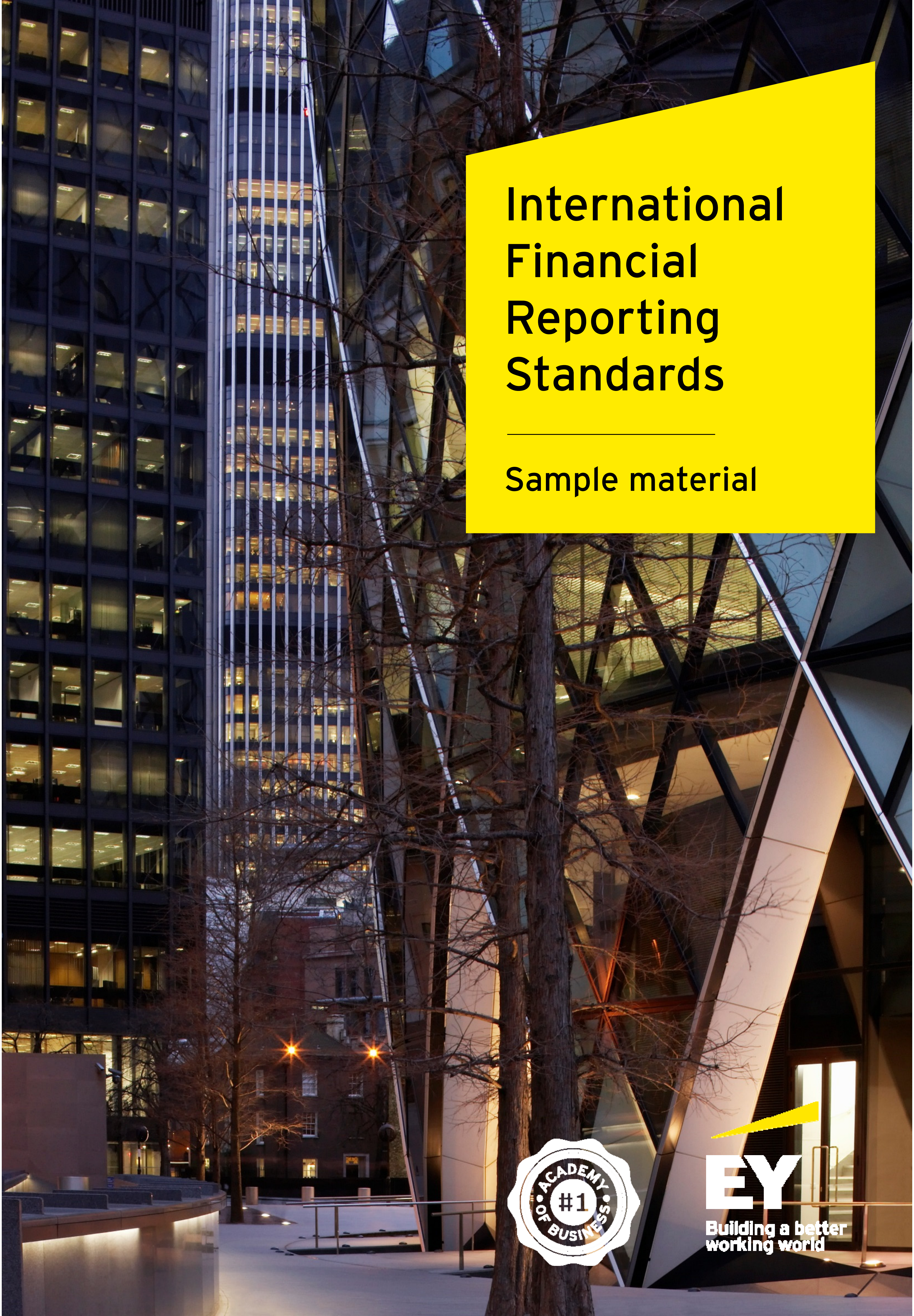

International Financial Reporting Standards

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REVENUE RECOGNITION

CHAPTER CONTENTS

- The provisions of IAS 18 (Revised): *Revenue*
- Appendix to IAS 18
- IFRIC13 *Customer loyalty programmes*
- IFRIC Interpretation 15 *Agreements for the Construction of Real Estate*

DEFINITION

Revenue in the gross inflow of economic benefits during the period arising from the ordinary activities of an enterprise.

