Perspective

This is one of a series of articles where experts in assurance, reporting and regulatory matters discuss recent technical and policy developments in these areas

Are you ready to implement the new major accounting standards?

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Introduction

The wait is almost over, with the new revenue and financial instruments requirements just about to hit 31 December 2018 reporters for the first time affecting both interim and year-end financial statements. While dealing with the first time adoption of revenue and financial instruments requirements, businesses also need to start planning for the new standards on leases and, in Australia, income of not-for-profits, which both become effective from 1 January 2019.

All these new requirements represent a major change, however despite the extent of the changes and persistent calls for action by standard setters, regulators, professional accounting bodies and firms over the last few years, many entities are still quite underprepared to transition to the new requirements.

With this in mind, this article highlights some of the key areas of change with respect to each major standard that businesses need to think about in the lead up to the 31 December 2018 reporting season.

IFRS 15 *Revenue from Contracts with Customers (AASB 15/NZ IFRS 15)*

IFRS 15 is one of the most complex and judgemental standards to apply in practice. While many businesses may not be significantly impacted by IFRS 15, such a conclusion cannot be reached without performing detailed technical assessments under IFRS 15 going through the five-step model and having regards to the detailed application guidance and illustrative examples.

Key areas that business need to consider include:

Area	Consideration
Identification of "distinct" performance obligation(s)	This is the most critical step (Step 2) which drives the application of the five-step model. Identification of 'distinct' performance obligation(s) can be quite judgemental in some cases (e.g. revenue contracts in IT and life sciences industries).
Accounting for variable consideration	When consideration is variable or uncertain (e.g. due to incentives, bonuses, penalties, discounts, rebates), entities are required to estimate the transaction price using either the most likely amount or expected value method (whichever best predicts). The estimated amount is then constrained if it is highly probable that a significant reversal of cumulative revenue will occur when the uncertainty is resolved which is a judgement call.
Determination of stand-alone selling price	For bundled contracts (e.g. software contracts with multiple performance obligations), stand-alone selling price for each 'distinct' performance obligation may not be evident and in such case it needs to be estimated.
Non-refundable upfront fees	Upfront fees such as golf club joining fees and gym membership joining fees in most cases would not result in transfer of a 'distinct' good or service to the customer in which case they need to be treated as advance consideration for future goods or services.
Contract costs	Unlike IAS 18, IFRS 15 requires entities to capitalise contract costs representing incremental contract acquisition costs (e.g. sales commission) and contract fulfilment costs when certain conditions are met. Capitalised contract costs are then amortised on a systematic basis consistent with the pattern of transferring the goods or services. For contract acquisition costs, entities may expense costs as incurred if the amortisation period would be less than 12 months.

IFRS 9 *Financial Instruments (AASB 9/NZ IFRS 9)*

IFRS 9 introduces new:

- classification and measurement requirements for financial assets
- expected loss impairment model and
- somewhat simplified (but still complex) hedge accounting requirements.

Under IFRS 9, financial assets are classified into four categories depending on the entity's business model for managing the financial asset ("business model test") and the contractual cash flow characteristics of the financial asset ("cash flow characteristics test"):

i. amortised cost
ii. fair value through profit or loss – FVTPL
iii. fair value through other comprehensive income [for certain debt instruments] – Debt FVTOCI
iv. fair value through other comprehensive income [for certain equity instruments] – Equity FVTOCI.

Equity FVTOCI is an irrevocable election only available on inception or transition whereby all fair value gains and losses are quarantined permanently in other comprehensive income and such instruments are not subject to impairment.

Key application issues associated with AASB 9 include:

Area	Consideration
Contractual cash flow test	Determination of whether an instrument satisfies solely payments of principal and interest (SPPI) test is not always straightforward. In some of the more complex scenarios it may be necessary for the holder of the asset to 'look through' the particular underlying assets or cash flows.
Investments in unquoted equity instruments	Unlike IAS 39, IFRS 9 no longer permits any cost option for equity investments. These must be measured at fair value, which could present valuation challenges and additional costs for businesses.
Investments in managed funds and similar limited life vehicles	Such investments must be accounted for at FVTPL. They are not eligible for Equity FVTOCI election as they do not meet the strict definition of "equity instrument" in IAS 32 *Financial Instruments: Presentation*.
Impairment	The practical application of the expected loss impairment model requires entities to make judgements based on past experience on historical losses, current conditions and reasonable/supportable forecasts of future cash flows. This is likely to be quite an involved process with a number of significant judgements and assumptions.

IFRS 16 *Leases (AASB 16/NZ IFRS 16)*

IFRS 16 makes substantial changes to lessee accounting and requires lessees to recognise assets and liabilities for most leases. Lessor accounting is substantially unchanged from current lease accounting under IAS 17 *Leases*.

For entities with material off balance sheet leases, the most significant effect of IFRS 16 on the balance sheet will be an increase in lease assets and lease liabilities. Accordingly, key financial ratios derived from a company's reported assets and liabilities are expected to change (for example, leverage ratios). The changes could also result in some companies no longer complying with debt covenants when IFRS 16 is applied if those covenants are linked to a company's IFRS financial statements without adjustments for off balance sheet leases.

Main application issues include:

Area	Consideration
Determination of discount rates	Determination of discount rate will be a major challenge for many lessees. Under IFRS 16, a lessee's lease liability represents the present value of lease payments discounted using either (a) the interest rate implicit in the lease (if can be readily determined) or (b) the lessee's incremental borrowing rate. Determining the appropriate incremental borrowing rate is likely to be problematic for many lessees. It would not be appropriate for a lessee to use its weighted average cost of capital (WACC). WACC includes equity as well as borrowings. An entity's WACC is not specific to the term, security and amount of the lease.
Transition	The transition requirements in IFRS 16 are more complex than IFRS 15 & IFRS 9. In addition to choosing either the full retrospective or limited retrospective transition method, there are a number of other decisions involved in first time adoption, which include the possible use of various "practical expedients" permitted by the standard to reduce complexity. These decisions can have a significant effect on both the statement of financial position and on profit or loss in the first year and in subsequent years.

AASB 1058 *Income of Not-for-Profit Entities (Australian entities only)*

AASB 1058 replaces the existing requirements in AASB 1004 *Contributions* for not-for-profit entities. While AASB 1004 continues to be in force, its scope has been reduced to only cover issues specific to government departments and contributions by owners in the public sector.

The new requirements are expected to result in better matching of income and related expenses as income recognition will now be deferred under AASB 15 when there is a sufficiently specific and enforceable performance obligation. In addition, more assets will now be recorded on the balance sheet as the new requirements broaden the "fair value on initial recognition" principle to cover all assets where NFPs pay significantly less that the fair value (not just those assets acquired at nil or nominal consideration as currently required), principally to enable the NFPs to further their objectives (i.e. not trade discounts or distress sales).

The practical application of AASB 1058 poses a number of significant challenges including the following:

Area	Consideration
Determination of "sufficiently specific" performance obligations	While the standard contains detailed application guidance and illustrative examples, the consideration of whether a performance obligation is "sufficiently specific" will be based on individual facts and circumstances and this is expected to be a major challenge in practice.
Fair value measurement of non-financial assets, including peppercorn leases	Fair values for right to use assets such as peppercorn leases need to be estimated having regards to the principles in AASB 13 *Fair Value Measurement*. Given the nature of the not-for-profit industry and the unique issues faced by entities in the sector, determination of fair value will be a significant implementation issue for the sector.

Conclusion

Time is running out for entities to prepare for the rollout of these new major standards so the message is quite simple–if you haven't already started or progressed with your implementation projects, now is your final chance to act.