BDO

BDO TECH UPDATE

QUARTERLY NEWSLETTER

20th June, 2018

Strategic directions for implementation of "Three Forces" of Accounting Standards

Between now and 2020 financial reporting will go through the biggest change this century with the introduction of three new accounting standards, SLFRS 9 - Financial Instruments, SLFRS - 15 Revenue from Contracts with Customers and SLFRS - 16 Leases. This 'Three Forces' 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.

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.

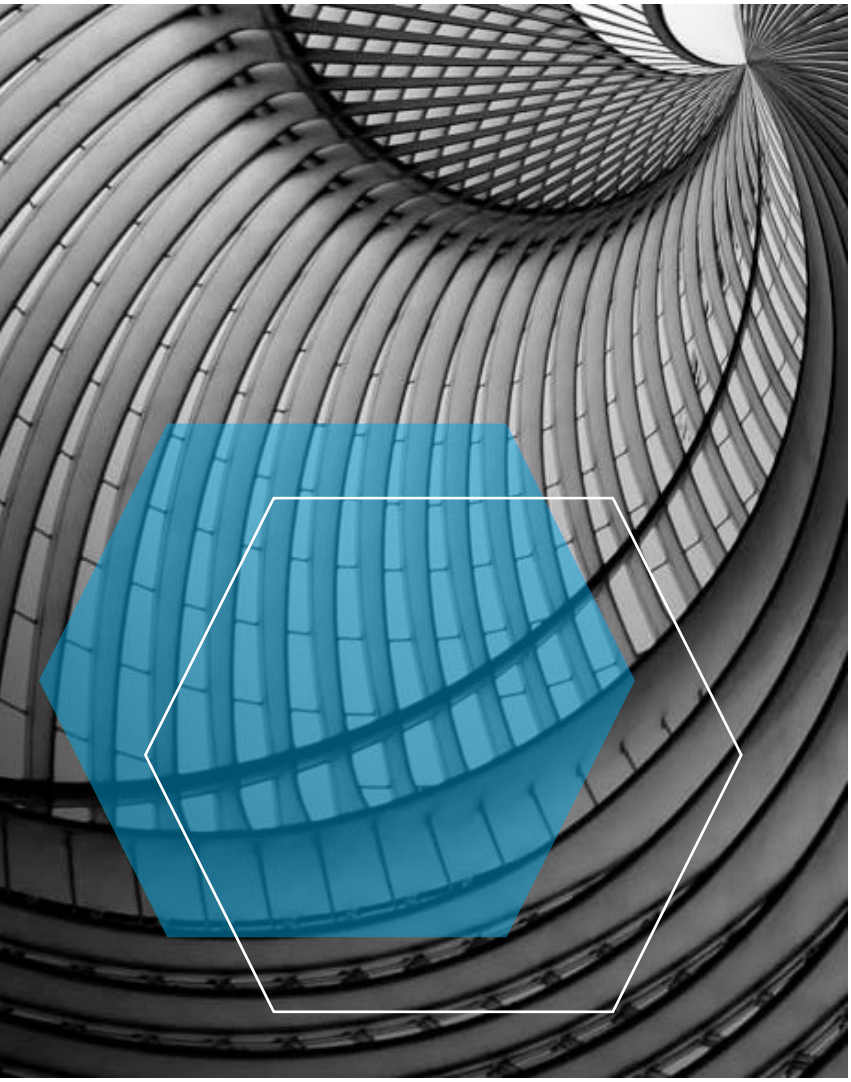
How entities can better prepare for these changes? What strategic initiative should be in place? It is critically important to prepare for proper implementation of these three standards now, rather later which will create more challenges and cost burning to the entity.

For entities that have yet to implement those standards, through this article, we will share the seven factors identified that should help make for a smooth implementation process and avoid any surprises.

1. Planning. Like any important event, the adoption of a significant accounting guidance will require thorough planning. Management must read the literature to identify areas of its accounting operations that will be impacted by the adoption. Adequate understanding of the literature will be critical in planning for a roadmap of how adoption can be implemented. A CFO can hold meetings with their company's controller and accounting team to brainstorm how those standards would affect the company's accounting operations. After identifying key areas that would be affected, the CFO can map a desired implementation plan for which the deadline for the completion of the work was prior to the adoption date.

"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."

> “Companies that adopt new accounting guidance must plan on a timeline with the expectation that there will be some hiccups along the way, whether they be internally or externally caused. There are a variety of scenarios wherein management does not fully understand the time involved in evaluating the impact of those new standards.”



