REVENUE RECOGNITION IN THE HOUSING AND RESORT CONSTRUCTION - ISSUES AND PROSPECTS

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Introduction

For decades revenues have been regarded as a key indicator of the financial condition and capabilities of every enterprise. In view of their importance to the owners, managers and other stakeholders, it can be presumed that the accounting standards on their recognition, naturally, have developed in the course of time in such a way as to be clear and coherent for the various transactions, enterprises and states. Regrettably, today’s standards on revenues feature none of these qualities, as a result of which the parties concerned are forced to accept complex economic decisions. Owing to the joint effort of the International Accounting Standards Board (IASB) and the Board of the US Generally Accepted Accounting Principles (GAAP) of the USA (the two Boards for short), which have been working “towards convergence for the past 10 years”¹, and in view of the fact that they jointly dominate accounting on a global scale, “every big change in them will have an enormous effect on the parties concerned – the consumers”².

The aim of this article is to reveal a big part of the problems and the conceptual differences in the standards, concerning the technology of determining and recognizing revenues, causing the need to improve, harmonize and replace the existing standards regulating revenue recognition from the contracts for housing and resort construction.³

1. Theoretical as well as practical and applied issues of revenue recognition.

The frequently quoted discrepancy between the International Financial Reporting Standards (IFRS) and the Generally Accepted Accounting Principles (GAAP) of the USA, is most evident in the area of revenue recognition. The Generally Accepted Accounting Principles of the USA contain more than 100 explanations and guidelines regarding revenue recognition and profit, which in many cases are industry-specific, and turn out to be contradictory and difficult to grasp.⁴

In their turn, although the International Accounting Standards (IAS) have comparatively few requirements on revenue recognition, the two main standards IAS 11 Construction Contracts, and IAS 18 Revenue, turn out to be difficult to understand

³ From the range of contracts under study there have been excluded public procurement contracts.
and apply. They can provide different treatment of similar transactions, because with the one revenue recognition is on the basis of the transfer of risks, benefits and control, while the other is on the basis of the activities or the expenses incurred at a particular moment in time - the date of the Statement of Financial Condition.  

IAS 11 details the accounting of specific deals, and in it “too concisely there are regulated the combined and segmented contracts, the accounting of contractual options and stages, which would lead to difficulties in the application of the standard”.  

IAS 18 is a broad-spectrum, somewhat vague document, in short something like guidelines of the kind “how to”. In addition to that, it is composed of a small number of explanations with respect to combinations consisting of many elements – multielement (multicomponent) contracts.  

Since both were revised for the last time in 1993 in accordance with the Project for improving comparability, they are among the oldest standards within the entire set of International Financial Reporting Standards. That, in turn, is the next, successive step towards the achievement of the main goal – a single, common set of high-quality, global accounting standards.

8 It is not by accident that here is used the term revised and not amended, since such comprehensive revision of the formulations in the above standards was carried out for the last time in 1993 // http://www.sec.gov/rules/concept/34-42430.htm, (09.2013).  
Without any claims on exhaustiveness, there could be drawn the following more important theoretical as well as practical and applied issues from the currently effective standards regulating revenue recognition from the contracts for housing and resort construction, namely:

1. The enterprises run into difficulties in determining within the scope of exactly which accounting standard there falls a particular contract/contractual component for construction, and thence which criteria and when those are met;

2. There is no definition of control, and this leads to confusion along with its comprehensive application with the risks and the benefits, while the Project speaks only about control and gives detailed and clear explanations of what it is and when it is considered as transferred to the customer;

3. The terms “after-sales support” and “subsequent servicing” are not defined with accuracy in the Bulgarian legislation, and in the literature they are used interchangeably. However there should be made a distinction between those, as being thus mentioned in IAS 18, they result in confusion and incorrect treatment;

4. The notions of property developer and construction enterprise are not completely correlatable and each individual case must be considered in itself. This in turn necessitates a correction in the Bulgarian version of IAS 11 Construction Contracts, as well as in NAS 11, of the kind that was made in the Law of the Spatial Planning (LSP) and Ordinance No3 of the Ministry of Regional Development and Public Works in their amendment of 2003;

5. An important question that has been overlooked by the accounting standards and the literature is, precisely on what basis should the allocation of “the fair value of the total received or payable compensation” between the individual contractual components be done;

6. The global financial crisis and the difficulties ensuing from the application of the accounting standards have necessitated the purposeful division of the activity and the construction contracts into separate items in order for the enterprises to be able to cope with the uncertainties and the risks, which the present standards are unable to resolve;

7. Besides the terminological differences, there are also conceptual ones between the national and international variants of the standards discussed here, in determining the scope of the applicable standard, which leads to confusion among practitioners. It is caused by the fact that “for issues unresolved in the National Financial Reporting

14 Probably due to the vagueness concerning the role of the property developer and the range of their duties, the legislator excludes them from the circle of the persons participating in construction - Art. 160, Para. 1 and Art. 164, Para. 1 of the LSP.
Standards for Small and Medium-sized Enterprises (NFRSSME) there shall be applied accounting principles and solutions in accordance with the International Financial Reporting Standards.”  

