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CHARTERED ACCOUNTANTS OF SRI LANKA

LKAS 18 - Revenue

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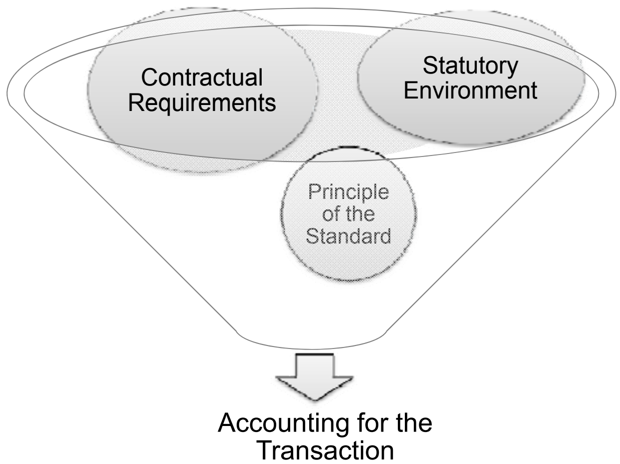
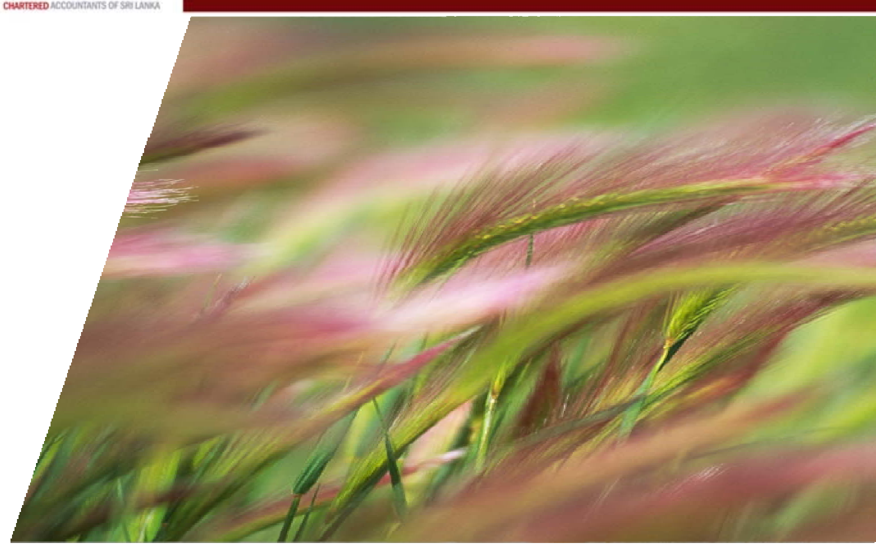
Accounting for substance of transactions



Ex: CIF with Installation

LKAS 18 - Revenue



What is Revenue?

- Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

- LKAS 18 shall be applied to
  - the sale of goods
  - the rendering of services, *and*
  - the use by others of the entity's assets yielding interest, royalties and dividends

Scope exclusions

- The standard does not deal with revenue arising from;
  - Lease agreements
  - Dividends arising from investments which are accounted for under the equity method
  - Insurance contracts within the scope of SLFRS 4
  - Changes in the fair value of financial assets and financial liabilities, or their disposal
  - Changes in the value of other current assets
  - Initial recognition and changes in the fair value of biological assets related to agricultural activity
  - Initial recognition of agricultural produce
  - The extraction of mineral ores
  - Construction contracts

Scoping of real estate sales – IFRIC 15

Two forms of contract are seen in practice:

- The buyer is able to specify the major structural elements of the design of the real estate before construction begins and/or specify major structural changes once construction is in progress.
- The buyer may only have limited ability to influence the design of the real estate, Ex: to select a design from a range of options specified by the entity, or to specify only minor variations to the basic design such as types of flooring or kitchen fittings.

