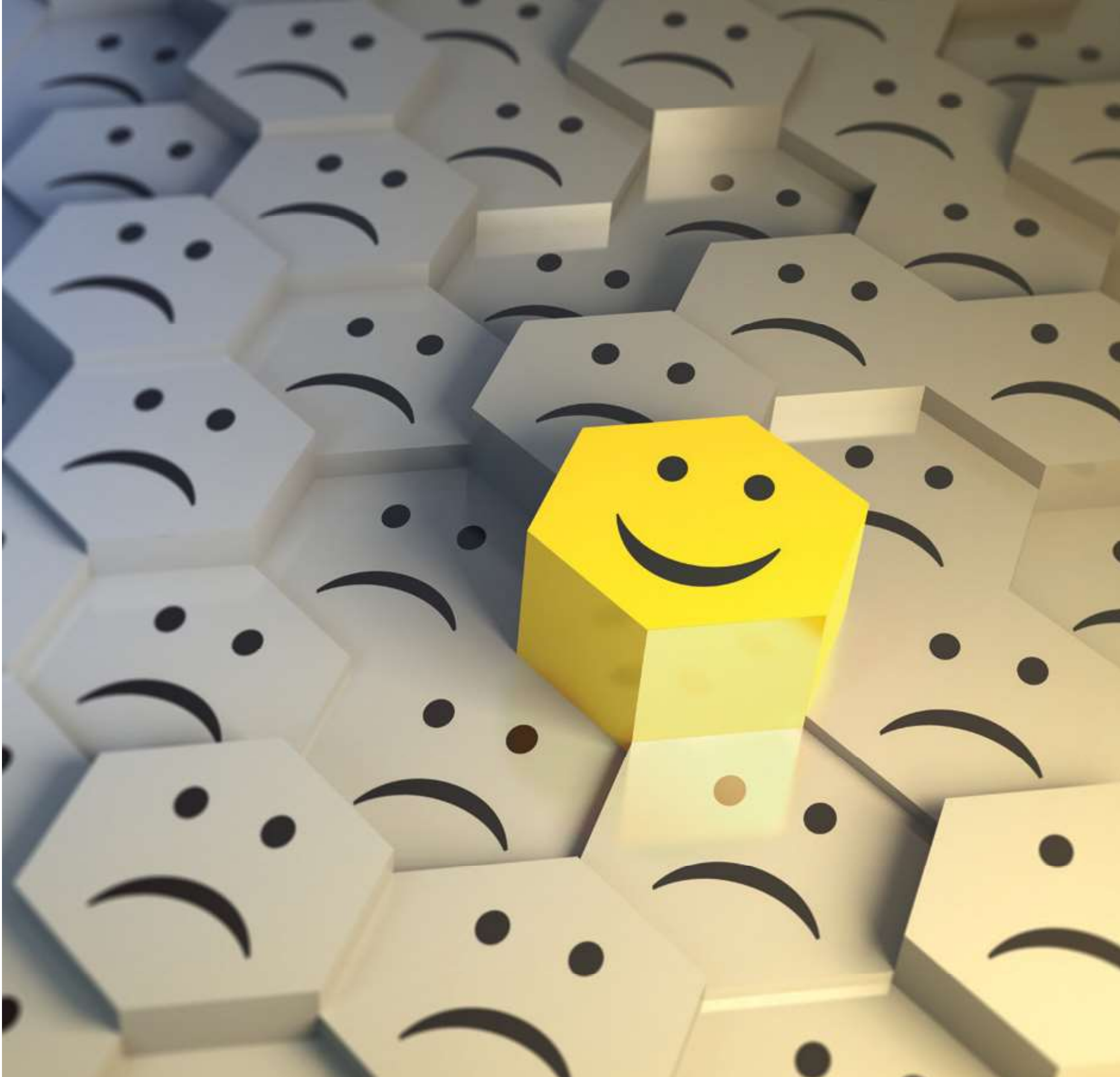

Accounting standards: The latest (and greatest) changes

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There's a first time for everything and that includes two new accounting standards which will soon affect many financial statements.

The first transition period for IFRS 15 *Revenue from Contracts with Customers* and IFRS 9 *Financial Instruments* has now ended. How have you fared? Or do you still have scuffed knees from ducking for cover?

In 2019 we will begin to see the results of the new standards on New Zealand's largest companies. Certain industries are expected to see a greater impact, but the changes do not discriminate! In addition to financial reporting changes, there is likely to be an impact on dividends paid by companies and banking covenants as revenue and profits are impacted.

For early adopters globally, very few have discussed their dividend policy. Banking covenants are either expected to be updated to reflect the changes to IFRS 15 or apply 'frozen GAAP' clauses for the purposes of calculation.

What common transition changes are being affected by these new standards?

