REVENUE IN SMEs

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“Many SMEs pursue optimization of taxable profit (i.e., minimizing taxes)”

Do you agree?

What is an SME?

According to IASB

(a) do not have public accountability, and

(b) publish general purpose financial statements for external users.

No limit on the size of an entity

What is an SME?

Depends the focus; but:

TURNOVER: > Kes. 5 million to < Kes. 1 billion per annum

EMPLOYEES: > 10 to < 100

IFRS adoption by Emerging Nations

- Why did Kenya adopt IFRS in 1999?

  – increase the relevance and quality of financial statements issued (Sellhorn & Gornik-Tomaszewski, 2006) – benchmark, what are the alternatives?

  – legitimization act (Irvine, 2008)

- Benefits: increased transparency, economic opportunities and enhanced competitiveness, lower CoC? Market efficiency?

Key milestones

- Topics not relevant to SMEs are omitted:
  - interim financial reporting, segment reporting, special accounting for assets held for sale and earnings per share
- Where full IFRSs allow accounting policy choices, the IFRS for SMEs allows only the easier option.
- Many of the principles for recognising and measuring assets, liabilities, income and expenses in full IFRSs are simplified.
- Significantly fewer disclosures are required, the standard has been written in clear, easily translatable language.

To further reduce the reporting burden for SMEs, revisions to the IFRS will be limited to once every three years.

The Journey: IFRS for SMEs

2001
- Project c/f from IASC

24 Jun. '04
- DP: Preliminary Views on Accounting Standards for SMEs

15 Feb. '07
- ED: Proposed IFRS for SMEs

9 Jul. '09
- IFRS for SMEs issued – effective immediately st. jurisdictional approval

25 Jun. '12
- RFI: Review of IFRS for SMEs

3 Oct. '13
- ED/2013/9 Proposed Amendments

21 May '15
- 2015 Amendments to IFRS for SMEs issued (w.e.f 1 Jan. 2017)

Revaluation now permitted

Deferred income tax aligned with IAS 12

Exploration & evaluation of mineral resources aligned with IFRS 6

Journal of International Financial Management & Accounting 24:2 2013

Implementation of IFRS for SMEs in Emerging Economies: Stakeholder Perceptions in the Czech Republic, Hungary, Romania and Turkey

Cătălin Nicolae Albu

- Albu et al. (2013) [& 13 others!]
- Differences exist between stakeholder groups and in a number of countries on preferred implementation approach of IFRS for SMEs
  - Mandatory adoption?
  - Voluntary adoption?
  - Convergence of national regulations with IFRS for SMEs? – less supported by auditors!
- Most support for the convergence approach.

Contents of the *IFRS for SMEs*

Topic 1.6

Section 23 *Revenue*

Section 23 – Overview

- **Section 23 combines** the topics covered separately in
  - IAS 18 *Revenue*
  - IAS 11 *Construction Contracts*
- The principles in Section 23 are the same as those in IAS 18 and IAS 11
- Section 23 includes an Appendix of examples

Section 23 – Scope

- **Section 23 covers revenue from**
  - Sale of goods
  - Rendering of services
  - Construction contracts
  - Use of an entity’s assets by others:
    - interest,
    - royalties,
    - dividends received

Section 23 – Scope exclusions

- **But some specialised revenue is dealt with in other sections of *IFRS for SMEs***
  - Leases (Section 20)
  - Financial instruments (Sect 11 and 12)
  - Associates and joint ventures (Sections 14 and 15)
  - Investment property (Section 16)
  - Agriculture (Section 34)

Section 23 – Main topics covered

- **Section 23 principles cover**
  - What is revenue
  - How to measure revenue
  - When to recognise revenue
  - Identification of the revenue transaction
    - Multiple deliverables
  - Disclosures

Definition of revenue

- Gross inflow of economic benefits during the period from the ordinary activities of an entity
  - Measured ‘gross’ (different from gains)
  - ‘Economic benefits’ means cash or other assets
  - Results in increases in equity (ie exchanges are not revenue)
  - ‘Ordinary activities’ (not one-off gains)

Section 23 – Example: definition

- **Example: Chain of 10 bicycle shops sells new and used bicycles and rents bicycles. This year it sold the land and building for one of its shops, which was closed.**
  - It has 3 types of revenue: Sale of new bikes, Sale of used bikes, and Rentals.
  - The proceeds from selling the land and building are not revenue (not ‘ordinary’); instead, this is presented net as a gain or loss.