Will the transactions be scoped under LKAS 18 or LKAS 11?

Definition of a construction contract is:

'a contract specifically negotiated for the construction of an asset or a combination of assets...'

Principle agency relationship

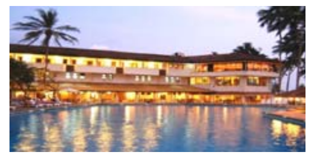
Revenue - the gross inflows of economic benefits received/receivable by the entity on its own account.

Practical Scenarios

- Taxes (NBT)
- Ticketing agencies
- Hotels – Spas
- Travel Agents
- Distributing Channels
- Shipping – Freight forwarding/cargo etc.

Indicators of acting as principle

- Entity is primarily responsible for providing goods and services to customers Ex: Hotel Spa
- Entity has inventory risk Ex: Shipping
- Entity has latitude in establishing prices Ex: Shipping/Ticketing
- Entity has customers credit risk



Measurement

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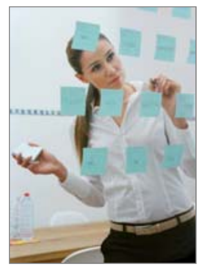
Measurement of revenue

Revenue shall be measured at the **fair value** of the consideration received or receivable.

- The standard defines fair value as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.



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Example:

When inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable.

Ex: Interest free credit to the buyer.

Example – Cont;

The difference between the FV and the nominal amount of the consideration is recognised as interest revenue. (LKAS 39)

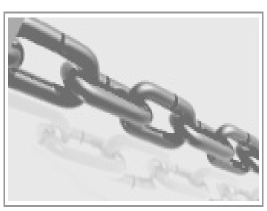
FV of the Sale + Financing Element = Nominal Value

Recognised when goods are sold

Recognised over the financing period

Identification of the Transaction

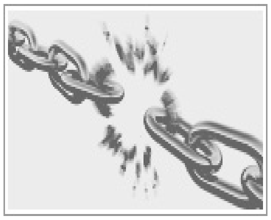
LKAS 18 requires transactions to be **combined or segmented** when this is necessary in order to reflect the substance of the arrangements.



Combining a series of transactions for the purpose of revenue recognition is required when two or more transactions are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole.

Ex: Bundled offers in Telecommunication Industry

Identification of the Transaction cont…..



Revenue recognition criteria must be applied to separately identifiable components of a single transaction when the components are essentially unrelated.

Ex: When product includes subsequent servicing
Rewards points

IFRIC 13: Customer Loyalty Programmes

An entity's obligation to provide free or discounted goods or services ('awards') in the future under a customer loyalty programme should be recognized and measured by revenue deferral.

• The award credits are accounted for as a separately identifiable component of the sales transaction

• The consideration allocated to the award credits shall be measured by reference to their fair value.

How do you measure FV of loyalty schemes?

IFIRC does not specify a quantitative technique.

There are two interpretations of measurement of FV.

a) equal to their fair value (irrespective of the fair values of the other elements); or

(b) a proportion of the total consideration based on the fair value of the award credits relative to the fair values of the other elements of the sale.

Example 1

A retailer sells goods to a customer and issues 100 award credits for a total consideration of Rs1,000. The retailer determines that the fair value of the 100 award credits is Rs 50.

Applying the two approaches above, the retailer could allocate the revenue as follows:

a) equal to the fair value of the credits:

Revenue allocated to the award credits (deferred)	Rs 50
Revenue allocated to the goods (recognised in P&L)	Rs 950
	Rs 1,000

b) based on the relative fair values:

Revenue allocated to the award credits (deferred) $\left(\frac{1,000}{\mathbf{1,050}} \times 50\right)$	Rs 48
Revenue allocated to the goods (recognised in P&L) $\left(\frac{1,000}{\mathbf{1,050}} \times 1,000\right)$	Rs 952
	Rs 1,000

Example 2

An entity issues 5,000 award credits. It expects 80% of these award credits (i.e., 4,000) to be redeemed, and estimates the fair value of the 5,000 award credits to be Rs. 2,000 and defers revenue of this amount.
By the end of year one, 1,500 award credits have been redeemed.

