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Articles

Recognition of Revenue from Operating Activities in Construction Organizations in Accordance with IFRS 15

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Abstract

The adoption of International Financial Reporting Standards is to increase the volume of foreign investment in the domestic market and expand the opportunity to access international markets by providing investors with the necessary information environment. Therefore, joint-stock companies, commercial banks, insurance companies, and large taxpayers operating are being required to organize accounting based on IFRS from January 1, 2021, and from the ending of 2021 to prepare reports based on international financial reporting standards in Uzbekistan. For that reason, a study was conducted to determine the rights and obligations of customers under contracts, combining and modification of contracts based on the criteria of stage 1 of the 5-step revenue recognition model of IFRS 15 in recognition of revenue from operating activities in construction companies. The results of the study show that IFRS 15 provides an appropriate basis for measuring rights and obligations under contracts in the recognition of revenue. Applying these criteria ensures that contractors monitor the terms of the contract over time. Requirements for the consolidation of contracts based on IFRS 15 in construction companies operating in the Republic of Uzbekistan lead to significant changes in practice in the construction industry.

Keywords: construction contract, contract combining, contract modification, revenue, revenue recognition, performance obligation.

1. Introduction

In order to provide foreign investors with the necessary information environment and expand access to international financial markets by accelerating the transition to international financial reporting standards, by Decree of the President of the Republic of Uzbekistan Sh. Mirziyoyev dated February 24, 2020, legal entities belonging to joint-stock companies, commercial banks, insurance companies, and large taxpayer organizations are planned to maintain accounting on the basis of international financial reporting standards from January 1, 2021. The result of this reform gives local scientists and practitioners the task of studying and applying the requirements of the International Financial Reporting Standards. Factors of the lack of industry-specific guidance on revenue from the operating activity and the complexity of the construction industry make it difficult for local construction organizations to apply IFRS 15.

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Research method

In accordance with the above objectives, doctrinal research was conducted to define rights and obligations in construction contracts, combining and modification of contracts in accordance with the requirements of IFRS 15

The purpose of the study was to determine the nature of construction contracts, consolidation and modification of contracts based on the criteria of IFRS 15 in the recognition of revenue from operating activity in construction organizations.

As a result of the study, it was noted that step 1 of the 5-step revenue recognition model of IFRS 15 provided the basis for the correct interpretation of contractual rights and obligations and was the main criterion for revenue recognition in construction organizations.

Literature Review

The main goal of any business entity is to generate high profits in the condition of market economy. The achievement of this result will depend on a number of economic processes. Their main ones are represented in the recognition of revenue and the realization of expenses. Revenue is the main source of financing for business activities. Revenue is regarded as one of the most significant measures of financial performance (Wagenhofer, 2014). Revenues are the increases, expenses the decreases, in its net resources which arise largely from its operating activities (Sutton, 2004). M. Dobler (2008) contemplates revenue to be a crucial number in financial reporting, which could be used for accounting manipulation. D. Henry, A. David, (2014) consider revenue is an asset that is generated when goods or services are transferred to a customer.

Depending on the characteristics of the recognition and areas of activity of the enterprise revenue is divided into revenue from operating, investing, and financial activity (Khalilov, 2012). R. Tomas, V. Hennie, E. Henry, A. Michael, (2009) comments on operational activities as follows: operating activities are those activities that are part of the day-to-day business functioning of an entity. T. Sutton (2004) considers operating activities are the sale of goods and services and related to trading cost of firms. The above definitions of operative activities do not fully explain the essence of the concept of operational activity. In our opinion, operational activity is carried out within the enterprise and ensures continuity of core activities and generates revenue in the current period (Khalilov, 2012). Revenue from operating activities in construction organizations relates to revenue from the sale of construction works and services.

To improve revenue recognition, the International Accounting Standards Board (IASB) developed IFRS 15 “Revenue from Contracts with Customers”, which became effective on 1 January 2018. The IFRS 15 supersedes, amongst others, International Accounting Standard 11 (IAS 11) “Construction Contracts” for all financial year-ends starting from 01 January 2018.

In the condition of a market economy economic entities provide a variety of work and services to the customers. In particular, it has become customary to provide multiple work and services to the customer or the relevant parties of the customer at the same time in the global construction industry (Daniel, Bolivar, 2011). Currently, the components of work and services provided by organizations operating in the construction industry include construction site cleaning, foundation laying, construction of buildings and structures, pipelines and electrical works, and many other services.

