition in 2002. The project had been

¹ There are some opinions that the conceptual change is not needed (see e.g. Wüstemann, 2005).
officially added to agenda of the joint convergence programme in October 2004. The draft and complete standard were going to be published in 2005. However, there have been important conceptual disagreements between IASB and FASB and issue date of those documents has been repeatedly postponed. According to current IASB Work Plan\(^2\) (as at March 2009), the Project agenda is planned as follows:

- Discussion paper has been issued in December 2008,
- Exposure Draft is to be published during the 1\(^{st}\) half of 2010,
- the new standard should be effective from January 2011.

In present, there are only proceedings (Board meeting minutes) of Boards provided for the information and convenience of constituents who want to follow the Boards’ deliberations available. Based on these tentative conclusions\(^3\) we can deduce that Boards’ members are considering some principles that depart significantly from current practice.

As mentioned earlier, revenue recognition is one of the biggest problems to which accountants are facing. According to the research carried out by the Security Exchange Commission in 2003, revenue recognition errors are the most frequent reason for the restatement of published financial statements.

**Tab. 1: Errors in Financial Statements Published in Compliance with US GAAP**

<table>
<thead>
<tr>
<th>Error type</th>
<th>Occurrence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue recognition</td>
<td>126</td>
</tr>
<tr>
<td>Expense recognition</td>
<td>101</td>
</tr>
<tr>
<td>Management comments</td>
<td>43</td>
</tr>
<tr>
<td>Business combination</td>
<td>23</td>
</tr>
<tr>
<td>Related parties disclosures</td>
<td>23</td>
</tr>
<tr>
<td>Non-monetary transactions and round-trip sales</td>
<td>19</td>
</tr>
<tr>
<td>Foreign currency transactions</td>
<td>6</td>
</tr>
<tr>
<td>Off-balance sheet financing</td>
<td>3</td>
</tr>
</tbody>
</table>

Source: SEC, 2003, p. 6

The survey of specialised server [www.recognition.com](http://www.recognition.com) (2007, p. 2 – 4) confirms that entities are struggling to provide information about revenues. According to the survey:

- 57 % of listed companies reporting under US GAAP are not able to prepare revenue


\(^3\) [http://www.fasb.org/project/revenue_recognition.shtml](http://www.fasb.org/project/revenue_recognition.shtml)
information on timely basis for the monthly financial statements,

- the delays (approximately 3 weeks) are caused by growing complexity of economic transactions and unavailability of needed information in due time,

- as far as implementation of internal control tools concerns, the most difficulties are evidenced in customer contracts management and revenues arising from these contracts,

- the measurement of revenue is not done in the accounting system, but it is performed outside the system using supplementary sheets, etc.

Despite huge authoritative literature on revenue recognition within both US GAAP and IFRS, all problems mentioned above are well inherent to current accounting practice. When trying to find solution to those problems, standard setters should reflect accounting and economic aspects of revenue recognition. The suggested solutions should be supported by theoretical conclusions, too.

We can distinguish two directions in the revenue theory. In the broad sense, the nature and measurement of revenue are integral part of both economic and accounting theories of income. Marshall (1947), Fisher (1906, 1930), Knight (1921), Hicks (1946) or Mises (1966) introduced the most important economic concepts of income. In accounting theory, the most famous concepts of income were developed by MacNeal (1979), Edward and Bell (1973) or Chambers (1974). All authors prefer income concept based on capital maintenance. According to capital maintenance approach, the revenue is the increase of entity’s capital excluding contributions from owners. The measurement of revenue corresponds to the chosen concept of capital and its maintenance. E.g. MacNeal (1979, p. 87) preferred the measurement of all accounting elements by the economic value, Edwards and Bell (1973, p. 45 and fol.) introduced opportunity costs for determination of excepted realisable profit and current costs for determination of business profit or Chambers (1974, p. 92) worked with current cash equivalents. Nevertheless, the definition and measurement of revenue is the inevitable consequence of capital maintenance approach to determination of income. Therefore, authors did not pay attention to particular practical problems regarding the revenue recognition. Some support for practical issues of revenue recognition can be found in the works of German theoreticians (e.g. Schmalenbach, Schmidt or Sommerfeld) or in the work of Belkaoui (2004).

