Analysis on New Revenue Standard's Impacts on Revenue Disclosure

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Abstract: China's Ministry of Finance officially revised and promulgated "Accounting Standards for Business Enterprises No. 14 - Revenue" on July 5, 2017, which is implemented from January 1, 2018. Basing on the changes of the revenue standard, this paper aims to examine the impacts new revenue standard brings to the disclosure of revenue information, and proposes how to deal with these impacts. In this way, this paper hopes to provide enterprises with suggestions on improving disclosure quality of revenue information after the implementation of the new revenue standard.

1. Introduction

Global economic integration has led to the emergence of new business models, and some have made transactions more complicated. Forms and cycles of goods or services provided differ greatly from traditional ones. In practice, the old revenue standard is controversial in dealing with transactions in terms of revenue item identification, price allocation, recognition point, accounting policy choice and revenue information disclosure.

In order to standardize revenue information quality and effectively solve the problems in the old standard, in May 2014, IASB issued *IFRS 15– Revenue from Contracts with Customers*, which comes into effect on January 1, 2018. Correspondingly, in order to maintain convergence, in December 2015, China also issued a draft for the revision of revenue standard, which was officially revised and released In July 2017. The new revenue standard not only modifies certain clauses, but also innovates in its overall thinking, bringing challenges to the disclosure of revenue information.

2. Changes and Features of the New Revenue Standard

2.1 Changes in the New Revenue Standard

The new revenue standard sets a unified five-step model for revenue recognition: the first is to identify contracts with customers; the second is to identify performance obligations in contracts, and to break down revenue; the third is to determine transaction prices basing on the amount to be obtained; the fourth is to apportion transaction prices to each performance obligation; and the fifth is to recognize revenue when fulfilling each obligation using transfer of control rights as the standard. The new standard requires revenue information disclosure to be more detailed, covering revenue decomposition, performance obligations, significant judgments, and contract performance costs.

In respect of revenue recognition principles, the new revenue standard stipulates that recognition method should reflect the mode in which an entity transfers goods or services to its customers, and the consideration confirmed should reflect the amount that the entity is expected to be entitled to. In terms of measurement principles, the new standard requires enterprises to subdivide contracts and to determine performance obligations. Considering multiple revenue sources is also necessary when measuring revenues.

2.2 Main Features of the New Revenue Standard

2.2.1 Emphasizing Recognizing Revenue Basing on Business Models

In judging methods and time of revenue recognition, the new standard requires accounting entities to further consider their roles in transactions and the modes of transferring goods or services.

Enterprises that use different business models may recognize revenue at different points, and the amount confirmed may also vary. In the selling of audiovisual products, the revenue recognition point depends on it is whether the intellectual property right or the access right that is being provided. If usage right is provided, then revenue is recognized when usage right is transferred; if access right is provided, the obligation is fulfilled within a period of time, so revenue is recognized after this period. Another example is in retail industry where products are sold via dealers. It is necessary to distinguish between consignment and non-consignment contracts. The point of revenue recognition depends on the time control rights are transferred, business models of enterprises and professional judgments should be analyzed as well.

2.2.2 Requiring More Subjective Estimates

The words “expectation” and “estimation” repeatedly appear in the new revenue standard. Accounting entities need to make significant judgments and estimates on core issues more often, which is evident in the five steps of revenue recognition. For example, when identifying contracts with customers, enterprises should analyze whether the new requirements are met. If modification is involved, judgement on whether to resign contracts is needed. Meanwhile, in performance obligations, enterprises need to evaluate the agreed facts by both parties, and use significant judgments to split promised goods and services into identifiable obligations. Judgments and estimates also manifest in other revenue recognition steps.

3. Impacts on Revenue Disclosure

Basing on the changes mentioned above, this paper believes that the new revenue standard may bring the following impacts and challenges to revenue information disclosure:

3.1 Increasing Subjective Judgments Challenge Accuracy of Estimation

In the new revenue standard, many subjective judgments are required to determine how to allocate consideration to goods or services. The new standard stipulates to determine consideration according to observable information or reasonable estimation methods. In practice, however, there is room for manipulation. Price estimates are especially difficult when prices are unobservable, or when goods or services are offered as incentives to encourage customers to buy more. Confirmation of transaction price is also difficult. The new standard defines transaction price as the consideration an enterprise is expected to be entitled to, which actually increases the uncertainty of revenue estimation. For example, estimates of variable considerations (discounts, refunds, credits, incentives, etc.) use probability-weighted expectations or the most likely amount to be earned, as well as the likelihood of major sales returns in the future. To improve accuracy of estimates, enterprises need to seek for professional helps. In terms of supervision, as more concerns are involved, the difficulty of supervision is increased in the implementation of the new revenue standard.

3.2 Ambiguity of Existing Provisions Makes Revenue Disclosure Difficult to Unify

From previous analysis, it is not difficult to note that business models of enterprises play an important role in revenue recognition, measurement and presentation. Disclosure of business models help regulators and investors understand the meaning behind revenue information, especially for GEM enterprises whose industries, technologies, and business models are relatively new. In order to determine the rationality of enterprises’ revenue recognition method and time, regulators need to understand more about the role of enterprises in transactions and their mode of transferring goods or services to customers.