2. Time. Quite an obvious and significant consideration, and yet somehow always underestimated, companies that adopt new accounting guidance must plan on a timeline with the expectation that there will be some hiccups along the way, whether they be internally or externally caused. There are a variety of scenarios wherein management does not fully understand the time involved in evaluating the impact of those new standards.

3. Knowledge and resources. Management should also gauge whether it has adequate technical accounting experts internally to sufficiently implement the adoption of any accounting guidance. Depending on the complexity of the company’s transactions (revenue contracts, in the case of SLFRS 15), the company may decide to hire third-party consultants to assist in the application.

One thing to keep in mind prior to engaging a third-party firm to assist with any technical accounting matters is that management must perform its own due diligence on the competence, not just of the firm from which a consultant comes, but also the actual consultant assigned to the company’s works. Most firms have a tiered offering of consultants with varying degrees of expertise and experience. In addition, it may be a good idea for management to obtain proposals from several firms, as the pricing on such services can vary widely. Again, depending on the complexity of a company’s accounting operations affected by the guidance change, or the extent of assistance they will need, the range of fees can be significant. The management must always understand the proposed scope by the consultant and must be alert with hidden charges that may come down the line. Low price is not necessarily the main criteria to look in to, but the detailed scope of work promised through the proposal.

4. Internal controls. The impact on the company’s internal control over financial reporting resulting from the adoption of a significant accounting standard is oftentimes overlooked, or at the very least becomes an aspect of adoption that does not get the assessment it deserves. Most whitepapers released by the national accounting firms include internal control considerations that most companies can use as a roadmap to internal control evaluation. The company’s internal audit function, if there is one, or the accounting group should look at the implementation of new accounting guidance as if it were a separate significant process. Having this perspective entails management separately evaluating the “What Could Go Wrongs” for the adoption and future ongoing accounting operations.

5. Disclosure. The disclosures required for new standards will be exhaustive, and company drafts of the disclosure may often not quite adequate, even when the underlying analyses were accurate and complete. The literature itself clearly specifies the disclosure requirements of the guidance, and most whitepapers on the subject also include a checklist-type section that provides detailed guidance on what should be included in the footnotes to the financial statements. The consideration for internal control impact should be made at the outset of the planning stages of the adoption process, with input from the company's multi-departmental representative depending on the accounting operations.

> "The company's internal audit function, if there is one, or the accounting group should look at the implementation of new accounting guidance as if it were a separate significant process. Having this perspective entails management separately evaluating the "What Could Go Wrongs" for the adoption and future ongoing accounting operations."

6. Auditor input. There's no use going through a full-blown analysis of the impact of an accounting change and then have the company's independent auditors mention that during their review or audit, the adoption efforts require significant additional work. Independent auditors should be included in the planning stages of implementation to get their input and ensure that the company's efforts overall are suitable to meet their requirements.

Note that adopting new guidance typically also entails significant management judgment, and so the sooner companies run these judgment-based assumptions with their independent auditors, the more time management has to respond or address auditor concerns. Auditor discussions on adoption implementation plans should actually occur before management puts such a plan together. It is highly encouraged for management to have ongoing conversation with its independent auditor to avoid surprises in the end.

7. Costs. The cost factor is often one of the biggest considerations in an adoption of these standards. As noted above, if the company were to use external consultants to assist in the adoption efforts, comparative shopping should be performed. A factor that is often overlooked in cost analysis is the internal cost of the adoption. Such a significant change will require time from the company's management, CFO, finance controller, accounting group, internal auditors, and quite possibly other personnel from non-accounting/finance departments including legal, sales, and operations. These personnel may have to incur significant hours that not only will affect their main responsibilities, but may also require monetary incentives.

The above list is clearly not comprehensive, and depending on the size of the company or the complexity of its accounting operations, the impact of any significant accounting guidance adoption will vary. The key to a successful and relatively painless. Adoption rests in management ensuring that the planning and coordination of the many moving pieces are monitored and updated to meet internal and external deadlines.

We hope that these insights are very useful for your strategic direction in implementation of SLFRS 9, SLFRS 15 and SLFRS 16. "What are you working on" We would like to hear from you on your SLFRS implementation strategy.

Key Contacts

Mr. Sujeewa Rajapakse
Managing Partner
sujeewa@bdo.lk

R Vasanthakumar
Partner
vasanthakumar@bdo.lk

Nishan Fernando
Managing Director – BDO Consulting (Pvt) Ltd
nishan@bdo.lk

Jerad Dias
Associate Director - Audit and Assurance
jeradd@bdo.lk