3 Motivation for the paper

Although respecting economic background, all above-mentioned theoretical contributions omit one important aspect – the perception of the revenue nature and the moment at which the revenue arises by the “common” users of financial statements. During the winter semester of academic year 2008/2009, the author of this paper conducted an empirical experiment with
students of the course “Introduction to Accounting”. Students enrol in this course in the 2nd year of their bachelor study programme. Students are recommended to enrol in the course after successful passing the courses of “Economics” and “Business Economics”. Therefore, they have basic economical and business knowledge, but they are not biased by accounting perception of business world. I guess we can assume those students to be representatives of “common” users of financial statements.

In the seminar⁴ which aim is to explain the differences between cash and accrual basis of accounting and to learn to detect the moment at which revenue arises and should be recognised, the students were called upon to determine the date when the entity may recognise the revenue from selling the machine. The illustrative example was as simple as follows:

**Example 1: Revenue recognition – an illustrative example**

The Manufacturer seeks the supplier for a new machine:

- On 1 November 20X0, the Manufacturer sends its demand to the domestic and one foreign suppliers. All suppliers send back their offers with technical, delivery and payment terms.
- On 20 November 20X0, the Manufacturer chooses the foreign supplier to produce and deliver the machine.
- The contract between the Manufacturer and the Supplier to deliver machine is concluded on 25 November 20X0.
- The Supplier starts the production of the machine on 1 December 20X0.
- The machine is finished on 20 December 20X0.
- A deputy of the Manufacturer accepts the condition of produced machine after technical tests made by the Supplier on the next day.
- The machine is shipped on 28 December 20X0.
- On 30 December 20X0, the Supplier sends an electronic invoice to the Manufacturer.
- The Manufacturer receives the delivery on 6 January 20X1.
- On 31 January 20X1, the Supplier receives the payment for the machine.

The students’ task was to determine the moment at which the revenue arises. *Table 2* summarises the results.

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⁴ The fourth seminar of the course (out of 13 seminars).
Tab. 2: Empirical Experiment – Students of “Introduction to Accounting”

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
<th>Occurrence (Number of students)</th>
<th>Occurrence (In %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>01.11.20X0</td>
<td>demand</td>
<td>0</td>
<td>0,0%</td>
</tr>
<tr>
<td>20.11.20X0</td>
<td>decision</td>
<td>0</td>
<td>0,0%</td>
</tr>
<tr>
<td>25.11.20X0</td>
<td>contract inception</td>
<td>97</td>
<td>63,8%</td>
</tr>
<tr>
<td>01.12.20X0</td>
<td>start of production</td>
<td>1</td>
<td>0,7%</td>
</tr>
<tr>
<td>20.12.20X0</td>
<td>finish of production</td>
<td>2</td>
<td>1,3%</td>
</tr>
<tr>
<td>21.12.20X0</td>
<td>technical approval</td>
<td>5</td>
<td>3,3%</td>
</tr>
<tr>
<td>28.12.20X0</td>
<td>shipping</td>
<td>9</td>
<td>5,9%</td>
</tr>
<tr>
<td>30.12.20X0</td>
<td>invoicing</td>
<td>24</td>
<td>15,8%</td>
</tr>
<tr>
<td>06.01.20X1</td>
<td>delivery</td>
<td>11</td>
<td>7,2%</td>
</tr>
<tr>
<td>30.01.20X1</td>
<td>payment</td>
<td>3</td>
<td>2,0%</td>
</tr>
<tr>
<td>Total</td>
<td>xxx</td>
<td>152</td>
<td>100,0%</td>
</tr>
</tbody>
</table>

In my opinion, the experiment demonstrates very interesting inferences. When discussing with students the results of the example and accounting and economic aspects of the revenue-generating process, I arrived to the following conclusions regarding students’ point of view:

- concluding the contract is an important business act and under normal circumstances both seller and buyer are willing and doing the best to fulfil their contractual obligations,
- sales representatives, marketing employees and other employees are often remunerated with reference to the volume of concluded contracts (sales),
- the crucial point in the entrepreneurship process is gaining the customer, because under current economic development there is not a problem to produce goods or to provide service, but to find the customer,
- risk and reward approach or realisation approach that were explained afterwards were understandable to students, but they still insist on the superiority of economic concept of revenue and therefore revenue should be recognised at the contract inception.

