PART ONE

REVENUE AND EXPENSES

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REVENUE RECOGNITION

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INTRODUCTION

Many entities stretch the boundaries of how much revenue they can recognize within an accounting period, since they want to show exceptional revenue growth to their investors and creditors. This tendency has resulted in a number of IFRS rulings regarding the appropriate recognition of revenue. Most such rulings are relatively simple, single-paragraph statements, but others are more complex. The next section deals with the simpler revenue recognition rules, while other, more complex areas are addressed later in separate sections.

REVENUE RECOGNITION RULES

This section contains the bulk of all revenue recognition rules under IFRS, in alphabetical order. More complex revenue recognition situations, such as construction projects and customer loyalty programs are dealt with later, in separate sections. The simpler revenue recognition rules are:

- *Admission fees*. The fees generated from artistic performances and other special events are recognized when the event takes place. If the seller is selling subscriptions to a number of events, then it allocates the subscription to each event covered by the subscription, based on the extent to which services are performed at each event.
- *Advance payments*. The buyer may send either full or partial payment to the seller in advance of the delivery of goods. The seller may not yet have the items in inventory, they may still be in the production process, or they will be drop shipped by a third party. Under these circumstances, the seller should not recognize revenue until the goods are delivered to the buyer.

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- *Barter exchange*. A transaction does not generate revenue if it involves the exchange of goods or services of a similar nature or value. If the exchange is for dissimilar goods or services, the transaction *does* create revenue; this is measured at the fair value of the goods or services received, as modified by the amount of any cash transferred. If the fair value of received goods or services cannot be reliably measured, then use instead the fair value of the goods or services given up, as modified by the amount of any cash transferred.
- *Bill and hold*. In a bill and hold sale, the buyer requests that delivery be delayed, but accepts billing and takes title to the goods. The seller recognizes revenue when the buyer takes title and the following conditions are satisfied:
  - Normal payment terms apply to the transaction
  - The buyer acknowledges the delayed delivery instructions
  - It is probable that delivery will be made
  - The goods are identified, on hand and ready for delivery

  The seller cannot recognize revenue related to a bill and hold transaction if there is only an intention to acquire or produce the goods in time for delivery, as opposed to actually being on hand.
- *Cash on delivery terms*. If a seller is selling goods based on cash on delivery terms, then it should recognize revenue when it delivers the goods and collects the cash from the transaction.
- *Deferred payments*. In the event of a deferred cash payment, the fair value of the consideration received may be reduced. When a delayed payment effectively constitutes a financing transaction, recognize revenue as the discounted cash flow of the transaction, using an imputed interest rate that is the more clearly determinable of either a) the

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Example

Snoring Sofas is offering a year-end deal for its luxury leather sofas, under which customers can either pay €2,000 in cash or a zero-down payment with 24 monthly payments of €100 each, totaling €2,400. Since there is a difference of €400 between the cash price and the extended terms, the zero-down payment deal is essentially comprised of separate financing and sale transactions. For any sale under the zero-down payment plan, Snoring should record a sale of €2,000, which is the amount of consideration attributable to the sofa. The difference between the cash price and the total payment stream is interest revenue, and Snoring should record it under the effective interest method over the two-year payment period.

prevailing interest rate for a similar transaction by an entity with a similar credit rating; or b) a rate of interest that discounts the transaction to the current cash price of the underlying goods or services.

- *Goods sold*. If goods are sold, then measure revenue at the fair value of the consideration received, taking into account the amount of any trade discounts and volume rebates accepted by the entity. When paid in cash, recognize revenue only for the amount of cash received or receivable. You can only recognize revenue from the sale of goods when all of the following conditions have been recognized:
  - *Benefits assured*. The economic benefits associated with the transaction will flow to the entity.
  - *Costs measurable*. The costs related to the transaction can be reliably measured.
  - *Ownership relinquished*. The entity no longer retains management control over the goods sold.
  - *Revenue measurable*. The amount of revenue to be recognized can be reliably measured.
  - *Risks and rewards transferred*. All significant risks and rewards associated with the goods have been transferred to the buyer. This usually coincides with the transfer of legal title or possession to the buyer.
- *Initiation fees*. If an initiation or membership fee only creates a membership condition, then the seller can recognize revenue when there is no significant uncertainty regarding fee collectability. However, if the fee entitles the buyer to services or publications or discounted purchases from the seller during the membership period, then the seller recognizes revenue on a basis that reflects the timing, nature, and value of the benefits provided.
- *Installation fees*. When a seller charges an installation fee associated with a delivery of goods, the seller recognizes revenue in accordance with the stage of completion of the installation. However, if the installation fee is incidental to the sale of goods, then the fee is recognized when the goods are sold.
- *Installment sales*. The buyer may send a series of payments to the seller in exchange for the immediate delivery of goods from the seller to the buyer. In this case, the seller can recognize revenue once the goods are delivered; however, the amount recognized is the present value of all payments, which the seller calculates by discounting the payments at the imputed rate of interest. The seller recognizes the interest portion of the payments as it earns them, which it calculates using the effective interest method.

