



# Tech

**Q** I understand the Institute held a financial reporting forum in September in relation to the International Accounting Standards Board's exposure drafts on **Revenue from Contracts with Customers** and **Leases**. Can I have an overview of the two proposals? What would be the impact if they were adopted?

**A** The Institute invited IASB member, Tatsumi Yamada, and technical principal, Henry Rees, to speak in a financial reporting forum on 2 September introducing the IASB exposure drafts on *Revenue from Contracts with Customers* and *Leases*. The main proposals of the drafts are as follows:

## Revenue from Contracts with Customers

The objective of the IASB and the U.S. Financial Accounting Standards Board in developing this project is to improve financial reporting by clarifying the principles for recognizing revenue and creating a single joint revenue recognition standard for IFRSs and U.S. GAAP that companies can apply consistently across various industries and capital markets.

If the proposed standard were to be adopted, the single joint revenue recognition standard would replace IAS 18 *Revenue*, IAS 11 *Construction Contracts*, IFRIC 13 *Customer Loyalty Programmes*, IFRIC 15 *Agreements for the Construction of Real Estate*, IFRIC 18 *Transfers of Assets from Customers* and SIC-31 *Revenue-*

## Barter Transactions Involving Advertising Services.

The proposed requirements specify the principles that an entity would apply to report useful information about the amount, timing and uncertainty of revenue and cash flows arising from its contracts to provide goods or services to customers. In summary, the core principle would require an entity to recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration that it receives, or expects to receive, in exchange for those goods or services.

To use that principle, an entity would need to apply a five-step model for revenue recognition:

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

Usually a company would apply the proposals to a single contract. However, in some cases the company would account for two or more contracts together if the prices of those contracts are interdependent. Conversely, a company would segment a single contract and account for it as two or more contracts if some goods or services are priced independently of other goods and services.

### Step 2: Identify the separate performance obligations in the contract

A contract includes promises to provide goods or services to a customer, or performance obligations. A company would account for a performance obligation separately only if the promised goods or services are distinct. Goods or services are distinct if it is sold separately or if it could be sold separately because it has a distinct function and a distinct profit margin.

### Step 3: Determine the transaction price

The transaction price is the amount of consideration a company expects to receive from the customer in exchange for transferring goods or services. It would reflect the company's probability-weighted estimate of variable consideration (including reasonable estimates of contingent amounts) in addition to the effects of the customer's credit risk and the time value of money (if material).

**Step 4: Allocate the transaction price to the separate performance obligations**  
A company would allocate the

transaction price to all separate performance obligations in proportion to the stand-alone selling price of the goods or services underlying each performance obligation. If the goods or services are not sold separately, the company would estimate its stand-alone selling price.

### Step 5: Recognize revenue when the entity satisfies each performance obligation

A company would recognize revenue when it satisfies a performance obligation by transferring the promised goods or services to the customer. The goods or services are transferred when the customer obtains control of the promised goods or services. The amount of revenue recognized is the amount allocated to that performance obligation in Step 4.

The proposed requirements also specify the accounting for some costs. An entity would recognize the costs of obtaining a contract (for example, selling and marketing costs) as expenses when incurred. If the costs incurred in fulfilling a contract are not eligible for capitalization in accordance with other standards

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(for example, IAS 2 *Inventories*), an entity would recognize an asset only if those costs:

- (a) relate directly to a contract (or a specific contract under negotiation),
- (b) generate or enhance resources of the entity that will be used in satisfying performance obligations in the future, and
- (c) are expected to be recovered.

In terms of disclosure, the boards propose enhanced disclosure requirements, which would require a company to disclose qualitative and quantitative information about:

- (a) its contracts with customers, including a maturity analysis for contracts extending beyond one year, and
- (b) the significant judgments, and changes in judgments, made in applying the proposed standard to those contracts.

For some contracts (for example, many retail transactions), the proposed requirements contained in the draft would have little, if any, effect on current practice. However, the proposed requirements would differ from current practice in the following ways:

#### *Recognition of revenue only from the transfer of goods or services*

Contracts for the development of an asset (for example, construction, manufacturing and customized software) would result in continuous revenue recognition

only if the customer controls the asset as it is developed.

#### *Identification of separate performance obligations*

An entity would be required to divide a contract into separate performance obligations for goods or services that are distinct. As a result of those requirements, an entity might separate a contract into units of accounting that differ from those identified in current practice.

#### *Licensing and rights to use*

An entity would be required to evaluate whether a licence to use the entity's intellectual property (for less than the property's economic life) is granted on an exclusive or non-exclusive basis. If a licence is granted on an exclusive basis, an entity would be required to recognize revenue over the term of the licence. That pattern of revenue recognition might differ from current practice.

#### *Effect of credit risk*

In contrast to some existing standards and practices, the effect of a customer's credit risk (such as collectibility) would affect how much revenue an entity recognizes rather than whether an entity recognizes revenue.

