REVENUE RECOGNITION

This article is relevant to the Diploma in International Financial Reporting and ACCA Qualification Papers F7 and P2

For almost all entities other than financial institutions, revenue is the largest single number in the financial statements. It is also a number that attracts a great deal of user attention. Whilst it might be accepted that profit is the most important single indicator of corporate financial performance revenue does not fall far behind. Indeed in many sectors, for example the retail food sector, revenue is a 'headline number' that is often announced first when results are communicated externally. In sectors where this is true, the remuneration packages of senior executives often include a 'performance related element' with revenue growth as the key determinant of 'performance'.

Given the importance of revenue to the picture painted by the financial statements is it important that it is measured and presented fairly so that the users are given useful information on which to base their performance appraisal. The International Accounting Standards Board (IASB) has issued two International Financial Reporting Standards (IFRSs) that provide guidance in this area:

- IAS 18 – Revenue.
- IAS 11 – Construction Contracts.

IAS 18 is the IFRS that deals with revenue for the majority of entities, whilst IAS 11 very much applies the principles of IAS 18 to entities in the construction sector. Both standards are principles based and short on detail (this is particularly true of IAS 18). Therefore this has led to calls by some users for a more rigorous approach that removes some of the uncertainty that is caused by the existing IFRSs. As a result, the IASB is currently examining the existing standards with a view to replacing them with a more comprehensive standard in the future.

In this article we will:

- Explain exactly what IAS 18 and IAS 11 mean by 'revenue'.
- Outline the principles that underpin the recognition and measurement of revenue.
- Review some of the implementation examples that are provided as an accompaniment to IAS 18.
- Outline the changes that are likely to the method of accounting for revenue in the future.

MEANING OF 'REVENUE'

IAS 18 defines revenue as 'the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in

increases in equity, other than increases relating to contributions from equity participants' *(1).* The following implications flow from this definition:
(a) Revenue should be stated before deduction of costs of sale. For example if goods are sold for $100 that cost the seller $60 to manufacture the revenue is $100, not $40.
(b) Revenue is recognised on the provision of goods and services that relate to the ordinary activities of the entity. If an entity disposes of property, plant and equipment at the end of its useful economic life the proceeds of disposal are not revenue for the entity. Instead the profit or loss on disposal is treated as a deduction from operating expenses (or as a separate line item in the statement of profit or loss, if it is sufficiently material).
(c) Sales taxes that are collected from the customer and remitted to the relevant authorities are not 'revenue'. For example if goods are sold for $110, inclusive of recoverable sales taxes of 10%, the revenue is $100, not $110.
(d) If the seller is acting as agent, rather than as the principal, in a transaction, the revenue the seller should recognise is the amount of commission receivable rather than the gross amount collected from the customer. For example, if a travel agent sells a holiday to a customer for $1,000 plus a commission of $100, so that the customer pays $1,100 and the travel agent remits $1,000 to the entity actually providing the holiday, then the travel agent recognises revenue of $100.

PRINCIPLES UNDERPINNING RECOGNITION OF REVENUE

IAS 18 outlines the recognition principles in three parts:

1. **Sale of goods:**

Revenue is recognised when all the following conditions have been satisfied *(2)*:
(a) The seller has transferred the significant risks and rewards of ownership of the goods to the buyer.
(b) The seller does not retain control over the goods or managerial involvement with them to the degree usually associated with ownership.
(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 seller
(e) The costs incurred or to be incurred by the seller in respect of the transaction can be measured reliably.

As far as these conditions are concerned, it is notable that:

- A number of the conditions ((a) and (b) particularly) are subject to a degree of interpretation and therefore there can be some uncertainty about whether or not revenue should be recognised.
- The conditions are such that all are likely to be satisfied at a particular point in time and so there is a critical point at which all the revenue from the sale of goods would be recognised. This approach contrasts with the approach taken to the recognition of revenue from the provision of services (see below):

2. Provision of services:

As stated above, there is a different approach taken to the recognition of revenue from the provision of services. IAS 18 states that 'where the outcome of a transaction involving the rendering of services can be estimated reliably, associated revenue should be recognised by reference to the stage of completion of the transaction at the end of the reporting period' *(3)*. In other words, the revenue is recognised gradually, rather than all at one 'critical point', as is the case for revenue from the sale of goods. IAS 18 further states that the outcome of a transaction can be estimated reliably when all the following conditions are satisfied *(3)*:

(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 seller.
(c) The stage of completion of the transaction at the end of the reporting period can be measured reliably.
(d) The costs incurred to date for the transaction and the costs to complete the transaction can be measured reliably.