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- *Layaway sales*. Layaway sales occur when goods are delivered to the buyer only when the buyer has completed the final payment in a series of installment payments. In a layaway sale, the seller only recognizes revenue when it delivers the goods. However, if the seller's historical experience shows that most layaway transactions are converted into sales, it can recognize revenue when it receives a significant deposit, provided that the goods are on hand, identified, and ready for delivery.
- *Royalties*. Recognition is in accordance with the terms of the relevant agreement, unless the substance of the agreement calls for a different method. From a practical perspective, recognition may be on a straight-line basis over the term of the agreement. If the agreement is an assignment of rights in exchange for a fixed fee or non-refundable guarantee where the licensor has no remaining performance obligations, the licensor can recognize revenue at the time of sale. If payment under the agreement is contingent upon the occurrence of a future event, revenue should be recognized when it is probable that the fee or royalty will be received.
- *Servicing fees*. A seller of goods may include in the selling price a fee for subsequent servicing or product upgrades. If so, the seller should defer the amount of revenue related to the servicing fee, which should cover the servicing cost and a reasonable profit. It should then recognize the associated revenue over the servicing period.
- *Subscriptions*. When the seller makes deliveries of publications and similar items to the buyer under a subscription agreement, it normally recognizes revenue on a straight-line basis over the period when the items are issued. However, if the items vary in value by period, then the seller should recognize revenue based on the sale value of each item in proportion to the total estimated sales value of all items included in the subscription.
- *Tuition fees*. The provider of educational services should recognize revenue from tuition fees over the period of instruction.

IMPACT OF GOODS OWNERSHIP ON REVENUE RECOGNITION

If an entity retains significant risks of ownership in ostensibly transferred goods, then it cannot recognize related revenue. Examples of significant retained ownership risks are:

- *Contingent conditions*. The buyer of the goods must in turn sell the goods before it pays the entity for the sale.
- *Installation conditions*. Installation is a significant part of the contract, and it has not yet been completed. The seller can recognize revenue

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immediately after the buyer accepts delivery if the installation process is simple, or when the inspection is performed only for purposes of final determination of contract prices.

- *Performance obligations*. The entity retains an obligation for unsatisfactory performance that exceeds normal warranty provisions.
- *Return rights*. The buyer is entitled to rescind the purchase, and the probability of such return is uncertain. The seller can recognize revenue when the buyer has formally accepted delivery or when the time period allowed for rejection has expired.

Example

Diamond Flatware sells its tableware through the Garnet retail chain. Garnet purchases tableware from Diamond under a consignment agreement. Diamond should recognize revenue from the sale of its tableware only when the goods are sold by Garnet.

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If an entity retains an *insignificant* risk of ownership, it can recognize revenue. For example, if an entity has transferred the significant risks and rewards of ownership, except for legal title in order to protect collectibility, then revenue may be recognized. Similarly, a retail establishment can recognize revenue even when customers have a refund right, as long as the retailer can reliably estimate future returns, and recognizes a related liability.

ADVERTISING BARTER TRANSACTIONS

An entity may enter into a barter transaction to provide advertising services in exchange for receiving advertising services from its customer. This can involve the exchange of no cash at all, or approximately equal amounts of cash or other consideration. Two forms of revenue recognition can arise from this scenario:

1. *Similar services*. If there is an exchange of similar advertising services, then the exchange does not result in revenue recognition by either party.
2. *Dissimilar services*. If there is an exchange of dissimilar advertising services, the seller can recognize revenue. It is not allowable to do so based on the fair value of advertising services received. Instead, the

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seller can measure revenue based on the fair value of the advertising services it provides, by reference to non-barter transactions that:

a. Involve advertising similar to that included in the barter transaction

b. Occur frequently

c. Involve a different counterparty than in the barter transaction

d. Involve cash or other consideration that has a reliably measurable fair value

e. Represent a predominant number of transactions and amounts as compared to the barter transaction

Example

Trouser TV enters into an advertising barter transaction with Macho magazine, where Trouser advertises Macho on its cable network in exchange for similar coverage in Macho magazine. Trouser is providing Macho with five advertising spots of 30 seconds duration. Trouser normally provides such coverage at a rate of $10,000 per spot, and does so frequently with other parties, who pay cash. The proportion of transactions where Trouser is paid cash for advertising is approximately 90 percent of all of its advertising transactions. Accordingly, Trouser TV can recognize the fair value of its advertising as revenue, which is $10,000 multiplied by five coverage spots, or $50,000.

