

## Revenue from contracts with customers under IFRS 15

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**Abstract:** *The paper deals with the reporting of revenues according to international rules. IFRS 15 Revenue from contracts with customers specifies how and when an IFRS reporter will recognize revenue as well as requiring such entities to provide users of financial statements with more informative, relevant disclosures. The paper provides view a single, principles based five-step model to be applied to all contracts with customers. One identifies contracts with customers. Solves the case when an entity combines two or more contracts entered into at the same time with the same customer and accounts for the contracts as a single contract. It deals with the reporting of revenues from contracts with customers and identifies costs related to these contracts.*

**Keywords:** revenue, reporting, contracts, IFRS 15

JEL codes: M40, M48, M50

### 1 Introduction

The paper deals with the recognition of revenues accordance with IFRS 15 – Revenue from Contracts with Customers in the consolidated financial statements of the company. The objective of IFRS 15 is to establish the principles that an entity shall 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. To meet this objective, the core principle of IFRS 15 is that an entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. An entity shall consider the terms of the contract and all relevant facts and circumstances when applying IFRS 15.

An entity shall apply IFRS 15, including the use of any practical expedients, consistently to contracts with similar characteristics and in similar circumstances. IFRS 15 specifies the accounting for an individual contract with a customer. However, as a practical expedient, an entity may apply IFRS 15 to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying IFRS 15 to the portfolio would not differ materially from applying IFRS 15 to the individual contracts (or performance obligations) within that portfolio. When accounting for a portfolio, an entity shall use estimates and assumptions that reflect the size and composition of the portfolio (Kubaščíková and Pakšiová, 2015). The objective of IFRS 15 is to establish the principles that an entity applies when reporting 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, 2014). Application of the standard is mandatory for annual periods beginning on or after 1 January 2018. They analyze the recognition of income and other items in the financial statements in accordance with IFRS (Mokošová, 2016), or (Kubaščíková et. al. 2019) and (Ješš, et al., 2013).

### 2 Methodology and Data

An entity shall apply IFRS 15 to all contracts with customers, except the following:

- a) Lease contracts within the scope of IFRS 16 Leases,
- b) Financial instruments and other contractual rights or obligations within the scope of IFRS 9 Financial Instruments, IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements etc.; and non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers.

An entity shall apply IFRS 15 to a contract only if the counterparty to the contract is a customer. A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. A counterparty to the contract would not be a customer if, for example, the counterparty has contracted with the entity to participate in an activity or process in which the parties to the contract share in the risks and benefits that result from the activity or process (such as developing an asset in a collaboration arrangement) rather than to obtain the output of the entity's ordinary activities. They analyze the recognition of income and other items in the financial statements in accordance with IFRS for example (Hladka, et al. 2017) and (Parajka, 2015).

### 3 Results and Discussion

Basic principles of revenue recognition: The following five step revenue recognition model must be applied to determine when revenues associated with sales contracts made with customers are recognized:

Step 1: Identify the contract with the customer

Step 2: Identify distinct performance obligations within the contract

Step 3: Determine the transaction price of the contract

Step 4: Allocate the transaction price to the performance obligations that are identified within the contract

Step 5: Recognize revenue when, or as, the performance obligations are satisfied - either at a point in time or over time (IFRS 15, 2014).

An entity shall account for a contract with a customer that is within the scope of IFRS 15 only when all of the following criteria are met:

- a) The parties to the contract have approved the contract (in writing, orally or in accordance with other customary business practices) and are committed to perform their respective obligations;
- b) The entity can identify each party's rights regarding the goods or services to be transferred;

*Example:* Company XY enters into a contract with Company A for supply of maintenance. The rights and obligations of the parties are not yet known when the contract is signed. This is the first time XY has entered into a contract with Company A and both entities are still negotiating the terms of the agreement. In this case, if XY provides services to Company A, no revenue should be recognized until XY has an understanding of each party's rights. If the promised goods and services cannot be identified, the transfer of control of those goods and services also cannot be assessed;