The revenue recognised is:

$$\frac{1,500}{4,000} * 2,000 = \text{Rs. } 750$$

By the end of year two, a further 800 award credits have been redeemed, bringing the total award credits redeemed to date to 2,300. Management now expects 85% of the issued award credits (i.e., 4,250 award credits) to be redeemed. Revenue recognised for the year is:

$$\frac{2300}{4,250} *2000 – 750 = \text{Rs. } 332$$

Sale of Goods

Sale of goods

Revenue from the sale of goods shall be recognized, when all the following conditions have been satisfied.

- The significant risks and rewards of ownership of the goods have been transferred to the buyer
- The seller retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold

Ex: Sale of Land

- The amount of revenue can be measured reliably
- It is probable that economic benefits associated with the transaction will flow to the entity **and**
- The costs incurred or to be incurred can be measured reliably

The risks and rewards of ownership

- Examples where the risks and rewards are retained
  - the entity retains an obligation for unsatisfactory performance not covered by normal warranty provisions
  - the receipt of the revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of the goods
  - the goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the entity,
  - the buyer has the right to rescind the purchase for a reason specified in the sales contract and the entity is uncertain about the probability of return

Example: Accounting Policy

Atlas Copco AB (2008)
Notes to the Consolidated Financial Statements [extract]
Significant accounting principles [extract]
Revenue recognition [extract]
Goods sold [extract]

Revenue from sale of goods is recognized when the significant risks and rewards of ownership have been transferred to the buyer, which in most cases occurs in connection with delivery. **When the product requires installation and installation is a significant part of the contract, revenue is recognized when the installation is completed**.

Example: Sale of Goods

Entity Vstart sells goods to Entity Realstart.

At Realstart's request the delivery of goods is delayed.

However, Vstart has fulfilled all of its responsibilities as the sellers: the goods are identified and ready for delivery to Realstart.

Realstart has specifically acknowledged the deferred delivery instruction and the usual payment terms apply.

Recognize revenue

Revenue from Services

Rendering of Services

When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the end of the reporting period.

The outcome of a transaction can be estimated reliably when all the conditions below are satisfied:

1. The amount of revenue can be measured reliably
2. It is probable that economic benefits will flow to the entity
3. **The stage of completion can be measured reliably**
4. The costs incurred and the costs to complete the transaction can be measured reliably

Ex: Installation fees are recognised as revenue by reference to the stage of completion of the installation.

Determining stage of completion

- Surveys of work performed
- Services performed to date, as a percentage of total services to be performed, *or*
- The proportion that costs incurred to date bear to the estimated total costs of the transaction
  - For this purpose, only costs that reflect services performed to date are included in costs incurred to date, and only costs that reflect services performed or to be performed are included in the estimated total costs of the transaction