This chapter considers the general problem of revenue recognition: what conditions must be satisfied before income can be reported in the income statement. IAS 18 (Revised) *Revenue* deals with this area.

Objectives

By the time you have finished this chapter you should be able to outline the principles of revenue recognition as described in IAS 18 (Revised).

1 The provisions of IAS 18 (Revised): *Revenue*

This section is concerned with the question of when revenue and expenses should be recognised in the income statement.

1.1 Meaning of revenue

The term ‘revenue’ could apply in any of the following situations

(a) the supply of goods on cash or credit sale terms

(b) the provision of services on cash or credit terms

(c) the receipt of interest, royalties and dividends.

This Standard does not deal with revenue arising from:

(a) lease agreements (see IAS 17 Leases);

(b) dividends arising from investments which are accounted for under the equity method (see IAS 28 Investments in Associates);

(c) insurance contracts within the scope of IFRS 4 Insurance Contracts;

(d) changes in the fair value of financial assets and financial liabilities or their disposal (see IAS 39 Financial Instruments: Recognition and Measurement);

(e) changes in the value of other current assets;

(f) initial recognition and from changes in the fair value of biological assets related to agricultural activity (see IAS 41 Agriculture);

(g) initial recognition of agricultural produce (see IAS 41); and

(h) the extraction of mineral ores.

1.2 Measurement of revenue

Revenue should be measured at the fair value of the consideration received or receivable.

(a) If the sale is a cash sale, then the revenue is the immediate proceeds of sale. Allowance may be made for expected returns.

(b) If the sale is a credit sale, i.e. a sale for a claim to cash, then anticipated cash is revenue.

Allowances for bad debts and returns are usually computed as a separate exercise and disclosed separately. If the anticipated collectable value on sales of $1,000 is $950, some accountants would argue that this should be shown as $950 revenue. Current practice, however, would show $1,000 as revenue and $50 as an expense in the income statement.

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KEY POINTS

If the inflow of cash is deferred, the fair value of the consideration may be less than the nominal amount receivable. If the provision of interest free credit effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts. The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue in the period or periods over which the credit is granted.

If the inflow of cash is deferred, the fair value of the consideration may be less than the nominal amount receivable. If the provision of interest free credit effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts. The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue in the period or periods over which the credit is granted.

In most cases, the consideration is in the form of cash or cash equivalents and the amount of revenue is the amount of cash or cash equivalents received or receivable. However, when the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable. For example, an entity may provide interest free credit to the buyer or accept a note receivable bearing a below-market interest rate from the buyer as consideration for the sale of goods. When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest. The imputed rate of interest is the more clearly determinable of either:

(a) the prevailing rate for a similar instrument of an issuer with a similar credit rating; or

(b) a rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services.

The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue and in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* and *IFRS 9 Financial Instruments* (when applied).

KEY POINTS

Revenue from the sale of goods should be recognised when all the following conditions have been satisfied:

- the enterprise has transferred the significant risks and rewards of ownership of the goods;
- the enterprise retains neither continuing managerial involvement nor effective control over the goods sold;
- the amount of revenue can be measured reliably;
- it is probable that the economic benefits associated with the transaction will flow to the enterprise; and
- the costs incurred or to be incurred in respect of the transaction can be measured reliably.

1.3 Identification of the transaction

The recognition criteria in this Standard are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. For example, 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. Conversely, the recognition criteria are applied 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, an entity may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction; in such a case, the two transactions are dealt with together.

