It‘s Time For Change. Are You Getting Ready?

IFRS 9, IFRS 15 and IFRS 16

IFRS Executive Brief

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“στέργει γὰρ οὐδεὶς ἄγγελον κακῶν ἐπῶν”

“no one loves the messenger who brings bad news”

Antigone by Sophocles

IFRS 15 Revenue from Contracts with Customers

INTRODUCTION

Superseded standards

Supersedes previous IASs, SICs and IFRICs related to revenue

- IAS 18 *Revenue*
- IAS 11 *Construction Contracts*
- IFRIC 13 *Customer Loyalty Programmes*
- IFRIC 15 *Agreements for the Construction of Real Estate*
- IFRIC 18 *Transfers of Assets from Customers*
- SIC-31 *Revenue - Barter Transactions Involving Advertising Services*

→ **IFRS 15** *Revenue from Contracts with Customers*

FIVE STEP MODEL

New approach

Step 1	Step 2	Step 3	Step 4	Step 5
Identify the contract	Identify separate performance obligations	Determine the transaction price	Allocate the transaction price to performance obligations	Recognise revenue when each performance obligation is satisfied

FIVE STEP MODEL
COMMON PRACTICAL ISSUES

Step1	• Combining/ Linking contracts, contract modifications
Step2	• Distinct POs in multiple deliverable arrangements vs. bundles • "Free" goods/services, material rights to customers
Step3	• Variable consideration and the "reversal constraint", financing components, non-cash consideration
Step4	• Estimating standalone price, allocating discounts, variable consideration, modified contract price
Step5	• Revenue to be recognised over time or at a point in time

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STEP TWO: IDENTIFY PERFORMANCE OBLIGATIONS

Example: Determining whether goods or services are distinct

- Retailer Co sells a washing machine for €1,000
- The washing machine comes with a 12 month warranty against manufacturing defects (not sold separately)
- Retailer Co also provides the following free ‘gifts’:
  - An extended 2 year warranty against manufacturing defects
  - Free repair and maintenance service for 3 years
  - 1kg of washing powder every month for the next 18 months
  - A discount voucher for a 50% discount off its next in store purchase in the next 6 months up to the value of €100

Question:

How many performance obligations are in the contract?

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STEP THREE: DETERMINE THE TRANSACTION PRICE

Example: Sale with a right of return

Book sales with right of return for unsold copies

The entity sells 500 books to a customer (store) for €50,000

After 12 months, the customer can return any unsold copies for a refund

Based on previous history, the entity estimates that no more than 100 will be returned by the customer after 12 months (€10,000).

Therefore, at inception the entity recognises:

Dr	Cash	50,000	
Cr	Revenue		40,000
Cr	Contract liability		10,000
Dr	Contact Asset	6,000	
Dr	COS	24,000	
Cr	Inventory		30,000

STEP FOUR: ALLOCATE TRANSACTION PRICE

Example: Allocate transaction price

Contract for sale of new VW Golf and a 3 year service contract for CU26,000

	Stand-alone selling price	Selling price %	Allocate transaction price
VW Golf	€24,000	88.9% (€24,000/€27,000)	**€23,114** (€26,000x88.9%)
Service contract	€3,000	11.1% (€3,000/€27,000)	**€2,886** (€26,000x11.1%)
Total	€27,000		**€26,000**

OTHER CONSIDERATIONS

- Contract costs
- Transitional provisions
  - Retrospective Method
  - Cumulative Effect Method
- Changes in processes
- Disclosures in 2017 Financial statements

IFRS 9 Financial Instruments

INTRODUCTION

IFRS 9 *Financial Instruments*

Key changes - financial assets

- Three measurement categories for financial assets
  - Fair value through Profit or Loss (FVPL)
  - Fair value through Other Comprehensive Income (FVOCI)
  - Amortised cost

Key changes - impairment (expected loss model)

- Introduces more complex three stage model
- Recognise impairment based on expectations of future loss events
- Significant increases in loss allowances expected

Key changes - hedge accounting

- Accounting more clearly linked to risk management activities
- 80-125% effectiveness limits eliminated

CLASSIFICATION AND MEASUREMENT

Classification of non-equity financial assets

Cash flow type	Business models: Hold to collect	Business models: Hold to collect and sell	Business models: Other
Solely payments of principal and interest (SPPI)	Amortised cost	FVTOCI	FVTPL
Other	FVTPL	FVTPL	FVTPL