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CONSTRUCTION CONTRACT REVENUE RECOGNITION

The contractor can recognize the revenues and expenses associated with a contract, through the stage of completion of the contract at the end of the current reporting period (the *percentage of completion method*), when it can reliably estimate the outcome of the contract.

If the contract is fixed price, the contractor can consider the contract's outcome to be reliably estimated when the following four conditions are satisfied:

- All contract revenue can be reliably measured.
- The benefits of the contract will probably flow to the contractor.
- The remaining contract costs and the stage of completion at the end of the reporting period can be reliably measured.
- Costs attributable to the contract can be identified and reliably measured, so that costs actually incurred can be compared to prior cost estimates.

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If the contract is cost plus, the contractor can consider the contract's outcome to be reliably estimated when the following two conditions are satisfied:

- The benefits of the contract will probably flow to the contractor.
- Contract costs, whether or not reimbursable, can be reliably measured.

If the contractor cannot reliably estimate the outcome of a contract, then it can only recognize revenue to the extent of contract costs incurred that it will probably recover, with no profit recognition.

Under the percentage of completion method, the contractor matches revenues with contract costs incurred in reaching a designated stage of completion; this results in the reporting of both revenue and expenses that can be attributed to the proportion of work completed. If the contractor has incurred costs that relate to future contract activity, then it categorizes these costs as an asset (assuming that the costs are recoverable) designated as Contract Work in Progress.

A contractor can use a variety of methods to determine the stage of completion of a contract, including the following:

- Surveys of work performed.
- Completion of a physical proportion of the work.
- The contract costs incurred to date as a percentage of the estimated total contract costs. This calculation should exclude contract costs related to future activity on a contract and payments made to subcontractors in advance of work performed.

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Example

Wolf Construction is working on a contract for Mr. Grimm, involving a main house and guest house. The first segment of the contract is for the main house. Wolf spends €180,000 for building materials that have been delivered to the construction site, but which are designated for the guest house, for which no work has yet begun. Wolf has also made an advance payment of €25,000 to Piglet Concrete for the construction of an Olympic-size swimming pool. In both cases, Wolf cannot include the expense in its percentage of completion calculations, since they do not reflect work performed to date.

The percentage of completion method involves making ongoing changes in accounting estimates. As such, changes in estimate are recognized in the period in which the change is made and in subsequent periods; it does not alter the accounting in prior periods.

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Example

Wolf Construction enters into a fixed price contract with Amiens Prefecture to build a suspension bridge. The amount of revenue listed in the contract is €5,800,000. Wolf's initial estimate of project costs is €5,000,000 over the expected three-year term of the project.

At the end of Year 1, Wolf revises its estimate of project costs upward to €5,100,000.

In Year 2, Amiens approves a change in the contract scope to include temperature sensors on the bridge surface that will transmit a warning when the road temperature drops below freezing. The scope change calls for a revenue increase of €300,000, and Wolf estimates additional contract costs of €250,000. At the end of that year, Wolf has spent €150,000 for materials that are stored at the construction site, but which are intended for use in the following year.

Wolf calculates its revenue recognition based on the percentage of completion method. A summary of its calculations follows:

	Year 1	**Year 2**	**Year 3**
Initial revenue in contract	€5,800,000	€5,800,000	€5,800,000
Contract scope changes	–	300,000	300,000
Total contract revenue	€5,800,000	€6,100,000	€6,100,000
Costs incurred to date	1,785,000	4,013,000	5,350,000
Estimated costs to complete	3,315,000	1,337,000	–
Total estimated contract costs	5,100,000	5,350,000	5,350,000
Estimated profit	€ 700,000	€ 750,000	€750,000
Stage of completion	40%	80%	100%

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Wolf calculates the 80% stage of completion at the end of Year 2 without the €150,000 of contract costs related to materials stored for use in Year 3.