1.4 Revenue from the sale of goods

Revenue from the sale of goods should be recognised when all the following conditions have been satisfied:

- the enterprise has transferred to the buyer the significant risks and rewards of ownership of the goods;
- the enterprise retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
- the amount of revenue can be measured reliably;
- it is probable that the economic benefits associated with the transaction will flow to the enterprise; and
- the costs incurred or to be incurred in respect of the transaction can be measured reliably.

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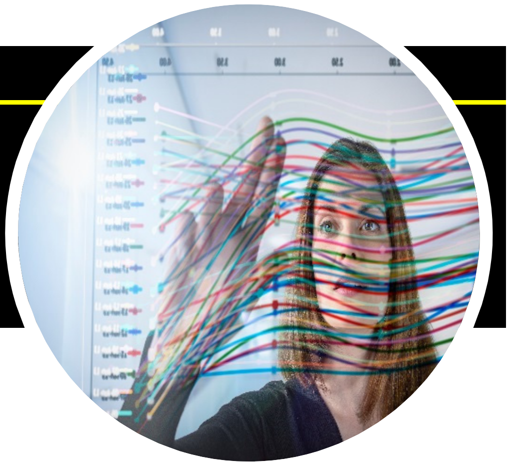

KEY POINTS

Examples of situations in which the entity may retain the significant risks and rewards of ownership are:

(a) when the entity retains an obligation for unsatisfactory performance not covered by normal warranty provisions;

(b) when the receipt of the revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of the goods;

(c) when the goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the entity; and

(d) when the buyer has the right to rescind the purchase for a reason specified in the sales contract and the entity is uncertain about the probability of return.

If the entity retains significant risks of ownership, the transaction is not a sale and revenue is not recognised. An entity may retain a significant risk of ownership in a number of ways. Examples of situations in which the entity may retain the significant risks and rewards of ownership are:

(a) when the entity retains an obligation for unsatisfactory performance not covered by normal warranty provisions;

(b) when the receipt of the revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of the goods;

(c) when the goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the entity; and

(d) when the buyer has the right to rescind the purchase for a reason specified in the sales contract and the entity is uncertain about the probability of return.

If an entity retains only an insignificant risk of ownership, the transaction is a sale and revenue is recognised. For example, a seller may retain the legal title to the goods solely to protect the collectibility of the amount due. In such a case, if the entity has transferred the significant risks and rewards of ownership, the transaction is a sale and revenue is recognised. Another example of an entity retaining only an insignificant risk of ownership may be a retail sale when a refund is offered if the customer is not satisfied. Revenue in such cases is recognised at the time of sale provided the seller can reliably estimate future returns and recognises a liability for returns based on previous experience and other relevant factors.

1.5 Rendering of services

KEY POINTS

When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction should be recognised by reference to the stage of completion of the transaction at the reporting date.

When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction should be recognised by reference to the stage of completion of the transaction at the reporting date. The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:

- the amount of revenue can be measured reliably;
- it is probable that the economic benefits associated with the transaction will flow to the enterprise;
- the stage of completion of any transaction at the end of reporting period can be measured reliably; and
- the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

An entity is generally able to make reliable estimates after it has agreed to the following with the other parties to the transaction:

(a) each party's enforceable rights regarding the service to be provided and received by the parties;

(b) the consideration to be exchanged; and

(c) the manner and terms of settlement.

It is also usually necessary for the entity to have an effective internal financial budgeting and reporting system. The entity reviews and, when necessary, revises the estimates of revenue as the service is performed. The need for such revisions does not necessarily indicate that the outcome of the transaction cannot be estimated reliably.

