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# Comparative Analysis of Revenue Recognition Principles According to International Financial Reporting Standards and Russian Accounting Standards

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## **List of abbreviations**

EBITDA	Earnings before interest, tax, depreciation and amortization
ED	Exposure Draft
EPS	Earnings per share
FASB	Financial Accounting Standards Board
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IFRIC	International Financial Reporting Standards Interpretation Committee
IFRS	International Financial Reporting Standards
MNE	Multinational enterprise
RAP	Russian Accounting Principles
RAS	Russian Accounting Standards
SIC	Standing Interpretations Committee
TACIS	Technical Aid to the Commonwealth of Independent States
US GAAP	United States Generally Accepted Accounting Principles
USSR	The Union of Soviet Socialist Republic





## **1. Introduction**

### **1.1. Problem background**

Corporate financial reporting and accounting are not identical in different countries of the world, so there is a point in studying comparative international accounting. Parker and Nobes listed at least four reasons why the study of comparative financial reporting and accounting is important. They are<sup>1</sup>:

- (a) historical reasons;
- (b) multinational reasons;
- (c) comparative reasons;
- (d) harmonization reasons.

Different cultural background of contributors of accounting studies causes mainly historical reasons. Influence of traditions and culture of different countries can be still noticed in Anglo-American and Continental models of accounting. While multinational enterprises (MNEs) spreading across the whole world give rise to another reason for studying comparative financial reporting and accounting. This situation is also being encouraged by internationalization and globalization. MNEs play an important role in interchange of accounting technics and technologies across the world. The comparative reason is useful for those countries, which intend to adapt foreign successful accounting practice or at least to improve their own accounting principles by observing those of foreigners. The harmonization reason has been growing rapidly in recent years.<sup>2</sup> Parker defines harmonization as “a process of increasing the compatibility of accounting practices by setting bounds to their degree of variation.”<sup>3</sup>

It is obvious that “factors which are seen as influencing accounting development include the nature of the legal system, the prevalent providers of

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<sup>1</sup> Cf. Parker/Nobes (1995), p. 3

<sup>2</sup> Cf. Parker/Nobes (1995), pp. 5-7

<sup>3</sup> Parker/Nobes (1995), p. 7

finance, the influence of taxation. And the strength of the accountancy profession.”<sup>4</sup>

Companies situated in Russia prepare their financial statements according to Russian Accounting Standards (RAS). However, nowadays there is an increasing number of Russian companies now also required to produce annual financial statements that comply with IFRS, US GAAP or other GAAP, in order to meet the following:

- “(a) reporting and consolidation requirements of the foreign parent;
- (b) reporting and listing requirements of a foreign stock exchange;
- (c) information needs of western banks and lenders.”<sup>5</sup>

Although Russia tries to harmonize its accounting standards with IFRS, differences between IFRS and RAS are still significant. This issue leads to incomparability of financial statements prepared according RAS and IFRS. Experts emphasize that in last two decades, the use of IFRS parallel to RAS by Russian companies on a voluntary basis has been growing. Reasons have been the requirements of international financial institutions and investors, and needs of management and shareholders for more transparent and internationally comparable financial information. In this environment of rapid internationalization and globalization, the need to understand the differences between IFRS and RAS has never been more important.<sup>6</sup>

## **1.2 Aim of the thesis**

It is obvious that revenue as the top line in the income statement is an important measure of the size and growth of entity. It is the key measure for calculating ratios and other significant numbers, which are of great relevance for management and external users. Revenue is considered as the most important

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<sup>4</sup> Parker/Nobes (1995), p. 11

<sup>5</sup> <http://www.iasplus.com/europe/0909doingbusinessrussia2009.pdf>

<sup>6</sup> Cf. <http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/documents/IFRS-compared-to-Russian-GAAP-O-200510.pdf>

indicator of entity's financial performance. Revenue directly impacts the gross margin, operating profit, EPS, EBITDA of an entity.<sup>7</sup>

The aim of this thesis is to analyze IFRS and RAS, focusing on the standards concerning revenue recognition in different business transactions. Features, advantages and disadvantages will be discussed, and a comparative analysis of revenue recognition of each business transaction will be carried out. Also definitions of revenue and its categorization will be given and analyzed, emphasizing interpretation issues. For practical purposes, the general scope and measurement prescriptions will be given in the chapter concerning definition of revenue according IFRS and RAS to avoid duplications.

In further chapters only revenue recognition criteria and analyses of these criteria will be provided. If there are specific prescriptions for scope, measurement, or disclosure, these will be discussed in chapters with relevant business transaction.

It is also necessary to notice that in this thesis only the latest editions of standards, laws and regulations have been used. Russian laws and regulations were translated by the author of thesis due to the absence of official translations of Russian laws and regulations in English.

The abbreviation IFRS will be used when referring to current international accounting principles, including International Financial Reporting Standards (IFRS), International Accounting Standards (IAS), interpretations of the International Financial Reporting Interpretations Committee (IFRIC) preceded by the Standing Interpretations Committee (SIC), and IASB's Framework for the Preparation and Presentation of Financial Statements (*Framework*).

Russian Accounting Standards (RAS, sometimes Russian GAAP – Russian Generally Accepted Accounting Principles, or RAP – Russian

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<sup>7</sup> Cf. Global Accounting Consulting Services team of PricewaterhouseCoopers LLP (2011), p. 9001

Accounting Principles) is the term used unofficially to indicate the whole body of Russian regulatory documents governing accounting and reporting.<sup>8</sup>

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<sup>8</sup> Cf. <http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/documents/IFRS-compared-to-Russian-GAAP-O-200510.pdf>

## **2. Fundamentals**

### **2.1. Overview on Russian Accounting Standards (RAS)**

#### **2.1.1. Legal aspects**

Accounting in Russia before market economy was always the object of strict state regulations. Calculating plans, provisions were developed for the enterprises of all branches of a domestic economy. Standardization of accounting in the whole USSR was the main task of that time. Being regulated by state authorities as the Ministry of Finance, the State Planning Committee and the State Committee for Pricing of the USSR, the disadvantage of the Soviet accounting system consisted in inflexibility and inadaptability for constantly changing market conditions. The ranges of products, applied raw materials, materials, the production equipment, and most important the prices were determined by governing bodies, and not by demand and supply.<sup>9</sup>

From the beginning of the 1930 the accounting in the country was absolutely out of control. A transition to daily balance sheet preparation became a way, when daily information on an enterprise condition could be received. There were several transitions from decentralized accounting to centralized accounting, and backwards until 1964. The accounting system in the USSR according to requirements of the centralized economy was rigidly regulated and almost completely standardized. It existed without essential amendments up to 1990.<sup>10</sup> New forms of the enterprises and business activities could not adapt traditional Soviet accounting system and consequently demanded its changes.

Since the beginning of 1992 Russia began to issue new accounting standards, which were relatively nearer to the standards accepted abroad.<sup>11</sup> With the disintegration of the USSR and becoming of Russia a state with new economic system there were considerable changes in its economic policy. Transition from a Soviet system to the market economy should have affected the

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<sup>9</sup> Cf. Sokolov (1996), pp. 598-601

<sup>10</sup> Cf. Sokolov (1996), p. 602

<sup>11</sup> Cf. Kondrakov (2008), pp. 15-24

accounting system as well. Changes in economic system of the Russian Federation led to change in enterprises' policies, which should have found adequate reflection in accounting.

By preparation of the documents regulating accounting, many standards of the international accounting practice were considered. Nevertheless, the current Russian accounting system has the specifics which are connected with Russia's accounting system in the environment of a planned economy.<sup>12</sup>

Despite the existence of similarities between the accounting systems according to RAS or IFRS. These systems have often various fundamental principles, theories and the purposes. Divergences between RAS and IFRS result in considerable differences between the financial statements made in Russia and in other countries. The main differences between IFRS and RAS are connected with historically caused differences in ultimate users of financial information. IFRS emphasize the importance of information needs of financial statements users, among which shareholders comprise the main addressed group. While the financial statements which are drawn up according to RAS, are usually used by state bodies (tax authorities, etc.) and statisticians. As these groups of users have various interests and various information needs, the principles underlying preparation of financial statements, developed in different directions.

Since the acceptance in 1996 of the Federal Law *About Accounting*, the main documents were accepted which define the basic directions of legal regulation development of accounting in Russia. Among them it is necessary to note:<sup>13</sup>

(a) the *Accounting Concept in market economy of Russia*, approved by Methodological Council for Accounting at the Ministry of Finance of the

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<sup>12</sup> Cf. Kondrakov (2008), pp. 27-32

<sup>13</sup> <http://www1.minfin.ru/ru/accounting/accounting/basics/programs/>

Russian Federation, on 29<sup>th</sup> of December 1997 (the “Concept of 1997”);

(b) the *Program of Reforming of Accounting according to the International Financial Reporting Standards*, approved by the Governmental Order #283 of the Russian Federation from 6<sup>th</sup> of March 1998 (the “Program”);

(c) the *Concept of Development of Accounting and Reporting in Russian Federation on the intermediate term prospect*, approved by the Order #180 of the Ministry of Finance of the Russian Federation from 1<sup>st</sup> of July 2004 (the “Concept of 2004”).

The “Concept of 1997” has been generated in the conditions of transition from planned to market economy. Its basic aim consisted in the reorientation of the accounting purposes. It was noticed that in the conditions of a planned economy accounting information was mainly prepared for the state with a purpose of control, while the new accounting concept should have created elements of the market infrastructure, providing a favorable climate for foreign investment. Thus, according to the “Concept of 1997” accounting should be focused on information needs of potential investors.<sup>14</sup> It is necessary to notice that such concept is a characteristic of Anglo-American accounting model.<sup>15</sup>

The following are aspects of Anglo-American model:

- “(a) absence of a legislative regulation for registration procedures;
- (b) a considerable role of stock market in capital attraction;
- (c) relative independence of accounting from tax system;
- (d) an appreciable role of professional self-regulation;
- (e) division of accounting on financial, focused on external users, and internal (administrative) accounting.”<sup>16</sup>

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<sup>14</sup> Cf. Article 3.3 of the Accounting Concept in market economy of Russia

<sup>15</sup> Cf. Pepelyaeva (2009), p. 107

<sup>16</sup> Pepelyaeva, (2009), p. 107

Russia applied historically the continental system of accounting regulation. It means that with the acceptance of the “Concept of 1997” there was a reorientation from continental model to the Anglo-American.

The Continental model is characterized by:

- “(a) high degree of intervention of the state in registration practice;
- (b) orientation of financial reporting on satisfaction of information needs of tax and other public authorities;
- (c) satisfaction of capital financing needs of entities not through stock market, but banks;
- (d) an auxiliary role of the professional self-adjustable organizations of accountants and auditors.”<sup>17</sup>

Accepted in 1998 the "Program" has accurately defined the purpose of accounting system reform as bringing national accounting system in conformity with requirements of market economy and IFRS. In particular, the reform`s tasks were:

- “(a) to generate accounting and reporting standards which provide users with the helpful information, first of all investors;
- (b) to relate accounting reforms in Russia to the basic tendencies of harmonization of standards at the international level.”<sup>18</sup>

In the “Program” it is not directly established on which international accounting standards the Russian accounting system should be based. For a long time the choice between IFRS and US GAAP was discussed. The idea of an

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<sup>17</sup> Pepelyaeva, (2009), p. 107

<sup>18</sup> Article 1 of the *Program of Reforming of Accounting according to the International Financial Reporting Standards*



orientation towards US GAAP has received special favor among representatives of oil business and other extracting branches.<sup>19</sup>

However, by accepting the “Concept of 2004”, its developers have proclaimed that “principles and requirements on the organization of standard-setting process, and also basic rules and principles of accounting should be established taking into account principles and requirements of IFRS.”<sup>20</sup>

In the development of “Concept of 2004” there were two stages:

- “(a) 2004-2007: obligatory transfer on IFRS for the socially significant entities which prepare the consolidated financial statements, except those whose securities are traded in stock markets of other countries and which make consolidated financial statements under other international-recognized standards; the establishment of basic individual (non-consolidated) financial statements on the basis of IFRS;
- (b) 2008-2010: transition on IFRS of all other entities which prepare the consolidated financial statements; the consideration of possibility of transfer onto IFRS (instead of the Russian standards) by certain circle of entities which prepare individual (non-consolidated) financial statements.”<sup>21</sup>

Today, when according to the “Concept of 2004” both stages should already be carried out, it is possible to draw preliminary conclusions on efficiency of this reform. It is obvious that since 2004 the circle of the companies applying IFRS has essentially been extended, but the second part of transition planned for years 2008-2010 has not been fulfilled as for today.

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<sup>19</sup> Cf. Pepelyaeva (2009), p. 107

<sup>20</sup> Article 2.1 (3) of the *Concept of Development of Accounting and Reporting in the Russian Federation on the intermediate term prospect*

<sup>21</sup> Pepelyaeva (2009), p. 108

In the year 2007 TACIS project *Realization of Accounting and Reporting Reform in the Russian Federation*, financed by the European Union, was realized. It is directed on granting technical help to the Ministry of Finance of Russia and the Ministry of Agriculture to develop national accounting standards, being based on the international experience and according to IFRS.

The Order #160Н of the Ministry of Finance of Russia from 25 November 2011 *About Entering in power of IFRS and Interpretations of IFRS in territory of the Russian Federation* was published and from 1 January 2012 IFRS can be officially used for the preparation of financial statements in Russia, which does not mean that Russian Accounting Standards lose their power. Companies can choose which standards to follow, except those which are obliged to prepare their financial statements in accordance with IFRS – in particular, socially significant entities like banks, insurance organizations, in preparation of their consolidated financial statements, except those whose securities are traded in stock markets of other countries and which prepare consolidated financial statements under other international-recognized standards (US GAAP, UK GAAP etc.). These entities will need to apply IFRS obligatory only starting from the year 2015.

### **2.1.2. Main principles and concepts**

Principles and concept of RAS are formulated in the following basic documents:

- (a) the Federal Law *About Accounting* from 6 December 2011 (amended version of the Federal Law *About Accounting* from 21<sup>st</sup> November 1996);
- (b) RAS 1/2008 *Accounting policy of an Organization* (amended version of RAS 1/98 *Accounting policy of an Organization* from 9<sup>th</sup> of December 1998);
- (c) RAS 4/99 *Reporting of an Organization*;

- (d) the *Accounting Concept in market economy of Russia* from 29<sup>th</sup> of December 1997 (the “Concept 1997”)

The aim of the Federal Law *About Accounting* from 6 December 2011 is to create unique regulation requirements on accounting and financial reporting.<sup>22</sup> The Concept of 1997 treats this purpose more widely, focusing attention that the reporting should be equitable, first of all, to interests of its internal and external users for decision-making.<sup>23</sup> Undoubtedly, this point is a considerable step towards IFRS though it is necessary to note that in practice, reporting originators also pursue other aims, first of all, the fiscal.

