**ED 164**

**Comments due by 31 August 2018**

# ACCOUNTING STANDARDS BOARD

# PROPOSED INTERPRETATION OF THE STANDARDS OF GENERALLY RECOGNISED ACCOUNTING PRACTICE ON

# ACCOUNTING FOR ADJUSTMENTS TO REVENUE

# (ED 164)

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## Interpretation of the Standards of Generally Recognised Accounting Practice: *Accounting for Adjustments to Revenue*

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# ACCOUNTING FOR ADJUSTMENTS TO REVENUE

## Introduction

## Interpretation of the Standards of Generally Recognised Accounting Practice

The Accounting Standards Board (the Board) is required in terms of the Public Finance Management Act, Act No. 1 of 1999, as amended (PFMA), to determine generally recognised accounting practice referred to as Standards of Generally Recognised Accounting Practice (GRAP).

The Board must determine GRAP for:

(a) departments (national, provincial and government components);

(b) public entities;

(c) trading entities (as defined in the PFMA);

(d) constitutional institutions;

(e) municipalities, municipal entities or any other entities under the ownership control of a municipality and boards, commissions, companies, corporations and funds; and

(f) Parliament and the provincial legislatures.

The above are collectively referred to as “entities” in Standards of GRAP.

The Board has approved the application of International Financial Reporting Standards (IFRS® Standards) issued by the International Accounting Standards Board® for:

(a) public entities that meet the criteria outlined in the Directive on *The Selection of an Appropriate Reporting Framework by Public Entities;* and

(b) entities under the ownership control of any of these entities.

Financial statements should be described as complying with Standards of GRAP only if they comply with all the requirements of each applicable Standard and any related Interpretations of the Standards of GRAP.

This Interpretation is set out in paragraphs .01 to .20. All paragraphs in this Interpretation have equal authority. The status and authority of appendices are dealt with in the preamble to each appendix. This Interpretation should be read in the context of its objective, its basis for conclusions, and where applicable, the *Preface to Standards of GRAP*, the *Preface to the Interpretations of the Standards of GRAP* and the *Conceptual Framework for General Purpose Financial Reporting*.

Standards of GRAP and Interpretations of the Standards of GRAP should also be read in conjunction with any directives issued by the Board prescribing transitional provisions, as well as any regulations issued by the Minister of Finance regarding the effective dates of the Standards, published in the Government Gazette.

Reference may be made to a Standard of GRAP that has not been issued at the time of issue of this Interpretation. This is done to avoid having to change the Standards already issued when a later Standard is subsequently issued. Paragraph .11 of the Standard of GRAP on *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

# Interpretation of the Standards of GRAP on *Accounting for Adjustments to Revenue*

## References

- GRAP 3 *Accounting Policies, Changes in Accounting Estimates and Errors*
- GRAP 9 *Revenue from Exchange Transactions*
- GRAP 19 *Provisions, Contingent Liabilities and Contingent Assets*
- GRAP 23 *Revenue from Non-Exchange Transactions (Taxes and Transfers)*
- GRAP 108 *Statutory Receivables*
- GRAP 109 *Accounting by Principals and Agents*
- IGRAP 1 *Applying the Probability Test on Initial Recognition of Revenue*

## Background

.01 In the public sector, there are a number of legislative and regulatory processes (hereafter legislation or similar means) that govern how entities levy, charge or calculate (hereafter charge) revenue.

.02 Adjustments to revenue recognised in terms of legislation or similar means arise from the completion of an internal review process within the entity, and/or the outcome of an external appeal or objection process undertaken in terms of legislation or similar means. Adjustments to revenue include any refunds that become payable as result of the completion of the review, appeal or objection processes.

.03 The adjustments to revenue following the outcome of any review, appeal or objection process can either result in a change in an accounting estimate, or a correction of an error.

## Scope

.04 This Interpretation clarifies the accounting:

(a) for adjustments to revenue charged, including refunds, in terms of legislation or similar means; and

(b) interest and penalties that arises from the recognised revenue.

The accounting of the underlying receivable is dealt with in accordance with the applicable Standard (also see paragraph .05(d)).