Section 23 – Measurement principle

- **Principle: Fair value of consideration received or receivable**
  - Net of trade discounts, prompt settlement discounts, volume rebates
  - Does not include amounts collected on behalf of others, such as:
    - Sales tax, value added tax
    - Amounts collected while acting as an agent rather than principal seller (only the commission is revenue)

Section 23 – Example: cash discount

- **Example: Goods sold for 500, due in 60 days. Customer can take 10% discount if paid in 30 days.**
  - If customer gets the discount, revenue is 450.
  - Would be wrong to have revenue 500 and interest or some other expense of 50.

Section 23 – Example: ‘sale’ to agent

- **Example: We sell goods for 100 through an intermediary (agent) who gets a commission of 10. We own goods until sold to end users. We are responsible for defects and returns from end users.**
  - We have revenue of 100 and commission expense of 10 <u>only when</u> agent sells goods to end user.
  - Would be wrong to recognise revenue when goods are shipped to agent.

Section 23 – Example: sale to reseller

- **Example: We sell goods for 90 to reseller who sells them for 100. We accept returns from the reseller.**
  - We have revenue of 90 when goods are sold to the reseller.
  - We would accrue estimated returns at the same time.

Section 23 – Example: collect sales tax

- **Example: We sell goods for 100 plus 10 sales tax. We remit the tax monthly to the government. Buyer immediately pays us 110.**
  - We have revenue of 100
  - Would be wrong to have revenue of 110 and tax expense of 10

Section 23 – Deferred payment

- **Receipt of revenue is deferred**
  - If deferral is normal credit terms in the industry, revenue = contract amount (no discounting)
  - But if deferral constitutes a financing transaction, revenue = present value of all expected receipts. Discount rate is either:
    - Prevailing rate for similar instrument
    - "Implicit" interest rate that discounts cash flows to current cash sale price

Section 23 – Example: deferred payment

- **Example: We sell goods costing 1,500,000 for 2,000,000 due in 2 years interest free. Current cash price would have been 1,652,893.**
  - Financing transaction.
  - Up front revenue is 1,652,893. Profit is 152,893.
  - PV = (FV) / ((1+int)^periods)
  - 1,652,893 = (2,000,000) / ((1+int)^2)
  - Int. = .10 (10%) by solving the equation

Section 23 – Example continued

- **Example, continued:**
  - Interest income year 1 = 1,652,893 x 10% = 165,289, unpaid, bringing receivable up to 1,818,182.
  - Interest income year 2 = 1,818,182 x 10% = 181,818, bringing receivable up to 2,000,000, which is then repaid.

Section 23 – Example continued

- **Example, continued: Journal Entries**

1 Jan 16	Account receivable	1,652,893	
	Revenue		1,652,893
31 Dec 16	Account receivable	165,289	
	Interest revenue		165,289
31 Dec 17	Account receivable	181,818	
	Interest revenue		181,818
31 Dec 17	Cash	2,000,000	
	Account receivable		2,000,000

Section 23 – Exchanges

- **Exchanges of goods or services**
  - Do not recognise revenue if:
    - Exchange of similar goods / services, or
    - Transaction lacks **commercial substance**
  - Do recognise revenue if:
    - Exchange of dissimilar goods / services, and
    - Transaction has commercial substance

Section 23 – Measurement of an exchange

- **If revenue is recognised on an exchange of [dissimilar] goods or services, measurement hierarchy:**
  1. FV of goods/services received (adjusted for any cash transferred)
  2. FV of goods/services given up (adjusted for any cash transferred)
  3. If neither of above can be measured reliably, then revenue = carrying amount of asset given up (adjusted for any cash transferred)

Section 23 – ‘Unit of account’

- **Normally each individual sale transaction**
- But if ‘multiple deliverables’ may need to recognise revenue **for each component separately**, such as:
  - Sale of goods and subsequent servicing
  - Sale of goods and installation
  - Sale of hardware and software
  - Sale of software and future maintenance

