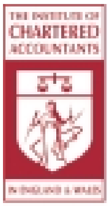

The Institute of
Chartered Accountants
in England & Wales

Revenue and expense recognition

An issues paper

November 2000

REVENUE AND EXPENSE RECOGNITION

An Issues Paper

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Accountants in England
and Wales

Preface

Revenue recognition is crucial to reporting corporate performance. Over recent years, the ICAEW Financial Reporting Committee has challenged companies and investors to push back the frontiers of public performance reporting. Last year, we published papers on risk reporting, alternative views of financial performance and reporting on shareholder value. Last month, we tackled the subject of prospective financial information*.

By contrast, this issues paper looks at unresolved questions that still arise in reporting financial performance within mainstream historical financial statements. Many of these questions have assumed fresh importance in the new economy as companies have pioneered new business models.

Tony Wedgwood chaired the working party responsible for the paper and Kathy Leach performed the research and detailed work with the support of a grant from the P D Leake Charitable Trust. We originally intended to develop a series of industry-specific case studies with guidance on the criteria to be applied in deciding when and how to recognise revenue and related costs. However, our research highlighted a more fundamental need to agree on important underlying issues of principle. These issues are the subject of this paper.

In view of the imminent discussion paper on revenue recognition expected from the Accounting Standards Board, we are not seeking comments on our work. However, we trust that readers will find it a helpful contribution to the forthcoming debate.

Robert Hodgkinson
Chairman, ICAEW Financial Reporting Committee

November 2000

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* Financial performance: Alternative views of the bottom line - January 1999
No Surprises: The case for better risk reporting - July 1999
Inside out : Reporting on shareholder value - October 1999
Prospective financial information : Challenging the assumptions - October 2000

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Summary

Users attach considerable importance to a company's performance statement. Revenue is both the starting point for that statement and an important measure of performance in its own right; yet there is little guidance in UK financial reporting standards on when to record, or recognise, revenue.

The International Accounting Standard on revenue recognition, IAS 18, is based on recognising revenue to reflect the performance of business activity. IAS 18 is seen as a good working standard which, in the absence of specific guidance, embodies existing UK GAAP. But it is arguably inconsistent with a conceptual framework based on assets and liabilities and revision of the standard is likely to be a priority for the new IASC Board.

In contrast, the ASB's Statement of Principles for Financial Reporting, has to date been applied to develop standards with a clear focus on the recording of assets and liabilities that can be reliably measured and without specific performance criteria.

In this paper, we explore some key questions that a UK revenue recognition standard derived from the Statement of Principles will need to address and suggest the difference that applying this approach could make to existing GAAP in a variety of practical situations. Our intention is to promote informed discussion on this important subject.

We have identified the following key issues:

1. *What is revenue?*

   A revenue recognition standard will need to define the distinction between revenue and gains and expenses and losses, as the Statement of Principles does not cover this.

   In this paper we have based the distinction between revenue and gains on operating activities. However, we note that the practical application of this approach will present difficulties.

2. *Is a reliably measured increase in <u>the value of operating assets</u> a better criterion for recognising revenue than realisation?*

   Revenue has traditionally reflected the performance of business activity. In some situations, applying the criterion of reliability of measurement can reflect this aspect of performance better than recognising revenue on realisation.

   However, drafting appropriately robust recognition criteria without reliance on realisation will present a significant challenge for the ASB.

3. *Is performance of the primary business activity necessary in addition to increased asset value?*

   Where a long term contract is entered into, applying the criterion of reliability of measurement would mean that revenue could reflect a different aspect of performance, i.e. the creation of value through entering into the contract rather than through performing a business activity under the contract.

   It is important that users understand which aspect or aspects of performance revenue reflects. We believe, therefore, that the ASB will need to specify what aspects of performance it intends profit from operating activities to show.

4. *How are non-financial obligations arising from a contract to be measured?*

   An asset/liability approach is likely to lead to earlier recognition of the rights and obligations arising from contracts. At this point the financial benefits - in other words the asset - resulting from a contract may be clear but the obligation may be expressed only in non-financial terms.

   The resulting uncertainty over how to measure such obligations may create fertile ground for unscrupulous preparers. We believe that guidance on measuring liabilities in these circumstances is vital.