Important

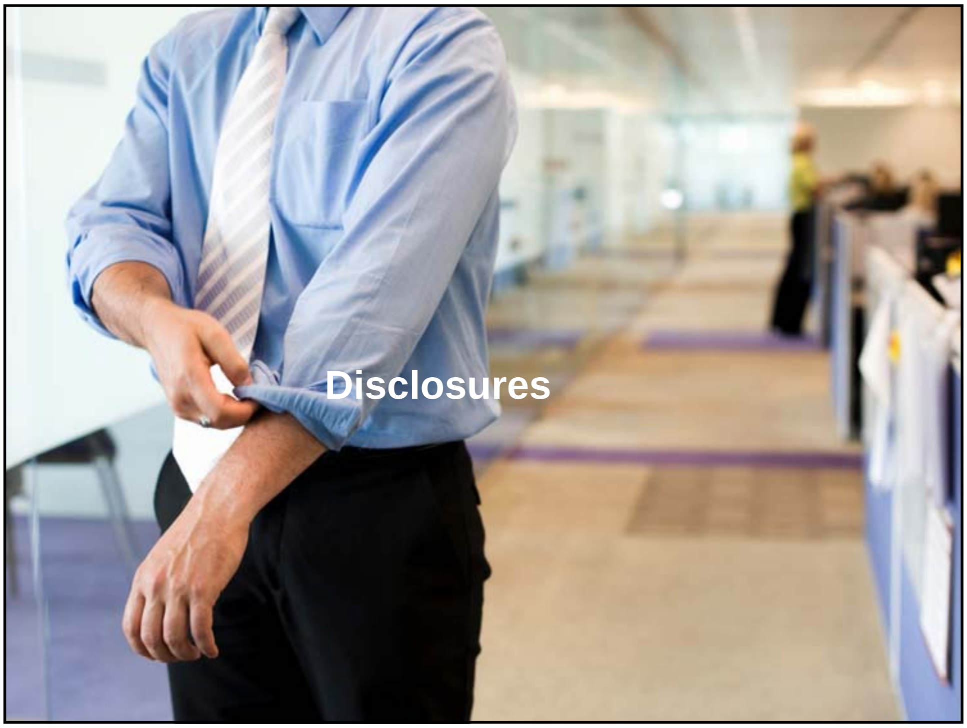
• For practical purposes, when Services are performed by an indeterminate number of acts over a specified period, the standard states that revenue should be recognised on a straight line basis over the specified period unless there is evidence that some other method better represents the stage of completion.
•Ex: Outsourcing arrangements, helpdesk support, etc.

• However, when a specific act is much more significant than any other acts, the standard requires that the recognition of revenue be postponed until the significant act is executed.

Interest, royalties and dividends

Interest, royalties and dividends

- Provided it is probable that the economic benefits will flow to the entity, and the amount of revenue can be measured reliably, revenue is recognised as follows
  - Interest: using an effective interest method as set out in LKAS 39
  - Royalties: on an accrual basis in accordance with the substance of the relevant agreement, *and*
  - Dividends: when the shareholder’s right to receive payment is established



Disclosures

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Disclosure requirements

- The amount of each significant category of revenue recognised during the period, including revenue arising from:
  - the sale of goods
  - the rendering of services
  - interest
  - royalties, *and*
  - Dividends

- The amount of revenue arising from exchanges of goods or services included in each significant category of revenue

Disclosure requirements

- The accounting policies adopted for the recognition of revenue, including the methods adopted to determine the stage of completion of transactions involving the rendering of services

Example: Nokia Corporation 2008

Notes to the consolidated financial statements [extract]

1. Accounting principles [extract]

Revenue recognition [extract]

In addition, sales and cost of sales from contracts involving solutions achieved through modification of complex telecommunications equipment are recognized using the percentage of completion method when the outcome of the contract can be estimated reliably. A contract's outcome can be estimated reliably when total contract revenue and the costs to complete the contract can be estimated reliably, it is probable that the economic benefits associated with the contract will flow to the Group and the stage of contract completion can be measured reliably. When the Group is not able to meet those conditions, the policy is to recognize revenues only equal to costs incurred to date, to the extent that such costs are expected to be recovered.

Progress towards completion is measured by reference to cost incurred to date as a percentage of estimated total project costs, the cost-to-cost method.

Scoping of real estate sales – IFRIC 15

- This Interpretation applies to the accounting for revenue and associated expenses by entities that undertake the construction of real estate directly or through subcontractors.
- Agreements in the scope of this Interpretation are agreements for the construction of real estate. In addition to the construction of real estate, such agreements may include the delivery of other goods or services.

•**Issues**
The Interpretation addresses two issues:
•(a) Is the agreement within the scope of IAS 11 or IAS 18?
•(b) When should revenue from the construction of real estate be recognised?