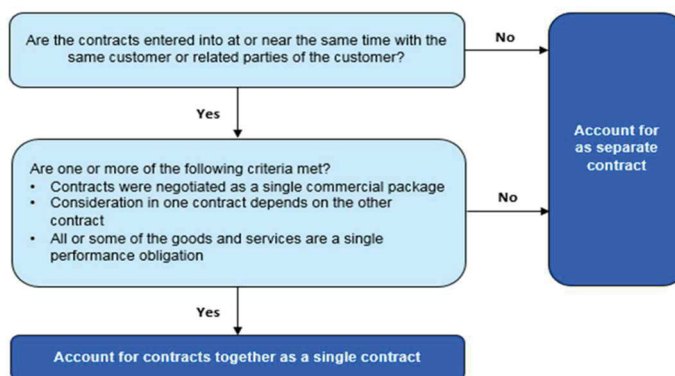
- c) The entity can identify the payment terms for the goods or services to be transferred;
- d) The contract has commercial substance (ie the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract); and
- e) It is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. When evaluating the collection of the contract consideration from the customer, third party guarantees (e.g. bank guarantees) are considered as long as this credit enhancement is initiated by the customer. In substance, this is considered a payment on behalf of the customer. Any credit enhancement initiated by XY such as potential credit insurance proceeds or factoring arrangements should not be considered in this probability assessment. In assessing whether or not XY will collect "substantially all" of the entitled consideration, XY can use the knowledge of the contractual terms and its customary business practice.

A contract is an agreement between two or more parties that creates enforceable rights and obligations. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). Some contracts with customers may have no fixed duration and can be terminated or modified by either party at any time. Other contracts may automatically renew on a periodic basis that is specified in the contract. An entity shall apply IFRS15 to the duration of the contract (ie the contractual period) in which the parties to the contract have present enforceable rights and obligations. For the purpose of applying IFRS15, a contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (or parties). A contract is wholly unperformed if both of the following criteria are met: (i) the entity has not yet transferred any promised goods or services to the customer; and (ii) the entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services (Tumpach, M. 2016).

An entity shall combine two or more contracts entered into at or near the same time with the same customer (or related parties of the customer) and account for the contracts as a single contract if one or more of the following criteria are met: (i) the contracts are negotiated as a package with a single commercial objective; (ii) the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or (iii) the goods or services promised in the contracts are a single performance obligation. Contracts should be combined if the price or performance provided under one contract affects the consideration to be paid under another contract. This would for example be the case when failure to perform under one contract affects the amount paid under another contract.

Whenever for example company XY has multiple contracts with the same customer that was entered into at or near the same time, it must identify the performance obligations within those contracts and assess if such obligations are distinct from one another. If performance obligations are not deemed to be distinct, company XY must treat such contracts as a single contract with a single performance obligation by combining those contracts. Promises in a contract that are not distinct cannot be accounted for as if they are distinct solely because they arise from different contracts. For example, a contract for the sale of specialized equipment should not be accounted for separately from a second contract for significant customization and modification of the equipment. Following is the summary flowchart for the concept of conditions for combining contracts in single performance obligation:

**Scheme 1** Conditions for combining contracts into a single performance obligation



Source: IFRS 15, 2014

A contract modification is a change in the scope or price (or both) of a contract that is approved by the parties to the contract. In some industries and jurisdictions, a contract modification may be described as a change order, a variation or an amendment. A contract modification exists when the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract. A contract modification could be approved in writing, by oral agreement or implied by customary business practices. A contract modification may exist even though the parties to the contract have a dispute about the scope or price (or both) of the modification or the parties have approved a change in the scope of the contract but have not yet determined the corresponding change in price. In determining whether the rights and obligations that are created or changed by a modification are enforceable, an entity shall consider all relevant facts and circumstances including the terms of the contract and other evidence. An entity shall account for a contract modification as a separate contract if both of the following conditions are present: a) the scope of the contract increases because of the addition of promised goods or services that are distinct; and b) the price of the contract increases by an amount of consideration that reflects the entity's stand-alone selling prices of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract. For example, an entity may adjust the stand-alone selling price of an additional good or service for a discount that the customer receives, because it is not necessary for the entity to incur the selling-related costs that it would incur when selling a similar good or service to a new customer.

