

AMENDMENT TO FRS

AMENDMENT TO FRS 5

‘REPORTING THE SUBSTANCE OF TRANSACTIONS’:

REVENUE RECOGNITION

NOVEMBER 2003



ACCOUNTING
STANDARDS
BOARD

“Amendment to FRS 5 ‘Reporting the Substance of Transactions’: Revenue Recognition – November 2003” is issued by the Accounting Standards Board in respect of its application in the United Kingdom and by the Institute of Chartered Accountants in Ireland in respect of its application in the Republic of Ireland.

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C O N T E N T S

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DISSENTING VIEW

PREFACE

This document sets out an amendment to Financial Reporting Standard 5 'Reporting the Substance of Transactions', namely the addition of Application Note G 'Revenue Recognition'.

The Application Note has been prepared in response to the need for clarity in respect of questions that arise concerning the treatment of revenue and, in particular, the treatment of turnover (as a subset of revenue).

The amendment was published as an Exposure Draft in February 2003 for public comment. In finalising this document the Accounting Standards Board has taken into consideration the comments received in response to the Exposure Draft and has consulted interested parties.

The amendment takes effect for accounting periods ending on or after 23 December 2003, with early adoption encouraged.

STATEMENT OF STANDARD ACCOUNTING PRACTICE

- 1 In FRS 5 'Reporting the Substance of Transactions', in the list of contents immediately preceding the summary, the list of Application Notes is extended by adding at the end:

'G REVENUE RECOGNITION'.

- 2 The list of contents immediately preceding the Application Notes in FRS 5 is amended by adding at the end:

'G REVENUE RECOGNITION'.

- 3 There shall be inserted into FRS 5, immediately following Application Note F, Application Note G, the text of which is set out in the Appendix to this document.
- 4 The provisions of this amendment should be applied in financial statements for accounting periods ending on or after 23 December 2003.

ADOPTION OF AMENDMENT TO FRS 5 BY THE BOARD

‘Amendment to FRS 5 “Reporting the Substance of Transactions”’: Revenue Recognition – November 2003’ was approved for issue by a vote of eight of the nine members of the Accounting Standards Board. Mr Wild dissented. His dissenting view is set out on pages 41–42.

Members of the Accounting Standards Board

Mary Keegan Chairman

Allan Cook CBE Technical Director

Douglas Flint

Huw Jones

Roger Marshall

Isobel Sharp

John Smith

Jonathan Symonds

Ken Wild

APPENDIX

APPLICATION NOTE G – REVENUE RECOGNITION

INTRODUCTION

- G1** This Application Note deals with revenue recognition from the supply of goods or services by a seller to its customers. It sets out basic principles of revenue recognition which should be applied in all cases. It also provides specific guidance for:
- long-term contractual performance;
 - separation and linking of contractual arrangements;
 - bill and hold arrangements;
 - sales with rights of return; and
 - presentation of turnover as principal or as agent.
- G2** The Application Note does not apply to the following arrangements:
- those resulting from transactions in financial instruments;
 - those arising from insurance contracts; and
 - those which are dealt with more specifically elsewhere in this, and other, accounting standards.

DEFINITIONS

- G3** The following additional definitions apply in the Application Note:

Fair value

The amount at which goods or services could be exchanged in an arm's length transaction between informed and willing parties, other than in a forced or liquidation sale.

Performance

The fulfilment of the seller's contractual obligations to a customer through the supply of goods and services.

Right to consideration

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.

BASIC PRINCIPLES

- G4** A seller recognises revenue under an exchange transaction with a customer, when, and to the extent that, it obtains the right to consideration in exchange for its performance. At the same time, it typically recognises a new asset, usually a debtor.
- G5** When a seller receives payment from a customer in advance of performance, it recognises a liability equal to the amount received, representing its obligation under the contract. When the seller obtains the right to consideration through its performance, that liability is reduced and the amount of the reduction in the liability is simultaneously reported as revenue.

- G6** 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.
- G7** Revenue should be measured at the fair value of the right to consideration. Subject to paragraphs G8 – G9 or other evidence to the contrary, this will normally be the price specified in the contractual arrangement, net of discounts, value added tax and similar sales taxes.
- G8** Where the effect of the time value of money is material to reported revenue, the amount of revenue recognised should be the present value of the cash inflows expected to be received from the customer in settlement. The unwinding of the discount should be credited to finance income as this represents a gain from a financing transaction.
- G9** Where at the time revenue is recognised on a transaction there is a significant risk that there will be default on the amount of consideration due and the effect is material to reported revenue, an adjustment to the price specified in the contractual arrangement will be necessary to arrive at the amount of revenue to be recognised.
- G10** Subsequent adjustments to a debtor as a result of changes in the time value of money and credit risk should not be included within revenue.

TURNOVER

- G11** Turnover (which may be described as ‘sales’ in a seller’s financial statements) is the revenue resulting from exchange transactions under which a seller supplies to customers the goods or services that it is in business to provide.*

* *These transactions are often referred to as being part of the seller’s ‘operating activities’.*

- G12** A seller may enter into other exchange transactions such as the sale of fixed assets. Such transactions do not normally give rise to turnover, as they do not normally fall within the class of transactions set out in paragraph G11.*

AREAS OF SPECIFIC GUIDANCE

- G13** Although revenue recognition is normally straightforward, in a number of areas inconsistencies have arisen in practice. In addition to the basic principles outlined above, which should be applied in all cases, the Application Note addresses a number of specific types of transaction. These are confined to transactions that are generally regarded as giving rise to turnover.