It is known that the works and services provided by construction organizations are carried out on the basis of contracts within the framework of the construction project. As a rule, construction contracts should clearly describe the rights and obligations agreed between the construction organization and the customer. The construction contract usually specifies the project details, construction works and services to be performed within the project, as well as the procedure in which payments related to the project will be made.

2. Results and discussion

Identify rights and obligations in the contract with the customer. The contract shall meet the following criteria based on the requirement of step 1 (Identify contract with the customer) of the 5-step revenue recognition model under IFRS 15:

- The parties must have approved the contract and must be committed to perform their respective obligations;

- The entity must be able to identify the rights and obligations regarding the goods or services to be transferred;
- The entity must be able to identify the payment terms of the goods or services to be transferred;
- The contract has commercial substance, meaning goods or services of economic value are transferred;
- It must be probable that the entity will collect the consideration to which it will be entitled

The above criteria make it possible to define the rights and obligations in the contract of the construction organization. T. Randolph, Jr. Ellis (2007) confirmed that the identification of the rights and obligations could be straightforward for the construction industry if the rights and obligations are clarified in the contract. In addition, H. Ndlovu (2017) pointed out that there are different forms of contracts in South Africa that would assist in providing standardized and more simplified contracts to clarify the rights and obligations. Construction companies carry out construction work on the contractual price on the basis of a certain risk. The above criteria serve as the basis for controlling this risk. These criteria require consideration of only the obligations to be performed in determining the revenue to be derived from the contracts. Thus, these criteria provide a suitable basis for measuring contractual rights and obligations, thereby laying the groundwork for applying steps 2, 3, 4 and 5 in revenue recognition.