IAS 18 does not prescribe one single method that should be used for determining the stage of completion of a service transaction. However the standard does provide some examples of suitable methods *(4)*:
(a) Surveys of work performed.
(b) Services performed to date as a percentage of total services to be performed.
(c) The proportion that costs incurred to date bear to the estimated total costs of the transaction.

If it is not possible to reliably measure the outcome of a transaction involving the provision of services (perhaps because the transaction is in its very early stages) then revenue should be recognised only to the extent of costs incurred by the seller, assuming these costs are recoverable from the buyer *(5)*.

Construction contracts

IAS 18 does not adequately address the issue of revenue recognition on a construction contract. However, IAS 11 applies the basic principles we have already identified to such contracts, which are defined in IAS 11 as follows *(6)*:
'Contracts specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use'.

Most construction contracts are 'fixed price contracts'. In such contracts the seller agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases could be subject to cost escalation clauses *(6)*.

Whilst a construction contract relates to the supply of goods, the 'critical event basis'

used in IAS 18 as a means of determining the timing of the recognition of revenue on the supply of goods is not really suitable. This is because the 'supply' by the seller in the case of a construction contract takes place gradually over the term of the contract. Therefore IAS 11 basically requires that, where the outcome of a construction contract can be recognised reliably, revenue on such contracts should be recognised according to the stage of completion of the contract *(7)*. IAS 11 imposes conditions very similar to the ones included in IAS 18 for the provision of services *(3)* that need to be satisfied before the outcome of a construction contract can be recognised reliably*(8)*:

(a) Total contract revenue can be measured reliably.
(b) It is probable that the economic benefits associated with the contract will flow to the seller.
(c) Both the seller's costs to complete the contract and the stage of contract completion at the end of the reporting period can be measured reliably.
(d) The seller's costs to date attributable to the contract can be clearly identified and measured reliably so that actual costs incurred can be compared with prior estimates.

As is the case with service revenue recognition in IAS 18, IAS 11 does not prescribe one single method of computing the stage of completion of a construction contract. IAS 11 provides the following examples of methods that might be suitable *(9)*:

(a) The proportion that contract costs incurred for work performed to date bear to total estimated contract costs.
(b) Surveys of work performed.
(c) Completion of a physical proportion of the contract work.

In another similarity with the treatment of revenue from the rendering of services under IAS 18, IAS 11 states that *(10)*:
'Where the outcome of a construction contract cannot be estimated reliably revenue shall be recognised only to the extent of contract costs incurred that it is probable will be recoverable'.

In summary, then, IAS 11 very much applies the principles set out in IAS 18 (for the recognition of revenue on the rendering of services) to the recognition of revenue from construction contracts.

3. Interest, royalties and dividends

IAS 18 states that entities should recognise revenue from the use of their assets yielding interest, royalties and dividends when *(11)*:
(a) It is probable that the economic benefits associated with the transaction will flow to the entity.
(b) The amount of the revenue can be measured reliably.

The exact basis for the recognition of revenue from the use by others of the 'seller's'

assets depends on the type of transaction *(12)*:

(a) Interest revenue should be recognised on the ‘effective interest’ basis.
(b) Royalties should be recognised on an accruals basis in accordance with amounts receivable as a result of ‘asset use’ up to the reporting date.
(c) Dividend revenue should be recognised when the right to receive payment is established. Often this does not happen in the case of dividends until the shareholder actually receives the dividend.

PRINCIPLES UNDERPINNING MEASUREMENT OF REVENUE

IAS 18 states that ‘Revenue shall be measured at the fair value of the consideration received or receivable’ (12). In determining fair value it would be necessary to take into account any trade discounts or volume rebates granted by the seller.