LONG-TERM CONTRACTUAL PERFORMANCE

- G14** Statement of Standard Accounting Practice 9 ‘Stocks and long-term contracts’ (SSAP 9) sets out requirements for accounting and disclosure under a long-term contract. The Application Note provides additional guidance on the recognition of turnover derived from such contracts, but does not amend the requirements of that accounting standard.

Features

- G15** A seller’s performance under a contractual arrangement with a customer for the design, manufacture or construction of a single substantial asset or the provision of a service may be significant in the context of the seller’s overall business activities and fall into different financial periods.
- G16** Recognition of turnover arising from these contractual arrangements on their completion, and not at interim stages,

* For example, paragraph 20 of FRS 3 requires material profits or losses on the sale of fixed assets to be shown after operating profit.

would result in the seller's financial statements reflecting the results relating to contracts that had been completed during the financial period, rather than its performance during the period. Therefore, in accordance with SSAP 9, the seller should recognise changes in its assets or liabilities, and related turnover, that represent the accrual, over the course of the contract, of its right to consideration.

Analysis

- G17** The purpose of the analysis below is to assess how changes in a seller's assets or liabilities, and related turnover, that arise from its performance under an incomplete long-term contract should be recorded in its financial statements.
- G18** A seller should recognise turnover in respect of its performance under a long-term contract when, and to the extent that, it obtains the right to consideration. This should be derived from 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. In some contracts, this proportion will correspond with the proportion of expenditure incurred in comparison with total expenditure; however, this will not always be the case. For all contracts, 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 (as defined in paragraph G3). As a result, different stages of contracts may vary in their relative profitability.
- G19** The fair values used should represent those applicable on inception of the contract, unless the contractual terms specify that changes in prices will be passed on to the customer. Paragraphs G22 – G42 may be relevant when attributing fair values to the goods or services which have been provided up to the seller's reporting date.

Required accounting

- G20** The application of SSAP 9 to the recording of a seller's long-term contractual performance results in the seller recognising turnover as contract activity progresses, to the extent that the outcome of the contract can be assessed with reasonable certainty.
- G21** The seller should recognise changes in its assets or liabilities, and turnover, in accordance with the stage of completion of its contractual obligations, which reflects the extent to which it has obtained the right to consideration. The amount of turnover recognised should be derived from the proportion of costs incurred only where these provide evidence of the seller's performance and hence the extent to which it has obtained the right to consideration.

SEPARATION AND LINKING OF CONTRACTUAL ARRANGEMENTS

Features

- G22** A single contractual arrangement may require a seller to provide a number of different goods or services (or 'components') to its customers. These components may be unrelated and capable of being sold individually; alternatively, two or more components may be so closely related that their individual sale is not commercially feasible from either the seller's or the customer's perspective.
- G23** A seller may provide a number of goods or services to customers as a package, in which the amount payable is set below the price at which these items would be sold individually.

Analysis

- G24** The purpose of the analysis below is to determine whether, as a result of its performance:

- (a) the seller should recognise a change in its assets or liabilities, and turnover, in respect of its right to consideration for each component on an individual basis; or
- (b) two or more components should be combined and turnover recognised on that basis.

G25 A contractual arrangement should be accounted for as two or more separate transactions only where the commercial substance is that the individual components operate independently of each other. 'Operate independently' means that each component represents a separable good or service that the seller can provide to customers, either on a stand alone basis or as an optional extra. Alternatively, one or more component(s) may be capable of being provided by another supplier. This separation for accounting purposes is frequently referred to as the 'unbundling' of a contractual arrangement.

G26 Conversely, the commercial substance of two or more separate contracts may require them to be accounted for as a single transaction. This is frequently referred to as the 'bundling' of a contractual arrangement.

G27 Where various components are to be unbundled, the seller should normally be capable of attributing a reliable fair value to each of them by reference to individual transactions. If various components are combined and sold at a price less than the total fair values of the individual components, the reduction should be allocated to each component pro rata to their fair values.

G28 Where it is not possible to attribute reliable fair values to every component, the seller may be able to unbundle the arrangement where reliable fair values can be obtained for either the completed or the uncompleted component(s). For example, where reliable fair values can be obtained only for the uncompleted components, the seller may be able to calculate by deduction a value for the completed

components. Where a reliable fair value cannot be obtained for the uncompleted component(s), particular care must be taken to ensure that turnover is not overstated for the completed components. That is because the contract price may be set at a discount from the total amount at which the components would be sold individually.

Required accounting

Components operate independently of each other

- G29** Where a contractual arrangement consists of various components that operate independently of each other and a reliable fair value can be attributed to every component, the seller should recognise changes in its assets or liabilities, and related turnover, in respect of its right to consideration for each component as if it were an individual contractual arrangement.
- G30** Where reliable fair values can be attributed only to the uncompleted component(s), the fair value of the uncompleted component(s) should be deducted from the total fair value of the contract to derive the amount of turnover attributable to the completed component(s). Where reliable fair values cannot be attributed to the uncompleted component(s), particular care must be taken to ensure that turnover is not overstated for the completed components.
- G31** Where reliable fair values cannot be attributed to individual completed or uncompleted components, the seller should recognise changes in its assets or liabilities, and turnover, for those components as a single, bundled, contractual arrangement. For example, where a contractual arrangement consists of three components and a reliable fair value can be attributed only to the second and third components combined, and not to any components individually, a fair value should be attributed to the first component in accordance with paragraph G30. The second and third components are then viewed together in accordance with paragraph G32 when determining the point at which changes

in its assets or liabilities, and turnover, attributable to those components should be recognised by the seller.

Components do not operate independently of each other

- G32** Where a contractual arrangement consists of various components that do not operate independently of each other, the seller should account for them together to reflect the seller's performance of its obligations as a whole in obtaining the right to consideration. Where the contractual arrangement meets the definition of a long-term contract in SSAP 9, it should be accounted for in accordance with that standard and paragraphs G14 – G21 of this Application Note.

