

Accounting and Reporting Policy

FRS 102

Staff Education Note 7

Revenue recognition

Disclaimer

This Education Note has been prepared by FRC staff for the convenience of users of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. It aims to illustrate certain requirements of FRS 102, but should not be relied upon as a definitive statement on the application of the standard. The illustrative material is not a substitute for reading the detailed requirements of FRS 102.

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Introduction

This Staff Education Note provides a comparison of revenue recognition requirements set out in Section 23 *Revenue* of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and current UK accounting standards including:

- (a) FRS 5 *Reporting the substance of transactions*;
- (b) SSAP 9 *Stocks and long-term contracts*; and
- (c) UITF abstract 40 *Revenue recognition and service contracts*.

This Staff Education Note is written to highlight key areas of consideration when transitioning to FRS 102 and is not designed to be exhaustive. In practice, for the majority of entities, there will be no significant changes to the recognition of revenue.

Basic Principles

Scope and recognition

FRS 5 – Application Note G	FRS 102
<p>Applies to any activity giving rise to revenue.</p> <p>Provides that a seller recognises revenue when it obtains the right to consideration in exchange for its performance.</p> <p>(FRS 5 paragraph G4)</p> <p>Provides areas of specific guidance for a number of specified types of transactions (FRS 5 paragraph G1).</p>	<p>Provides recognition criteria for:</p> <ul style="list-style-type: none"> (a) the sale of goods; (b) rendering of services; (c) construction contracts in which the entity is the contractor; and (d) interest, royalties and dividends. <p>(FRS 102 paragraph 23.1).</p>

There appears to be no difference in the basic scope and recognition principles.

Measurement

FRS 5 – Application Note G	FRS 102
<p>Requires revenue to be measured at the fair value of the right to consideration.</p> <p>(FRS 5 paragraph G7)</p>	<p>Requires revenue to be measured at the fair value of the consideration received or receivable.</p> <p>(FRS 102 paragraph 23.3)</p>

If consideration is received or receivable, then it follows that the entity has a right to that consideration (under a contractual arrangement). Likewise, if an entity has a right to consideration, that consideration would be receivable by the entity.

Therefore, there appears to be no difference in the basic measurement principle.

Discounting

FRS 5 – Application Note G	FRS 102
<p>States that where the effect of the time value of money is material, the amount of revenue recognised should be the present value of the cash inflows expected to be received.</p> <p>(FRS 5 paragraph G8)</p>	<p>Requires that where payment is deferred under a financing transaction, the fair value of the consideration is measured as the present value of all future receipts determined using an imputed rate of interest.</p> <p>This imputed rate of interest is either the prevailing rate for a similar instrument of an issuer with a similar credit rating or a rate that discounts the nominal value of the instrument to the current cash sales prices of the goods or services.</p> <p>(FRS 102 paragraph 23.5)</p>

Both standards permit discounting, therefore there does not appear to be any significant difference in the treatment of deferred payment arrangements, although FRS 102 is more prescriptive regarding the discount rate.

Risk of default

FRS 5 – Application Note G	FRS 102
<p>Requires that where, at the time revenue is recognised, there is a significant risk that there will be default, then an adjustment is made to the amount of revenue recognised.</p> <p>(FRS 5 paragraph G9)</p>	<p>Requires that revenue is measured at the fair value of the consideration received or receivable. Although it does not explicitly address the risk of default at the time of recognition, a fair value measurement would be expected to reflect any significant credit risk.</p> <p>Further, the revenue recognition criteria for the sale of goods or the rendering of services, requires that revenue is recognised only when it is probable (more likely than not) that the economic benefits will flow to the entity.</p> <p>(FRS 102 paragraph 23.10(d) and 23.14(b))</p>

Where there is a risk of default at the time of revenue recognition, FRS 5 takes this into account when measuring revenue, which at the extreme could result in no revenue being recognised at that time. FRS 102 requires that, if the risk of default is so high that it is not probable that any payment would be received, no revenue should be recognised until receipt is probable. Therefore in practice the amount recognised may not differ.

Detailed recognition requirements

Point of recognition for sale of goods

FRS 5	FRS 102
<p>Treats the sale of goods as derecognition of the stock and recognition of a new asset, usually a debtor.</p> <p>Evidence that an entity has rights or other access to benefits (and hence has an asset) is given if the entity is exposed to the risks inherent in the benefits, taking into account the likelihood of those risks having a commercial effect in practice.</p> <p>(FRS 5 paragraph 17)</p> <p>An asset should be recognised if:</p> <ul style="list-style-type: none"> (a) there is sufficient evidence of the existence of the item (including, where appropriate, evidence that a future inflow or outflow of benefit will occur); and (b) when the item can be measured at a monetary amount with sufficient reliability. <p>(FRS 5 paragraph 20)</p>	<p>Requires that an entity shall recognise revenue from the sale of goods when all the following conditions are satisfied:</p> <ul style="list-style-type: none"> (a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods; (b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold; (c) the amount of revenue can be measured reliably; (d) it is probable that the economic benefits associated with the transaction will flow to the entity; and (e) the costs incurred or to be incurred in respect of the transaction can be measured reliably. <p>(FRS 102 paragraph 23.10)</p>

There is unlikely to be any significant difference in the recognition of revenue recognised on the sale of goods.

