



CHARTERED CERTIFIED ACCOUNTANTS

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Revenue Recognition

The concept of revenue recognition can be a complex issue and in recent years has been the subject of some high profile accounting restatements – particularly in the US. Undeniably, there can be a temptation to manipulate revenue for various reasons and it is for this reason that standard setters are particularly keen on the principles of revenue recognition. In addition, there can sometimes be considerable tax implications if revenue is inappropriately recognised or if it is deferred inappropriately.

This article looks at some of the issues concerning revenue recognition. Revenue recognition is dealt with in IAS 18 'Revenue', Application Note G (ANG) to FRS 5 'Reporting the Substance of Transactions' and in FRSSE. For the purposes of this article we will look at the provisions in FRS 5, though the FRSSE equivalent also follows the principles in ANG.

Definition of revenue

ANG does not define the term 'revenue'. The basic principle to be applied when considering revenue is to decipher whether there is either an increase in an asset (i.e. debtors) or a reduction in a liability (for example where a customer has made an advance payment and the reporting entity has fulfilled some of its obligations). ANG does, in fact, define 'turnover' as:

'the revenue resulting from exchange transactions under which a seller supplies to customers the goods or services that it is in business to provide'.

Figure 1

A motor dealer is in the business of selling new and used vehicles. It has a fleet of demonstration vehicles which it allows customers to test drive before they decide to purchase. The dealer adopts a policy of using the demonstration vehicles for one year and then selling the vehicles on. The question is does the sale of one of the used vehicles constitute revenue or is it a fixed asset disposal?

As the motor dealer is in the business of selling new and used vehicles then the sale of one of the demonstration vehicles would constitute turnover.

Figure 2

Company A Ltd is a distributor of construction equipment and has recently expanded its operations to the extent that they have had a purpose-built distribution centre built for them and have sold their old building. The company has sold its previously occupied building for £500,000.

The sale of the company's premises would not give rise to turnover because ANG at paragraphs G11 and G12 makes it clear that the sale of company premises would be a fixed asset disposal and as such the gain or loss on disposal of the company premises would be reported separately after operating profit to accord with FRS 3 '*Reporting Financial Performance*'.

Long-term contractual performance

Long-term contracts are also covered in the provisions contained in SSAP 9 '*Stocks and Work-in-Progress*' and are specific to long-term contract accounting.

Long-term contracts need to be assessed on a contract by contract basis. Turnover and related costs are accounting for in the profit and loss account as contract activity progresses. A typical calculation is as follows:

Total contract revenue x % of completion = Revenue to be recognised at the period/year end

Figure 3

A contractor has a fixed price contract for £12,000. The total estimated costs amount to £7,500 resulting in an expected profit of £4,500. At the end of year 1 the contract is estimated to be 40% complete.

As the contract is deemed to make a profit then the company should record (£12,000 x 40%) £4,800 in turnover. It should also recognise (£7,500 x 40%) £3,000 in costs resulting in a profit being recognised of £1,800 being recognised in year 1.

If the contract was estimated to make a loss of, say £1,000, then the company should still recognise £4,800 in turnover but then £5,800 of costs to result in a loss being recognised of £1,000. Paragraph 11 of SSAP 9 states that where losses are foreseen, they should be recognised as soon as they are foreseen.

ANG provides additional guidance as opposed to overruling SSAP 9. SSAP 9 still contains the rules on long-term contract accounting.

UITF Abstract 40

The Urgent Issues Task Force issued Abstract 40 on 10 March 2005 which gave rise to considerable controversy within the profession. This was because prior to the issue of UITF 40, entities such as professional partnerships (firms of solicitors and accountants etc) recognised revenue in their financial statements when fee notes were raised. Any work-in-progress was simply carried forward to the next accounting period. UITF 40 says that revenue should be recognised when the entity obtains a 'right to consideration'.

Of course, it can sometimes be difficult to establish when a right to consideration has been obtained. Most accountants' view is that no right to consideration exists until the work is complete (a half completed tax return is often cited). On the basis that no right to consideration exists then no revenue or profit is recognised and work-in-progress is carried forward to the next accounting period. This defers profit and thus the associated tax liability.

Where the view is that a right to consideration exists throughout an assignment then all such activity must be accounted for as revenue and no work-in-progress is carried forward in the balance sheet. This then accelerates revenue and profit and thus tax liabilities will also be accelerated. HMRC did introduce 'spreading provisions' but in order for the spreading provisions to be granted, the reporting entity's accounting policy must be GAAP compliant.

