

The Revenues: Changes in the Registration of This Accounting Item in Italy



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ABSTRACT: In November 2021, the Italian Accounting Board (OIC) issued a draft accounting standard concerning revenues accounting (draft accounting standard OIC 34 The Revenues). The standard sets out some exciting observations that can potentially apply in Italy and other countries that accept the considerations set out in the draft. In the article, the focus will be on what is imposed on medium and large-sized companies.

KEYWORDS: revenues from sales and service, accounting units, financial reporting, accounting.

1. INTRODUCTION ¹

Revenues are one of the most important financial reporting items. Revenues identify the positive income components related to the sale of goods and services that represent the company's core business.

The correct recognition of The Revenues is fundamental to ensure that financial reporting is true and fair. In Italy, financial reporting is regulated by the Civil Code and supplemented by national accounting standards. This is because, in 2014, Law No. 116 of 11 August 2014 was issued, which established that the Italian Accounting Board (OIC) must perform the following functions:

- (a) issue national accounting standards, inspired by best practice, for the preparation of financial statements by the provisions of the Italian Civil Code;
- b) it provides support to the activities of Parliament and Government Bodies in the field of accounting regulations and expresses opinions when required by specific provisions of law or at the request of other public institutions
- c) participates in the process of developing international accounting standards adopted in Europe, maintaining relations with the International Accounting Standards Board (IASB), the European Financial Reporting Advisory Group (EFRAG) and the accounting bodies of other countries.

Listed companies and other particular companies are not subject to the rules of the Civil Code and national accounting standards. Still, they are obliged to prepare their financial reporting following IAS/IFRS.

In this article, we will refer exclusively to the draft national accounting standard issued by the Italian accounting body (OIC) applicable to unlisted companies and, therefore, to companies subject to the civil code rules regarding the preparation of financial reporting. The draft also contains simplifications for small and micro-enterprises. This article will focus only on the requirements for medium-sized and large companies, and we will leave out the simplifications for small companies.

The Revenues document issued by the OIC is currently still subject to public consultation. When the final standard is published in March 2022, the rules contained therein will be mandatory. It should note that the transition between the draft and the final document generally does not imply significant differences in the current consultation. This article will analyse the novelties concerning financial statements and the rules proposed for their accounting by the draft currently in consultation.

¹ To facilitate reading, I have decided not to include in the text, except in exceptional cases, the names of the scholars who have dealt with the subject under analysis since the bibliography is endless, I have opted not to indicate all the terms of the scholars in the text because this would have meant a continuous interruption of the reading of the complete sentence in which I express my thought.

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In the communication related to the issuance of the standard OIC 34 The Revenues, it was highlighted that the main novelty of the new accounting standard concerns the Introduction of accounting techniques aimed at identifying and valuing the "elementary units of accounting". A single sales contract may include different services that require separate accounting. This may be the case, for example, when a vehicle is sold together with the provision of a maintenance service for a certain number of years. In that case, the proceeds from the sale of the asset - according to the new accounting standard - must be separated from the consideration for the maintenance service and accounted for separately. However, a simplified procedure has been provided for companies that report in an abbreviated form and for micro-enterprises. In that case, for a single consideration for the sale of an asset and the provision of a service in a subsequent accounting period, companies may apply a simplified model that does not require the separation and valuation of the different accounting units. Therefore, they may recognise the entire revenue at the time of sale of the asset and consider identifying in financial reporting a provision for risks and charges against the cost they expect to incur for the service.

Another important innovation of the new accounting standard concerns the accounting of The Revenues for the provision of services. These are to be recognised in the income statement on a progress basis when two conditions are met, namely that

- the agreement between the parties provides that the right to the consideration accrues as the service is performed;
- it can measure the amount of the revenue accruing reliably. Otherwise, the revenue for the service provided is recognised in profit or loss when the service is finally completed.