5. *How is expense recognised and what does this imply for 'investment in the future'?*

   The Statement of Principles rejects revenue/cost matching in the recognition of expense. Instead, expenditure must meet the rigorous criteria for recognition of an asset before it can be carried forward to set against future revenues. The effect has been that most expenditure expected to benefit future periods is written off as an expense in the period it is incurred rather than in the period expected to benefit.

   We believe that the ASB should explore ways to limit the impact of this approach on the assessment of performance.

6. *On what basis should barter transactions be recognised?*

   The recent UITF draft abstract on the recognition of barter transactions in advertising would suggest a very restrictive approach generally to the recognition of revenue and expense from transactions which do not ultimately involve realisation of a financial asset.

   We invite the ASB to consider whether the appropriate principle should be the reflection of economic activity.

7. *When should revenue be recorded net rather than gross?*

Revenue is an important performance indicator in its own right and consistency of calculation is therefore important. The new business models developing on the Internet have raised the profile of when it is appropriate to take a gross inflow as revenue rather than presenting a net amount. This has highlighted inconsistencies of approach which extend beyond the Internet.

Guidance from the ASB to promote consistency of presentation would be helpful.

Introduction

It is generally agreed that users attach considerable importance to a company's performance statement. Revenue is both the starting point for that statement and an important measure of performance in its own right; yet there is little guidance in UK financial reporting standards on when to record, or recognise, revenue. The ASB is soon to remedy that omission with the publication of a discussion paper on revenue recognition.

International convergence is an increasingly important influence in the development of new UK reporting standards and, now that they have gained IOSCO's (albeit qualified) approval, International Accounting Standards (IAS) are a credible alternative to US GAAP. There is a powerful argument that, in the interests of international harmonisation, the ASB should adopt the principles of the IASC's revenue recognition standard, IAS 18, in its forthcoming revenue recognition paper.

But this is unlikely because, although IAS 18 incorporates some use of fair values and modern phraseology, it is firmly rooted in the traditional approach of recognition of revenue to reflect the performance of business activity and reliance on matching to link revenue and expense. IAS 18 embodies existing international and UK GAAP but is arguably inconsistent with the IASC's framework for the preparation and presentation of financial statements. Revision of the standard is likely to be a priority for the new IASC Board.

In contrast, the ASB has applied its own conceptual framework, the Statement of Principles for Financial Reporting, in developing a valuation approach to reporting, with a clear focus on the recording of assets and liabilities that can be measured reliably and without any specific performance criteria. In addition, the Statement of Principles specifically rejects revenue/expense matching; expenditure must meet the criteria for recognition of an asset before it can be carried forward to set against future revenues.

In this paper, we explore some key questions that a UK revenue recognition standard derived from an asset/liability approach will need to address and suggest the difference that applying this approach could make in a variety of practical situations.

1. What is revenue?

The Statement of Principles focuses on criteria for the recognition and measurement of assets and liabilities with gains and losses being a residual calculation. Revenue and expenses are described as subsets of gains and losses but the statement does not define the distinction between revenue and gains or expenses and losses because there is no conceptual difference between them under an asset/liability approach.

However, the distinction is important as revenue is a key performance indicator, closely followed by users of financial statements, and the definition therefore needs to be provided in a revenue recognition standard.

A distinction often made is that revenue derives from a company's basic business processes while gains arise from non-operating or fixed assets. IAS 18 defined revenue as gross inflows of economic benefits arising from the ordinary activities of a business. However, this was at a time when the key distinction in the profit and loss account was that between ordinary and extraordinary items and it might now be more appropriate to define revenue in terms of inflows from the operating activities of a business.

In this paper we have based the distinction between revenue and gains on the concept of operating activities. However, it will at times be difficult to apply any boundary, including that between operating and non-operating activities, because differences in the way companies operate will lead to inconsistency of allocation. Practical guidance on the way the definition of revenue chosen by the ASB is to be applied will therefore be needed. For example, how will different definitions of operating activities affect whether interest income should be presented as revenue, as a gain or as a reduction in a financing charge?