8. NFRSSME, regulating the recognition of revenue and expenditure from the activity of construction enterprises, ought to be harmonized with the International Accounting Standards. Although they are based on their international equivalents, it turns out that those differ conceptually. With regard to the used terminology, principles and approaches to revenue recognition, those should be carefully defined and specified so that there is a more uniform understanding of them. The unification of terminology is of crucial importance for every field of activity, since only in this way can there be started its adequate assessment and tracing, as well as the conducting of analyses and outlining of the trends in its development;  

9. As regards the international variants of the standards IAS 11 and IAS 18, they should and will be replaced by the New Standard, but we hope this happens only if the terminology, criteria and approaches to revenue recognition from construction contracts (contracts with customers) in its final version have been carefully defined, otherwise its advent will not help improve the accounting. 

However, the very idea of creating a single standard for revenue recognition deserves our attention, because that will put an end to the ceaseless wandering among standards, interpretations, clarifications and comments. In this connection we are of the opinion that Interpretation 15 should also be repealed completely, although during the meeting of the two Boards of 19 Mar 2013, there was taken the decision to keep it in its present form. It prepared the advent of the new standard and “patches” part of the “ruptures” in the International Standards, but at the same time it caused also the conceptual differences between them and the NFRSSME. We must not forget that Interpretation 15 refers to their international variants, which is why the national ones ought to be terminologically and conceptually harmonized with their international equivalents, instead of making loose interpretations as well as “mistakes and losses in translation”.  

Based on what has been stated so far we can conclude that the difficulties in the application of the currently effective accounting rules and regulations as well as interpretations concerning revenue recognition with all components of construction contracts, require changes - the finding of a solution that is radically new in its sense. Otherwise the risk of historical accumulation, the stacking of omissions and inaccuracies

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16 Annual financial report 2010, Kurortno Stroitelstvo OOD, reference Companies Register with the Registry Agency.  
17 The two Boards use the term “contracts with customers” and in this way avoid the difficulty, which Interpretation 15 by the International Financial Reporting Interpretations Committee (IFRIC) introduced.  
19 We express the hope that it will be kept only until the moment the new standard is introduced, but not afterwards.  
20 In this way there will be achieved one of the objectives in the general provisions of the NFRSSME – “unified application of the adopted international accounting terminology”.
would ultimately lead, and it actually does lead, to unjustified - in terms of time and amount - revenue recognition, which is observed not only in the Bulgarian, but also in the global practice. At present we have at our disposal two overlapping in certain circumstances standards, with a multitude of criteria, whose full application and intertwining turns the process of revenue recognition into a difficult process relying on a largely subjective, but at the same time professionally objective, and - we hope - conscientious judgement.

2. **Comparative analysis of the formulations in the Project and the ones applied by the enterprises under IAS.**

Three years later, with two projects to be discussed, over 1300 letters containing comments and a great number of meetings and information activities, the two Boards are within several weeks of the publication of the new standard on revenue. The main goals of the joint project on revenue recognition are relatively simple – convergence and coordination, and as Leslie Seidman, president of FASB says, “It is important that we have global comparability on the most important line of the statement of every company around the world – that of the revenues”.

We should point out some of the major changes that are expected to occur with the new standard.

1. There is introduced a specific five-stage model of revenue recognition, which is to be applied consistently to the various industries, geographical regions and transactions.\(^{21}\) It is intuitive and outlines the entire process of the conclusion of the contract/s and their combination or segmentation; it passes through the identification of each individual duty of performance with the particular contract or group of contracts (if those are reported in a group); determining the contractual remuneration, up to the amount the enterprise estimates it is entitled to and will receive; its subsequent allocation to the individual obligations for execution under the contract; and lastly, revenue recognition after the execution of each individual duty of performance, through transferring the control over it to the customer;

2. There are removed the industry-specific guidelines and in this way there is introduced a new approach, more dependent on one’s professional judgement and the contractual clauses and terms. There is introduced a complete model, with its underlying principles and aims. In this way the lawyers and other consultants can play a key role in the drafting of the contracts, in order to specify clearly when and how the reporting entity transfers the control over goods, production and/or services to the customer. The new guidelines will also require that the enterprise uses more approximate estimations than those with the currently effective standards;

3. The interpretations of the new standard with respect to determining the number of the individual obligations for execution in the particular contract are more intuitive and comprehensible. In addition to that it gives thorough guidelines for determining their estimation (the independent selling price), and its setting. As it becomes clear, that void in the currently effective applicable accounting standards has been filled.

