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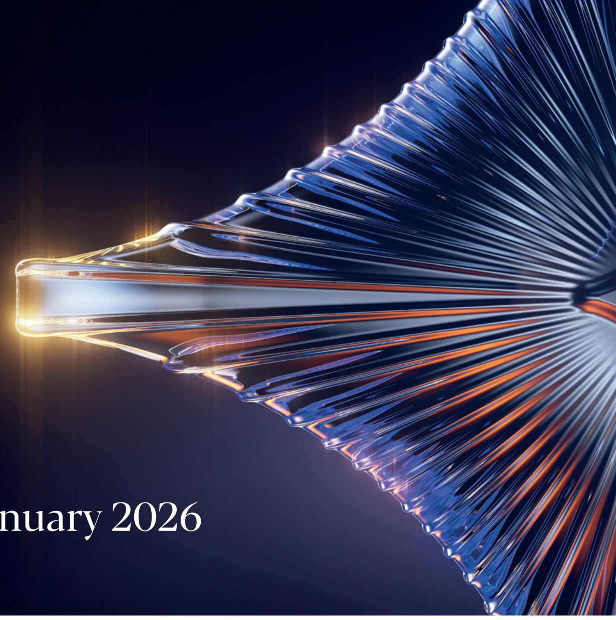

FRS 102 changes for revenue recognition

For accounting periods beginning on or after 1 January 2026

1. Introduction: Why Revenue guidance is changing

The Financial Reporting Council's 2024 Periodic Review introduced major amendments to various elements of FRS 102 "The Financial Reporting Standard applicable in the UK and Republic of Ireland". Section 23 on Revenue is one area that has seen significant change as the old section has been wholly replaced with a new approach to revenue recognition that replaces the previous risks-and-rewards approach with one broadly aligned to the IFRS 15 "Revenue from Contracts with Customers". The revised standard introduces a new five-step revenue recognition framework, more prescriptive guidance throughout, and enhanced or clarified guidance on topics such as principal versus agent roles, variable consideration and contract balances.

The revised standard is effective for accounting periods beginning on or after 1 January 2026, with early adoption permitted.

2. The Five-Step Revenue Recognition Model

The five-step revenue recognition model will be familiar to those familiar with IFRS 15 but represents a significant change to UK financial reporting standards as it replaces the old model that considered the sales of goods and services separately, with one which applies to all revenue from contracts with customers.

It is important to be aware of the contracts that are outside of the scope of Section 23, which principally include lease contracts (which are in scope of Section 20 of FRS 102), financial instruments (in scope of Sections 11 and 12 of FRS 102), income from Associates and Joint ventures (Sections 14 and 15 of FRS 102) and insurance contracts (which are covered by FRS 103).

For those contracts in scope, there is one five-step approach that applies to contracts with customers. As explained overleaf, the five steps set out new requirements on identifying revenue, how to calculate it and when to recognise it.

Step 1: Identify the contract(s) with a customer

Step 2: Identify the performance obligations

Step 3: Determine the transaction price

Step 4: Allocate the transaction price

Step 5: Recognise revenue

Step 1: Identify the contract(s) with a customer

A contract must meet criteria stated in the standard, including approval by both parties, have identifiable rights and payment terms, have commercial substance, and probable collectability. Contracts may be combined when negotiated as a package or interdependent.

Step 2: Identify the performance obligations

When assessing recognition, the entity must identify the performance obligations (or "promises") within the contract to transfer distinct goods or services. The word "distinct" is used as the separate goods and services included in the contract must be separately identified and assessed where they are capable of being distinct both in terms of the individual obligations and in context of the contract. In some cases, goods and services may not be distinct (e.g. the installation of a product that can only be performed by the manufacturer). Section 23 explains how to identify distinct goods and services or those that are combined (or "bundled").

> ***Example – Identifying performance obligations***
>
> Up In The Air Software Limited ("Up In the Air") sells a software product. A typical customer contract includes:
>
> 1. A licence to use the software
> 2. Initial set up and configuration services
> 3. Ongoing customer support (helpdesk and updates) for a year
>
> Up In the Air must assess which promised goods or services are distinct performance obligations.
>
> In this case, the set-up and configuration do not provide a separate distinct benefit to the customer – the software cannot be used without the service. These services are bundled with the licence to form a single performance obligation.
>
> The ongoing support is a separate service from which the customer benefits. It does not change or modify the software or impact on the configuration service. It is distinct from the licence and set up services.