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Recognise revenue

Sale of goods

- The Seller of goods has transferred to the buyer the significant risks and rewards of ownership

Provision of Services

- The stage of completion of the transaction at the reporting date can be measured reliably

- The amount of revenue/costs incurred or to be incurred in respect of the transaction can be measured reliably
- It is probable that the economic benefits associated with the transaction will flow to the enterprise

Interest

- On a time basis

Royalties

- On an accrual basis

Dividends

- When the shareholders right to receive payment is established

2 Appendix to IAS 18

The examples generally assume that

(a) the amount of revenue can be measured reliably,

(b) it is probable that the economic benefits will flow to the entity, and

(c) the costs incurred or to be incurred can be measured reliably.

2.1 Sale of Goods

The law in different countries may mean the recognition criteria in this Standard are met at different times. In particular, the law may determine the point in time at which the entity transfers the significant risks and rewards of ownership. Therefore, the examples in this section need to be read in the context of the laws relating to the sale of goods in the country in which the transaction takes place.

'Bill and hold' sales, in which delivery is delayed at the buyer's request but the buyer takes title and accepts billing.

Revenue is recognised when the buyer takes title, provided:

(a) it is probable that delivery will be made;

(b) the item is on hand, identified and ready for delivery to the buyer at the time the sale is recognised;

(c) the buyer specifically acknowledges the deferred delivery instructions; and

(d) the usual payment terms apply.

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SAMPLE

INTANGIBLE NON-CURRENT ASSETS

1.14 Impairment losses

IAS 36 Impairment of Assets requires all non-current assets, tangible and intangible, to be monitored for possible impairment. The provisions of IAS 36 are covered in another chapter.

Irrespective of whether there is any indication of impairment, an entity shall:

(a) test an intangible asset with an indefinite useful life or an intangible asset not yet available for use for impairment annually by comparing its carrying amount with its recoverable amount. This impairment test may be performed at any time during an annual period, provided it is performed at the same time every year. Different intangible assets may be tested for impairment at different times. However, if such an intangible asset was initially recognised during the current annual period, that intangible asset shall be tested for impairment before the end of the current annual period.

(b) test goodwill acquired in a business combination for impairment annually.

1.15 Retirements and Disposals

An intangible asset should be derecognised (eliminated from the statement of financial position) on disposal or when no future economic benefits are expected from its use and subsequent disposal.

Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the income statement.

ACTIVITY 1

(a) An entity is developing a new production process. During 20X5, expenditure incurred was $1,000, of which $900 was incurred before 1 December 20X5 and $100 was incurred between 1 December 20X5 and 31 December 20X5. The entity is able to demonstrate that, at 1 December 20X5, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be $500.

(b) During 20X6, expenditure incurred is $2,000. At the end of 20X6, the recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be $1,900.

Required

How is this accounted for?

Feedback to this activity is at the end of the chapter.

FEEDBACK TO ACTIVITY 1

(a) At the end of 20X5, the production process is recognised as an intangible asset at a cost of $100 (expenditure incurred since the date when the recognition criteria were met, i.e. 1 December 20X5). The $900 expenditure incurred before 1 December 20X5 is recognised as an expense because the recognition criteria were not met until 1 December 20X5. This expenditure does not form part of the cost of the production process recognised in the statement of financial position.

(b) At the end of 20X6, the cost of the production process is $2,100 ($100 expenditure recognised at the end of 20X5 plus $2,000 expenditure recognised in 20X6). The entity recognises an impairment loss of $200 to adjust the carrying amount of the process before impairment loss ($2,100) to its recoverable amount ($1,900). This impairment loss will be reversed in a subsequent period if the requirements for the reversal of an impairment loss in IAS 36 are met.

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ADDITIONAL PRACTICE QUESTIONS

1

Lock plc has recently embarked on several projects designed to expand the business in the future.

During the year ended 30 June 20X1 you ascertain that the following occurred in relation to certain of the projects.