Payments in advance

Where a company receives payments in advance, these payments do not represent turnover because they have not been earned. The company receiving the payment has to fulfil its obligations to its customer. Until the seller fulfils its obligations, then the increase in cash is matched by an increase in liabilities which represents the company's obligation owed to its customer.

Payments in advance can also relate to invoices issued to customers which span two accounting periods. For example if a company's year-end is 31 March 2009 and it invoices its customer on 31 March 2009 for services for the period 1 April 2009 to 30 September 2009, then the company should recognise the sale in the next accounting period (the year to 31 March 2010).

Bill and hold arrangements

Under these types of arrangements, legal title to the goods passes before the goods have been delivered.

Under normal circumstances, revenue on the sale of goods will only ever be recognised when the performance conditions have been satisfied e.g. delivery of the goods to the buyer. Normally customers might place an order for goods and then take delivery and the seller would recognise turnover upon delivery of the goods to the customer. However in order for sales to be recognised as 'bill and hold arrangements' there have to be some specific conditions to distinguish bill and hold arrangements from executory contracts. The conditions are:

- The goods should be complete and ready for immediate delivery.
- The seller does not retain any significant performance obligations other than simply storing the goods safely and arranging for their delivery at the customer's request.
- The seller should have the right to be paid regardless of whether the goods are shipped (subject to any rights of return).
- The goods are capable of being separately identified and not be capable of being used to fulfil other orders.

- The terms of the bill and hold sale should be in accordance with the customer's commercial objectives and not those of the seller.

Rights of return

It is very common for clients in the retail industry to have a policy of giving refunds on returned goods regardless of whether the goods are defective or not. Rights of return can be explicit or implicit in contractual arrangements and can also arise through statutory requirements. Turnover should exclude the sales value of expected returns. The retailer should be able to estimate reliably the sales value of the returns by looking at historical trends, for example looking at the amount of similar goods that have been returned in the past as a proportion of total sales of that particular product.

However, where the seller cannot reliably estimate the value of future returns, it should calculate the maximum amount possible that it could be required to pay back to its customers.

Figure 4

A retailer sells a range of jumpers for £20 each. The cost to the retailer is £10 and the retailer's returns policy allows customers to return goods within 28 days of purchase if the jumpers are unworn and undamaged. Historical trends have shown that approximately 10% of these jumpers will be returned by customers with half of them being resold.

The retailer should recognise $£20 - (10\% \times £20 = £2) = £18$ as turnover with the remaining £2 being recognised as a provision for returned goods. Cost of sales on each sale is the cost of the jumpers at £10 less $(£10/£20 \times 50\% = £0.25)$, therefore £9.75. The 25p reduction in stock will partially offset the provision for returns.

Warranties

Manufacturers of goods will often include a warranty. In addition, customers can also purchase an extended warranty.

Figure 5

A manufacturer of hairdryers places a 1 year warranty on its products. Customers can also purchase warranties to cover years 2 and 3.

Where customers take up the extended warranty, then the revenue should be deferred and recognised in turnover on a straight line basis over the period which the extended warranty is provided.

Presentation of turnover as principal or agent

In order to recognise turnover as principal, then all risks and rewards should be retained by the principal. Usually this will be evident by the ability to set the price of the goods and have exposure to the risks of technical obsolescence of the goods.

Where the seller acts as principal then turnover is the gross amount received or receivable in return for the principal's performance under the contract.

Where the seller acts as an agent then the commission the agent receives is reported as turnover. The commission is calculated as the amount billed to the customer less the amount paid to the principal.

Figure 6

Company A (the agent) arranges to ship goods to Company B on behalf of Company C (the principal). The terms of the arrangement are that Company B will pay Company A who will then pay Company C. Company A will take a 20% commission.

In the above example, Company A is acting as agent. It will receive payment from Company B which it will then pass on to Company C, less 20% commission. Company A should recognise the amount billed to the customer (Company B) less the amount paid to the principal (Company C) as turnover. It should not recognise any amounts in its turnover as agent that have to be paid to the principal.

This article has looked at some of the more contentious issues surrounding revenue recognition and accountants should look to the provisions of ANG to FRS 5 if they are unsure as to the correct accounting treatment of an item that may (or may not) need to be recognised as revenue.

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