Issuance of a comprehensive standard for revenue recognition

The Institute has recently issued HKFRS 15 *Revenue from Contracts with Customers*, which establishes a single, comprehensive framework for revenue recognition.

Revenue is a vital metric for users of financial statements and is used to assess a company's financial performance and prospects. However, significant diversity in revenue recognition practices has arisen because the extant version of revenue standards contains limited guidance on many important topics, such as accounting for arrangements with multiple elements.

Furthermore, the limited guidance that is provided is often difficult to apply to complex transactions, particularly because the extant version of revenue standards does not include any basis for conclusions. Consequently, some companies supplement the limited guidance in IFRS by selectively applying United States Generally Accepted Accounting Principles, which itself underwent a major transformation early last decade.

Broad revenue recognition concepts are supplemented by numerous industry and transaction specific requirements in U.S. GAAP, which often results in economically similar transactions being accounted for differently. Even with all of those specific requirements, revenue recognition questions continued to arise as new types of transactions emerged. In terms of disclosure requirements, the extant version of IFRS and U.S. GAAP often results in information that is inadequate for investors to understand a company's revenue, and the judgments and estimates made by the company in recognizing that revenue.

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Responding to these challenges, new and fully converged requirements for the recognition of revenue in both IFRS and U.S. GAAP have been developed – providing substantial enhancements to the quality and consistency of how revenue is reported while also improving comparability. The Institute issued HKFRS 15 in July to maintain international convergence arising from the issuance of IFRS 15 by the International Accounting Standards Board.

The core principle in HKFRS 15 is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. An entity recognizes revenue in accordance with that core principle by applying the following five-step model:

Step 1: Identify the contract(s) with a customer – a contract is an agreement between two or more parties that creates enforceable rights and obligations. The requirements of HKFRS 15 apply to each contract that has been agreed with a customer and meets specified criteria. In some cases, HKFRS 15 requires an entity to combine contracts and account for them as one contract. HKFRS 15 also provides requirements for the accounting for contract modifications. Depending on the specific facts and circumstances, a modification may be accounted for as a separate contract or a modification of the original contract.

Step 2: Identify the performance obligations in the contract – a contract includes promises to transfer goods or services to a customer. If those goods or services are distinct, the promises are performance obligations and are accounted for separately. A good or service is distinct if the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer and the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

Step 3: Determine the transaction price – the transaction price is the amount of consideration in a contract to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. The transaction price can be a fixed amount, but it may sometimes include variable consideration (because of discounts, rebates, refunds, etc.) or consideration in a form other than cash. The transaction price is also adjusted for the effects of the time value of money if the contract includes a significant financing component, and for any consideration potentially payable to the customer. If the consideration is variable, an entity estimates the amount of consideration to which it will be entitled in exchange for the promised goods or services. The estimated amount of variable consideration will be included in the transaction price only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

Step 4: Allocate the transaction price to the performance obligations in the contract – an entity typically allocates the transaction price to each performance obligation on the basis of the relative standalone selling prices of each distinct good or service promised in the contract. The best evidence of a standalone selling price is the price at which the good or service is sold separately by the entity. If that is not available, an entity is required to estimate the standalone selling

price by using an approach that maximizes the use of observable inputs. Sometimes, the transaction price includes a discount or a variable amount of consideration that relates entirely to a part of the contract. The requirements also specify when an entity should allocate the discount or variable consideration to one or more, but not all, performance obligations (or distinct goods or services) in the contract.

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation – an entity recognizes revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer, which is when the customer obtains control of that good or service. The amount of revenue recognized is the amount allocated to the satisfied performance obligation. A performance obligation may be satisfied at a point in time (typically for promises to transfer goods to a customer) or over time (typically for promises to transfer services to a customer). For performance obligations satisfied over time, an entity recognizes revenue over time by selecting an appropriate method for measuring the entity's progress towards complete satisfaction of that performance obligation.

HKFRS 15 also includes requirements for accounting for some costs that are related to a contract with a customer. A company would recognize an asset for the incremental costs of obtaining a contract if those costs are expected to be recovered. For costs to fulfil a contract that are not within the scope of other standards, a company would recognize an asset for those costs if the following criteria are met:

- The costs relate directly to a contract (or a specific anticipated contract);
- The costs generate or enhance resources of the company that will be used in satisfying performance obligations in the future; and
- The costs are expected to be recovered.

With respect to disclosure, HKFRS 15 requires an entity to disclose the following quantitative and/or qualitative information so as to help investors better understand the nature, amount, timing and uncertainty of revenue and cash flows from contracts with customers:

- Revenue recognized from contracts with customers, including the disaggregation of revenue into appropriate categories;
- Contract balances, including the opening and closing balances of receivables, contract assets and contract liabilities;
- Performance obligations, including when the company typically satisfies its performance obligations and the amount of the transaction price that is allocated to the remaining performance obligations in a contract;
- Significant judgments, and changes in judgments, made in applying the requirements; and
- Assets recognized from the costs to obtain or fulfil a contract with a customer.

The following standards and interpretations will be superseded when HKFRS 15 comes into effect:

- HKAS 11 *Construction Contracts*;
- HKAS 18 *Revenue*;
- HK(IFRIC) - Int 13 *Customer Loyalty Programmes;*
- HK(IFRIC) - Int 15 *Agreements for the Construction of Real Estate;*
- HK(IFRIC) - Int 18 *Transfers of Assets from Customers;* and
- HK(SIC) - Int 31 *Revenue-Barter Transactions Involving Advertising Services.*

For many contracts, such as straightforward retail transactions, HKFRS 15 will have little, if any, effect on the amount and timing of revenue recognition. For other contracts, such as long-term service contracts and multiple-element arrangements, HKFRS 15 could result in some change to the amount and/or timing of the revenue recognized. Because of this, users of the standard are reminded to study the requirements carefully.

HKFRS 15 is effective for annual periods beginning on or after 1 January 2017 with earlier application being permitted.

This article is contributed by the Institute's Standard Setting Department.