*Example* (Contract modification accounted for as a separate contract): Company XY enters into a contract with Company A to produce 200 substations over 5 years. The parties modify the contract at the end of year 1 to include the production of additional 50 power grids over the remaining 4 year period. The increase in the contract price, based on the change in contract terms, is representative of XY's standalone selling prices for the power grids on the modification date. In this case, XY would account for this contract modification as a separate contract because the additional power grids are deemed to be distinct and the increase in contract price for the production of these grids represents XY's standalone selling price. Note that XY would not make any modification to the existing contract.

If a contract modification is not accounted for as a separate contract, an entity shall account for the promised goods or services not yet transferred at the date of the contract modification (i.e. the remaining promised goods or services) in whichever of the following ways is applicable:

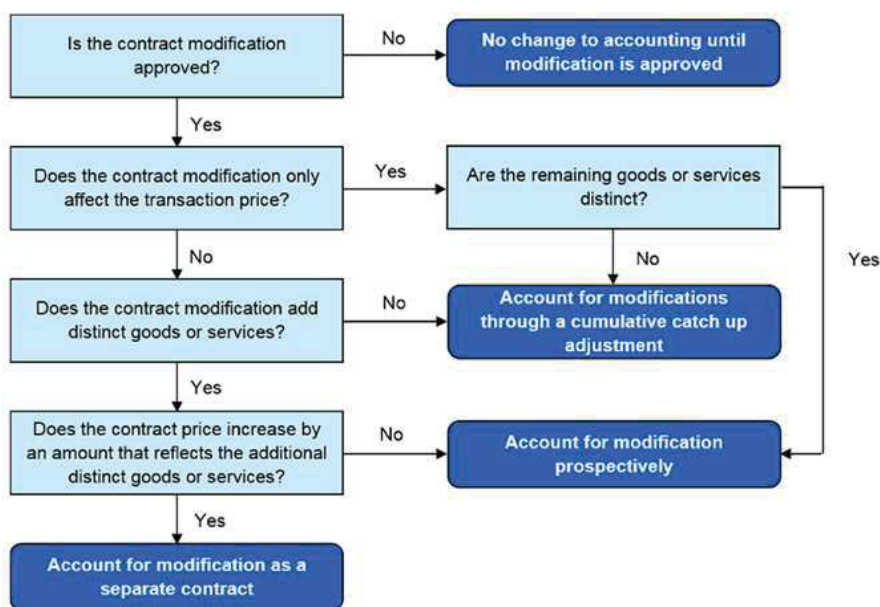
- a) An entity shall account for the contract modification as if it were a termination of the existing contract and the creation of a new contract, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification. The amount of consideration to be allocated to the remaining performance obligations is the sum of: (i) the consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognized as revenue; and (ii) the consideration promised as part of the contract modification;
- b) An entity shall account for the contract modification as if it were a part of the existing contract if the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification. The effect that the contract modification has on the transaction price, and on the entity's measure of progress towards complete satisfaction of the performance obligation, is recognized as an adjustment to revenue (either as an increase in or a reduction of revenue) at the date of the contract modification (ie the adjustment to revenue is made on a cumulative catch-up basis).

*Example* (Modification of the original contract): Company XY enters into a two year contract to build a power grid for 100 USD for Company A. The construction of this grid is considered to be a single performance obligation. Both Company A and XY agree to modify the original construction plan at the end of the first year. This modification will increase the contract price by 5 USD. In this case, XY will treat this contract modification as part of the original contract because this modification does not create an additional performance obligation as the additional goods and/ or services to be provided are not

distinct. To account for this modification, XY updates its estimate of the contract price and its measure of the contract progress. This modification will thus result in a cumulative catch up adjustment at the date of the contract modification;

- c) If the remaining goods or services are a combination of items (a) and (b), then the entity shall account for the effects of the modification on the unsatisfied (including partially unsatisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of this paragraph.