I will use the outcome of this experiment as a starting point for evaluation the current development of Revenue Recognition Project. Independent on joint Revenue Recognition Project, IASB published the interpretation IFRIC 13 which deals with the revenue recognition from the customer loyalty programmes. Principles introduced by the Interpretation are in the concord with both current theory (Belkaoui, 2005) and practice (Epstein, 2008 or Bokšová, 2004). However, the Interpretation opens space for new significant changes especially as far as revenue measurement concerns. The impact of changing business paradigm and its influence on
the setting-standard process can be clearly seen in the documents published within Revenue Recognition Project.

To reach the aim of this paper I will outline shortly the basic features of IFRIC 13 and will analyse open issues arising from this Interpretation in the context of the preliminary views of the Boards on revenue measurement outlined in Revenue Recognition Project. The evaluation will respect the perception of the financial statements information by “common sense”.

4 IFRIC 13 – basic features

4.1 Scope

Interpretation IFRIC 13 constitutes the rules for revenue recognition from multiple-element transactions, i.e. the sale transactions that consists of two or more deliverables. Customer loyalty programmes are the particular example of multiple-element transaction.

The main issues solved by Interpretation are:

1. whether the entity’s obligation to provide free or discounted goods or services in the future should be recognised and measured by:
   a) allocating some of the consideration received or receivable from the sales transaction to the award credits and deferring the recognition of revenue (applying paragraph 13 of IAS 18); or
   b) providing for the estimated future costs of supplying the awards (applying paragraph 19 of IAS 18); and

2. if consideration is allocated to the award credits:
   a) how much should be allocated to them;
   b) when revenue should be recognised; and
   c) if a third party supplies the awards, how revenue should be measured.

4.2 Solution

According to IFRIC 13, the entities are required to apply paragraph 13 of IAS 18 and to account for award credits as separately identifiable elements of the sale transaction in which they were granted. The fair value of the consideration (received or receivable) shall be allocated between the award credits and the other components of the sale. The moment of revenue realisation depends on the fact if the awards are supplies by the entity itself or by the third party.

If the entity supplies the awards itself, it shall recognise the consideration allocated to award credits as revenue when the award credits are redeemed and the entity fulfils its obligations to supply the awards. The allocated amount is based on the number of the award credits that have been redeemed in exchange for awards, relative to the total number expected to be redeemed.
If the third party supplies the awards, the entity shall assess whether it is collecting the consideration allocated to the award credits on its own account (the entity acts as a principal in the transaction) or on behalf of the third party (the entity acts as an agent).

1. In the first case, the entity shall measure revenue as the gross consideration allocated to the award credits and recognise the revenue when it fulfils its obligations in respect of the awards.

2. If the entity acts as agent for the third party, the entity is required to:
   a) measure revenue at the net amount retained on its own account, (i.e. the difference between the consideration allocated to the award credits and the amount payable to the third party for supplying the awards); and
   b) recognise this net amount as revenue when the third party becomes obliged to supply the awards and entitled to receive consideration for doing so. These events may occur as soon as the award credits are granted. However, if the customer can choose to claim awards from the entity or a third party, these events may occur only when the customer chooses to claim awards from the third party.

4.3 Open issues
IFRIC 13 requires an entity operating customer loyalty programme to allocate some of the consideration received to goods or services to be redeemed for award credits granted to customers in the initial sale. However, the Interpretation does not prescribe the exact measurement (or allocation) method. In accordance with IFRIC 13.6, “the consideration allocated to the award credits shall be measured by reference to their fair value, i.e. the amount for which the award credits could be sold separately.” There are two possible methods to measure revenue from customer loyalty programmes:

- the amount allocated to the award credits could be equal to their fair value (irrespective of the fair values of the other components); or
- the amount allocated to the award credits could be a proportion of the total consideration based on the fair value of the award credits relative to the fair values of the other components of the sale.