Illustrations

Sales of software and related maintenance services

- G33** A customer may purchase 'off the shelf' packaged software from a seller, which also offers separately a support service that provides helpline assistance and advice about the package's operation. An analysis of the arrangement shows that the customer has no commercial obligation or requirement to purchase the support service; it is not needed for the software package to operate satisfactorily. The seller's performance is made up of two components and it should recognise turnover separately for each.
- G34** Conversely, a seller may enter into a contractual arrangement for the supply of bespoke software, together with its maintenance and the customer's right to future upgrades for a period of three years. An analysis of the arrangement shows that the maintenance and upgrades are required in order to ensure that the software continues to operate satisfactorily throughout the three year period and that these services are offered only by the supplier of the software. The commercial substance of the arrangement is therefore that the customer is paying for a three year service agreement. The seller should treat all three components (the software,

the upgrades and the maintenance) as linked, and recognise turnover on a long-term contractual basis.

Inception fees

- G35** A contractual arrangement may require the payment of a fee at inception which permits the customer to purchase goods or services over a period of time. In determining when the seller should recognise turnover attributable to the fee, it should determine whether or not the fee and the charges for goods or services operate independently of each other.
- G36** The fee and the charges for goods or services may often together provide the seller's return on the contract as a whole. This may be the case, for example, where payment of the fee entitles the customer to purchase goods or services at lower prices than would otherwise be payable. In these circumstances the seller should record the fee as turnover on a systematic basis over the average period in which goods or services are expected to be provided to the customer. Before the seller has provided goods or services, it should report a liability for the fee to the extent that this has not been included in turnover.
- G37** Where it can be demonstrated that the seller has no further obligations to the customer in respect of the fee, the seller should record the fee as turnover on the date on which it becomes entitled to it. This may be the case, for example, where, notwithstanding payment of the fee, the customer is required to pay for all goods or services supplied under the arrangement at the current commercial rate.

Vouchers

- G38** A seller may, in a single transaction, sell goods or services and vouchers, where the vouchers are redeemable against future purchases from the seller. Where the fair value of the voucher is significant in the context of the transaction, revenue should be reported at the amount of consideration received or receivable less the fair value of the voucher

issued. The latter represents a liability for future performance, which is extinguished and recognised in revenue when the voucher is tendered as part of the consideration on a future transaction.

- G39** The fair value of a voucher will often be less than its face value. In determining the fair value of a voucher, regard should be paid to the terms of the voucher, including:
- (a) the range of the goods or services which the customer can obtain on redemption of the vouchers;
 - (b) the discount the customer obtains when redeeming the voucher compared with the discount which might be obtained by customers who do not redeem vouchers;
 - (c) the length of time before which the right to use the voucher expires; and
 - (d) the extent to which the voucher is similar to other vouchers that are distributed to customers free of charge.

Regard should also be paid to the proportion of vouchers that are expected to be redeemed.

- G40** An analysis of the above factors may indicate that the fair value of a voucher is not significant; in effect the issue of the voucher is an inducement to undertake a future transaction rather than being a separable component of the original transaction. In such circumstances, no adjustment is required to revenue at the time the voucher is issued.
- G41** At each reporting date, the seller should review its estimated liability for outstanding vouchers having regard to experience of the proportion that are redeemed and expire. Adjustments to the estimate should be included within revenue.
- G42** Vouchers distributed free of charge, independently of another transaction, do not give rise to a liability except

where redemption of the voucher will result in products being sold at a loss. Where this is the case, the seller has entered into an onerous contract and provision will need to be made in accordance with FRS 12 'Provisions, Contingent Liabilities and Contingent Assets'. When the vouchers are redeemed, the seller should recognise revenue at the amount received for the product, ie after deducting the discount obtained for the vouchers.

BILL AND HOLD ARRANGEMENTS

Features

- G43** Under a bill and hold arrangement, a seller enters into a contractual arrangement with a customer for the supply of goods where there is transfer of title but physical delivery is deferred to a later date.

Analysis

- G44** The purpose of the analysis below is to determine whether, in the circumstances described in paragraph G43, the seller should:
- (a) recognise turnover and a right to consideration; or
 - (b) continue to recognise the goods as stock.
- G45** In accordance with the general principles of the FRS the goods cease to be assets of the seller and become assets of the customer (and in exchange the seller obtains the right to consideration) when the seller transfers to the customer access to the significant benefits relating to the goods and exposure to the risks inherent in those benefits. From the customer's perspective, the principal benefits and risks include:

Benefits

- (a) the right to obtain the goods as and when required;

- (b) the sole right to the goods for their sale to a third party and the future cash flows from such a sale; and
- (c) insulation from changes in prices charged by the seller (eg because the seller has revised its standard price list).

Risks

- (a) slow movement, resulting in increased costs of financing and holding of the goods, and an increased risk of obsolescence; and
- (b) being compelled to take delivery of goods that have become obsolete or not readily saleable, resulting in no onward sale or a sale at a reduced price.

G46 In order for the seller to have the right to recognise changes in its assets or liabilities, and turnover, arising from its right to consideration in respect of the bill and hold arrangement, the terms of the contractual arrangement between the seller and the customer should include all of the following characteristics:

- (a) the goods should be complete and ready for delivery;
- (b) the seller should not have retained any significant performance obligations other than the safekeeping of the goods and their shipment when the customer requests this;
- (c) subject to any rights of return, the seller should have obtained the right to consideration regardless of whether the goods are shipped, at the customer's request, to its delivery address. Where rights of return are granted, particular consideration is required of the commercial substance of the related sales, especially the transfer of risk. Rights of return are addressed at paragraphs G49-G59 below;

- (d) the goods should be identified separately from the seller's other stock and should not be capable of being used to fill other orders that are received between the date of the bill and hold sale and shipment of the goods to the customer; and
- (e) the bill and hold terms should be in accordance with the commercial objectives of the customer and not the seller. For example, where the delay in the delivery of the goods is to meet the customer's need for flexibility in the timing and location of delivery, and the conditions set out in paragraphs (a) to (d) above are met, it will be appropriate for the seller to recognise changes in assets or liabilities, and turnover.