Project A

Costs of $70,000 were incurred in substantially improving an existing product with a view to making it safer and with fewer side effects. Tests were still in progress at the year end, but it was hoped to market the product in time for Christmas 20X1. In addition to the above $70,000, the company has purchased a special analysing machine for $50,000 which has a useful life of 4 years with a residual value of $10,000. They have also spent $20,000 on market research in relation to the above project.

Project B

The company has spent $40,000 investigating possible alternative raw materials with similar properties that they could use instead of asbestos. They also purchased a machine that could analyse the properties of various materials for $45,000. It is the company's intention to spend another 2 years researching into this field. At the end of this time if the research has not proved fruitful they will research into making asbestos safer to use.

Project C

Three years ago the company deferred expenditure of $100,000 on developing asbestos cables and insulation. The product was declared safe for industrial use on 1 March 20X1 and commercial production commenced from that date. The company has patented its idea and the patent will last 17 years, and although after this period there will be a free market, it foresees being able to market essentially the same product, profitably, indefinitely. It expects a reaction from existing cable and insulation manufacturers, but expects it will be June 20X6 at least before they will have been able to develop an equivalent product. The machinery needed to make this product has an effective useful life of 10 years, after which time it will need to be replaced. The patent does not apply outside the UK and the company considers it will be 4 years before foreign competitors will be on an equal footing. The company has also spent $40,000 on an extensive advertising campaign for this product during the year.

	Demand
Year ending 30 June	$000
20X2	30
20X3	60
20X4 onwards, at capacity of	100

Sales in 20X1 were $10,000.

Required

Explain how the above items should be dealt with in the company's accounts for the year ended 30 June 20X1 in accordance with IAS 38: Intangible assets. Discuss briefly the factors which are to be taken into account in determining the accounting treatment to be selected.

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2

Forkbender Limited develops and manufactures exotic cutlery and has the following projects in hand:

	Project				
	1	2	3	4	5
	$'000	$'000	$'000	$'000	$'000
Deferred development expenditure b/f 1 January 20X2	280	-	450	-	-
Development expenditure incurred during the year					
Salaries, wages etc.	35	29	-	60	20
Overhead costs	2	5	-	-	3
Materials and services	3	13	-	11	4
Patents and licences	1	2	-	-	-
Market research	-	10	-	2	-

Project 1 was originally expected to be highly profitable but this is now in doubt, since the scientist in charge of the project is now behind schedule, with the result that competitors are gaining ground.

Project 2 $370,000 development expenditure on this project has been written off in previous years. Directors now believe, on the best advice, that the project will in future earn revenue considerably in excess of all development costs and they therefore wish to reinstate the expenditure of previous years.

Project 3 commercial production started during the year. Sales were 20,000 units in 20X2 and future sales are expected to be: 20X3 30,000 units; 20X4 60,000 units; 20X5 40,000 units; 20X6 30,000 units. There are no sales expected after 20X6.

Project 4 these costs relate to a new project, which meets the criteria for deferral of expenditure and which is expected to last for three years.

Project 5 is another new project, involving the development of a 'loss leader', expected to raise the level of future sales.

Development expenditure carried forward is written off over the expected sales life of projects, starting in the first year of sale.

Required

Show how the above projects should be treated in the financial statements of Forkbender Limited for the year ended 31 December 20X2 in accordance with IAS 38 – *Intangible Assets.* Justify your treatment of each project.

For the answer to these questions, see the 'Answers' section at the end of the chapter.

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1

Project A

The $70,000 spent on "substantially improving" an existing product falls under the definition of development expenditure. Lock must defer this expenditure and amortise it on a systematic basis over the period the product will be produced commercially it the enterprise can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale

(b) its intention to complete the intangible asset and use or sell it

(c) its ability to use or sell the intangible asset

(d) how the intangible asset will generate future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself, or, if it is to be used internally, the usefulness of the intangible asset

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset, and

(f) its ability to measure the expenditure attributable to the intangible asset during its development period.

