KPMG

The Internet

Accounting in the new economy

November 2000

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1 Introduction

As internet companies have mushroomed, so has accounting struggled to keep up. Of course, the principles are familiar; but their application has particular problems. This booklet is one of the first comprehensive guides to the issues involved. It covers transactions which we have come across in practice in this young industry sector and looks at the appropriate treatment of these in financial statements prepared in accordance with UK GAAP. We also review accounting policies which have been adopted in practice by a range of technology and internet companies.

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Internet companies often have significant values attached to their shares which are supported by very little in the way of recognised assets or profit. The industry is in its early stages and, with companies experiencing significant operating losses, the share price or overall valuation is normally based on anticipated future sales revenue - and hope value - rather than operating results. Reported results, particularly of listed companies, will be the confirmation (or otherwise) to the financial markets that at least part of the promise has been met.

Recent months have seen a significant change in the stance of financial markets with the failure of boo.com and other high profile start-ups, and sharp declines in the values of many dot-com companies' shares. With increasing levels of scepticism surrounding the commercial viability of many start-up internet companies, listings on stock exchanges are being delayed or cancelled. Investors have become more reluctant to support heavy ongoing cash requirements of these companies and are focusing more on the, often lengthy, forecast period before, and uncertainty over whether, a return on their investment might be received.

This background means that internet companies present a number of accounting challenges. Some of these are new, others are more familiar. What is perhaps unique is the extent to which the nature of these companies brings together these issues which thereby acquire a new significance because of their materiality and their wide occurrence.

This booklet looks at certain more common transactions which internet companies are undertaking, and how these should be treated in the financial statements. Some of the issues arise because cash is in short supply (barter and share issues, for example); others because the absence of profits has resulted in assessments of value being placed on turnover, together with assessments of the period during which particularly high marketing expenses will be incurred by start-up ventures. Other questions arise from tensions that may be felt by directors. When losses are being incurred, the temptation to write off costs will be high, so as to free future profits (when they arise) from the burden of the past. Prudence, indeed, might be invoked in aid of such an approach. But matching is not entirely dead, despite the best efforts of the Accounting Standards Board (ASB), and if, for example, an intangible asset can properly be recorded as a result of expenditure, it is better that this should be done.

It should be understood that for some of the arrangements entered into by internet companies there is no generally accepted accounting approach. In these cases, our views are necessarily tentative. Practice is evolving and the Urgent Issues Task Force (UITF) has already issued Abstracts covering advertising barter transactions and the appropriate treatment of start-up costs. However, the accounting will always reflect the exact arrangements and so any decisions on the treatment in specific cases must be taken by companies in conjunction with their advisers, and by reference to the specific terms of those arrangements.

When considering their own accounting treatment, companies frequently ask about the approach being adopted by others in their industry sector. Consequently, in addition to presenting guidance for the appropriate treatment of transactions, we have reviewed accounting policies adopted by 25 internet and technology companies, as disclosed in their financial statements. Extracts from these are included within each section of this booklet.

2 Types of internet company

Internet companies exist in a number of forms, the most common of which are described below.

Internet service providers (ISPs)

ISPs provide consumers and businesses with access to the internet. Often, in the UK, they have charged for access on a 'cost per minute' basis, although highly publicised developments have seen a number of service providers moving to an annual fee with unlimited (or near unlimited) access at no further cost. This latter arrangement is similar to that which has been in existence in the US for some time, although current indications are that this type of charging structure may not last for long in the UK.

Internet portal companies (IPCs)

Normally with no subscription fee, IPCs' web sites provide a search facility for other sites, or may link to another search provider's site. Principal sources of revenue are advertising placed by other companies, and payments related to the number of 'hits' originating from their search facility. IPCs include Infoseek, Yahoo and Excite.

Internet commerce companies (ICCs)

ICCs are companies which sell only on the internet. These may either sell goods directly (such as Amazon.co.uk) or act as a broker, receiving what is essentially a commission for each transaction (such as Lastminute.com).

Internet related companies (IRCs)

IRCs are generally IT equipment suppliers and consultants which, while not dependent on web sites for their trade, derive sales from the provision of the internet's hardware and software, and related services. Consequently they are, to an extent, tied to the expansion of the internet and may enter into contracts which contain unusual or unexpected terms and conditions.

Established, 'traditional' companies

Many traditional companies now have a presence on the internet. Their sites can be divided broadly into those which are used for promotional purposes and those which form a sales channel in themselves. Manufacturers have tended to avoid selling goods through their web sites in order to avoid competing with their existing distributors and retailers, whereas retailers themselves are more in favour of active sites that are, in effect, another shop.

3 Revenue and cost issues

Barter transactions

Barter transactions have become increasingly common among internet companies, in part due to the small amounts of cash being generated from operations and the significant outlay which is required in the early years of trading.

Advertising arrangements

A typical transaction arises where two internet companies enter into an arrangement where they place advertisements on each others' web sites. The issues revolve around whether the transactions should be recognised within each company's financial statements and, if so, the values which should be attributed.

If the services are provided concurrently, as is often the case, there will be no effect on the net result shown by each company, but there could be a significant effect on reported revenue. If the services are not concurrent, temporary profits and losses will arise if both recognition and valuation criteria are met.

The UITF has issued an Abstract *Barter transactions for advertising* which contains proposals which are similar to those issued in the United States by the Emerging Issues Task Force. These are prescriptive and limit the recognition of advertising barter transactions to only those instances where an entity has a history of selling directly comparable advertisements for cash, and where substantially all turnover from advertising in an accounting period is derived from cash sales. The UITF's Abstract is particularly strict, requiring that turnover and costs in respect of barter transactions for advertising should only be recognised where "there is persuasive evidence of the value at which, if the advertising had not been exchanged, it would have been sold for cash in a similar transaction".

Recognition

Clear evidence is required of both real demand for the services which are being exchanged and genuine commercial purpose. At one extreme, a company may, for example, enter into barter arrangements merely to fill available space on its web site which it cannot otherwise dispose of to third parties for settlement in cash. This would not be regarded as giving rise to real revenue. A further consideration arises from the ability of a web site to be expanded significantly at little cost; barter transactions arising merely from the expansion of companies' sites will not lead to recognition of income and related expenditure.

The principal test is whether it is possible to establish, with an appropriate degree of confidence, that the services have sufficient commercial substance. The most important question is whether the company has a recent track record of selling advertisements on its web site to third parties for cash settlement as well as through barter transactions. Unless it can clearly be demonstrated that substantially all (say, in excess of 90 percent) of the total value of advertising sales made within six months of the

date of the barter transaction are settled in cash, the barter transactions should not be recognised.

If a sufficiently large proportion of advertisements have been sold for cash, consideration should then be given to whether there is evidence to suggest that the advertisements would have been sold for cash had they not been exchanged. In its Abstract, the UITF states that it believes that "such circumstances would be rare". If there is insufficient evidence to support the genuine alternative of a cash sale, the barter transactions should not be recognised.

It is most unlikely that sufficient evidence will be available for internet companies in their early stages of trading and, consequently, they will report within their accounts only those transactions which are settled in cash. It will, for example, be inappropriate for a company which derives all, or a large proportion of, its trade or advertising activity from barter transactions alone, to recognise income and expenditure.

Recognition criteria need to be placed on the services supplied by the internet company rather than those received. Consequently, although start-up

companies might enter into barter arrangements with established companies which do have sufficient directly comparable transactions and track record for recognition of the transactions and therefore include them in their financial statements, the fact that the start-up companies have insufficient track records of their own means that services exchanged will not qualify to be recognised within their profit and loss accounts.

