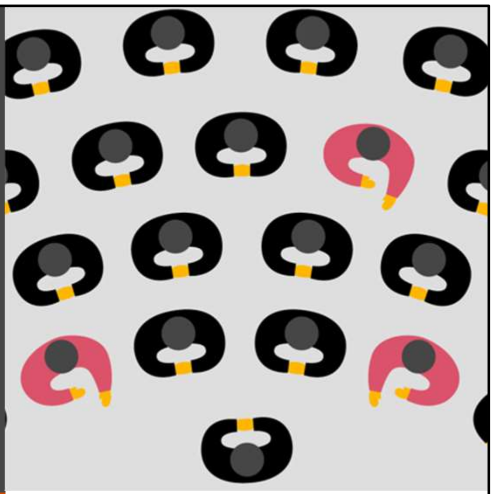
Practical Issues Implementing IFRS 9, 15 & 16

March 2020



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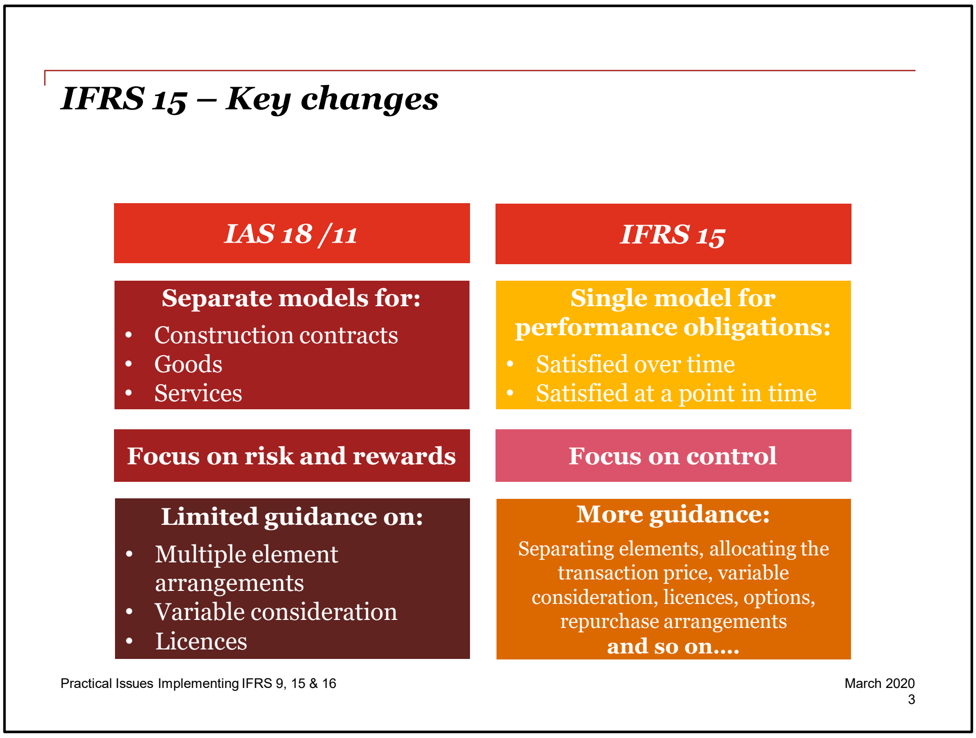
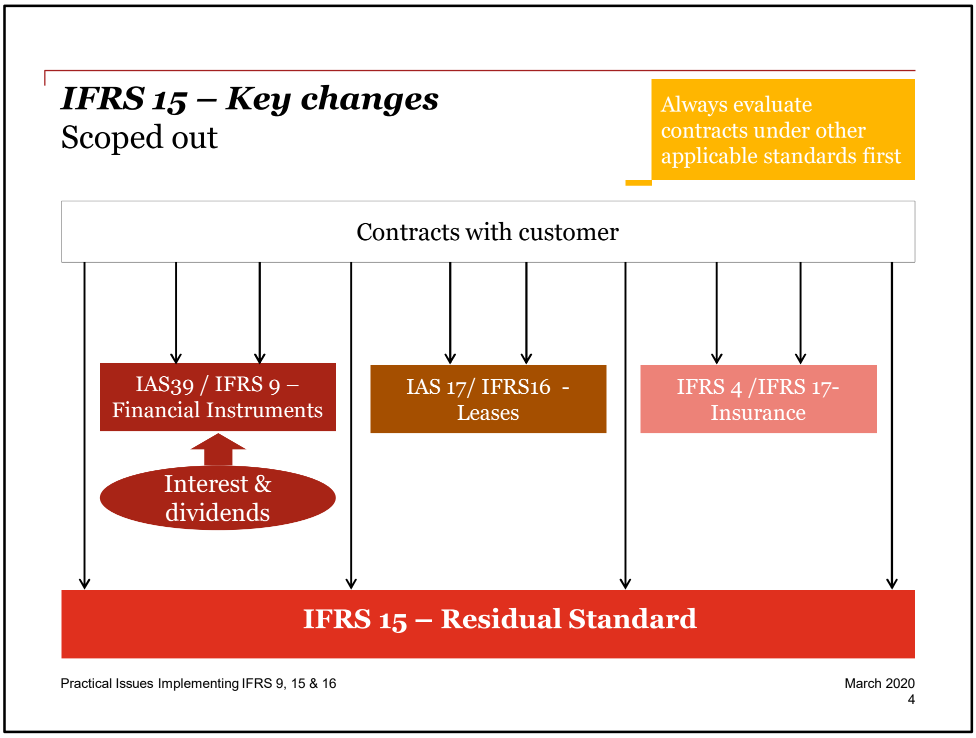
IFRS 15
'Revenue from contracts with customers'



IFRS 15 will replace IAS 18 and IAS 11 which currently provide separate revenue recognition models for goods and services and for construction contracts. IFRS 15 is based on a single model that distinguishes between promises to a customer that are satisfied at a point in time and those that are satisfied over time. IFRS 15 does not distinguish between sales of goods, services or construction contracts. It defines transactions based on performance obligations satisfied over time versus point in time.

Revenue is recognised when control of a good or service transfers to a customer. The notion of control replaces the notion of risks and rewards in the existing guidance. The focus on IAS 18 and 11 is on risk and rewards with control (that is, managerial control) as an aspect of risk and rewards. IFRS 15 focuses on control although risk and rewards is still an indicator of control.

One of the more significant changes is that IFRS 15 provides a lot more guidance than the existing standards. For example, it has more detail on multiple element arrangements and variable consideration and provides specific guidance on the accounting for licences, customer options and repurchase arrangements. This is likely to affect existing practice, especially in complex arrangements where existing guidance is limited. IAS 18 provides very limited guidance and the new standard provides significant guidance on key practice issues. This was one of the key objectives of the project from an IFRS perspective.



The proposed standard provides a number of **scope exceptions**. They are very similar in practice to those in today's guidance. No industries are scoped out of the standard, only transactions.

- Leases – Lease transactions are out of the scope of the revenue standard. However, intangibles have been scoped out of the leasing standard and are captured in the revenue standard.
- Financial instruments – Financial institutions will need to look to IAS 39 / IFRS 9 to determine whether transactions are financial instruments or services under the revenue standard.
- Insurance – Insurance contracts are within the scope of IFRS 4/17. Guarantee contracts in the scope of other standards are outside the scope of IFRS 15. Product guarantees, however, are in scope.
- Non-monetary transactions – IFRS 15 excludes non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. For example, IFRS 15 would not apply to a contract between two oil companies that agree to an exchange of oil to fulfil demand from their customers in different specified locations on a timely basis.