Required accounting

Substance of the transaction is that the goods represent an asset of the customer

- G47** Where it is concluded that the stock is an asset of the customer, resulting in the seller having a right to consideration, the seller should recognise the related changes in its assets or liabilities, and turnover.

Substance of the transaction is that the goods represent an asset of the seller

- G48** Where it is concluded that the stock remains an asset of the seller, it should be retained on the seller's balance sheet. Any amounts received from the customer should be included within creditors in accordance with paragraph G5.

SALES WITH RIGHTS OF RETURN

Features

- G49** The terms of contractual arrangements may allow customers to return goods that they have purchased and obtain a refund or release from the obligation to pay.

- G50** Rights of return may be included explicitly or implicitly within contractual arrangements. Alternatively, they may arise through statutory requirements.

Analysis

- G51** The purpose of the analysis below is to determine the effect of rights of return on a seller's recognition of changes in its assets or liabilities, and turnover.
- G52** The inclusion of rights of return in a contractual arrangement may affect both the quantification of the seller's right to consideration, compared to an otherwise identical arrangement which does not have these rights, and the point at which the seller should recognise that right. This is because rights of return give rise to a contractual obligation on the part of the seller to transfer economic benefits to its customer and in some cases oblige the seller to defer recognition of the sales transaction so long as substantially all of the risks associated with the goods are retained.
- G53** The seller's recognition of its right to consideration and contractual obligation to transfer economic benefits to its customer in respect of rights of return are linked transactions. In consequence, changes in the seller's assets or liabilities should reflect the loss expected to arise from the rights of return. Turnover should exclude the sales value of estimated returns.
- G54** A seller will generally be able to estimate reliably the sales value of returns, having regard to risk, which may be less than its maximum potential obligation. It will generally be possible to derive a reliable estimate from historical experience of the amount of comparable goods returned as a proportion of comparable sales.
- G55** If a seller is unable to estimate reliably the expected value of returns, the maximum potential amount should be calculated in accordance with the terms of its contractual arrangement with the customer and excluded from turnover.

G56 In some cases, the risk of return may be so significant that substantially all of the risks associated with the goods are retained by the seller and accordingly the seller does not have the right to consideration. In such circumstances the seller should not recognise any changes in its assets or liabilities, and turnover, from the transaction. Any amounts received from the customer should be accounted for as a payment in advance, in accordance with paragraph G5.

Required accounting

G57 A seller should record changes in its assets or liabilities, and turnover, to the extent that its performance has earned it the right to consideration, taking account of the expected loss in accordance with paragraphs 23 and 73. The amount recorded as turnover should exclude the sales value of estimated returns from the total sales value of the goods supplied to customers.

G58 At each reporting date, the seller should review its estimate of returns, having regard to changes in expectations and the expiry of contractual rights of return. Subsequent adjustments to the estimate should be recorded within revenue.

G59 Where a seller has been precluded from recognising changes in its assets or liabilities, and turnover, because substantially all of the risks associated with the goods are retained and so has not earned the right to consideration, it should recognise these changes and turnover on the earlier of the dates on which:

- (a) it is capable of estimating the level of returns with reliability; and
- (b) the right of return expires or is surrendered.

PRESENTATION OF TURNOVER AS PRINCIPAL OR AS AGENT

Features

- G60** A seller may act on its own account when contracting with its customers for the supply of goods in return for the right to consideration. In such transactions the seller is frequently referred to as a principal.
- G61** Alternatively, a seller may act as an intermediary, earning a fee or commission in return for arranging the provision of goods or services on behalf of a principal. In such transactions, the seller is frequently referred to as an agent.

Analysis

- G62** The purpose of the analysis below is to determine whether a seller obtains the right to consideration by performing its contractual obligations:
- (a) as principal in an exchange transaction with its customer; or
 - (b) as agent in relation to a transaction between its principal and the principal's customer.
- G63** The general principles of the standard require that, in order for a seller to account for exchange transactions as principal, it should normally have exposure to all significant benefits and risks associated with at least one of the following:
- (a) Selling price: the ability, within economic constraints, to establish the selling price with the customer, either directly or, where the selling price of an item is fixed, indirectly by providing additional goods or services or adjusting the terms of a linked transaction; or
 - (b) Stock: exposure to the risks of damage, slow movement and obsolescence, and changes in suppliers' prices.

- G64** Where the seller has not disclosed that it is acting as agent, there is a rebuttable presumption that it is acting as principal.
- G65** Additional factors which indicate that a seller may be acting as principal include:
- (a) performance of part of the services, or modification to the goods supplied;
 - (b) assumption of credit risk; and
 - (c) discretion in supplier selection.
- G66** In contrast, where a seller acts as agent it will not normally be exposed to the majority of the benefits and risks associated with the exchange transaction. Agency arrangements will typically include the following characteristics:
- (a) the seller has disclosed the fact that it is acting as agent;
 - (b) once the seller has confirmed its customer's order with a third party, the seller will normally have no further involvement in the performance of the ultimate supplier's contractual obligations;
 - (c) the amount that the seller earns is predetermined, being either a fixed fee per transaction or a stated percentage of the amount billed to the customer; and
 - (d) the seller bears no stock or credit risk, other than in circumstances where it receives additional consideration from the ultimate supplier in return for its assumption of this risk.