An application guide is included in the standard that deals with specific cases (including sale with guarantee, transfer of licences, sales with the obligation to repurchase, issues of companies acting on their account or behalf of third parties). In addition, 12 examples have been included, which, although not an integral part of the standard, respond to clarification needs raised by various stakeholders.

2. THE REVENUES AND THE ELEMENTARY UNITS OF ACCOUNTING: SOLUTIONS PROPOSED BY THE DRAFT ITALIAN ACCOUNTING STANDARD OIC 34 THE REVENUES

Before addressing the issue of recording The Revenues, the Italian national accounting standard OIC 34 The Revenues in the accounts provides a precise definition of some terms helpful in understanding the problem under analysis. These definitions are given as they are essential to dealing with the accounting solutions for The Revenues proposed by the accounting mentioned above principle.

The definitions provided are as follows:

1. Customer: the person who has entered into a contract to obtain goods or services in exchange for consideration.
2. Aggregate contract price: the amount of the contractually agreed consideration for the goods or services transferred to the customer. In determining the total price, the company considers all the variable care provided in the contract.
3. Variable consideration: the amount that the company estimates it needs to take into account to determine the overall price of the contract. Variable consideration means incentives, performance bonuses, discounts (other than unconditional discounts indicated on the invoice), rebates, penalties, returns.
4. Basic unit of account: individual service included in the contract to be accounted for separately.
5. Non-commercial transactions: transactions carried out to obtain goods of similar characteristics without the objective of securing revenue.

After providing the basic definitions of terms helpful in understanding the subject matter of analysis, the draft accounting standard OIC 34 The Revenues highlights what should be understood by the total price of the sales contract. The total price of the contract can be inferred from the terms of the agreement. If the total price is not immediately apparent in the contract, these variable components must be valued since it contains variable elements. In addition, the amounts paid to the customer, which can be assimilated to discounts and therefore accounted for as a reduction of the overall price, are also considered when determining the overall price. On the other hand, amounts paid to the customer relating to services received, included in the same contract, are to be accounted for as an expense. If, on the other hand, the contract provides for payment terms that expire more than 12 months from the time of initial recognition, without payment of interest, or with interest significantly different from market interest rates, the overall price of the contract is determined by discounting future cash flows at the market interest rate. Finally, in arrangements that provide for settlement through an asset other than cash, the overall contract price equals such assets' current realisable market value.

The draft accounting standard OIC 34 also deals with the issue of the recognition of the so-called variable considerations, i.e. those considerations that cannot be quantitatively determined fixedly and determined with certainty at the signing of the sales contract. The draft accounting standard states that additional variable payments (e.g. incentives and performance bonuses) are included in the total price of the sales contract only when they become reasonably sure. If the other consideration depends on customer

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performance or the performance of market indices, then the criterion of reasonable certainty is not satisfied until such elements have occurred. On the other hand, discounts, allowances, penalties and returns are accounted for as a reduction of revenues based on the best consideration estimate considering the historical experience and statistical data. To estimate this amount, the company may use one of the following methods, choosing the method that it expects will best predict the amount of variable consideration:

- (a) the weighted average of the possible amounts of the consideration. This method is applied when the company expects more than two scenarios to occur (e.g. a penalty that varies with the number of days of delay);
- (b) the most probable amount when the contract has only two possible outcomes (e.g. the agreement provides a fixed penalty for late delivery).

As regards the recognition of returns in the accounts, the following case can be considered as an example:

A company that manufactures handbags sells 600 units of goods to its receivable accounts, for \$100 each, during the year 202X. The company estimates that the average unit cost of each good is \$90. Assume that the company grants the customer a return of 100 per cent of the sale to be made within 150 days of delivery.

Assume that in this specific case, there is only one basic unit of accounting for the supply of goods for 60,000 paid in cash for 50% of the amount and with deferred payment for the remaining amount. At the balance sheet date, the company assesses the transfer of risks and rewards. Specifically, it considers that the benefits have been fully transferred, as the customer can decide the use of the goods autonomously already at the time of delivery.