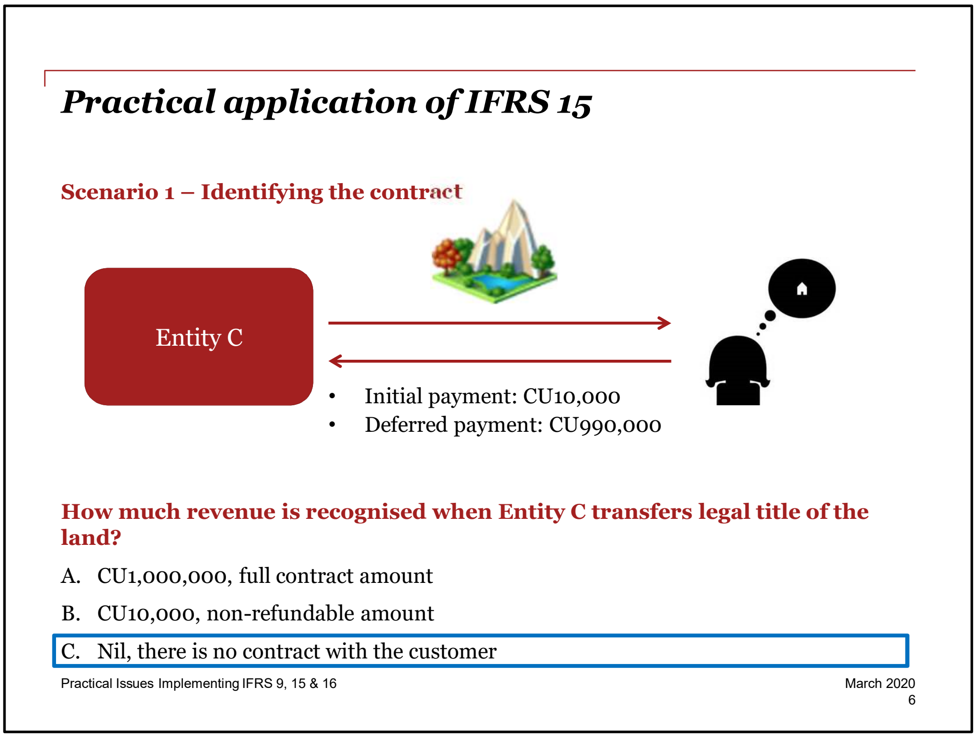
IFRS 15 – Key changes

The five-step approach

Core principle – Revenue recognised to depict transfer of goods or services

Step 1	Identify the contract with the customer
Step 2	Identify the performance obligations in the contract
Step 3	Determine the transaction price
Step 4	Allocate the transaction price
Step 5	Recognise revenue when (or as) a performance obligation is satisfied

Handout material only.

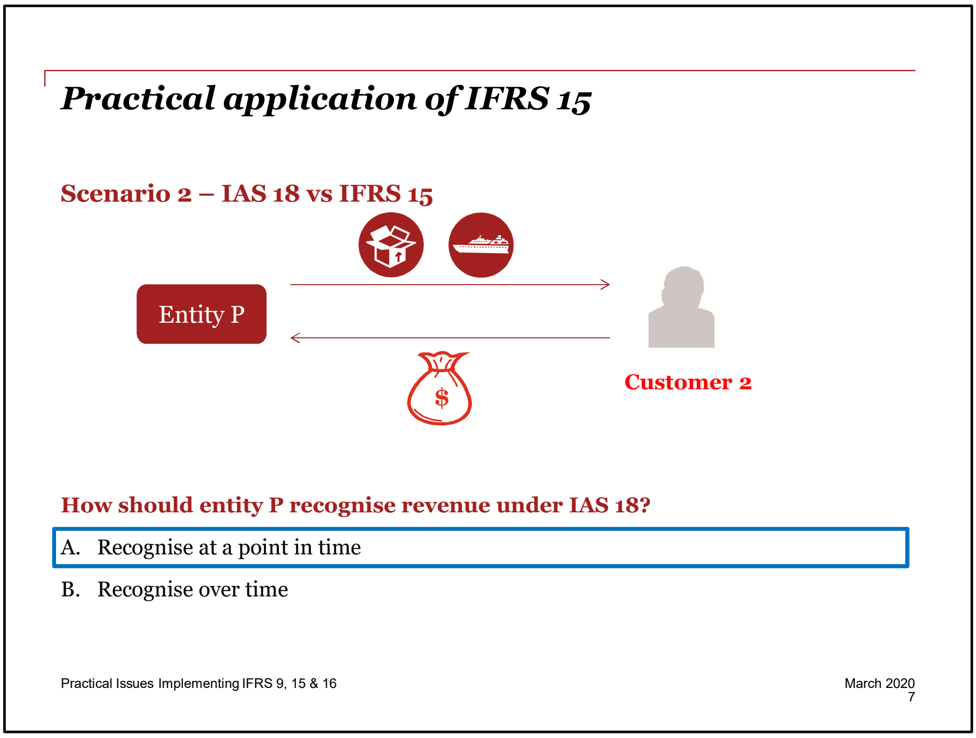


- Customer D plans to construct a housing development on a land.

- So the customer enters into an agreement with Entity C.

- The total contract price is C1 million and Customer D is required to pay a non-refundable upfront payment (equals to 1% of the price) when legal title is transferred. The remaining balance is settled in five years when Customer D expects to have completed the development. In the background information, it also mentioned that Entity C can re-take the legal title to the land as well as any assets on the land if Customer D defaults the final payment. So far, as Entity C has no history with this customer, it does not have sufficient information to conclude the ability and intention of Customer D to pay the final payment.

- **Question** – how much revenue is recognised when Entity C transfers the legal title of the land?
- **Answer** C – no revenue can be recognised. *One of the criteria necessary in order to account for a contract with a customer is that the entity needs to assess collectability of an amount as probable. In this case Entity C has no history with this customer, and does not have sufficient information to conclude the ability and intention of Customer D to pay the final payment.*



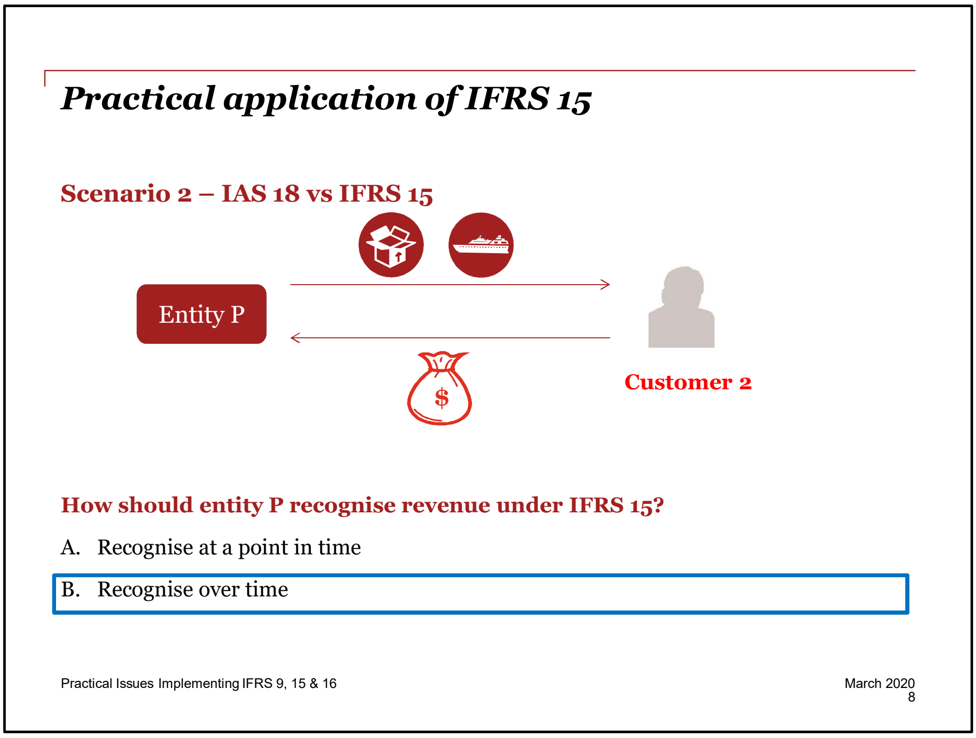
Scenario 2.