Step 3: Determine the transaction price

Entities must estimate the consideration expected, including fixed and variable amounts, and assess constraints on variable consideration. In determining the transaction price, the new Section 23 is more prescriptive and useful than the old version, particularly for variable consideration which includes items such as performance related consideration, discounts, rebates and refunds.

The "constraint on variable consideration" (or "variable consideration constraint") is a new concept for FRS 102 and requires an entity to include the estimated amount of variable consideration only to the extent that it is "highly probable" (which is not defined but in practice would be 80% or more likely) that it will be entitled to the cumulative amount of revenue recognised when the uncertainty associated with the variable consideration is subsequently resolved.

Step 4: Allocate the transaction price

Entities are required to allocate the consideration to the performance obligations identified in Step 2 based on relative "standalone selling prices". The standalone selling price is defined by Section 23 as "the price at which an entity would sell a good or service promised in a contract separately to a customer". The standard provides guidance and approaches on how entities should identify or estimate the standalone selling price if it is not directly observable.

Example – Allocating the transaction price

Following on the previous example, Up In the Air has identified the following performance obligations:

- **Performance Obligation 1:** A bundled obligation comprising the software licence and the initial set up and configuration services (not distinct).
- **Performance Obligation 2:** Ongoing customer support for one year (distinct).

Up In the Air charges a total transaction price of £12,000 for the combined contract.

The standalone selling prices ("SSPs") of the components—if sold separately—are:

- Software licence (annual) – £10,000
- Set up and configuration – £4,000
- Ongoing support – £6,000

The total SSP is £20,000. Up In the Air must allocate the £12,000 transaction price across the performance obligations in proportion to their relative standalone selling prices.

Step 1 – Determine allocation percentages

- Bundled licence + set-up: £14,000 ÷ £20,000 = 70%
- Support: £6,000 ÷ £20,000 = 30%

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Step 2 – Allocate the consideration

- Allocation to Bundled licence + set-up: 70% × £12,000 = £8,400
- Allocation to Support: 30% × £12,000 = £3,600

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Conclusion

- 8,400 is recognised when the software is installed and the customer can use it (point in time).
- £3,600 is recognised over the year as customer support services are provided.

Step 5: Recognise revenue

Recognise revenue when or as each performance obligation is satisfied, based on transfer of control. The recognition of revenue based on the transfer of control rather than the transfer of risks and rewards is a fundamental difference to the old revenue recognition model.

The considerations at this step are those which will determine if revenue is recognised "at a point in time" or "over time".

At its simplest the model considers an entity to satisfy a performance obligation over time and therefore requires revenue recognition over time when one of the following criteria is met:

1. The customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs the obligation – for instance a recurring service like cleaning.
2. The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced – for instance a construction contract in which the customer controls the work in progress.
3. The entity's performance does not create an asset with alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

Where none of the above criteria are met, revenue is recognised at a point in time.

Example

Returning to the "Up In the Air" example the revenue allocated to the different performance obligations would be recognised differently. As a reminder the typical customer contract includes:

1. A licence to use the software
2. Initial set up and configuration services
3. Ongoing customer support (helpdesk and updates) for a year

Up In The Air must assess how the customer receives the benefits of the contract and any asset created.

In this case, the consideration allocated to the bundled set-up and configuration, and licence obligation would be recognised when the software is ready for use by the customer, i.e. when it can control the software. This revenue would be recognised at a point in time.

The ongoing support is a separate service from which the customer benefits. It does not change or modify the software or impact on the configuration service. It is distinct from the licence and set up services. The customer receives and consumes the benefits of the entity's performance as it occurs, so the revenue is recognised over time.

3. Key Areas of Enhanced Guidance Under Revised FRS 102

Beyond the introduction of the five-step model, the new Section 23 gives deeper and more prescriptive guidance over several different revenue related items. These include:

3.1 Principal vs Agent Considerations

The guidance on whether an entity is acting as a principal or agent has been significantly enhanced and requires an entity to determine whether the nature of its promise is to provide the specified goods or services itself (i.e. the entity is a principal) or to arrange for those goods or services to be provided by another party (i.e. the entity is an agent).

