



# SRI LANKA BEGINS TO APPLY NEW REVENUE RECOGNITION STANDARD

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## Executive Summary

This study provides the facts on a new revenue recognition standard which is to be adopted by Sri Lanka. Basically, any organization be it a conglomerate, multinational company, or a small private limited company, the revenue related information is used to evaluate the financial performance and position of the company and to compare that company with other companies. However, due to certain inherent limitations related to recognition and presentation of revenue, the evaluation of the performance of a company has been difficult for investors and other analysts.

## Introduction

The present guidelines have evolved over a period of time and it goes back in history up to 1995, where the first revenue recognition standards IAS 11: Construction Contracts (IASB, IAS-11, 1995) and IAS 18: Revenue were introduced (IASB, IAS-18, 1995). Since then, these two standards were revised on several occasions and many interpretation standards were issued by the International Accounting Standards Board (IASB), to accommodate the different aspects of revenue recognition demanded by the business communities. These standards include IFRIC 13: Customer Loyalty Programmes (IASB, IFRIC-13, 2008), IFRIC 15: Agreement for the Construction of Real Estate (IASB, IFRIC-15, 2018) and IFRIC 18: Transfer of Assets from Customers (IASB, IFRIC-18, 2018). Nevertheless, these standards contained limited guidelines, hence diverse practices were observed in the practice hindering comparability. For investors to understand the nature, performance and how revenue is generated, it requires a considerable amount of disclosures. A significant vacuum is observed with regard to disclosure requirements, due to limited mandatory minimum disclosures requirements stipulated in the present guidelines.

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## Identification of problem

To address these deficiencies, the new revenue recognition standard IFRS 15: Revenue from Contracts with Customers has been introduced. This standard will be effective from 1st January 2018 and the companies with financial year ends on December 31st and March 31st shall report, applying this standard on 31st December 2018 and 31st March 2019.

## The New Revenue Recognition Standard in a Nutshell

The new standard provides a comprehensive framework on how to determine, when to recognize revenue and how much revenue to recognize. Addressing these simple questions (when and how much) has been proven to be quite complex. Nevertheless, the new standard is a principles based standard, which provides adequate guidelines to address these two simple questions in complex scenarios (IASB, IFRS-15, 2018).

The core principle of revenue recognition is that a company shall recognize revenue to depict the transfer of goods and services to a customer, in an amount that reflects the consideration agreed with the customer, for the task agreed to be performed. Further, the new quantitative and qualitative disclosure requirements enable the users to understand the nature, amount, timing and uncertainty arising from revenue from contracts with customers. The new standard is applied to contracts to deliver goods and service to customers in all industries.

The new standard is organized and evaluated under five steps (IASB, IFRS-15, 2018), as follows;



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### ***Step 1 – Identify the contract***

The standard defines a contract as an agreement between two or more parties that contain enforceable rights and obligations, where enforceability is a matter of law. Further, the standard identifies that the contract can be written, oral or implied by the business practices. A contract with a customer is in the scope of this standard only if the contract has a commercial substance, the collection of consideration is probable, the rights and obligation of the respective parties can be identified and the contract is approved and the parties are committed to their respective obligations. There is no definition to enforce a contract or customer, nor is it viable in the existing literature on revenue recognition. This development provides much clarity in identifying the appropriate contracts under revenue recognition.

### ***Step 2 - Identify performance obligation***

Performance obligations are promises within the contract that is agreed to transfer goods and service. The performance obligation is the unit of account for revenue recognition. Hence, it is required to identify the distinct performance obligations or goods and services. Goods or services are distinct, if the customer can benefit from the promised goods and services on its own or together with other readily available resources and the entity's promise to transfer the goods ( capable of being distinct) and services separately, identifiable from the other promises (distinct within the context of the contract). The current literature includes very limited guidelines in the determination of separately identifiable components (performance obligations). This is a very welcoming development that provides guidelines for types of revenue generating transactions.