Directors of start-up companies may argue that this does not reflect the true position of their company's trading. However, there is a need for any revenue which is recognised to be based on transactions which can be demonstrated to have genuine substance. Others should be excluded from the financial statements, instead being reflected in the company's operational review or otherwise disclosed.

Value

If sufficient evidence can be obtained to support recognition, the assignment of values might be regarded as being straightforward as there will be a substantial number of directly comparable transactions. Consequently, the barter value can be obtained by looking at the transactions which have been settled in cash. To an extent this is true; however, there are certain aspects of each arrangement which need to be taken into account.

Web site advertising rates may depend on the positioning on a web page, or other factors which need to be considered in deciding whether transactions are comparable. Consequently, if recognition criteria are met, substantial additional evidence is required to support the value of the advertising exchanged. To provide such evidence, the advertisements sold for cash must be similar in all significant respects to those exchanged.

The following are relevant:

- circulation, exposure or saturation within an intended market;
- timing and duration of display (eg, time of day, season of the year, frequency, duration);
- prominence (eg, position on web page, section of periodical, size of advert);
- demographics of readers, viewers or customers.

The specific circumstances of each case need to be analysed due to the diversity of types of advertisement on web sites, and the variety of arrangements which companies are entering into.

VAT considerations

Although barter transactions do not involve cash payments between each of the parties involved, they do result in a supply of services on which VAT needs to be recorded. Companies which enter into such transactions will need to ensure that their accounting records for barter transactions are adequate for this purpose, and it will be appropriate for sales invoices to be raised and recorded by both parties. Customs and Excise are unlikely to be sympathetic if they find errors in VAT returns.

Where there is a mismatch in the rate of supply of services, such as in the example below, cash inflows and outflows will arise due to the need to account for related VAT in the periods in which supplies are made and received.

Where arrangements are between a UK company and one overseas, further issues may arise. Appropriate advice should be sought before entering into such arrangements to reduce the risk of difficulties arising in the future. For example, if the overseas company is resident within the EU, it may be possible for the UK company to supply services free of VAT if the counterparty's VAT number is obtained and included on the sales invoices.

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Example

Background

Two internet companies, A and B, enter into an arrangement whereby A and B will place advertisements with a value of £250,000 on each others' web sites. Both companies have a 31 December year end, and the arrangement commences on 1 January 2001. All advertisements will be placed during the year ending 31 December 2001.

A is an established internet company with advertising sales of approximately £10 million per annum during the year ended 31 December 2000. All advertising sales, other than the arrangement with B and certain other barter transactions with a cumulative value of £400,000, are settled in cash. Within the past six months, A has sold for cash advertisements with a value of £3 million on a directly comparable location on its web site and of the same size as those exchanged with B.

B is an internet company in its early stages, entering its second full year of trading. Its advertising sales during the year ended 31 December 2000 amount to approximately £2 million, of which £1 million have been exchanged with other companies. The advertisements to be placed on behalf of A are directly comparable to advertisements with a value of £400,000 which have appeared on B's web site within the past six months, of which £300,000 have been settled in cash with the balance being exchanged.

A's accounting

Sufficient evidence is available to support recognition of the contract with B, and income and advertising expenses of £250,000 will be included within A's financial statements for the year ending 31 December 2001.

Indicators to support the recognition of transactions in the financial statements include:

- A has an established record of selling substantially all of its advertising for cash; and
- There is evidence to support the sale for cash of directly comparable advertisements with a value in excess of 90 percent of the total value of those sold for cash and exchanged within six months of the commencement of the arrangement with B.

B's accounting

Insufficient evidence is available to support recognition of the contract with A. Instead, details of the contract will be included within B's operating and financial review.

Indicators which support the exclusion of transactions from the financial statements include:

- Only 50 percent of B's advertising has been sold for cash in 2000; and
- Only 75 percent of directly comparable advertisements sold within the past six months have been settled in cash.

So far as A is concerned, if the services did not fall wholly within its financial year, with more services having been provided than received, net income would arise followed by a net expense in the subsequent accounting period. As evidence suggests that the advertisements could have been sold for cash rather than having been exchanged, there is no reason to treat the advertising exchanged any differently from that sold for cash.

If, in the above example, the period during which services were provided extended beyond 31 December 2001 and, at that date, A had provided services with a value of £200,000 and received services of £150,000, with the balance of services being provided and received during the subsequent year, the following entries would be included in A's profit and loss account and balance sheet:

	31 December 2001 £000	**31 December 2002 £000**
Profit and loss account		
Sales	200	50
Advertising expenses	(150)	(100)
Balance sheet		
Prepayments	50	–

Conversely, if a smaller value of services had been provided than received in the year ending 31 December 2001, a net expense would arise for that year followed by net income in the year ending 31 December 2002, with deferred revenue included within creditors at 31 December 2001.

Arrangements with up-front costs and payments

Where contractual arrangements cover periods in excess of one year, or where a contract straddles a financial year end, it will be appropriate to recognise income and expenditure over the contract term in line with the timing of the provision of services, regardless of the actual timing of costs or cash flows. In the event that there is no pattern to the provision of services, revenue should be recognised evenly over the period.

This approach is acknowledged in the accounting policies of a number of companies included within our survey, such as Interactive Investor International plc which states that *"Up-front or periodic payments are deferred and recognised as revenue over the period and level of page views to which the contract relates"*. This treatment also applies to subscription income where this is received in advance.

Huon Corporation Limited, which provides support for the sale and maintenance of specialist software for the insurance sector, also spreads its income:

"Where maintenance services cover future periods, that portion relating to the future is shown as deferred income in creditors and released to turnover in the period".

Example

A provides an on-line transaction processing service to companies which wish to sell products over the internet from their web sites. Charges by A consist of an annual fee of £12,000 plus a fixed percentage of the value of transactions processed. The contractual arrangements provide for the provision of the processing service, with no separation of fees for the set up of the companies' accounts.

Revenue recognised by A will consist of £1,000 per month relating to the annual fee plus the percentage commission on the value of transactions processed on an accruals basis.

Similar considerations would apply if Company A charged a first year set up fee of £12,000 followed by annual subscriptions from the second year onwards, payable in advance, of £12,000. In substance, the first year set up fee is identical to the annual subscription, and should be accounted for as such.

However, where an initial fee was charged, followed by the percentage commission only, the position might change. Assume, in the above example, that A had incurred substantial costs in setting up its payment processing facility and that it will incur costs in setting up each of its customers. An initial, one-off set up fee of £12,000 is charged, followed by a fixed percentage of the transactions processed. The percentage does not change year on year. The initial fee is non refundable.

In this case, it will be appropriate for A to recognise £12,000 on establishment of the payment processing facility for the customer. The establishment procedure would be expected to include a formal acceptance by the customer that the facility was operating satisfactorily. Commission payments would be recognised as above, subject to consideration of whether the set up fee is artificially inflated at the expense of very low margins, or reduced charges in comparison to their level had the set up fee not been charged, on subsequent processing fees.

Other arrangements may involve further judgements, either in the case of advertising providers or in the case of advertisers.

Advertising providers

Example

A's web site provides an internet based directory of products and services to customers. It enters into an agreement with a large number of businesses that it will design advertisements on their behalf and place these on its web site. Access to these advertisements will be through a search facility on A's site. The design and inclusion of the advertisements takes place at the start of the contract and there are no provisions for these to be updated over time. The search facility does not differentiate among the subscribers.

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Two possible scenarios are that:

- the advertiser pays a fee covering the provision of services for a period of one year; or
- the advertiser pays a set-up fee, followed by a further fee covering the placement of the advertisement for a period of one year.

