

Current Income Recognition Principle Analysis of IFRS 15, ASC 606 and CAS 14

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ABSTRACT

Income recognition principle under IFRS and GAAP has changed into convergence in the last few years. With a demand of converting to IFRS, Chinese accounting standards have also obtained development in income recognition. All income recognition principles under the three different accounting system contain core element of 5-step model for income recognition. On the other hand, they all maintain certain difference as the external environments vary from place to place. For IFRS, which is principle based, the new IFRS 15 prescribes more detailed methods to deal with construction contract, variable consideration and contract amendments. For GAAP part, income recognition steps with special requirements and difference with IFRS 15 is illustrated in detail. For Chinese accounting standards, with an unmaturing market, they maintain a relatively flexible requirement with potential problems. This essay demonstrates major differences among the three principles towards income recognition, further exploring disadvantages of current principles.

Keywords: *income recognition, IFRS 15, ACS 696, CAS 14, five step model*

1. INTRODUCTION

In April of 2020, Luckin Coffee disclosed that it has inflated its revenue by 0.32 billion dollars, bringing significant shock to the capital market. Income inflation is the most common financial fraud as it's one of the elements shareholders care about most, reflecting the corporate profitability. Income recognition principle affects the time, amount and scope of income, which vitally affects information users' decisions. With demand for complete income recognition standards to improve the quality of financial reports, GAAP and IFRS are converging to each other to provide a better recognition model.

IFRS 15 was mainly the combination of previous IFRS 8 and IFRS 11, as the new income recognition model is comprehensive, taking most transactions, including construction contract into its scope and no longer give different guidance for specific goods or services. Although it increases the complexity in accounting treatment and include much discretion factors, the new IFRS 15 brings important advantages to previous principles.

The new version ASC 606 are generally similar to IFRS 15, however, it maintain different characteristics

with more strict requirements. GAAP is principle based and the American market holds a more prudent and strict attitude for accounting procedures, especially after some significant financial fraud cases. GAAP requires more detailed disclosure and limit corporates' options to choose from towards income recognition.

With prevailing trend of convergence, Chinese accounting principles have also makes amendments for income recognition principle, accepting the 5-step model and maintaining high convergence with IFRS 15 in most areas. Although CAS 14 leaves more discretion and flexibility to corporates than IFRS 15, the excessive procedures and complexity have becoming debatable issues for corporates.

Those aforementioned three principles have been developed into a stricter and complete base for income recognition, although there are still some blank space to specify, especially for IFRS 15 and CAS 14. Avoiding redundancy is also important to in case of excessive cost and complication.

2. HOW ACCA ACCOUNT INCOME

2.1. status of IFRS 15

Income is one of the most important indicators of corporates financial performance. Hence it is important to have a complete and wide-applied income recognition regulations which can enhance the comparability between different entities.

The latest IFRS 15 provide guidance on recognizing income from customers from 2018, which superseded the IAS 11 and IAS 18. The IRFS 15 is the result of convergence of IFRS and GAAP. IASB and FASB cooperate to design the new IFRS 15 to apply the principle to the whole world accounting standards. IFRS is related to most transactions in different industries, including goods, services and special cases like construction contract, which has always been a debating issue in income recognition under IFRS.

And the new IFRS 15 is expected to reach the several goals. Firstly , IFRS 15 will eliminate the discrepancy of existing principles about income recognition. Secondly, IFRS 15 will provide a more complete and comprehensive framework for income recognition system. Thirdly, IFRS 15 can increase the comparability between different entities in different industries in income recognition. And last, IFRS requires more detail disclosure to users to provide more accurate and useful information. As a result, IFRS 15 is much more complicated and well-developed than previous IAS related to income recognition. IFRS 15 brought the well accepted income recognition model with 5 steps to the accounting industry. The model can be applied to all kinds of contacts with customers except few cases specifies by other IFRS or IAS.

2.2. development of IFRS 15

2.2.1. IFRS 15 compared with IAS 11

IAS 11 prescribes the recognition about cost and revenue of construction contract. It went into effect in Jan. 1980. It aims at providing guidance about long-term income. The general framework about the construction contract is similar to the IFRS 15, which is recognize the cost and revenue to the proportion of completion. however, IAS 11 is hard to follow in reality as it gives much discretion, and most of the decisions depends on the accountants valuation of the contract. The new IFRS 15 give more details about the combination of contract and how the contract is identifies.