- Entity P enters into a contract with customer 2 supplying highly specialised semi-fabricated products that have no alternative use. Entity P is also responsible for the delivery and related insurance of the product.

- The shipment term is ‘FOB Destination’ and customer 2 will only pay for the goods upon delivery.

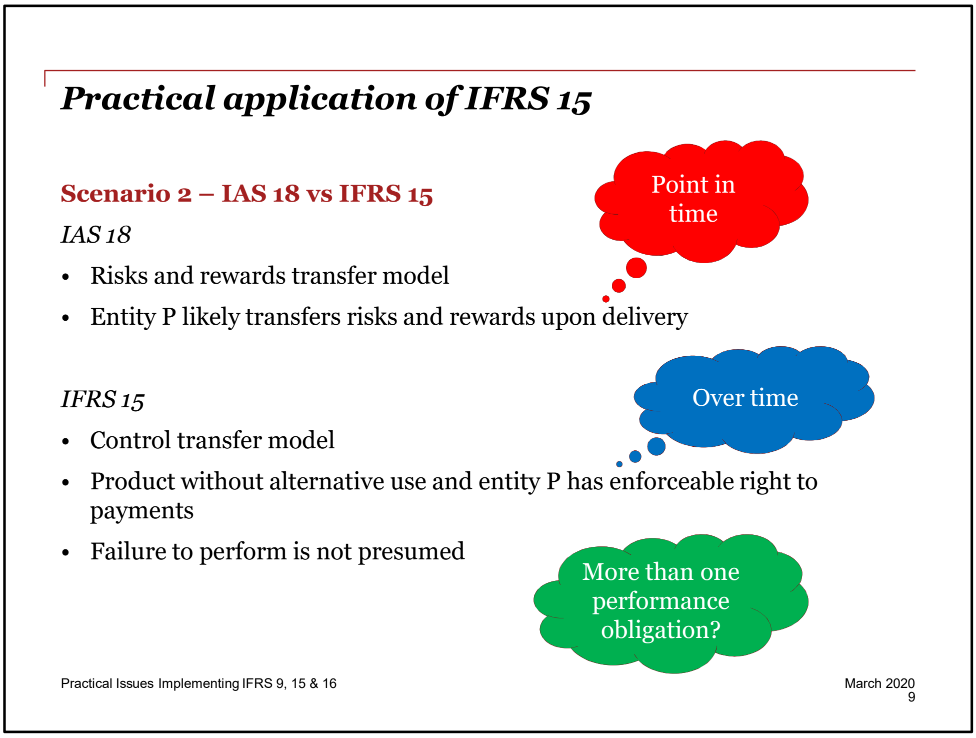
- **Question:** How should entity P recognise revenue under existing standards? Recognise at a point in time or over time?

- **Answer:** The answer is A, recognise revenue at a point in time. (Discussed after next questions)



Now under the same scenario, what would your answer be when recognising revenue under IFRS 15?

- **Answer:** The answer is B – recognise revenue over time. Refer to the next slide for rationale.



Key Learning Point: Distinction of revenue recognition between risks and rewards model (IAS 18) and control model (IFRS 15)

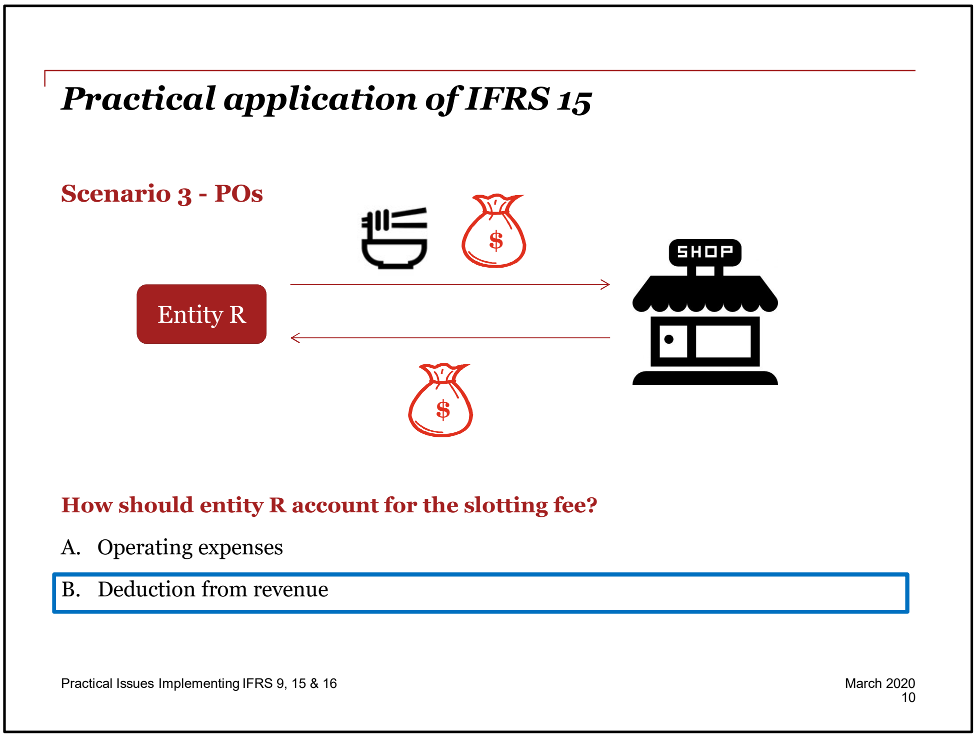
- IAS 18 focuses on the transfer of risks and rewards. In this scenario, entity P likely transfers risks and rewards of the products to its customer upon delivery.

- Therefore, entity P should recognise revenue at a point in time under IAS 18.

- In contrast, IFRS 15 looks at the transfer of control. In this scenario, as the products entity P supplies have no alternative use and there is an enforceable right to payment (the customer is required to compensate entity P on contact termination without cause based on performance to-date and compensation is cost plus a reasonable margin), entity P transfers control of the goods to customer over time.

- IFRS 15 is clear not to assume failure to perform when assessing the revenue recognition pattern.

- In this scenario, management might also consider if it has more than one performance obligation. For example, the obligation for the shipment.



Entity R sells instant noodles to a supermarket. In order to place its products in a prominent place, entity R also pays a slotting fee to the supermarket.

- **Question:** How should entity R account for the slotting fee? Include in operating expenses or report as a deduction from revenue?

- **Answer:** The answer is B. Based on this fact pattern, entity R should deduct slotting fee from revenue. The reason is covered in the next slide.

Practical application of IFRS 15

Scenario 3 - POs

- No distinct good or service received from supermarket
- Deduction from revenue

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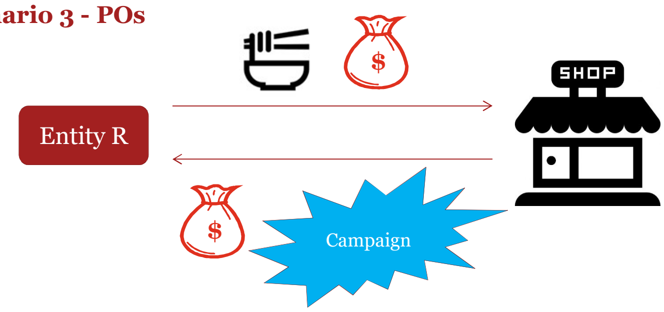
Key Learning Point: Considerations of whether a payment to a customer is in exchange for a **distinc**t good or service

- This scenario discusses payments to a customer. When accounting for payments to customers, an entity needs to first determine if it has transferred a distinct good or service to the customer. In this scenario, there is no distinct good or services received from the supermarket. Therefore, the payment should be deducted from revenue.

Practical application of IFRS 15

Scenario 3 - POs



Should entity R account for the fee paid for advertising campaign differently?