In the first case, it might be argued that, as additional costs have been incurred on inception of an agreement, income should be accelerated in order that the margin achieved throughout the period of the agreement is constant. This is incorrect; the revenue arising from the arrangement arises evenly throughout the period of the contract since the advertiser has paid a fee for the provision of services for a period of one year and has no concern over the timing of costs which the provider might incur. Consequently, A should recognise revenue evenly over the period of the agreement.

Further, if the fee is collected through monthly subscriptions, there is the potential for the subscriber to cancel the agreement (whether the terms of the contract allow for this or not). In such cases, the amounts involved in this particular example may make it uneconomic for the internet company to pursue for payment. In such circumstances, if revenue recognition has been accelerated, A might be faced with an adjustment to eliminate revenue recognised in advance of its receipt.

The question then arises of whether the costs incurred may be deferred and expensed such that, for example, a constant margin is achieved on the overall revenue arising from the contract. This is an appropriate approach if the contract can be demonstrated to be profitable; if the contract is loss making, however, deferral of costs would be equivalent to a deferral of losses which would not be acceptable.

In practice, initial set up costs often represent a small proportion of overall costs incurred. Consequently it may be more appropriate for the initial costs to be expensed as incurred and revenue recognised evenly throughout the contract period as the time and expense involved in analysing the costs and related revenue can outweigh the benefit derived.

Where a separate set up fee is charged it should, in theory, be possible to match revenue and related costs. However, a set up fee should be recognised on commencement only if the period fee (and subsequent period fees) provides a appropriate return for the service provider. The expectation would normally be that the initial fee would be at a low margin, with the ongoing service at a higher margin due to the low level of ongoing costs.

It will, generally, be rare for a contract to be loss making when revenue is compared with identifiable direct, and attributable indirect, costs. In cases where it is found that a contract is, overall, loss making it is necessary to analyse its overall terms. If the contract cannot be terminated, it will be appropriate for a provision to be recognised for the loss arising under FRS 12 *Provisions, contingent liabilities and contingent assets.* However, if the contract is being used as a 'loss leader' in order to attract customers and the service provider can, at its option, terminate the agreements, losses should be recognised evenly as the services are provided.

Advertisers

Companies may also incur up front costs for advertising arrangements where, to revert to a non internet example, an advertising agency is paid for work carried out some months before a television advertisement is screened. The current focus for internet companies is more on revenue growth than profitability and it is possible that costs will simply be expensed as incurred. This is incorrect as the payment of fees and appearance of the advertisement may be in different accounting periods. Instead, the costs should be deferred and matched to the planned exposure period for the advertisement, in order that the costs are matched with the related provision of services.

Difficulties experienced within the internet sector, and a possible decline in the effectiveness of web site advertising, may encourage companies to review the value of deferred expenditure at period ends and write off costs in advance of exposure periods. For example, in an extreme case, a company might pay £1.2 million on 1 September 2000 for advertising on a web site for the next year. At 31 December 2000, its financial year end, there has been a minimal response. Management consider the likely value of advertising to be received over the period to 31 August 2001 to be negligible and propose that the remaining £800,000 is expensed immediately.

While each case would need to be reviewed on its own merits, it is considered unlikely that this would arise in practice. If the advertising really was as ineffective as in the above example,

management of the purchasing company would be expected to take action in order that their company received its money's worth. Further, if the advertising were to appear on the web site of a relatively newly established internet company, it might well be the case that the initial response would be low, followed by increasing numbers as the number of visitors to the new company's site increased.

Gross vs Net recognition of revenue

An internet company may act merely as an intermediary for the sale of goods or services, for example, the sale of airline tickets, magazine subscriptions or other goods, where these are held by a third party and delivered directly to the customer.

A critical issue for internet companies is whether the revenue generated from these transactions should be recognised at the gross amount, with the cost of the goods or services being included within cost of sales, or whether the internet company should recognise only the amount of income equivalent to commission receivable from the ultimate supplier as payment for having generated the sale.

An initial question is whether the internet company acts as principal or agent, either disclosed or undisclosed, for the sale. If it acts as principal, gross recognition is likely to be appropriate; if agent, the commission or margin element only should be recognised.

While it is likely that each case will need to be analysed on its own merits, in order to determine the appropriate accounting treatment of transactions it will be necessary to analyse whether the internet company at any point acquires any significant risk or reward relating to the good or service being sold under the definitions of FRS 5, *Reporting the substance of transactions*. Broadly, if an entity is exposed to the principal risks and rewards of ownership of the products, the transaction should be accounted for on that basis, with revenues and costs being grossed up.

Considerations include:

- whether the internet company has any exposure, in addition to variations in a commission element, to the risk of gain or loss through changes in prices of the goods being sold;
- which entity physically holds the goods in stock;
- which entity bears insurance costs of the goods;
- which entity bears the credit risk arising from the sale;
- which entity bears stock obsolescence (such as not all of the seats in an aircraft being sold prior to a flight) or other risk;
- whether the internet company has any exposure through, for example, an up-front payment made for right of access to financial reports which it proposes to sell on its web site, to market risk (ie that the sales revenue generated from its sales will not be sufficient to cover the cost of the 'asset' purchased).

The fewer risks which accrue to the internet company, the more persuasive is it that the revenue recognised should consist only of the commission element.

Similar considerations arise for the recognition of delivery costs, which are often significant for internet sales companies. Two possible approaches exist:

- delivery charges are regarded as a cost recovery and are netted within overall costs; and
- the cost and income are separated, charges made for delivery being recognised as sales revenue.

The question of which is appropriate depends upon the contractual relationships between the delivery company, the internet company and the ultimate customer. Broadly, if the delivery company acts as an agent for the internet company, with the internet company being responsible to its customer for compensation in the event of delivery delays or damage to goods delivered, it is persuasive that the costs and revenue should be separated; if as an agent for the customer, where the delivery company is at risk, the two should be netted. If costs are separated, the expense should be charged to cost of sales as it is directly related to the sale.

Other aspects which need to be considered are the pricing and cost structures. For example, the internet company may charge its customers a fixed delivery fee, regardless of the amount which it is charged by the delivery company. In these circumstances, the internet company bears the risk of not being able to pass increases in charges made by the delivery company onto its customers, and it is appropriate to separate the revenue and costs.

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Alternatively, the internet company may contract with the delivery company at fixed rates, being free to charge its customers any other amount, which may include a profit element. This is persuasive for the adoption of separate recognition, although the basic tests for which entity is responsible to the customer for the satisfactory performance of the delivery process will be of primary importance.

FRS 12 considerations

Where contractual terms of sales allow customers to return faulty goods and receive compensation from the internet company, it will be appropriate for a provision to be included for anticipated costs when sales are made. The internet company has a legal obligation at this point; it would be inappropriate to defer recognition of costs to the date on which customers claim compensation. Similar considerations apply if a constructive obligation arises where, although contractual terms do not require it, a company has an established track record of providing compensation to its customers and they have an expectation that this will be replicated in future.

Similar considerations apply where the internet company could reclaim compensation payments, which it has made to customers, from its own suppliers.

Heavily discounted services and incentives

Certain services provided by internet companies are being sold with an initial incentive, such as a free period of service at the start of a contract or the provision of CD-ROMs at a nominal cost on inception. Certain companies have argued that these offers should be recognised as if the sale had been made at full price, with the expense recorded as a marketing cost.

This is inappropriate; although the incentive is given in order to attract more subscribers, the substance is that the service is being offered at a reduced sales price. The discount is simply being given as an up-front reduction in sales price or through the provision of other products at minimal cost; both reduce the overall value of the amount invoiced to customers, which represents the actual sales value. Issues concern the pattern of recognition of the gross sales revenue and the timing of recognition of the incentive costs. In all cases, it will be appropriate for the 'costs' to be set against the gross revenue rather than being accounted for as a separate cost. Two approaches to the timing of recognition of incentive costs might be considered:

- recognise the reduction in revenue immediately; or
- in a manner similar to that required for recipients of property lease incentives, spread the amount of the incentive over the minimum period of the contract.

