

An In-depth Analysis of the Essence of Income

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Abstract. This paper considers recognize the contracts and use five steps to recognize revenue, the international financial framework standard 15 gives a clearly definition towards revenue. In this process, there will exist some transactions which their substance of account is different from the legal form, the specific items include the principal versus agent problems, consignment stock, sales and repurchase agreement and bill and hold sale. Towards these transactions, the entity should clutch its substance of account not its legal form. And this paper will give some methods and indicators to help the entity to recognized them and give the correct accounting treatment towards them.

Keywords: Contract, Revenue, the substance of transactions, Agency, Consignment stock, sales and repurchase agreement, 'bill and hold' sale.

1. IFRS 15 Revenue from Contracts with Customers

Definition:

Revenue: Income arising in the course of an entity's ordinary activities.

Contract: An agreement between two or more parties that creates enforceable rights and obligations.

Performance obligation: A promise in a contract with a customer to transfer to the customer either:

(a) a good or service (or a bundle of goods or service) which is distinct

(b) a service of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

2. Five Steps to Recognize the Revenue.

Step 1: Identify the contracts with a customer-a contract is an agreement between two or more parties that creates enforceable rights and obligations. And the contract has commercial substance.

Step 2: Identify the performance obligations in the contract-a contract includes promise to transfer goods or services to a customer. If those goods or services are distinct, the promise are performance obligations and are accounted for separately.

A good or service is distinct if either of the following criteria is met:

the entity regularly sells the good or service separately or

the customer can benefit from the good or service either on its own or together with resources which are readily available to the customer.

Step 3: Determine the transaction price-the transaction price is the amount of the consideration in a contract to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. The transaction price can be a fixed amount of customer consideration, but it may sometimes include variable consideration or consideration in a form other than cash such as discounts, rebates, refunds, credits, incentives, bonuses, penalties. Under the proposal, these variable amounts would be estimated and included in the transaction price using either the 'expected value' or the 'most likely amount' approach. Additionally, the effect of time value of money or the fair value of any non-cash consideration should also be included in the contract price.

Step 4: Allocate the transaction price to the performance obligations in the contract-an entity typically allocates the transaction price to each performance obligation on the basis of the relative stand-alone selling prices of each distinct good or service promised in the contract. If a stand-alone selling price is not observable, an entity estimates it.

Step 5: A company would recognize revenue when it satisfies a performance obligation by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service).

To determine the point in time when a customer obtains control of a promised asset and an entity satisfies a performance obligation, the entity would consider indicators of the transfer of control that include, but are not limited to, the followings:

- ①The entity has a present right to payment for the asset.
- ②The customer has legal title to the asset.
- ③The entity has transferred physical possession of the asset.
- ④The customer has the significant risks and rewards of ownership of the asset.
- ⑤The customer has accepted the asset.

If the performance obligation is satisfied over time, the revenue allocated to that performance obligation will be recognised over the period the performance obligation is satisfied. It may include the following situations:

- ①The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs. Such as the service contract.
- ②The entity's performance creates or enhances an asset that the customer controls as the asset is created and enhanced. Such as the construction contract.
- ③The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date, for example, the construction contract.

3. The Substance of Transactions

In IAS1 , a key objective is to ensure that an entity reports the true commercial effect of all its transactions. A traditional approach to revenue may be inadequate to deal with complex situations where the commercial substance of a transaction may not be the same as its strict legal form. So the enterprises should recognize the substance of transactions rather than their legal form.

In order to identify the substance of a transaction, it is necessary to determine whether the assets or liabilities of the enterprise have changed as a result of entering into the transaction.

The features suggesting a transaction's substance may be different from its legal form.

(a) Separation of the legal title to an item from its control. For example, an entity may sell an asset to a third party, but still retain control of the asset.

(b) Including options in a transaction where the terms of option make it highly likely that the option will be exercised. For example, an entity may sell an asset and then repurchase it at a below market price.

(c) Assets are sold at values that differ from their fair value.

3.1 Principle Versus Agent Problem

In an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principle and which do not result in increase in equity for the entity. The amounts collected on behalf of the principle are not revenue. Instead, revenue is the amount of commission.