The following economic subjects fall under the scope of Federal Law *About Accounting* and must prepare financial statements:

- “(a) commercial and non-profit organizations;
- (b) state authorities, local governments, governing bodies of the state off-budget funds and territorial state off-budget funds;
- (c) Central bank of the Russian Federation;
- (d) individual entrepreneurs, and also the lawyers who have founded lawyer offices, notaries and other persons who are engaged in private practice;
- (e) branches, representations and other structural divisions of the organizations, situated on the territory of the Russian Federation created according to the legislation of the foreign states, the international organizations, if other is not provided by international arrangements of the Russian Federation.”<sup>24</sup>

In Russian Federal Law *About Accounting* from 6 December 2011 the list of the financial reporting elements characterizing financial position and performance of the entity is given:

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<sup>22</sup> Cf. Article 1 (1) of the Federal Law *About Accounting*

<sup>23</sup> Cf. Article 3.3 of the *Accounting Concept in market economy of Russia*

<sup>24</sup> Article 2 (1) of the Federal Law *About Accounting*

- “(a) facts of economic life;
- (b) assets;
- (c) liabilities;
- (d) equity;
- (e) income;
- (f) expenses;
- (g) other objects, if it is determined by other federal standards”.<sup>25</sup>

The following entities are allowed not to prepare financial reporting statements:

- “(a) an individual entrepreneurs, the persons who are engaged in private practice, – in case if they conduct accounting of income or the income and expenses and (or) other objects of the taxation according to the tax legislation of the Russian Federation;
- (b) branches, representations and other structural divisions of the organizations, situated on the territory of the Russian Federation created according to the legislation of the foreign states, the international organizations, – in case if they conduct accounting of income or the income and expenses and (or) other objects of the taxation according to the Tax legislation of the Russian Federation;
- (c) [...]
- (d) the organizations which have received the status of participants of the project on implementation of researches, development and commercialization of their results according to the Federal law N 244-FZ *About the Innovative Center "Skolkovo"* from 28<sup>th</sup> of September 2010, having the right to apply the simplified ways of conducting accounting, including the simplified financial reporting, established for subjects of small business.”<sup>26</sup>

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<sup>25</sup> Chapter II, Article 5 of the Federal Law *About Accounting*

<sup>26</sup> Article 6 (2) of The Federal Law *About Accounting*

An entity independently forms its accounting policy, being guided by the legislation of the Russian Federation on accounting, federal and branch standards.<sup>27</sup> Changes in accounting policy can be made only under following conditions:

- “(a) changes of the requirements established by the legislation of the Russian Federation on accounting, by federal and (or) branch standards;
- (b) development or a choice of a new way of conducting the accounting which application leads to improvement of quality of information on object of accounting;
- (c) essential changes of conditions of activity of the economic subject.”<sup>28</sup>

RAS 1/2008 *Accounting Policy of an Organization* regulates choosing accounting policy and its disclosure for legal entities in the Russian Federation, except for the credit organizations and the state-financed organizations.<sup>29</sup>

Branches and the representations of foreign organizations located in the Russian Federation can form accounting policies according to RAS 1/2008 or according to the regulations established in the origin country, if the later do not contradict IFRS.<sup>30</sup>

When forming an accounting policy the following basic principles should be considered:

- “(a) assets and obligations of the organization exist separately from assets and obligations of owners of this organization and assets and obligations of other organizations (an assumption of separate entity);
- (b) the organization will continue the activity in the foreseeable future and it has no intentions and need of elimination or essential reduction of

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<sup>27</sup> Cf. Article 8 (2) of The Federal Law *About Accounting*

<sup>28</sup> Article 8 (6) of the Federal Law *About Accounting*

<sup>29</sup> Cf. Article 1 (1) of RAS 1/2008

<sup>30</sup> Cf. Article 1 (2) of RAS 1/2008

- activity and, therefore, the obligation will be repaid in accordance with the established procedure (an assumption of going concern);
- (c) the accounting policies accepted by the organization are applied consistently from one fiscal year to another (an assumption of assumption of the consistent application of accounting policies);
  - (d) the facts of economic activity of the organization belong to that reporting period in which they took place, irrespective of the actual time of receipt or payment of the money connected with these facts (an assumption of accrual basis of accounting).<sup>31</sup>

It is worth to notice that in case when an entity does not apply the listed above basic principles for conducting accounting, preferring another ones, these own assumptions should be disclosed together with the reasons of their application.<sup>32</sup>

The accounting policies of the organization should provide:

- “(a) completeness of reflection in accounting of all facts of economic activity (requirement of completeness);
- (b) timely reflection of the facts of economic activity in accounting and the accounting reporting (requirement of timeliness);
- (c) greater readiness for recognition of expenses and liabilities in accounting, rather than the possible income and assets, without allowing of hidden reserves creation (requirement of discretion);
- (d) reflection of the facts of economic activity proceeding from their economic content rather than legal form (substance over form);
- (e) identity of turnover and balances from analytical account to those from synthetic account as of the last calendar day of every month (requirement of consistency);

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<sup>31</sup> Article 5 of RAS 1/2008

<sup>32</sup> Cf. Article 19 (2) of RAS 1/2008

- (f) rational conducting of accounting, proceeding from management conditions and organization`s size (requirement of rationality).<sup>33</sup>

Although among the requirements there is a requirement to treat transactions according to their economic substance rather than legal form, it is the common case in Russian accounting system that the reflection of transaction is carried out strictly according to their legal form, instead of reflection of its economic essence. An example when the form prevails over the substance in RAS is the case of absence of appropriate documentation for impairment of fixed assets. Despite of the fact that the management knows that these fixed assets do not already have the specified balance cost, it is forbidden to write-off these fixed assets.<sup>34</sup>

The next requirement of RAS 1/2008, which confuses users of this RAS is requirement of timeliness. This requirement actually means that an entity must recognize income and expenses in those accounting periods when they took place, which also refers to accrual basis.<sup>35</sup> However, the absence of definition of a matching concept in regulatory documents and RAS, according to which expenses are reflected in the period of expected income receipt, allows in fact more flexibility in expenses accounting for entities. Furthermore, in RAS expenses are reflected after the meeting of certain requirements concerning documentation. The requirement to have all appropriate documentation often does not allow Russian entities to account all transactions related to a certain period, which results in differences in the moment of recognition, leading to hindering of matching concept.<sup>36</sup>

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<sup>33</sup> Article 6 of RAS 1/2008

<sup>34</sup> Cf. <http://www.klerk.ru/buh/articles/70415/>

<sup>35</sup> Cf. Article 6 of RAS 1/98

<sup>36</sup> Cf. <http://www.klerk.ru/buh/articles/70415/>

There are the following obligatory financial statements according to RAS 4/99 *Reporting of an Organization*:<sup>37</sup>

- (a) balance sheet;
- (b) profit and loss account;
- (c) notes to financial statements;
- (d) audit report, if an entity is a subject for obligatory audit according to federal laws.

In its turn notes to financial statements (to balance sheet, profit and loss account) contain such separate forms of reporting as cash flow statements and statement of changes in equity.<sup>38</sup>

The financial reporting year begins on 1<sup>st</sup> January and ends on 31<sup>st</sup> December. In case when an entity is set up before 1<sup>st</sup> of October the financial reporting year ends on 31<sup>st</sup> of December of current year, if after 1<sup>st</sup> of October – financial reporting year lasts till 31<sup>st</sup> of December of the next year.<sup>39</sup> It is not allowed setting financial reporting date other than 31<sup>st</sup> of December. Financial statements are prepared in Russian language, Russian Rubles, and signed by the Chief Executive Officer and Chief Accountant.<sup>40</sup>

## **2.2. Definition of revenue**

### **2.2.1. IFRS**

The elements reflecting financial performance of the enterprise are incomes and expenses. Income is defined in the *Framework* as “increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in

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<sup>37</sup> Cf. Article 5 of RAS 4/99

<sup>38</sup> Cf. Article 28 of RAS 4/99

<sup>39</sup> Cf. Article 13 of RAS 4/99

<sup>40</sup> Cf. Article 15-17 of RAS 4/99



equity, other than those relating to contributions from equity participants.”<sup>41</sup>

According to IFRS “the definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent.”<sup>42</sup> In its turn gains are another type of income that can or cannot occur in the course of the ordinary activities of an entity. Gains are also increases in economic benefits of an entity, that is why they have no significant nature difference from revenue.<sup>43</sup> However, *Framework* gives further example of gains mentioning gains from disposal of non-current assets that cannot be considered as ordinary course of business activity of an entity.<sup>44</sup> Based on this reason gains according to IFRS should also be referred to receipts from non-ordinary business activity of an entity.

Another definition of revenue was suggested by Barker, who said, that “income is an increase in equity, excluding contributions from equity participants, capital maintenance adjustments and changes in other reserves.”<sup>45</sup>

Revenue is not formally defined in the *Framework* but it is said that revenue is to arise “in the course of the ordinary activities”<sup>46</sup>, and to be included such items into sales to customers. Gains are defined residually as income other than revenue.<sup>47</sup>

As already noticed, the income in IFRS contains both, revenue and gains. In conditional character of reference of incomes to this or that group depending on concrete activity of the company and uniform character of various articles of incomes by the economic. However, since gains may or may not arise in the course of ordinary activities, it seems that some income from ordinary activities is

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<sup>41</sup> F. 70 (a)

<sup>42</sup> F. 74

<sup>43</sup> Cf. F. 75

<sup>44</sup> Cf. F. 76

<sup>45</sup> Barker (2010), p. 201

<sup>46</sup> Cf. F. 74

<sup>47</sup> Cf. Nobes (2012), p. 86

revenue and some is not. It is general practice that “revenue” includes only economic benefits arising in the ordinary course of an entity’s activities, whereas “income” includes such benefits that arise from all activities whether ordinary or otherwise.”<sup>48</sup>

In comparison to the *Framework* IAS 18 explains that revenue is “the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.”<sup>49</sup> It should be also considered that in IFRS revenue “includes only the gross inflows of economic benefits received and receivable by the entity on its own account. Amounts collected on behalf of third parties such as sales taxes, goods and services taxes and value added taxes are not economic benefits, which flow to the entity and do not result in increases in equity”<sup>50</sup>. In other words both revenue and income exclude contributions from equity participants.<sup>51</sup>

This shows that revenue is a gross concept, because revenue does not involve the deduction of an expense. By contrast, the standards that deal with gains require net measurements, which is a gain calculated as the difference between two values.<sup>52</sup>

Although in practice the accountants have always problems with distinction between gross and net revenues, the International Accounting Standards Board (IASB) explained this issue in April 2009 in guidance to IAS 18 regarding revenue and agency relationships (available in the Annual Improvements to IFRS 2009).<sup>53</sup>

IAS 18 aims to prescribe the accounting treatment of “revenue arising

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<sup>48</sup> Global Accounting Consulting Services of PricewaterhouseCoopers (2011), p. 9003

<sup>49</sup> IAS 18.7

<sup>50</sup> IAS 18.8

<sup>51</sup> Cf. Global Accounting Consulting Services of PricewaterhouseCoopers (2011), p. 9003

<sup>52</sup> Cf. Nobes (2012), p. 87

<sup>53</sup> Cf. The International Financial Reporting Group of Ernst &Young (2012), p.1778

from the following transactions and events:

- (a) the sale of goods;
- (b) the rendering of services; and
- (c) the use by others of entity assets yielding interest, royalties and dividends.”<sup>54</sup>

Meanwhile IAS 18 points out which items are out of its scope – “revenues arising from:

- (a) lease agreements (see IAS 17 *Leases*);
- (b) dividends arising from investments, which are accounted for under the equity method (see IAS 28 *Investments in Associates and Joint Ventures*);
- (c) insurance contracts within the scope of IFRS 4 *Insurance Contracts*;
- (d) changes in the fair value of financial assets and financial liabilities or their disposal (see IFRS 9 *Financial Instruments*);
- (e) changes in the value of other current assets;
- (f) initial recognition and from changes in the fair value of biological assets related to agricultural activity (see IAS 41 *Agriculture*);
- (g) initial recognition of agricultural produce (see IAS 41); and
- (h) the extraction of mineral ores.”<sup>55</sup>

From the list above it is also obvious that revaluation gains are not revenues, “because the definition of revenue does not include ‘enhancement of assets’” and refers to inflows of economic benefits alone as giving rise to revenue.”<sup>56</sup>

It is worth to notice that revenue should be measured at consideration`s or receivables` fair value. The amount of revenue is usually determined in

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<sup>54</sup> IAS 18.1

<sup>55</sup> IAS 18.6

<sup>56</sup> Global Accounting Consulting Services of PricewaterhouseCoopers (2011), p. 9004

agreement between the entity and the buyer. And as it was already written above, the revenue should be measured at consideration's or receivables' fair value taking into account the amount of any trade discounts and volume rebates.<sup>57</sup>

The standard gives definition of fair value saying it "is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."<sup>58</sup>

There is one tricky moment about fair value because in most cases, the consideration is in the form of cash or cash equivalents. However, there are often cases when cash or cash equivalent's inflow is deferred. In such cases the fair value of the consideration can be less than the nominal amount of cash. Thus, the consideration's fair value should be determined by discounting all future receipts using an imputed rate of interest.<sup>59</sup> The imputed rate of interest is determinable as one of follows:

- "(a) the prevailing rate for a similar instrument of an issuer with a similar credit rating; or
- (b) a rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services."<sup>60</sup>

In its turn, the difference between the fair value and the nominal amount is to account as interest revenue in accordance with paragraphs 29 and 30 and in accordance with IFRS 9.<sup>61</sup>

A further issue is when a company offers to its customers quick settlement discounts. For instance, company allows a reduction of 5% of the selling price, if the customer pays an invoice within 7 days instead of foreseen 60 days. In these situations, to comply IAS 18's requirement such revenue should be measured at

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<sup>57</sup> Cf. IAS 18.9-18.10

<sup>58</sup> IAS 18.7

<sup>59</sup> Cf. IAS 18.11

<sup>60</sup> Cf. IAS 18.11

<sup>61</sup> Cf. IAS 18.11

the fair value of the consideration received.<sup>62</sup>

In IFRS revenue recognition is regulated by IAS 18 Revenue, which was adopted by IASB in April 2001, which had originally been issued by the IASC in December 1993. IAS 18 *Revenue* replaced IAS 18 *Revenue Recognition*, issued in December 1982. However, there is one more specific standard, which is also linked to revenue recognition, IAS 11 *Construction Contracts*, which was originally issued by the International Accounting Standards Committee in December 1993, and adopted by IASB in April 2001. IAS 11 will be discussed in detail in chapter 2.