Principals recognise revenue on a gross basis while agents recognise only their fee or commission.

Section 23 gives guidance on indicators as to whether an entity is a principal or agent. Indicators that the entity is acting as principal in a contract include whether the entity: has control over the specified good or service; bears inventory risk; or has discretion in establishing prices. Even with this enhanced guidance, determining whether an entity is principal or agent may require significant judgement and careful consideration of specific factors and conditions.

3.2 Contract Assets and Contract Liabilities

The old Section 23 didn't explicitly cover the balance sheet impact of revenue items in detail, but the new section defines and clarifies concepts such as contract assets (rights to consideration for goods/services transferred but not yet billable) and contract liabilities (obligations arising when consideration is received or due before goods/services are transferred).

3.3 Non-Refundable Upfront Fees

Some contracts include a non-refundable upfront fee at or near contract inception. Examples include joining fees in health club membership contracts, or set-up fees in some service contracts.

Upfront fees rarely separate performance obligations as they are unlikely to relate to the transfer of a distinct good or service to the customer. So, they are typically recognised over the period of service. Where the overall contract term is undefined, such as for joining fees, the relevant period will need to be estimated, which is another source of judgment and potential uncertainty.

3.4 Customer options for additional goods and services

Some contracts grant customers the option to acquire additional goods or services for free or at a discount. If the option (e.g. sales incentives, contract renewal options or discounts on future goods or services) provides the customer with a "material right" that it would not receive without entering into that contract, the option gives rise to a separate performance obligation.

If an option provides a material right to a customer, the customer is effectively paying the entity in advance for future goods or services. Consequently, the entity recognises revenue when those future goods or services are transferred or when the option expires.

3.5 Licensing Income

Paragraph 105 of Section 23 explains that "A licence establishes a customer's rights to the intellectual property of an entity (such as software, technology, trademarks, patents, franchises, music and motion picture films)".

The Section 23 includes guidance to help determine whether the licence is transferred over time or at a point in time, which then determines the revenue recognition. The guidance classifies licences between two types:

- a right to access the intellectual property as it exists throughout the licence period. The revenue derived from such licences would be recognised over time; or
- a right to use the entity's intellectual property as it exists at the point in time at which the licence is granted. For such licences, revenue is recognised at the point in time at which the licence transfers.

> ***Example***
>
> The "Up In the Air" example provides an opportunity to illustrate the difference in licences and accounting treatment.
>
> In the previous examples the licence to use the software was bundled with the set-up services and so there was one performance obligation being the set up and configuration of the operational software, however in other situations the licence might be distinct.
>
> Software licences may take either form, either:
>
> 1. A licence provides the customer to use the software as it exists at that point and so revenue is recognised at a point in time, or
> 2. The licence provides a right to access the software for a given period of time. Though circumstances vary, this is the case for "Software as a service" transactions where the customer receives a service facilitated by access to the vendors cloud (or otherwise) based software. In this case, the entity recognises revenue over time.

3.6 Contract modification

A contract modification is explained as a "change in the scope or price (or both) of a contract that has been approved by both parties to the contract. A contract modification either creates new enforceable rights and obligations or changes the rights and obligations that already exist".

The new Section 23 provides guidance on how and when to account for a contract modification as a change to an existing contract and when the modifications increase the scope and price such that the contract modification should recognised as a separate contract.

In some circumstances a contract modification is accounted for as a separate contract. A contract modification is accounted for as a separate contract if:

(a) the modification increases the scope of the existing contract because of additional goods or services promised that are distinct from those in the existing contract; and

(b) the modification increases the price of the existing contract by an amount of consideration that reflects the entity's stand-alone selling price of the additional goods or services and any appropriate adjustments to that price to reflect the circumstances of that contract

If a contract modification is not treated as a separate contract, the accounting is:

(a) If the remaining goods or services are distinct from those transferred on or before the modification date, the modification is accounted for as the termination of the existing contract and the creation of a new contract. The transaction price of the new contract comprises the consideration previously included in the transaction price of the original contract that has not yet been recognised as revenue, together with the additional consideration arising from the modification.

(b) If the remaining goods or services are not distinct from those already transferred, the contract modification is treated as part of the original contract. Revenue is adjusted at the modification date using a cumulative catch-up basis to reflect changes in transaction price and progress.