Required accounting

Seller acts as principal

- G67** Where the substance of a transaction is that the seller acts as principal, it should report turnover based on the gross

amount received or receivable in return for its performance under the contractual arrangement.

Seller acts as agent

- G68** Where the substance of a transaction is that the seller acts as agent, it should report as turnover the commission or other amounts received or receivable in return for its performance under the contractual arrangement. Any amounts received or receivable from the customer that are payable to the principal should not be included in the agent's turnover.

Illustrations

- G69** A seller acts as a building contractor for the construction of a new office block. An analysis of the arrangement shows that the terms of the seller's contract with its customer include a negotiated selling price, credit risk for amounts due from the customer, primary responsibility for the construction and quality of the new building and discretion as to whether it carries out the work itself or employs subcontractors. The seller is acting as principal and should account for the gross amount of turnover, regardless of whether it carries out the work itself or employs subcontractors to carry out part or all of the construction activities.
- G70** A seller acts as an online retailer from a website, where it advertises holidays. An analysis of the arrangement shows that it acts as an intermediary between its customers and the ultimate sellers of the holidays and that it does not set the selling price. Its contractual terms of business include an exclusion of any liability to its customers once they have been put in touch with the ultimate sellers. The seller is paid a fee for each customer that purchases a holiday from an ultimate seller and has no involvement in the transaction after it has put the customer in touch with the ultimate seller. The seller is acting as agent and its turnover should include only the fees it receives from the ultimate seller.

- G71** A department store provides space for concessionaires to sell products and receives a fixed amount of rental income from the concessionaire. An analysis of the factors discussed in paragraphs G63 – G66 shows that the concessionaire is acting as principal in an exchange transaction with its customers and is entitled to the amounts received from the sale of the goods and services. In these circumstances, the concessionaire should include within its turnover the amounts received or receivable in respect of the sale of the goods and services. The department store should not include within its turnover the value of the concessionaire’s sales.

Disclosure – seller acts as agent

- G72** Where a seller acts as agent, it is encouraged, where practicable, to disclose the gross value of sales throughput as additional, non-statutory information. Where such disclosure is given, a brief explanation of the relationship of recognised turnover to the gross value of sales throughput should be given.

THE DEVELOPMENT OF THE APPLICATION NOTE

THE NEED FOR GUIDANCE ON REVENUE RECOGNITION

- 1 The absence of a UK standard dealing explicitly with revenue recognition has been a source of muted but continuing criticism for some time. Different entities and industries have followed practices that are in some respects inconsistent with one another. More generally, there are different views of what revenue is or represents, and of how financial statements should portray a business's operating activities.
- 2 In practice, those seeking guidance on whether or when to recognise revenue have turned to International Accounting Standards (IAS) or accounting standards adopted in the United States. The international standard, IAS 18 'Revenue', was originally issued in 1982 and substantially revised in 1993. US requirements on the subject are to be found in various standards issued by the Financial Accounting Standards Board (FASB) and pronouncements of its Emerging Issues Task Force; the US Securities and Exchange Commission has also issued a relevant Staff Accounting Bulletin (SAB 101 'Revenue Recognition in Financial Statements' issued in 1999).
- 3 In recent years it has become common for investors in certain industries and start-up businesses to focus on revenue growth as an important indicator of a company's ability to meet its targets and achieve (or regain) profitability. This has led to, or highlighted, certain divergences in accounting treatments, some of which have been eliminated by pronouncements of the Urgent Issues Task Force, addressing specific issues. The Board therefore took the subject of revenue recognition on to its agenda and in July 2001 issued a Discussion Paper 'Revenue Recognition'.

- 4 A challenge for all standard setters in addressing this subject has been the need to tie in the principles of revenue recognition with other development work in progress. In September 2002 the International Accounting Standards Board and the FASB agreed to combine their work on this subject into a joint project that focused on the recognition of revenue based on the recognition of changes in assets and liabilities.
- 5 The Board considered whether it should develop its Discussion Paper into a new Financial Reporting Standard. It decided against this course of action for two reasons. First, in accordance with its convergence policy the Board intends to issue full standards on major topics of concern only after consultation with the Board's international partners. Secondly, at this stage the principles underlying the international project on revenue recognition have not yet been determined.
- 6 Nevertheless, questions continue to arise on accounting practices in this area. The Board has therefore issued this Application Note to promote the consistent treatment of exchange transactions that are reported as turnover.

THE RATIONALE OF THE APPLICATION NOTE

- 7 The Application Note contains basic principles of revenue recognition which set out the general approach and should be applied in all cases. These are accompanied by specific guidance for five types of transactions which give rise to turnover and have been subject to differing interpretations in practice.
- 8 The Application Note is based on the principle that a seller generates revenue by performing its contractual obligations and in exchange obtains the right to consideration. This entitles the seller to recognise either:
 - (a) an increase in assets (such as a debtor); or

- (b) a decrease in liabilities (normally the release from an obligation arising from receipt of a payment in advance of performance).
- 9 The principle that a seller generates revenue by performing its contractual obligations to the customer is consistent with the idea of performance under the law of contract.*
- 10 The intention of the Application Note is to codify existing good practice and ensure that entities report turnover in accordance with the substance of their contractual arrangements with customers.

MATTERS CONSIDERED IN THE LIGHT OF RESPONSES TO THE EXPOSURE DRAFT

- 11 This Application Note is based on an Exposure Draft which was published in February 2003. The following paragraphs give further details of the Board's reasoning for the requirements of the Application Note and explain changes made to the Exposure Draft.