CLASSIFICATION AND MEASUREMENT

Classification of investments in equity instruments

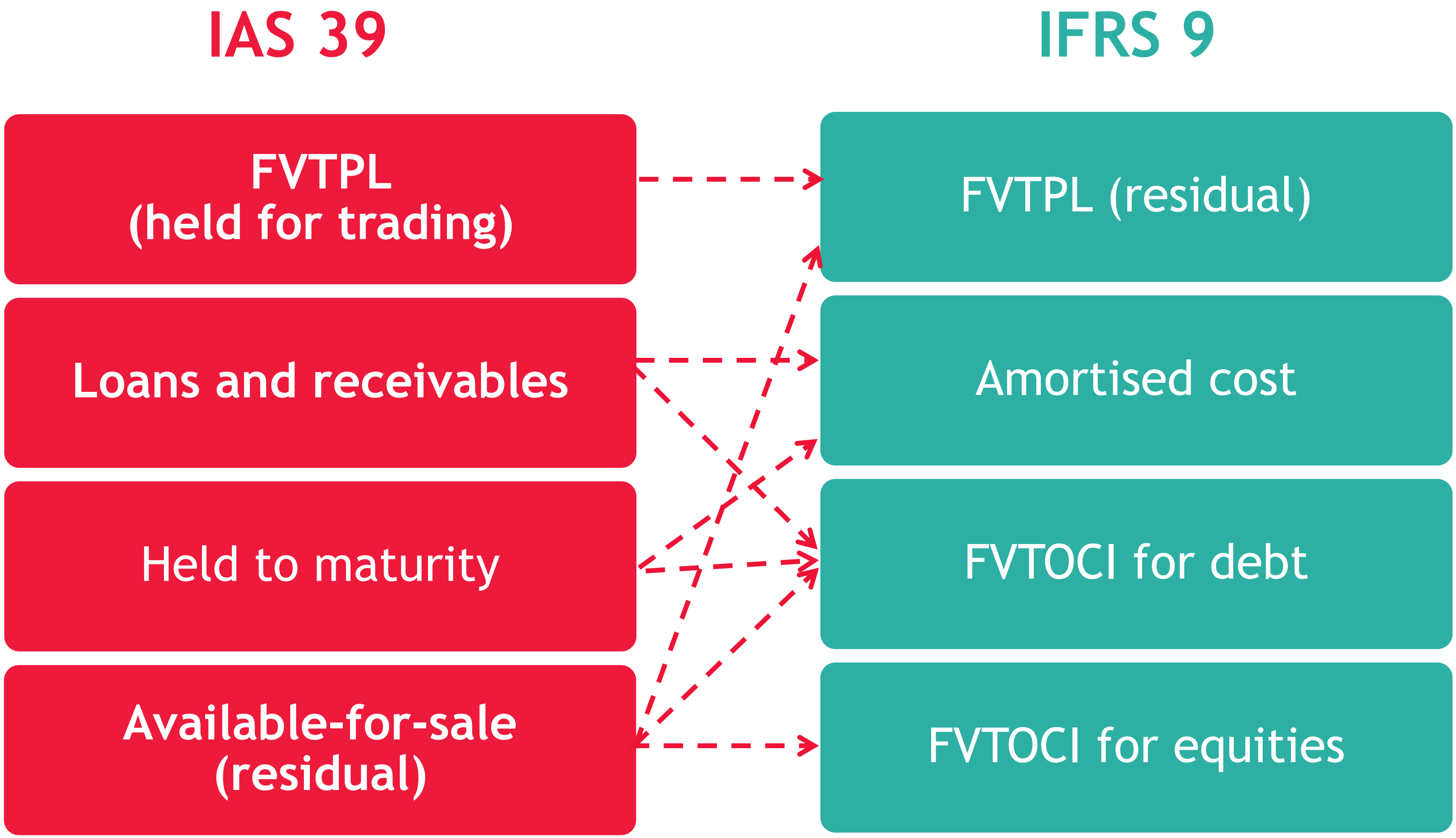
Investments in equity instruments

FVTPL

FVTOCI

Note: The exception to measure investments in unquoted equity instruments at cost has been eliminated

COMPARISON


IAS 39
IFRS 9
FVTPL
(held for trading)
Loans and receivables
Held to maturity
Available-for-sale
(residual)
FVTPL (residual)
Amortised cost
FVTOCI for debt
FVTOCI for equities

IMPAIRMENT

3 stage expected credit loss model

Stage 1

- Credit risk <u>**has not**</u> **increased** significantly since initial recognition
- Recognise 12 month expected credit losses
- Interest recognised on a gross basis

Stage 2

- Credit risk <u>**has**</u> increased significantly since initial recognition
- Recognise life time expected credit losses
- Interest recognised on a gross basis

Stage 3

- Credit impaired financial asset (IAS 39 triggers)
- Recognise lifetime expected credit losses
- Interest recognised on a net basis

IMPAIRMENT

Trade receivables, contract assets and lease receivables

Simplified model

- Trade receivables and contract assets with maturity <1yr
- Recognise lifetime expected credit losses
- Would not wait until the receivable is past due before recognising a provision
- Provisional rates to reflect current and forecast credit conditions

Option to apply either 3 stage model or simplified model for

- Trade receivables and contract assets with maturity >1yr
- Lease receivables
- Accounting policy choice can be selected separately for trade receivables, contract assets and lease receivables