An entity must establish in any transaction whether it is acting as principle or agent by whether the nature of a performance obligation is:

- To provide the specified goods or services itself, this is the principle.
- To arrange for another party to provide the goods or service, this is an agent.

Indicators:

- Is another party primarily responsible for fulfilling the contract?
- Does the entity afford inventory risk before or after the goods have been ordered?
- Does the entity have discretion in establishing prices for the other party's goods or services, therefore, the benefit that the entity can receive from those goods or services is unlimited?
- Is the entity's consideration in the form of commission?

- Is the entity exposed to credit risk for the amount receivable from customers in exchange for the other party’s goods or services?

The five indicators can be answered by yes or no, if the most of answers are yes, that indicates the entity should act as agent. The accounting treatment is that recognise fees revenue or commission in exchange for arranging transaction for other party. If the most of the answers are no, that indicates the entity should act as a principle. The accounting treatment is that recognise revenue in gross amount when performance obligation is satisfied.

3.2 Consignment Stock

This area has been of greatest relevance to the car industry. When a dealer holds stock from a manufacturer on a sale or return basis, legal title passes when there is a sale to a third party or after a predetermined period of time.

In keeping with general principles this will depend on whether it is the dealer or the manufacturer who controls the goods or inventories.

Indicator:

- Is the product controlled by the manufacturer until a specified event occurs?
- Is the manufacturer able to require the return of the product or transfer the product to a third party, such as another dealer?
- Does the dealer have an unconditional obligation to pay for the product?

The three indicators can be answered by yes or no, if the most of the answers are yes, that indicates this is dealer’s stock, the accounting treatment is that sales at delivery. If the most of the answers are no, this will be recognised consignment stock, and the accounting treatment is that no sales at delivery

3.3 Sale and Repurchase Agreements

A common way to dress up a secured loan is to disguise it as a sale and repurchase agreement. Normally, the vendor has the option to repurchase the goods sold, and the repurchase price will include an element of interest.

Indicators:

- Is an entity’s obligation to repurchase the asset at the customer’s request and does the buyer have a significant economic incentive to exercise that right?
- Is the buyer limited in its ability to direct the use of and obtain substantially all of the remaining benefits from the asset?

The followings are the accounting treatment.

Table 1. The Accounting Treatment.

Was there is substance a sale?		
	Yes	No
On “sale”	Recognise sale and any profit	Leave asset in BS. Record proceeds as liability. Accrue for any interest which will be payable
On “repurchase”	Recognise purchases, including any interest payable, as cost of sales	Settle liability and accrued interest.
Effect	Finance cost recognised on repurchase(as part of cost of sales) Finance is off BS.	Finance cost recognised an “sale”(as interest payable) Finance is on BS.

3.4 ‘Bill and Hold’ Sales

A bill-and-hold arrangement is a contract under which an entity bills a customer for a product but the entity retains physical possession of the product until it is transferred to the customer at a point in time in the future.

An entity shall determine when it has satisfied its performance obligation to transfer a product by evaluating when a customer obtains control of that product. For some contracts, control is transferred

either when the product is delivered to the customer's site or when the product is shipped, depending on the terms of the contract (including delivery and shipping terms). However, for some contracts, a customer may obtain control of a product even though that product remains in an entity's physical possession. In that case, the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the product even though it has decided not to exercise its right to take physical possession of that product.

Indicator:

- Is the reason for the bill-and-hold arrangement substantive (for example, the customer has requested the arrangement)?
- Is the product identified separately as belonging to the customer?
- Is the product currently ready for physical transfer to the customer?

If the answer is yes, it is not a real sale and should recognise the revenue when customer obtains control later, usually at delivery. If the answer is no, it is a real sale and should recognise the revenue when the bill is received.

4. Conclusion

In an entity, revenue is an important factor to consider, it takes a significant role in the financial statement, so the recognition and measurement of revenue is very important. However, in this process, the entity should grasp the essence of the transactions, to realize their substance of account not the legal form. Using some indicators to distinguish them.

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