### **2.2.2. RAS**

RAS 9/99 *Income of an Organization*, which was approved by the Order #32n from 6<sup>th</sup> of May 1999 issued by the Ministry of Finance of the Russian Federation, has entered into force on 1<sup>st</sup> of January 2000. The try to adapt this Standard to internationally general accepted accounting practice was taken by the Order #116n from 18<sup>th</sup> of September 2006 issued by the Ministry of Finance of the Russian Federation.

Classification of the income in RAS 9/99 *Income of an Organization* was much more detailed until 2006, because income was divided into income of from ordinary activities, other operating income, other non-operating income and extraordinary income. After entering in power of Order #116n from 18<sup>th</sup> of September 2006 issued by the Ministry of Finance of the Russian Federation this classification was removed. Now, similar to IFRS, in RAS 9/99 the income is subdivided into incomes of usual kinds of activity of firm (i.e. revenue) and other income (i.e. gain).<sup>63</sup>

For accounting purposes RAS 9/99 says that “income of an organization is the increase in economic benefits as a result of receipt of assets (money

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<sup>62</sup> Cf. The International Financial Reporting Group of Ernst & Young (2012), p.1780

<sup>63</sup> Cf. Ionova/ Scholz (2008), p. 212

resources, other property) and (or) repayments of the obligations, leading to an increase in the capital of this organization, except for contributions of participants (proprietors).”<sup>64</sup> It is necessary to note the similarity in definition of the enterprise’s revenue in the Concept of 1997, RAS 9/99 *Income of an Organization* and IAS 18 *Revenue*.

In its turn increase in economic benefit is “a potential possibility of asset directly or indirectly to promote inflow of cash or cash equivalents to the organization. It is considered that the object of property will bring economic benefits when it can be in the future:

- (a) used separately or in a combination with other object in the course of production, works, and services intended for sale;
- (b) exchanged for other object of property;
- (c) used for repayment of liabilities;
- (d) distributed among owners of the organization”<sup>65</sup>

A principle of reference of income to certain groups is the same as in IFRS – depending from character of activity of the enterprise and its operations. In RAS the convention of references of income to income of usual kinds of activity for the different enterprises is marked: the same income can be the main for one enterprise and other incomes for others (for example a rent, etc.). RAS 9/99 states that the organization independently decides if receipts are the income of usual kinds of activity or other income proceeding from requirements of the present Standard, nature of the activity, a type of income and conditions of their receipt.<sup>66</sup>

The income of usual kinds of activity (revenue) proceeds from sales of production and the goods, the receipts connected with works, rendering of

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<sup>64</sup> Chapter I, Article 2 of RAS 9/99

<sup>65</sup> Tumasian (2011), p. 302

<sup>66</sup> Cf. Chapter I, Article 4 of RAS 9/99

services.<sup>67</sup>

RAS 9/99 gives further examples:

- “(a) the receipts from lease contracts are considered as revenue, if organization`s main activity is granting the assets for a payment in temporary use (temporary possession and usage) according to the lease contract;
- (b) the receipts which are received for granting the rights arising from patents for inventions, industrial samples and other types of intellectual property for a payment (royalties for using objects of intellectual property), are considered as revenue, if it is the main activity of the organization;
- (c) the receipts obtained from participation in authorized capitals of other organizations are considered as revenue, if this activity is set as main activity for the organization.
- (d) the income received by the organization from granting the assets in temporary use (temporary possession and using), the rights arising from patents for inventions, industrial samples and other types of intellectual property for a payment, and participation in authorized capitals of other organizations are considered as other income if these activities are not main activity for the organization.”<sup>68</sup>

Although the Standard states that the organization should decide itself how to recognize its main activity, which gives wide flexibility for accountants, some authors drawing from their experience offer other options for determination of main activities. For instance, which activities are considered as main activities of an organization is set usually in the organization chart/statute, if not, the materiality principle should be used. If income of certain activity comprises more than 5% of organization`s total income, this should be considered as income

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<sup>67</sup> Cf. Chapter II, Article 5 of RAS 9/99

<sup>68</sup> Chapter II, Article 5 of RAS 9/99

from main activity. However the materiality issue should also be considered – immaterial receipts should be treated as other income, even if they are from main business activity of organization.<sup>69</sup>

The following benefits are not considered as income and out of scope of RAS 9/99:

- “(a) sums of the tax to the added cost, excises, tax from sales, export duties and other similar obligatory payments;
- (b) commission contracts, agency and other similar contracts in favor of the committent, the principal, etc.;
- (c) an advance payment of the goods, works, services;
- (d) a deposit;
- (e) repayment of credit, loan given to a borrower.”<sup>70</sup>

The organization should measure revenue and trade receivable as “the price established by the contract between the organization and the buyer (customer) or the user of assets of the organization. If the price is not provided in the contract and cannot be established proceeding from contract conditions, the amount of revenue and trade receivable should be defined as the price of the similar goods, works, services which in comparable circumstances the organization usually defines a revenue.”<sup>71</sup>

To notice is that the amount of revenue and (or) receivables is recognized with all discounts (capes) provided to the organization according to the contract.<sup>72</sup>

RAS 9/99 deals with income as a whole, including both revenues and gains, while IAS 18 deals only with revenue and not with other forms of income. This can be another confirmation of the fact that IFRS have more further specific

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<sup>69</sup> Cf. Ionova/Scholz (2008), p. 213

<sup>70</sup> Chapter I, Article 3 of RAS 9/99

<sup>71</sup> Chapter II, Article 6.1 of RAS 9/99

<sup>72</sup> Cf. Chapter II, Article 6.5 of RAS 9/99



standards with detailed guidance than RAS.

## **2.3. Recent Developments**

### **2.3.1. The new Exposure draft of IASB on revenue recognition**

Revenue is an important element of financial statement for users, which helps to assess a company's performance and prospects. IASB and FASB have been working since 2002 on a joint project on revenue recognition to clarify the principles for revenue recognition from contracts with customers. It applies to all contracts with customers except leases, financial instruments and insurance contracts.

The main objectives of this project are as follows:

- “(a) to remove inconsistencies and weaknesses in existing revenue recognition standards by providing clear principles for revenue recognition in a robust framework;
- (b) to provide a single revenue recognition model which will improve comparability over a range of industries, companies and geographical boundaries;
- (c) to simplify the preparation of financial statements by reducing the number of requirements to which preparers must refer.”<sup>73</sup>

Such sophisticated financial reporting systems like US GAAP had already broad revenue recognition concepts, which were specifically tailored for different industry- and transaction-specific requirements. The evolution of these concepts led to new joint project on Revenue Recognition, in particular concerning with individual types of contracts. IFRS have fewer standards related to this issue, the two main standards, IAS 18 and IAS 11, are not enough to apply to complex transaction.

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<sup>73</sup><http://www.ifrs.org/Current+Projects/IASB+Projects/Revenue+Recognition/Revenue+Recognition.htm>

This project was undertaken in order to provide more clear principles on when and in which amount revenue should be recognized. The key principle of project is that revenue should be recognized on transfer to the customer, measured at transaction price with consistency to practice.<sup>74</sup> The standard developers explain that this will improve financial reporting by:

- “(a) providing a more robust framework for addressing issues as they arise;
- (b) increasing comparability across industries and capital markets;
- (c) providing enhanced disclosures;
- (d) clarifying accounting for contract costs.”<sup>75</sup>

As ED/2011/6 points out itself that new proposed requirements specify the principles proceeding from which an entity could report useful information about the amount, timing and uncertainty of revenue and cash flows arising from goods sold or services rendered. Summarizing all proposals, the main principle will require an entity to recognize revenue in such way so that it depicts the transfer of goods or services in an amount that reflects the consideration that it receives, or expects to receive.<sup>76</sup>

It is very likely that most of entities will be affected by this new Standard, although the amendments change accounting treatment not significantly. The ED will also propose more detailed guidance on such transactions as multiple-element arrangements, which are more detailed described in US GAAP than in IFRS.<sup>77</sup>

This new IFRS will apply “to all contracts with customers except:

- (a) lease contracts within the scope of IAS 17 *Leases*;

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<sup>74</sup>Cf. <http://www.ifrs.org/Current+Projects/IASB+Projects/Revenue+Recognition/Revenue+Recognition.htm>

<sup>75</sup><http://www.ifrs.org/Current+Projects/IASB+Projects/Revenue+Recognition/Revenue+Recognition.htm>

<sup>76</sup> Cf. ED/2011/6, para. 8

<sup>77</sup> The International Financial Reporting Group of Ernst & Young (2012), p. 1798

- (b) insurance contracts within the scope of IFRS 4 *Insurance Contracts*;
- (c) contractual rights or obligations within the scope of IFRS 9 *Financial Instruments* or IAS 39 *Financial Instruments: Recognition and Measurement*; and
- (d) [this paragraph in the FASB exposure draft is not used in the IASB exposure draft]
- (e) non-monetary exchanges between entities in the same line of business to facilitate sales to customers other than the parties to the exchange (for example, an exchange of oil to fulfill demand on a timely basis in a specified location).<sup>78</sup>

The entities should apply this IFRS retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.<sup>79</sup> Although some limited reliefs, for example allowing estimations and reducing disclosures, are expected to be offered.<sup>80</sup>

### **2.3.2. The harmonization process of RAS and IFRS**

Globalization and internationalization of the world economy resulted in the needs of harmonization of all economic areas and activities which are related to accounting, financial reporting, banking and investment analysis, etc. It was not a desire of concrete professional organizations, but of new modern economy. However, there were many years of evolutionary development of the separate directions and disciplines.<sup>81</sup>

According to IASB, IFRS intend to provide a common set of globally applicable accounting standards, having the ultimate target to reduce international financial reporting diversity.<sup>82</sup>

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<sup>78</sup> ED/2011/6, para. 9

<sup>79</sup> Cf. ED/2011/6, para. C2

<sup>80</sup> Cf. IASB Update, Agenda Paper 4A, June 2011

<sup>81</sup> Cf. Mikerin/Sivetc (2006), pp. 10-14

<sup>82</sup> Cf. Jones/Finley (2011), p. 22

As it was already discussed, in the Russian Federation orientation to the international standards was defined by the “Concept of 1997” which established bases of accounting system in the conditions of the economic environment developing in the country. The “Concept of 1997” only generally indicated use of experience of the countries with the developed market economy and orientation on internationally recognized financial reporting standards. In more detail bringing the national accounting system in compliance with requirements of the market economy and IFRS was defined in the “Program”. Result of the above-stated “Program” was the “Concept of 2004”. From the moment of the beginning of implementation of the above-stated programs domestic accounting experts noted a need of systematic and consecutive transition to the international standards by harmonization of accounting systems, because domestic accounting systems and approaches represented continental model of accounting, which essentially differ from IFRS.<sup>83</sup>

Experts have been warning that it is necessary especially to notice a translation problem of IFRS into Russian language. Historical and cultural distinctions of RAS and IFRS practically exclude the possibility of a literal translation of the latter into Russian, so that Russian accountants absolutely understand them.<sup>84</sup> However, on 25<sup>th</sup> of November 2011 all current IFRS, IAS, SIC, and IFRIC were officially published in Russian language on the official website of Ministry of Finance of the Russian Federation, giving a note that “International Financial Reporting Standards are protected by the copyright of IFRS Foundation. In case of modification of any International Financial Reporting Standards for the purpose of assistance to its acceptance within the national legislation this change will be accurately designated in the text of this International Financial Reporting Standard. The approved text of the International Financial Reporting Standards and other Publications of IFRS Council represents the text issued by IFRS Foundation in English. Copies of such text can be received in IFRS Foundation. [...] The IFRS Foundation refused the right to

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<sup>83</sup> Cf. Kuznetsov (2005), pp. 22-29

<sup>84</sup> Cf. Kuznetsov (2005), pp. 22-29

protect the copyright concerning the International Financial Reporting Standard in the territory of the Russian Federation. The IFRS Foundation keeps all rights outside of the specified territory.”<sup>85</sup>

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<sup>85</sup> [http://www1.minfin.ru/ru/accounting/mej\\_standart\\_fo/docs/index.php?pg4=4](http://www1.minfin.ru/ru/accounting/mej_standart_fo/docs/index.php?pg4=4)



### 3. Revenue recognition in cases of goods sold

#### 3.1. IFRS

Revenue recognition of goods sold is the most often and common revenue transaction in business world. Sale of goods is a transaction by which the seller transfers or agrees to transfer the property to the buyer for a money consideration, called the price. IAS 18 details that “goods include goods produced by the entity for the purpose of sale and goods purchased for resale, such as merchandise purchased by a retailer or land and other property held for resale.”<sup>86</sup>

Under IAS 18 revenue from goods sold shall be recognized only when all the following conditions are met:

- “(a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
- (b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
- (c) the amount of revenue can be measured reliably;
- (d) it is probable that the economic benefits associated with the transaction will flow to the entity; and
- (e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.”<sup>87</sup>

For first criterion IAS 18 details that the determination of the point of time when an entity has transferred the significant risks and rewards of ownership to the buyer can vary from transaction to transaction. In some cases, the significant risks and rewards of ownership pass with transfer of the legal title, while in other

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<sup>86</sup> IAS 18.3

<sup>87</sup> IAS 18.14

cases they may pass in different point of time than the legal title.<sup>88</sup> In other words the transfer of risk and rewards of ownership can occur before or after delivery, the timing of the transfer is usually dependent from the terms and conditions of sale contract.<sup>89</sup>

So according to IAS 18, if the entity transfers significant risks and rewards to the buyer, revenue from this sale should be recognized, if not, the revenue shall not be recognized. IAS 18 gives following examples of situations when an entity retains significant risks and rewards:

- “(a) when the entity retains an obligation for unsatisfactory performance not covered by normal warranty provisions;
- (b) when the receipt of the revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of the goods;
- (c) when the goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the entity; and
- (d) when the buyer has the right to rescind the purchase for a reason specified in the sales contract and the entity is uncertain about the probability of return.”<sup>90</sup>

But IAS 18 also emphasizes if an entity retains only an insignificant risk of ownership, revenue should be recognized, because the transaction is considered as a sale. For example, a seller retains the legal title only to be sure that trade receivables from customer will be collected, while all significant risks and rewards were already transferred to customer. Another example of an entity retaining only an insignificant risk of ownership may be a retail sale when the entity offers a refund in case the customer is not satisfied. In this case revenue should be recognized at the time of sale, under condition that the seller can reliably

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<sup>88</sup> Cf. IAS 18.15

<sup>89</sup> Cf. Global Accounting Consulting Services team of PricewaterhouseCoopers LLP (2011), p. 9012

<sup>90</sup> Cf. IAS 18.16



estimate future returns and recognizes a liability for returns based on previous experience and other relevant factors, i.e. the entity makes provision for such refunds.<sup>91</sup>

In general practice there can be given following potential indicators that the risks and rewards of ownership have not passed:

- “(a) the seller retains the risk of physical damage to the product;
- (b) the buyer lacks economic substance apart from that provided by the seller;
- (c) there is significant doubt as to the buyer’s intention or ability to take delivery of goods;
- (d) the seller shares in the future revenue of the goods’ onward sale (when this is not contingent consideration);
- (e) the seller has a repurchase option at a fixed price.”<sup>92</sup>

In other words, if a sale agreement includes any of the above conditions, it can be considered as indication that the risks and rewards of ownership were not transferred and, hence, no revenue allowed to be recognized.