Revenue recognition for rendering of services

SSAP 9, UITF Abstract 40	FRS 102
<p>Under SSAP 9, once the outcome of a long-term contract can be assessed with reasonable certainty, attributable profit is calculated on a prudent basis and revenue recognised accordingly.</p> <p>(SSAP 9 paragraph 9)</p>	<p>Requires that when the outcome of a transaction can be estimated reliably, an entity shall recognise revenue associated with the transaction by reference to the stage of completion of the transaction at the end of the reporting period.</p> <p>The outcome of a transaction can be estimated reliably when all the following conditions are met:</p> <ul style="list-style-type: none"> (a) the amount of revenue can be measured reliably; (b) it is probable that the economic benefits associated with the transaction will flow to the entity; (c) the stage of completion of the transaction at the end of the reporting period can be measured reliably; and (d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably. <p>(FRS 102 paragraph 23.14)</p>

There does not appear to be any significant difference between FRS 102 and SSAP 9 regarding the point at which profit may first be recognised on a long-term contract for the rendering of services. The SSAP 9 requirement for the outcome to be reasonably certain is normally equal to a reliable estimate.

Amount of revenue recognised on service contracts

SSAP 9, UITF Abstract 40	FRS 102
<p>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 (ascertained in a manner appropriate to the stage of completion of the contract, the business and the industry in which it operates) and the related costs.</p> <p>(SSAP 9 paragraphs 8 and 9)</p>	<p>When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue is calculated by reference to the stage (or percentage) of completion of the transaction at the end of the reporting period. Further guidance is provided on applying the method.</p> <p>(FRS 102 paragraph 23.14)</p>
<p>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.</p> <p>(UITF Abstract 40 paragraph 19)</p> <p>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.</p> <p>(UITF Abstract 40 paragraph 28)</p>	<p>When services are performed by an indeterminate number of acts over a specified period of time, an entity recognises revenue on a straight-line basis over the specified period unless there is evidence that some other method better represents the stage of completion. When a specific act is much more significant than any other act, the entity postpones recognition of revenue until the significant act is executed.</p> <p>(FRS 102 paragraph 23.15)</p>
<p>Where the outcome of long-term contracts cannot be assessed with reasonable certainty before the conclusion of the contract, no profit should be reflected in the profit and loss account in respect of those contracts, although in such circumstances, if no loss is expected it may be appropriate to show as turnover a proportion of the total contract value using a zero estimate of profit.</p> <p>(SSAP 9 paragraph 10)</p>	<p>When the outcome of the transaction involving the rendering of services cannot be estimated reliably, an entity shall recognise revenue only to the extent of the expenses recognised that are recoverable.</p> <p>(FRS 102 paragraph 23.16)</p>
<p>If it is expected that there will be a loss on a contract as a whole, all of the loss should be recognised as soon as it is foreseen.</p> <p>(SSAP 9 paragraph 11)</p>	<p>When it is probable that total contract costs will exceed total contract revenue, the expected loss shall be recognised as an expense immediately.</p> <p>(FRS 102 paragraph 23.26)</p>

The facts of each contract will need to be reviewed in detail to determine if there is any change the timing or amount of the revenue recognised, although the requirements of the two standards are similar. Contingent fee arrangements will normally be accounted for under paragraphs 23.14 to 23.16 of FRS 102.

Unbundling of contracts

FRS 5 Guidance Note G	FRS 102
<p>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 components(s) may be capable of being provided by another supplier.</p> <p>(FRS 5 Guidance Note G paragraph G25)</p> <p>Conversely, the commercial substance of two or more separate contracts may require them to be accounted for as a single transaction.</p> <p>(FRS 5 Guidance Note G paragraph G26)</p>	<p>An entity shall apply the recognition criteria to the separately identifiable components of a single transaction when necessary to reflect the substance of the transaction. For example, when the selling price of a product includes an identifiable amount for subsequent servicing.</p> <p>Conversely, an entity applies the recognition criteria to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole. For example, when an entity sells goods and, at the same time, enters into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction.</p> <p>(FRS 102 paragraph 23.8)</p>

Both FRS 102 and current UK accounting standards require a single contract to be accounted for as two or more separate transactions where this is necessary to reflect the commercial substance.

They also both require that more than one contract is considered together where this is necessary to understand and reflect the commercial substance.

Contracts for multiple services

UITF Abstract 40	FRS 102
<p>Only contracts for services that constitute a single service, or a number of services that constitute a single project, are accounted for as long-term contracts.</p> <p>(UITF Abstract 40 paragraph 11 and 24)</p> <p>A contract to provide services on an on-going basis, for example a contract to provide repetitive services, is not accounted for as a long-term contract.</p> <p>(UITF Abstract 40 paragraph 12 and 26)</p> <p>Therefore, the entity would recognise revenue when and to the extent that it obtained the right to consideration in exchange for performance under FRS 5, which would be on the basis of each service performed.</p>	<p>For a contract for services, where those services are performed by an indeterminate number of acts over a specified period of time, an entity recognises revenue on a straight-line basis over the specified period unless there is evidence that some other method better represents the stage of completion.</p> <p>(FRS 102 paragraph 23.15)</p>

In practice, since under current UK accounting standards revenue would be recognised as each service (or number of services that constitute a single project) is performed and under FRS 102 revenue would be recognised using a method representing the stage of completion, the recognition of revenue would generally be the same under both standards.