Ticking time on new revenue recognition standard: Less than two years away now, but can you wait any longer?

New standard summary

The International Accounting Standards Board and the United States' Financial Accounting Standards Board have jointly issued a new revenue standard, IFRS 15 *Revenue from Contracts with Customers*, that will supersede virtually all revenue recognition requirements in IFRS and U.S. GAAP for all companies in all industries. This is to put IFRS and U.S. GAAP on an equal footing given the current more extensive U.S. GAAP revenue recognition guidance. The U.S. Securities and Exchange Commission staff continues to make public companies encouraging a "practical approach" to implementation while emphasizing the importance of consistency in application across industries for important issues.

In Hong Kong, IFRS or HKFRS 15 is effective for annual periods beginning on or after 1 January 2018. While both the IASB and FASB have deferred the effective date by one year from the original effective date and proposed several amendments including on principal versus agent, transition and collectability, and licenses and performance obligations to the new standard, companies should not slow down their implementation activities. In fact, given the principles-based guidance without bright lines, many companies are finding that implementation requires significantly more efforts and judgment than they expected.

Early adoption is permitted for IFRS preparers, provided that such fact is disclosed, and for first-time adopters of IFRS. While the changes are scheduled to take effect in 2018, their extent leaves no time for complacency, especially for those companies planning for an initial public offering in the next two years.

The new revenue standard would change the way many Hong Kong companies measure and recognize revenue and expand the disclosure requirements for all companies. More judgments and estimates may be required across multiple business functions than in the past. For example, certain items not typically thought of as revenue such as certain costs associated with obtaining and fulfilling a contract and the sale of certain non-financial assets are now scoped into HKFRS 15. Companies with the support of their audit committees should be timely executing on a well-developed plan to implement the new standard.

Revenue is a key metric. Understanding the potential consequences of the new standard across your organization – beyond just finance – can avoid unexpected issues related to your revenue recognition process. For example, finance would need to consult with others involved in the company's pricing decisions to determine estimated standalone selling prices with limited or no observable inputs and customer credit information to apply the collectability criterion.

Which transition method to adopt?

IFRS 15 requires retrospective application. The boards decided to allow either "full retrospective" adoption in which the standard is applied to all of the periods presented or a "modified retrospective" adoption.

Entities electing the full retrospective adoption will apply the provisions of HKFRS 15 to each period presented in the financial statements in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Under the full retrospective method, non-U.S. entities would be required to restate one comparative year prior to the implementation date. But U.S. public entities would be required to restate two comparative years prior to the implementation date. That means, for U.S. public entities, their financial reporting system must be able to support both the old GAAP and new GAAP as early as 2016.

Under the modified retrospective method, entities only have to recognize the cumulative effect of initially applying HKFRS 15 as an adjustment to the opening balance of retained earnings (or other appropriate components of equity) on the date of initial application.

So why not adopt the "modified retrospective" approach to avoid dual reporting under old GAAP and new GAAP in 2016? There are two considerations:

1. *Applying the "modified retrospective" approach may be more difficult than a company would anticipate:*
- The performance obligations identified under HKFRS 15 are different from the elements or deliverables identified under today's standards.
- The relative standalone selling price allocation under HKFRS 15 results in different amounts of the consideration being allocated to performance obligations than had been allocated in the past.
- The contract contains variable consideration and the amount of variable consideration that can be included in the allocable consideration differs from the amount under today's standards.

2. *Because the "full" method has a major advantage over the "modified" method.* The "full" approach provides users of the financial statements with useful

trend information across all periods presented. Trend analysis is important for investment and credit analysis. During deliberations, the boards seemed to prefer the full retrospective approach. For companies going public, using the full retrospective approach would tell a more coherent story of their historical performance.

Status of management's implementation

No matter which approach is selected, the starting point is to understand the potential impact of the proposed changes on major contracts with customers and key revenue streams. If the company's business offers multiple products and services, then assessing the right level at which to perform the analysis is an important initial consideration. Companies also need to determine the right time to engage with other internal functions, such as sales, tax and legal, to evaluate the consequences of changing contractual terms.

Many companies have received training on this new standard and are aware of the technical aspects of the standard. However, very few companies have actually completed an initial assessment of the potential effects of the standard, including on systems and process, given most of the company resources are devoted to prepare for the 2015 year end audit. As a result, most companies could still disclose in their 2015 footnotes that they are still assessing the impacts of the standard and cannot provide users more information on the company's readiness, including whether significant change would occur to the company's current systems and processes. Regulators are likely to expect an entity's disclosures to evolve in each reporting period as more information about the effects of the new standard becomes available. Accordingly, management should accelerate their assessment of the potential efforts of the standard in conjunction with the completion of their year-end audits as audit committees would really be interested to know.

Key implementation considerations

Identifying where to begin and which resources to involve can be challenging for any company with competing priorities. Companies should spend time to understand the intricacies of the accounting guidance and develop a proper approach by paying attention to the following key implementation considerations:

- Perform a comprehensive assessment to identify the effects of the new standard, including the increased volume of new disclosures, on the company's businesses, processes, IT and financial reporting
- Consider the effects on internal control, including whether there are material internal control changes that could impact the Exchange Listing Rules Practice Note 21 *Due Diligence by Sponsors in respect of Initial Listing Applications* assessment for a Hong Kong IPO candidate
- Evaluate whether the company has sufficient resources for an effective implementation
- Benchmark the company's preliminary assessment against its competitors
- Disclose the anticipated transition method and effect of the standard and develop a plan for updating disclosures during the transition period

Timing is key. It gives organizations a chance to adopt the wide scope of internal changes. The new rules will call for more judgment and effort. Smart planning now will help avoid painful surprises.

Yin Toa Lee is Partner at EY's Capital Markets Centre