The second criterion for revenue recognition is no control over the goods sold and no continuing managerial involvement. The concept of control is quite straightforward because the *Framework*’s definition on assets contains direct reference to the term “control”: “An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.”<sup>93</sup> So if the entity has still effective control over goods sold, the revenue is not to be recognized. The term “continuing managerial involvement” is not so easy, although it is unusual that an entity retains managerial involvement without retaining the risks and rewards. And it is also unusual situation that a buyer would be happy with managerial involvement of

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<sup>91</sup> Cf. IAS18.17

<sup>92</sup> Global Accounting Consulting Services of PricewaterhouseCoopers (2011), p. 9014

<sup>93</sup> F. 49 (a)

the seller if the buyer purchased the goods for fair consideration.<sup>94</sup>

In practice indicators of continuing managerial involvement or effective control of entity might include:

- “(a) the seller can control the future onward sale price of the item;
- (b) the seller is responsible for the management of the goods subsequent to the sale (outside of any other separable contract for management services);
- (c) the economics of the transaction make it likely that the buyer will return the goods to the seller;
- (d) the seller guarantees the return of the buyer’s investment or a return on that investment for a significant period;
- (e) the seller has control over the re-sale of the item to third parties (for example, the seller can control the selling price, timing or counterparty of any re-sale transaction or, alternatively, re-sale is entirely prohibited).”<sup>95</sup>

For the third criterion IAS 18 gives three conditions of reliable estimation of revenue for services rendered, but these conditions can also be applied to goods sold if they are suitably adapted.<sup>96</sup> The standard says that “an entity is generally able to make reliable estimates after it has agreed to the following with the other parties to the transaction:

- (a) each party’s enforceable rights regarding the service to be provided and received by the parties;
- (b) the consideration to be exchanged; and
- (c) the manner and terms of settlement.”<sup>97</sup>

For these purposes an entity should have an effective internal financial

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<sup>94</sup> Cf. Global Accounting Consulting Services of PricewaterhouseCoopers (2011), p. 9019

<sup>95</sup> Global Accounting Consulting Services of PricewaterhouseCoopers (2011), p. 9020

<sup>96</sup> Cf. Global Accounting Consulting Services of PricewaterhouseCoopers (2011), p. 9008

<sup>97</sup> IAS 18.23

budgeting system. And if necessary, an entity can revise estimates, which does not mean that outcome of transaction cannot be reliably estimated.<sup>98</sup> The seller should also have enough resources to reliably estimate any discounts, rebates or warranties offered in connection with the product to determine the revenue to be recognized for the sale of goods.<sup>99</sup>

A next criterion for revenue recognition from goods sold is probability that economic benefits will flow to the entity. For this criterion IAS 18 gives following explanation: sometimes it is obvious that the economic benefits associated with the transaction will flow to the entity, then the revenue should be recognized. But in some cases there can be uncertainty if such economic benefits associated with the transaction will flow to the entity or not. If this is a case, an entity should delay recognition of revenue until an uncertainty is removed or consideration is already received. But if an uncertainty arises about the collectability of an amount already included in revenue, the amount, which is considered to be uncollectible, or the amount in respect of which recovery has ceased to be probable must be recognized as an expense, rather than as an adjustment of the amount of revenue originally recognized.<sup>100</sup> Further IAS 18 gives an example: “it may be uncertain that a foreign governmental authority will grant permission to remit the consideration from a sale in a foreign country. When the permission is granted, the uncertainty is removed and revenue is recognized.”<sup>101</sup>

The last criterion is reliable measurement of cost incurred. Costs incurred for the sale of goods are generally production costs, which are calculated in accordance with IAS 2 *Inventories*. If goods are bought for resale, costs incurred usually comprise all costs of purchase. The measurement of these costs is generally quite straightforward for an established business, however it can be

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<sup>98</sup> Cf. IAS 18.23

<sup>99</sup> Cf. Global Accounting Consulting Services of PricewaterhouseCoopers (2011), p. 9009

<sup>100</sup> Cf. IAS 18.18

<sup>101</sup> IAS 18.18

tricky for new businesses or an entity, which sells new products.<sup>102</sup>

The standard also states that referring to matching principle revenue and expenses that relate to the same transaction should be recognized simultaneously. Expenses, which include warranties and other costs to be incurred after the shipment of the goods, can normally be measured reliably, and if all the other conditions for revenue recognition have been satisfied along with this criterion, revenue can be recognized. If the expenses cannot be measured reliably, revenue cannot be recognized. In this case, any consideration already received for the goods sold is recognized as a liability.<sup>103</sup>

### **3.2. RAS**

In RAS there is no definition what “sale of goods” or “goods” are. However, the Tax Code of the Russian Federation defines “sale of goods, works or services” for taxation purposes as follows: “Sale of the goods, works or services by an organization or an individual entrepreneur is transfer of goods, results of the executed works by one party for another, services rendered on a compensation basis (including an exchange of the goods, works or services), and in cases provided by the present Code, transfer of ownership of the goods, results of the executed works for third party, services rendered on a gratuitous basis.”<sup>104</sup>

According to RAS 9/99 there are “five criteria to recognize all types of revenue:

- (a) the organization has the right to receive this income following from the concrete contract or confirmed with other appropriate document;
- (b) the amount of revenue can be measured;

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<sup>102</sup> Cf. Global Accounting Consulting Services of PricewaterhouseCoopers (2011), p. 9009

<sup>103</sup> Cf. IAS 18.19

<sup>104</sup> Section IV, Chapter 7, Article 39, Para 1 of the Tax Code of the Russian Federation

- (c) there is a confidence that as a result of concrete transaction there will be an increase in economic benefits of the organization. The confidence that as a result of concrete transaction there will be an increase in economic benefits of the organization, is available in a case when the organization has received payment or there is no uncertainty concerning receiving of payment;
- (d) the title of ownership (right to possess, use and dispose) on products (goods) has passed from the organization to the buyer or work is accepted by the customer (service is rendered);
- (e) costs, which are made or will be made in connection with this transaction, can be measured. <sup>105</sup>

In such circumstances, when money and other assets have been received by the organization as payment, but one of the named conditions is not met, the organization should recognize a liability instead of revenue. <sup>106</sup>

RAS 9/99 does not detail these criteria, and does not provide readers with examples. So the accountants should apply the criteria according to generally accepted practice, although it is very tricky to judge if these criteria are fulfilled or not.

The first criterion requires that there must be “a concrete contract or [...] other appropriate document”<sup>107</sup> to confirm that an organization has a right on revenue. If during inventory check absence of the documents necessary for confirmation of validity of records was revealed (as a result of loss, damage, etc.), the lost documents should be restored. <sup>108</sup>

RAS 9/99 does not give further explanations which tools the accountants should use to determine whether the amount of revenue can be measured or not. The standard only states that the price is established by the contract between the

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<sup>105</sup> Chapter V, Article 12 (1) of RAS 9/99

<sup>106</sup> Cf. Chapter V, Article 12 (2) of RAS 9/99

<sup>107</sup> Chapter V, Article 12 (1) of RAS 9/99

<sup>108</sup> Cf. Kasyanova (2010), p. 351

organization and the buyer (customer) or the user of assets of the organization. If the price is not provided in the contract and cannot be established proceeding from contract conditions, the amount of revenue and trade receivable should be determined as the price of the similar goods, works, services which in comparable circumstances the organization usually determines a revenue.<sup>109</sup> And if the amount of revenue from goods sold cannot be measured, it should be reflected in the amount of expenses recognized for those works and services, which will be compensated subsequently by the customer.<sup>110</sup>

There are plenty of critics on this paragraph amongst experts in Russia; they argue that even the one who does not participate in business activity knows that a basic element of any economic contract like sale contract is its price. And criticism concludes that the absence of price on a sale contract leads to absence of revenue recognition.<sup>111</sup> Besides, the Article 14 of RAS 9/99, which states that if revenue cannot be determined, this should be recognized up to amount of expenses incurred only, enters in a direct contradiction with the revenue recognition criteria (b), which is in Article 12 of the same RAS.

For the taxation purposes there is a guidance in the Tax Code of the Russian Federation how the price, i.e. revenue can be defined: “the price of the goods, works or services specified by the transaction parties is accepted, if other option is not provided by the present article. Until proved the contrary, it is supposed that this price corresponds to level of market prices.”<sup>112</sup>

The third criterion requires that there is “confidence” that economic benefit flows in an organization. Criticism is very common from experts concerning following point – “confidence” that economic benefit inflows will occur only when

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<sup>109</sup> Cf. Chapter II, Article 6.1 of RAS 9/99

<sup>110</sup> Cf. Chapter IV, Article 14 RAS 9/99

<sup>111</sup> Cf. Zaharin (2007), p. 5

<sup>112</sup> Section IV, Chapter 7, Article 40, Para 1 of the Tax Code of the Russian Federation

these inflows (payment) are actually already received. In other situations, an accountant is never “confident” that payment will be completed.<sup>113</sup>

The next condition, transfer of ownership, occurs usually at the time of the delivery of the goods. This time is determined by the corresponding delivery note. In certain cases, the dates of the ownership transfer and delivery of the goods may differ from each other. The time of ownership transfer can contractually be set, for example, only when the goods are paid or until they are delivered to a certain location, or any other contract terms. Concerning documentation, the presence of an acceptance protocol is a prerequisite for the realization of revenue.<sup>114</sup> In the Civil law of the Russian Federation the term of “title of ownership” is defined as a right of owner “to possess, to use and to dispose its property.”<sup>115</sup> Therefore, transfer of the limited rights to a buyer (for example, it happens at transfer of assets as a deposit to storage at the pawnbroker, the goods on the commission, etc.) does not involve property right transition, and respectively such transactions are not allowed to be reflected as a realization even if payment is received.<sup>116</sup>

The last requirement of possibility of costs definition means that at the revenue recognition moment an entity can measure the total cost of sales (cost of goods sold).<sup>117</sup> Furthermore, according to RAS 10/99 costs of goods sold can be incurred when an entity has collected all confirming documents only.<sup>118</sup>

### **3.3. Comparison**

At first sight it can be said that the principles of revenue recognition under RAS and IFRS are quite similar. But detailed analysis of recognition criteria and

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<sup>113</sup> Cf. Medvedev (2011), p. 353

<sup>114</sup> Cf. Ionova/Scholz (2008), p. 218

<sup>115</sup> Article 209 of the Civil Code of the Russian Federation

<sup>116</sup> Cf. Kasyanova (2010), p. 352

<sup>117</sup> Cf. Kasyanova (2010), p. 352

<sup>118</sup> Cf. Article 16 of IAS 10/99

wording as a whole shows that RAS lack details, explanations and sometimes even logic.

First of all, the differences in revenue recognition criteria, in particular RAS` criterion that the organization should have the right on receipt, which is confirmed by concrete contract or other appropriate document. There is not such condition in IFRS, because the *Framework* requires to use assumption of substance over form which states “if information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.”<sup>119</sup> Thus, the contract or other appropriate document that confirms the right of an entity on revenue is not of such relevancy in revenue recognition according to IFRS.

Next condition of RAS to recognize revenue is transference of ownership right, this could be considered as the same condition of IFRS, which requires transfer of significant risks and rewards for revenue recognition. But in practice, there are much more situations when transfer of ownership and transfer of significant risks and rewards take a place at different times. While RAS requires to recognize revenue when the ownership transfer is officially documented in an appropriate way, IFRS give exact situations and examples which help to determine if the risks and rewards were transferred or not, and which could also not be confirmed by documents, but a result of professional judgment.

Principles of revenue measurement in IAS 18 and in RAS 9/99 also essentially differ. If the contract provided delay in a payment, according to IFRS it is necessary to recognize revenue taking into account an imputed rate of interest. While according to RAS the revenue is recognized derived from the total trade receivables from a customer, without considering discounting.

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<sup>119</sup> F. 35



### Example 1<sup>120</sup>

The company sold goods for 230 000 EUR, the payment will occur in a year. A market average rate is 15 % per annum. According to IFRS the revenue should be recognized of 200 000 EUR (230 000/115 %), and other 30 000 EUR will be reflected as the financial income. According to RAS 9/99 the whole amount of 230 000 EUR should be recognized as revenue immediately, corresponding to the full sum of receivables.

The other IFRS` condition, which is proper to compare in this point is retaining “neither continuing managerial involvement... nor effective control”.<sup>121</sup> RAS 9/99 does not have this criterion, but it clearly requires that the title of ownership must be transferred to the customer. In the Civil law of the Russian Federation the term of “title of ownership” is defined as a right of owner “to possess, to use and to dispose its property.”<sup>122</sup> According to this term the owner has all risks and rewards associated with the property. This way, it could be said that RAS and IFRS have this criterion in common, but IFRS give more explanations and examples, while RAS include this criterion in term of “title of ownership”.

RAS also differ from IFRS in criterion of probability of economic benefits inflow. RAS state that there should be “confidence” that transaction will lead to increase in economic gains of entity, while IFRS use the term “probability”. *Framework* defines “the concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the entity. The concept is in keeping with the uncertainty that characterizes the environment in which an entity operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the

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<sup>120</sup> <http://www.consult.ru/themes/default/publication-print.asp?folder=1924&publicationid=315>

<sup>121</sup> IAS 18.14

<sup>122</sup> Article 209 of the Civil Code of the Russian Federation

financial statements are prepared.<sup>123</sup> In its turn Russian law does not explain what “confidence” in this case is and how it could be defined and measured.