2.2.2. IFRS 15 compared with IAS 18

The IAS 18 went into effect in January 1984. IAS 18 is aimed at providing guidance about revenue recognition about various transactions, including sale of

goods, rendering of services, and for interest, royalties and dividends. IAS 18 separately gives definition about the transaction and the characteristics of recognition points. However, it omit some elements which can make the transaction complicated, like a transaction includes various types of elements at the same time. The IFRS 15, to some extent, avoids such disadvantage. IFRS 15 give detailed guidance in each steps of the recognition model and take all elements into account and support every single contract.

2.3. the advantages about IFRS 15

IFRS 15 has several advantages over previous principles. It demonstrates the details about construction contract, variable consideration and contract amendments. By providing more requirements, IFRS 15 makes the dealings with such debatable issues more clear and strict. The core about IRFS 15 is that the way how corporates provides goods and service should be reflected in the accounting process. And the proceeds is the amount that the corporate is obligated to receive from the goods and service provided.

Especially for construction contract, the cost is continuously increasing when the constructor is performing the obligation, but the client pay the consideration on several time points. this makes it hard to match the cost with the cash inflows. because the percentage of completion method lead to overestimation of their income and positive assumption, the construction contract is an issue deserves attention under prevailing principle before 2018. On the contrast, the IFRS 15 is much different to the original principle.

Firstly, the recognition of income based on the transfer of ownership while the old principle based on the assumption of risk and future benefits transfer. Secondly, IFRS 15 specifies the condition weather a contract can recognize income at a point of time or in a period time according to the process of completion. Thirdly, it cancels the so called “percentage of completion method” and validates the “input method” and “output method ”, which gives detailed instruction for calculating the specific progress of completion and decreased the discretion.

Besides aforementioned points, IFRS 15 brings change to the income amount to be recognized. It takes the time value of financing, the variable consideration and the payments to customers into consideration into account. The variable consideration can be measured by the most possible method or the weighed average method. IFRS 15 gives discretion but also guarantee the prudence. All of those guidance on income amount make it more accurate and reasonable.

Last, the IFRS 15 also make specific regulations about the contract amendments. IFRS 15 emphasize the consensus of both party and consider it to be the symbol

of contract amendments instead of high possibility of approval. Consensus is a higher threshold for amendments, basically it means the amendment has been approved. Compared with the so called “highly probable”, consensus is more prudent and requires more communications between involved parties.

2.4. the disadvantages of IFRS 15

There are still some disadvantages of IFRS 15. Although IFRS 15 is more specific and detailed in directing income recognition, IFRS 15 makes it hard to implement in reality for some cases for it heavily relies on the judgement and skills of accounts.

Firstly, as many united performance obligations are to be split into several ones, the accountings will accurate but also more complicated. Secondly, the price allocation to performance obligation can be hard. Without standalone selling price, the different performance obligation price in the construction contract can be hard to determine, as different services used to be considered as a whole. Last, some discretion can still have large effect on the income recognition. Such as the weighted average method in variable consideration measurement, the individual possibility of each option can be hard to estimated and hard to tell the accuracy and reliability.

Detailed guidance increases the complexity and the accounting cost, while some discretions are worthy discussion and deserve more instructions about the measurement. IFRS 15 can be better-developed in the future by adding more direction.

3. GAAP INCOME RECOGNITION

3.1. ACS 606 changes compared with ASC 605.

The ASC 606 and IFRS 15 are generally convergent as a result of negotiation of FASB and IASB. The ASC 605 is much complicated as it contained many categories and detailed the income recognition rules in each case, giving clear and strict guidance according to different transactions. But the new version ASC 606 gives more direction than ASC 605.

First impact of the ASC 606 is that it may influence the income recognized by corporates which apply GAAP to their financial statement. However, the detailed rule about listed company’s profit specified by SEC. As a result, the ASC 606 may affect some listed companies validation if the list companies no longer satisfy the profit rule. Secondly, ASC 606 is more comprehensive and it contains almost most transactions between companies and clients, covering all categories of income for a company. Except some special transactions which are specified in other ASC, like financial instrument or insurance contract. There

exceptions are quite similar to the exceptions of IFRS 15.