As far as the risks are concerned, since the company has only retained the return risk, it takes over The Revenues according to the provision described above.

It thus proceeds to assess this risk and considers that the accounts receivable will return 10% of the products sold (equal to 60 units of products).

Consequently, the company records a sales revenue of \$o 60,000 and a provision for charges equal to the amount it expects to return to the customer (amounting to \$o 6,000) as a contra entry to the revenue.

The entries are shown below (for simplicity, without highlighting tax effects):

01.01.202X		Debit	Credit
	Revenues from sales and services		60.000
	Cash	30.000	
	accounts receivable	30.000	
31.12.202X			
	Revenues from sales and services	6.000	
	Risk and charge provision		6.000

In addition, the cost of the goods to be returned is recorded under current assets at the original book value at which it was recorded in inventory (an amount of \$ 5,400 equal to the cost of \$ 90 for 60 units) as an offsetting entry to the inventory change.

31.12.202X		Debit	Credit
	Inventories finished products (balance shee)	5.400	
	Inventories finished products (profit and loss)		5.400

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As regards the recognition of prize competitions in the accounts, the following case can be considered as an example:

A supermarket implements a loyalty policy with reward points linked to purchases made at the shop. Each customer can therefore accumulate bonus points for each purchase made over a certain period. At the end of the points collection, the customer can choose whether to obtain a prize in kind or a cash discount on future purchases upon reaching a certain amount of points.

In detail, accounts receivable get a . for every \$o spent. For every 200 points, the customer is entitled to a 2 \$o discount on future purchases or, if he reaches 5,000 points, he can get a prize that costs the company 90 \$.

During the financial year 202X, the accounts receivable purchased products for \$ 5,000,000. The company does its valuation at 31.12.202X.

If it assumes, for the sake of simplicity, that all accounts receivable opt for the discount on future purchases, it will adjust The Revenues at the end of the financial year by 12,500 \$.

31.12.202X	Debit	Credit
Cash		12.500
Revenues	12.500	
-		

If, on the other hand, at the end of the points collection, the customer can only obtain a prize in kind (e.g. toys), the company estimates the cost it expects to incur to purchase the prizes it will give to the accounts receivable that reach 2,000 points and recognises a provision for charges without adjusting The Revenues. If the estimated cost is \$14,000, the accounting entry will be as follows:

31.12.202X	Debit	Credit
allowance of premium vouchers	14.000	
Provision premium voucher		14.000
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Example of accounting for sales with a legal guarantee

A company that manufactures and sells domestic appliances enters into a contract with a customer to deliver 100 units of goods on 31 December 202X for \$600 each. The unit cost of each item is \$440, and the contract provides for payment in cash.

As required by law, the company provides the customer with free service for two years after the sale.

The company proceeds with the contractual analysis to identify the individual components.

In this case, only one elementary unit is identified regarding the supply of goods. Therefore, the related revenue is recognised when the substantial transfer of risks and benefits occurs. At the time of delivery, the entity assesses the transfer of risks and rewards. Specifically, it considers that the benefits have been fully transferred since the customer can decide the use of the goods autonomously.

As far as the risks are concerned, the company has only retained the risk relating to the free legal assistance to be provided and therefore takes over The Revenues following the provisions set out in the preceding pages.

It evaluates this risk and assumes that the customer will require service for 10% of the products (i.e. 10 product units) and therefore estimates that it has transferred all risks substantially. Thus, against the sales proceeds of USD 60,000, the company recognises a provision for charges equal to the replacement and repair cost that the company estimates it will incur to meet its commitment (equivalent to USD 4,400).