Based on the preceding information, Wolf recognizes revenue and expenses by year in the following amounts:

	Project to Date	**Prior Years Recognition**	**Current Year Recognition**
Year 1			
Revenue (€5,800,000 × 40%)	€2,320,000	–	€2,320,000
Expenses (€5,100,000 × 40%)	2,040,000	–	2,040,000
Profit	280,000	–	280,000
Year 2			
Revenue (€6,100,000 × 80%)	4,880,000	€2,320,000	2,560,000
Expenses (€5,350,000 × 80%)	4,280,000	2,040,000	2,240,000
Profit	600,000	280,000	320,000
Year 3			
Revenue (€6,100,000 × 100%)	6,100,000	4,880,000	1,220,000
Expenses (€5,350,000 × 100%)	5,350,000	4,280,000	1,070,000
Profit	750,000	600,000	150,000

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The contractor should recognize an expected loss immediately when it is probable that total contract costs will exceed total contract revenue. The amount of the loss recognized is not impacted by the stage of project completion or the amount of profits that the contractor may earn from contracts that are not treated as part of the same contract. Examples of situations where contract recoverability is in doubt are:

- Contracts that are not enforceable
- Contracts that are subject to litigation or legislation
- Contracts for property that are likely to be condemned or expropriated
- Contracts where the customer is unlikely to meet its obligations
- Contracts where the contractor cannot meet its obligations

CUSTOMER LOYALTY PROGRAM REVENUE RECOGNITION

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A customer loyalty program is used by a company to give its customers an incentive to buy its goods or services. Customers earn award credits by buying from the company, which they can then use to obtain free or discounted goods or services.

A company that issues award credits shall treat them as a separately identifiable component of the sales transaction in which they are granted. The company must allocate the sale between the award credits and the other components of the sale. The amount of the allocation to the award credits shall be based on the fair value of credits, which is the price at which the credits can be sold separately, or the fair value of the awards for which they can be redeemed. In the latter case, the fair value of the awards should be reduced to account for the proportion of award credits that the company does not expect its customers to redeem. If customers can select from a number of awards, then the fair value analysis should reflect an average of the award fair values, weighted for the frequency of expected award selection. If an allocation of consideration to award credits is not possible based on fair values, a company may use alternative methods.

If the company pays out awards itself, then it recognizes revenue for the consideration allocated to the award credits when customers redeem the awards and the company delivers the awards.

Example

Manchester Electronics has a customer loyalty program. It grants participating customers award points every time they purchase from Manchester. Customers can redeem their points for free oil changes at any Manchester store.

(*continued*)

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The points are valid for three years from the date of each customer's last purchase, so that points essentially have no termination date as long as customers keep buying from Manchester.

During February, Manchester issues 80,000 award points. Management expects that 75% of these points, or 60,000 points, will eventually be redeemed. Management estimates that the fair value of each award point is ten cents, and so defers revenue recognition on €6,000.

After one year, customers have redeemed 30,000 of the award points for oil changes, so Manchester recognizes revenue of €3,000 (30,000 redeemed points/60,000 estimated total redemptions × €6,000 deferred revenue).

During the second year, management revises its redemption estimate, and now expects that 70,000 of the original 80,000 award points will be redeemed. During that year, 20,000 points are redeemed, so that a total of 50,000 points have now been redeemed. The cumulative revenue that Manchester recognizes is €4,286 (50,000 redeemed points/70,000 estimated total redemptions × €6,000 deferred revenue). Since Manchester already recognized €3,000 in Year 1, it now recognizes €1,286 in Year 2.

During the third year, customers redeem an additional 20,000 award points, which brings total redemptions to 70,000. Management does not expect additional redemptions. Accordingly, Manchester recognizes the remainder of the deferred revenue, which is €1,714.

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If a third party pays out the awards, the company is essentially collecting the consideration allocated to the awards on behalf of the third party. In this scenario, the company measures its revenue as the difference between the consideration allocated to the award credits and the amount payable to the third party for supplying the awards. The company can recognize this net difference as revenue as soon as the third party becomes obligated to supply awards and is entitled to be paid for doing so. This recognition may arise as soon as the company grants award credits. However, if customers can claim awards from either the company or the third party, revenue recognition only occurs when customers claim awards.

Example

Real Fruit, a purveyor of organically-grown farm produce, participates in the customer loyalty program operated by Icarus Airlines. Real Fruit grants its participating customers one air travel point for every dollar they spend on farm produce. These customers can then redeem the points for air travel with Icarus. Real Fruit pays Icarus €0.008 for each point. During the first year of the program's operation, Real Fruit awards 3 million points.

