UITF abstract 40
Revenue recognition and service contracts

(Issued 10 March 2005)

Background

Since the ASB issued Application Note G: Revenue Recognition, as an Amendment to FRS 5, 'Reporting the Substance of Transactions' ('Application Note G') in November 2003, questions have arisen about the accounting for revenue (ie turnover) from contracts to provide services, and the UITF has been asked to provide guidance. Although many of these requests specifically refer to services rendered by professional service firms (for example, firms of accountants and solicitors), the UITF believes the same principles should be applied in accounting for all service contracts. This Abstract therefore applies to all contracts for services. 1

The issues

The main point at issue, which this Abstract addresses, is when the applicable accounting literature requires or allows revenue to be recognised as contract activity progresses or on contract completion. In this Abstract, the term 'accounted for as a long-term contract' refers to the method described in SSAP 9 'Stocks and long-term contracts' of recognising revenue as contract activity progresses. 2

In some cases, it may be appropriate to treat a single contractual arrangement as two or more separate transactions, where there are distinguishable phases. This approach may only be adopted where the value of each element can be reliably estimated. Application Note G provides further guidance on this treatment (paragraphs G22-G28). 3

The contract terms and commercial substance of contracts for services vary considerably in practice, and it is therefore impracticable to provide definitive guidance for every situation. Each entity needs to develop an appropriate accounting policy, having regard to the requirements of this Abstract, Application Note G and SSAP 9. In some cases, a single approach will be appropriate for all contracts undertaken by an entity: in others, different approaches will be required for different classes of contracts. 4

Application Note G: general principles

5 Application Note G requires a seller to recognise revenue under an exchange transaction with a customer when, and to the extent that, the seller obtains a right to consideration in exchange for its performance*. At that time it recognises a new asset, usually a debtor (paragraph G4).

6 Application Note G also states that a seller may obtain a right to consideration when some, but not all, of its contractual obligations have been fulfilled. Where a seller has partially performed its contractual obligations, it recognises revenue to the extent that it has obtained the right to consideration through its performance (paragraph G6).

7 Application Note G requires that the amount reported as revenue should be the fair value of the right to consideration: this will usually be based on the price specified in the contractual arrangement net of discounts, and any allowance for credit risk and other uncertainties (paragraph G7).

Long-term contracts

8 SSAP 9 has been in issue for many years, and was last revised in 1988. SSAP 9 provides specific guidance on the accounting treatment of long-term contracts. It requires turnover (and related costs) to be recorded in the profit and loss account as contract activity progresses (paragraph 28). Turnover is ascertained in a manner appropriate to the stage of completion of the contract, the business and the industry in which it operates. Where the outcome of a contract can be assessed with reasonable certainty, the prudently calculated attributable profit should be recognised as the difference between turnover and the related costs. The excess of turnover over payments on account is reported as 'amounts recoverable on contracts' within debtors.

9 Application Note G confirms that SSAP 9 should be applied in accounting for long-term contracts. It is consistent with, and does not amend, the requirements of SSAP 9. The guidance in Application Note G requires a seller to measure turnover in respect of long-term contracts by an assessment of the fair value of the goods or services provided to its reporting date as a proportion of the total fair value of the contract, noting that the guiding principle is to consider the stage of completion of the contractual obligations, which reflects the extent to which the seller has obtained the right to consideration (paragraph G18). The amount of turnover recognised may be derived from the proportion of costs incurred only where it provides evidence of the seller's performance and hence the extent to which it has obtained the right to consideration (paragraph G21).

---

* Application Note G defines 'right to consideration' as 'A seller's right to the amount received or receivable in exchange for its performance. This right does not necessarily correspond to amounts falling due in accordance with a schedule of stage payments which may be specified in a contractual arrangement. Whilst stage payments will often be timed to coincide with performance, they may not correspond exactly. Stage payments reflect only the agreed timing of payment, whereas a right to consideration arises through the seller's performance'. The Application Note defines 'performance' as 'The fulfilment of the seller's contractual obligations to a customer through the supply of goods and services'.

The definition of a long-term contract is set out in SSAP 9. It is: 10

A contract entered into for the design, manufacture or construction of a single substantial asset or the provision of a service (or of a combination of assets or services which together constitute a single project) where the time taken substantially to complete the contract is such that the contract activity falls into different accounting periods. A contract that is required to be accounted for as long-term by this accounting standard will usually extend for a period exceeding one year. However, a duration exceeding one year is not an essential feature of a long-term contract. Some contracts with a shorter duration than one year should be accounted for as long-term contracts if they are sufficiently material to the activity of the period that not to record turnover and attributable profit would lead to distortion of the period's turnover and results such that the financial statements would not give a true and fair view, provided that the policy is applied consistently within the reporting entity and from year to year. (paragraph 22)

The definition is clear that, in the case of contracts for assets, only those for 'a single substantial asset' are required to be accounted for as long-term contracts. Similarly, in the case of a contract for a combination of assets or services only those that 'constitute a single project' are required to be accounted for as long-term contracts. 11