2. *Is a reliably measured increase in the value of operating assets a better criterion for recognising revenue than realisation?*

Reliability of measurement has always been important to accountants and traditionally has led to the reflection of business activity in the financial statements only on realisation by a transaction. This has the effect of delaying recognition of revenue in the financial statements to a point late in a company's operating cycle.

IAS 18 reflects this position by using a risk-based test. So revenue from the sale of goods is recognised when the significant risks and rewards of ownership of the goods have been passed to the customer, which is normally on delivery to the customer.

However, it is now widely accepted that other events have economic effects that can be measured reliably enough for inclusion in financial statements. So, the Statement of Principles focuses on the recording of assets and liabilities that can be measured reliably, with a gain or loss being the difference between the assets and liabilities recorded. The essence of an asset is that a business will obtain future economic benefits from it in the form of cash inflows to the business. It will be possible to anticipate these benefits reliably, and therefore recognise an asset, in a variety of situations prior to realisation including:

- Where there is an active market in the operating assets of a business, and

- When goods are produced to a customer's order.

Use of market values

The change in value of the operating assets of a business may reflect the performance of business activity better than delaying recognition to the point of actual realisation, particularly when the business has a long operating cycle and realisation lies some time in the future.

This is the rationale behind E65, the 1999 IASC exposure draft on Agriculture. The exposure draft proposes that biological assets are valued at their fair value at each balance sheet date and that the change in fair value is included as part of profit or loss from operating activities for the period.

The Agriculture exposure draft represents the most comprehensive application to date of fair value accounting. But 'marking to market' is already widely used to recognise revenue where there is an active market for the products of a company, for example in commodity production and trading, including trading in financial assets and liabilities.

Goods produced to a customer's order

The Statement of Principles introduces the idea of recognising revenue on the critical event in a company's operating cycle as an illustration of the point at which the gain from the provision of goods or services can normally be measured with sufficient reliability. This would frequently be the point of sale but it could be earlier in the operating cycle.

Where goods are produced to a customer's order, for example cars built to a customer's specification, it will normally be possible to measure both the revenue and costs with sufficient reliability in advance of sale of the goods. Revenue would then be recognised at an earlier point in the operating cycle, for example on completion of production of the goods.

These examples show that, in some situations, applying a criterion of reliability of measurement can reflect the performance of business activity better than recognising revenue on realisation. So revenue recognition based upon reliability of measurement will be less reliant upon realisation as the principal recognition criterion. Realisation might be seen as an appropriate condition for revenue recognition, but not a necessary one. Drafting rigorous recognition criteria to reflect this approach could represent a significant challenge for the ASB.

3. *Is performance of the primary business activity necessary in addition to increased asset value?*

Reliability of measurement is, without question, an important and necessary condition for revenue recognition. But is it sufficient alone? Should revenue be recognised whenever there is an increase in the value of a company's operating assets that can be measured reliably regardless of whether that revenue is seen as having been earned?

An alternative analysis of the example of goods being produced to a customer's order is that the reference in the Statement of Principles to measuring a gain with sufficient reliability is anomalous. It runs counter to the primary emphasis of the Statement of Principles on asset and liability recognition as separate tests, without any linking mechanism such as that of matching. This would imply that a gain could be recognised as long as an asset can be measured reliably - even if measurement of the obligation is subject to greater uncertainty. Revenue could then be recognised earlier in the cycle. It may be possible to measure receipts from an order reliably, and hence revenue, as early as when the order is signed.

But an order for goods is a just a specific example of a more general case, namely entering into an enforceable contract. It will normally be possible for a business to anticipate inflows, and therefore an asset, reliably whenever a contract is entered into. The supply of either goods or services can be regulated by a contract, with contracts for the provision of services particularly likely to be for the longer term.

Under IAS 18, revenue from services is recorded to reflect the performance of business activity by recognising revenue on an ongoing basis over the period of a contract on the basis of the stage of completion of the contract.

In contrast, a pure asset/liability approach would recognise immediately a gain resulting from a business's performance in entering into a contract, as this quotation illustrates in the context of revenue recognition by lessors:

> "As a general principle, it is the Group's [the Group of members of G4+1] view that a gain should be recognised at the beginning of the lease term if (a) there is evidence that the value of the lessor's assets (less its liabilities) has increased as a result of its performance in entering into the lease contract, and (b) the increase can be measured reliably."
>
> *Leases: Implementation of a New Approach,* ASB Discussion Paper, 1999, paragraph 8.15, p.149.