RAS conditions about measurement of revenue amount and costs incurred are quite similar to IFRS` criteria, but even in this point there is a difference in wording. RAS do not use word “reliably”, which again gives raise for wider judgment possibilities. The term “reliable” is defined in *Framework* as follows – “...Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.”<sup>124</sup>

It is obviously that IFRS operate generally using qualitative concepts (“the significant risks and rewards”, “reliable measurement of revenue”, etc.), leaving the considerable open space for professional judgment of financial statements` preparers. RAS operate with more exact definitions of conditions of revenue recognition (“the right following from the concrete contract or confirmed with other appropriate document”, “the ownership passed from the organization to the buyer”), which have documentary confirmation.

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<sup>123</sup> F. 85

<sup>124</sup> F. 31

#### **4. Revenue recognition in cases of services rendered**

Service is an intangible commodity, whose most wide spread characteristics in literature are intangibility, inseparability, heterogeneity and perishability.<sup>125</sup>

##### **4.1. IFRS**

IAS 18 states that “the rendering of services typically involves the performance by the entity of a contractually agreed task over an agreed period of time.”<sup>126</sup> Due to their features, the services can be rendered within a single accounting period or longer than one accounting period. Some service rendering contracts are directly connected with construction, thus such service contracts should be dealt with the requirements for construction contracts as specified in IAS 11 *Construction Contracts* and not IAS 18.<sup>127</sup>

It is not always easy to judge whether a contract should be treated as a construction contract according to IAS 11 or a contract according to IAS 18. There are some principles for the situation when a contract belongs to the scope of application of IAS 11. First of all, service contracts, which are in scope of IAS 18 are usually not specific and tailored made, they are a standard model ordered in advance. Service contracts of IAS 18, compared to construction contracts, can be cancelled without a contractual penalty.<sup>128</sup>

Revenue recognition criteria for services rendered are quite similar to those for goods sold, but there are of course some specific requirements. First of all there is no criteria requiring transference of significant risks and rewards to a customer and absence of managerial involvement and control, which is understandable due to specific features of services as intangibility. IAS 18

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<sup>125</sup> Cf. Wolak/Kalafatis/Harris (1998), pp. 11-14

<sup>126</sup> IAS 18.4

<sup>127</sup> Cf. IAS 18.4

<sup>128</sup> Cf. Parkkinen (2011), p. 43

determines that revenue recognition in cases services rendered can be executed if the outcome of a transaction involving the rendering of services can be estimated reliably and this outcome of such transactions can be estimated reliably, if following conditions are met:<sup>129</sup>

- “(a) the amount of revenue can be measured reliably;
- (b) it is probable that the economic benefits associated with the transaction will flow to the entity;
- (c) the stage of completion of the transaction at the end of the reporting period can be measured reliably; and
- (d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.”<sup>130</sup>

So there are three common revenue recognition conditions of goods sold and services rendered, and additionally one specific condition concerning the stage of completion of services rendered. Detailed analysis of those three common criteria is given above in the chapter concerning revenue recognition from goods sold. If performance of a single service contract takes place over time, revenue should be recognized as performance takes place as well. The percentage of completion method is used to recognize revenue from services rendered in accordance with IAS 18. IAS 11 and IAS 18 both give similar guidance about determination of stage of completion, with one difference that IAS 18 deals with services whereas IAS 11 deals with construction of assets.<sup>131</sup>

Revenue recognition from services rendered depends on stage of completion of these services. In its turn stage of completion in this case refers often to the percentage of completion method. Under this method, revenue is recognized in those accounting periods in which the services are rendered. This revenue recognition method provides useful information on the extent of service

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<sup>129</sup> Cf. IAS 18.20

<sup>130</sup> IAS 18.20

<sup>131</sup> Cf. Global Accounting Consulting Services team of PricewaterhouseCoopers (2011), p. 9027

activity and performance during a period. IAS 18 points out that IAS 11 also requires the recognition of revenue on this basis and that the requirements of this standard are generally applicable to the recognition of revenue and the associated expenses for a transaction involving the rendering of services as well.<sup>132</sup>

When it is necessary to determine the stage of completion an entity should use the method, which can reliably measure the services already performed. These methods may include:

- “(a) surveys of work performed;
- (b) services performed to date as a percentage of total services to be performed; or
- (c) the proportion that costs incurred to date bear to the estimated total costs of the transaction. Only costs that reflect services performed to date are included in costs incurred to date. Only costs that reflect services performed or to be performed are included in the estimated total costs of the transaction.”<sup>133</sup>

Also IAS 18 states that it is much more practical to recognize revenue on straight-line basis over the contract life if service contract consists of an indeterminate number of acts over a specified period of time. However, if there is evidence that some other method is more relevant and represents the stage of completion more faithfully, this method should be chosen. And if a specific act is much more significant than any other acts, the recognition of revenue is postponed until the significant act is executed.<sup>134</sup> For example outsourcing arrangements, which are contracts where services are provided in ongoing basis, often for a number of years. These arrangements are very common in usual life. In most cases it is not easy to identify revenue and costs for those services due

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<sup>132</sup> Cf. IAS 18.21

<sup>133</sup> IAS 18.24

<sup>134</sup> Cf. IAS 18.25

to determination complexity of their stage of completion. And this is the situation when revenue should be recognized on a straight-line basis over the contract period.<sup>135</sup>

IAS 18 provides limited guidance on what may determine whether an act is significant or not. The appendix provides three examples:

- “(a) commissions on the allotment of shares to a client;
- (b) placement fees for arranging a loan between a borrower and an investor; and
- (c) loan syndication fees that an entity receives for arranging a loan for which it retains no portion of the loan package for itself.”<sup>136</sup>

Sometimes it is necessary to split one service contract into several, if service contract terms are so that the separation could offer more faithful presentation of information. Also considering how to account for services contract it is necessary to understand the contractual terms. In the terms in the contract the parties specify at what point the contract has value to the buyer. These terms will indicate when the criteria for revenue recognition are met. If the vendor renders services over the whole contract period, the timing of revenue recognition should reflect this. However, if the vendor has only performed under the contract after the fulfillment of a significant act, no revenue should be recognized until that act has occurred.<sup>137</sup>

Further IAS 18 gives guidance in case “when the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue shall be recognized only to the extent of the expenses recognized that are recoverable.”<sup>138</sup> It is possible that at the very beginning of a service rendering process, the outcome of a transaction cannot be estimated reliably.

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<sup>135</sup> Cf. The International Financial Reporting Group of Ernst & Young (2012), p. 1786

<sup>136</sup> Global Accounting Consulting Services team of PricewaterhouseCoopers (2011), p. 9030

<sup>137</sup> Cf. Global Accounting Consulting Services team of PricewaterhouseCoopers (2011), pp. 9027-9028

<sup>138</sup> IAS 18.26

Nevertheless, it may be probable and also very common that the entity recovers the transaction costs incurred. Therefore, revenue is recognized only to the extent of costs incurred that are going to be recoverable. In other words, if the outcome of the transaction cannot be estimated reliably, no profit is recognized.<sup>139</sup>

In the situation “when the outcome of a transaction cannot be estimated reliably and it is not probable that the costs incurred will be recovered, revenue is not recognized and the costs incurred are recognized as an expense.”<sup>140</sup> However, if these uncertainties about outcome of the contract do not exist any longer, revenue should be recognized in accordance with paragraph 20, in other words in the standard way.<sup>141</sup>

The standard points out that an entity is usually able to make reliable estimates only if it has agreed to the following with the other parties of the transaction:

- “(a) each party’s enforceable rights regarding the service to be provided and received by the parties;
- (b) the consideration to be exchanged; and
- (c) the manner and terms of settlement.”<sup>142</sup>

## **4.2. RAS**

The Civil Law of the Russian Federation does not give a definition of services, but a short explanation what service rendering contract is: “under the service rendering contract a performer is obliged to render services (to make certain actions or to carry out a certain activity) on the instructions of a customer,

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<sup>139</sup> Cf. IAS 18.27

<sup>140</sup> IAS 18.28

<sup>141</sup> Cf. IAS 18.28

<sup>142</sup> IAS 18.23

and the customer undertakes to pay these services.”<sup>143</sup> This definition actually does not define what features services have.

It is important to understand that RAS do not provide specific revenue recognition criteria for services rendered. They have generally the same treatment as goods sold, and this issue does these transactions very complicated to account for. It has to be considered that RAS 9/99 often uses in its articles concerning services rendered the phrase “long cycle of manufacture”, which confuses readers and makes the understanding of its scope very tricky. Because “long cycle of manufacture” is usually related to construction contracts.

Revenue recognition criteria for services rendered are “similar to the recognition of revenue from the sale of goods”<sup>144</sup> which also sets out five requirements:

- “(a) the organization has the right to receive this income following from the concrete contract or confirmed with other appropriate document;
- (b) the amount of revenue can be defined;
- (c) there is a confidence that as a result of concrete transaction there will be an increase in economic benefits of the organization. The confidence that as a result of concrete transaction there will be an increase in economic benefits of the organization is available in a case when the organization has received payment or there is no uncertainty concerning receiving of payment;
- (d) the title of ownership (right to possess, use and dispose) on products (goods) has passed from the organization to the buyer or work is accepted by the customer (service is rendered);
- (e) costs, which are incurred or will be incurred in connection with this transaction, can be defined.”<sup>145</sup>

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<sup>143</sup> Article 779 (1) of the Civil Code of the Russian Federation

<sup>144</sup> Ernst & Young LLC (2009), p. 28

<sup>145</sup> Chapter V, Article 12 (1) of RAS 9/99



If an organization is already paid for rendering services, but one of the named conditions is not met, the organization should recognize a liability instead of revenue.<sup>146</sup>

These five conditions were discussed in detail in the previous chapter concerning revenue recognition from goods sold. RAS does not specify these conditions for cases of services rendered, which reveals some confusions and logical questions.

First problem is the determination of the title of ownership in case of services rendered. As the definition of the title of ownership states that a person should have a right to possess, to use and to dispose a property. Considering that services are intangible goods which do not have physical nature, it seems to be complicated “to possess, to use or to dispose” them.

The second problem is, which document should be considered as appropriate and have priority, the service contract itself or significant acts. General Russian accounting practice shows that most accountants recognize revenue from services rendered on the basis of acts, which are signed by the customer when one separate service is rendered and accepted by the customer.

The Civil Code of the Russian Federation also states, that “the performer is obliged to render services personally, if other is not provided by the service rendering contract.”<sup>147</sup> And concerning payment: “The customer is obliged to pay the services rendered to it in terms and as it specified in the contract of rendering of services. In case of the impossibility of the execution, which has arisen because of the customer, service is to be paid in full if the law or the contract of rendering of services does not provide other. In a case when the impossibility of execution arose on circumstances for which any of the parties is not responsible, the customer refunds to the performer expenses actually incurred if the law or the

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<sup>146</sup> Cf. Chapter V, Article 12 (2) of RAS 9/99

<sup>147</sup> Article 209 of the Civil Code of the Russian Federation

contract of rendering of services does not provide other.”<sup>148</sup> Which actually means that contract for rendering services can prescribe any terms and conditions, and they will be held. Other explanations on the timing of contract execution are not given.

RAS 9/99 specifies that the organization can recognize revenue from performing of works, rendering of services, with a long cycle of manufacturing using methods – percentage of completion or completed-contract method. But the standard gives further explanation to this situation saying that if it is possible to estimate stage of completion, this method should be used, i.e. this method has priority over the completed-contract-method.<sup>149</sup> To avoid confusion with the phrase “long cycle of manufacture”, which has already been discussed above, it is important to emphasize that only revenue from service contracts can be recognized using these two methods. Revenue from construction contracts according RAS can be recognized only using percentage of completion method.

There is also one more flexible characteristic of RAS concerning transactions with long manufacturing cycle, which states that because of “difference in character and conditions of works, rendering of services, manufacturing of products the organization can apply at the same time in one reporting period different methods of recognition of the revenues.”<sup>150</sup> The issue is that having this option Russian accountants can “regulate” their judgment on whether it is possible to carry out estimation of stage of completion or not.

One confusing moment in RAS 9/99 is the following statement: “If the amount of revenue from works performed and services rendered can not be defined, it should be reflected in the amount of expenses recognized for those works and services, which will be compensated subsequently by the customer organization.”<sup>151</sup> This paragraph says exactly “if the amount of revenue [...] can

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<sup>148</sup> Articles 780-781 of the Civil Code of the Russian Federation

<sup>149</sup> Cf. Chapter IV, Article 13 (1-2) of RAS 9/99

<sup>150</sup> Chapter IV, Article 13 (3) of RAS 9/99

<sup>151</sup> Chapter IV, Article 14 RAS 9/99

not be defined”, which actually contradicts the second revenue recognition criteria. There would be no confusion if it stated: “if the stage of completion cannot be reliably estimated, the revenue should be reflected in the amount of expenses recognized for those works and services, which will be compensated subsequently by the customer organization.”

Entities should disclose information on the determination method of stage of completion.<sup>152</sup>

### **4.3. Comparison**

First of all it has to be noticed that the scope and definition of services rendered under IFRS and RAS differ significantly. Lack of exact definition and illustrative examples in RAS makes it quite difficult to understand which standard should be applied. The choice of the used standard seems to be more complicated under RAS than under IFRS. Even though a construction contract is actually defined the same way as under IFRS, difficulties arise especially related to pure service contracts.<sup>153</sup> And advantage of IFRS is that it gives much clearer definition and illustrative examples in Appendix A to IAS 18.

As it was already discussed, IAS 18 provides four revenue recognition criteria for services rendered; three of them are the same as in case of goods sold. In its turn RAS provides the same five revenue recognition criteria for services rendered, as for goods sold. Although, as noticed above, not all of those five criteria are relevant for services, for instance, transference of title of ownership. As a whole there is a lot of criticism on RAS 9/99 because of the lack of specifics for services rendered.

There is a specific criterion in IAS 18, which is reliable measurement of stage of completion at the end of reporting period. IAS 18 also gives detailed

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<sup>152</sup> Cf. Chapter V, Article 14 (b) RAS 9/99

<sup>153</sup> Cf. Parkkinen (2011), p. 51

guidance on how the stage of completion can be measured, and on a situation if it is impossible to measure such. RAS 9/99 does not include such cases, because it is more document-oriented, and requires a signed hand-over act.

Another significant difference between IAS 18 and RAS 9/99 is that RAS allows choosing between two revenue recognition methods – completed-contract method and percentage of completion. Although the percentage of completion method is considered as priority, there is an option for Russian accountants to select one of these two or even apply different methods on one contract in the same accounting period, if it is necessary. In its turn IFRS do not allow to use the completed-contract method.