Multiple elements: Illustration – used car dealership

Section 23 – Ex: multiple deliverables

- **Example: Normally, car dealer sells car for 10,000 and offers 3-year service for an extra charge of 400. As a promotion, dealer includes 3-year service as part of sale of a car for total price 10,200.**
  - *Multiple element transaction*
  - Revenue from sale of car = 10,000 / 10,400 x 10,200 = 9,808 (recognised at delivery) **BODMAS!**
  - Revenue from service 392 recognised over 3 year service period

Section 23 – Multiple deliverables

- **Occasionally, ‘multiple deliverables’ must be recognised as a single transaction to reflect the commercial substance:**
  - Sale of goods with a separate agreement to repurchase the goods at a later date

Section 23 – Customer loyalty awards

- **Sale of goods/services with customer loyalty awards**
  - In substance, this is a multiple deliverable
  - Allocate FV of consideration received to (a) the main sale and (b) award credits based on FV. Award credits become deferred revenue (liability) until redeemed.

Kes. 3.8 billion

The Estimated Worth of Unredeemed Safaricom Bonga Points (2015) -

http://techmag.co.ke/redeem-safaricom-bonga-points/

Section 23 – Recognition principle

- **Recognition** means incorporating an item that meets the **definition of revenue** in profit or loss when it meets the following criteria:
  - it is probable that any future economic benefit associated with the item of revenue will flow to the entity, and
  - the amount of revenue can be measured with reliability.

Section 23 – Recognition sale of goods

- **Sale of goods: Recognise revenue when**
  - risks and rewards are transferred;
  - seller has no continuing involvement;
  - amount of revenue is reliably measurable;
  - it is probable that seller will receive the revenue; and
  - costs incurred (including those to be incurred) can be measured reliably.

Section 23 – Recognition sale of goods

- **Sale of goods: When are risks and rewards transferred?**
  - Normally: Title is transferred and/or buyer takes possession
  - Risks are retained if:
    - Performance obligation beyond normal warranty
    - Sale contingent on buyer reselling
    - Significant remaining installation
    - Uncertainty about buyer returns

Section 23 – Examples: sale of goods

- **Example: Goods sold with 2-year warranty**
  - Warranty does not prevent revenue recognition if estimated cost is measurable. Normally not a separate deliverable.

- **Example: Seller retains title to goods sold until final payment is received**
  - Does not prevent revenue recognition if collectability is assured or measurable

- **Rendering of services:**
  - Recognise revenue based on stage of completion when the outcome of the transaction can be estimated reliably (see next slide)
    - Straight line if many service acts
    - Significant act(s)
  - Cost recovery method when outcome cannot be estimated reliably

Section 23 – Examples: rendering of services

- **Example: Security firm receives 10,000 to respond to alarms for 2-year period**
  - Service contract stage of completion is even over two years. 10,000 / 24 = 417 revenue recognised per month.
- **Example: Law firm fee contingent on winning the case, otherwise nothing. Outcome unknown. Costs are incurred.**
  - Service contract, outcome cannot be estimated reliably. Costs = expense.

Section 23 – Stage of completion

- **Stage of completion – outcome can be estimated reliably when:**
  - Amount of revenue is measurable
  - Collection is probable
  - Stage of completion at reporting date can be estimated reliably
  - Costs incurred and future costs can be measured reliably

Section 23 – Construction contracts

- **Construction contracts:**
  - Recognise revenue based on stage of completion when the outcome of the transaction can be estimated
  - Cost recovery method when outcome cannot be estimated reliably
  - Normally each contract separately, but occasionally:
    - Split single contract into multiple
    - Combine multiple contracts into single

- **Construction contracts: Ways to estimate stage of completion**
  - Based on inputs: % of costs incurred to estimated total costs. (This is most common.)
  - Based on outputs:
    - Engineering survey of work performed
    - Physical portion of work that has been completed (eg km of road paved)
  - Exclude costs incurred for future activities (eg materials inventory and prepayments)

Section 23 – Construction contracts

- **Construction contracts: Other points**
  - Costs whose recovery is not probable are an immediate expense
  - If a contract will probably result in a loss, immediately recognise the loss and a provision (onerous contract – Section 21)

Section 23 – Example: % of completion

- **Example: Contract signed X1 for 2,000. Initial cost estimate is 1,200. In X1 cost incurred 800. Estimated additional cost 400.**
  - For X1: % complete based on costs = 800 / 1,200 = 66.7%. Revenue = 2,000 x .667 = 1,333. Cost = 800. Profit = 533.
  - For X2: **Contract finished middle of X2. Total cost = 1,250.** Revenue 667. Cost = 450. Profit = 217.