The entries are shown below (for simplicity, no tax effect is considered):

31.12.202X	Debit	Credit
Revenues from sales and services		60.000
Cash	60.000	
Provision		
Risk and charge provision	4.400	
		4.400

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As already pointed out above, the main novelty of the Italian national accounting standard OIC 34 concerns the introduction of accounting techniques to identify and value 'elementary units of accounting'. A single sales contract may, in fact, include different services that require separate accounting. In this respect, the draft standard provides an exact definition of an elementary unit of account. According to the above draft, at initial recognition, the preparer of financial reports must proceed with the analysis of the sales contract to determine which are the basic units of accounting. Specifically, the individual goods, services or other benefits promised to the customer through the agreement must be treated separately. Segmentation of the contract is necessary because a single sales contract may give rise to several rights and obligations that must be accounted for separately.

The preparer of financial reports does not segregate individual reporting units when:

- a) (a) the goods and services under the contract are integrated or interdependent with each other. (a) the contractual goods and services are integrated or interdependent with each other. This is the case when the individual goods or services cannot be used separately by the customer but only in combination with each other; or
- b) (b) one or more services under the contract are not part of the company's characteristic activities and are provided free of charge.

The leading cause of difficulty in applying the above is the determination of the elementary units of accounting. Once these units have been identified, it is necessary to proceed with the valuation of each of them by allocating the total price of the contract to each elementary unit of the account identified.

If this is the case, the draft principle 34 OIC The Revenues states that The total price is allocated to each elementary unit of account based on the ratio between the selling price of the individual elementary unit of account and the sum of the selling prices of all the elementary units of account included in the contract. The selling prices are net of the discounts usually applied.

The selling price of individual metering units is the contract price unless the contract price is significantly different from the price list, taking into account regular discounts. In the absence of a reference price, the company may estimate the selling price of individual reporting units by the following methods:

- (a) market price valuation method: the company estimates the selling price based on prices in the market in which it operates. This method may also involve reference to the fees charged by the company's competitors for similar goods or services and adjustment of those prices to reflect the company's costs and margins;
- (c) expected cost plus margin method: the company estimates the selling price based on the expenses incurred or to be incurred in performing the contract and adds a reasonable margin for the good or service in question;
- (d) residual method: the company estimates the stand-alone selling price of the good or service as the difference between the total contract price and the sum of the observable stand-alone selling prices of other goods or services included in the contract.

Example of accounting for Revenues with more than one elementary unit.

Assume that a company sells equipment not serviced by law and enters into a contract with a customer that calls for delivery of the goods sold on 31/12/202X for a total price of \$10,000. Assume that the company gives the customer two years of free service for three years after the sale.

First, it is necessary to check whether there are one or more elementary units of accounting. The company makes this identification. Management considers that it identifies two basic units of accounting: one relating to the sale of the equipment, the other relating to the free assistance provided for three years after the sale.

The transfer of risks and benefits and this evaluation is carried out for each elementary unit of accounting.

At the time of delivery, the company assesses the transfer of risks and rewards. Only about the delivery of the asset does it conclude that substantially both risks and rewards have been transferred.

Concerning the free assistance, the company assesses that it has not transferred the risks and benefits. Since it is not a legal guarantee, it proceeds with the accounting of a separate accounting unit.

As noted above, the company determines the total price to be \$ 10,000 and allocates this amount to the individual reporting units. For allocation purposes, the company considers what is shown in its price list about the goods supplied and the service. Respectively, the one is usually sold at \$ 8,000 and the service at \$ 3,000 for two years. Since the company usually sells the two supplies together for \$ 10,000, the company considers an implicit discount of \$ 1,000 and thus allocates the total price:

Sales revenues 72.72% on 11,000 \$(price of the two income components sold separately)
72.72% out of 10,000 = \$ 7,272

Free support 27.28% out of 11,000 \$ (price of the two revenue components sold separately)
27.28% out of 10,000 = 2,728 \$

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Di seguito si riportano le scritture (per semplicità non si considera effetto fiscale):

	31.12.202X	Debit	Credit
Revenues from sales and services			10,000
Cash	10.000		
	31.12.202X	Debit	Credit
Revenues from sales and services		2.727	
Deferred income (for free assistance)			2.727

Nei tre anni successivi la scrittura all'1/1, il deferred income sarà ridotto di 909 (quota di competenza anno) e il valore sarà girato al conto revenues di vendita e prestazioni.

