A closer look at the new revenue recognition standard

Vivian Lai looks at the main changes to existing practices brought by the new standard and the challenges entities may face

In July, the Institute issued HKFRS 15 *Revenue from Contracts with Customers*, which is identical to IFRS 15 issued by the International Accounting Standards Board. Entities that prepare financial statements in accordance with HKFRS/IFRS need to apply HKFRS/IFRS for financial periods beginning on or after 1 January 2017, with earlier application permitted.

While the 2017 effective date may seem far off, proper preparation is essential. Revenue recognition is probably the most critical accounting policy and companies cannot afford to get it wrong. Those closely following the project will know there are potentially significant changes coming for certain industries, for example real estate, telecommunications, automotive, pharmaceuticals and technology.

It is worth highlighting that there will be some level of change for almost all entities even if just in the way they think about their revenue transaction and how they document their revenue policies. The more significant impact may be beyond accounting. It is a new model and companies need to have a new mindset.

This may impact the way companies do business and write their contracts in the future. This has a domino effect on systems, compensation, debt covenants, etc. There have been few changes, if any, in financial reporting that would have impacted businesses in this way. Below are some of the areas that could create the most significant challenges for entities as they make transition to the new revenue standard.

Control instead of risk and rewards

The new model is based on transfer of control. Although transfer of control should generally coincide with transfer of risk and rewards, there may be many situations where they could be different. An example may be sales to distributors where control is transferred to the distributors but risk and rewards may not have, because distributors are granted price protection and full right of return. Shipping terms and rights and obligations of the contracts will have to be reassessed. The standard provides five indicators to assess when control is transferred and significant judgment will be needed.

Over-time or point-in-time recognition?

The new model introduces a new concept. Revenue should be recognized overtime when, among other factors, there is "no alternative use" and "right to payment for performance to-date."

The assessment of the enforceability of the right to payment should include consideration of the contract terms and any legal precedent that could override the contract terms. Determining whether the product has "alternative use" and the arrangement entitles the entity to have "right to payment" will require significant judgment and depends on the specific enforceable contract terms.

This will potentially impact many real estate companies that pre-sell apartment units and some outsource manufacturers where the products being produced are proprietary products that would be difficult to redirect to others. More revenue may be recognized overtime based on the new standard.

Arrangements for which HKAS/IAS 11 *Construction Contracts* is currently applicable because the buyer is able to specify the design of the asset do not automatically result in overtime recognition. Careful assessment is needed to determine when control of work-in-progress is transferred and whether there is a "right to payment."

Specific guidance on multi-element arrangements

HKFRS/IFRS currently provides limited guidance on separation of multiple elements and allocation of the transaction price. The new standard provides specific guidance and requires "distinct" performance obligations be separated based on relative standalone selling price. Application of this guidance may require significant judgment. Where a large proportion of offers are bundled, companies, such as in telecoms and software, are more likely to have to make changes to their systems and processes in order to capture the required information and to see a change in their reported revenue on transition.

Variable consideration

The new standard introduces explicit guidance on variable consideration and requires that the amount be included in the transaction price only where it is highly probable revenue will not be reversed in the future. The standard will also require the minimum amount that meets the criteria to be included in the transaction price. Variable fees like performance bonuses and other forms of contingent consideration can be a significant portion of revenues for certain industries, like engineering and construction, asset management, pharmaceutical and life sciences, technology, and entertainment and media. The realizability and the point to recognize variable fees need more judgment from management. This may result in the need for new processes to estimate variable amounts and to then revisit these estimates for each reporting period.

Significant financing component

A significant financing component is factored in when determining the transaction price. This concept is applicable to upfront payments as well as payments in arrears. The standard provides certain exceptions to apply this guidance, and also a practical expedient that allows entities to ignore time value of money if the time between transfer of goods or services and payment is less than one year. Determining whether a financing component is significant may require judgment based on when payments are received and when performance occurs.

Accounting for licences

The standard requires an assessment of whether a licence is distinct from other elements of the arrangement. If distinct, the licence is assessed as either a dynamic licence (recognized overtime) or a static licence (recognized at a point in time). Dynamic licences are those where the licensor performs activities that significantly affect the licence. Otherwise, the licence is a static licence. For example, a licence to place a famous sports team's brand on T-shirts might be dynamic, as the sales of T-shirts (and therefore the value of the licence) could be impacted by the team's performance. In contrast, a static licence provides the customer with right to use intellectual property that does not change after the licence transfers to the customer (e.g., purchasing a licence to download the content of a textbook). This may have a significant impact to media, software companies and others that have substantial licensing arrangements.

Contract costs

Not only covers revenue, the new standard also provides guidance about "contract cost," which may have significant impact to some HKFRS and IFRS preparers. Entities sometimes incur costs (such as sales commissions or mobilization activities) to obtain or fulfill a contract. Contract costs that meet certain criteria are capitalized as an asset and amortized as revenue is recognized. Management will also need to consider how to account for contract costs incurred for contracts that are not completed upon the adoption of the standard.

Other specific guidance

The new standard provides more specific guidance on collectability, contract combination, contract modifications, option, principal agent analysis and other issues provides over 60 illustrative examples for the application of the principles established in the new standard.

More disclosures

Extensive disclosures are required to provide greater insight into both revenue that has been recognized, and revenue that is expected to be recognized in the future from existing contracts. Quantitative and qualitative information will be provided about the significant judgments and changes in those judgments that management made to determine revenue that is recorded, for example, disaggregation of revenue (both for interim and final reporting), contract balances, remaining performance obligations, etc.

The above are the usual suspects but there are much more to think about with the new standard as it introduces new concepts and provides more specific guidance in many areas. The effect on entities will vary depending on industry and current accounting practices. Those most significantly impacted are likely to be companies who offer bundled products and services, provide arrangements where the amount of consideration varies, or have complex licence arrangement. More companies may also be required to recognize revenue over time based on the new guidance.

Since entities cannot change their business strategy and practices overnight, they will need to determine the extent of the impact on their business and to consider changes that might be necessary to their business arrangements, information technology systems, processes, and internal controls now. For many companies the impact will be manageable closer to transition date, but those with large numbers of medium to long term customer contracts, diverse or constantly changing contract terms, or complex system should act now.

The impact is beyond accounting and may require a business process change. What else might also be impacted?

Compensation and bonus plans *Revenue recognition can trigger payments like bonuses. Consider how timing changes for revenue recognition affect these and other internal arrangements.*

Contracts *Existing terms could take on new meaning under the new standard, so entity may need to renegotiate debt covenants or customer contracts to maintain the original intent.*

Systems *Current software may need to be updated to capture new information that might not have been necessary before.*

Tax implications *The timing of cash tax payments could be affected if, for example, revenue is recognized sooner than in the past.*

Controls and processes *The standard requires management to make more estimates, judgment and disclosures, calling for new controls and processes.*

Investor relations *Stakeholders will want to know how revenue recognition will change and how the new standard affects the entity's financial picture.*

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