Example 2: Measurement of revenue in multiple-element sale transaction
Company SWEETS grants its customer with the award credits for each purchase. Customers are entitled to redeem their points for discounted goods. In December 200X the entity realised sales at total amount 100 €. The management estimates fair value of award credits to be 6 € and fair value of goods sold in the initial sale to be 90 €.

The entity could recognise alternatively:
a deferred revenue with respect to the expected redemption of award credits at amount of 6 € and the revenue from selling the goods at amount 94 €; or
- a deferred revenue with respect to the expected redemption of award credits at amount of 6.25 € and the revenue from selling the goods at amount 93.75 €.

Both methods are well accepted by accounting profession. The first method (“subtractive”) is preferred within IFRS. IAS 18 does not exactly prescribe the allocation of the consideration received or receivable in the multiple-element sale transaction to each separable component. However, paragraph 11 of Appendix A to IAS 18 states that if the selling price of the goods sold includes a measurable amount for subsequent services to be provided by the entity, the entity shall defer this amount and recognise it as revenue at the time when the service is actually rendered. The second method (“pro rata”) is utilised especially under US GAAP (e.g. EITF 00-21). Nonetheless, IFRIC 13 stresses that “pro rata” method is also in the accordance with IFRS principles.

Let us go one-step beyond! If we consider the above-mentioned allocation methods carefully, we can arrive at the third possible solution. We can contemplate about the measurement of each component of the multiple-element sale transaction at its fair value. This measurement method is in a certain manner revolutionary and conceptually departed from the present status. Nevertheless, it is (or better said it was) seriously deliberating by IASB and FASB within Revenue Recognition Project.

5 Revenue Recognition Project

5.1 Motivations for launch of Revenue Recognition Project

IASB would like to eliminate weaknesses in existing general concepts and standards. IAS 18 requires recognising the revenue based on critical event in an earning process (earnings process approach – EP). This requirement contradicts the definition of revenue that is based on the changes in assets and liabilities (assets-liabilities approach – AL). This situation implies the

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5 Revenue from discounted goods which will be redeemed by customers for the award credits is measured at fair value of these award credits (i.e. 6 €) and the residual of consideration received (i.e. 94 = 100 – 6) is recognised as the revenue the goods sold in the initial sale.
6 The measurement of revenue from each element of the sale transaction is on pro rata basis. Revenue from discounted goods which will be redeemed by customers for the award credits is 6.25 € = 100*6/(6+90) and the revenue from the goods sold in the initial sale is measured at 93.75 € = 100*90/(6+90).
7 The allocated amount should be measured as expected expenses to render service plus profit margin. The provisions of IFRIC 13 are conceptually in the line with the Appendix. The only difference (but of high importance) is the measurement of revenue from the complementary performance. The cost-plus-method is replaced by the measurement at fair value.
8 Revenue of each component of the multiple-element sale transaction is measured at its fair value. In Example 3 the fair value of the award credits is 6 € and fair value of the goods is 90 € and both amounts are to be recognised as the revenues from each respective component of the sale. However, it arises a questions what to do with the residual amount of 4 €? This issue will be examined in the next part of the paper.
presentation of items on balance sheet that do not meet the definitions of assets and liabilities. The main weakness of IAS 18 is an absent guidance on presentation of the revenue from „multiple-element contracts“. The multiple-element arrangements consist of more than one goods and service that are the subject of delivery to customer. IAS 18 requires separating the revenue-generating transaction into individually identifiable elements if there are any. Nevertheless, it does not cope with a question in what cases to divide the transaction into individually components and how to measure individual revenues.

Statements of Financial Accounting Concepts No. 5 and No. 6 issued by the FASB are inconsistent as well. Application criteria constituted by SFAC 5 can override definitions given by SFAC 6 in some cases. According to SFAC 5, revenues must be realised or realisable and earned (for example by delivery of the product). When is the revenue earned in the case of multiple-element contract? It is very difficult to identify a moment when reporting entity accomplished all activities so that the revenue could be earned and recognised.