Section 23 – Construction contracts

- **Construction contracts where the outcome cannot be estimated reliably:**
  - Use cost recovery method:
    - Recognise revenue only to the extent of costs incurred whose recovery is probable
    - Recognise contract costs as expense when incurred

Section 23 – Example: cost recovery method

- **Example: Fixed price, 5-year contract for 100,000. Year 1, 5,000 costs incurred. Unable to estimate additional costs but (a) loss is unlikely and (b) collectibility is highly probable.**
  - Use cost recovery method
  - In Year 1 revenue of 5,000, costs of 5,000, profit of 0

Section 23 – Interest, royalties, dividends

- **Interest:** Recognise using the effective interest method
- **Royalties:** Recognise on an accrual basis in accordance with the substance of the relevant agreement
- **Dividends:** Recognise when the right to receive payment is established
- All of these assume collectability and measurement reliability

Section 23 – Example: interest revenue

- **Example: We buy zero coupon bond for 100,000, redeemable at 134,010 in 6 years.**
- PV = (FV) / ((1+int)^periods)
- 100,000 = (134,010) / ((1+int)^6) → int = .05 = 5%

Year	Interest at 5% x Receivable	Bond Receivable
	Debit Bond, Credit Int. Revenue	100,000
1	5,000	105,000
2	5,250	110,250
3	5,513	115,763
4	5,788	121,551
5	6,078	127,629
6	6,381	134,010

Section 23 – Disclosure

- Accounting policies for revenue recognition
- Amount of revenue for each category:
  - Sale of goods
  - Rendering of services
  - Interest
  - Royalties
  - Dividends
  - Commissions
  - Government grants
  - Any others

Revenue recognition

“ Revenue from sales of goods is recognised when the goods are delivered and title has passed. Royalty revenue from licensing patents for use by others is recognised on a straight-line basis over the license period. Revenue is measured at the *fair value of the consideration received or receivable, net of discounts and sales-related taxes* collected on behalf of the government.”