3.2. steps in 5-step model

The 5-step model devises the income recognition process into 5 individual stages. The first stage is about identify the contract with customers, which is to find if the contract meet the requirements for being valid. The second stage is identifying the performance obligations in the contract, that is assess the goods and services that have been promised to the customer. The third stage is determining the transaction price, which is the amount the entity expected to be entitled in exchange for the goods and services provided. The fourth stage is to allocate price to allocate transaction price to performance obligation. The fifth stage is to recognize revenue when entity satisfies the obligation, either at time point or over a period of time.

3.2.1. identify the contract with a customer.

For the first step, ASC 606 emphasize more about the enforceable legal rights and obligation instead of the contract itself. Besides the rights and obligation, there are another 2 points need to be noticed.

Firstly, the consideration is probable. The probability requires expertise to assess the risk of defaulting. And the amount which faces a risk of default should not be involved in the income. This mechanism may obtain incentive from the medicine system and installments payments in US. The living cost in US is high, especially in medicine without insurance coverage. In order to reduce the risk of defaulting, hospitals would be willing to give the patients bargain power to reduce the fees and reach a balance acceptable by both parties. And the reduced fees will not be counted in the income. In previous rules, the total amount in the bill will be brought to the revenue and then large allowances and bad debts were made.

The new accounting treatment will just allow for the amount which is probable, which reduce the risk of later adjustments.

Secondly, previous rule requires the income amount to be reasonably estimated. SAC 606 do not make strict rule about the amount. The final transaction price can be different from the old one.

3.2.2. identify performance obligation

The second step of the income recognition model after identifying the contract is to identify the performance obligation, which is what need to be done for obtaining consideration from another party. In this stage, two criteria are to be considered when determining whether they are individual performance obligation. They are individually beneficial and

identifiable. The beneficial criteria starts from the clients position, giving some discretion for reasoning. The identifiable criteria can be determined by the individual price.

This splits of performance obligation leaves considerable problems for software and maintenance industries. There are many separable obligations in their operations as there are different works during the service stages, selling goods and services at the same time. The 2 criteria brought more challenges to dealing with later-stages services.

3.2.3. allocate price to obligations

This fourth stage about price allocation is flexible but also with more rules. The allocated price to each obligation highly depends on standalone selling price. There are 3 ways to determine the price when single price is not available. The first method relies on market for similar products by taking other related internal information into account. However, the second and third method both gives uncertainty and dissection which may make the result not appropriate. The second one relies the expected margin and the third one relies on the residual value in a combination of other products. The two methods left potential problems for manipulations of income, a firm's policy for recognizing the standalone selling price is required to be consistent, eliminating constant variation. To some extent, this regulation deter financial staffs from manipulation.

3.3. difference between ASC and IFRS

3.3.1. how FASB changes the principle

The income recognition principle is the achievement of FASB and IASB convergence. But still, there are some differences when the principle firstly issued.

In 2016, FASB issued ASU2016-08 to assist former principle, but IFRS did not accept all the changes, which brings more discrepancies to the income recognition principle in two systems

3.3.2. initial difference between IFRS and ASC in income recognition principles

Firstly, the probable is defines differently in IFRS and GAAP. This probable criteria is used to define the existence of the contract in the first step of income recognition model. GAAP requires the probable to be 75%-80%, while the IASB defies probable as higher than 50%. Secondly, besides disclosures for the allocation of price to different obligations, the disclosure requirements of FASB is more strict, requiring contract balance and residual contract obligation to be disclosed. Thirdly, the impairment loss is recoverable in IFRS when the entity meet certain condition, but it is not

allowed in ASC, which requires prudent consideration when making impairment losses under GAAP framework.

3.3.3. additional difference after amendment

Firstly, ASC specifies how to deal with payment to customers. Only when the payments related goods or services are separated from the original transaction with reasonably estimated fair value can be seen as independent purchasing transactions, or the amount would be a deduction in the original transaction price. The payment to customers frequently happens in retailing industry as manufactures provide refrigerators and shelves for retailers. This can not be considered as separated identifiable service as it is closely related to the goods selling. As a result, cost of providing the refrigerators and shelves should be deducted from the original transaction price.

Secondly, the amendment give direction about when to recognize income if the basic recognition condition is not met. 3 another elements need to be taken into account, including control right, no more performance obligation, and payment is not obligated for returning. If these conditions were met, then the received consideration can be recognized as income, while IFRS do not make specific guidance.