The basic principles

The right to consideration

- 12 The Exposure Draft contained the basic principle that the seller obtains 'the right to be paid' in return for its performance of its obligations under a contractual arrangement. Some respondents were unclear as to what was meant by this right and how the proposals were linked to the seller's performance of its contractual obligations. The Exposure Draft stressed that the right to

* *Sir Guenter Treitel, in 'The Law of Contract' makes the point as follows:*

"A party who performs a contract in accordance with its terms is thereby discharged from his obligations under it. Such performance also normally entitles him to enforce the other party's undertakings." (*Tenth edition*), 1999, (page 697).

be paid does not necessarily correspond to the falling due of stage payments. Nevertheless, a number of respondents queried what else this right might represent.

- 13 In agreeing a contract, the seller and the customer will wish to ensure that they minimise the risk of losses arising from default by the other party. One way in which this is achieved is through the specification of stage payments. Often these stage payments will reflect the seller's performance of its contractual obligations in providing something of value to the customer. However, an exact correspondence is not necessarily obtained with a claim for stage payments; stage payments may fall short of or exceed the right to consideration that the seller has obtained through its performance.
- 14 The right to consideration does not represent a contractual right to demand stage payments from the customer. Rather, a seller obtains the right to consideration in exchange for the performance of its obligations under a contractual arrangement with a customer. This approach avoids the recognition of revenue being distorted by the timing of payment; to do so would move towards cash accounting. This would lead to a lack of comparability and allow wide discretion in reporting revenue.
- 15 The Application Note contains a definition of performance to emphasise the importance of the seller's performance. Furthermore, in the interests of clarity, the Application Note uses the term 'the right to consideration' in place of 'the right to be paid' to emphasise that this right does not necessarily correspond to stage payments. The Application Note stresses that a seller recognises revenue when, and to the extent that, it obtains this right as a result of its performance of its contractual obligations.

The measurement of revenue

- 16 The Exposure Draft proposed that revenue should be measured at the fair value of the consideration receivable. It noted that this would normally be the amount specified in the contractual arrangement, with adjustments made, where material, for the time value of money and risk. A number of respondents suggested that this requirement would result in widespread changes to current practice.
- 17 The difficulty stems from the fact that, while the great majority of transactions are conducted at fair value, the amounts at which these are reported in financial statements depart, to some degree at least, from a strict representation of fair value. If the seller's right to consideration were to be stated at fair value, strictly, it should reflect both a discount in respect of any interest free period and an allowance for possible default by the debtors.
- 18 The Board is concerned that adjustments should be made to the price specified in the contractual arrangement in those cases where revenue would otherwise be materially overstated. This might be the case where the buyer makes payments on interest free credit over a number of years, or where at the time of the sale, the seller knows that there is a significant risk about the customer's ability to pay. This is made clear in paragraphs G8 and G9.
- 19 The Board believes that the Application Note achieves a reasonable accommodation between the principle that revenue should be recognised at fair value, which it asserts, and the present state of international practice in this area. It notes that this is consistent with the requirements of IAS 18 (paragraphs 9 – 12).

Payment received in advance of performance

- 20 A contract may require the customer to make payment in advance of the seller's performance. In such situations the seller recognises a liability equal to the amount of consideration received, representing its obligation under the contract. The seller is released from its obligation when its performance under the contract earns it the right to consideration.
- 21 The Application Note requires that liabilities relating to payments received in advance are reported at the amount the seller has received, for taking them on, which is their entry value. Some respondents to the Exposure Draft observed that the use of entry value reflected a fundamental assumption in this area which required debate.
- 22 The Board agrees that the measurement of assets and liabilities is a fundamental issue and is participating in various initiatives which it is hoped will develop thinking in the UK and elsewhere on these issues. The Application Note is not intended to pre-empt the outcome of this work. The Board notes, however, that this requirement of the Application Note reflects the prevailing practice in the UK and the Republic of Ireland.
- 23 In the Board's view there are also conceptual reasons for reporting liabilities for payments in advance at the amount received. In the normal case of a profitable contract the amount received will be greater than the expected cost of performance. On making a payment in advance, the customer will have a claim on the entity to receive value for the amount paid. If the liability were reported at the cost of performance, the financial statements would not faithfully report the entity's obligation to its customer. Reducing the liability would also give rise to a reported gain, which might suggest that the success of the business in a particular

period depended on obtaining orders rather than satisfying customers.*

Partial performance

- 24 Some respondents requested further clarification as to how the principles in the Exposure Draft should be applied to situations where the seller's contractual performance is incomplete.
- 25 The final Application Note contains additional guidance on this issue. It states that there will be some arrangements where the seller obtains 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, the Application Note stresses that it recognises revenue to the extent that it has obtained the right to consideration through the performance of its contractual obligations in supplying goods and services.
- 26 Obtaining the right to consideration does not necessarily involve delivery or the transfer of title. For example, if a seller is constructing a building to a customer's design, the customer may gain neither title nor physical custody until construction is complete. Nevertheless, the seller obtains the right to consideration through its performance as construction activity progresses, reflecting the value of the work performed to date.

Sales tax

- 27 The current treatment of sales tax is well established and is set out in both legal requirements and in other accounting standards.

* This issue is explored in greater depth in 'Liabilities and how to account for them: an exploratory essay', which is available at www.asb.org.uk/public/downloads.cfm

- (a) Section 262 (1) of the Companies Act 1985* defines turnover in relation to a company as the amounts derived from the provision of goods and services falling within the company's ordinary activities, after deduction of:
 - (i) trade discounts,
 - (ii) value added tax, and
 - (iii) any other taxes based on the amounts so derived.
- (b) SSAP 5 'Accounting for value added tax' requires that turnover should exclude VAT on taxable outputs.