The latter do not give explanations about determining what amount of the negotiated remuneration ought to be allocated to the individual contractual commitments;

4. The key to revenue recognition within the new approach is “the transfer of control” over the promised good or service (not the transfer of the risks and the benefits). This will considerably facilitate the work of practitioners in considering only the transfer of control, in contrast to the way Interpretation 15 introduced the complex and difficult simultaneous execution of the risks, the benefits and the effective control over the production, the goods or the services;

5. The new rules will be applied to all contracts with customers. Unless the contract is one of the exceptions for the applicability of the revenue standard (such as insurance contracts and lease contracts), the guidelines of the Project will be applicable.

Applying the new approach to revenue recognition, construction enterprises will be subject to extended requirements with respect to disclosures. In reality, in many cases revenue recognition will be accelerated, since according to the currently effective standards, when the outcome of a particular construction contract cannot be valued reliably, revenues ought to be recognized only up to the degree of the costs incurred under the contract, which are likely to be reimbursed. In this way the reporting enterprise does not include the variable amounts in the price of the deal, until the uncertainty is overcome. According to the new guidelines, if the promised value of the remuneration under the contract is variable, the enterprise will have to calculate the sum of the remuneration, up to which it will be entitled (either with the help of the “expected value” approach, or that of the “most likely amount”), and to update this estimation towards each reporting date. It is accepted that there is sufficient evidence or experience in support of the conclusion that the recognized revenue will not be subjected to subsequent considerable “reverse expression” (reversal). This estimation is qualitative and encompasses all facts and circumstances connected with this risk of fiscal turnaround, caused by an uncertain future event and by the amount of the recovery, in case that uncertain event occurs. This is just one of the many definitions in the new guidelines, which will require considerable in nature judgements and assessments.

In our opinion this change has two extremely important aspects. The First is that there is already removed the difficulty before practitioners in determining the applicable standard, caused by the definition of construction contract and whether it is existent or not. There is introduced a single requirement, namely the presence of a contract with a customer, and its definition is clear and comprehensible and does not cause ambiguity and erroneous interpretations. Secondly, the accelerated revenue recognition should not be viewed as a possibility for the managers to manage revenues, but rather as improved guidelines for the application of a semblance of the model stage of completion, which - with the observance of the approach, the reduced and intuitive criteria in the Project - would lead to more frequent revenue recognition, reflecting also the actual economic character and the results of the execution of the contracts with customers.

22 After the introduction of the changes it will not make any difference whether the customer is also an assignor in accordance with the LSP and whether they can or cannot make substantial structural changes over the asset being developed.
A typical example are construction contracts with which there is established the development right of a third party (the so-called “off-plan”). We are of the opinion that the limitation time period for execution of the site to carcassing work is 5 years and the management should very carefully analyze the expected value, or the most likely amount, which will be received (earned), and which will not lead to a subsequent considerable reverse expression (reversal). And such would be the case if the enterprise recognizes revenues in the various reporting periods without taking into consideration the risk of being unable to reach the stage of carcassing work within the indicated time period, after which all that has already been built is acquired - by virtue of the capital gains - by the owner of the land.\(^{21}\);

6. The rules on reporting the operations under long-term contracts have been changed. In their accounting, according to the effective standards, enterprises are to recognize revenues by applying the method percentage of completion, based on reliable estimates. According to the new approach, a contractual obligation will be considered as executed over time only if there are met certain criteria. In this way, the accounting and recognition of revenue will depend on when and how the control over the asset is transferred to the customer according to the terms of the contract;

However, the moment when the accounting of the stage is to be done with the sequential revenue recognition is not expressly specified in the Project, and it is rather debatable, that is, it is not clearly indicated as it was in the definition of IAS 11 – “as at the date of the statement” – 31 Dec of the accounting year.