Thus contracts that require services to be provided on an ongoing basis rather than the provision of a single service (or a number of services that constitute a single project) do not fall to be accounted for as long-term contracts under SSAP 9. For example, a contract to provide repetitive services (such as general professional advice, accounting support, help desk support, maintenance or cleaning) on an ongoing basis should not be accounted for as a long-term contract. 12

The definition is clear that a contract for services that constitute a single project with duration of more than a year should be accounted for as a long-term contract. It is also clear that contracts with a shorter duration should be accounted for as long-term if contract activity falls into different accounting periods and a failure to reflect turnover and attributable profit would result in distortion of turnover and results, such that the financial statements would fail to give a true and fair view.* 13

* The ASB's Statement 'Interim Reports' recommends that interim reports are prepared on the discrete method and notes that, under this method, incomplete transactions are treated according to the same principles as are applied at the year-end. Thus entities that prepare interim reports should consider the effect on their interim reports of not treating contracts as long-term contracts, even where they do not straddle the end of an annual accounting period.

14 Although SSAP 9 suggests that materiality should be judged in the context of turnover and attributable profit, other implications, for example the effect on reported assets and liabilities, may require that some contracts are accounted for as long-term contracts. The UITF takes the view that in considering whether contracts for services should be accounted for as long-term contracts, the aggregate effect of all such contracts on the financial statements as a whole should be considered.

15 As noted in SSAP 9, it is important that an entity applies its policy consistently to all similar contracts and from year to year.

Other contracts for services

16 The UITF takes the view that Application Note G requires all contracts for services to be accounted for in accordance with its general principles, including those stated in paragraphs 5 to 7 above. The overriding consideration is whether the seller has performed, or partially performed, its contractual obligations. If it has performed some, but not all, of its contractual obligations, it is required to recognise revenue to the extent that it has obtained the right to consideration through its performance.*

17 Revenue is recognised according to the substance of the seller's obligations under the contract (see paragraphs 18 to 20 for further explanation).

18 Where the substance of a transaction is that the seller's contractual obligations are performed gradually over time, revenue is recognised as contract activity progresses to reflect the seller's partial performance of its contractual obligations. This is the case where the substance of the obligation is either (i) to provide the services of staff, ie where the seller earns the right to consideration as each unit of time is worked or (ii) to require the seller to use its skills and expertise in carrying out acts that will take some time to perform, even when the output is encapsulated in a document, such as a report. In such cases, revenue is recognised to reflect the accrual of the right to consideration as contract activity progresses, by reference to valuation of the work performed as described in paragraph 9 above in relation to long-term contracts. Thus, subject to the considerations in paragraph 20, in case (i) the amount of revenue may be derived from the time spent; in case (ii) the amount of revenue will reflect the fair value of the services provided as a proportion of the total fair value of the contract, which will reflect the time spent and the skills and expertise that have been provided.

19 Where the substance of a contract is that a right to consideration does not arise until the occurrence of a critical event, revenue is not recognised until that event occurs. This only applies where the right to consideration is conditional or contingent on a specified future event or outcome, the occurrence of which is outside the control of the seller.

* This conclusion is broadly comparable to the requirements of IAS 18 'Revenue', which requires revenue from the rendering of services to be recognised by reference to the stage of completion of the transaction at the balance sheet date.

The amount of revenue recognised should reflect any uncertainties as to the amount which the customer will accept and be able to pay. It may be the case, for example, that even where the contract states that fees are to be calculated on a time basis, the customer will not accept that the time spent is reasonable. 20

Application to smaller entities

Reporting entities applying the Financial Reporting Standard for Smaller Entities currently applicable are exempt from this Abstract. 21

UITF consensus

This UITF consensus applies to all contracts for services. 22

Where there are distinguishable phases of a single contract it may be appropriate to account for the contract as two or more separate transactions, provided the value of each phase can be reliably estimated. 23

Contracts for services should not be accounted for as long-term contracts unless they involve the provision of a single service, or a number of services that constitute a single project. 24

A contract for services should be accounted for as a long-term contract where contract activity falls into different accounting periods and it is concluded that the effect is material. In determining whether contracts should be accounted for as long-term contracts, the aggregate effect of all such contracts on the financial statements as a whole should be considered. 25

Where the substance of a contract is that the seller's contractual obligations are performed gradually over time, revenue should be recognised as contract activity progresses to reflect the seller's partial performance of its contractual obligations. The amount of revenue should reflect the accrual of the right to consideration as contract activity progresses by reference to value of the work performed. 26

Where the substance of a contract is that a right to consideration does not arise until the occurrence of a critical event, revenue is not recognised until that event occurs. 27

The amount of revenue recognised on any contract for services should reflect any uncertainties as to the amount that the customer will accept and pay. 28

An entity should apply its policy consistently to all similar contracts and from year to year. 29

Date from which effective

30 The accounting treatment required by this Abstract should be adopted in financial statements relating to accounting periods ending on or after 22 June 2005 but earlier adoption is encouraged. Where applicable, corresponding amounts should be restated.

References

SSAP 9 'Stocks and long-term contracts'

FRS 5 Application Note G—'Revenue Recognition'

FRS 18 'Accounting Policies'

International Accounting Standard 18 'Revenue'