(c) If the remaining goods or services include both distinct and non-distinct items, account for the modification's impact on unsatisfied obligations partly prospectively and partly using the cumulative catch-up method, as appropriate.

Example

Returning to the "Up In the Air" example again, gives an opportunity to consider the differing types of contract modifications.

On 1 January 20X6, Up In the Air Ltd enters into a contract with a customer to:

- Deliver 100 licences of its project management software. The licences are for the software in its current form and do not include updates or support.
- Price: £500,000

Under the amended Section 23 of FRS102, revenue is recognised using the five step model. Up In the Air determines that the software licences are a distinct performance obligation and recognises revenue when control transfers (on delivery).

On 1 March 20X6, the customer requests:

- An additional 40 licences
- At the normal standalone selling price (SSP) of £4,800 per licence
- Total for modification: 40 × £4,800 = £192,000

The extra 40 licences are distinct from the original 100, they are priced at the current SSP (£4,800) and no part of the original contract is altered. Therefore, the modification meets both criteria and is treated as a separate contract.

If on 1 March 20X6, instead of ordering additional licences, the customer requested an upgrade to the 50 licences undelivered at that date for an additional £180,000 this modification would not be treated as a separate contract because:

- The upgraded licences are not distinct from those in the original contract - They are upgrades to remaining items in the existing performance obligation.
- No new licences or services are added.
- The modification affects only the remaining unfulfilled items, whose specifications and cost-to-complete change.
- The additional £180,000 does not represent the standalone selling price of a separate good or service—it is an adjustment to the existing contract terms.

3.7 Contract costs

The outgoing Section 23 did not explicitly explain on how entities should account for costs of obtaining and fulfilling contracts, leaving preparers to look to other section FRS 102. The new version provides guidance on both, particularly for the costs incurred obtaining contracts where the standard permits entities to capitalise incremental recoverable costs of obtaining a contract.

3.8 Disclosures

In line with the increased scale of guidance and its prescriptive nature, there are more disclosure requirements to satisfy.

These include

- More granular information about revenue streams within the accounting policies disclosures
- Explanations of why and how revenue is recognised including identification of performance obligations
- Requirements to present contract related balances and
- Greater emphasis on the disclosure of significant judgements

4. Initial application of the New Requirements

On initial application of the new requirements, entities are offered a choice between either:

- Applying the new requirements retrospectively with the cumulative effect recognised as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application (the "modified retrospective" approach). This will not require the restatement of comparatives and need only be applied to contracts that are not completed by the date of initial application; or
- Full retrospective application in accordance with paragraph 10.12 of FRS 102 which applies to changes in accounting policies. This approach does require the restatement of comparatives and the recognition of the impact of the revised accounting treatment as at the beginning of the earliest comparative period presented in the financial statements.

5. Key Impacts and Practical Tips for Preparers of financial statements

The impact of the changes to Section 23, will of course be different for each entity, reflecting variables such as detailed contract terms, the nature of the industry, business practices, commercial and operational factors.

Management teams will need to be aware of the potentially significant impacts of the new Section 23 on reported revenue, EBITDA and profitability and consider how those in turn affect the entity and its stakeholders. Even where the end result is not a significant change in the reported figures, management will still need to have gone through the process of demonstrating that fact for the entity's various stakeholders, particularly where the entity is also subject to external audit.

There are however, some practical tips to follow in order to prepare for the changes:

Contract Review and Classification

- Review all contracts or standard contract types & map each revenue stream to the five-step model and identify bundled versus distinct obligations
- Identify consideration, and assess and evaluate any complex terms including variable consideration, or contract modification terms.
- Consider any enforceable up-front fees and their impact

Systems and Processes

- Ensure systems track contract assets/liabilities and the satisfaction of performance obligations.
- Align billing schedules with revenue recognition profiles.

Internal Reporting

- Consider and assess impact on revenue recognition and model the effects on performance measures such as EBITDA or Profit.
- Ensure that management accounts and other internal financial reports include the impact of the changes to revenue recognition

Internal Training & Governance

- Train finance teams on the new requirements
- Enhance controls over contract approval and modifications.