28 The final Application Note contains guidance on the treatment of sales taxes which is consistent with the requirements noted in paragraph 27 above.

Specific guidance

29 As well as setting out basic principles of revenue recognition, the Application Note also provides specific guidance in areas that have given rise to either inconsistency in practice or inappropriate accounting.

Long-term contractual performance

30 SSAP 9 contains guidance for the accounting and disclosure by a seller of its performance under a long-term contract. The Application Note also contains guidance for the recognition of turnover on such contracts and does not amend the requirements of SSAP 9.

* The corresponding provision in Northern Ireland is Article 270(1) The Companies (NI) Order 1986, inserted by The Companies (NI) Order 1990 (SI 1990/593) (NI 5) Article 24; and in the Republic of Ireland, Paragraph 75, Schedule to Companies (Amendment) Act 1986.

- 31 Some respondents to the Exposure Draft commented that SSAP 9 was already adequate in prescribing the treatment in this area. It was also suggested that the guidance in the Exposure Draft could change existing practices as set out in SSAP 9, on the grounds that the Exposure Draft advocated a move away from measuring performance as the proportion of costs incurred to date in comparison with total expenditure.
- 32 SSAP 9 does not require costs incurred to date to be used in measuring turnover in a long-term contract. Paragraph 9 notes that the profit taken up needs to reflect the proportion of work carried out at the accounting date. There will be contracts where costs incurred to date do reflect the work performed and in such circumstances it would be appropriate to use the proportion of costs incurred in comparison with total expenditure in measuring revenue; however, this will not always be the case. The incurrence of costs by a seller, does not, in itself, justify the recognition of revenue. The Application Note therefore re-emphasises that the key principle in recognising revenue is the seller's performance of its contractual obligations.

Separation and linking of contractual arrangements

- 33 Most respondents were supportive of the proposals in the Exposure Draft which provided guidance on when the seller should combine or unbundle any separate components contained in a single contractual arrangement.
- 34 The Exposure Draft noted that one of the requirements for the unbundling of a contractual arrangement was whether or not reliable fair values could be attributed to at least the uncompleted components. Some respondents were unsure as to the degree of reliability that was required.

- 35 The existence of measurement uncertainty is acknowledged in the criteria for the recognition of an asset. This requires that the monetary amount at which an asset is to be measured is capable of being measured with sufficient reliability. As discussed in the Board's Statement of Principles, if uncertainty exists, the only way to determine an appropriate monetary amount is through the use of estimates.
- 36 However, in order for the seller to account for a contractual arrangement as separate transactions, the Application Note requires that the individual components operate independently and represent goods or services that the seller can provide on a stand alone basis or as an optional extra. Therefore, if the components do operate independently, the seller should be able to arrive at a measure that is sufficiently reliable to meet the asset recognition criteria.

Separation and linking of contractual arrangements - vouchers

- 37 The Board received requests from respondents to clarify the accounting treatment of points schemes and money-off coupons. The final Application Note therefore contains additional guidance in respect of revenue recognition in this area. It uses the term 'vouchers' which is intended to encompass all types of arrangements where the seller is committed to perform in the future at a reduced price.
- 38 The Board notes that issues might also arise as to whether the seller might have an onerous contract, for example if the exercise of the vouchers would result in products being sold at a loss. Where this is the case, it will be necessary to consider whether the vouchers give rise to an obligation on the part of the seller. Where an entity is obliged to supply goods or services at a loss, that is an onerous contract and provision will need to be made in accordance with FRS 12 'Provisions, Contingent Liabilities and Contingent Assets'.

Separation and linking of contractual arrangements – inception fees

- 39 The Exposure Draft contained proposals on when the seller should record turnover in respect of non-refundable fees. In the final Application Note, the term ‘inception fees’ has been used in place of non-refundable fees. That is because the principle as to when the seller should recognise turnover in respect of a fee does not necessarily depend on whether or not a fee is refundable. Whilst the fact that a fee is stated to be non-refundable may suggest that the seller has no further performance obligations in respect of that fee, in some cases an obligation to provide goods or services may remain.

Bill and hold arrangements

- 40 Most respondents agreed with the guidance in the Exposure Draft on bill and hold arrangements. Some, however, disagreed with the condition that the goods should be identified separately from the seller’s other stock in order for the seller to recognise revenue. It was suggested that the separate identification of the goods should not be necessary where the item is fungible.
- 41 The Board reconsidered this point when finalising the Application Note. It concluded that the buyer would not have the principal benefits and risks until the goods have been identified separately from the seller’s other goods; the seller would continue to bear these benefits and risks until that time. This condition was therefore retained in the final Application Note. The Board also noted that this requirement is consistent with both IAS 18 and SAB 101.

Sales with rights of return

- 42 Most respondents agreed with the proposals in the Exposure Draft which required the seller to exclude from turnover the sales value of estimated returns. However, some respondents were concerned that the

proposals would require extensive changes to ‘point of sale’ systems in order to capture the required information on returns.