In China's current financial reporting system, there are no specific disclosure requirements for business models, only a few sketchy rules exist. For instance, the CSRC stipulates enterprises to disclose their business methods, profit models and risks in the report of the directors, however, as for what elements should be presented, and how to combine it with specific accounting accounts, these provisions do not give detailed instructions, and do not have enough enforcements as a result. Therefore, timely, comparable and useful information cannot be provided, and investors are not aware of the risks in transactions and their possible impacts on financial statements. The ambiguity of existing provisions on business model disclosure makes it difficult to unify revenue disclosure among enterprises, adding difficulty to its supervision under the new revenue standard. Enterprises are likely to manipulate the recognition method and time of revenue by concealing business model information.

3.3 Enterprises Face Higher Requirements on Information Collection

The new standard will not only affect the financial system, but also affect customer relationship management, sales and distribution systems, as well as cross-departmental collaboration. For accounting information systems of enterprises, the new revenue standard makes basic data and information more subdivided and diversified, adding difficulty to their collection.

The first step of revenue recognition in the new standard is to identify contracts with customers. Key information in contract terms has a significant impact on subsequent steps, providing bases for judgements and estimates follows. However, contracts with customers are mainly signed by sales departments in enterprises, so when formulating contract texts, key issues of revenue recognition may not be considered by them. In addition, enterprises that operate various segments and product lines may find it more challenging to collect the data needed for disclosure. If enterprises' preliminary preparations are not in place, the information needed for implementing the new revenue standard will not be effectively collected and disclosed. Meanwhile, the risk of financial data distortion will increase, bringing difficulties to the supervision of revenue disclosure.

4. Measures to Address the Impacts of the New Standard

4.1 Refining Internal Control and Revenue Disclosure Provisions

The new revenue standard emphasizes professional judgments of financial personnel, which is reflected in the identification of performance obligations, selling prices, and allocation of transaction prices. When making judgments, we should not only rely on the professionalism of financial personnel, but also pay attention to the allotting of responsibility to relevant enterprise departments. To this end, it is imperative to establish more effective communication and linkage mechanisms within enterprises. It is important to further improve internal control policies and procedures to establish effective internal control for business processes.

Providing guidance and examples of judgment methods on revenue recognition steps of enterprises, *IFRS15* is being revised with time. However, the guidelines themselves are principle-oriented, when new business models are utilized, professional judgments are required. Therefore, disclosure provisions should be refined along with the revision of *IFRS15*. Where there is doubt about accuracy and where there may be manipulative space for enterprises, requirements on what evidence is to be presented should be clearly defined. For some special industries and transactions, additional disclosure requirements can also be added.

4.2 Strengthening Supervision Related to Business Models

In implementing the new revenue standard, those industries with complicated transactions or those whose revenue is sensitive to business models should be required to disclose in detail their business and profit models, as well as their stakeholder relationships. The key point is that regulatory authorities should develop a unified disclosure framework and clearly define the disclosure methods and elements for enterprises.

Moreover, when business model information is to be used as an important criterion for judging and estimating, regulators need to urge consistency in disclosure among enterprises. An ex post review mechanism is necessary, focusing on whether enterprises disclose relevant information when significant changes occur in their business models, necessity of changes should also be explained.

4.3 Integrating the Internal and External to Optimize Processes and System Gaps

Facing the new revenue standard, enterprises need to optimize their accounting information systems immediately, each subsystem should be analyzed in terms of whether the new requirements are met. Enterprises should identify and upgrade the gaps in their entire systems. For the upgrade and optimization of their accounting systems, enterprises can either choose to outsource or set up their own team. Meanwhile, basing on the new requirements, it is necessary to implement reforms in business model analysis, accounting methods, selling price estimates, and revenue distribution, etc. Some accounts and calculation formulas in systems may also need to be reworked.

Regulatory authorities should inform enterprises in a timely manner of the processes to be concerned and the information required for disclosure. They should also require enterprises to make preparations actively, such as hiring consultants to optimize business processes. To help listed enterprises better complete the transition to the new revenue standard, regulators can consider summarizing possible problems encountered in regulatory practice, issuing counseling documents, preparing guiding cases, as well as providing systematic trainings to enterprises.

5. Conclusion

Starting from changes in the revenue standard, this paper finds that the new standard emphasizes business models in revenue recognition, and requires more subjective estimates of accounting personnel. These changes inevitably impact revenue disclosure, including the impact increasing subjective judgments bring to disclosure accuracy, the impact ambiguity of current disclosure requirements on business models brings to the unification of revenue disclosure, as well as the impact data refinement brings to information collection of enterprises, etc.

In the context of the new revenue standard, addressing these challenges requires the joint efforts of enterprises and regulatory authorities. On the one hand, enterprises need to improve the effectiveness of internal control, identify and optimize their systems and processes. On the other hand, regulatory authorities should further refine revenue disclosure rules, and strengthen supervision related to enterprise business models. Only through the efforts of both parties can the quality of accounting information be improved, thus promoting the sustainable development of China's economy and capital market.

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