There are many facets to a company's performance in a period. The performance of business activity and performance in entering into contractual relationships are two different aspects of performance, gains from holdings of operating assets is a third. Which of these gains should be reported as revenues and included in the profit from a company's operating activities?

It is important that users understand which aspect or aspects of performance revenues and operating profit are meant to reflect. This is a key issue for the ASB to address in its revenue recognition paper as we think it likely that contractual relationships will increasingly be recognised in financial statements under an asset/liability approach. Steps have already been taken in this direction: IAS 39 *Financial Instruments: Recognition and Measurement* requires the recording of all financial instruments at their fair value and the ASB discussion paper on Leases proposes extension of the recognition of leasing obligations to include obligations arising under operating leases.

A related issue is whether the traditional emphasis on the necessity for performance of a contract before the effects of that contract are recognised remains valid under an asset/liability approach. Conventionally, contracts which are equally unperformed by both parties, or executory contracts, are not recorded while the effects of the contract are recognised if there has been significant performance by one of the parties.

However, logic would indicate that a performance based distinction is unnecessary under an asset/liability approach. The Statement of Principles acknowledges that an unperformed contract can have a net value which qualifies for recognition as a gain under a fair value accounting model if it can be measured with sufficient reliability. The value of a forward currency contract could, for example, meet this criterion, although actual performance in that case is something of a formality.

But belief in the need for performance remains pervasive. The ASB discussion paper on Leases specifically noted that recording the rights and obligations under a lease should happen only after significant performance had taken place, which was defined as being on delivery of the leased asset to the lessee.

4. *How are non-financial obligations arising from a contract to be measured?*

Revenue and expense recognition cannot be divorced from each other, which is perhaps most clearly seen in accounting for contractual rights and obligations where accounting for only rights or only obligations could not represent the substance of the exchange. Consequently, in our view, the ASB's revenue recognition discussion paper cannot ignore the need for guidance on the measurement of liability and the associated expense.

In the Leases discussion paper, the payments to be made under the lease enable the financial obligation arising from a lease to be calculated.

However, the asset created by a contract is often expressed in financial terms but the obligation imposed in exchange is not. The asset will qualify for recognition and the value of the obligation therefore needs to be quantified.

A simple example of this is a health club subscription where services are provided over a period of time and paid for in advance. But a similar analysis could apply whenever a contract stipulates advance payments, for example deposits for goods and advance royalties, or even to any series of payments scheduled by a contract where the likelihood of receiving the contractual payments is high.

Accounting for subscriptions paid in advance

IAS 18 provides for revenue from services to be recognised by reference to the stage of completion of a contract. Therefore, at each accounting date an appropriate proportion of the subscription paid in advance is credited to revenue. The balance is treated as deferred income and shown as a credit in

the balance sheet, although it does not necessarily meet the definition of a liability as no consideration is given to whether any obligation exists. In allowing this, IAS 18 may be considered to be inconsistent with an asset/liability approach. Costs incurred in providing the service are matched, or recognised simultaneously with the revenue, so that profit is recognised over the period of the subscription.

The position under an asset/liability approach is less straightforward. On payment of the subscription, there is an exchange of assets and liabilities. The company has an asset, cash, and a liability - the obligation to provide services to the member over a period of time. The difference in value between the asset and the obligation is the profit to be recognised on the exchange. The value of the asset can be measured with certainty but what is the value to be placed on the obligation?

Four bases of measurement would seem possible:

i. The amount that the company would be legally obliged to refund to the member in the event that membership ceases - as many subscriptions are non-refundable, this value may be nil;

i. The marginal cost of providing the services that the member is expected to benefit from over the subscription period;

ii. The full cost of the same; or

iii. The fair value of the obligation, i.e. the sum required by another business to take on the liability.

The four bases of measurement would give very different amounts for the gain to be recognised on entering into the contract.