- 43 The Board’s subsequent research has indicated that a seller will generally be able to estimate reliably the level of returns without the need for extensive systems changes. The final Application Note stresses that a seller will generally be able to derive a reliable estimate from historical experience of the proportion of comparable goods returned as a proportion of comparable sales.
- 44 Some respondents suggested that the proposals on sales with rights of return were inconsistent with the derecognition principles of the FRS. The Board debated this issue during the development of the Exposure Draft and, for the reasons outlined below, believes that the provisions are consistent with the FRS.
- 45 The Board noted that the FRS requires that an entire asset should be derecognised when a transaction transfers all significant rights or other access to benefits and all significant exposure to the risks inherent in those benefits. The FRS also contains requirements (paragraph 23) which cover transactions that have resulted in a significant change in the entity’s rights to benefits and exposure to risk, but where the provisions for full derecognition are not met. This might be where a transaction involves a transfer of all of the item for all of its life, but where the entity retains some significant right to benefits or exposure to risk. In such circumstances, the FRS requires the description or monetary amount to be changed and a liability recognised for any obligations to transfer benefits that are assumed.
- 46 A particular issue raised by some respondents was a perceived inconsistency between the requirements of the FRS in respect of receivables “sold” or securitised with full recourse to the seller (Application Notes C and D)

and the treatment proposed in the Exposure Draft for expected returns of goods sold. No sale recognition was given to the former, to the extent that there was any possibility that the receivables could be put back to the transferor; for goods sold, however, the Exposure Draft proposed, and the final Application Note confirms, that revenue should generally be recognised after making an estimate of future returns.

47 The Board concluded that a different approach was needed to reflect a fundamental difference in the effect of the two transactions. A “sale” of receivables with full recourse does not change in the slightest the exposure of the seller to the benefits and risks attaching to the receivables: the speed of collection and the incidence of defaults are both borne by the seller to the same extent as if no transaction had taken place. The only effect is a cash advance, which should be recognised as a liability. By contrast, a normal sale of goods with rights of return is a significant event for the seller in that it transfers the great majority of the benefits and risks relating to the goods (for example, the purchaser is able to use the goods as it wishes and is exposed to the risk of subsequent damage). For the seller, subject to a provision for the return of some portion, the sale crystallises the profit from the production/sale process.

48 The objective of the FRS is to ensure that the substance of an entity’s transactions are reported in its financial statements and that the commercial effect should be faithfully represented. The Board believes that the requirements on sales with rights of return are consistent with this objective and with the provisions of the FRS.

Presentation of turnover as principal or as agent

49 Respondents were generally supportive of the proposals in the Exposure Draft which provided guidance as to whether the seller should be regarded as acting as

principal or agent in an exchange transaction with a customer.

- 50 In determining whether the seller is acting as principal or agent, the final Application Note gives greater prominence to the question of whether the agency relationship is disclosed. It states that where the seller has not disclosed that it is acting as agent, there is a rebuttable presumption that it is acting as principal.
- 51 The Board received requests to clarify the application of the principles in the Exposure Draft to trading concessions operated in department stores. The Board recognises that there are a wide variety of potential arrangements between department stores and concessionaires. However, where the department store is not acting as principal in an exchange transaction with the concessionaire's customers, it would be inappropriate for the department store to include within its own revenue the value of the concessionaire's sales. The final Application Note makes this clear.

Disclosure of accounting policies

- 52 The Board believes that preparers should provide disclosures that will help users understand the entity's adopted accounting policies and how they have been applied. This is one of the objectives of FRS 18 'Accounting Policies', which stresses that sufficient information should be provided in the financial statements to meet this objective. Entities should therefore have regard to the requirements of that standard when considering the disclosures required in respect of accounting policies. The Board's statement on the 'Operating and Financial Review' also contains guidance on accounting policies. It stresses the fact that the Operating and Financial Review should highlight accounting policies that are key to an understanding of the entity's performance and financial position.

Implementation

- 53 The Board considered whether or not special transitional arrangements should be included in the final Application Note and concluded that they were not required. Accordingly, on implementation an entity should compare its current accounting for revenue with the requirements of this Application Note. If any change is required, it should consider whether this represents a change of accounting policy or of estimation technique in accordance with FRS 18 'Accounting Policies'.

DISSENTING VIEW

Mr Wild dissents from the issue of this Amendment to FRS 5 because he believes that the Application Note it inserts, rather than significantly improving the quality of UK financial reporting, could introduce sufficient confusion over the principles to be adopted to have a detrimental effect on such reporting.

Internationally, revenue recognition is the subject of a joint project by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) in the US. Mr Wild agrees that the ASB should not seek to issue a comprehensive revenue standard until the IASB and FASB have completed their review and accepts that the Application Note is intended to be an interim measure. However, he believes the Application Note is an inadequate compromise between a desire to establish principles and a desire to avoid major changes to existing practice for the majority of transactions. As a result, to the extent that current practice is open to abuse, the requirements of the Application Note are not sufficiently precise or clear to prevent it. Moreover, the inconsistent application of underlying principles, in favour of the status quo, may create confusion and, perhaps, extend opportunities for abuse.

Examples of aspects of the Application Note which particularly concern Mr Wild in this way are set out below.

- The requirement to measure revenue at the fair value of the right to consideration means, in principle, that account has to be taken of both the time value of money and the risk of default. While Mr Wild acknowledges that this principle may well be appropriate in the context of a full revenue standard, and is indeed set out in the international standard on revenue, he notes that it is not consistently applied in practice either in the UK or elsewhere. The Application Note attempts to reconcile

this theory with practice by suggesting that existing practice is adopted merely on the grounds of materiality. Mr Wild thinks this leaves the position unhelpfully ambiguous for many entities.

- Mr Wild believes the treatment of sales with rights of return contradicts principles set out in other Application Notes to FRS 5. While in his view the treatment of sales with rights of return is appropriate to the current state of development of principles for revenue recognition, it is inconsistent with the existing requirements for the derecognition of items as a result of arrangements carried out other than as part of the normal business operating cycle. Consequently the various Application Notes seem to specify different treatments depending on the intent of the directors on any particular occasion. He thinks the confusion resulting from such an apparently self evident contradiction between the requirements of different Application Notes to the same standard could lead to those Application Notes being undermined, and could be exploited by those seeking to construct complex financial arrangements.

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