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> Real Fruit estimates that the fair value of an award point is €0.01. It therefore allocates to the 3 million issued points €30,000 of the consideration it has received from the sale of its produce. Real Fruit has no further obligation to its customers, since Icarus is now obligated to supply the awards. Accordingly, Real Fruit can recognize the €30,000 of revenue allocated to the award points at once, as well as the €24,000 expense payable to Icarus (€3,000,000 × €0.008).
>
> If Real Fruit had acted as an agent for Icarus and simply collected funds on behalf of Icarus, then it would only recognize revenue as the net amount it retains, which is €6,000 (€30,000 allocated to the awarded points - €24,000 paid to Icarus).

If the cost of the obligation to supply awards exceeds the consideration received, the company should recognize a liability for the excess amount. This situation can arise, for example, when the cost of supplying awards increases, or when the proportion of award credits redeemed increases.

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FRANCHISE FEE REVENUE RECOGNITION

Franchise fees are recognized based on the purpose for which they were charged. The following types of fee recognition can be used:

- *Assets*. The franchisor recognizes fees as revenue either when it delivers assets to franchisees or when it transfers title.
- *Services*. The franchisor recognizes revenue associated with continuing services over the period during which the services are rendered. If the related fee is not sufficient to cover the franchisor's provisioning costs and a reasonable profit, then it must defer the necessary additional amount from its initial franchise fee and recognize it as revenue over the servicing period. The franchisor can recognize the remainder of any initial fee when it has performed all of its obligations to the franchisee.
- *Continuing franchise fees*. When the franchisor charges a fee for various continuing rights or services, it recognizes revenue over the applicable period.
- *Agency transactions*. If the franchisor acts as an agent for a franchisee, such as when it orders supplies on behalf of the franchisee at no profit, this transaction cannot be recognized as revenue.

If franchise fees are collectible over an extended period and there is significant collection uncertainty, then the franchisor recognizes revenue as it collects cash installments.

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If the franchisor's obligations under an area franchise agreement depend on the number of outlets established, revenue recognition should be based on the proportion of outlets for which services have been substantially completed.

PROFESSIONAL SERVICES REVENUE RECOGNITION

Commissions can be earned for a variety of transactions. Here are the recognition criteria for several types of commissions:

- *Advertising*. An advertising agency can recognize commissions when the related advertisements are released. If it earns commissions for production work, it recognizes revenue based on the stage of completion of the project.
- *Financial services*. Revenue recognition of fees earned for financial services requires the seller to distinguish between the following:
  - Fees that are really part of the interest rate of a financial instrument, which should be treated as an adjustment to the effective interest rate.
  - Fees earned for services to be rendered, such as a loan servicing fee or an investment management fee.
  - Fees earned upon the completion of a significant act, such as a loan placement fee or a loan syndication fee.
- *Insurance*. An insurance agent is not normally obligated to render further services once the policy commences. If so, the agent can recognize the commission as revenue on the policy commencement date. If the agent is required to render further services during the policy period, then the agent must recognize the commission over the policy period.

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SERVICES REVENUE RECOGNITION

An entity is usually able to make reliable revenue estimates after the parties to the transaction have agreed to the terms of settlement, consideration to be exchanged, and each party's rights regarding services to be provided and received. An entity can recognize the revenue associated with services provided when it satisfies all of the following conditions:

- *Revenue measurable*. The amount of revenue to be recognized can be reliably measured.
- *Benefits assured*. The economic benefits associated with the transaction will flow to the entity.

- *Completion measurable*. The stage of completion at the end of the reporting period can be reliably measured.
- *Costs measurable*. The costs related to the transaction can be reliably measured, as can the costs to complete it.

The following issues drive the calculation method used to recognize services revenue:

- *Straight-line recognition*. If the services provided are comprised of an indeterminate number of acts over a specified period of time, revenue should be recognized on a straight-line basis over the designated time period, unless some other method better represents the provision of services.
- *Significant activities*. If a specific activity is substantially more significant than other activities, then an entity should defer revenue recognition until that activity has been completed.
- *Unreliable estimates*. When an entity cannot reliably estimate the outcome of services, it should only recognize revenue to the extent of the expenses recognized that are recoverable. Under this scenario, no profit is recognized. If it is not probable that the costs incurred are recoverable, then the entity does not recognize revenue and it recognizes all costs incurred as expenses.

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DISCLOSURES

An entity should disclose the following items:

- *Policies*. The revenue recognition policies the entity has adopted, including the methods it uses to determine stages of completion for the provision of services.
- *Revenue categories*. The amount of revenue associated with each of the following categories:
  - Sale of goods
  - Rendering of services
  - Interest
  - Royalties
  - Dividends
- *Exchanges*. The revenue caused by exchanges of goods or services in each of the preceding categories.

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