Policy Documentation

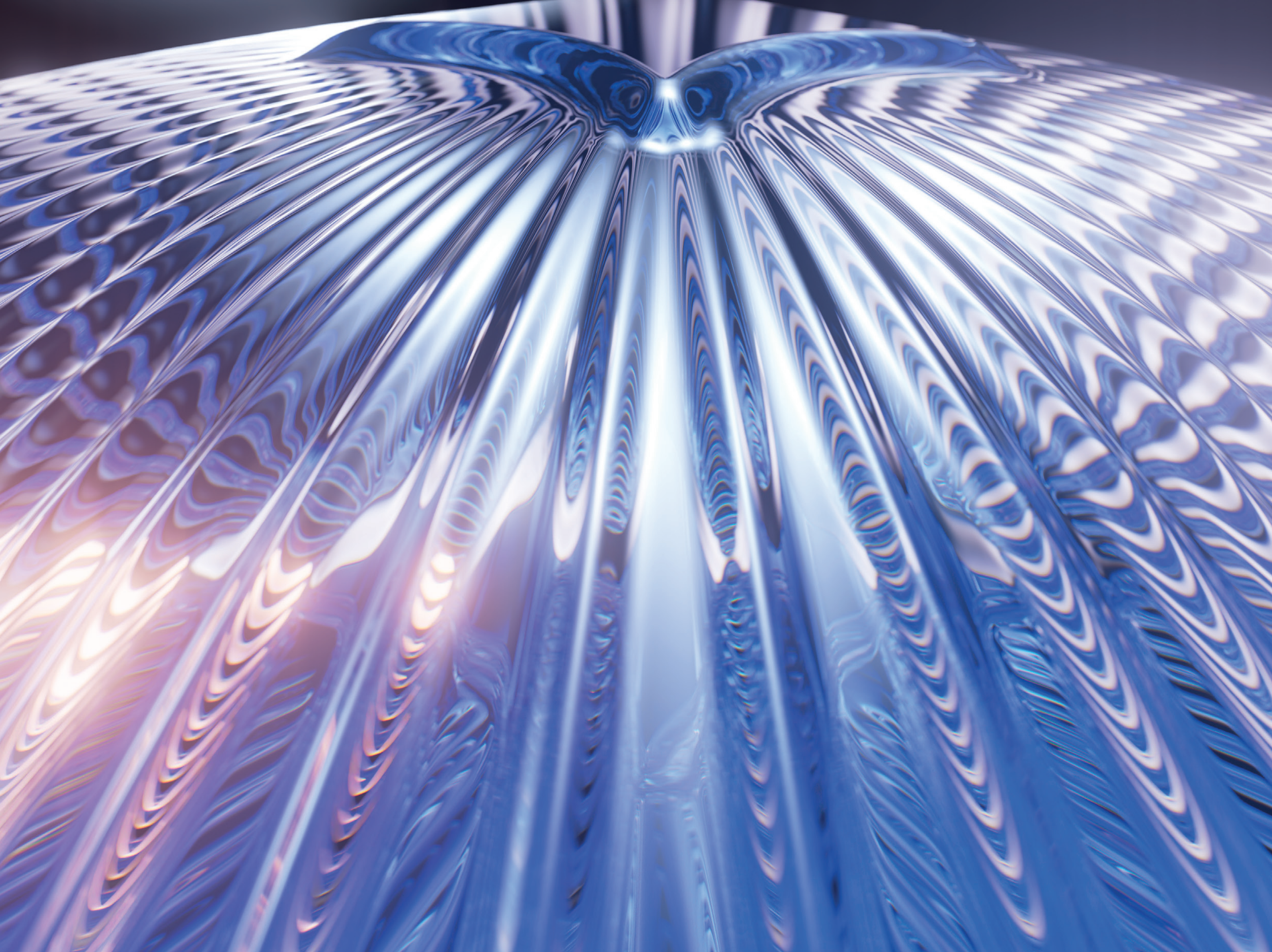
- Update accounting policies and disclose significant judgements and estimates in the annual financial statements.
- Document standalone selling price methodologies.

Communication with Stakeholders

- Explain expected changes in revenue patterns and KPIs to management, lenders, and investors.
- Consider impacts on financing covenants and remuneration metrics (including bonus and share based payment schemes) and discuss with relevant stakeholders.

Tax

- Consider the tax effects and discuss with your advisors where complex or material



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