If the company cannot reliably estimate the selling price of the reporting units, the revenue of those for which a reasonable estimate could not be produced is equal to the cost incurred.

After having identified the elementary units of accounting, it is possible to proceed to the recognition of Revenues which, as established by the above mentioned draft, can only take place when three conditions are met:

- A) the substantial transfer of the risks and rewards associated with the sale has taken place (regarding the transfer of risks, it should be noted that the company has to consider both qualitative factors (e.g. an assessment of the contractual terms) and quantitative factors (e.g. an assessment of historical experience). However, it does not take credit risk into account, as it affects the assessment of the recoverability of receivables recognised in financial reporting. Receivables are recognised and quantified at the time the allowance for doubtful accounts is determined, i.e. at the time the collectable and doubtful accounts are assessed. With regard to the transfer of benefits, the draft accounting standard identifies the moment of transfer when the company transfers to the counterparty the ability to decide on the use of the asset and to obtain the related benefits on a definitive basis. Benefits are understood as the possible cash flows that can be obtained directly or indirectly from the asset. Thus, the benefits are transferred to the customer when the customer can dispose of them freely, by reselling them in full autonomy, renting them or using them in its own production. Some examples of the ways in which an enterprise may obtain such benefits are as follows: (1) use of the asset to produce other goods or provide services; (2) use of the asset to increase the value of other assets; (3) use of the asset to discharge liabilities or reduce expenses; or (4) sale or exchange of the assets;
- B) the amount of the revenue can be reliably determined;
- C) the production process of the assets is completed

It should note that the accounting recognition of Revenues follows the accrual principle, taking into account, however, the tax regulations of each country that may indicate the critical moment of revenue recognition at a precise moment in the timing of the sale (e.g. when the invoice is issued).

The sales contract may provide for the possibility of return. In this case, the revenue associated with the sale must be recognised for the total amount of the contract. For potential returns, on the other hand, must establish a provision. The provision must be assessed based on experience and considering the probability that the adverse event may occur. This procedure should only be followed if the return is followed by a refund, which is, in practice, always the case in every contract. If, however, there is no refund or only a partial refund, the provision for risks must consider that the actual risk is net of the amount not to be refunded.

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The recognition of the return also involves the reversal of the cost of goods sold that the company expects to receive. The amount of this cost is recorded in a separate item under current assets at the original carrying amount at which it was recorded in inventory.

The draft accounting standard OIC 34 The Revenues also addresses, in an analytical manner, the issue of the recognition of Revenues arising from the provision of services. According to the above-mentioned draft, The Revenues for services are recognised in the income statement on a progress basis if both of the following conditions are met

- (a) the agreement between the parties provides that the seller's right to consideration accrues as the service is performed; and
- (b) it can measure the amount of revenue accruing reliably.

Various methods may determine accrual. The preparer of financial statements proceeds by the process that leads to a reliable determination of the services rendered. Depending on the type of transaction, the methods may be:

- (1) proportion of hours worked at the financial reporting date to the total hours estimated to perform the work; or
- 2) the proportion of costs incurred at the financial reporting date to the estimated total costs of the transaction.

If the entity cannot recognise revenue on a progress basis, revenue for the service provided is recognised in profit or loss when the service is finally completed.

Of course, suppose the company revises its estimates after initial recognition. In that case, it updates them to consider additional information that the passage of time provides regarding assumptions or facts on which the original estimate was based.