One of practical solutions is to defer revenue as a balance sheet item. However, deferred revenues sometimes do not meet the definition of liability. The reason is discrepancy between application criteria for the revenue recognition and liability recognition rules. The recognition of deferred items is a consequence of the superiority of revenue recognition criteria over definition of liability. The most severe problem of existing revenue recognition principles under IFRS and US GAAP is the discrepancy between conceptual definitions (IFRS Conceptual Framework and SFAC 6) and application criteria (IAS 18 and SFAC 5).

The definitions of revenue are based on the capital maintenance approach and the revenue arises thus because of the change in net assets. The assets and liabilities approach identifies assets and liabilities that are generated by a sale transaction. The LA approach focuses on the changes in the entity’s financial position. The assets and liabilities generated by transaction are measured at fair value. Applications criteria for revenue recognition are based on the earnings process approach. The EP approach identifies the individual components of the earnings process and measures the corresponding revenues at their relative fair value via allocation method.

Current guidance on revenue recognition contains application criteria, which are not consistent with definition of revenue. Those criteria modify the definition and even they override it. The Boards do not treat this situation as satisfactory. All reasons mentioned above implicate incomparability of financial statements and reduce the quality of decision-oriented information on allocation of scarce resources. IASB and FASB come to realize the importance of consistent and unified revenue recognition and presentation for smooth functioning of capital market. Therefore, the revenue recognition is included in the joint convergence project. The Boards’
effort is to harmonize the financial reporting in compliance with IFRS and US GAAP. The objectives of joint convergence project are to⁹:

- eliminate inconsistencies in existing accounting regulations;
- create a conceptual base for solutions of new problems in the future;
- take out the deficiencies in present revenue recognition rules;
- develop a new general revenue recognition standard;
- achieve a consistent accounting presentation of revenue according to IFRS and US GAAP.

5.2 New conceptual approach to revenue recognition

New revenue recognition rules should be “well-balanced“ without inherent discrepancies. Revenue definition and measurement are of fundamental importance. The Boards prefer the assets and liabilities approach (revenue is a result of increase in net assets) and from conceptual point of view, the Boards support the measurement at fair value. The measurement of revenue at its fair value when net assets are increasing is distinctive change in comparison with present practice because:

- the asset is recognised already at the inception of a contract;
- revenue can be recognised without any delivery of contractual goods or services;
- there exist concerns about the reliability of the measurement.

New revenue recognition concept has some advantages:

- the new concept is more neutral (in the opposite of current prudence principles) and represents more faithfully the economic reality;
- eliminates the deferral of revenue which violates the definition of the liability;
- eliminates the different approaches to revenue recognition depending on the entity’s specific business model or industry accounting methods, which is the main reason of incomparability of financial statements (Pelák, 2005).

Example 3: A new approach to the measurement of revenue

Entity “Surfers” enters into an agreement to provide its customer “BCP” with a website presentation. The agreement is concluded on August 20, the work has to be performed by the end of September. Company BCP pays in advance the amount 100 €, which is the fix remuneration for Surfers for creating the website. In a situation, when company Surfers is overloaded with orders and is not able to provide the work itself it outsources programmers’ services from its competitors. Estimated wholesale fair value of a website presentation for the

⁹ http://www.fasb.org/project/revenue_recognition.shtml
Under current guidance (based on transaction price) company Surfers recognises the increase in cash by 100 € and the increase in liabilities to its customers by the same amount. The selling transaction comprises only one performance obligation, the obligation of entity to provide to customer with the website presentation. Under EP model this performance obligation is measured at consideration received, i.e. at 100 € and no revenue is recognised until the fulfilment of the obligation.