In most cases, ‘fair value’ will represent the cash or cash equivalents received or receivable by the seller. However, where the consideration is deferred, IAS 18 explains that the arrangement effectively constitutes a financing transaction and the substance of the transaction is a supply of goods or services plus the provision of finance. In such circumstances, the amount receivable is split into *(13)*:

(a) An amount receivable for the supply of goods or services. This is arrived at by discounting the future cash receivable by the seller. The imputed rate of interest is the prevailing borrowing rate of the buyer or, if more easily determinable, the rate that discounts the future cash receivable to the current cash price of the goods or services. This is recognised immediately.
(b) An amount receivable for the supply of finance to the buyer, recognised over the implied term.

Example

A retail entity supplies products to the public on three year deferred payment terms. On 1 January 2013 the entity supplies a product for a total price of $13,310, payable on 1 January 2016. The credit rating of the customer is such that a relevant imputed annual rate of interest is 10%. The entity’s year end is 31 December.

On 1 January 2013 the total revenue from the sale would be split into:
(a) Revenue from the sale of goods of $10,000 ($13,310/(1.10) *(3)*. This is recognised immediately by crediting revenue and debiting receivables.
(b) Interest revenue of $3,310 ($13,310 - $10,000). This is recognised over the three years as shown in the table below:

Year ended 31 December	Opening receivable	Finance income (10%)
$	$	$

Year ended 31 December $	Opening receivable $	Finance income (10%) $	
2013	10,000	1,000	11,000
2014	11,000	1,100	12,100
2015	12,100	1,210	13,310

On 1 January 2016, the cash is received and the receivable derecognised.

IAS 11 uses similar principles to measure revenue from construction contracts, stating that 'Contract revenue is measured at the fair value of the consideration received or receivable' *(14)*.

IAS 18 IMPLEMENTATION EXAMPLES

As stated earlier, these implementation examples accompany, but are not part of, IAS 18. However they are useful as an aid to application and well worth reviewing. They assume that the amounts of revenue and related costs can be measured reliably, and that the economic benefits will probably flow to the seller. Most of the examples are relatively self-explanatory. We will review two of the more complex examples:

Example 5 – sale and repurchase agreements *(15)*

Where goods are 'sold' under conditions that either require the seller to repurchase them in the future or contain options to repurchase that are likely to be exercised then the substance of the transaction of often that the 'sale' is actually a provision of finance.

Suppose entity A 'sells' goods to entity B on 1 January 2013 for $400,000. The goods are inventories that need to mature for five years before being ready for sale. Their market value on 1 January 2013 was $800,000 and entity A has the option to repurchase the goods from entity B on 1 January 2018 for $600,000. The market value of the goods is expected to rise by 5% per annum from 2013 to 2017 inclusive. Entity A's credit rating is such that it would have to pay interest at 8.447% per annum on borrowings. The goods are expected to remain at the premises of entity A throughout the five year period beginning on 1 January 2013 and entity A is responsible for their safe custody.

The fact pattern in this example indicates that at least two of the conditions required for the recognition of revenue on the sale of goods have not been satisfied:

- Entity A retains the risks and rewards of ownership despite the fact that legal ownership has been transferred to entity B.

- Entity A retains managerial involvement to the degree usually associated with ownership.

Therefore it is inappropriate for entity A to recognise revenue when the goods are sold on 1 January 2013. The 'sales proceeds' should be recognised as a borrowing with an annual finance cost of 8.447%. Over the next five years the borrowing will grow as follows:

Year ended 31 December $	Opening borrowing $	Finance cost (8.447%) $	
2013	400,000	33,788	433,788
2014	433,788	36,642	470,430
2015	470,430	39,737	510,167
2016	510,167	43,094	553,261
2017	553,261	46,739	600,000

The almost certain 're-purchase' on 1 January 2013 will eliminate the borrowing.

Example 11 – servicing fees included in the price of a product *(15)*

When the selling price of a product includes an identifiable amount for subsequent servicing that amount is deferred and recognised as revenue over the period during which the service is performed. The amount deferred is that which will cover the expected costs of the services, together with a reasonable profit on those services.