TRADE RECEIVABLES

Illustration

- At 31/12/18 Company M has a portfolio of trade receivables of €30million
- The customer base consists of a large number of small clients
- Company M estimates the following provision matrix (based on historical observable default rates and adjusted for forward looking estimates)

	Expected default rate (A)	Gross carrying amount (B)	Credit loss allowance (A *B)
Current	0.3%	€15million	€45,000
1-30 days past due	1.6%	€7.5million	€120,000
31-60 days past due	3.6%	€4million	€144,000
61-90 days past due	6.6%	€2.5million	€165,000
>90 days past due	10.6%	€1million	€106,000
Total		**€30million**	**€580,000**

TRANSITION

Overview

Effective 1 January 2018, early application permitted

Classification and measurement	Impairment	Hedge accounting
Retrospective	Retrospective	Prospective (with certain exceptions)

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IFRS 16 Leases

IFRS 16, *LEASES*

Definition of a Lease

‘A contract, or part of a contract, that conveys the right to use an asset (Right-of-use asset) for a period of time in exchange for consideration.’

MEASUREMENT ON INITIAL RECOGNITION

LEASE LIABILITY AND RIGHT OF USE ASSET

Fixed payments from commence-ment date + Some Variable Payments + Residual Value Guarantee + Purchase option price + Termination penalties = Lease Liability

Lease Liability + Initial Direct Costs + Costs to Restore or remove + Payments made at or before commence-ment − Lease incentives received = Right-of-use Asset

RECOGNITION EXEMPTION
SHORT-TERM LEASES AND LOW VALUE LEASES

Short-term leases

- Lease terms is 12 months or less
- No purchase option
- Factor in lessee options to terminate or extend lease if exercise is reasonably certain
- Apply consistently by class of underlying asset

Low value leases

- Assess based on value of an equivalent new asset;
- Not judged by reference to materiality
- Made on a lease by lease basis
- The lessee can benefit from the use of the asset on its own or together with other resources readily available to the lessee
- Underlying asset is not highly dependent/interrelated to other assets

PRESENTATION
EXAMPLE

Scenario

Entity C has a 5-year lease for the floor of an office building. It pays CU 75,000 a year and has an incremental rate of borrowing of 5% (the rate implicit in the lease is not readily determinable).

Let's examine the impact on net income and EBITDA depending on whether IAS 17 or IFRS 16 is used to account for the lease. Assume the entity has no other transactions other than CU 100,000 of sales in each year.

PRESENTATION

	IAS 17			
	Amortization	Interest	Lease Exp.	Net income
Year 1	-	-	75,000	25,000
Year 2	-	-	75,000	25,000
Year 3	-	-	75,000	25,000
Year 4	-	-	75,000	25,000
Year 5	-	-	75,000	25,000
Total	-	-	375,000	125,000
	IFRS 16			
	Amortization	Interest	Lease Exp.	Net income
Year 1	64,942	16,235	-	18,823
Year 2	64,942	13,297	-	21,761
Year 3	64,942	10,212	-	24,846
Year 4	64,942	6,972	-	28,086
Year 5	64,942	3,571	-	31,487
Total	324,711	50,289	-	125,000

EFFECT ON BALANCE SHEET

IMPACT ON FINANCIAL STATEMENTS FOR LESSEES WITH OPERATING LEASES

Lease assets

Financial liabilities

Equity

- Carrying amount of lease assets will typically reduce more quickly than the carrying amount of lease liabilities
- Actual effect depends on lessees' leverage, the terms of the lease

- **Will impact leverage and performance ratios (e.g. Debt/EBITDA, interest cover, return on capital employed)**

EFFECT ON INCOME STATEMENT

IMPACT ON FINANCIAL STATEMENTS FOR LESSEES WITH OPERATING LEASES

EBITDA

- Interest implicit in the lease now presented as part of finance costs
- Today the entire operating lease expense is included as part of operating costs
- Amortisation of the right of use asset is presented below EBITDA line

Operating profit and financial costs

- Interest implicit in the lease now presented as part of finance costs
- Magnitude of change will depend on the significance of the lease, the length of the lease and the implicit interest rate.

EFFECT ON CASH FLOW STATEMENT

IMPACT ON FINANCIAL STATEMENTS FOR LESSEES WITH OPERATING LEASES

Operating cash flow

- Today the cash flow on operating leases are presented as operating activities
- Only interest component will be presented as operating activities under the new *Leases* standard (note: interest component can also be presented as financing)

Financing cash flow

- Principal repayments on all lease liabilities presented as financing
- Interest can also be included within financial activities

Total cash flow

OTHER CONSIDERATIONS

- **Separation of lease and non-lease components**
- **Transition**
  - Full Retrospective Method
  - Modified Retrospective Method
- **Subsequent measurement**
  - Reassessment (existing clauses)
  - Modification (change in the scope that was not part of the original terms and conditions)
  - FV (IAS 16 or IAS 40)
- **Sale & Leaseback Transactions**
- **Intercompany Leases**

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THANK YOU