<table>
<tr><td colspan="4">Asset: Subscription received</td></tr>
<tr><td colspan="4">Liability:</td></tr>
<tr><td>i. Refund, which is often nil</td><td>ii. Marginal cost</td><td>iii. Full cost</td><td>iv. Fair value</td></tr>
<tr><td colspan="4">Profit recognised on payment of subscription:</td></tr>
<tr><td>i. Up to the full subscription</td><td>ii. Increase in net assets from entering into contract</td><td>iii. Total profit on contract</td><td>iv. Profit on contract to date</td></tr>
</table>

Unless the subscription is proportionately refundable and the refundable amount is used as the measure of liability, under any of the first three bases, the gain recognised would anticipate performance of business activity and

result in a mismatch between subscription income and the cost of earning that income. The second basis would, however, reflect the performance from entering into the contract - the expected increase in its assets from gaining an additional member.

Adopting the fourth basis would tend to reflect better the performance of business activity because another business would wish to make a profit on any obligation it took over. However, this basis could be thought difficult to reconcile with the ASB's Statement of Principles which states that "an obligation implies that the entity is not free to avoid the outflow of resources."[1] The higher fair value of the obligation can always be avoided by choosing to provide the services to the member rather than sell on the obligation.

The Statement of Principles offers little guidance on choosing between these measures of liability, stating only that the most relevant of the reliable alternatives should be chosen. The first three bases can all be measured reliably, but whether a fair value can be measured reliably depends on there being a genuine market, even if actual transactions are relatively infrequent. Which of these measures of liability is the most relevant to users is difficult to say but it would certainly be helpful to them to know what kind of performance the profit and loss account is intended to reflect. The concept of fair, or relief, value in particular may require development in the light of the answer to the performance question.

In a more complex exchange, it becomes even more uncertain how an asset/liability approach might operate. As an illustration, we refer below to the example of revenue support grants to train operating companies. This shows some further possibilities for the measurement of a non-financial obligation when a long term contract for services is entered into as well as the effect of uncertainty about the need for performance prior to recognition under an asset/liability approach.

Revenue support grants to train operating companies

The government pays support grants to train operating companies to compensate for the operating losses predicted by the company in their bid for the franchise. The grants are fixed at the level specified in the franchise agreement, a typical franchise runs for at least seven years with the grants paid declining in value over time.

Train operating companies currently recognise the grants as they accrue over the franchise period as part of their profit or loss from operations. This is consistent with IAS 18's 'stage of completion of performance' approach, the actual pattern of receipt of the grants providing a better basis for assessing performance than time apportionment.

[1] *Statement of Principles for Financial Reporting*, ASB, 1999, para. 4.25

However, under an asset/liability approach, there is an exchange of assets and liabilities on signing the franchise agreement. The train operating company obtains the right to receive a stream of payments from the government, an asset which can be valued with sufficient reliability for recognition as there is only a very low probability that the grant will not be paid. Simultaneously, the company takes over the government's obligation to provide a rail service to passengers. Should this income stream be recognised and, again, how is the obligation imposed on the franchisee to be measured?

Additional uncertainties are introduced by:

- The long term nature of the contract;

  Measurement of the obligation, which is the net shortfall in income from passengers, is subject to considerable uncertainty and, in addition, expectations about the cost of fulfilling the obligations will change over the period of the contract.

- Uncertainty about the need for performance of the contract under an asset/liability approach;

  Initially, on signing the franchise agreement, the obligations of both parties are unperformed to an equal degree - the contract is executory. Such contracts are not normally recognised under a historical cost accounting model.

  Does the contract remain so over its entire period? Both parties to the contract will perform their obligations over the whole period of the contract, the franchisee on a continuous basis and the government at a series of points. Such a contract cannot strictly be called executory, as it will only be by chance that the contract, once commenced, is unperformed to an equal degree. However in the Leases discussion paper contracts for the provision of services over an extended period where payments are made regularly over that period are said to be executed throughout their term, with the unperformed part remaining executory.

  Even if the contract is deemed to remain executory, circumstances may alter over the franchise period to give the contract a net value, for example many train operating companies have experienced strong growth in passenger numbers since privatisation which may exceed the forecasts made in bidding for the franchise.