If contracts with customers do not contain any minimum period, allowing them to cancel the arrangement at any point, the reduction in revenue should be recognised immediately, as to defer recognition could result in the company facing a scenario where customers cancel contracts and leave no future revenue stream to cover the costs deferred.

If contracts contain minimum periods, where the internet company can legally pursue for compensation, the cost of incentives should be deferred, being offset against sales revenue during the contract term up to the point at which the customer can cancel the arrangement. It will, however, be necessary to review the commercial as well as legal reality as, if it is clear that customers would not be pursued in the event that they cancelled contracts early due to the costs involved outweighing the benefits which might be obtained, costs should be recognised immediately instead of being deferred.

If, as is common, CD-ROMS are included in mail shots and magazines in order to attract new subscribers to services, all costs should be expensed immediately as these are simply marketing expenses.

Interruptions to service

Internet companies may experience difficulties with the provision of their services. Commonly this results from faults with hardware or software, a number of examples of which have been highly publicised, although there have also been cases where internet companies have been subject to 'attack'.

Issues surround the nature of customer costs which are then incurred and their appropriate accounting treatment. Types of cost and their potential treatment are:

Rebates to customers

These may arise through contractual relationships or, in order to retain customers and generate goodwill, discretionary refunds. It might be argued that discretionary refunds should be recognised as a marketing expense and revenue left at its full amount. However, the refunds are in substance discounts

and it is appropriate for these to be accounted for as such, being treated as reductions in revenue.

As an alternative to making payments to customers, internet companies may instead extend the period of service given under the existing contract. This is likely to be an attractive option for the companies concerned, as it removes the need for cash payments. Such extensions should be accounted for by deferring revenue from the period in which the interruption occurs to later periods, this being recognised when services are resumed and spread over any extended period.

Internet retail companies

In the event of difficulties with an order, companies may either issue a credit against the original order or provide the customer with a voucher which can be used against the total cost of future purchases.

In these cases, the refunds should be treated as an immediate reduction in sales revenue as these simply reduce the sale proceeds from the transaction. Vouchers should be accounted for in the same manner, the credit being in deferred income and being released when the vouchers are used.

Where vouchers were issued on the basis, say, of a £20 discount if the customer spends £50 or more in a future transaction, the precise terms would need to be examined in some detail in order that the £20 discount can be applied to the appropriate transaction, or both, as the case may be.

FRS 12 considerations

Issues might arise where provisions are considered for amounts which are due to be refunded to customers, or where extensions to service are granted. This could be where there has been an interruption to services close to a financial period end.

Where the contractual terms of contracts mean that there is a legal obligation to provide cash compensation to customers, it will be appropriate to include a provision. A provision may also be appropriate if a constructive obligation arises, where a company has an established track record of compensating its customers for poor service, which they have an expectation will be replicated in future, notwithstanding that the contractual terms do not include specific compensation terms. The amount provided would be dependent on the contractual terms or known history; however, this should be possible to obtain with a reasonable level of accuracy.

No provision would be made where an extension of service was granted, as FRS 12 requires the existence of an obligation to transfer economic benefits (ie a cash payment). Consequently, if an extension is granted at a period end, it will result in reduced profits (or increased losses) in the subsequent period. The UITF considered a similar type of transaction in the context of regulated industries, where high profits in one year may give rise to a forced reduction in prices in the next, and concluded that no liability should be included in financial statements unless the company concerned had a binding obligation to repay amounts to customers at the balance sheet date.

Revenue recognition for auction sites

An increasing number of internet companies run auction sites. Typically no title is taken to any of the goods for sale, the company acting merely as a facilitator. Contractual arrangements vary, although a common structure is for a fee to be charged on initial listing, with a further fee being charged on completion of sales.

Fees charged for displaying items for auction

The timing for recognition of the initial fee is dependent principally on contractual arrangements and the structure of the site. In many cases, the display of items will be through a search facility and, given the low cost of maintenance and, if necessary, extensions to the size of a web site, it might be argued that revenue should be recognised on initial display as delivery of this service is substantially complete at that point. However, fees should be matched with the delivery of the entire service and the appropriate approach will be to spread the revenue over the period of display. It will be necessary to consider the circumstances where refunds may be made, the minimum period for which a listing will be held and any commitments entered into by the auction company.

Where an internet auction company is expanding rapidly, some further consideration of whether income should be deferred will be required at the year end.

A site may also be designed such that, if a search is carried out for a particular type of good rather than a specific item (say, hand held computers), a list of items will be displayed. In these circumstances, a premium fee may be payable if a particular item is to be displayed at the top of the list or is to appear on screen without the site visitor having to scroll down.

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In these cases, it will be appropriate to spread the premium element of revenue over the contracted or anticipated period of display in the premium space. The amount of such revenue recognised at this point will depend on contractual arrangements, as a fee may cover display for a short period in the premium space followed by a subsequent period in 'standard' space.

Commission fees for sales

It is common for terms and conditions of 'virtual' auction sites to require the submission of valid credit card details when a bid is made. Penalty fees are charged if the purchase is subsequently cancelled. While the legal position is far from clear, it may perhaps be assumed for accounting purposes that there is an effective contract for payment at the point at which the offer is 'clicked' with details submitted, and the sale is legally completed. No doubt the position will be further clarified as this type of business gains greater currency.

Terms and conditions often limit the auction company's responsibilities to only the arrangement of sales. Liability for any unsatisfactory goods purchased through the web site and any transactions which are not satisfactorily completed may be excluded through these contractual terms.

Under such circumstances, commission receivable by the internet auction company should be recognised at the point when a legally binding, satisfactory offer has been made and credit card details submitted, with a provision being made to cover instances where the sale is subsequently cancelled.

Provisions made will include:

- Commissions where credit cards are subsequently rejected by the credit card company through, for example, breach of credit limits or fraudulent use.
- Any shortfall between the commission amount and the amount of the penalty fee.
- The proportion of penalty fees which will not be recovered through, for example, credit card payments being rejected by the credit card companies.

Expense classification

For many established companies, expense classification is not a major issue. However, the market often places more emphasis on the nature of the revenue and expenses of internet companies than in their bottom line. In addition, while companies are in their early stages, investors may also expect substantial marketing costs to be incurred, the extent of which will reduce considerably in future periods. Accordingly, this area deserves careful attention.

Direct distribution expenditure may be considered, wrongly, by some to be part of marketing costs. It is more appropriately dealt with as part of cost of sales, being directly related to sales rather than to the generation of future business. If it is considered that delivery costs charged to customers can properly be regarded as turnover, similar considerations apply for the classification of related costs.

Further, for certain internet companies, delivery charges may represent a significant part of turnover. In such cases, disclosure should be made of how these have been recognised within both the accounting policies note and a note providing a segmental analysis of turnover.

Published accounting policies for revenue recognition

All 25 companies reviewed, other than one which remains in its product development phase and has no turnover, have a stated turnover policy. Fifteen companies provided information in addition to bland statements such as "Turnover represents the value of goods and services provided, and is stated net of value added tax", perhaps recognising the importance placed on this caption.

Detailed disclosures are made by Interactive Investor International plc, one of the longest established internet companies, which provides disclosure of the treatment for each of its various sources of revenue in its accounts for the year ended 30 September 1999:

"Net revenues

Net revenues represents the amounts (excluding value added tax) derived from trading transactions, advertising, and consulting and systems construction.