.05 This Interpretation does not deal with the:

(a) classification of the revenue as either exchange or non-exchange revenue (see the Standards of GRAP on *Revenue from Exchange Transactions* (GRAP 9) and *Revenue from Non-Exchange Transactions (Taxes and Transfers)*(GRAP 23));

(b) application of the probability test on initial recognition and measurement of revenue (see the Interpretation of the Standards of GRAP on *Applying the Probability Test on Initial Recognition of Revenue* (IGRAP 1));

(c) assessment of whether the entity undertakes transactions as the principal or agent in a principal-agent arrangement (see *Accounting by Principals and Agents* (GRAP 109)); and

(d) accounting for receivables or payables following any adjustments to recognised revenue (see the Standards of GRAP on *Provisions, Contingent Liabilities and Contingent Assets* (GRAP 19) or *Statutory Receivables* (GRAP 108)).

## Issues

.06 Some revenue is based on prescribed tariffs, bases, percentages or formulas that are promulgated in legislation or similar means after the completion of a due process.

.07 Revenue charged can be appealed by the person or entity responsible for the payment of the revenue charged through the following processes:

(a) an appeal or objection process established by the entity that charged the revenue;

(b) specific legislation or similar means that establishes an appeal and/or an objection process; and/or

(c) another legal process.

.08 The entity that charges revenue can also apply its own internal review process to assess if the revenue was charged correctly in terms of the prescribed tariff, basis, percentage or formula as promulgated in legislation or similar means. This may result in the entity itself identifying that the recognised revenue needs to be adjusted.

.09 Following the outcome of the processes in paragraphs .07 and .08, this Interpretation addresses how revenue, including interest and penalties, is adjusted when:

(a) a due process was not followed in promulgating the tariff, basis, percentage or formula that led to the charging of the revenue;

(b) the tariff, basis, percentage or formula was incorrectly applied in charging revenue; and/or

(c) an estimate may need revision as a result of changes in the circumstances on which the estimate was based, or as a result of new information that becomes known to the entity.

## Consensus

.10 The Standard of GRAP on *Accounting Policies, Changes in Accounting Estimates and Errors* (GRAP 3) defines a change in an accounting estimate as "an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities".

.11 In accordance with GRAP 3, adjustments to revenue are either accounted for as a change in an accounting estimate, or a correction of an error.

.12 GRAP 3 defines a prior period error as "omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

(a) was available when financial statements for those periods were authorised for issue; and

(b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud".

.13 Determining whether an adjustment to revenue charged in terms of legislation or similar means is a correction of an error or a change in estimate requires the application of judgement by management. When adjustments to revenue arise from new information that becomes known to the entity, the following considerations may be applied to determine whether the adjustment to revenue is a correction of an error or a change in an accounting estimate:

(a) If information becomes known to the entity, but the entity could not reasonably have been expected to know of this information when the revenue was charged, the adjustment to revenue is likely to be a change in an accounting estimate.

(b) If information becomes known to the entity, and the entity could reasonably have been expected to know of the information, and/or that the information used was incorrect, the adjustment to revenue is likely to be the correction of an error.

.14 GRAP 3 clarifies that, as a result of uncertainties inherent in delivering services, conducting trading or other activities, many items in the financial statements cannot be measured with precision, but can only be estimated. The use of estimates is an essential part of the accrual basis of accounting, and estimation involves judgements based on the latest available information.

.15 At each reporting date, the entity considers the outcomes of the processes in paragraphs .07 and .08 to assess whether the recognised revenue should be adjusted. The entity also needs to consider any additional facts and circumstances that may exist at the reporting date.

**Accounting for adjustments to revenue that correct an error or prior period error**

.16 Following the outcome of the processes in paragraphs .07 and .08, an entity accounts for an adjustment to revenue, including interest and penalties, as the correction of an error or prior period error where the entity:

(a) has not followed a proper due process to promulgate the tariff, basis, percentage or formula to charge the revenue; and/or

(b) incorrectly applied the tariff, basis, percentage or formula in charging revenue.

.17 The principles in GRAP 3 are applied to account for the adjustment to revenue as a result of the correction of an error or prior period error.

**Accounting for adjustments to revenue as a change in an accounting estimate**

.18 Following the outcome of the processes in paragraphs .07 and .08, an entity accounts for any adjustment to revenue, including interest and penalties, as a change in an accounting estimate if:

(a) changes occur in the circumstances that led to the recognition of the revenue; or

(b) as a result of new information that becomes known.