If there is a change in the contractual agreement that provides additional services for additional consideration, it is accounted for separately. Suppose there is only a change in the thinking or only a change in the services to be rendered. In that case, the effects of the change are accounted for by allocating the residual value of the contract to the services to be generated.

The draft standard OIC 34 The Revenues, in order to have a complete global vision of the problem of the recognition of Revenues, has identified four categories of Revenues distinguished by particular clauses. Each of these categories has identified the rules to be followed to ensure compliance with the accrual principle and the postulate of the truthfulness of financial reporting.

The four categories of Revenues distinguished by particular clauses are the following:

A) Sale with a guarantee

The customer service warranty, required by law, may not be separated from the goods sold and therefore treated as if it were not a separate accounting unit. In this case, the company recognises the revenue for the entire sale. It assesses the recognition of a provision for charges equal to the cost of replacement and repair that the company estimates it will have to incur to meet its commitment following the requirements of OIC 31 - Provisions for risks and charges and termination indemnities. This provision also applies to cases where the guarantee, similar to that required by law, is given to receivable accounts resident in jurisdictions where such an obligation does not exist.

In contrast, all other guarantees given to the customer are basic units of accounting that should be accounted for as separate income following the above

B) Transfer of licences

A licence transfer produces income in the income statement when the company transfers the right to the customer for use over a specified period. Revenue from the licence transfer is recognised in profit or loss on a pro-rata basis over the contractual term unless other criteria are not identifiable (e.g. based on sales).

Suppose the customer obtains the full benefits of using the licence without further activity by the supplier. In that case, the revenue from the sale of the right is recognised as profit or loss when the request is delivered.

C) Sales with an obligation to repurchase

In cases where there is an obligation on the part of the seller to repurchase since the transfer of risks and benefits does not take place, the transaction shall be accounted for as follows:

- 1) if the sale price is lower than the repurchase price, the transaction will be financial. Therefore, the spot seller will record a liability to the forward seller against the amount received for the initial sale. The difference between the repurchase price (higher) and the sale price (lower) will be charged to the income statement on an accrual basis as financial expenses (item C17 - Interest and other financial expenses). The balancing entry for these financial charges will be the liability to the forward seller. This liability will close at the time of the retrocession (i.e. when the sum received plus the related charges is returned).
- 2) If the sale price is higher than the repurchase price, the transaction will be operational. Therefore, the seller will record a contra-entry to the sum received for the initial sale: a payable to the counterparty corresponding to the agreed price for the future

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repurchase and a deferred income for the (positive) difference between the sale price and the repurchase price. This deferred income, which represents the consideration received for granting the use of the asset to the buyer, will be released to the income statement on a straight-line basis as operating income.

D) Company acting on its behalf or behalf of third parties

When a third party other than the seller and the customer is involved in a transaction, the selling company must assess all the elements of the contract to determine whether it is acting on its behalf or behalf of a third party.

A company acts on its behalf when it

- it is responsible for providing the goods/services to the customer;
- it has inventory risk in the sense of the risk that goods remain unsold and therefore lose value; and
- has the discretionary power to decide the price of the good or service.

If the company is not acting on its own by applying the preceding paragraph, it must account for the service rendered to the customer as if it were acting on behalf of a third party. In this case, it records the proceeds of the sale net of the costs incurred in acquiring the good, thereby identifying the value of the commission due.

3. CONCLUSIONS

From what has been illustrated above, it can be understood how the "Revenues" can be, in reality, a very complex accounting item. The draft accounting standard illustrated has been issued by an Italian body and, consequently, will only apply to the Italian State. However, considering the observations proposed by the draft standard OIC 34 The Revenues, the writer believes that other countries may also draw useful considerations from the above. The veracity of the Revenues accounting item also depends on the way it is accounted for. It is therefore desirable that each scholar analyses these observations and expresses his or her own opinion. Only in this way will there be a worldwide dialogue on the various items of accounts, irrespective of the laws that each nation may have enacted.

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