### ***Step 3 - Determine transaction price***

The transaction price is the amount of consideration to which a company expects to be entitled to, in exchange for transferring the promised goods or services to a customer. Transaction price shall be estimated at the inception of the contract. Accordingly an entity assumes that the goods

and services will be provided to the customer, as per the existing terms and conditions of the contract. Usually, the transaction price is a fixed amount. However, in determining the transaction price, an entity shall factor components such as variable considerations, significant financing components, non-cash considerations and considerations payable to customers. These elements would require significant judgment and estimation at the inception of the contract.

When estimating a transaction price, the entities may use expectations and probabilities. However, revenue shall be recognized only to the extent it is probable where no significant reversal would occur, when the uncertainties are subsequently resolved. The constraint on reversal of revenue is a significant change in accounting for revenue under the new standard. In other words, the constraint sets a ceiling, up to which the revenue can be recognized. Presently, revenue is recognized, only if it can estimate the amounts reliably. This practice may preclude entities from recognizing revenue, until the uncertainties are cleared.

### ***Step 4 - Allocate the transaction price***

Transaction price is allocated to each of the performance obligations, to depict the amount of consideration expected from each promise under the contract. The allocation is based on the stand alone selling price of each of the performance obligations. If standalone selling prices are not available or observable, then entities could estimate. Current guidelines are largely silent on the allocation of considerations among the spate of components (performance obligations). Much diversity in reporting is observed, due to limited guidelines. Therefore, the new guidelines enhance the comparability of financial statements.

### ***Step 5 – Recognize revenue***

The entities shall recognize revenue when the performance obligations are satisfied or delivered. That is, when the customer receives the control over the promised goods and services. Performance obligations may be satisfied at a point in time (typically for sale of goods) or over a period of time (for services). The new standards provide guidelines, in determining whether the revenue shall be recognized at a point in time or over a period of time. The standard further provides indicators of transfer of control of the goods and services.

This is a clear move away from the risk and reward based revenue recognition approach. This standard introduces a new approach on revenue recognition, i.e. revenue is recognized when control over the promised goods or services are transferred to the customer.



## Findings and discussion

The entity that uses the stage of completion method/ percentage completion method is required to reassess whether their revenue recognition policy needs to be changed to a point in time revenue recognition. Entities that are in the business of construction (particularly construction of condominium properties) and business of sale of real estate (particularly multiunit residential developers), may have a significant impact on revenue recognition. (KPMG, 2014). The following findings are based on the Issue in- Depth: Revenue from Contracts with Customers (2014) and KPMG Audit Committee Institute (2016).

### *Revenue may be recognized at a point in time or over time*

Presently, IAS 11, IAS 18 and IFRIC 15 are applied on a selection of appropriate accounting bases for revenue recognition, for construction contracts and sale of real estate properties. On a close observation of the construction and real estate industries current practices, the revenue recognition stage of completion method, has been a popular practice. Despite the fact that IFRIC 15 introduced and emphasized the notion that the revenue from sale of goods, shall be recognized when the risk and rewards associated with goods and service are passed, many constructions of condominium properties companies and real estate companies, recognized revenue on a stage of completion basis, way before risk and rewards were passed.

It is noteworthy to state that the adoption and application of IFRIC 15 was differed by the Institute of Chartered Accountants of Sri Lanka since the year 2012, until the time the new revenue recognition standard is adopted. That is application of IFRIC 15 was voluntarily and not mandatory. Given this background, many Construction and real estate companies in Sri Lanka, applied the stage of completion method in revenue recognition.

However, applying the specific criteria stipulated in the new standard, may alter the timing of revenue recognition for construction and real estate companies. Therefore it is critical to evaluate terms and conditions of the contracts with customers, in determining the appropriate accounting treatment. Even a subtle change in contract terms, could result in different assessment of outcome.