Transactions related revenue is derived from three types of transactions: subscription to information services, pre-purchase transactions and purchase transactions. Subscription income is recognised over the period to which the subscription relates. Pre-purchase transactions which generate revenue for the company include brochure requests, and other third party referrals which are generated from accessing the company's web site. Revenue normally comprises a flat fee although there may be a variable element dependent on the nature of the referral. All transactions related revenue is billed and recognised as revenue in the period that the transaction occurs.

Advertising revenue is earned in the form of upfront and variable payments, dependent on delivery of a required number of page views and in the form of revenue share arrangements. Upfront or periodic payments are deferred and recognised as revenue over the period and level of page views to which the contract relates.

Revenue from consulting and systems construction projects is earned either based on time incurred or as a fixed fee basis. Revenue is recognised in the profit and loss account on fixed fee contracts based on the percentage completion method. Provision is made for losses to completion when it is anticipated that a loss will arise."

Interactive Investor International plc also analyses its net revenue among these three main headings as part of its segmental analysis.

Other companies, which have simpler income streams, necessarily have more straightforward disclosures. Huon Corporation Limited gives its principal activity as being ".. to support the sales and maintenance of specialist software for the insurance sector." Its accounting policy reads:

"Turnover (excluding value added tax) represents the invoiced value of services supplied. Where maintenance services cover future periods, that portion relating to the future is shown as deferred income in creditors and released to turnover over the period."

The majority of other companies reviewed, where additional disclosures were given, were similar in their approach where fees were received in advance, amounts being deferred to future periods.

4 Fixed assets

Capital costs of web sites and amortisation periods

In October 2000, the UITF issued a draft Abstract on web site development costs. The following comments are based on present accounting standards and guidance and will need to be refined in the light of the Abstract's requirements when it is issued in final form.

Web sites are by their nature intangible assets, falling within the FRS 10, *Goodwill and intangible assets,* definition of such assets, being 'Non-financial fixed assets that do not have physical substance but are identifiable and are controlled by the entity through custody or legal rights'. However, certain assets are required for their operation which fall within the FRS 15, *Tangible fixed assets,* definitions of tangible, having physical substance and being held for use in the supply of goods or services, such as operating hardware.

Costs relating to the development of a web site should be capitalised if the site is functional in nature (ie it is designed directly to generate revenue from on-line sales). Costs for other sites, such as those which act purely as a means for a company to advertise products and services, should be expensed as incurred. Costs, relating to both hardware and software, may fall into the following categories:

- initial costs of infrastructure and set up; and
- ongoing costs related to subsequent site maintenance and its update.

Initial costs

Initial costs range from the purchase (or direct internal costs, where assets are constructed or developed internally) of hardware and operating software which relate to the functionality of the site (which should be considered for capitalisation under FRS 15), to costs associated with the design, content and appearance of individual web site pages which should not.

Functionality

Under FRS 15, tangible fixed assets should include the cost of hardware, and of software which provides the web site with its operational ability such as interfaces with existing accounting and other IT systems used by the entity, and encryption software to be used for credit card transactions. FRS 10 requires that operating software is not capitalised as an intangible asset but instead is included within the amount attributable to the tangible asset to which it relates.

Direct installation costs may also be considered capital in nature.

Design, content and appearance

There are few opportunities for capitalisation of costs associated with design, content and appearance, particularly if the costs are internal, because FRS 10 prohibits the capitalisation of internally generated intangibles. In particular, costs associated with the design and layout of a web site should normally be written off as incurred. Some consideration might be given to whether any of these costs attach to the software, which might be capitalised as described above.

Training costs

Costs associated with training staff to use new IT systems may be substantial at their implementation stage and at times of further systems development. However, such costs do not give rise to an asset under the definitions of FRS 5 as they do not result in the entity concerned acquiring rights to future benefits. Consequently they should be expensed as incurred, being neither capitalised as part of the cost of the fixed asset nor deferred to a future accounting period within current assets.

Deferral of costs

Although costs relating to promotional sites should not be capitalised, established practice within an existing industry may allow costs to be deferred in order that they are matched with related income. For example, travel operators incur costs in producing hard copies of their brochures well in advance of each holiday season and

might defer recognition of these in order to match them to the period of display. Where such companies include their brochure on a web site, costs directly associated with the production and display might similarly be deferred.

Ongoing costs

Similar considerations to those set out above apply to ongoing costs. Only specific hardware and operating system costs, which either enhance the existing systems or replace them, or a separately depreciated component thereof, should be capitalised. All other costs incurred should normally be expensed immediately.

Depreciation periods

In view of the rate of technological change in the sector, it would be appropriate for any costs which are capitalised to be depreciated over a relatively short period. It would be unlikely for that period to exceed three years, and it may frequently be shorter; our review of policies adopted in practice indicates that many companies currently choose a period of three years.

Domain names

Cost of domain names

The cost of registering a domain name will often be small. However, in certain cases, domain names have been registered by so-called 'cybersquatters' who have obtained the rights to domain names which entities might find desirable. Substantial costs may subsequently be incurred by those entities in acquiring these rights.

Where a pre-existing name unrelated to that of the business is purchased, the external direct costs of acquiring the name may be capitalised if it is to be used in a new business. This is because it is separable intellectual property, that is, an asset which can be purchased and disposed of separately from the business to which it relates.

If it is acquired in order to protect an existing business or brand, neither it nor associated internal costs should be capitalised as this would appear to be tantamount to paying for the company's own pre-existing goodwill.

Amortisation periods

When determining the useful economic life, future revenue which is likely to be generated under the name needs to be considered. The pace of change in the internet sector, combined with many companies being in their early stages of trading means that a conservative view should be taken. As with web sites themselves, periods of no more than three years would seem appropriate.

Databases

Costs incurred to construct and populate a database

A database will be required where, for example, an internet company's trade is to match customers with suppliers such as hotels, cinemas, electricians etc. These suppliers would pay a fee in order for their contact details to be included on the database which would then be accessed through a search facility on the company's web site.

Issues arise with regard to the treatment of

- initial costs, being functionality (operating hardware and software) and the initial population of the database; and
- updates and other maintenance to the database.

Initial costs

Functionality and construction of operating software

FRS 15 permits direct costs to be capitalised where they relate to hardware and associated software which is required directly to operate the database. The standard prohibits the capitalisation of administrative and other general overhead costs. Any abnormal costs, such as additional costs incurred through difficulties with the design of the operating system, should also be expensed as incurred.

The principle which needs to be applied is that any expenditure that does not contribute to the new asset should not be capitalised. Although certain costs, such as the debugging of a new database operating structure, would be expected to be incurred in ensuring that it operates satisfactorily and, consequently, would be capitalised, if costs in excess of those anticipated are incurred, these should be expensed.

Initial population

FRS 10 permits internally generated intangible fixed assets to be capitalised only if they have a readily ascertainable market value. For databases constructed for internal use, it is unlikely to be possible to obtain such a valuation, meaning that costs of the intellectual content of the database itself should be

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written off as incurred. Only where a database is purchased which has been populated by a third party should costs be considered for capitalisation.

Classification as Research and Development

Suggestions that SSAP 13, *Research and development costs*, might be used to justify capitalisation where FRS 10 does not allow this are unlikely to be fruitful. SSAP 13 should be read strictly if there is any intention to apply it to internet companies. It is hard to see how any expenditure related to databases could be considered to fall under the definitions of research, while development expenditure may be deferred to future periods under the SSAP only if:

- there is a clearly defined project; and
- the related expenditure is separately identifiable; and
- the outcome of the project has been assessed with reasonable certainty as to:
  - its technical feasibility; and
  - its ultimate commercial viability considered in the light of factors such as likely market conditions (including competing products), public opinion, and consumer and environmental legislation; and
- the aggregate of deferred development costs, any further development costs, and related production, selling and administrative costs is reasonably expected to be exceeded by related future sales or other revenues; and
- adequate resources exist, or are reasonably expected to be available, to enable the project to be completed and to provide any consequential increases in working capital.