A. Yes

B. No

Now, a slight change to the fact pattern. If instead of paying a slotting fee, entity R contracts with the supermarket for a specific advertising campaign, would the accounting change? The supermarket advertises entity R’s products locally, say in newspaper or other media. It is also noted that entity R could pay a similar fee to a third party for a similar campaign.

Question: Would you account for this payment differently?

Answer: The answer is A. Let’s check out the rationale for this in the next slide.

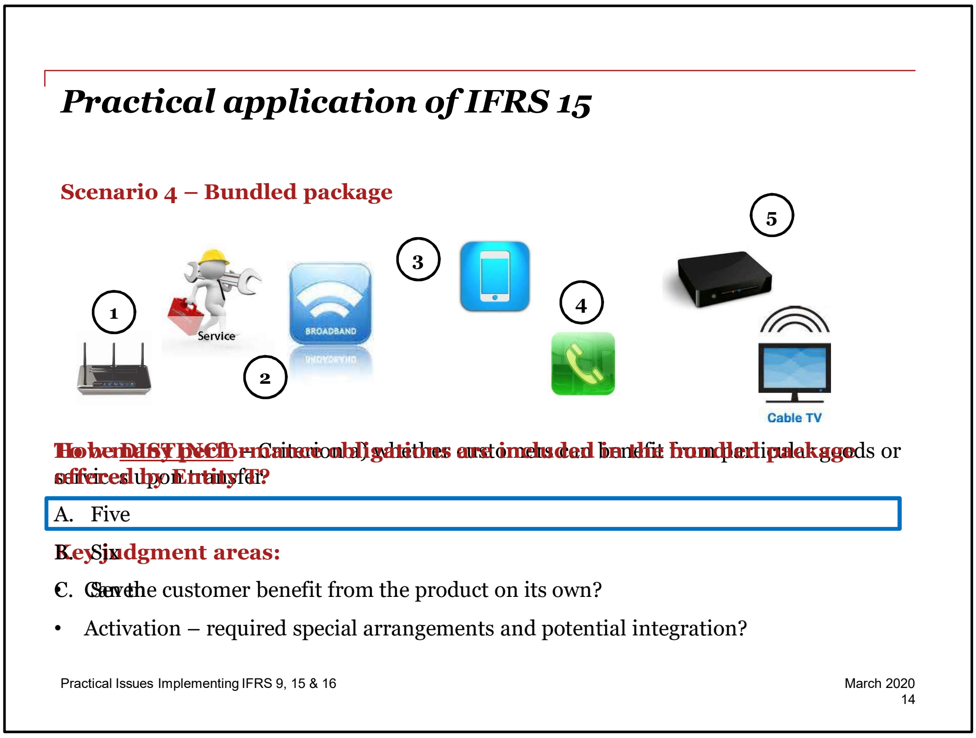
Practical application of IFRS 15

Scenario 3 - POs

- Payment for a distinct service and reflects fair value
- Presented as an operating expense

Key Learning Point: Payment to customers – consider (1) whether the payment is in exchange for distinct good or service; and (2) the payment exceeds the fair value of goods / services received

- This time, the payment is for a distinct service (the campaign). This can be evidenced by the fact that entity R could have engaged a third party, who is not its customer, to perform a similar service. In addition, as entity R could also run a similar campaign by paying a similar fee, the whole amount should be presented as an operating expense and not as a deduction from revenue.



- From the background, you might count there is a maximum of 7 goods and services.

Question: How many performance obligations are included in the bundled package offered by Entity T?

Answer: A. Five

Let's have a closer look at these individual performance obligations.

- *[1st PO]* – Free router as the customer is not precluded from using their own.

- *[2nd PO]* – However, as broadband cannot go live without the activation, the broadband and activation services should be counted as one single PO. The activation is not a separate PO as it does not transfer a distinct good or service to the customer.

- *[3rd & 4th PO]* – Next, regarding the mobile services, as the customer can use another phone, or can use the selected mobile phone for another contract with another provider, these are regarded as two separate performance obligations.

- *[5th PO]* – Finally, similar to the broadband and set-up services we discussed, the TV box cannot be used for services other than watching the designated TV channels. Therefore, these are regarded as one single performance obligation.

- This scenario illustrates one key learning point. When considering whether a particular good or service is distinct, an entity first has to examine whether a customer can benefit from the particular goods or services on its own or together with other resources that are readily available to them.

- In this scenario, the key judgments are determining the exclusivity of the products and establishing the significance of activation services (that ultimately provide the benefits to the customers together with the router).

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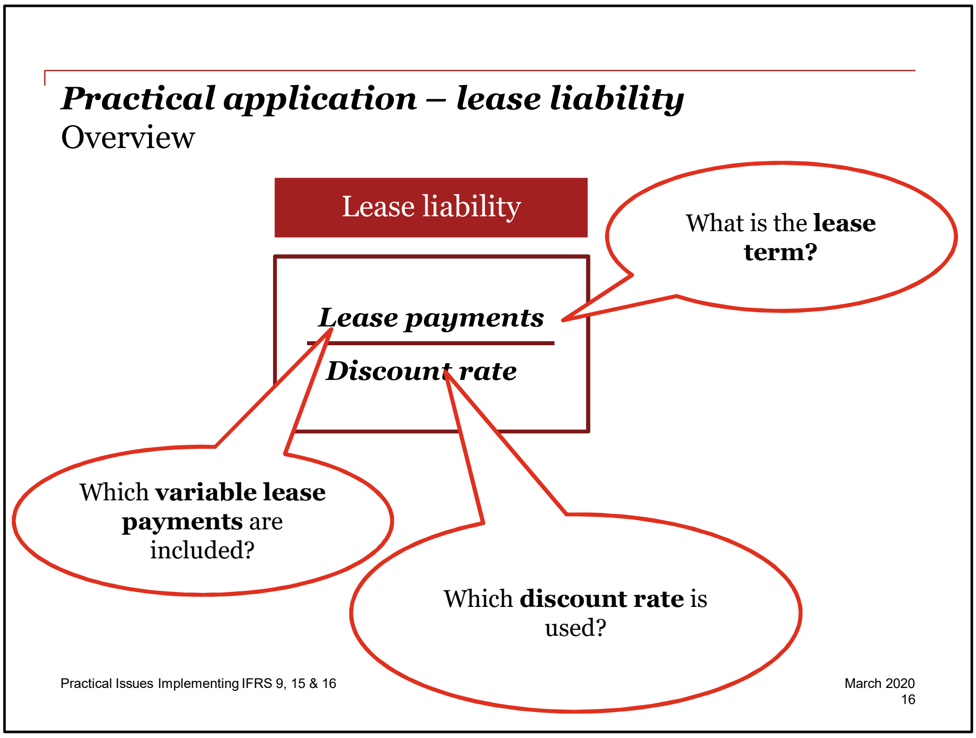
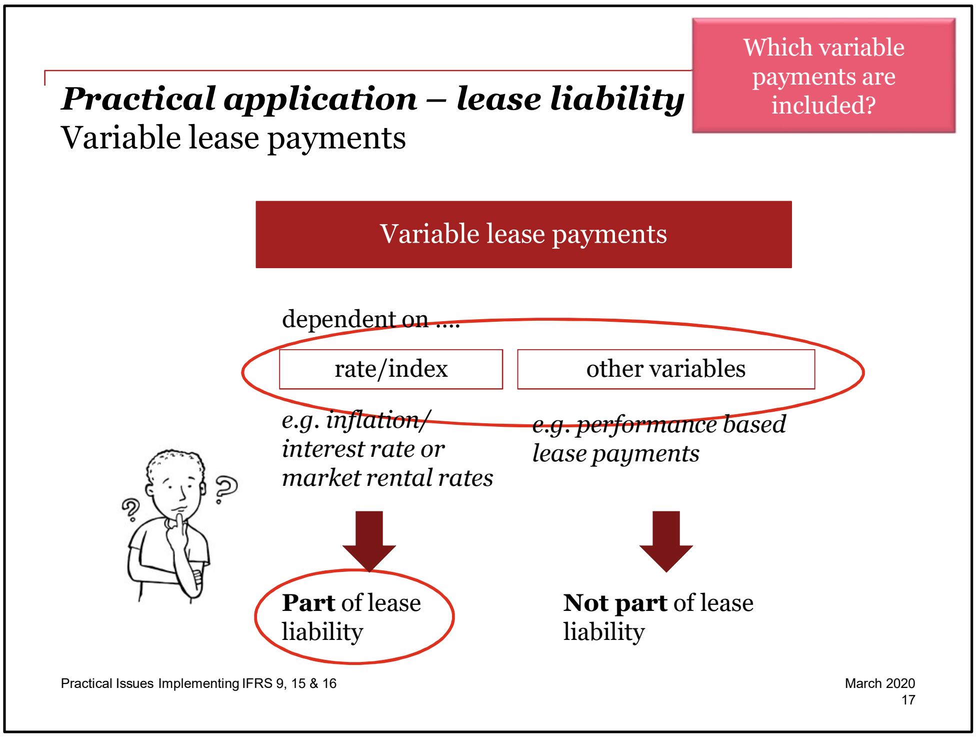
IFRS 16
'Leases'