Assuming these criteria have been met, the company should show the $70,000 as an intangible non-current asset; it should also be shown as part of the movement in the deferred development expenditure note to the statement of financial position.

The $20,000 spent on market research should be excluded from the research and development expenditure and should be charged to the profit and loss account for the year.

The analysing machine should be capitalised and written down to its residual value over its estimated useful economic life. Assuming a straight-line depreciation charge, and a full year's charge in year of purchase, there would be a charge to depreciation of $(50,000 - 10,000)/4 = $10,000. The charge for depreciation should be included as part of the expenditure on research and development and deferred until production commences. The machine should be included in non-current assets at a carrying amount of $40,000.

In future years, the above criteria must be considered before deciding whether deferral can continue. If not the deferred expenditure should be written off immediately through the income statement.

Project B

This $40,000 is classified as applied research, and must be written off in the year it is incurred. However, the machine should be capitalised and depreciated over its useful economic life down to its residual value. Assuming a residual value of nil, its useful economic life is 3 years (2 years to go + 20X0/X1) so the depreciation charge is

$$\frac{45{,}000}{3} = \$15{,}000$$

Project C

The company must amortise this expenditure starting from commercial production on a systematic basis over the period which the product is expected to be sold or used, or by reference to the sale or use of the product. The matching concept is being applied here, with the proviso that prudence should rule if ever a doubt arises about justification for continuing to defer.

A systematic basis means that an arbitrary annual write off is not valid. An attempt must be made to match costs with the related benefits. Unless Lock plc is in the export market, the period of the write off should be 5 1/3 years (after which time competition appears, and a doubt arises as to recoverability of such deferred expenditure - for example the price might fall, or the competitors' product might be superior etc.).

An acceptable systematic basis would be to write off according to sales, thus

Forecast demand until June 20X6 of commercial production are

	$
20X1	10,000
20X2	30,000
20X3	60,000
20X4	100,000
20X5	100,000
20X6	100,000
	400,000

So the company should amortise $\frac{10,000}{400,000}$ x $100,000

= $2,500 in the accounts for the year ended 30 June 20X1.

The money spent on advertising should be written off in the year as it cannot prudently be deferred.

2

Project 1 expenditure, including that relating to previous years, should all be written off in 20X2, as there is now considerable doubt as to the profitability of the project.

Project 2 expenditure for 20X2 must be deferred, but that from previous years which was written off cannot be reinstated.

Since commercial production has started under Project 3 the expenditure previously deferred should now be amortised. This will be done over the estimated life of the product, as stated in the question.

Project 4 - The development costs must be deferred.

Since project 5 is not expected to be profitable its-development costs should not be deferred.

Statement of financial position as at 31 December 20X2 (extract)

	$'000
Non-current assets	
Intangible assets	
Deferred development expenditure (Note 2)	518

Notes to the accounts

1. Accounting policies

   Research and development

   Research and development expenditure is written off as incurred, except that development expenditure incurred on an individual project is carried forward when its future recoverability can be foreseen with reasonable assurance. Any expenditure carried forward is amortised over the period of sales from the related project.

2. Deferred development expenditure

	$'000	$'000
Balance brought forward 1 January 20X2		730
Development expenditure incurred during 20X2	118	
Development expenditure amortised during 20X2	(330)	
		(212)
Balance carried forward 31 December 20X2		$518

Workings

(1)	Incurred:	$	$
	Project 2		29
			5
			13
			47
	Project 4	60	
		11	71
			118
(2)	Amounts written off:		$
	Project 1		280
	Project 3 (W3)		50
			330
(3)	$\frac{20,000}{180,000}$ x \$450,000 =	50	

Income statement		
Research costs		
Project 1 (all costs)		41
Project 2		
Patents and licences	2	
Market research	10	12
Project 4		
Market research		2
Project 5 (all costs)		27
		82

Patents and licences

It could be argued that these are intangible assets that meet the separability criterion and should be capitalised.