Whilst it is difficult to give a definitive answer to the effect of applying an asset/liability approach, the options at the accounting dates within the franchise term are as follows:

a. *Recognition of the rights and obligation under the franchise agreement:*

A number of bases would, as in the previous example, appear possible for measurement of the obligation:

i. Nil. Government grants are stated to fall within the scope of the 1999 G4+1 paper on the recognition of non-reciprocal transfers because there is only an indirect link between the government paying the grant and those who benefit from the rail service. It is debatable whether government grants are usefully regarded as non-reciprocal. By definition, there can be no obligation relating to a non-reciprocal transfer.

ii. The relatively small deposit that would be forfeited if the franchisee surrenders the franchise.

iii. The present value of management's original forecast of the deficit from operating the franchise.

iv. The present value of management's current forecast of the deficit from operating the franchise. This will reflect both market movements and the extent to which the contract has been performed.

These bases of measurement of liability would each give a different pattern for recognition of the gain from the contract as summarised in the following table:

Asset: Valued at the present value of the stream of receipts from the government.			
Liability:			
i. Nil	ii. Deposit forfeit	iii. Original forecast	iv. Current forecast
Gain recognised:			
i. Present value of the stream of receipts from the government at the start of the franchise period.	ii. As i. minus the deposit forfeit.	iii. In line with the payments made by the government over the period of the franchise.	iv. Over the period of the franchise though earlier than iii. if forecasts made in bidding for the franchise are exceeded.

b. As an executory contract:

i. Under a historical cost model:

Nil. The transactions are recorded as they accrue.

ii. Under a fair value model:

As basis iv. above, except that the asset and obligation would be shown net rather than gross in the balance sheet.

5. How is expense recognised and what does this imply for 'investment in the future'?

Under IAS 18, expenses are recognised in the profit and loss account on the basis of a direct association between the costs incurred and the earning of specific items of revenue, a process known as revenue/cost matching. In contrast, the Statement of Principles specifically rejects revenue/cost matching, although it may be that a similar effect is obtained for direct expenses by identifying all the assets and liabilities affected by an event in order to record the substance of that event.

However, matching more generally is the allocation of expense to the period expected to benefit from the expenditure and revenue/cost matching has also been used to justify the carry forward of expenditure expected to generate future revenues but with only an indirect association with specific revenues. In rejecting revenue/cost matching, the ASB argued that unrestricted matching could be used to delay the recognition as a loss of most items of expenditure insofar as the hoped-for benefits lay in the future. So under the Statement of Principles, expenditure must meet the criteria for recognition of an asset before it can be carried forward to set against future revenues, otherwise it must be recognised as an expense immediately.

In principle, an asset/liability approach could lead to more effort being made to develop methodologies for the valuation and recognition of non-financial and intangible assets to enable these to be recorded in financial statements. In practice the ASB in its Statement of Principles has set the reliability threshold higher for assets than liabilities and has imposed an additional criterion of a company having control over the expected benefits before it can recognise an asset, leading to asymmetry in the recognition of assets and liabilities. The hurdle that expenditure must meet to be carried forward as an asset is therefore high.

Under the ASB's asset/liability model, the effect is that only a small subset of expenditure expected to benefit future periods is recognised as an asset and most is written off as an expense in the period in which it is incurred.

At the same time there is widespread acceptance that intangibles are of increasing importance to the future success of many companies. One example is relationship assets, which include the value of customer loyalty

and employees' knowledge and skill base. However, such assets inevitably fail the control test and so can never be recorded as an asset.

In FRS 10 the ASB applied its approach even more restrictively to prohibit the carry forward of any expenditure on internally generated intangibles. In contrast, SSAP 13 uses the concept of matching, supplemented by a recoverability test, to justify the carry forward of expenditure on the development of new products and services. In any future revision of SSAP 13, its logic will presumably need to be brought into line with the Statement of Principles. In the current climate, it seems likely that the carry forward of expenditure on product development would be further restricted. But this may have a limited practical impact as few companies adopt the provisions of SSAP 13 in an atmosphere where companies are expected to write everything off.

Money spent as an 'investment in the future' does not benefit the current accounting period and writing it off immediately fails to match expense to the period expected to benefit from the expenditure. This treatment therefore fails to reflect the performance of business activity.

