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.

How will the Three New Accounting Standards Affect your Deals?

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Between now and 2020 financial reporting will go through the biggest change this century with the introduction of three new accounting standards, AASB 9 *Financial Instruments*, AASB 15 *Revenue from Contracts with Customers* and AASB 16 *Leases*. This 'Triple Whammy' of standards will impact how bad debt provisions are calculated, cause more financial assets to be measured at fair value, introduce very complex rules as to when revenue can be recognised and effectively scrap the operating lease classification, bringing all leases, together with the lease liability onto an entity's balance sheet.

The prime impact of these standards lies in the change to the timing of profit recognition and reported earnings.

Changes to bad debt provisioning rules meaning that bad debts will be recognised earlier than they are currently. Application of the new rules on revenue recognition will most likely delay revenue, with the new leasing standard front loading lease expenses but improving reported EBITDA.

As entities adopt the new standards, they will post journals to retained earnings to reflect the impact of adoption. In many cases, the application of the new standards result in a debit entry to opening retained earnings. This in turn will most likely improve post adoption earnings and EBITDA whilst at the same time weakening an entity's balance sheet.

Transaction Elements Reliant on Profit, EBIT or EBITDA

If any elements of your transactions rely on measures of reported profit, EBIT or EBITDA (for example earn-out clauses, employee share schemes, bonus schemes) then these measures will likely change. Clarity is required over which measurement basis—the 'old' or the 'new' standards—is to be used when negotiating transactions. Bear in mind that for statutory reporting purposes the new revenue and financial instruments standards are effective from 1 January 2018 (1 July 2018 for June year ends) and the new leasing standard from 1 January 2019 (1 July 2019 for June year ends), unless early adopted.

For example, if you are designing an earn-out or bonus scheme, which is based on profits over the next three years, reported profits for those three years could all be measured on a different basis:

- Year to 30 June 2018 (current year) – all the 'old' standards – AASB 118 (Revenue), AASB 117 (Leases) and AASB 139 (Financial Instruments: Recognition and Measurement)
- Year to 30 June 2019 – new revenue standard (AASB 15) and new financial instruments standard (AASB 9) but still AASB 117 (Leases), the old leasing standard
- Year to 30 June 2020 – all the new standards – AASB 15, AASB 9 and the new leasing standard, AASB 16.

Changes that Impact Earnings Introduced by the New Standards

The high-level impact areas on earnings and EBITDA introduced by the new standards include:

AASB 9 Financial Instruments

Changes to the classification and measurement of assets is likely to result in additional profit or loss volatility in the income statement as more financial assets will be measured at fair value.

New Impairment Model

AASB 9 sets out a new forward looking 'expected loss' impairment model which replaces the incurred loss model in AASB 139 *Financial Instruments: Recognition and Measurement*.

Under the AASB 9 'expected loss' model, a credit event (or impairment trigger) no longer has to occur before credit losses are recognised. An entity will now always recognise at a minimum 12-month expected credit losses in profit or loss. Lifetime expected losses will be recognised on assets for which there is a significant increase in credit risk after initial recognition.

Trade Receivables

As a practical expedient, a simplified model applies for trade receivables with maturities of less than 12 months and other long-term trade and lease receivables.

There are two key differences between the AASB 139 impairment model and the new model for impairment of trade receivables:

- Entities will not wait until the receivable is past due before recognising a provision, and
- The amount of credit losses recognised is based on forward looking estimates that reflect current and forecast credit conditions.

Likely Impact on Transition

All of these changes are likely to mean that bad debts are recognised earlier, giving rise to a debit to opening retained earnings on transition. Depending upon how conservative an entity is preparing its bad debt provision, transition will mean that some bad debt expenses will never be recognised in the income statement, effectively improving future profitability, EBIT and EBITDA.

AASB 15 Revenue from Contracts with Customers

AASB 15 establishes a single and comprehensive framework which sets out how much revenue is to be recognised, and when. The core principle is that a vendor should recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the vendor expects to be entitled in exchange for those goods or services.

There is a disconnect between when items are invoiced to customers and when revenue is recognised. In many instances upon adoption of AASB 15, revenues will be deferred when compared to their recognition in accordance with the current standard, AASB 118 Revenue.

Conditions that are likely to result in revenue being deferred under AASB 15 as compared to the current standard are:

- AASB 15 introduces the ‘reversal constraint’, allowing revenue to be recognised only if it is highly probable that revenue will not reverse. This is likely to delay revenue where the contract is subject to penalties or returns.
- The requirement to consider revenue in the context of the overall promise to the customer, will likely defer revenue on the sale of goods or services that requires installation, integration or support services.
- ‘Free’ goods and services represent separate performance obligations and accordingly part of the revenue received should be allocated to these items and only recognised when the ‘free’ good or service is provided.
- Revenue can only be recognised when the customer has received a benefit. This will impact mobilisation costs charged to customers for bringing equipment to the client’s premises or where goods or services are not constructed at the customer’s premises.
- If an assurance warranty is provided to a customer that is over and above any statutory warranty, this is a performance obligation for which revenue is to be deferred and recognised over the warranty period and
- AASB 15 is likely to significantly change over time (percentage of completion) revenue recognition, making earnings a lot more volatile.

If revenues are deferred on adoption of AASB 15 this can result in certain revenues on transition being recognised in the income statement twice and hence improving post transition results.

AASB 16 Leases

AASB 16 removes the concept of operating and finance leases for lessees which exists under AASB 117 Leases. All leases will be recognised on the balance sheet as a right of use asset and a lease liability.

Any earn-out arrangements with EBITDA will be impacted as rental expense is replaced by depreciation expense (depreciation of the right of use asset) and interest expense (finance charge on the lease liability). The lease expense profile will be front-loaded for most leases, even when rental payments are constant year-to-year. Entities will see an increase in their

EBIT/EBITDA profitability and ratios given the lease expense will be reported below the line. An increase in leverage ratios will reflect additional debt on the balance sheet from the lease liability.

On transition to AASB 17, entities may obtain the benefit of the front-loading of interest expense being charged to opening retained earnings. This would improve future earnings as an expense that would otherwise have been recognised on a straight-line basis (rental expense) is now front loaded into opening retained earnings, having never been charged to the income statement.

Impact of Transition Rules

The transition rules can also lead to some interesting impacts, with the possibility of showing revenue in 2017 under the existing standards, then reporting that same revenue AGAIN in 2018 under the new standard. In respect of bad debt expenses, it may be possible that a bad debt expense will not be recorded in 2017 under the old rules, but under the new rules rather than be recorded in 2018, it will be adjusted for against retained earnings, effectively never being recognised in the entity's operating result.

Whilst any agreements could specify the measurement basis to be used (e.g. state the old standards should be applied) this would also have practical implications. It would effectively require an entity to maintain two sets of books and given the significant changes likely to be wrought by the new standards this could be a complex and expensive exercise. Also, if assurance is required (for example, often the start point of any calculation would be the audited results for the year) the parallel set of books, being kept solely for this purpose, wouldn't ordinarily be audited; auditing them would add another cost.

Understanding the Impacts of the New Standards

We have generalised over the likely impact of the new standards, their impact will obviously be different for every entity. Understanding their impact on the parties to any deal, and how they will affect reported results, EBIT and EBITDA, as well as the design of any earn-outs, employee bonus and share plans or other arrangements to accommodate the coming changes is highly recommended before negotiating a new transaction.