.19 The principles in GRAP 3 are applied to account for the change in the accounting estimate.

## Effective date

.20 An entity shall apply this Interpretation prospectively for annual financial statements covering periods beginning on or after DDMMYYY.

# Appendix – Illustrative examples

*This appendix is illustrative only and does not form part of IGRAP xx. The purpose of this appendix is to illustrate the application of the Interpretation and to assist in clarifying its meaning.*

**Example 1: Change in an accounting estimate following an adjustment to a property value as reflected in the valuation roll**

Municipality A levies property taxes on property owner X based on the value reflected in its updated valuation roll.

The valuation roll was updated in the previous financial period after Municipality A compiled an analysis of property values in its area. The analysis was based on the physical inspection and valuation of each property. Municipality A's accounting policy indicates that it can use estimates to compile and update its valuation roll where it is unable to inspect and value a particular property.

In updating the valuation roll, Municipality A issued the roll as part of its public consultation process as required in legislation, allowing property owners the opportunity to object to the value of their property. During this consultation process, no objections were received from any resident. The updated valuation roll became effective on 1 July 20X0.

Municipality A's undertakes a physical inspection in the current reporting period to ensure that the property values based on estimates in the valuation roll are accurate. During this assessment, Municipality A concluded that the value of property owner X is overstated.

Following the outcome of the physical inspection, Municipality A needs to adjust the value of the property for owner X. The property tax that was charged to property owner X in the previous reporting period needs to be adjusted following the change in property value.

Municipality A appropriately applied its policy to obtain property values from a number of resources in updating its valuation roll. Municipality A also followed the required due process prior to charging property rates in terms of the new valuation roll. The adjustment to revenue should therefore be accounted as a change in an accounting estimate.

**Example 2: Accounting for an adjustment to revenue as a correction of an error or prior period error**

Municipality A levies property rates on a municipal valuation roll that is effective for a period of four years. At the commencement of the current reporting period, Municipality A updated its municipal valuation roll. However, Municipality A neglected to publish the valuation roll in the Government Gazette for public inspection and comment.

After Municipality A followed its own internal review process, it concluded that the new values in the valuation roll cannot be used to levy property taxes as it did not follow the legislative due process. As a result, the difference between the property tax levied using the valuation roll that was not promulgated, and the property tax that should have been levied using Municipality A's existing valuation roll, is accounted for as a correction of an error.

**Example 3: Accounting for an adjustment to revenue as a change in an accounting estimate**

Municipality A issues Mr X with an infringement notice following a traffic violation. Mr X makes a representation to the Road Traffic Infringement Agency that appoints a representation officer to consider the representation made by Mr X.

The representation officer concludes that the infringement of Mr X should be reduced due to Mr X's personal circumstances, and that Mr X should not be held liable for the full fine.

Based on the outcome of the appeal by Mr X, Municipality A needs to account for the adjustment to revenue as a change in an accounting estimate as a result of the new information that became known.

The effect of the change in the accounting estimate is accounted for in the current period's surplus or deficit, even if Municipality A accounted for the traffic fine in a previous reporting period.

**Example 4: Accounting for an adjustment to revenue as a correction of an error**

Assume the same fact pattern as in example 3, except that the representation officer concludes that Municipality A did not recalibrate the traffic camera that led to Mr X's traffic fine.

The representation officer concluded that Mr X's traffic fine should be voided as Municipality A did not comply with the legislative requirements in relation to the recalibration of traffic cameras.

As a result of the non-compliance with legislation, the adjustment to revenue is accounted for as a correction of an error by Municipality A.

**Example 5: Consider whether an adjustment to revenue is a correction of an error or an change in an accounting estimate**

A new taxpayer omits to include information on retirement annuity deductions in its tax return. As it is a new taxpayer with no historical information known to the South African Revenue Service (SARS), SARS could not have been reasonably been expected to know that the taxpayer will be entitled to a deduction from its taxable income when revenue was initially charged.

When SARS adjusts the recognised revenue initially charged to its administrative accounts in terms of legislation or similar means following the subsequent submission of information by the taxpayer, the adjustment to revenue is accounted for as a change in an accounting estimate.