IFRIC 15 - Agreements for the Construction of Real Estate

Real Estate Contracts

(a) Entity does not have to acquire and supply construction material

(b) Entity has to provide services and construction materials to deliver the real estate to the buyer

Scope of LKAS 18

- Rendering of services (a)
- Sale of goods (b)

Agreement is a Construction contract

Scope of LKAS 11

- Revenue recognition by reference to the stage of completion in accordance with LKAS 11

Revenue recognition under IFRIC 15

Rendering of services

- Revenue recognition based on reference to stage of completion

Sale of goods

- Control and the significant risks and rewards of ownership
  - Of the work in progress is transferred in its current state as construction progresses. Revenue recognised by reference to the stage of completion using the percentage of completion method
  - Of the real estate is transferred in its entirety at a single time (eg at completion, upon or after delivery). Revenue recognised only when all the criteria in paragraph 14 of IAS 18 are satisfied

Ruling

Ruling on Deferring Application of IFRIC 15 – Agreements for the Construction of Real Estate

With the adoption of IFRIC 15, there have been concerns expressed by the entities on the recognition of revenue and associated expenses by entities that undertake the construction of real estate directly or through sub-contractors.

Considering the latest developments in revenue recognition – the five step model, which will bring more clarity on revenue recognition, the Institute of Chartered Accountants of Sri Lanka has decided to grant an option for entities to defer application of IFRIC 15 until the five step model comes into effect. However, the companies who use the above mentioned option should disclose that fact in the financial statements.

Yours faithfully
THE INSTITUTE OF CHARTERED ACCOUNTANTS
OF SRI LANKA

Upendra Wijesingha | Senior Manager – Technical

IFRIC 18

Transfer of Assets from Customers

Transfer of Assets from Customers (IFRIC 18)

This IFRIC applies:

- When an entity receives from a customer an item of **property, plant and equipment or cash** that the entity must then use either to connect the customer to a network or to provide the customer with ongoing access to a supply of goods or services, or to do both.

If the entity concludes that the definition of an asset is met, it shall recognise the transferred asset as an item of property, plant and equipment in accordance with LKAS 16.

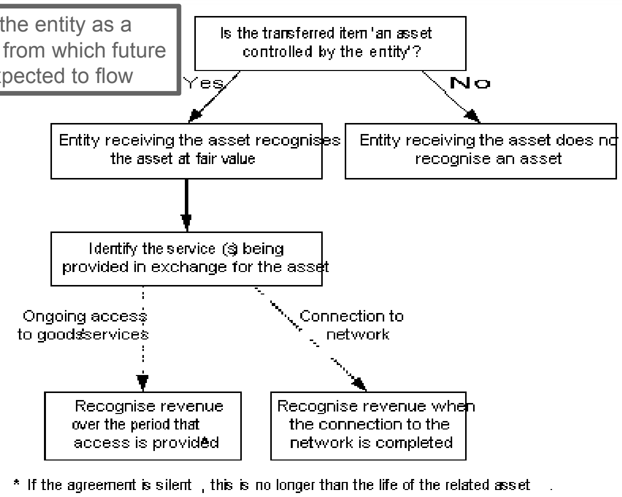
Example

An entity enters into an agreement with a customer involving the outsourcing of the customer's information technology (IT) functions. As part of the agreement, the customer transfers its existing IT equipment to the entity.

How should the entity account for the receipt of IT equipment?

IFRIC 18

A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow



Indicators that the asset is controlled by the entity

The entity's ability to:

- exchange the asset for other assets to deliver the same service;
- employ the asset to produce other goods or services or settle a liability;
- charge a price for others to use it; and
- determine how the transferred asset is operated and maintained and when it is replaced.

Example

An entity enters into an agreement with a customer involving the outsourcing of the customer's information technology (IT) functions. As part of the agreement, the customer transfers ownership of its existing IT equipment to the entity.