The lease liability is calculated as the present value of future lease payments. When calculating that number several questions arise:

- Which variable lease payments are part of the lease payments and how are they included?
- What is the lease term?
- What discount rate is used to calculate the present value of the lease payments?

Each of these is considered separately in the following slides.



IFRS 16 distinguishes between variable lease payments ....that depend on an index or a rate and lease payments that depend on any other kind of variable.

- Variable lease payments based on an index or a rate include for example payments linked to a consumer price index, a benchmark interest rate or a market rental rate.

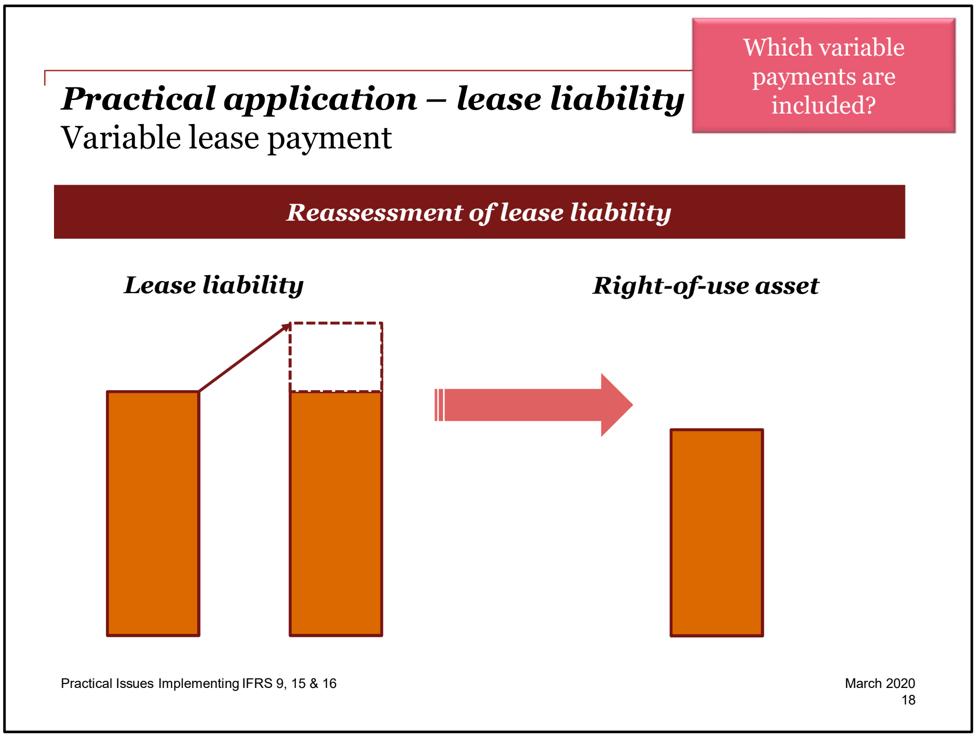
Variable lease payments based on an index or a rate are part of the lease liability. From the perspective of the lessee, these payments are unavoidable, because any uncertainty relates only to the measurement of the liability but not to its existence.

- Variable lease payments not based on an index or a rate include for example payments linked to a lessee's performance derived from the underlying asset, such as payments of a specified percentage of sales made from a retail store or based on the output of a solar or a wind farm. Similarly payments linked to the use of the underlying asset (say for example payments if the lessee exceeds a specified mileage) also fall into this bucket.

Variable lease payments not based on an index or a rate are not part of the lease liability. Such payments are recognised in profit or loss in the period in which the obligation for the payment occurs, that is, when the contingent event takes place.

- So the first question the lessee has to answer is whether the variable that the lease payment depends on is an index or a rate.

Once it has been concluded that the variable is an index or a rate the second question is how those lease payments are included in the lease liability. On initial recognition, variable lease payments based on an index or a rate are measured using the index or the rate at the commencement date. This means that an entity does not forecast future developments regarding the index/rate but includes the initial lease payments as they are based on the index/rate at the date of initial recognition.

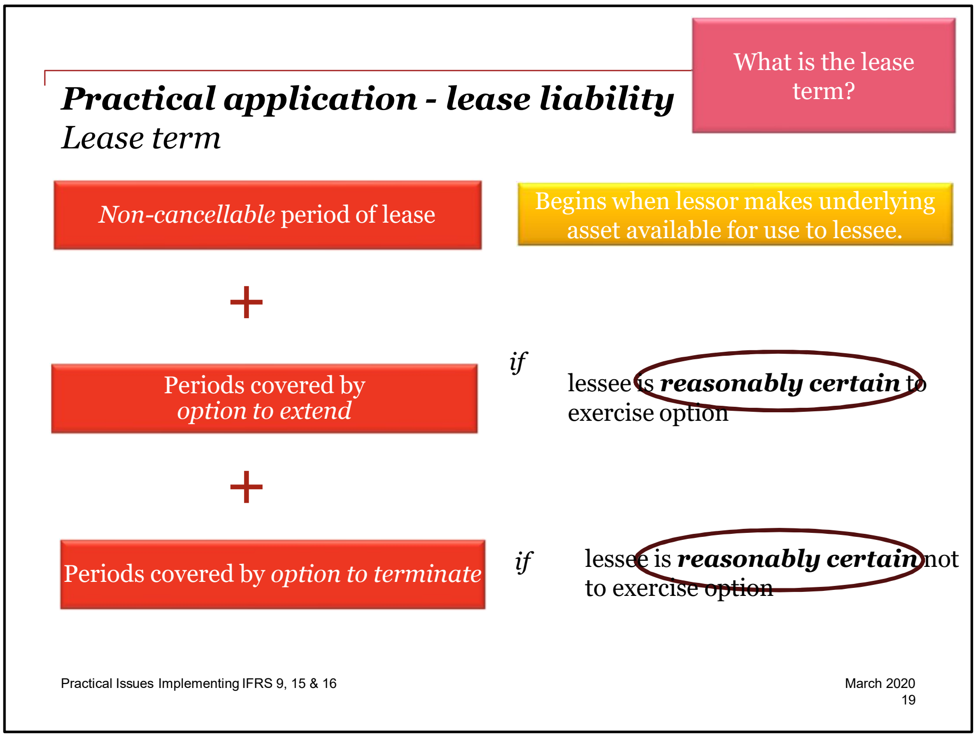


If the change in lease payments results from a change in floating interest rate the lessee shall use a revised discount rate that reflects changes in the interest rate.

What happens in subsequent periods?