Confusion occurs when RAS 9/99 prescribes to use percentage of completion or completed-contract method not only for services rendered but also for “sales of products with a long cycle of manufacturing”<sup>154</sup>. It is clear that sale is a transaction with one point of time, and if an entity sells products, which need long cycle of manufacturing, it should be in scope of RAS 2/2008 *Construction Contracts*.

## **Example 2**

Company A renders services to Company B in year 2011, contract was signed in June 2011. The service contract consists of three parts for which there are three hand-over acts, representing 10%, 20% and 70% of this service contract respectively. Services should be rendered in August 2011, October 2011 and January 2012 respectively. Prices are stated in the contract and costs can be measured reliably. Note that 10%, 20% and 70% are not relevant for costs, which fall due totally different.

According to RAS after completion of first part of services, a customer signs hand-over act #1 (10% of whole contract) which gives rise to revenue recognition in August 2011 in amount of 10% of total contract price. Further 20%

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<sup>154</sup> Chapter IV, Article 13 (1) of RAS 9/99

and 70% in October 2011 and January 2012 respectively. It is worth to notice that in year 2011 only 30% of total contract price should be recognized as revenue, and not proportionally according to months 6/7 (where 7 months are total contract term), i.e. no straight-line revenue recognition.

According to IFRS in year 2011 revenue should be recognized in extent of stage of completion, not in extent of signed hand-over acts (which do not actually represent stage of completion). Furthermore, if the vendor confirms that for practical purposes and faithful presentation it is more useful to recognize revenue on straight-line basis, in accordance with IFRS it is allowed to recognize revenue on straight-line basis.

### **Example 3**

Company A renders services to Company B in year 2011. The service contract does not consist of several parts of services and has only one hand-over act at the end of contract term in January 2012. Prices are stated in contract and costs can be measured reliably.

Under RAS revenue is to be recognized in January 2012, when customer signs hand-over act – in accordance with the completed-contract method.

IFRS do not allow the application of the completed contract method, thus it is necessary to measure the stage of completion at the end of reporting period, i.e. 31 December 2011, and recognize revenue in extent of the contract's stage of completion. If the stage of completion is not to be measured reliably, revenue should be recognized in extent of costs incurred and which are expected to be recoverable.

### **Example 4**<sup>155</sup>

Company A signs a services contract with Company B. The services

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<sup>155</sup> [http://russia-consulting.eu/Files/booklets/Russia\\_Briefing\\_%20November\\_%202010.pdf](http://russia-consulting.eu/Files/booklets/Russia_Briefing_%20November_%202010.pdf)

(costing USD 500 000) are rendered by Company B to Company A from September 2010 until June 2011. On the contract signature date, Company A pays to Company B the full amount of USD 500 000 as a prepayment.

In IFRS, the important issue to look at is: what part of the services is rendered in 2009 and what part in 2010. The bookings are made accordingly.

In RAS, it depends on how the contracts are set up. If it is defined that there are several steps of service rendering process, and after each step a hand-over protocol is signed, then revenue should be recognized only after each signed hand-over protocol and in amount stated in such hand-over protocol. In case the whole services are defined as one, and only one hand-over protocol for the rendered services is made and signed in 2011, the full costs can only be shown in 2011. If there are hand-over documents for all the works until December 31, 2010, a part of the costs can be shown in 2010.

## **5. Revenue recognition in cases of construction contracts**

### **5.1. IFRS**

The objective statement of IAS 11 says that its aim is to prescribe the accounting treatment for construction contracts` revenue and costs. Due to the nature of construction contracts, the date at which the contract begins and the date when the contract activity is completed usually fall into different accounting periods. Therefore, the tricky moment occurs when, how and in which amount to allocate revenue and costs of construction contract.<sup>156</sup>

IAS 11 defines construction contract as “a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.”<sup>157</sup>

Additionally IAS 11 distinguishes two types of construction contracts:

(a) “A fixed price contract is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.”<sup>158</sup>

(b) “A cost plus contract is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.”<sup>159</sup>

Although there is no fixed contractual period stated in the definition of construction contract, it is always considered that the construction contract last more than one accounting period. However, there are plenty of examples when construction contracts last less than one accounting period, but fall under IAS 11 treatment as well. The point is if the beginning of the construction contract and its

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<sup>156</sup> Cf. Objective of IAS 11

<sup>157</sup> IAS 11.3

<sup>158</sup> IAS 11.3

<sup>159</sup> IAS 11.3

completion fall in different accounting periods.<sup>160</sup>

There is an opinion that construction contract is a more binding, detailed agreement with more technical specifications which should be made before the work starts. Usually the content of construction contract is tailored and requirements of the customer are taken into account. The objects of such contracts, whether they are goods, services or property, are mostly designed and developed individually for the purposes of the customer. In its turn, it includes substantial terms of cancellation, which means that such contracts can be cancelled only with a contractual penalty.<sup>161</sup>

For the purposes of IAS 11, construction contracts include:

- “(a) contracts for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects; and
- (b) contracts for the destruction or restoration of assets, and the restoration of the environment following the demolition of assets.”<sup>162</sup>

If it is unclear whether transaction should fall under IAS 11 or IAS 18, entities should refer to the guidance in IFRIC 15.

It is worth to notice that the requirements of IAS 11 are usually applied separately to each construction contract. However, in some circumstances it is much more reliable and faithful if the requirements of IAS 11 are applied to the separate components of a certain contract or to a group of contracts as whole to represent the substance of one contract or several contracts.<sup>163</sup>

The IAS 11 provides guidance in three separate cases. The first one is “when a contract covers a number of assets, the construction of each asset shall

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<sup>160</sup> Cf. Global Accounting Consulting Services team of PricewaterhouseCoopers LLP (2011), p. 9096

<sup>161</sup> Parkkinen (2011), p. 43

<sup>162</sup> IAS 11.5

<sup>163</sup> Cf. IAS 11.7



be treated as a separate construction contract when:

- (a) separate proposals have been submitted for each asset;
- (b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
- (c) the costs and revenues of each asset can be identified.”<sup>164</sup>

The second one is vice versa to the first one when “a group of contracts, whether with a single customer or with several customers, shall be treated as a single construction contract when:

- (a) the group of contracts is negotiated as a single package;
- (b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
- (c) the contracts are performed concurrently or in a continuous sequence.”<sup>165</sup>

And the third one is when a contract provides “for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset shall be treated as a separate construction contract when:

- (a) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or
- (b) the price of the asset is negotiated without regard to the original contract price.”<sup>166</sup>

However, the accounting experts complain about one clear weakness of IAS 11, which is lack of detailed guidance on segmenting and combining

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<sup>164</sup> IAS 11.8

<sup>165</sup> IAS 11.9

<sup>166</sup> IAS 11.10

contracts.<sup>167</sup>

Contract revenue should contain:

- “(a) the initial amount of revenue agreed in the contract; and
- (b) variations in contract work, claims and incentive payments:
  - (i) to the extent that it is probable that they will result in revenue; and
  - (ii) they are capable of being reliably measured.”<sup>168</sup>

Revenue is measured at the fair value of the consideration received or receivable. This revenue measurement can be influenced by a variety of uncertainties. In its turn these uncertainties can be influenced by the outcome of future events. Therefore, estimates need to be revised when events occur and uncertainties are resolved. This leads to the fact that the amount of contract revenue may increase or decrease from one period to the next.<sup>169</sup> This means if payments are received in such arrears that the fair value of the consideration is less than the nominal amount of cash received or receivables, it is necessary to discount the revenue to fair value.<sup>170</sup>

IAS 11 explains what “variation”, “claim” and “incentive payments” mean and when they can be included in revenue. So according to IAS 11 a variation is “an instruction by the customer for a change in the scope of the work to be performed under the contract.”<sup>171</sup> It is obvious that variations can lead not to both – an increase or a decrease in contract revenue. A variation is included in contract revenue “when:

- (a) it is probable that the customer will approve the variation and the amount of revenue arising from the variation; and

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<sup>167</sup> The International Financial Reporting Group of Ernst & Young (2012), p. 1517

<sup>168</sup> IAS 11.11

<sup>169</sup> Cf. IAS 11.12

<sup>170</sup> Cf. IAS 39.43, AG79

<sup>171</sup> IAS 11.13

- (b) the amount of revenue can be reliably measured.”<sup>172</sup>

A claim is defined as “an amount that the contractor seeks to collect from the customer or another party as reimbursement for costs not included in the contract price.”<sup>173</sup> Claims bring high level of uncertainty and affect the outcome of contract. Thus, claims are included in contract revenue only “when:

- (a) negotiations have reached an advanced stage such that it is probable that the customer will accept the claim; and
- (b) the amount that it is probable will be accepted by the customer can be measured reliably.”<sup>174</sup>

In its turn IAS 11 defines incentive payments as “additional amounts paid to the contractor if specified performance standards are met or exceeded.”<sup>175</sup>

Incentive payments are included in contract revenue “when:

- (a) the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and
- (b) the amount of the incentive payment can be measured reliably.”<sup>176</sup>

In accounting there is a term “accretion approach”, which “involves the recognition of revenue during the process of production, rather than at the end of a contract or when production is complete.”<sup>177</sup> Construction contracts are a perfect example where the accretion approach is used.

IAS 11 states, that revenue recognition from construction contracts should be executed according to its stage of completion. In its turn stage of completion is often referred to the method called “percentage of completion”. In accordance with this method, revenue from construction contract should be

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<sup>172</sup> Cf. IAS 11.13

<sup>173</sup> IAS 11.14

<sup>174</sup> IAS 11.14

<sup>175</sup> IAS 11.15

<sup>176</sup> IAS 11.15

<sup>177</sup> The International Financial Reporting Group of Ernst & Young (2012), p. 1774

“matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit, which can be attributed to the proportion of work completed. This method provides useful information on the extent of contract activity and performance during a period.”<sup>178</sup>

Under this method, revenue from construction contract should be recognized in profit and loss account and in those accounting periods in which the work was performed. Costs of these contracts are usually recognized as an expense in profit and loss account and also in respective accounting periods in which the work was performed. IAS 11 also emphasizes that any expected loss (excess of total contract costs over total contract revenue) of the contract must be recognized as an expense immediately in accordance with paragraph 36.<sup>179</sup>

Further IAS 11 details the ways in which the stage of completion of a contract may be determined:

- “(a) the proportion that contract costs incurred for work performed to date bear to the estimated total contract costs;
- (b) surveys of work performed; or
- (c) completion of a physical proportion of the contract work.”<sup>180</sup>

But in cases “when the outcome of a construction contract cannot be estimated reliably:

- (a) revenue shall be recognized only to the extent of contract costs incurred that it is probable will be recoverable; and
- (b) contract costs shall be recognized as an expense in the period in which they are incurred.”<sup>181</sup>

IAS 11 prescribes following disclosure requirements for construction

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<sup>178</sup> IAS 11.25

<sup>179</sup> Cf. IAS 11.26

<sup>180</sup> IAS 11.30

<sup>181</sup> IAS 11.32

contracts:

- “(a) the amount of contract revenue recognized as revenue in the period;
- (b) the methods used to determine the contract revenue recognized in the period; and
- (c) the methods used to determine the stage of completion of contracts in progress.”<sup>182</sup>

If an entity has contracts in progress at the end of the reporting period, it shall disclose each of the following:

- “(a) the aggregate amount of costs incurred and recognized profits (less recognized losses) to date;
- (b) the amount of advances received; and
- (c) the amount of retentions.”<sup>183</sup>

Further an entity should present “the gross amount due from customers for contract work as an asset; and the gross amount due to customers for contract work as a liability.”<sup>184</sup>

## **5.2. RAS**

Since 2009 Russian organizations are required to take into a consideration a new RAS – RAS 2/2008 *The Accounting of Construction Contracts*. Norms of RAS 2/2008 are addressed to the organizations carrying out contracts, listed in Articles 1 and 2 of RAS 2/2008, which will be discussed below. The contracts listed fall under RAS 2/2008 only if they have long-term character (last more than one fiscal year) or terms of their beginning and the termination fall on different fiscal years.<sup>185</sup> If the contract is begun and ended in the same reporting year, it is out of scope of RAS 2/2008.

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<sup>182</sup> IAS 11.39

<sup>183</sup> IAS 11.40

<sup>184</sup> IAS 11.42

<sup>185</sup> Cf. Chapter I, Article 1 RAS 2/2008

RAS includes following contracts in its scope:

- “(a) services rendering contracts in the field of architecture, technical design in construction and other services which are inseparably linked with object under construction;
- (b) works on restoration of buildings, constructions, vessels;
- (c) works elimination (dismantling), including the related restoration of the environment [...] which last more than one fiscal year (long-term character) or which beginning and termination fall on different accounting periods years.”<sup>186</sup>

However, budgetary and credit organizations are allowed not applying RAS 2/2008.<sup>187</sup> RAS 2/2008 regulates that accounting of construction contracts is conducted separately for every contract, thus establishing conditions, at which two and more contracts are considered as one contract, and also cases at which the separate accounting of construction works provided by one contract are kept.<sup>188</sup>

There are three situations when separation and grouping of contracts can occur. First of all when an organization has a complex of objects in construction, RAS 2/2008 considers each object as a separate contract, if the following “two criteria are met:

- (a) there is technical documentation on building of each object;
- (b) the income and expenses on each object can be reliably determined.”<sup>189</sup>

The second situation when two and more contracts, concluded by the organization with one or several customers, should be considered for accounting as one contract, “if following conditions are met:

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<sup>186</sup> Chapter I, Article 2 RAS 2/2008

<sup>187</sup> Cf. Chapter I, Article 1 RAS 2/2008

<sup>188</sup> Cf. Mizikovskii/Bronnikova (2011), pp. 11-13

<sup>189</sup> Chapter II, Articles 4 RAS 2/2008

- (a) owing to interrelation separate contracts actually belong to the uniform project with the rate of return determined as a whole by contracts;
- (b) contracts are executed at the same time or consistently (continuously following one by one).<sup>190</sup>

And last one – in case when during performance of the contract an additional object of construction (additional works) is brought in technical documentation – for accounting purposes building of additional object (performance of additional works) should be considered as the separate contract if “at least one of the following conditions are met:

- (a) the additional object (additional works) differs from the objects provided by the contract according to constructional, technical or functional characteristics essentially;
- (b) the price of additional object construction (additional works) is defined on the basis of an additional budget coordinated by the parties.<sup>191</sup>

RAS 2/2008 says that the amount of revenue of construction contract is defined proceeding from the price defined in the contract “corrected by the following deviations:

- (a) variations in costs of work arising in course of contract execution and coordinated by the parties under the contract (further – deviations) which are caused either from use of better and expensive building materials and designs, or fail in provision of any works according to engineering specifications (revenue reduction under the contract);
- (b) claims from customers and other persons specified in the contract;