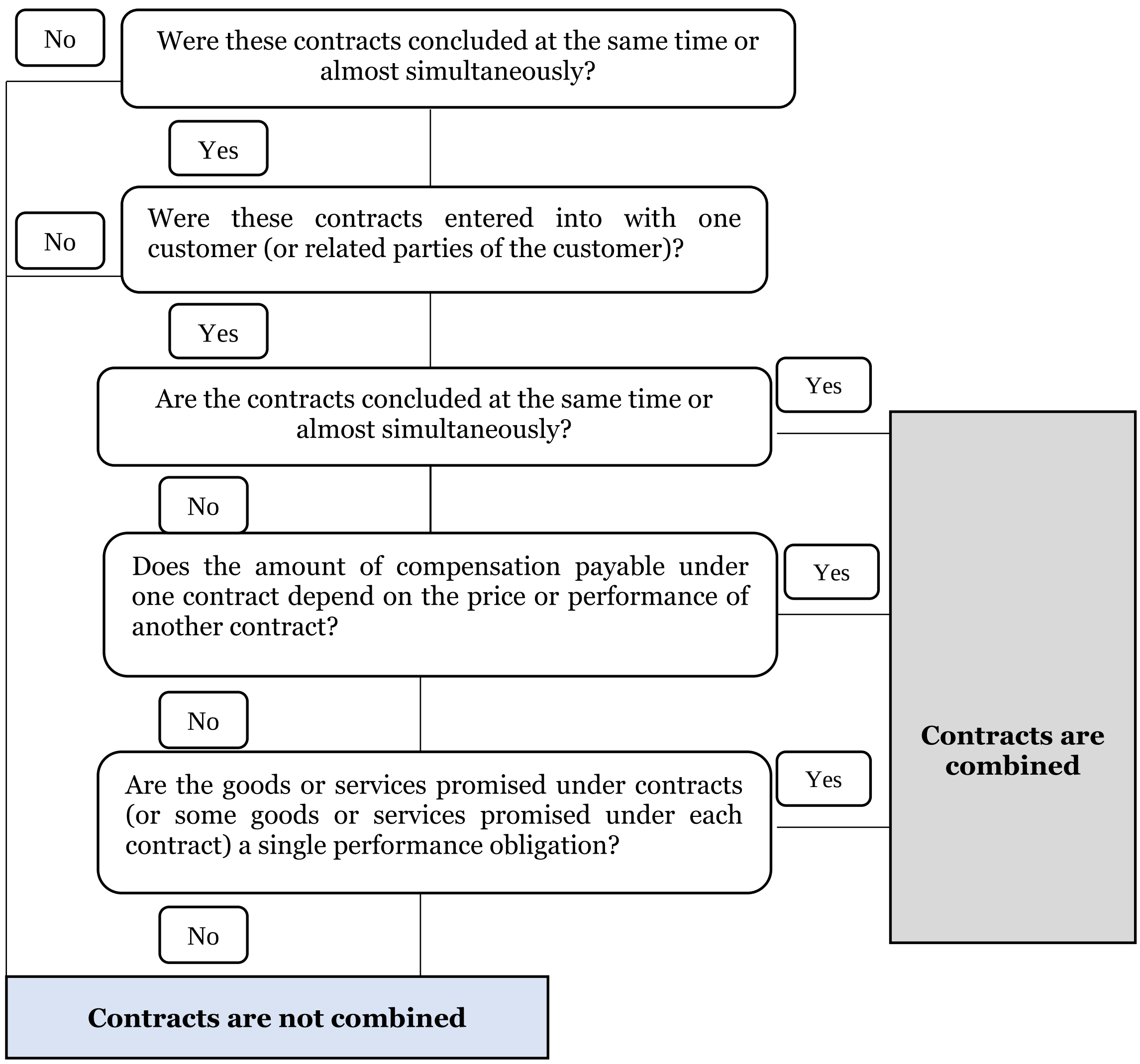

Fig. 1. Identify the combining or separation of contracts in construction organizations

Combining of contracts based on requirements of step 1 of the five-step revenue recognition model of IFRS 15. Construction work and services provided by construction organizations are carried out on the basis of several construction contracts between the customer and its relevant parties. This has led to some difficulties in recognizing revenue from operating activities under contracts between construction organizations and the customer. Step 1 of the five-step revenue recognition model under IFRS 15 provides the criteria that require two or more contracts to be combined into one contract in order to recognize revenue.

Such a combining of contracts is possible if the contracts are concluded with the customer or its respective parties at the same time or almost simultaneously, and at least one of the following criteria is met:

- The contracts are negotiated with a single commercial objective;
- The amount of consideration in one contract depends on the other contract;
- The goods or services promised are a single performance obligation.

We recommend this following scheme to identify the combining or separation of contracts in construction organizations.

The customer hires construction organizations to provide services for the construction of a house (contract price of 300 000,000 UZS) and a warehouse (contract price of 60 000 000 UZS). Separate contracts were signed for these two projects. The construction company provided a discount of 10,000,000 UZS for the construction of a warehouse, taking into account that the foundation of the house and the warehouse can be built at the same time, and the equipment used in the construction of the house can also be used in the construction of the warehouse. However, the construction company agreed with the customer that within the next two months it is necessary to finish the house first and then the warehouse. The expected cost of building a house and warehouse will be 260 000 000 UZS and 34,000,000 UZS, respectively. As of May 30, 2020, the construction company has incurred costs of 100,000,000 UZS for the house and 4,000,000 UZS for the warehouse. In this case, it is possible to can combine these contracts, given that the customer enters into a contract with the construction company almost simultaneously, the contract is concluded with one customer, and payment for one contract depends on the performance of another contract. And revenue from operating activity on this combing contract is recognized as follow:

Table 1. Recognition of revenue of operating activities under a combining contract on the basis of IFRS 15 "Revenue from contracts with customers" (in thousands of UZS)

Components of the contract	Contract price	Stand-alone selling price	The relative price of stand-alone sale	The expected costs of the contract (Estimate contract cost)	Costs as of June 30, 2019	Revenue recognized as of June 30, 2019
House	300 000	300 000	291 666.667 300 000/360 000 x 350 000	260 000	100 000	112 179.487 291666.667x 100000/260000
Warehouse	50 000	60 000	58 333.3333 60 000/360000 x 350 000	34 000	4 000	6 862.74509 58333.3333 x 4000/34000
Total	350 000	360 000	350 000	294 000	104 000	119 042.232

If there is more than one obligation performance in the contract with the customer, step 4 of 5-step of revenue recognition of IFRS 15 requires the construction organization to redistribute the contract price to the performance obligation on the basis of the relative stand-alone selling price.

Accounting for contract modification. Construction is considered as an area in which the size and value of the contract are constantly changing (Lucas, 2015). The scope and price of the construction contract will change as a result of changes in the volume of construction work or the addition of new works and services to the contract at the request of the customer (Daniel, Bolivar, 2011).