### *Revenue recognition may be accelerated or deferred*

Compared to current accounting standards, the revenue recognition may be accelerated or deferred for a transac

tion with multiple components (performance obligations) or variable considerations. A transaction with material rights to purchase additional goods and services such as loyalty points, could have a material impact. The material right to purchase additional goods, may be identified as a distinct performance obligation, identified separately from other promises in the contract. For example, the loyalty points accumulated/earned is a separate performance obligation, when compared with the original transaction that gave right for the loyalty points.

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The revenue from right for additional goods may be recognized in the pattern of how a customer uses such rights. This would significantly delay the recognition of revenue. The telecoms, FMCG retails, ticketing, hotels, transport, shipping and logistics industries may have a significant impact. Particularly for contracts with customers for sale of equipment and post-sale maintenance and repair services, it may have a significant shift in timing of revenue recognition. Revenue from the post-sale maintenance service may be deferred and recognized over a period of time whereas the sale of equipment, may be recognized upfront on transfer of control of the asset (goods), provided they are distinct performance obligations. The industries such as telecoms, vehicle dealers/agencies and other electronic and construction companies may have an impact.

### *New estimates and judgments required*

The new standard introduces new estimates and judgmental thresholds that will affect the amount or timing of revenue recognized. The common areas of estimates and judgment are exercised on identification of performance obligation, determination of level of completion of each of the performance obligations, estimation of variable consideration under transaction price, determination of point of revenue recognition and selection, whether revenue shall be recognized at a point in time or over a period of time (stage of completion basis).



A significant implication can be identified in the construction and real estate industries, software development industries and asset management industries. For example, an investment fund management contract may integrate different services such as administrative services, asset management and custodian services into a single package. An Investment Manager may need to apply judgment to determine identification of performance obligations and allocation of transaction price. Similarly, a composite software development contract may contain services of licensing of software, maintenance, optional upgrades and updates and technical support etc. A careful evaluation of terms and conditions of the contracts are required to identify distinct performance obligations and allocation of transaction prices.

It is important to critically evaluate the estimates and judgments used in measurement of performance based incentive fees. Particularly the hotel management companies, plantation management companies and financial asset management companies (fund management companies), are often remunerated by performance based incentives for management services, which are subject to estimation of variable consideration. Determination of variable consideration (transaction price) requires reliable estimation, using either the expected value method or most likely method, which shall ensure no significant reversal of revenue and the uncertainties on the revenue are cleared.

#### ***Extensive new disclosures will be required***

The current standards do not mandate much disclosure requirements. On review of many of the publicly available financial statements, one may notice that very limited disclosure is made available with regard to the most important item in the financial statements. The most common disclosure observed, is the basis on which revenue is recognized is stated as "revenue is recognized when risk and rewards are passed". This disclosure has been a very standard disclosure, irrespective of the industry in which the entity operates.

**“ The new revenue recognition standard is introduced with the objective of improving comparability and enable user understand nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers ”**

The new standard contains both qualitative as well as quantitative disclosures for annual and interim periods. The objective of the disclosure requirements are that the users of the financial statements shall understand the nature, amount, timing and uncertainty of revenue and cash flow, arising from contracts with customers. For this purpose, the new standard disclosure requirements include disclosures on the aggregation of revenue, contract balances, performance obligations, significant judgments, and estimates etc.

Yet, preparing new disclosure could be time-consuming and capturing the required information may require an incremental effort. However, the standard does not provide any provisions for commercially sensitive information and, therefore, careful strategic planning is required.

**“ Early communication on the implication of adoption of the new standard with the stakeholders of the entities such as shareholders, potential investors, employees, tax authorities, is important ”**

#### **Conclusion**

The new revenue recognition standard is introduced with the objective of improving comparability and enable user understand nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Therefore the users of this standard shall carefully plan the transition from existing standard to new standard. The transition procedures shall critically evaluate the appropriate application, availability of information, reliability of estimates and judgments.

Early communication on the implication of adoption of the new standard with the stakeholders of the entities such as shareholders, potential investors, employees, tax authorities, is important.

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