It is most unlikely that any expenditure incurred by an internet company, particularly those in their early stages, will meet the criteria for deferral. Further, SSAP 13 was designed for engineering developments and considerable caution should be exercised in broadening its scope, particularly in the light of FRS 10 which many regard as a more specific standard.

As additional discouragement, there was an announcement in February 2000 by the Financial Reporting Review Panel (FRRP) regarding costs capitalised under SSAP 13 by Sinclair Montrose Healthcare PLC. It revised its accounts to write off capitalised development expenditure costs which were judged by the FRRP not to fall within the precise definitions of the SSAP. While not an internet company, the expenditure was related to start-up costs which were associated with new activities of the company.

Consequently, any costs proposed to be treated as development expenditure must be carefully justified. If there is any doubt over either the precise nature of such costs, or the feasibility of a project, they should be expensed as incurred.

Start-up costs

Faced with the prospect of charging the majority, if not all, costs to the profit and loss account as incurred, internet companies may suggest that database development costs should be regarded as start-up costs and be deferred from one accounting period to the next, for example as a prepayment, deferred expenditure or other kind of asset, in order that they are matched against related income. However, UITF Abstract 24, *Accounting for start-up costs*, considers this point and concludes that costs should be expensed unless they meet the specific conditions for recognition as a fixed asset under a relevant accounting standard, such as FRS 10, FRS 15 or SSAP 13.

Period during which assets may be regarded as being 'under construction'

For hardware and software costs which may be capitalised, only those incurred up to the point at which the asset's operation becomes feasible, or up to the date of practical completion, may be capitalised. FRS 15 prohibits capitalisation of costs beyond the point at which the asset is ready for use, with its physical construction being complete, even if it has not yet been brought into use. The date of implementation is not appropriate, as this might lead to costs being accumulated and capitalised over an excessive period.

Updates and maintenance

The costs incurred in the maintenance and development of a database often cause difficulties in practice. It can be difficult to establish whether there has been an enhancement to an existing asset, or whether the work carried out has simply been part of normal ongoing maintenance. Maintenance may, for example, be required in order to maintain functionality and provide the ongoing enhancements to the database which are needed in order to ensure its performance remains competitive.

The following would be persuasive for capitalising costs:

- the number of subscribers to the service has increased substantially, requiring that the capacity and/or functionality of the database be improved; or
- an upgrade to hardware has been implemented which has enabled improvements to be made to the database.

Particularly in the latter case, care is needed in order to determine that the work carried out is an enhancement to an existing asset; should costs have been incurred in developing a new database, any residual value of the old database would need to be written off immediately. Consequently, when considering the value at which databases might be held within fixed assets at each period end, future plans and projections will need to be reviewed in detail in order that any impairment in value is recognised on an appropriate basis. Equally, given the pace of change in this sector, estimated useful lives need to be reviewed on a regular basis.

Where information from the database is to be sold to third parties, customers should be prepared to pay more per name for an enhanced database or the refinements should give the database a wider appeal. Unless one (or both) of these features is realised by an enhancement programme it is hard to support a case for capitalisation of costs.

Where costs incurred are all, or substantially all, related to maintaining the competitiveness of the database's operation, these should be expensed as incurred as they are ongoing normal costs of the business.

Accounting policies in practice

Purchased intangible assets

Few companies disclosed their accounting treatment of these assets. Of those which did, one (a start-up) dealt only with purchased computer software. Fuller disclosures are made by Gresham Computing plc which includes both purchased and internally developed intangibles in its policy and acknowledges many of the specific requirements of FRS 10:

"Intangible assets purchased separately from a business are capitalised at cost. Intangible assets acquired as part of an acquisition of a business are capitalised separately from goodwill if the fair value can be measured reliably on initial recognition, subject to the constraint that, unless the asset has a readily ascertainable market value, the fair value does not create or increase any negative goodwill arising on the acquisition. Intangible assets created within the business are not capitalised and expenditure is charged against profits in the year in which it is incurred. Intangible assets are amortised on a straight line basis over their estimated useful lives up to a maximum of 20 years. The carrying value of intangible assets is reviewed for impairment at the end of the first full year following acquisition and in other periods if events or changes in circumstances indicate the carrying value may not be recoverable."

Amortisation of goodwill

Many companies in this sector do not, as yet, have subsidiaries or other investments which give rise to goodwill, and this is reflected in only six of the 25 surveyed having a stated goodwill policy. All of these policies derive goodwill from a comparison of the consideration and the fair value of the net assets acquired.

Disclosures related to the useful life of goodwill vary in clarity. Typical of most, Affinity Internet Holdings plc's accounting policy states that:

"The directors consider each acquisition separately for the purpose of determining the amortisation period of any goodwill that arises. The following sets out the periods over which goodwill is amortised and the reasons for the periods chosen: Brightfibre Communications Plc - 3 years straight line. The Directors believe that 3 years represents a realistic assessment of the useful economic life of the customer contracts acquired."

Amortisation periods adopted vary, although the majority of companies consider the useful life to be rather less than ten years. Although even a ten year period might be considered lengthy in the context of internet companies, Easynet Group Plc goes further and extends the estimated life:

"The goodwill arising on the acquisition of Easynet Datenverarbeitungs GmbH was being amortised over a ten year period commencing in the year ended 31 December 1998. In the year ended 31 December 1999, the Directors reassessed the useful economic life of that goodwill to be twenty years and have accordingly commenced amortising the goodwill over a twenty year period in the year ended 31 December 1999. The goodwill arising in 1999 on the acquisition of 42 percent of the share capital in Easynet S.A. is being amortised over a twenty year period which is considered by the Directors to be a prudent estimate of its useful economic life."

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The principal activity of companies within the Easynet Group is given as:

"The provision of internet access services in the UK and continental Europe, which includes the provision of computer networking hardware, software, peripherals and consultancy."

In this context, a useful life rather greater than three years may well be considered appropriate, although there might be some debate over whether even internet access services can be assured of a 20 year life.

Research and product development costs

Of the 14 companies from the 25 surveyed which disclose an accounting policy, 13 choose to write off costs as incurred. For many, in their early stages of trading, this will be the most appropriate approach as the commercial viability of their services is unlikely to be sufficiently assured to allow costs to be capitalised.

Interactive Investor International plc discloses in its 30 September 1999 financial statements that it has changed its previous policy of capitalising costs associated with branded products to that of write off as incurred, stating that:

"Given the continuing development and redesign of the iii website and the relatively short life, to date, of each development, management believe that a more appropriate policy is to write off development costs as incurred."

The exception to this approach is Brightstation, perhaps reflecting its considerably greater history as the group has been in existence for over 20 years. Its accounting policy is:

"Intangible assets comprise both system and product development costs.

System development comprises costs associated with the Group's host computer systems and databases, and includes software licence fees and installation costs. These costs are amortised on a straight line basis over five years in line with the depreciation policy for the computer hardware used to host the Group's services.

Product development consists of the pre launch costs associated with the development of new products. These include the costs of consultancy, programmers' salaries and related overheads including depreciation and lease interest on computer hardware wholly used for product development. These costs are amortised on a straight line basis over three year commencing in the first month of revenue generation from the developed product.

Product development costs are reviewed regularly for impairment and additional depreciation is charged, if necessary, to reduce the net amount carried forward on a product by product basis to net revenues expected to be generated by that product."