IFRS 15 *Revenue from Contracts with Customers*

1 'Unbundling' of distinct performance obligations in contracts.

2 Recognising revenue either over time or at a point in time A separation between milestone billing and revenue recognition.

3 Accounting for variable consideration as a constraint to recognising revenue until certainty around payment is increased. For example, the shipping of goods, the price of which is dependent on a commodity price.

4 Principal vs. agency Determining who controls the good or service before it is transferred to the customer. Indicators include: primary customer relationship, inventory risk, discretion in pricing, credit risk and how commission is charged.

5 Contract costs Qualifying costs to obtain a contract or costs to fulfil a contract are required to be capitalised as an asset and generally amortised over the life of the contract. In some cases, concessions can apply.

6 Onerous contracts Where costs to fulfil exceed the consideration expected to be received. There is no guidance under IFRS 15, but IAS 37 (*Provisions, Contingent Liabilities and Contingent Assets*) provides some assistance with application. IAS 37 is more prudent in its approach to recognising loss-making contracts than IAS 11 *Construction Contracts*.

7 Impairment testing of contract assets Is a provision matrix the best method? This is very similar to the requirements for impairment testing of trade receivables.

IFRS 9 *Financial Instruments*

1 Changes to the classification of financial assets. Some instruments that were previously presented at amortised cost no longer satisfy the classification tests. Available for sale assets are being reclassed to fair value.

2 Significant rigour is involved in the calculation of expected credit losses. A provision matrix is the most effective way to calculate the simplified losses for trade receivables. You can not wait until a loss is incurred to assess impairment of trade receivables.

3 Increased disclosures.

4 A risk-based approach to hedge accounting which opens up the opportunity for more entities to hedge account. Some entities are identifying increased volatility in hedges as the 'bright-line test' is no longer required.

Year-end close is approaching, what should I focus on?

IFRS 15 *Revenue from Contracts with Customers*

- Ensure that explanations regarding the impact of the transition are comprehensive and linked to other relevant information in the annual report and accounts;
- changes to revenue policies are clearly described and explained, reflecting company-specific information – as are any associated management judgements;
- performance obligations are identified and explained, with a focus on how they have been determined and the timing of delivery to the customer; and
- the impact of the standard on the balance sheet is also addressed, including accounting policies for contract assets and liabilities.

IFRS 9 *Financial Instruments*

- Ensure that explanations regarding the impact of the transition are comprehensive, and are linked to other information disclosed in the annual report;
- changes made to accounting policies (including the reasons for these changes and associated judgements) are clearly articulated and convey company-specific information;
- disclosures are sufficiently granular to enable users to understand the impact on the business and key portfolios; and
- there is a clear linkage to the business model and risk management strategy which underpin the classification and hedging requirements of IFRS 9.

There are three financial asset categories under IFRS 9: Amortised cost, fair value through other comprehensive income and fair value through profit and loss. IFRS 9 also introduced a business model and cash flow characteristics test to assess the appropriate classification of financial assets. Amortised cost is intended for 'plain vanilla' financial assets only where cash flows represent solely payments of principal and interest. In the past you may have separately accounted for an exit option, that was driven from a performance multiple, from the main portion of the principal and interest payments, but this is no longer an option. The financial asset must be assessed in its entirety.

IFRS 9 has introduced further guidance on impairment. The key focus for some entities with 'straight-forward' financial instruments is 'how do I calculate my expected credit loss on trade receivables?'. If there is no significant financing component, the lifetime expected credit losses can be calculated using a provision matrix. The default rates are weighted towards the more significantly aged trade debtor 'buckets', and an overlay is made for the expected future impact on receivables.

"I'm caught in a trap, I can't get out"

WHAT IFRS 9 TRAPS HAVE WE SEEN?

- **Difficulty in determining whether it is still appropriate to measure financial assets at amortised cost;**
- **Accounting for an unlisted equity investment previously recorded at cost;**
- **Failing to apply a provision matrix approach to the impairment of trade receivables; and**
- **Determining how to account for debt renegotiations**

For example, if recovery of trade debtors is impacted by unemployment rates and in the past, this had the effect of decreasing recoverability by 10%, this may be factored into your future assessment of recovery. The International Accounting Standards Board has acknowledged that this is likely to introduce increased volatility and estimates into the impairment of trade receivables.

Have you renegotiated debt in the last year or the comparative period? Rather than spreading the gain or loss over the remaining contractual term, IFRS 9 requires an entity to recognise this on inception of the change. Some exceptions are available; this is not expected to apply to the rollover or renewal of a loan on the same terms.

So, the day is almost upon us. Every company, at a minimum, will be impacted by a change in disclosure and most require a review of the trade receivable provision. The devil is in the detail for both standards. Ensure customer contracts have been reviewed and if you have questions, we are always here to help.

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