Under fair value model the entity recognises the increase in cash by 100 € and the increase in liabilities by 90 €. The performance obligation to provide the website presentation is measured at its fair value, i.e. the amount for which the performance obligation could be sold separately at wholesale market. An interesting question arises. What does the difference (i.e. consideration received less the fair value of the performance obligation) represent? From the economic point of view, we can interpret this residuum as the revenue for the selling effort. Revenue for the selling effort is the entity’s remuneration for sacrifices associated with the preparation of the offer, which a customer has accepted.

The choice between transaction price and fair value represents the conflict whether performance obligations should be measured from the customer perspective or from the reporting entity perspective. From the customer perspective, the entity performs only when the performance obligation extinguishes. If the entity received in advance, it owes to the customer until the liability extinguishes. The revenue could not be recognised sooner than the entity fulfils its obligation to the customer. From the entity perspective, its activities are considered as the sacrifices associated with the contract with its customer. Those sacrifices comprise not only common contractual obligations, which are the subject of a particular contract, but also the services provided to customers in entering into the contracts.

At the start of the project, the Boards concurred that a reporting entity’s contractual rights and obligations arising from contracts with its customers should be accounted for on a basis that reflects the reporting entity perspective. Under the entity perspective, the fair value of entity’s performance obligations should reflect the price that the entity “would have to pay an unrelated party of equal credit standing to assume legal responsibility for performing all of its remaining obligations (i.e. the layoff price).” The fair value of an entity’s performance obligation could be defined as the amount of assets required to be sacrificed by the entity to settle its obligation.

Under the assets and liabilities approach to revenue recognition, an entity may recognise some

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10 The term “performance obligation” is used within Revenue Recognition Project for denotation of separately identifiable component of the sale transaction.
revenue upon entering into a contract with a customer even though delivery of contracted goods or services has not occurred. That revenue could be denoted as “selling revenue” and it results from providing customers with access to the goods and related selling services. The customer consideration amount equals the sum of the entity’s performance obligations, refund obligations, and obligations to provide “selling access” and “selling convenience.” Revenue can arise at the inception of a contract because the entity has completed its selling effort and has delivered this selling effort at that time. From the conceptual point of view, the revenue recognised at the contract’s inception is the revenue from selling activity of entity.

The biggest challenge of the issue is the measurement of revenue for the selling effort. The measurement is of a residual nature. The direct measurement of “selling revenue” is impossible because it cannot be sold as a separate deliverable. In certain instances, selling revenue may be measured as a “residual” as shown in the Example 3. The amount attributed to the revenue for selling effort is difference between the customer consideration and the total fair values of all performance obligations that the entity is obliged to fulfil. There are several issues emerging in the context with the unusual measurement of the selling revenue.

How should the possible negative difference be interpreted? Does the entity pursue any goal which accomplishment requires the low prices policy? Alternatively, is the customer consideration smaller than the sum of all performance obligations measured at their fair values because the entity sells the products at inconvenient prices unconsciously? How to account for this negative difference? Is it negative revenue or is it an expense?

Furthermore, we cannot exclude a possibility that the residuum occurs as a consequence of inaccurate measurement of performance obligations. The risk increases with growing number of contractual obligations in multiple-element arrangements that contain two or more performance obligations. It is understandable that some of the Boards members do not agree with the recognition of the selling revenue at the inception of a contract.

The supporters of the customer perspective under which performance obligations should be measured by the allocated customer consideration argue that selling price set agreed by the vendor and the customer in the arms’ length transaction between a willing buyer and seller is the best attribute for measuring the assets and liabilities arising from the contract. The transaction price represents the fair value reliably and there is no need to search for another value in order to measure each component of the selling arrangement.

Moreover, the customer’s notion whether the obligation is fulfilled may differ from the entity’s view. Both parties’ perspectives should be considered when determining if a liability has been

extinguished. Furthermore, the customer does not consider the selling effort as a separate contract element. Therefore, no revenue should be recognised at contract inception because both the buyer and the seller do not perceive the extinguishment of a liability.

On the other hand, the allocated consideration amount model struggles with two weaknesses:

- how to measure liabilities which other standards require to measure by specific measurement base (e.g. fair value); and
- how to allocate the difference between consideration received and the sum of the recognised amounts allocated to the performance obligations.