Thirdly, the carriage and assembly of goods after customers have obtained the control right can be considered to be either performance obligation or non-performance obligation, up to the entity. This decision relates to price allocation and income recognition in later period. IFRS does not provide such options for entity to choose from.

4. CAS 14

4.1. introductions of new CAS 14

With the development of globalization and increasing complexity of business transactions, previous CASs can no longer satisfy the accounting demand of different industries. In the July of 2017, China's ministry of finance issued the amended version of income recognition principle, CAS 14, which came into effect in January 1st, 2018. The new income recognition standard will complete the previous recognition system, increasing reporting quality by making detailed and strict requirement.

4.2 difference between new and old version CAS 14

4.2.1. 5-step recognition model

The new CAS 14 accepted some core elements in IFRS 15 and ASC 606, such as the 5-step model for

income recognition, increasing the convergence of Chinese accounting system and international system.

Firstly, compared with the old version, the 5-step model plays an important role in income recognition of various types of transactions, eliminating the complexity of illustrating for different kinds of transactions. It can be applied to basically all kinds of transactions as 5-step model provides a comprehensive and general framework, including the construction contract.

Secondly, when facing some special business, it can be hard to determine which standard to apply, especially for mixed performance obligations, which mainly rely on accountants subjective judgement. The unified model provide a clear solution to ambiguous boundaries to different kinds of transactions.

4.2.2. new CAS 14 is more completed

With the increasing complexity of transactions, the boundaries are becoming blurry. The new CAS gives more clear and detailed guidance on time, scope and disclosure of income recognition. Compared with the old version, the new one reclassify transactions in to a general group but gives stricter thresholds for definitions.

Firstly, the old version defines the time point of income recognition based on the concept of risks and future benefits transfer, which is mainly up to the judgement of accountants. The seller and buyer may recognize the revenue and purchase at different time, and this is not consistent with the matching principle in the whole supply chain. The amended versions defines the time point as transfer of control right, which is more obvious for determination.

Secondly, the amount to be recorded used to be the nominal value, which can be negotiated by both involved parties. It is the amount on the contract. However, the new version of CAS 14 defines the amount to be the fair value of the consideration received or to be receive. This change better reflected the transaction substance by relating the price to the external market and other evidence.

Thirdly, the disclosure requirements is more detailed and comprehensive. In the past, corporates are required to disclose the financial and accounting policies as well as related price amount, which is too general to providing further information. As a result, regulations are not binding, and it is hard to monitor the disclosure compliance. After the new CAS 14, corporates have to provide additional disclosures for changes in the book value of contract asset and contract liability, accounting estimations and income recognition principles they applied. These detailed and strict requirements about disclosure provide corporates and information users

with a more regulated and transparent information reporting environment.

4.3. CAS 14 compared with IFRS 15 and ASC 606

4.3.1. characteristics of CAS 14

All of CAS 14, IFRS 15 and ASC 606 have evolved into better constructed income recognition principles, with a lot of similarities. From new version of CAS 14, it can be told that China is trying to convert to the international standards by merging some core elements in international standard, such as the 5-step model and recognition threshold. However, considering the traits of Chinese market and difference of economic environment, there are still some differences remained, deserving further consideration.

4.3.2. major differences about income recognition

Firstly, CAS 14 has different requirement about using residual value method. The residual value method is used to determine the individual selling price of a certain performance obligation in a combined contract by deducting the identifiable prices of other performance obligations. CAS allow corporates to use residual value method for determining price when there is a fluctuation in market, no price set yet or the product have never been sold individually, which make the standalone selling price not available. There is no required order about the methods to be used among market adjustment method, cost-plus method and residual value method when standalone selling price is not available. Corporates are allowed to combine several method just in order to have a better estimation of the consideration entitled to receive. The requirement is much more relaxed than the requirements raised by IFRS, which strictly limits the application for this method.

Secondly, the requirements about how to deal with significant financing component is different. CAS 14 continues to use the old version's guidance on significant financing cost when credit sales happens, especially for instalments. CAS will take the price that the customer will pay in cash when obtaining the control right in full amount as the transaction price, and the difference between transaction price and contract consideration price will be amortized using effective interest method. While the IFRS and ASC use similar method which will adjust the initial contract consideration price using a fair interest rate. And the interest rate used should be the rate applied for individual financing transactions, as it better reflects the credibility of debtor. And the deducted amount of contract consideration will be recorded as the transaction price.