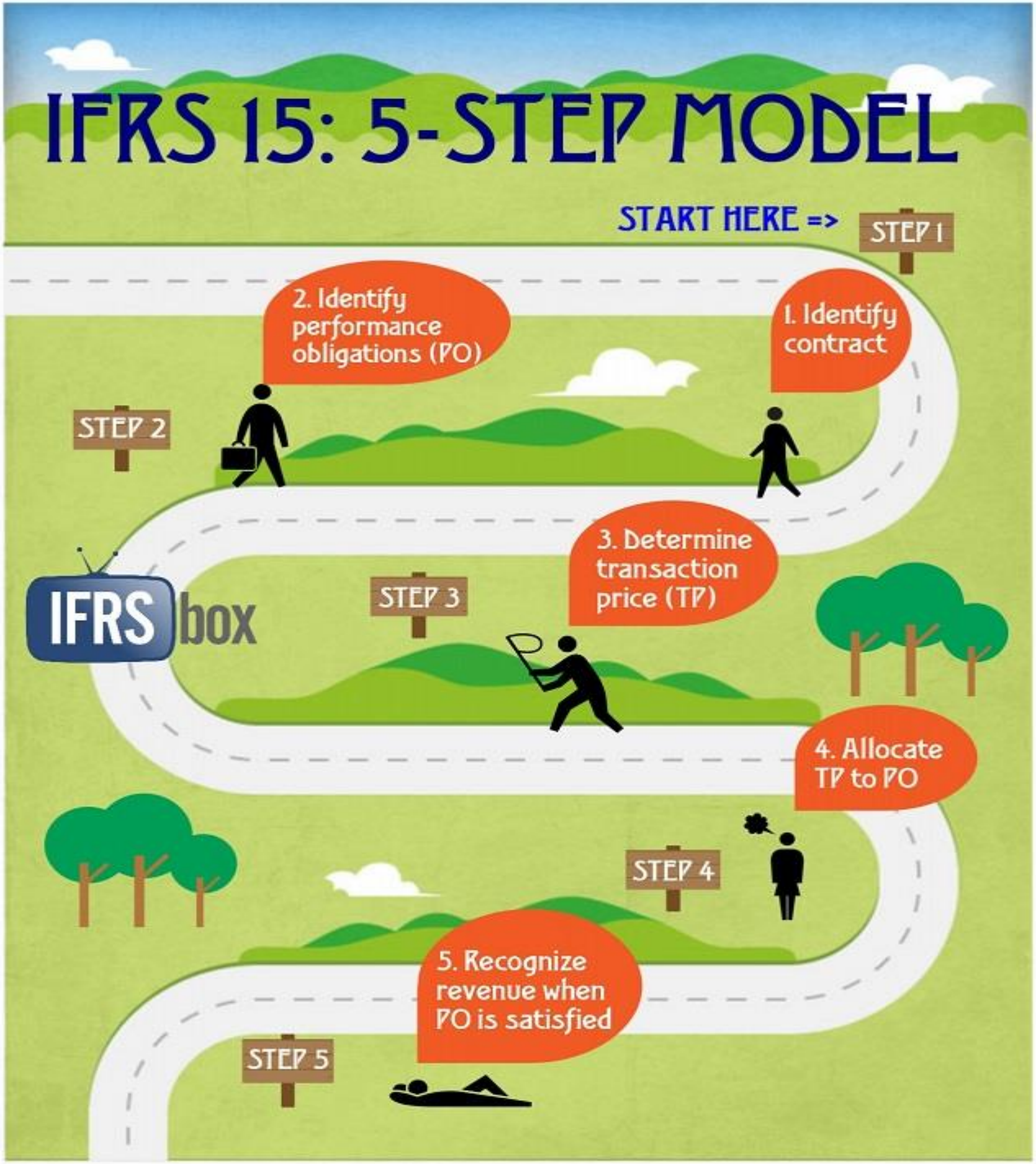
Note X Revenue

	20X2	20X1
Sale of goods	XX,XXX,XXX	XX,XXX,XXX
Royalties – licensing of patents	X,XXX,XXX	X,XXX,XXX
	XX,XXX,XXX	XX,XXX,XXX

Section 23 – Disclosure: contracts

- Additional disclosures for construction contracts:
  - Revenue recognised
  - Method for determining revenue
  - Method for determining stage of completion
  - Gross amount due from customers (asset)
  - Gross amount due to customers (liability)

THE BIG TAKE-AWAY



A Brief on IFRS 15

Source: IFRS Box

The Journey: IFRS 15

Mar. 1979
- ***IAS 11 Accounting for CCs***

Dec. 1982
- IAS 18: Revenue Recognition

Dec. 1993
- IAS 18: Revenue Recognition & IAS 11: CCs (rev.)

Apr. 2001
- IAS 11 & IAS 18 Adopted

Dec. 2001:
- SIC – 31: Revenue Barter Transactions involving advertisings services