In practice, it would be expected that only a company with a long established track record in a particular industry segment, such as Brightstation will be capable of meeting the strict requirements of SSAP 13 and FRS 10.

Depreciation rates for fixed assets

Accounting policies are disclosed for tangible fixed assets by 24 of the 25 companies surveyed. The exception, Overnet Data (UK) Limited, has no fixed assets included within its balance sheet and, although we are told that all research and development expenditure of this new company, which commenced trading on 3 June 1999, is written off as incurred, it is unusual for a company to have only current assets.

Depreciation rates applied to fixed assets are, for the most part, consistent. Fixtures, fittings and equipment (which, for some companies, includes computer equipment) are generally written off at rates between 25 and 33 percent per annum. Where separate disclosures are made for computer equipment and software, similar rates are used.

Exceptions are few although some companies, including Scoot.com, E-sync Networks (UK) Limited, Blueberry.net Limited and Cityjobs.com plc apply rates of between 10 and 15 percent to their fixtures and equipment.

5 Issue of share capital

In July 2000, the ASB issued a discussion paper which is principally directed towards employee compensation. The following comments are based on present accounting practices and would need to be refined in the light of any new standard that the ASB might issue.

Exchange of services for equity investments

An increasing trend is for established companies, which may themselves be internet companies, to provide internet companies with services in return for share capital. Considerations arise for both the company issuing the share capital and the investing company.

Issuer

Fair value

Shares in a UK company should be recorded at the fair value of the consideration received, and may not be issued at a discount from par value. Consequently the fair value of the services being provided needs to be determined. In many cases, evidence for the value of the services can be obtained from the provider issuing an invoice. However, the absence of cash requires some consideration of whether the invoice value can be supported (eg, by normal tariffs). This is so in all cases, but is particularly sensitive for a UK public company where the auditor (or a person qualified to be auditor) will be asked to give a report on the consideration received.

In other cases, there may be significant uncertainty over the fair value of certain elements of consideration received for shares. This can arise where two investors are subscribing for shares in a new internet company, one providing cash and the other services and intangible assets. Difficulties associated with valuation of contributions in kind are emphasised in a young industry sector like internet and technology as, in many instances, there may be little historic or current evidence available to support proposed values. Forecasts may also be difficult to substantiate, with many covering start-up operations which show steep growth curves.

In these cases, it will be appropriate for the fair value of the services and/or assets to be based on evidence which is considered to be the most reliable for the purposes of their valuation.

Example

A, a venture capital fund, and B, an internet company with an on-line financial services business in the US, enter into a joint venture arrangement (JV) to expand the service into the UK. A subscribes for shares in the new JV company, paying £10 million in cash and B agrees to provide operating software together with associated licences. B's US operation has been in existence for nine months and has no substantial track record. A and B receive equal numbers of shares with identical rights.

Although a business plan exists for the UK operation, significant uncertainties exist over the JV's ability to achieve forecasts which, as with many internet ventures, show substantial growth over its initial period. Consequently, it is considered that to discount the forecast operating cash flows to be derived from the business may not be a reliable method of attributing values to the intangible assets to be subscribed by B.

However, A has paid £10 million in cash for 50% of the share capital of the JV. Consequently, it is appropriate to use this as evidence of the value of the intangible assets and attribute a fair value of £10 million to them.

In some cases, evidence may suggest that the value of services being received is less than the value of the shares being issued in return. In such cases, the shares issued should be recorded at the fair value of the non-cash consideration received.

Example

A, a listed on-line internet company, enters into an arrangement where B, an international advertising company, will provide it with advertising services over a three month period. A's financial year end is 31 December 2001 and the services are to be provided during the quarter ending 30 June 2001.

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On the date on which the contracts are signed A's shares, which have a nominal value of 10p, are trading at £2. B will receive 1,000,000 shares, implying a value of services of £2 million. However, at standard rates, including discounts normally given to customers settling amounts due in cash, the fair value of advertising received by A is £1.5 million.

When the shares are issued, A will recognise a charge to its profit and loss account of £1.5 million, crediting share capital with the nominal value of the shares of £200,000 with a credit to share premium of the balance of £1.3 million.

This approach would apply regardless of movement in A's share price between the date of signature of the contracts and the date on which the shares were issued.

Additional considerations for public companies

The Companies Act 1985 (CA1985) contains restrictions on the consideration receivable by public companies.

s99 CA1985 does not allow them to issue shares for services which are to be carried out at a future date. Consequently, shares should be issued only when it can be determined that services amounting to at least their nominal value have been received and, similarly, neither should any share premium be recorded in advance. Where the provider of services requires assurance over the number of shares to be issued, the investee company may issue share options, which are exercisable on the date of issue of a sales invoice or, if later, completion of work.

s103, s108 and s109 CA1985 require an independent valuation of any non-cash consideration and a report to be prepared by the company's auditor (or a person qualified to be auditor) within a period of six months before the date of the agreement for the issue. This report needs to be sent to the company, investor and the Registrar of Companies.

s104 CA1985 does not allow a company to issue shares, which exceed 10 percent of the nominal value of its initial issued share capital, for non-cash consideration to a person who was an initial subscriber to the memorandum (ie, an investor in the company on its formation) during a period of two years following the date on which it is issued with a certificate under s117 CA1985 entitling it to carry on business as a public company. However, this might again be addressed by the issue of share options which could be exercised at the later of the end of the two year period, or the date on which the provision of services is complete.

Investor

Shares received in return for services should be recorded as an investment, usually fixed, unless there is evidence to support their being held only for the short term (principally where the issuing company is listed, and the intention of the recipient is to dispose of the shares). The fixed asset investment would be held at cost (generally measured at fair value in the same way as for the issuer) then being subject to revaluation or impairment in the usual way.

'Cost' would normally be regarded as being the amount of sales revenue given up and, consequently, the amount attributed to the cost of investment will often include a profit element. However, the receipt of shares, rather than cash, means that a realised profit will generally not arise until the shares are disposed of for cash. Consequently, any profit element will be excluded from the profit and loss account, instead being included within the statement of total recognised gains and losses (STRGL) and credited to unrealised reserves.

Where the sales value of services provided cannot be ascertained, only the direct costs incurred should be included as the cost of the investment.

Timing of recognition - investor and investee

The period during which companies should recognise the transaction will depend on the precise arrangements but this should mirror the timing of the provision of services.

The growing desire for internet companies to show a future improvement in operating performance may encourage the investee company, which receives the services in return for its shares, to anticipate its charge to the profit and loss account, offset by 'shares to be issued' in order that future periods' results will be enhanced. It would be inappropriate to recognise an expense in advance of the provision of services.

Example

A agrees to provide services in exchange for shares to B, a private start-up internet company in its early stages of trading. B agrees to issue shares to A as sales invoices are received for work which has been completed by A. The sales value of services to be provided is £100,000, with shares being issued at par value. A's attributable costs of providing the services are £50,000. All work will be carried out and completed during the year ending 31 December 2001. Accounting by each company for the transaction is as follows:

A will record its costs of providing services in the normal way, charging these to the profit and loss account. The investment in B will be recorded at £100,000 with £50,000 being credited to sales within the profit and loss account and £50,000 being included within the STRGL. This latter £50,000 will be credited to unrealised reserves, only becoming realised and available for distribution by way of dividends when the investment is disposed of.

B will charge its profit and loss account with £100,000 and record an addition to its share capital and share premium accounts of an equivalent amount.