Initially, the entity must use the equipment to provide the service required by the outsourcing agreement. The entity is responsible for maintaining the equipment and for replacing it when it decides to do so.

The useful life of the equipment is estimated to be 03 years.
The outsourcing agreement requires service to be provided for 10 years for a fixed price that is lower than the price the entity would have charged if the IT equipment had not been transferred.

Example – Cont;

These facts indicate that the IT equipment is an asset of the entity, who will recognise the equipment and measure its cost on initial recognition at its fair value.

Therefore, the entity should recognise revenue arising from the exchange transaction when the service is performed, i.e. over the ten-year term of the outsourcing agreement.

Alternatively, assume that after the first three years, the price the entity charges under the outsourcing agreement increases to reflect the fact that it will then be replacing the equipment the customer transferred.

In this case, the reduced price for the services provided under the outsourcing agreement reflects the useful life of the transferred equipment. For this reason, the entity should recognise revenue from the exchange transaction over the first three years of the agreement.

Complexities

- How do you measure the transaction?
- Do you recognise revenue?
- What if the relationship is between Parent and subsidiary?

Scopes out:

Government grants

Assets in relation to Service Concessions

SIC-31 - Barter Transactions Involving Advertising Services

The issue arises where an entity (the Seller) enters into a barter transaction to provide advertising services in exchange for receiving advertising services from its customer (the Customer).

In some cases, no cash or other consideration is exchanged between the entities. In some other cases, equal or approximately equal amounts of cash or other consideration are also exchanged.

The SIC concluded that revenue from a barter transaction involving advertising cannot be measured reliably at the fair value of advertising services received.

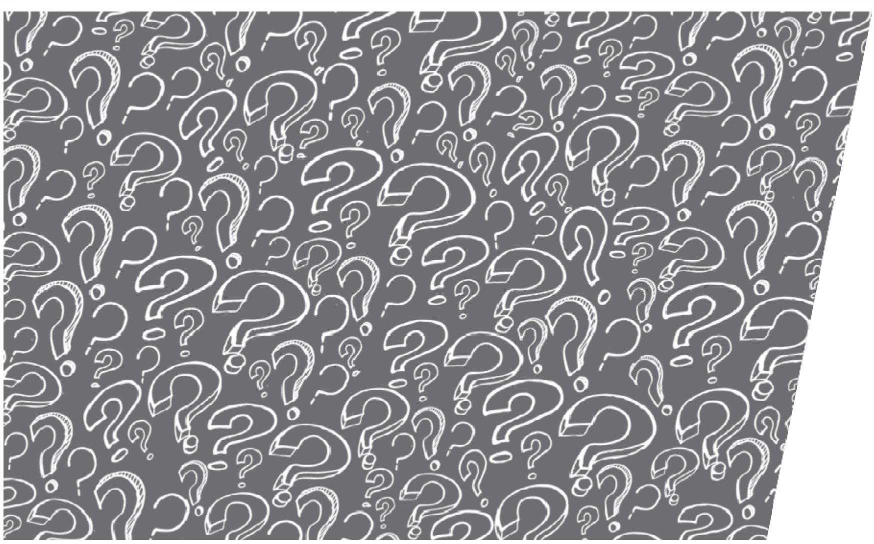
SIC-31 should not be applied to other situations by analogy

SIC-31 - Barter Transactions Involving Advertising Services - cont;

However, a Seller can reliably measure revenue at the fair value of the advertising services it provides in a barter transaction, by reference only to non-barter transactions that:

(a) involve advertising similar to the advertising in the barter transaction;
(b) occur frequently;
(c) represent a predominant number of transactions and amount when compared to all transactions to provide advertising that is similar to the advertising in the barter transaction;
(d) involve cash and/or another form of consideration (e.g. marketable securities, non-monetary assets, and other services) that has a reliably measurable fair value; and
(e) do not involve the same counterparty as in the barter transaction

Questions



Thank you.