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<sup>190</sup> Chapter II, Articles 5 RAS 2/2008

<sup>191</sup> Chapter II, Articles 6 RAS 2/2008

- (c) additional payments over estimated amounts to the organization (further - incentive payments), for example, for early completion of construction, etc. (revenue increase under the contract).<sup>192</sup>

RAS 2/2008 explains further when these deviations can be included in revenue – so the revenue under the contract can be corrected for the sums of variations, claims and incentive payments if there is a confidence that customers will recognize such sums and their amount can be reliably measured.<sup>193</sup>

RAS 2/2008 details that revenue and costs of the contract should be recognized under “percentage of completion” method, if financial result (profit or loss) of the contract at reporting date can be reliably defined.<sup>194</sup>

According to RAS the “percentage of completion” method considers that revenue and costs of the contract are determined proceeding from the confirmed stage of completion at reporting date and the organization recognizes them in profit and loss account for the same reporting periods in which the corresponding works were performed, irrespective whether the bills should be presented to customer or not until the completion according contract.<sup>195</sup> This method is based on the concept that construction represents a continuous process of production and realization, which is stretched in time.<sup>196</sup>

It is also worth to mention that RAS 2/2008 references to RAS 9/99 *Income of an Organization* and RAS 10/99 *Expenses of an Organization* for revenue and costs specification, although revenue may be recognized under RAS 2/2008 quite differently from RAS 9/99.<sup>197</sup>

Revenue, costs and the financial result recognized in the previous reporting periods under construction contract should be taken into account in

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<sup>192</sup> Chapter III, Article 8 RAS 2/2008

<sup>193</sup> Cf. Chapter III, Article 9 RAS 2/2008

<sup>194</sup> Cf. Chapter IV, Article 17(1) RAS 2/2008

<sup>195</sup> Cf. Chapter IV, Article 17 (2) RAS 2/2008

<sup>196</sup> Cf. Kurbangaleeva (2009), pp. 23-24

<sup>197</sup> Cf. Parkkinen (2011), p. 58



each reporting period when the method “percentage of completion” is used.<sup>198</sup> Which means that previously recognized revenue, costs and financial result (profit or loss) should be deducted. However, in case when it is impossible to determine financial result reliably in one of the reporting periods, the revenue should be recognized according to Article 23 of RAS 2/2008.<sup>199</sup>

In its turn the Article 23 of RAS 2/2008 states that in case it is impossible to determine financial result reliably in one of the reporting periods (for example, at the initial stage of contract when the contract terms concerning costs compensated by customer are being still specified) but there is a probability that the costs incurred under the contract will be compensated, the revenue under such contract should be recognized in the profit and loss account in the amount which is equal to the amount of costs incurred which during this reporting period are considered probable to be compensated.<sup>200</sup> The costs incurred that are not probable to be compensated (for example, under contracts which can be recognized as void transactions or on which the parties cannot carry out the contractual obligations) should be recognized in the profit and loss account in the current reporting period.<sup>201</sup>

According to RAS the organization can use following ways to determine the percentage of completion at the reporting date:

- “(a) as a portion of the amount of works executed to reporting date in total amount of works in the contract (for example, by an expert assessment of amount of completed work or by calculation of a portion in natural expression (in kilometers of a road cloth, concrete cubic meter, etc.);
- (b) as a portion of the costs incurred to reporting date in total expenses in

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<sup>198</sup> Cf. Chapter IV, Article 25 RAS 2/2008

<sup>199</sup> Cf. Chapter IV, Article 17 (3) RAS 2/2008

<sup>200</sup> Cf. Chapter IV, Article 23 (1-2) RAS 2/2008

<sup>201</sup> Cf. Chapter IV, Article 23 (1-2) RAS 2/2008

the contract.”<sup>202</sup>

In case when there are costs confirmed by documents under the contract, which are not compensated by the customer, RAS 2/2008 requires that revealed or expected amounts of excess of costs over revenue under the contract (an expected loss) should be recognized in the current reporting period.<sup>203</sup>

Disclosure requirements of RAS on construction contracts comprise the sum of the revenue recognized in the reporting period under the contract and ways of definition of the revenue recognized in the reporting period under the contract.<sup>204</sup> Further additional disclosure requirements for lasting construction contracts are as follows:

- “(a) total amount of the costs incurred and recognized profits (minus recognized losses) to reporting date;
- (b) total amount of received prepayments, advance payments, deposit for reporting date;
- (c) the amount of bills for the executed works, not presented to the customer before certain conditions completion or before elimination of the revealed shortcomings of work at reporting date.”<sup>205</sup>

On balance sheet an entity should present under assets the gross amount due from customers and under liabilities the gross amount due to customers.<sup>206</sup>

### **5.3. Comparison**

First of all the following wording difference in objectives of two standards is to be considered, although it does not lead to differences in revenue recognition methods – under IAS 11 construction contracts are contracts which

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<sup>202</sup> Chapter IV, Article 20 RAS 2/2008

<sup>203</sup> Cf. Chapter IV, Article 24 RAS 2/2008

<sup>204</sup> Cf. Chapter V, Article 27 RAS 2/2008

<sup>205</sup> Chapter V, Article 28 RAS 2/2008

<sup>206</sup> Cf. Chapter V, Article 29 RAS 2/2008

dates of beginning and completion fall into different accounting period, while under RAS 2/2008 construction contracts are long-term contracts (last more than one accounting period) *or* contracts which dates of beginning and completion fall into different accounting period.<sup>207</sup> An additional explanatory letter from the Ministry of Finance of the Russian Federation explains that it is necessary to understand the “manufacture with a long cycle” as a manufacture, which beginning and termination are in different tax/accounting periods, irrespective of the quantity of its execution days.<sup>208</sup> Although there is a difference in wording of definition, in practice the scope of RAS 2/2008 is the same as of IAS 11.

Further difference is that RAS 2/2008 does not contain any division of construction contracts into two categories – fixed price and cost-plus contracts; neither gives definitions of these two.<sup>209</sup>

Both IAS 11 and RAS 2/2008 provide situations in which combining and segmenting of construction contracts are possible. Standards define various situations – construction of a complex of objects can be combined as one contract, or vice versa when one construction contract can be split into several identifiable objects, or construction of an additional asset. The requirements for combining and segmenting such contracts are quite similar in both standards. However, RAS 2/2008 excludes condition, mentioning negotiations with customer as whole.

These two standards are also quite identical concerning objects of accounting. However there are also differences. So, for example, budgetary and credit organizations are allowed not applying RAS 2/2008, while there is no such option for this type of organizations in IAS 11.<sup>210</sup>

It is worth to notice that according to RAS the entity can account all deviations, incentive payments and other corrections only if there is a

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<sup>207</sup> Cf. Parkkinen (2011), p. 59

<sup>208</sup> Cf. Letter of the Ministry of Finance of the Russian Federation N 03-03-06/1/50 from 2.05.201

<sup>209</sup> Cf. Parkkinen (2011), p. 58

<sup>210</sup> Cf. Mizikovskii/Bronnikova (2011), pp. 11-13

“confidence” that customers will recognize the “corrected” amounts.<sup>211</sup> While IAS 11 requires only “probability” that the customer will approve such variations. Besides, there are no definitions of deviations, incentive payments and claims in RAS 2/2008, while IAS determines these terms.

Both standards require the entities to use the percentage-of-completion method for revenue recognition and if the outcome of the contract cannot be estimated reliably, revenue should be recognized only to the extent of contract costs incurred that will be probably recoverable.

There are also distinctions between IAS 11 and RAS 2/2008 regarding the determination of the stage of completion. RAS 2/2008 does not mention surveys and approve estimations while IAS 11 allows using surveys and “estimated total costs” in determining stage of completion.

Another significant difference is the determination of the expected loss. RAS 2/2008, as usual in Russian law, allows to recognize expected loss only if expenses which excess revenue are documentary confirmed, while IAS 11 states “when it is probable that total contract costs will exceed total contract revenue, the expected loss shall be recognized as an expense immediately.” Here it should be also emphasized the importance of such categories like “probability” in IFRS and “documentary confirmed” in RAS.

Both IAS 11 and RAS 2/2008 say that the company should provide in the accounting reporting information not only about revenue amount but also about methods of its definition in each reporting period. If there are the contracts, which have not been finished for reporting date, the entity should disclose information on expenses and recognized profit for the reporting period.<sup>212</sup>

In general RAS 2/2008 and IAS 11 do not differ significantly due to the fact that RAS 2/2008 is relatively new standard, which was initially oriented onto

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<sup>211</sup> Cf. Mizikovskii/Bronnikova (2011), pp. 11-13

<sup>212</sup> Cf. Mizikovskii/Bronnikova (2011), pp. 11-13

harmonization process of RAS and IFRS. This causes significant similarities of these two standards.



## **6. Revenue recognition in cases of interests, royalties and dividends**

### **6.1. IFRS**

IAS 18 includes in its scope transactions proceeding from the use by others of entity assets. These transactions can be in form of:

- “(a) interest — charges for the use of cash or cash equivalents or amounts due to the entity;
- (b) royalties — charges for the use of long-term assets of the entity, for example, patents, trademarks, copyrights and computer software; and
- (c) dividends — distributions of profits to holders of equity investments in proportion to their holdings of a particular class of capital.”<sup>213</sup>

IAS 18 prescribes that revenue arising from above listed transactions shall be recognized on the bases set out in IAS 18.30, when:

- “(a) it is probable that the economic benefits associated with the transaction will flow to the entity; and
- (b) the amount of the revenue can be measured reliably.”<sup>214</sup>

In its turn IAS 18.30 states that “revenue shall be recognized on the following bases:

- (a) interest shall be recognized using the effective interest method as set out in IAS 39, paragraphs 9 and AG5–AG8;
- (b) royalties shall be recognized on an accrual basis in accordance with the substance of the relevant agreement; and
- (c) dividends shall be recognized when the shareholder’s right to receive payment is established.”<sup>215</sup>

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<sup>213</sup> IAS 18.5

<sup>214</sup> IAS 18.29

<sup>215</sup> IAS 18.30

The distinction between ordinary and non-ordinary courses of business is also relevant for transactions related with interests, royalties and dividends. For example, the interest, which has been charged by banks on loans is revenue, in the same time such interest charged by manufacturing entity, is not revenue, if deriving interest income is not part of a manufacturing entity's ordinary activities.<sup>216</sup>

The Appendix to IAS 18 includes a series of illustrative examples on interest (financial services fees), emphasizing that revenue recognition of those depends on the purposes for which the fees are assessed and the accounting basis for any associated financial instrument.<sup>217</sup> According to Appendix to IAS 18 there are following types of fees:

- “(a) fees that are an integral part of the effective interest rate of a financial instrument – usually such fees are accounted as an adjustment to the effective interest rate. But if the financial instrument is measured at fair value with a change in fair value recognized in profit or loss, the fees are recognized as revenue when the instrument initially recognized;
- (b) fees earned as services provided – in case of such fees revenue should be recognized over the period of the related service;
- (c) fees that are earned on the execution of a significant act – in this case the revenue should be recognized when the significant act has been completed.”<sup>218</sup>

In situation when unpaid interest has accrued before the date of interest-bearing investment acquisition, the subsequent interest receipt should be allocated between pre-acquisition and post-acquisition periods. And only the

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<sup>216</sup> Cf. Global Accounting Consulting Services of PricewaterhouseCoopers (2011), p. 9005

<sup>217</sup> Cf. IAS 18.IE14

<sup>218</sup> Cf. The International Financial Reporting Group of Ernst & Young (2012), pp. 1812-1814



post-acquisition portion shall be recognized as revenue.<sup>219</sup>

Speaking about royalty, usually terms of agreement state at what point of time royalty should be recognized as a revenue. In general application of accrual basis means that the revenue should be recognized on a straight-line basis over the agreement's life or another systematic basis which is more relevant, reliable, and provides faithful presentation of transaction.<sup>220</sup>

Concerning licensing, which can be considered as a specific type of royalty, there is following tricky moment – whether to treat it as a sale of goods or to recognize revenue over the period of the license. This appears to be a matter of accountant's professional judgment.<sup>221</sup>

In its turn the determination of a date when the right to receive dividends enters in power can vary from one jurisdiction to another, but accounting of dividend receipt in a paying entity must be regulated by IAS 10 *Events after the reporting period*. And the accounting of parent company's investment in subsidiaries does not differ from that where shares are held as a trade investment.<sup>222</sup>

Bonus shares should not be recognized as revenue, due to absence of any value transference to the parent company. The following option of dividend receipt can occur – in form of cash or in new shares. Since there is an option to receive cash or cash equivalent value in new shares, the accounting of the latter option has its own treatment – in substance it is considered as a cash dividend with immediate reinvestment in shares. If this investment held at cost under IAS 27 (which will be replaced by new IFRS 10 starting from 1.01.2013) or classified as available for sale under IAS 39, the scrip dividend should be

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<sup>219</sup> Cf. IAS 18.32

<sup>220</sup> Cf. IAS 18.33

<sup>221</sup> Cf. Global Accounting Consulting Services team of PricewaterhouseCoopers LLP (2011), p.9073

<sup>222</sup> Cf. Global Accounting Consulting Services team of PricewaterhouseCoopers LLP (2011), pp.9070-9071

recorded as revenue in usual way, when the right to payment receive is established. However, if the scrip dividend is compulsory with no cash option, or if the cash dividend is at such unfavorable rate that the investor would not will to take that option, this dividend is not considered as a cash dividend with immediate reinvestment. In this case the transaction will not result in economic benefits and cannot be recognized as revenue.<sup>223</sup>

## **6.2. RAS**

RAS 9/99 also regulates accounting treatment of following types of transactions:

- “(a) granting assets for temporary using (temporary possessing and using);
- (b) the rights arising from patents for the inventions, industrial samples and other kinds of intellectual property;
- (c) participation in authorized capital stocks of other organizations.”<sup>224</sup>

RAS does not point out names of these types of income, but definitions, which are in practice mean the same as interest, royalty and dividend in IFRS. For practical purposes further the words “interest”, “royalty” and “dividend” accordingly are used, to define those types of income listed above.