The proponents of the fair value model assert that allocating customer consideration to the performance obligations is defensible only under the assumption that entity is not able to settle its obligations by delivering the goods or services and as a result of this it is obliged to return the payment (if any) received in advance. However, the “normal” business model of a going-concern entity is to settle its obligations by delivering a product or service according to the contract, not to take and refund cash deposits from customers. The selling revenue should be recognised because the entity has performed the selling services. The customer has proved the usefulness of those services by entering into the contract.

There are three possible models how to deal with all above mentioned issues regarding measurement of revenue:

- Model A under which all performance obligations are measured at their fair value with the possibility of recognition of revenue from the selling effort at the contract inception (“full fair value model”);
- Model B under which the consideration received or receivable is fully allocated to all performance obligations on pro rata basis, and therefore no revenue is recognised in the inception of a contract (“allocated consideration amount model”);
- Model C under which some performance obligations subject to requirements of other standards are measured at fair value and the remaining consideration is allocated to the rest performance obligations; and therefore no revenue is recognised in the inception of a contract (“hybrid model”).

The hybrid model seems to be a good compromise for both groups of opinions. It enables to measure certain performance obligations at fair value (as required by the other standards) on one side and on the other side it prevents from the recognition of “selling effort revenue” at the inception of a contract. However, the second advantage is only fictitious. The hybrid model fails if the selling transaction consists only of those performance obligations, which should be measured at fair value. Then it could happen that the sum of fair values of performance
obligations is not equal to consideration received and the residual has to be recognised as revenue at the time of the contract conclusion. Hybrid model – depending on an arrangement of the sale transaction – lead to different results of the same economic transaction, which is the worst possible situation. From my point of view the Boards should exclude the hybrid model and to decide only between Model A and Model B.

From the perspective of information usefulness for financial statements’ users, I can assert that the measurement of performance obligations at their fair value provides the users with the possibility to evaluate the relative margins (under assumption that income statement displays related expenses) from each separately identifiable element of the selling transaction that gives rise to revenue. The model based on the allocation of the customer consideration focuses on the selling transaction as a whole. Especially in multiple-element arrangements, this approach results in a measurement attribute that is difficult to interpret. Profit margins are distorted and not useful. Furthermore, the allocated customer consideration approach is conceptually consistent with a current earnings process that is a subject to be abandoned for its weaknesses.

In a simplified way we can describe the conflict between those two models as a dispute whether the more useful information is produced by some kind of the deferring the revenues (allocated customer consideration model) or by recognising the revenue from selling effort already at the inception of a contract (fair value model). The first approach is very close to the principles constituted by current accounting literature and it is a subject of the legitimate criticism for its inconsistency. The latter approach eliminates those weaknesses. On the other hand, the measurement of performance obligation at its fair value could lead to the recognition of the revenue already at the inception of a contract. This is a huge departure from the current accounting practice. It is obvious that this model elicits fears and disagreements.

When developing model for revenue recognition we should take into account how the users look on the information presented in financial statements. If we disregard the users with “good knowledge” of accounting (e.g. financial analysts, creditors) we have to conclude that “common” users with only basic knowledge do not always view the revenue under risks and rewards approach. The user perceive the revenue-generating process as a “function” of gaining (or contracting) the customers. If the entity succeeds concluding the contract with customer it should recognise some revenue; at least as a counterpart to costs sacrificed in the process of contracting the customers.

6 Conclusion

The conflicts about basic conceptual issues forced the Boards to reassess the aim and scope of the Revenue Recognition Project. As stated in the introductory documents the aim of the project
was to prepare a comprehensive standard on revenue recognition that would apply to all possible revenue-generating transactions. This approach showed to be unattainable. Because of big complexity of the revenue recognition issue, it was decided to limit scope of Revenue Recognition Project in the middle of 2005. The new scope should focus only on the revenues from transactions that are a consequence of the contract concluded with the customers. The revenues arising during the production process (without having a contract with the customer) is leaved out the scope as well as the revenues from the financial instruments.