7. The concepts of the kinds of guarantees and their treatment and accounting are more comprehensible and intuitive. There have been found solutions to the main issues concerning their accounting treatment, and despite the slight imperfections, the standard would contribute to aiding construction enterprises in determining the time and the amount for the recognition of revenue gained from them;

8. The most important of all that has been mentioned so far is that there is eliminated the continuous reference from one standard or explanation to another, and from one interpretation to another. The new standard is more principle- based, allowing the enterprise to have the freedom and the right to conduct grounded approximate estimations, naturally adhering to the requirements on disclosing the technology of their conducting;

9. It should be noted that the presented changes, which are to occur in the accounting of revenue in construction enterprises, will affect with a greater force and, respectively, will introduce to a considerably higher degree improvements in the accounting of multicomponent contracts. This is due to the detailed explanations of the model of the Project, the establishment of the value of every identifiable component and the subsequent recognition of the revenue from it.

The above list lays no claim on exhaustiveness with regard to the expected changes in the rules on revenue recognition. Rather, it is a summary of the most

\(^{21}\) For the purposes of the article there are not discussed the consequences of the so-called onerous contracts, as well as the non-performance of construction contracts. Those would be the object of a separate, independent study.
important among them, which can be used as a starting point for the comprehension of the new approach, and for assessing the effect of those changes. The enterprises are to perform an appraisal of their current systems and processes in order to identify the changes, which will take place in the accounting of the existing contracts, as well as those, which are yet to be prepared complying with the new approach. Although the two Boards plan to grant enterprises considerable time (headstart) before introducing the requirement on applying the final rules, the time for the analysis and planning of their impact is now.\textsuperscript{24}

3. Testing the effect the expected changes will have in the recognition of revenue from the housing and resort construction.

From a practical standpoint, the substantial and largely positive changes will exert significant influence, because some contracts fall in the category of multicomponent ones. Such are the contracts incorporating the following: designer’s services; delivery and installation of lifts; autoparallelpas for underground garages; central air-conditioning systems; systems for the collection and purification of rain water and waste water; pools; different types of CAW, etc.

In this connection we should once again review the formulations of the Project concerning the division or combining of the individual elements (components) of these contracts.

The two Boards point out that a separate duty of performance is a promise to transfer a “\textit{separate}” good or service to the customer. A good or service is deemed “\textit{separate}” (separate component), if one of the following conditions is met:

1. The enterprise regularly sells the good or service separately – and it is considered as such when:
   - it has a separate function, and
   - it has a differentiated profit margin;
2. The assignor (the customer according to the Project) can benefit from the good or service itself – independently (i.e. the good or service is an asset in itself, which can be used, consumed, sold for an amount different from that of scrap, held or otherwise utilized in a way that generates economic benefits), or in conjunction with other resources, which are easily accessible for them (are at their disposal). And these are goods or services, which are sold separately (by the enterprise itself or by another enterprise), or resources, which the customer has already acquired (from the enterprise or from other transactions or events).

In other words, the abovementioned components do not conform to the definition of “\textit{separate}” and are not to be treated individually. What is more, the Project states further that the goods or services promised together (in a package) are not deemed separate even if the individual goods or services in it fulfil independently the conditions to be considered as such. Also, there should be taken into account the expertise of the

construction enterprise, i.e. whether it sells the various goods or services independently, and not be influenced by that of other enterprises for the particular case.

Regardless of these criteria, a good or service that is part of the promised package of goods and services is not considered separate, and therefore the enterprise will account this package as a single duty of performance, if both of the following criteria are met:

1. The goods or services in the package are strongly interrelated in such a way that their transfer to the customer requires of the enterprise the provision of a considerable in nature service on the integration of the goods or services in a combined product, for which the customer has made an agreement;
2. The package of goods or services is considerably modified or personalized in order to meet the requirements of the contract.

Therefore the three kinds of contracts - for an apartment/residential building, summer house and resort complex, and the elements in them are to be treated as independent packages.

The recognition of revenue is carried out through transferring the control to the customer. It in turn is defined as the ability to manage the use of, and to obtain all benefits from, the asset, i.e. the customer should have the actual right to receive essentially all potential cash flows from that asset (incoming cash flows or a decrease in the outgoing ones). In the definition of Control there is included also the ability to prevent other persons from managing, using and receiving benefits from the asset. The latter are the potential cash flows, which can be obtained directly or indirectly in a number of ways, such as:

- the use of the asset to settle liabilities; sale or exchange of the asset; pledging the asset as collateral on a loan, etc.

It turns out that the assignor (whether it is a third party, or the enterprise investor from the same group), possesses the control over the asset being developed (from the considered examples) throughout the entire period of the contract, since they can use the asset to settle debts, to sell it or exchange it for another, to use it as collateral on a loan.