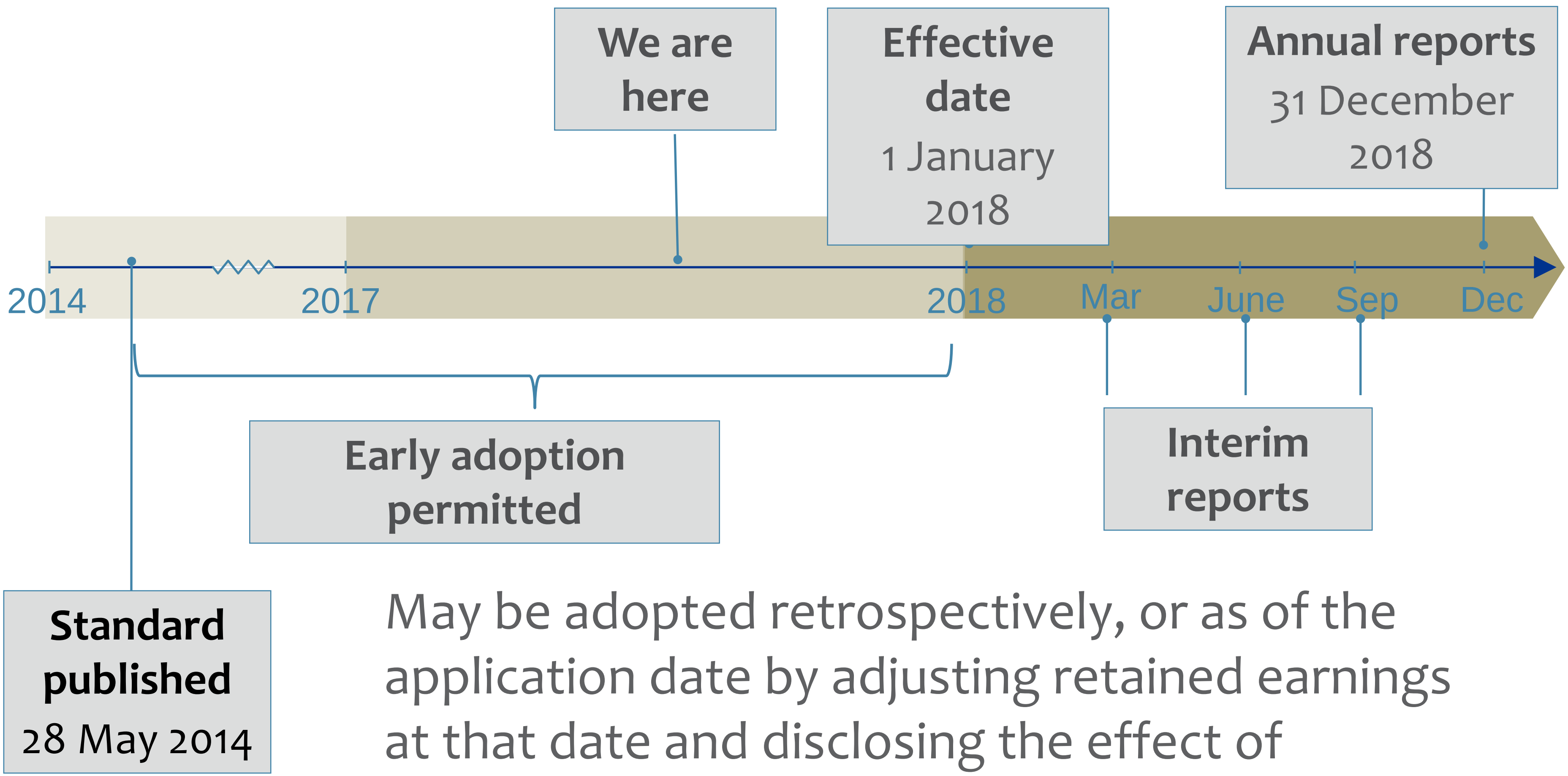
Jun. 2007:
- IFRIC 13: Customer Loyalty Programmes

Jul. 2008:
- IFRIC 15: Agreements for the Construction of Real Estate

Jan. 2009:
- IFRIC 18: Transfers of Assets from customers

May. 2014:
- IFRS 15: Revenue from contracts with customers w.e.f: 1 Jan '18

IFRS 15-Effective date



May be adopted retrospectively, or as of the application date by adjusting retained earnings at that date and disclosing the effect of adoption on each line of profit or loss (the 'cumulative effect approach')

Standards superseded

IFRS 15 supersedes:

(a) IAS 11 *Construction Contracts*;

(b) IAS 18 *Revenue*;

Related interpretations

(c) IFRIC 13 *Customer Loyalty Programmes*;

(d) IFRIC 15 *Agreements for the Construction of Real Estate*;

(e) IFRIC 18 *Transfers of Assets from Customers*; and

(f) SIC-31 *Revenue—Barter Transactions Involving Advertising Services*.