Guidance from the ASB on ways to redress the balance would be of assistance. At a minimum this could take the form of supplementary disclosures or presenting different kinds of expenditure separately in the profit and loss account. More fundamentally the restrictive definition of an asset might be revisited, neither the requirement for 'control' nor an asymmetric reliability hurdle between assets and liabilities are essential to an asset/liability framework.

6. On what basis should barter transactions be recognised?

IAS 18 provides that the exchange of dissimilar items should be recognised as revenue and expense at the fair value of the exchange with the objective of recognising economic activity if a sufficiently reliable measure can be found. If the fair value of the goods or services received cannot be reliably measured, revenue is measured as the fair value of the goods or services given up.

The guiding principle of IAS 18 is reflecting business activity, limited by the need for a reliable measurement of that activity. In contrast, the Statement of Principles has reliability of measurement as its single criterion.

So the recent draft UITF abstract on barter transactions in advertising effectively prohibits the recognition as revenue of such transactions because the UITF applied the reliability criteria of the Statement of Principles very restrictively. It argued that a barter transaction cannot be measured with sufficient reliability unless very similar sales for cash had taken place in the recent past. In addition, to ensure that only transactions with economic substance are recorded, the UITF imposed as a further condition that revenue from barter transactions in advertising can only be recognised where it is likely

that the space bartered could have been sold for cash. The hurdle for recognition of barter transactions in advertising is set very high.

This 'anti-abuse' approach is reasonable in the particular circumstances of Internet advertising where there are virtually no restrictions on the amount of advertising a website can carry and little cost to carrying an advertisement. At the same time, revenue is seen as a key performance indicator of dot.com companies.

However, it is a matter for concern that the UITF states that the principle may be appropriate to other barter transactions because this restrictive and industry specific approach applied generally will fail to capture elements of real economic activity altogether.

The revenue recognition discussion paper provides an opportunity for the ASB to express its guiding principle for the recognition of non-financial transactions and we invite the Board to consider whether the appropriate principle should be the reflection of economic activity.

7. *When should revenue be recorded net rather than gross?*

Neither IAS 18 nor the ASB's Statement of Principles offers comprehensive guidance on when revenue should be recorded gross rather than as a net figure. In addition to being the starting point for a company's performance statement, revenue is an important performance indicator in its own right and consistency of calculation is important.

The issue of gross or net presentation of revenue has gained recent prominence through the new business models developed for Internet trading. In addition to reflecting new ways of doing business, there is a strong incentive for Internet companies to maximise their revenues because the first indications of success are expected to be found in turnover rather than in operating profit.

Aggregators and other Internet intermediaries

As an example, some Internet companies act as intermediaries in selling the products or services of third parties. IAS 18 notes that the gross receipts collected by an agent on behalf on a principal are not his revenue. The revenue of an agent is the commission received. But many Internet intermediaries bear little business risk despite apparently trading as principal rather than agent.

The legal distinction between an agent and a principal adopted in IAS 18 appears inadequate when an Internet trader acts as a principal with the ability to control an item's selling price but bears neither credit risk nor the risk of unsold merchandise.

One alternative approach might be that of substance over form based on the balance of risk and reward in the business model.

Sales discounts and rebates

Another example, again given prominence by Internet trading, is whether sales discounts and rebates should be recorded as a marketing expense with the sales recorded gross or whether the net receipt should be shown as revenue.

In the US, the SEC has ruled that revenue should be recorded net. This is undoubtedly correct where the discount relates to a one-off sale. However, where the customer signs a contract for the supply of services over a long period and, for example, receives a free introductory period, the substance of the transaction would be better reflected by apportioning the discount over the whole contract period.

Inconsistencies in other industries

But this kind of issue does not affect the Internet alone. High street department stores commonly include in their revenues the turnover from shops-within-shops, although the stores receive rental or commission for the space occupied rather than the proceeds from the sales of goods by those concessions. In the insurance industry, gross premiums are recorded as revenue in their entirety, although for investment-linked insurance contracts these include an investment element (deposit) as well as the risk premium (revenue).

It would be helpful if the ASB's revenue recognition paper provided more robust guidance than is currently available on these issues.