Next, there should be established whether the obligation under the contract is executed continuously or as at given moment (the commissioning). It is executed over time, if it is estimated that at least one of the following two criteria are met at the very conclusion of the contract:

1. Through the execution of the obligation there is created or improved an asset, which the customer controls (for instance, the obligation is executed over time with many of the construction contracts when the customer controls the work in progress (tangible or intangible) resulting from the execution of the enterprise);
2. Upon undertaking the commitment there is not created an asset with an alternative use on the part of the enterprise, if each of the following criteria is met:
   • The customer simultaneously obtains and consumes the benefits with the very execution on the part of the enterprise;
   • Another enterprise should not, to a considerable degree, redo the work that has been completed up to that moment;
The enterprise has the right to receive its due compensation for what has been done up to that moment and expects to fulfil what has been promised under the contract.

It becomes clear that the very first criterion is met, because the assignor possesses the control throughout the entire period of the contract, which means that the hitherto existing practice of phased accounting and recognition of revenue is preserved. Quite another question is, as at which moment in time (when) the control over the asset is to be considered as transferred to the customer. In this way, according to the new approach, the accounting of the enterprise for the long-term construction contract will depend on when and how the control over the asset is transferred to the customer according to the terms of the contract.

In the notes to the Project (§ BC 91) it is stated that “the assignor has the right to require of the contractor, with most contracts, to make subsequent payments and to approve the erected facilities (or output, or services provided) until that moment, if they fulfil the requirements under the contract. The assignor has the right to obtain control over the work in progress as their option”. In other words, with the considered three examples of construction contracts, in effect the contractual clauses and the annexes to the construction contract, such as the schedule for approving the performed at a given moment work, will play a much greater role in determining the moment as at which (in which) the customer will receive control over the developed asset.

We are of the opinion that the recognition of revenue on the included in the package individual components, will be sequential as at the date of each Act mod. 19, with which they are approved. In view of the factual situation presented here, in order to preserve the principle of comparability, the enterprises with multicomponent contracts are to include in them suitable clauses, in order to continue to draft Act mod. 19, or Statement of Revenue Recognition (as is the practice in certain enterprises), as at 31 Dec of the accounting year. Those have to be bilaterally signed by the assignor (the customer) and the contractor, reflecting only the value and type of the actually incurred costs at the time, on the basis of which there is to be calculated the stage of completion and later on - the revenue recognized.

As regards the cases in which a customer (assignor - third party, external to the group), who has bought “off plan” or under Act mod. 14 a piece of residential property (apartment), whose construction will cover more than one reporting period, as at each date of preparing the financial statement is to draw “internal Act mod. 19”. We believe this is necessary, since that person is de jure under no obligation to accept a given stage or particular construction-assembly works, as it is in the majority of cases. This would be possible for the enterprises applying the NFRSSME, but not for those under IAS, since with the former the construction contract for an apartment is within the scope of AS 11, and in the latter there are no recognition criteria such as risks, benefits and effective control of the kind we find in IAS 18, in whose scope there falls the example given of construction enterprises, which apply the IAS. In this connection, with the latter there still exists the risk of recognizing the revenue of a completed contract.

Conclusion

The project has managed to find solutions to the main issues concerning the accounting treatment of the individual elements and the recognition of revenue from them, under the contracts for housing and resort construction. And despite the “specific economic, political, social and cultural environment characteristic of Bulgaria during the period of transition to market economy, determined by the legal and the tax systems and their impact on financial reporting; by the type and concentration of property, as well as by the scale of public enterprises; by the system of implementation and control over the observance of IAS/IFRS and largely by the reporting motives of the management of the companies in the preparation of the public financial statements”26, the replacement of the two currently effective standards with a new one is a step forward towards improving the accounting and the elimination of the existing discrepancies, omissions and ambiguities.

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Abstracts

In the present article there are considered the main theoretical as well as practical and applied issues of the recognition of revenues from the contracts for housing and resort construction, leading to the constant wandering between standards, explanations and comments. The difficulties in the application of the current accounting normative base necessitate changes - finding a radically new solution by its sense - a new standard, or else the risk of a historical accumulation of omissions and inaccuracies leads to an unreasonable in terms of time and amount revenue recognition, which is observed not only in the Bulgarian practice. As a next step there are deduced the anticipated changes and is tested the effect those are going to have.

Keywords IAS 11, IAS 18, revenues, construction, contracts.