Suppose an entity supplies a product to a customer for a total price of $20,000. The price includes two years 'free' servicing of the product. The entity estimates that the annual cost of servicing the product will be $2,400. The entity normally earns a margin of 20% on service revenue.

The expected total cost to the entity of providing the 'free service' is $4,800 (2 X $2,400). Given the normal margin on service work this would equate to revenue of $6,000 ($4,800 X 100/80). Therefore the entity would recognise revenue from the sale of the product of $14,000 ($20,000 - $6,000) at the date of supply and service revenue of $6,000 over the two years following the supply.

The situation is further complicated when a 'package' such as the one outlined above is supplied at a special price and the fair value of both components is known. Suppose in the above example the normal selling price of the product without any

‘free’ servicing was $18,000. We would then have two components to the transaction with fair values totalling $24,000 ($18,000 for the product + $6,000 for the servicing). If the whole package were supplied for $20,000 then this would be at 20/24 or 5/6 of the ‘normal’ price. This would be allocated to the components so that the total revenue of $20,000 would be allocated as follows:

- Sale of goods $15,000 ($18,000 X 5/6).
- Service revenue $5,000 ($6,000 X 5/6).

CHANGES THAT ARE LIKELY TO THE METHOD ACCOUNTING FOR REVENUE IN THE FUTURE

The background

As already stated, revenue is a crucial number to users of financial statements in assessing an entity’s financial performance and position. However, revenue recognition requirements in US generally accepted accounting principles (GAAP) differ from those in International Financial Reporting Standards (IFRSs).

Both sets of requirements need improvement. US GAAP comprises broad revenue recognition concepts and numerous requirements for particular industries or transactions that can result in different accounting for economically similar transactions. Although IFRSs have fewer requirements on revenue recognition, the two main revenue recognition standards, IAS 18, *Revenue* and IAS 11, *Construction Contracts*, can be difficult to understand and apply. In addition, IAS 18 provides limited guidance on important topics such as revenue recognition for multiple-element arrangements.

The detail

The International Accounting Standards Board (IASB) and the US national standard-setter, the Financial Accounting Standards Board (FASB), initiated a joint project to clarify the principles for recognising revenue and to develop a common revenue standard for IFRSs and US GAAP that would *(16)*:

(a) Remove inconsistencies and weaknesses in existing revenue requirements
(b) Provide a more robust framework for addressing revenue issues
(c) Improve comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets
(d) Provide more useful information to users of financial statements through improved disclosure requirements, and
(e) Simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer

The proposed requirements would affect any entity that enters into contracts with customers unless those contracts are in the scope of other standards (for example, insurance contracts or lease contracts).

To achieve that core principle, an entity would apply all of the following steps *(17)*:

(a) Identify the contract with a customer.
(b) Identify the separate performance obligations in the contract.
(c) Determine the transaction price.
(d) Allocate the transaction price to the separate performance obligations in the contract.
(e) Recognise revenue when (or as) the entity satisfies a performance obligation.

From an IFRS perspective, the new standard arising out of the project is likely to be more robust than the existing standards. This should assist in future convergence between IFRS and US GAAP.

The project is in its final stage of development and a new standard is likely to apply for accounting periods beginning on or after 1 January 2017.

References

1. Paragraph 7 – IAS 18.
2. Paragraph 14 – IAS 18.
3. Paragraph 20 – IAS 18.
4. Paragraph 24 – IAS 18.
5. Paragraph 26 – IAS 18.
6. Paragraph 3 – IAS 11.
7. Paragraph 22 – IAS 11.
8. Paragraph 23 – IAS 11.
9. Paragraph 30 – IAS 11.
10. Paragraph 32 – IAS 11.
11. Paragraph 29 – IAS 18.
12. Paragraph 9 – IAS 18.
13. Paragraph 11 – IAS 18.
14. Paragraph 12 – IAS 11.
15. IAS 18 IE
16. IN 2, ED 2011/6 *Revenue from Contracts with Customers*
17. Paragraph 4, ED 2011/6 *Revenue from Contracts with Customers*