RAS 9/99 states that in the organizations which main activity is granting the rights arising from patents for inventions, industrial samples and other types of intellectual property for a payment, and in the organizations which the main activity is participation in authorized capitals of other organizations, the receipts connected with these activities are considered as revenue.<sup>225</sup> While the income received by the organization from granting the assets, the rights arising from patents for inventions, industrial samples and other types of intellectual property

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<sup>223</sup> Cf. The International Financial Reporting Group of Ernst & Young (2012), p. 1791

<sup>224</sup> Chapter IV, Article 12 (3) of RAS 9/99

<sup>225</sup> Cf. Chapter II, Article 5 (3-4) of RAS 9/99

and from participation in authorized capitals of other organizations in temporary use (temporary possessing and using) for a payment, when those are not main activity of the organization, belong to the other income.<sup>226</sup>

In other words RAS 9/99 gives clear explanation whether income, as interests, royalties and dividends, is revenue or gain. The division of income on a basis of determination whether certain activity is main activity of organization or not, is also relevant in cases of interests, royalties and dividends.

According to RAS 9/99 there are three criteria to recognize revenue from interests, royalties and dividends:

- “(a) the organization has the right to receive this income following from the concrete contract or confirmed with other appropriate document;
- (b) the amount of revenue can be defined;
- (c) there is a confidence that as a result of concrete transaction there will be an increase in economic benefits of the organization. The confidence that as a result of concrete transaction there will be an increase in economic benefits of the organization is available in a case when the organization has received payment or there is no uncertainty concerning receiving of payment.”<sup>227</sup>

In case when money and other assets have been received by the organization as payment, but one of the named conditions is not met, the organization should recognize a liability instead of revenue.<sup>228</sup>

These three criteria represent the first three criteria for revenue recognition in cases of goods sold and services rendered discussed above.

RAS 9/99 does not specify, how revenue from each type of these

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<sup>226</sup> Cf. Chapter II, Article 5 (5) of RAS 9/99

<sup>227</sup> Chapter IV, Article 12 (1) of RAS 9/99

<sup>228</sup> Cf. Chapter IV, Article 12 (2) of RAS 9/99

transactions should be measured. RAS 9/99 prescribes that interests and royalties should be accounted proceeding from conditions of relevant contract.<sup>229</sup> While in general practice royalties are recognized on an accrual basis, generally on a straight-line basis over the period of the agreement.<sup>230</sup>

Russian Tax Code defines dividend as “any income received by the shareholder (participant) from the organization at distribution of profit, remaining after the taxation.”<sup>231</sup> Any income received from sources outside of Russian Federation also belongs to dividends if they are defined as such according to legislation of the foreign states.<sup>232</sup>

In case of dividends, revenue recognition criterion (c) can be considered as met when owners of the organization will make the decision on profit distribution, which is documented properly on board meeting. In practice, dates of dividend charge and their actual payment do not coincide. Thus, date of dividend charge is the date when an entity has a right to recognize revenue if other two criteria have been met.<sup>233</sup>

According to RAS 9/99 interests, royalties and dividends received are accounted for in an amount of cash receipts or receivables.<sup>234</sup>

### **6.3. Comparison**

First of all it is necessary to notice that RAS does not contain much information and guidelines on accounting treatment of interests, royalties, and dividends as IFRS. Appendix to IAS 18 gives more detailed information on types of financial services fees. As usual RAS requires the documents, which confirm that an entity has a right to receive economic benefits.

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<sup>229</sup> Cf. Chapter IV, Article 15 (1) of RAS 9/99

<sup>230</sup> <http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/IFRS-compared-to-Russian-GAAP-O-200510.pdf>

<sup>231</sup> Article 43 of the Tax Code of the Russian Federation

<sup>232</sup> Cf. Article 43 of Tax Code of the Russian Federation

<sup>233</sup> Cf. <http://www.buh.ru/document-969>

<sup>234</sup> Cf. Article 10.1 of RAS 9/99

IAS 18 states that interests should be recognized using the effective interest method, while RAS 9/99 prescribes that revenue should be in an amount of actual receivables, which are shown on the contract. Both standards require dividends to be recognized only when shareholders obtain right to receive payments. This right is established and documented properly during the annual shareholders` meeting of a paying entity.

Main similarity of both standards is how such revenue as interests and royalties are allocated between different accounting periods – accrual basis with consideration of all terms and conditions of the relevant contract.

According to RAS interests, royalties and dividends should be presented under revenue or other income depending on the main business activity of an entity.<sup>235</sup> IAS 18 does not specify how such inflows should be presented, assuming them as revenue since IAS 18 regulates these receipts. However, as it has been already noticed, the separation of inflows into revenue and other income (gains) is also relevant for IFRS.<sup>236</sup>

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<sup>235</sup> Cf. Chapter II, Article 5 (3-4) of RAS 9/99

<sup>236</sup> Cf. F. 74-76



## 7. Summary and conclusion

It is not a secret that RAS “borrowed” much from international accounting practice; nevertheless, the main difference of IFRS and RAS is an absolutely different approach in accounting and financial reporting.

The aim of the thesis was to compare revenue recognition principles according IFRS and RAS and to show if there are significant differences. In fields where differences were found, the further aim was to illustrate what effect on revenue amount those differences could lead to.

As it has been already noticed, the main underlying difference of IFRS and RAS, which cause further distinctions between these two, is the key user of financial statements. The fact that RAS aim mainly at authorities as a key user of financial information inserts many underlying assumptions and principles. These underlying assumptions and principles can look the same as those of IFRS but in practice are implemented in other ways. To emphasize is the importance of confirming documents in recording transactions in RAS, which include contracts, primary documents as invoice, act of acceptance etc. IFRS rely more on professional judgment of bookkeeper and follows the principle of substance over form. While in Russia conducting bookkeeping and preparation of financial statements are based on the following of instructive provisions and requirements of regulators. The Russian accountant is only a “performer” who must follow laws, resolutions, letters, instructions, without exercising professional judgment.

According to the basic concept of IFRS disclosure of greater volume of information on entity’s activity is required in order to direct attention of users to all essential details of work of the entity. In RAS there are essentially fewer of similar requirements, moreover, the regulations for disclosing financial information, for example concerning related parties, are practically ignored.<sup>237</sup> All this testifies that financial statements prepared according IFRS give a possibility

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<sup>237</sup> Cf. Sukonkina (2005), pp. 4-5

to better see the actual financial condition of an entity for users and to show significant independence in decision-making for preparers. These are general differences, now particulars are followings.

IFRS give much more detailed guidelines concerning measurement of revenue, explaining what fair value is, and if there is deferred revenue, how exactly it should be discounted. While RAS do not use at all discounting of deferred consideration, instead recognizing revenue in an amount of cash or receivables which are stated in contract, i.e. the contract price.

Further distinction between IFRS and RAS is that RAS require more than “probability”, stating that there should be “confidence” in occurring various actions, for example, inflow of economic benefits. In its turn, comparing to IFRS which give explanation of “probability” and on how it could be determined if an action is “probable” or not, RAS do not define what “confidence” is and how it can be estimated.

The difficulty of applying RAS are based on the fact that RAS give mostly the same revenue recognition criteria for all transactions, which have different features, for example, sale of goods, rendering of services, accounting of interests, royalties and dividends. The criterion of transfer title of ownership in transaction as rendering services illustrates that RAS were not elaborated properly for practical use.

Another key difference is that RAS allow using completed-contract method in cases of services rendered along with a percentage of completion method. However, revenue from construction contracts must be recognized using percentage of completion method only according to RAS, which is the same requirement as in IFRS. It is obvious that RAS, which were approved and entered in power in later dates, as RAS 2/2008 for example, have fewer differences in accounting treatment as those that are older, for example RAS 9/99.



There are also considerable similarities between RAS and IFRS, for example in definition of income and in subdivision of income into revenue and gains according to the fact whether income from ordinary business activity of an entity or not.

Summarizing all differences between IFRS and RAS, it might be concluded that IFRS operated generally with qualitative concepts, while RAS with facts. RAS lacks also main definitions (as incentives, claims etc.), explanations and further guidelines when compared to the detailed Appendixes and Explanatory notes of IFRS.



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The Federal Law *About Accounting* from 6 December 2011 (amended version of the Federal Law *About Accounting* from 21<sup>st</sup> November 1996)

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Письмо Минфина №03-03-06/1/50 от 2 мая 2010  
The Letter of the Ministry of Finance of Russian Federation N 03-03-06/1/50 from 2.05.2010

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*The Program of Reforming of Accounting according to the International Financial Reporting Standards*, approved by the Governmental Order #283 of Russian Federation from 6<sup>th</sup> of March 1998

Налоговый кодекс Российской Федерации от 31 июля 1998 г. N 146-ФЗ  
The Tax Code of Russian Federation from 31.07.1998 N146-FZ





## **Appendix 1: Russian Accounting Standards as of July 2012**

*RAS 1/2008 Accounting Policy of an Organization*

*RAS 2/2008 Construction Contracts*

*RAS 3/2006 Accounting of Assets and Liabilities with Value Expressed in Foreign Currency*

*RAS 4/99 Reporting of an Organization*

*RAS 5/01 Accounting of Inventories*

*RAS 6/01 Accounting of Fixed Assets*

*RAS 7/98 Events Occurring After the Reporting Date*

*RAS 8/01 Economic Contingencies*

*RAS 9/99 Income of an Organization*

*RAS 10/99 Expenses of an Organization*

*RAS 11/2008 Related Party Disclosures*

*RAS 12/2000 Segment Information*

*RAS 13/2000 Accounting of Government Grants*

*RAS 14/2007 Accounting of Intangible Assets*

*RAS 15/2008 Loan and Credit Expenses*

*RAS 16/02 Information on Discontinued Operations*

*RAS 17/02 Accounting of Research, Development and Technological Works*

*RAS 18/02 Accounting of Profits Tax Settlements of an Organization*

*RAS 19/02 Accounting of Financial Investments*

*PBU 20/03 Information Concerning Participation in Joint Activities*

*RAS 21/2008 Changes in Accounting Estimates*

Key Orders of the Ministry of Finance of the Russian Federation governing the management, maintenance and accounting of records as of July 2012:

*Order #94n Chart of Accounts and the Instruction on the Application*

*Order #34n Maintenance of Accounting Records and Accounting Reports in Russian Federation*

*Order #44n Methodological Instructions on the Preparation of Accounting Reports During Re-Organization*

*Order #67n Instructive Regulations on the Presentation of Financial Statements of an Organization*

*Order #112 Methodological Instructions on the Preparation and Presentation of Consolidated Financial Statements*

*Order #180 The Concept of Development of Accounting and Reporting in Russian Federation on the intermediate term prospect*

*Order #29n Methodological Instructions on Disclosing Earnings per Share*

*Order #15 Guidance on Accounting of Leasing Transactions*

## **Appendix 2: Abstract (English)**

Importance of comparative international accounting has been increasing during last decades. For Russia and countries that invest in Russian economy the issue of incomparability of financial statements became a significant problem in the 80s and 90s. Although Russia undertakes many harmonization projects to adapt its accounting and financial reporting system to IFRS, there are still significant differences between RAS and IFRS.

This thesis represents comparative analysis of revenue recognition principles according to IFRS and RAS, providing with information on revenue treatment in most common transactions in economic life – sale of goods, rendering of services, construction contracts, interests, royalties, and dividends.

The comparison shows not only differences between IFRS and RAS in revenue recognition principles but also similarities. The stated overview on Russian accounting system, historical background and specific features were an important part of the thesis in order to explain why there are many difficulties not only in harmonization process but also in transforming Russian accounts into international ones. It has been also discussed, in what extent underlying assumptions, accounting principles and concepts under RAS and IFRS differ.



### **Appendix 3: Abstract (German)**

Die Bedeutung der komparativen internationalen Rechnungslegung ist in den letzten Jahrzehnten stark angestiegen. Russland und Staaten, welche in die russische Wirtschaft investierten, wurden besonders in den 80er und 90er Jahren mit der Schwierigkeit der Vergleichbarkeit von Abschlüssen konfrontiert. Obwohl Russland viele Harmonisierungsprojekte zur Anpassung ihrer Rechnungslegung und deren Systeme zu IFRS unternimmt gibt es immer noch erhebliche Unterschiede zwischen RAS und IFRS.

Diese Arbeit beschäftigt sich mit der Analyse der Prinzipien des Ausweises von Umsatzerlösen nach RAS und IFRS mit Schwerpunkt auf die häufigsten wirtschaftlichen Transaktionen, wie z.B. Warenverkäufe, Dienstleistungen, Fertigungsaufträge, Zinsen, Lizenzgebühren und Dividenden.

Der Vergleich zwischen IFRS und RAS zeigt nicht nur die Unterschiede des Ausweises von Umsatzerlösen, sondern auch die Gemeinsamkeiten.

Der dargelegte Überblick über die russische Rechnungslegung und die damit verbundenen historischen Hintergründen sowie Besonderheiten sind ein wichtiger Bestandteil der Diplomarbeit. Dies dient im weiteren der Erklärung vieler Schwierigkeiten sowohl im Prozess der Harmonisierung als auch bei der Angleichung russischer Konten an internationale Standards. Letztlich werden noch die Auswirkungen der Unterschiede der zugrunde liegenden Annahmen, Rechnungslegungsgrundsätze und Konzepte nach RAS und IFRS behandelt.



## Appendix 4: Curriculum Vitae

### PERSONAL DATA

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Name: Anel SHONZHIGITOVA  
Date of birth: 19 March 1987  
Place of birth: Moscow, Russian Federation  
Citizenship: Russian  
Academic degree: Diploma degree with speciality "World Economy"  
Address: Kegelgasse, 6-22, A-1030, Vienna  
Cell phone: +43 680 1405491  
Email: [anel.shonzhigitova@yahoo.com](mailto:anel.shonzhigitova@yahoo.com)

### WORK EXPERIENCE

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01/2008 – 02/2010 Ernst and Young LLC, Moscow, Russia  
Audit and Assurance department

### EDUCATION

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03/2010 – expected 07/2012 University of Vienna, Austria  
Master Programme in International Business Administration

10/2008 – expected 07/2012 Institute of Europe of Russian Academy of Sciences, Moscow  
Russia Postgraduate degree in World Economy

09/2004 – 06/2008 Diplomatic Academy of the Ministry of Foreign Affairs of the Russian Federation, Moscow, Russia  
Diploma Degree in World Economy (with Honors)

09/1997 – 06/2004 High school, Taraz, Kazakhstan

09/1993 – 06/1997 Primary school, Taraz, Kazakhstan

## ADDITIONAL QUALIFICATION

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Awarded 05/2010	Institute of Chartered Accountants in England and Wales, London, England CFAB (Certificate in Finance, Accounting and Business)
06/2008 – expected 06/2013	Institute of Chartered Accountants in England and Wales, London, England ACA Certificate (Association of Chartered Accountants)

## LANGUAGES

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Russian (native)  
Kazakh (native)  
English (fluent)  
German (fluent)  
Spanish (basics)