# Basis for conclusions

*The basis for conclusions gives the Accounting Standard Board's (the Board's) reasons for accepting or rejecting certain solutions to the accounting for adjustments to revenue. This basis for conclusions accompanies, but is not part of this Interpretation.*

## Background

BC1. A number of issues have been raised about whether adjustments to revenue should be treated as a change in an accounting estimate or as a correction of an error. Most of the issues were raised in the context of non-exchange revenue transactions such as property taxes, fines or levies charged in terms of legislation or similar means. As a result of legislation or similar means that governs the charging of these types of revenues, it is often unclear when circumstances give rise to a change in an accounting estimate or a correction of an error.

BC2. Following the consultation on its 2017 to 2020 work programme, the Board agreed to develop a pronouncement to provide guidance on adjustments to revenue.

### Analysis of legislation or similar means

BC3. An analysis of the applicable legislation that govern entities' ability to levy revenue were undertaken to consider:

(a) how revenue is levied in terms of legislation or similar means;

(b) the appeal and objection processes, if any, that can be followed by a person or entity that is required to pay the revenue charged; and

(c) how, and under what circumstances, refunds are granted by the entity.

BC4. The analysis highlighted that revenue is often levied on prescribed tariffs, bases, percentages or formulas that are promulgated in legislation or similar means after the completion of a due process, where after the tariff, basis percentage or formula becomes effective.

### Appeal and objection processes that can be followed

BC5. The entity that charged the revenue will, in some instances, establish its own appeal or objection process that can be followed by the person or entity responsible for the payment of the revenue charged. Alternatively, the legislation or similar means that promulgated the revenue, can establish an appeal or objection process that can be followed to object to the revenue charged. Other legal processes also establish a general appeal process that can be followed in a court of law to appeal or object against the revenue charged.

BC6. Some entities also establish their own internal review processes to assess if the revenue was charged correctly in terms of the prescribed tariff, basis, percentage or formula.

BC7. Following the outcome of these internal and/or external review processes, the recognised revenue may need to be adjusted.

## Basis for consensus

### Adjustments to revenue

BC8. From the analysis of the legislative requirements, the Board noted that the tariff, basis, percentage or formula that is used to charge revenue, only becomes effective after completion of the required legislative due process. The Board therefore concluded that, where the entity that charges revenue did not follow the required legislative due processes prior to charging the revenue, this is non-compliance with the applicable legislation or similar means. As a result of the non-compliance, the revenue levied could be misstated in the financial statements. Similarly, where the entity charged revenue on an incorrect tariff, basis, percentage or formula, the Board concluded that this constitutes a correction of an error.

BC9. The Board further concluded that where adjustments to recognised revenue result from changes in the circumstances that led to the recognition of the revenue or new information becomes available following the outcome of an internal review, and/or external appeal or objection process, the adjustment constitutes a change in an accounting estimate.

### Refunds

BC10. The Board noted uncertainties from preparers on the appropriate treatment of refunds that become payable following the outcome of an internal review, and/or external appeal or objection process. The Board concluded that refunds are part of adjustments to revenue as a refund represents an overstatement of recognised revenue. As information presented in the financial statements should faithfully represent the transactions or other events it purports, the Board concluded that a refund should not be accounted for as an expense.

BC11. The Board agreed that this Interpretation will not provide guidance on the accounting for any receivables or payables that arise following an adjustment to recognised revenue.

**Other considerations**

BC12. The Board noted that, in limited circumstances, accounting for adjustments to revenue can result in revenue reflected at a negative amount in the financial statements. The possible recognition of negative revenue is a consequence of applying the principles in GRAP 3. As a result, an entity can provide additional information to the users of the financial statements in terms of the Standard of GRAP on *Presentation of Financial Statements* to inform users of the effect of the adjustment to revenue.

BC13. The Board considered the extent to which the principles on adjustments to revenue can be applied to the return of surpluses by public sector entities as currently required in legislation or similar means. The Board concluded that guidance on the return of surpluses is outside the scope of this Interpretation as the relevant guidance is provided by the National Treasury. This Interpretation can therefore not, by analogy, be applied to circumstances other that those outlined in the scope of this Interpretation.