#### *Use of estimates*

In determining the transaction price (for example, estimating variable consideration) and allocating the transaction price on the basis of stand-alone

## An entity would be required to disclose more information about its contracts with customers than is currently required, including more disaggregated information about recognized revenue.

selling prices, an entity would be required to use estimates more extensively than in applying existing standards.

#### *Accounting for costs*

The proposed requirements specify which contract costs an entity would recognize as expenses when incurred and which costs would be capitalized because they give rise to an asset. Applying that cost guidance might change how an entity would account for some costs.

#### *Disclosure*

The proposed requirements specify disclosures to help users of financial statements understand the amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. An entity would be required to disclose more information about its contracts with customers than is currently

required, including more disaggregated information about recognized revenue and more information about its performance obligations remaining at the end of the reporting period.

The draft does not propose an effective date for the new standard but the boards plan to issue the final standard next year.

#### **Leases**

The objective of the boards in initiating this project is to develop a new approach to lease accounting that would ensure that assets and liabilities arising under leases are recognized in the statement of financial position. To meet that objective, the boards have jointly developed a draft on leases, which proposes that lessees and lessors should apply a right-of-use model in accounting for all leases (including leases of right-of-use

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assets in a sublease) other than leases of biological and intangible assets, leases to explore for or use natural resources, and leases of some investment properties.

For leases within the scope of the draft IFRS, this means that:

- (a) A lessee would recognize an asset representing its right to use the leased (underlying) asset for the lease term (the right-of-use asset) and a liability to make lease payments.
- (b) A lessor would recognize an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset, would either:
  - recognize a lease liability while continuing to recognize the underlying asset (a performance obligation approach), or
  - derecognize the rights in the underlying asset that it transfers to the lessee and continue to recognize a residual asset representing its rights to the underlying asset at the end of the lease term (a derecognition approach).

Assets and liabilities recognized by lessees and lessors would be measured on a basis that:

- (a) assumes the longest possible lease term that is more likely

than not to occur, taking into account the effect of any options to extend or terminate the lease.

- (b) uses an expected outcome technique to reflect the lease payments, including contingent rentals and expected payments under term option penalties and residual value guarantees, specified by the lease.
- (c) is updated when changes in facts or circumstances indicate that there would be a significant change in those assets or liabilities since the previous reporting period.

For contracts that combine service and lease components, the right to receive lease payments and the liability to make lease payments would exclude payments arising from distinct service components and non-distinct service components for lessors that apply the derecognition approach.

For leases of 12 months or less, lessees and lessors would be able to apply simplified requirements.

The draft also proposes disclosures based on stated objectives, including disclosures about the amounts recognized in the financial statements arising from leases and the amount, timing and uncertainty of cash flows arising from those contracts.

The proposals in the draft would, if adopted, result in significant changes to the accounting requirements for both lessees and lessors as follows:

*Changes to lessee accounting*  
IFRSs and U.S. GAAP classify leases into two categories: finance leases and operating leases. Lessees would be most affected if they have a significant portfolio of assets held under operating leases, especially those with leases of property. At present, IFRSs and U.S. GAAP account for the lease payments arising from operating leases by recognizing them in the period in which they occur. The proposals would require lessees to recognize the assets and liabilities arising from those leases.

Although the proposed changes may be less fundamental for leases currently classified as finance leases, they would result in significant changes in the measurement of the assets and liabilities arising from those leases because of the way the draft proposes to account for options and contingent rentals. In addition, the pattern of income and expense recognition in profit or loss would change significantly.

*Changes to lessor accounting*  
The proposed approach to lessor accounting would differ significantly from existing IFRSs and U.S. GAAP. Depending on the extent to which a lessor retains exposure to risks or benefits associated with the underlying asset, a lessor would apply either a performance obligation or a derecognition approach.

If a lessor retains exposure to significant risks or benefits

associated with the underlying asset, the lessor would continue to recognize the underlying asset and in addition, recognize a right to receive lease payments and a lease liability. The lessor would be viewed as satisfying the lease liability continuously over the lease term, and therefore would recognize lease income continuously over the lease term.

If a lessor does not retain exposure to significant risks or benefits associated with the underlying asset, the lease would be accounted for in a way similar to the current accounting for finance leases. That pattern of income recognition is similar to the pattern of revenue recognition currently required for manufacturer or dealer lessors.

However, there would be significant changes in the measurement of the right to receive lease payments, the recognition of lease income and the recognition and measurement of residual assets. For such leases, the lessor would satisfy the lease liability at the date of commencement of the lease by delivering the right-of-use asset to the lessee and thus would recognize lease income representing the sale of the right to use the underlying asset.

The draft does not specify an effective date but the boards plan to issue the new standard next year.



Send your questions and comments to [commentletters@hkcipa.org.hk](mailto:commentletters@hkcipa.org.hk) for the attention of Steve Ong, the Institute's director of standard setting. The standard setting team will answer these questions in accordance with its policy, posted on the Institute's website.