- If later on the index or rate changes and this change affects lease payments the lease liability is remeasured based on the lease payments at that point in time (which means that also at that point in time the entity does not forecast future changes in the index or rate but only uses those changes which have changed lease payments). When doing this reassessment the discount rate remains unchanged. *Exception: the discount rate has to be updated if the change results from a change in floating interest rate.*

- Any remeasurement of the lease liability results in a corresponding adjustment of the right-of-use asset. If the carrying amount of the right-of-use asset has already been reduced to zero, the remaining remeasurement is recognised in profit or loss.



This slide sets out the standard's definition of a lease.

- Non-cancellable period of lease – In most cases this will be easy to determine from the contract itself. For example if the lessor and lessee enter into a 10 year lease contract, 10 years will be the non-cancellable period.

- The non-cancellable period begins on commencement date which is when the lessor makes the underlying asset available for use to the lessee.

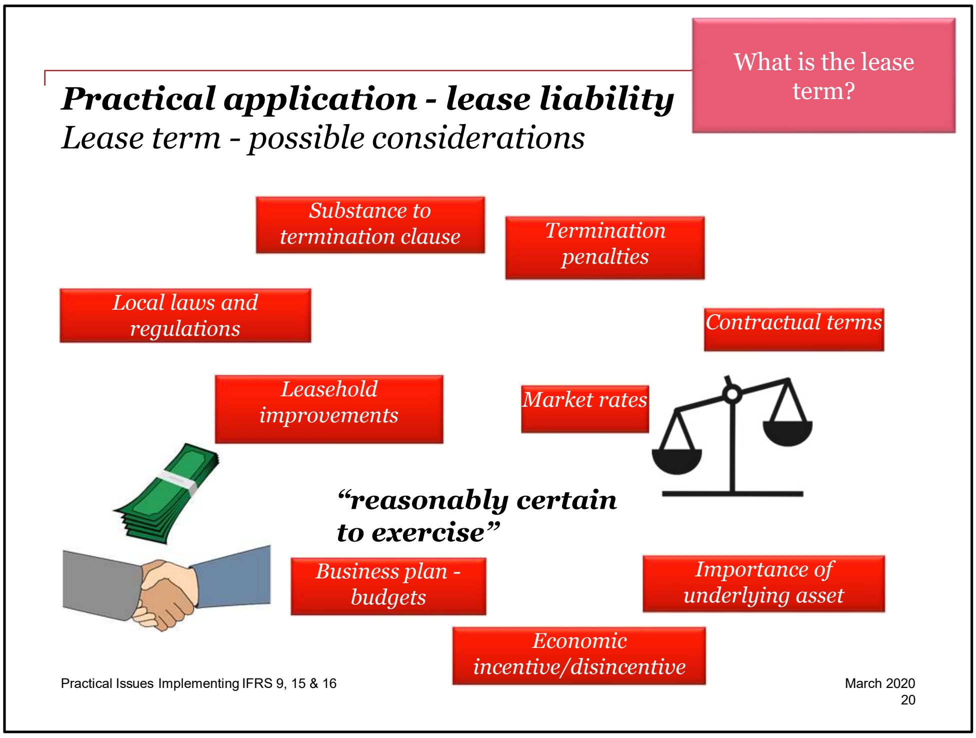
- The lease period also includes extension options, if it is reasonably certain that the option will be exercised.

- It is not uncommon for leases to contain break clauses. A break clauses gives the lessee the right to terminate a lease after a certain period. The lease term should disregard a termination option if it is reasonably certain that the termination option will not be exercised by the lessee.

A question that comes up often is how should a lessee assess whether exercising an option is reasonably certain? Reasonably certain is a highly judgmental area. The standard does provide some guidance on factors to consider when making that judgment. These will be considered on the following slide.

- Assessing "reasonably certain" – consider all facts/circumstances creating economic incentive to exercise, e.g.:
contractual terms/conditions for optional periods compared with market rates
significant leasehold improvements undertaken (or expected to be undertaken)

costs relating to termination of lease/signing of new replacement lease
importance of underlying asset to lessee’s operations
conditionality associated with exercising the option



As mentioned on the previous slide, reasonably certain is a highly judgmental area. The standard provides some guidance on factors to consider when making that judgement. Making this assessment requires a detailed understanding of the business and the economic reasons for leasing the asset.

- The standard states that the entity should consider all facts and circumstances creating an economic incentive for the lessee to exercise the option or to assess whether it is reasonably certain that the option will not be exercised. We will look at some of the factors that can be considered in this regard.

- If the lease payments in the option period are lower than market rentals as an example, the lessee has economic incentive to extend the lease into the option period. In this case, the option period will most likely form part of the lease term.

If rentals are reset to market rates however, there is no compelling reason for the lessee to extend the lease term. In this case other indicators need to be considered in determining whether the renewal period should be included. These will be discussed now.

- Similarly if the lessee can walk away from a lease agreement without a penalty it is more likely that the lessee will exercise the option.

- However if the lessee will incur a significant penalty for terminating the contract, the lessee has economic disincentive to cancel the contract. In this case the option period will most likely form part of the lease term.

- The lessee might have undertaken significant leasehold improvements to improve the leased asset or customise it for the special needs of the lessee. It is more likely in this case that the lessee will exercise an extension option.

- The lessee will more likely exercise an extension option if the asset is of a specialised nature or no other suitable alternatives exist. The costs of finding another location or relocating might be a disincentive for the lessee to give up an existing lease contract and negotiate a new lease.

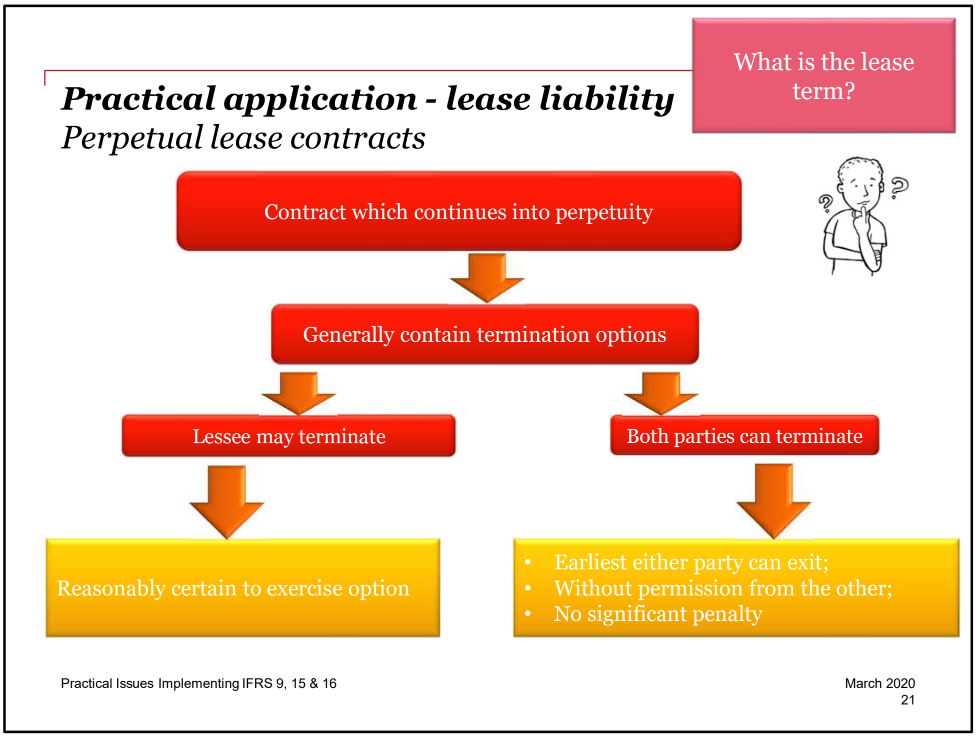
- A lessee's past practice regarding the period over which it has typically used particular assets, and its economic reasons for doing so may also provide useful information. Reviewing the entity's budget/impairment projections to assess the period over which the entity plans to generate cash flows from the leased property will also provide insight into whether the extension option will be reasonably exercised.