Thirdly, impairment related to contract cost is another major difference. The incremental cost for obtaining contract and performing obligations can be capitalized when they are eligible for capitalization. According to related CASs, the impairments of inventory and asset under construction are recoverable. But impairment losses of other non-current assets specified by CAS 8 are not recoverable in case of profit manipulation. Under IFRS system, the impairment loss are all recoverable except the goodwill, and they will be recorded in statement of profit and loss. Under GAAP, only the impairment of asset hold for sale will be recoverable, as hold for use assets may never realize its gain. GAAP requirement about impairment recoverability is more prudent than IFRS. CAS 16 has similarity with GAAP towards impairment recoverability.

4.4. analysis of CAS 14 in Chinese market

4.4.1. current position of CAS 14

CAS 14 was designed to adapt to the fast changing industry structure and increasing complexity in various transactions, taking convergence to IFRS 15 into consideration. Firstly, It revolutionizes previous income recognition model, demonstrating that the core of recognizing income is that corporates should recognize income when it has performed its obligation, that is when customers obtain the control right of goods or services. Secondly, CAS 14, compared to the old version, emphasizes that the way how corporates recognize its income should reflect the way how it transfer goods or services to its customers. Thirdly, the amount recognized should be reflecting the amount corporates are entitled to receive in future for providing goods and services. In conclusion, the amended CAS 14 can provide more strict and accurate income information by demonstrating a well-developed income recognition model. Take the construction contract as an example, under new CAS 14, the income recognition should be recognize during the process of construction, using input or output method, which better matches the cost with revenue. Under new version of principle, income recognition is more prudent and careful. It emphasize about the substance of performance obligation instead of contract surface.

4.4.2. disadvantages of current CAS 14

Although the amended CAS 14 has develop a lot from the new one, with efforts in converging to IFRS, there are some problems requiring further consideration. For the difference between CAS and another two accounting system, researchers should take the Chinese environment into account and investigate into the essential reasons.

Firstly, about the residual value method, in the aforementioned statement about ASC 606, residual value is not recommended for its potential problems of inaccuracy and manipulation. CAS 14 does not have strict requirements for using residual value method like IFRS 15, because Chinese market is not mature and need more flexibility, but it also increases financial risks. Secondly, CAS 14 determine the transaction price towards significant financing component in a different way by using the total amount need to be paid in cash when obtaining control right. This still relies on accountants judgement and gives chance for profit manipulation. Thirdly, the recognition heavily relies on control right transfer, which relies on discretion judgement of accountants. although the major risks and future benefits transfer is hard to determine but the control right is also a debatable criteria. Lastly, the split of performance obligation gives out more complexity and pressure for accounting, especially when income is recognized during a period of time. In conclusion, the new CAS 14 requires more professional judgment and skills form accounts and related personnel, and management team and auditor are required to pay more attention for monitoring the compliance and manipulation.

5. CONCLUSION

With increasing demand for a complete income recognition system for nowadays complicated transactions, the IFRS 15, ASC 606 and CAS 14 have been developed into convergence, providing more comparability and consistency in globalization. By maintaining certain differences in some special areas, those three principles can better fit into their own environment. For IFRS 15, it detailed the content in IAS 11 and summaries transactions in IAS 18 invented a wide-applied mode for various types, so it provides a more comprehensive way for accounting procedure by redefine the recognition procedure, especially for construction contract. For ASC 606, its requirements about income recognition are initially stricter than IFRS for the recognition and disclosure. After the amendments, ASC 606 additionally restrict and specify how to deal with some problems such as payment to customer as well as carriage and assembly obligations. For new version of CAS 14, it better reflects the market valuation by using fair value and require more disclosure for contract amendment, and those changes bring more relevant information to users, assisting them with decision making. And after convergence to IFRS 15, CAS 14 increases the comparability among international corporates in China. However, there are some disadvantages of the three convergent principle which are similar to each other to some extent. Including the complexity and extra dealing with split performances. In addition, some industries still face the problem of hard determination of obligation in different

stages for combined contract. And the discretionary judgement from accountants will also increase the pressure for monitoring for the whole system. In the future, it might be a global trend for principle convergence, bringing more changes and amendments for current principle, which require accountants to be equipped with more professional skills and judgement.

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