The Boards considered several alternatives how to continue with the project. It has been chosen the alternative with restricted scope. The second important conclusion is that the underlying documents should respect the different views how to measure the performance obligation. As a result, the tentative conclusions should contain both models. Allocated customer consideration model concentrates on the contract as a whole. The proper measurement attribute is the fair value of the transaction. It is equal to the total consideration paid by the customer. If the contract consists of several elements, each individual element is measured by the allocated customer consideration. The allocation is based on the relative fair values of the separately identifiable performance obligations.

The proponents of the fair value approach consider the allocated customer consideration approach as the best alternative. These supporters do not believe that the fair value approach could be approved despite the former approach struggles with the same conceptual difficulties as the fair value model. Both approaches require the measurement of the performance obligations by reference to their fair value. While the fair value model measures each of those obligations at its fair value, the allocated customer consideration model measures each separable element by the allocated amount of the customer consideration received or receivable based on the relative fair values of that element. The only one but very strong reason in favour of allocated customer consideration approach stems from its reluctance to recognise the revenue from the selling effort already at the contract’s inception.

The opponents of the fair value model have concerns about incorrect measurement of the performance obligation. It could lead to the “frontloading” of revenues (for some implications from accelerating revenue see Altamuro, 2005). The second argument against this approach is based on the subsequent remeasurement of performance obligations, which are initially measured at their fair value. Such a subsequent remeasurement, which is a normal procedure, could be incorrectly perceived as a mechanism to correct accounting errors made in the initial measurement at the contract’s inception. This could impair the credibility of financial reporting in the eyes of the users. The allocated consideration amount model eliminates the possible errors
at the initial identification and measurement of performance obligation and prevents from erroneous recognition of the selling revenue as well. On the other side, this approach leads to the significant inconsistencies\(^{12}\) and produces results that are hardly to interpret.

Despite some positive steps, the development of Revenue Recognition Project so far is perplexed. There are more open issues than solved, it is not clear the goal of the project, it is omitted the influence of suggested new rules on other standards or measurement of contractual rights is missing. Those weaknesses are caused by the fact that basic conceptual features of revenues are not described clearly and precisely. In my opinion, before issuing the final standard for revenue recognition standard-setters should:

- define the economic nature of revenue,
- determine what the amount of revenue should represent,
- clarify when the revenue arises with regard to different informational potential of each revenue recognition model,
- explore the behavioural model describing the users perception of revenue-generating process.

New standard for revenue recognition would be predetermined to failure without sound support in all of above-mentioned issues. The scrutiny should respect inferences of both accounting and economic theory regarding the concept of income and nature of revenue. However, the important question remains open. Are we able to describe and define exactly the users of financial statements, their needs and their point of view on business process and the way accounting is representing these business transactions in the financial statements?

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\(^{12}\) The biggest problem with which this model struggles is the measurement of „stand-ready“ performance obligations which other standards require to measure at the fair value. There are two possible solutions to this problem, but none of them is sound. The pure allocated consideration model contradicts the requirements of the other standards and it could happen that the same stand-ready obligations could be measured by two different attributes based on nature of transaction, which has given rise to that obligation. The hybrid model measuring stand-ready obligations at their fair value and remaining performance obligations by the allocated consideration amount results in inconsistent measurement of particular elements of revenue-generating transaction.
References


Summary

The paper outlines basic features of revenue recognition practice under IFRS and US GAAP. The revenues usually represent the greatest single item reported in the financial statements. The current guidance on revenue recognition suffers from some weaknesses and inconsistencies. Finding the solution to these problems is a subject of joint IASB’s and FASB’s Revenue Recognition Project. The main aim of Revenue Recognition Project is to remove inconsistency and to create a comprehensive standard on revenue recognition that would apply to all possible revenue-generating transactions. Unfortunately, there exist some conflicts regarding the measurement of revenue. The advantages and disadvantages of fair value and allocated customer consideration amount model are analysed from the point of users’ information need usefulness. Background for this evaluation is derived from the empirical experiment.

Key words: IASB; FASB; IFRIC 13; Revenue Recognition Project; Allocated consideration amount model; Fair value model.