Objective of IFRS 15

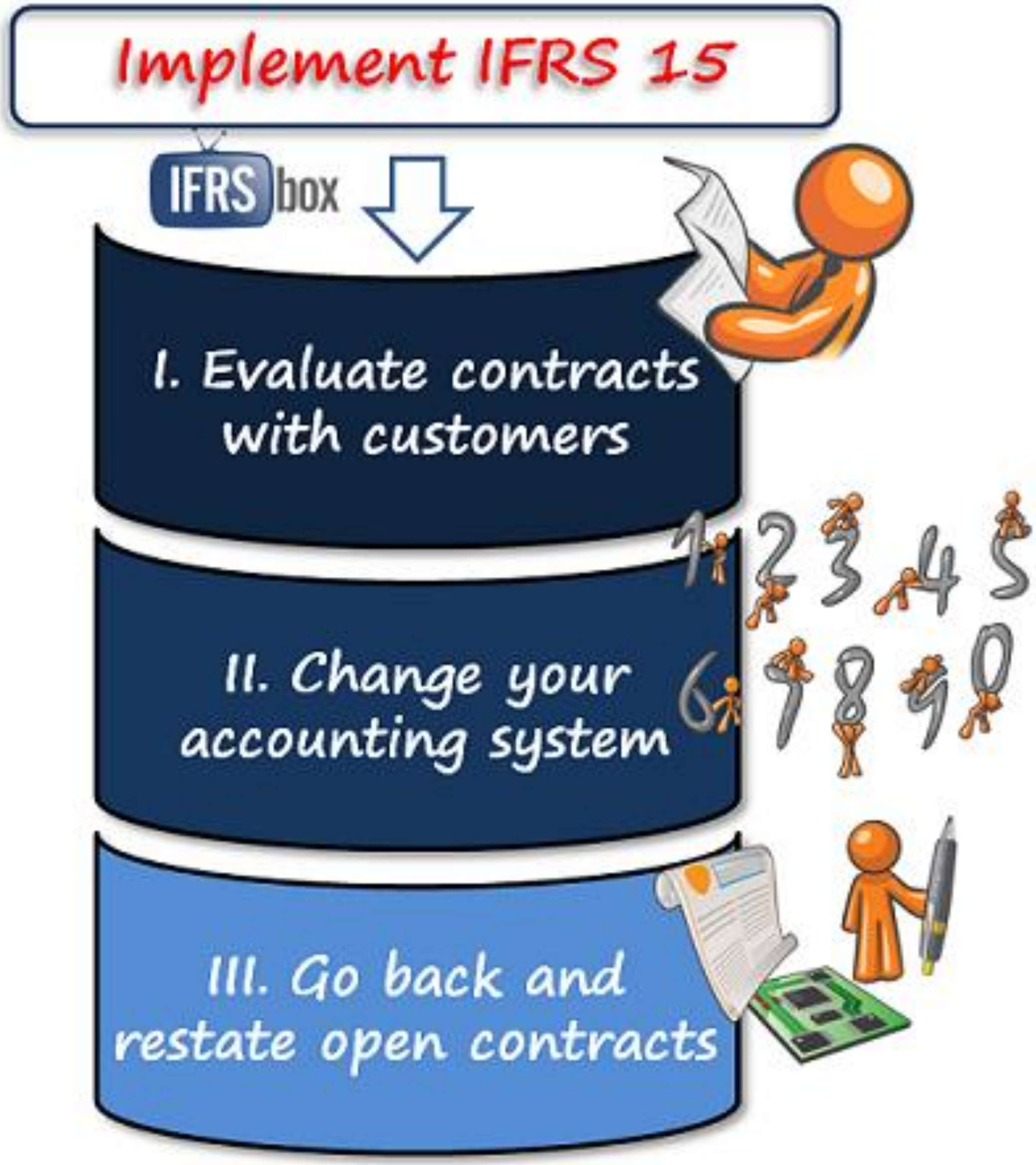
- Provide principles for reporting useful information to users of financial statements about the **nature, amount, timing** and **uncertainty** of revenue and cash flows arising from a *contract* with a *customer*.

IFRS 15: Differences with IAS 18 and IAS 11

IAS 18/11	IFRS 15
Separate models for -Construction contracts - Goods - Services	Single model for performance obligations -Satisfied over time - Satisfied at a point in time
Focus on risk and rewards	Focus on control
Limited guidance on -Multiple element arrangements -- Variable consideration -- Licenses	More guidance : Separating elements, Allocating transaction price, Variable consideration, Licenses, Options, repurchase agreements and so on…

The Five Step Model – Overview

1. Identify the contract with a customer
2. Identify the performance obligations
3. Determine the transaction price
4. Allocate the transaction price to performance obligations
5. Recognise revenue


Implement IFRS 15
IFRS box
I. Evaluate contracts with customers
II. Change your accounting system
III. Go back and restate open contracts

VIDEO ON IFRS 15

SOURCE: HTTPS://WWW.YOUTUBE.COM/WATCH?V=XS0R1T7ZZBW