WILL MOVING TO FRS 102 AFFECT WHEN CONTINGENT REVENUE IS RECOGNISED?

In this edition of a new series of views and commentary on FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland, Financial Reporting Faculty staff comment on some of the questions raised by members about the impact of the standard on the recognition of contingent revenue, taking account of member comments in response to recent faculty blogs on the issue.

A less rigid approach than under the old regime

UITF 40 paragraph 19 states explicitly that 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 applies when 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.

These requirements of UITF 40 have not been carried forward directly into FRS 102. The new standard does, however, say that 'when a specific act is more significant than any other act, the entity postpones revenue recognition until the significant act is executed'. Entities should, of course, bear this in mind when determining when contingent revenue is recognised. But, unlike UITF 40, this requirement does not explicitly prohibit the recognition of such revenue until such time as the contingency is resolved.

While different to previous UK GAAP, the approach adopted by the new standard is more closely aligned with IFRS.

Recognising revenue from the rendering of services

Entities with contingent revenue will therefore need to refer to FRS 102’s general guidance on recognising revenue arising from the rendering of services. This says that revenue is recognised by reference to the stage of completion at the end of the reporting period. It goes on to say, however, that such revenue can only be recognised when the outcome of a transaction can be estimated reliably. For this to be the case, all of the following conditions must be met:

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

Applying judgement

When applying these requirements to contingent revenue, entities will need to look in detail at the individual facts and circumstances of each case before reaching a conclusion on the appropriate accounting treatment. It is quite possible that entities in the same sector could reach different conclusions about when revenue can be recognised based on their specific circumstances. Significant judgement may well be needed when determining whether there is sufficient evidence
to justify the recognition of contingent revenue. These judgements may change over time as the service is delivered, with some aspects becoming more certain as the contract advances or nears completion.

Individual contracts
When looking at an individual contract with highly distinct features, it is unlikely on the face of it that an entity will be able to demonstrate that the outcome can be estimated reliably.

In such instances, it will usually be appropriate to wait until the contingency is settled before recognising any revenue on the contract. In these circumstances the standard allows revenue to be recognised to the extent of the expenses recognised that are recoverable – but in many instances where the outcome cannot be estimated reliably it will not be possible to determine whether the costs are recoverable. Where this is the case, no revenue is recognised until the outcome can be estimated reliably and the costs are recognised as expenses in the period in which they are incurred. Any expected loss should be recognised immediately.

Portfolios of contracts
FRS 102 does not specify whether or not it is acceptable to make this assessment on a portfolio basis. Therefore, when considering a portfolio of similar contracts of a type that the reporting entity is familiar with, it may be possible to point to a track record over time of particular outcomes and conclude that there is sufficient data to show that the outcome can indeed be estimated reliably.

In such instances, it may be acceptable to accelerate revenue recognition when compared with the previous UK GAAP regime.

Implications for auditors
As the application of these requirements will result in a greater level of subjectivity and judgement on the part of the financial statement preparer, auditors may wish to consider the increased risk of management bias. For example, some entities might wish to accelerate revenue recognition in order to improve their reported performance while others might prefer to delay recognition where this has an impact on the timing of tax cash flows.