A contract modification is a change in the scope or price (or both) of a contract between a construction organization and a customer. According to the IASB in the IFRS 15 (2014 a: para. 18), a contract modification exists when there is a change in the scope or price (or both) of a contract, which is approved by the parties. The criteria of the step 1 *(identify contract with the customer)* of revenue recognition model of IFRS 15 provides methodological guidance on contract modification in the recognition of operating income in construction organizations. The contract is modified in accordance with the provisions of this standard only if the contract is changed, new rights and obligations are fulfilled or existing rights and obligations are changed.

21 para of the IFRS 15 (2014 a:para.21) establishes three different approaches to account for contract modification. Depending on the circumstances, a contract modification is accounted for either as separate contract, as part of the original contract or as a new contract after the original contract. The following criteria are used to determine which approach requires contract modification:

- Are the additional work and services different from the work and services specified in the original contract?

- Does this modification reflect the cost of separate sales of additional work and services?

We recommend using the following scheme to account for contract modification in construction organizations:

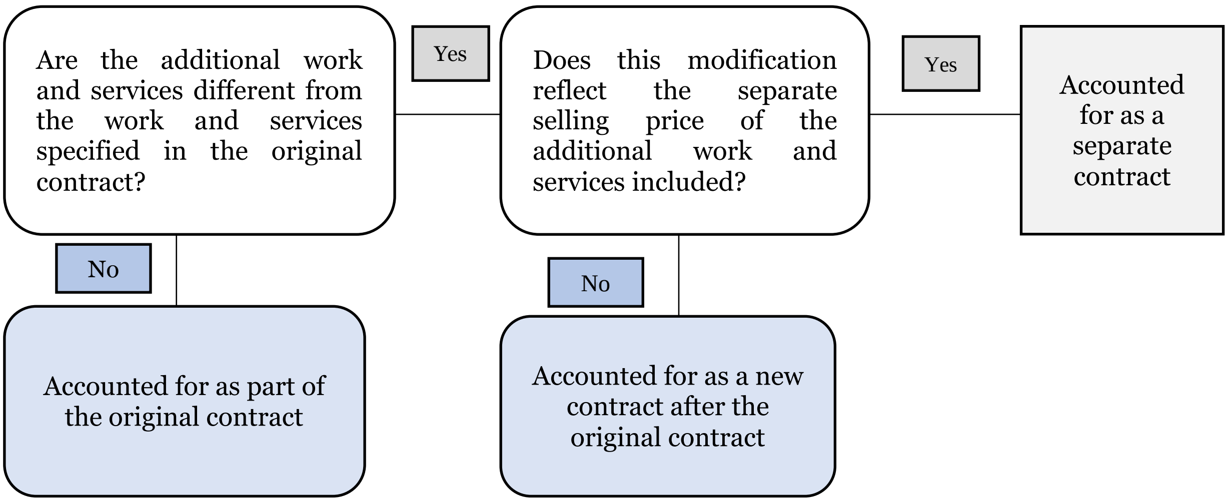

Fig. 2. The contract modification in construction organizations

IFRS 15 requires that the variable price concept be used in the valuation of the contract price if changes in the contract have been agreed by agreement of the parties, but the price resulting from these changes has not yet been agreed.

In step 1 (Identify contract with the customer*)* of the 5-step model of IFRS 15, the essence of the contract with the buyer was determined and the issues of combining contracts and contract modification were considered. The criteria of step 1 will be the basis for ensuring that only executable contracts are taken into account in recognizing the revenues of construction organizations. The results of the study show that IFRS 15 provides an appropriate basis for measuring rights and performance obligations under all contracts that are the basis for the recognition of revenue. Applying these criteria will lead to better control over the contract terms by contractors over time.

3. Conclusion

The requirements of construction companies operating in the Republic of Uzbekistan to combining a contract based on IFRS 15 lead to significant changes in practice in the construction industry. However, since construction contracts are constantly changing, the difference between contract change and the variable price is important for the construction industry. IFRS 15 provides the basis for modifying contracts and identifies three alternatives to which a contract may be modified as a result of a modification: a separate contract, a new contract, and part of the original contract (an existing unfinished contract). we consider it advisable to consider changes to construction contracts as generally incomplete given the specifics of the construction industry.

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