**Scheme 2** The illustration below summarizes the accounting treatment for contract modifications:



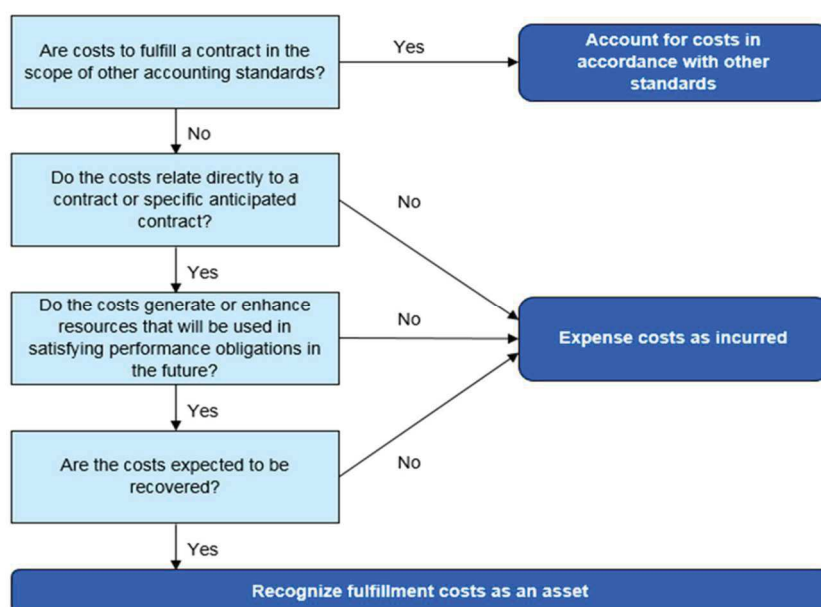
Source: IFRS 15,2014

An entity recognizes revenue when (or as) the performance obligations are satisfied - either at a point in time or over time. An asset is transferred when (or as) the customer obtains control of that asset. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by: (i) using the asset to produce goods or provide services (including public services); (ii) using the asset to enhance the value of other assets; (iii) using the asset to settle liabilities or reduce expenses; (iv) selling or exchanging the asset; (v) pledging the asset to secure a loan; and (vi) holding the asset. When evaluating whether a customer obtains control of an asset, an entity shall consider any agreement to repurchase the asset. As a general rule, a performance obligation is considered substantially completed if remaining costs and potential risks are insignificant in amount. Generally, this is the case after provisional acceptance or take over which defines the point in time when an entity has completed the work under the contract and usually triggers the start of the warranty period. If the customer takes the facility in "commercial operation" without formal acceptance, this shall be deemed to be a take-over by the customer. At the same time the full amount of revenue is recognized and a work-due provision must be established for the outstanding costs. If the remaining obligations are substantial, over time revenue recognition continues until such obligations have been fulfilled.

Contract cost is the cost of performing a contract with a customer if it is not within the scope of another standard (for example, IAS 2 Inventories, IAS 16 Property, Plant and Equipment or IAS 38 Intangible Assets), the entity recognizes an asset from the cost of performance of the contract only if these costs meet all the following criteria: (i) the costs relate directly to a contract or to an anticipated contract that the entity can specifically identify; (ii) the costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future; and (iii) the costs are expected to be recovered; (iv) the costs relate to contracts which extend over a period of more than 1 year (Vašeková, 2016) and (Tumpach and Baštincová 2014).

An entity shall recognize the following costs as expenses when incurred, for example: general and administrative costs (unless those costs are explicitly chargeable to the customer under the contract), costs of wasted materials, labor or other resources to fulfil the contract that were not reflected in the price of the contract, costs that relate to satisfied performance obligations in the contract, and costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations. Following flowchart summarizes costs of fulfilling a contract:

**Scheme 3** The illustration below summarizes the accounting treatment for contract



Source: IFRS 15, 2014

## Conclusions

An entity shall recognize revenue for a performance obligation satisfied over time only if the entity can reasonably measure its progress towards complete satisfaction of the performance obligation. An entity would not be able to reasonably measure its progress towards complete satisfaction of a performance obligation if it lacks reliable information that would be required to apply an appropriate method of measuring progress. In some circumstances (for example, in the early stages of a contract), an entity may not be able to reasonably measure the outcome of a performance obligation, but the entity expects to recover the costs incurred in satisfying the performance obligation. In those circumstances, the entity shall recognize revenue only to the extent of the costs incurred until such time that it can reasonably measure the outcome of the performance obligation. Presentation in the financial statements: When either party to a contract has performed, an entity shall present the contract in the statement of financial position as a contract asset or a contract liability, depending on the relationship between the entity's performance and the customer's payment. An entity shall present any unconditional rights to consideration separately as a receivable. Receivables are presented separately from contract assets.

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