- Contracts might be structured to be out of scope of IFRS 16, for example either party in the contract has the option to terminate the agreement after 12 months. Such clauses need to be carefully considered under IFRS 16 to assess if there is substance to the termination clause. To assess the substance of the termination clause, the indicators discussed above might in isolation or in combination demonstrate that the termination clause has no substance, either because it is unlikely either party will exercise the option and because it might give rise to a significant economic disincentive to one party (generally the lessee). If that is the case the termination clause will be ignored for purposes of looking at the lease term.

- The impact of local laws and regulations might also be used as an indicator of the lease term. For example, although the lessor may have the right to terminate a lease agreement within a certain period, local laws and regulations, give the lessee the option to continue to extend the lease.

Practically most companies find it quite challenging to apply and particularly how to weight the different factors indicated in IFRS 16. Past practice is a good indicator of how entities exercised similar options in the past, but the facts and circumstances surrounding each lease contract should be considered. So for example if an entity leased assets on average for 10 years in prior years, that fact alone does not mean that the lease term is reasonably certain for 10 years. Similarly there will be always be costs to move from one lease contract to the next. However this does not automatically mean that the lessee will extend the lease.

- *The assessment of whether an option is reasonably certain is made at the commencement date. A lessee reassess whether it is reasonably certain to exercise an option only when a significant event or change in circumstances occurs that is within the control of the lessee and affects the reasonably certain assessment. A lessor does not make a reassessment. If there is a change in the lease term, the revised payments are reflected using a revised discount rate.*



- It is not uncommon for entities, especially in the retail industry, to enter into perpetual lease contracts aka evergreen leases. These contracts generally do not have a fixed contractual term.

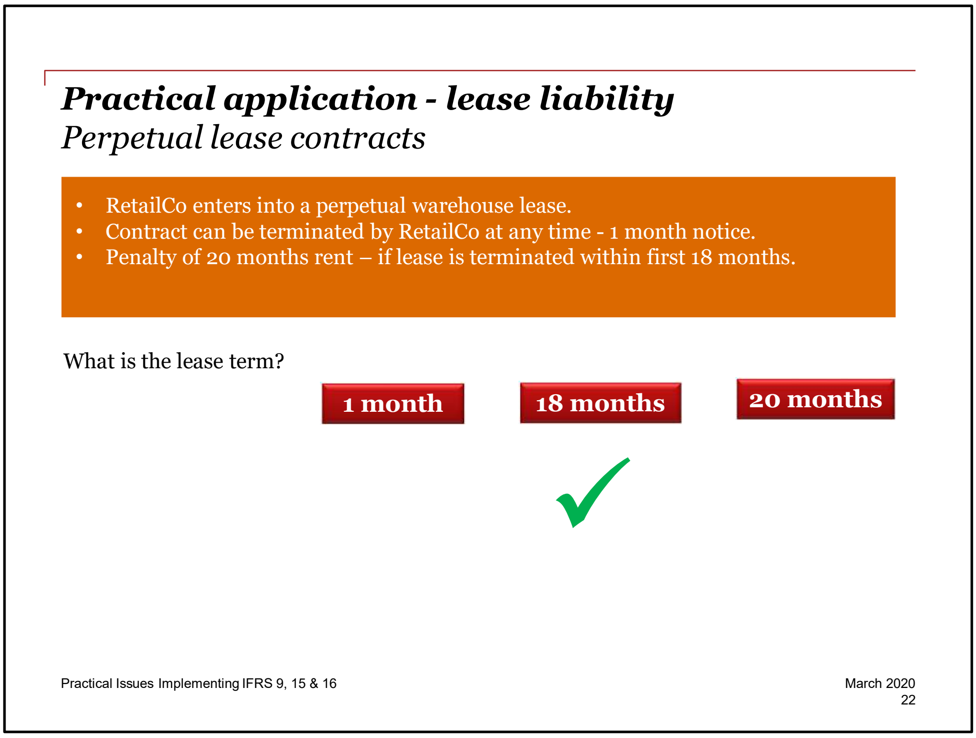
- Although there is no fixed contractual term, such contracts contain a termination option in the agreement.

- The most common arrangement is where the lessee has the termination option.

- In this case, the entity should include lease periods for which it is reasonably certain that it will not exercise the termination option.

- The contract may also give both the lessor and the lessee the right to terminate the lease.

- IFRS 16 requires in looking to the lease term, that the non-cancellable period is the period for which the lease is enforceable. A lease is no longer enforceable when the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty. In this case the period covered by the termination option is not included as part of the lease term even if the lessee is reasonably certain not to exercise the termination option.

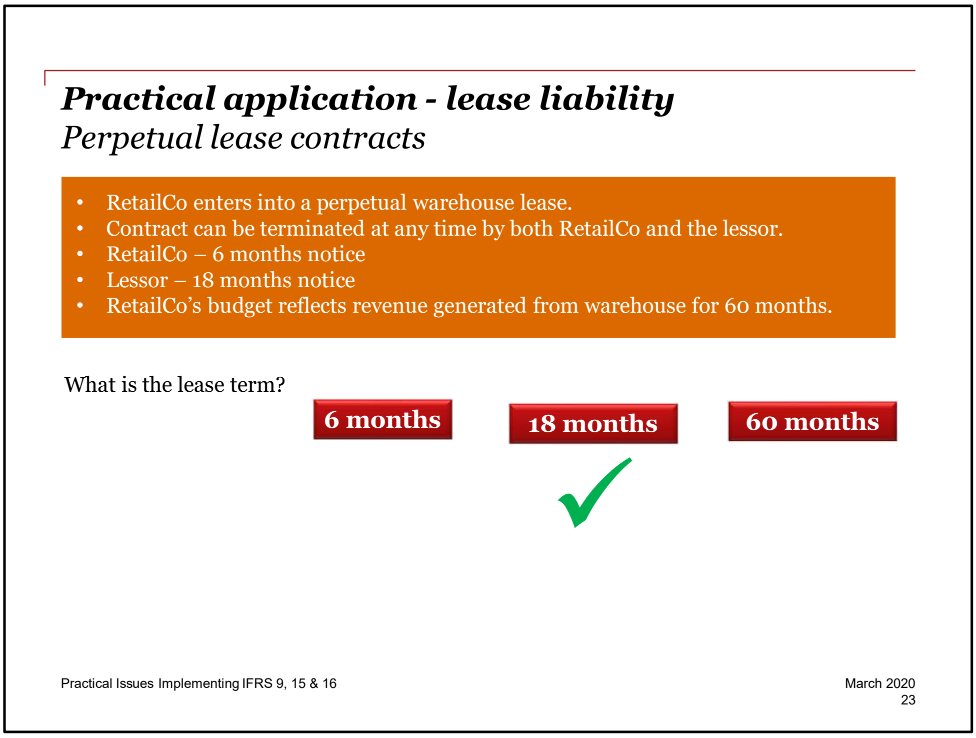


RetailCo enters into a perpetual warehouse lease. The contract can be terminated by RetailCo at any time by giving 1 months' notice. If the contract is terminated within the first 18 months, a penalty equal to 20 months' rent is payable.

What is the appropriate lease term?

Correct answer: 18 months

If a lease contains a break clause, the length of the lease depends on whether the lessee is reasonably certain not to exercise the option. If the lease contains an early termination clause, it is unlikely the termination option will be exercised if there is a significant penalty that kicks in. In this case, termination at any time within 18 months, will result in a 20 month penalty. This is considered to be a significant penalty as the cost of terminating the lease exceeds the cost of not terminating.



Example where both the lessee and lessor have the termination option:

RetailCo enters into a perpetual warehouse lease. The contract can be terminated at any time by either RetailCo or the lessor. RetailCo has to give 6 months' notice prior to terminating and the lessor has to give 18 months' notice.

RetailCo's budgets reflect revenue from the warehouse for 60 months. A termination penalty of 1 month rent will kick in if RetailCo terminates the contract.

What is the appropriate lease term?