Employee share schemes

UITF 17 *Employee share schemes*

Internet companies commonly grant share options to employees. Where the option price is less than the fair value of the shares at the date of grant, a charge needs to be made to the profit and loss account in accordance with UITF 17. The difference between the option price and the fair value is charged to the profit and loss account over a period, normally that over which performance is being measured. In practice this may lead to very high charges in comparison to other amounts recognised in an internet company's profit and loss account.

UITF 25 *National insurance contributions on share option gains*

A further consideration is the requirement for National Insurance contributions (NI) to be levied on the gain made by employees on the exercise of options granted after 5 April 1999 under unapproved schemes. In these cases, unless the company has transferred the NI obligation to the employee, a further charge needs to be made to the profit and loss account in accordance with UITF 25.

Under the Abstract the NI is charged to the profit and loss account over the period from grant to exercise as follows:

- Calculate the total potential NI charge in respect of the outstanding options expected to be exercised, based on the excess of the year end market price of the underlying shares over the option exercise price.
- Allocate that charge over the related performance period. This is the period from the grant date to the date at which the employee becomes unconditionally entitled to the options. Say, for example, an option had specified performance criteria for three years, following which the employee had to remain with the company for a further two years before becoming entitled to the options. The performance period would be five years.
- Each year's charge will include both the charge in respect of that year's performance and a revision to the opening accrual in respect of previous years' performance to adjust its basis to the year end market price.
- If there is no performance period, full provision should be made immediately and adjusted thereafter to reflect the current market price of the shares.
- From the end of the performance period to exercise, the provision should be adjusted to reflect the current market price of the shares.

NI liabilities - practical considerations

The payment of NI contributions by internet companies can present them with significant problems, as their cash resources are often fully utilised. In order that cash resources can be obtained to cover the cost, arrangements might be entered into for a placing of shares.

Alternatively, legislation now permits the employer to recover the NI from, or transfer the liability for the NI charge to, the employee. An arrangement might therefore be entered into where the employees concerned agree to meet the liability and are granted sufficient options to compensate for the estimated NI charges.

If there were such an agreement for recovery by the employer, the asset, representing the amount recoverable from the employee, and liability, representing the amount of NI payable, would both be shown in the balance sheet. These two entries would be netted in the profit and loss account. If the liability were fully transferred formally to the employee,

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UITF 25 states that the employer would have no liability to reflect in its accounts; however, the precise wording of the legislation will be key to determining whether in fact the liability is wholly removed.

Accounting policies in practice

Few companies include a specific policy covering the treatment of share schemes, with Interactive Investor International plc, 365 Corporation plc and Overnet Data (UK) Limited essentially replicating the basic requirements of UITF 17.

QXL.com does much the same, although its stated policy is for amounts charged to the profit and loss account over the vesting period of options to be credited to accruals, being transferred to share premium when the options are exercised. This suggests that the company is purchasing existing shares rather than issuing new ones. This is because the obligation for a company to issue shares is not regarded as a liability and, if new shares were to be issued rather than existing ones purchased, the credit entry would instead be recognised within shareholders' funds.

Overnet Data (UK) Limited also includes a policy covering NI charges:

Provision for National Insurance contributions on options granted on or after 6 April 1999 under unapproved share option schemes is made only if the option holder is an employee of the company at the date of grant.

However, this policy does not state whether the provision is made on a straight line basis, or the spreading basis which is required by the recently issued UITF Abstract 25. In practice, we expect that many companies will need to change their accounting treatment for NI charges as many have been accruing on a straight line basis. This would be treated as a change in accounting policy and, consequently, if the amounts were material, a prior year adjustment would be required.

6 Looking ahead

Employee share-based payments

The increasing use of share-based payments has raised questions about the accounting treatment of such transactions in companies' financial statements. The ASB has discussed these with the G4+1, a group comprising representatives of the accounting standard setting bodies in the UK, Australia, New Zealand, Canada and the USA, and the International Accounting Standards Committee, which expressed similar concerns. This led to the development by the G4+1 of a discussion paper (DP), which has been published by the ASB for comment.

The proposals would result in significant changes to current accounting practice, particularly in the case of employee share schemes. The principal proposals of the DP are:

- Transactions involving share-based payment should be measured at the fair value of the shares or share options at vesting date.
- An option-pricing model should generally be applied to measure the fair value of options. (Under UITF Abstract 17, they are valued at the market value of the underlying shares. The proposed approach would be more complex.)
- Vesting date is the date upon which the other party, having performed all of the services or provided all of the goods necessary, becomes unconditionally entitled to the shares or options.
- The estimated charge should be accrued over the performance period on the basis of the fair value of the shares/options at each period end. Therefore, the charge for the period would be in part a charge relating to that period's services and in part a revision of the opening accrual. The charge should be finalised on vesting date.
- Unless the company could be required to transfer economic benefits (eg, pay cash) at vesting, the 'accrual' would be included within shareholders' funds. (The paper notes that the presentation proposals require further work.)
- The current exemption from UITF Abstract 17 for SAYE and similar schemes would not be carried forward and they would therefore be covered by the requirements.

An eventual standard would supersede UITF Abstracts 13, *Accounting for ESOP Trusts*, and 17. However, they will remain in force in the UK for some time yet. The ASB is likely to want to review the comments received by all G4+1 members before deciding what specific proposals to advance in the UK in an exposure draft for an eventual Financial Reporting Standard.

The proposals of the DP would represent a significant change in the way that companies' 'costs' are determined and are likely to be met with significant opposition from companies which make use of options. Whatever the outcome, it seems clear that accounting for share-based payment is likely to become more complex in the future, and that the 'cost' to the companies concerned and their shareholders will be given greater prominence.

Revenue recognition

The ASB is considering a project covering revenue recognition, which may well affect internet companies in the future. Current indications are that a discussion paper may be available during the first half of 2001.

If you would like any further information on any of the matters discussed in this booklet, please get in touch with your usual contact at KPMG or call any of our offices. If you are not an existing client of the firm, contacts within our Information, Communication and Entertainment (ICE) business unit in the UK are:

Name	Office	Telephone	email
Sean Collins	London	020 7311 2855	sean.collins@kpmg.co.uk
James Conway	London	020 7311 2191	james.conway@kpmg.co.uk
Wayne Southwood	London	020 7311 3232	wayne.southwood@kpmg.co.uk
Rachel Yasue	London	020 7311 2194	rachel.yasue@kpmg.co.uk
Mark Summerfield	London	020 7311 3055	mark.summerfield@kpmg.co.uk
Mike Holly	Manchester	0161 838 4043	mike.holly@kpmg.co.uk
John Costello	Manchester	0161 838 4650	john.costello@kpmg.co.uk
Alan Aubrey	Leeds	0113 231 3191	alan.aubrey@kpmg.co.uk
Peter Meehan	Birmingham	0121 232 3362	peter.meehan@kpmg.co.uk
Xac Timmermans	Birmingham	0121 232 3020	xac.timmermans@kpmg.co.uk
Stephen Richardson	Birmingham	0121 232 3021	stephen.richardson@kpmg.co.uk
Martin Ross	Glasgow	0141 300 5581	martin.ross@kpmg.co.uk
Jandy Stevenson	Edinburgh	0131 527 6616	jandy.stevenson@kpmg.co.uk
Rick Clark	Aberdeen	01224 416831	rick.ph.clark@kpmg.co.uk
Nick Rossiter	St Albans	01727 733012	nick.rossiter@kpmg.co.uk
Sanjay Thakkar	St Albans	01727 733067	sanjay.thakkar@kpmg.co.uk
Robert Ferguson	Cambridge	01223 582007	robert.ferguson@kpmg.co.uk
Ian Turner	Bristol	0117 905 4147	ian.turner@kpmg.co.uk
Nick Talbot	Reading	0118 964 2020	nick.talbot@kpmg.co.uk

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