Correct answer: 18 months

The non-cancellable lease period is the period for which the contract is enforceable. A lease is no longer enforceable when the lessee and lessor each have the right to terminate the lease without permission from the other party with an insignificant penalty.

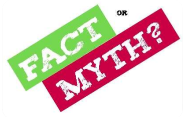
In this example it would be 18 months. The lessee has the ability to walk away from the contract after 6 months. However based on budget projections it is reasonably certain the lessee will use the warehouse for 60 months.

However the lessor has the right to cancel the contract after a period of 18 months. The earliest point in time would therefore be 18 months.

Measurement of the lease liability

Discount rate

Are the following statements a



		Fact?	Myth?
1.	Using the interest rate implicit in the lease or the incremental borrowing rate is an accounting policy choice.		✓

Is the following statement a fact or myth?

Using the interest rate implicit in the lease or the incremental borrowing rate is an accounting policy choice.

Correct answer: Myth. The discount rate applied is not an accounting policy choice. This will be explained on the next slide.

Practical application - lease liability

Discount rate

Which discount rate should be used?

Has this changed from IAS 17?

Interest rate implicit in the lease

if rate cannot be readily determined

Incremental borrowing rate at commencement date

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- The standard requires companies to use the interest rate implicit in the lease.

- The interest rate implicit in the lease is only used if it is readily determinable.

- Otherwise the standard allows the entity to use the incremental borrowing rate.

- This concept remains unchanged from the existing leases standard.

Practical application - lease liability

Discount rate

Are the following statements a

		Fact?	Myth?
2.	The interest rate implicit in the lease is generally not stipulated in the agreement.	✓	

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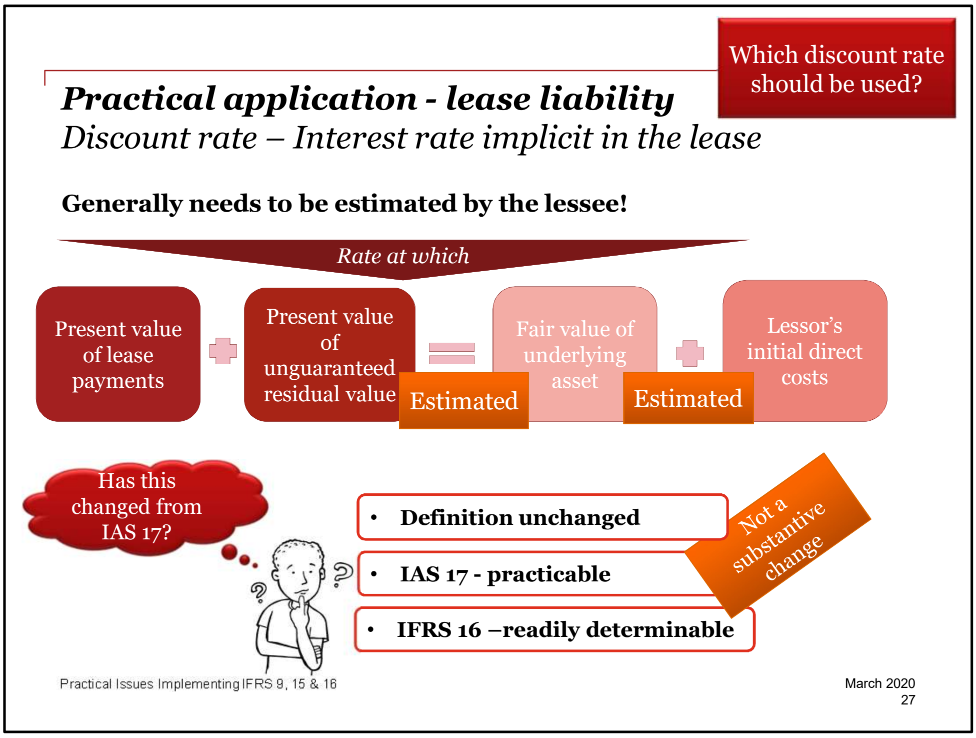
Is the following statement a fact or myth?

The interest rate implicit in the lease is generally not stipulated in the agreement.

Correct answer: Fact. In practice, the interest rate implicit in the lease is unlikely to be stipulated in the agreement and, unless the lessor volunteers the information, the lessee will need to derive an estimate of the rate from the information available. That can often be difficult to determine as companies might not have access to the information which would allow the fair value to be determined.



As mentioned on the previous slide, the interest rate implicit in the lease generally needs to be estimated by the lessee.

The interest rate implicit in the lease is the rate of interest that causes the:

- Present value of lease payments; and

- Present value of the unguaranteed residual value to equal the sum of

- The fair value of the underlying asset; and

- Any initial direct costs of the lessor.

When considering the components of the calculation of interest rate implicit in the lease the lessee will know with certainty the lease payments based on the contractual arrangement. However the lessee will need to estimate the unguaranteed residual value because this is the portion of the residual value that is guaranteed solely by a party related to the lessor. Similarly the fair value of the underlying asset might have to be estimated and the initial direct costs incurred by the lessor.

Therefore it is often difficult to determine the interest rate implicit in the lease.

Practical application - lease liability

Discount rate

Are the following statements a

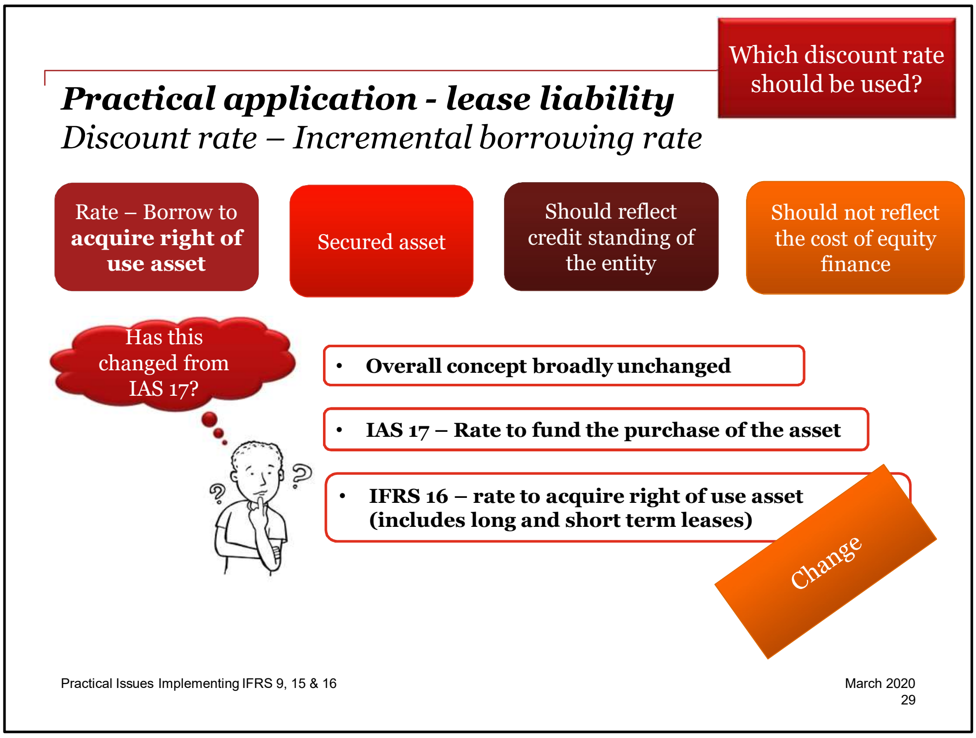
		Fact?	Myth?
3.	The incremental borrowing rate reflects the cost of equity financing.		✓

Is the following statement a fact or myth?

The incremental borrowing rate reflects the cost of equity financing.

Correct answer: Myth. The incremental borrowing rate should be the rate at which the entity could borrow. Therefore the rate should not reflect the cost of equity financing.

On the next slide we will consider the incremental borrowing rate in more detail.



The incremental borrowing rate is defined as the rate of interest that a lessee would have to pay to borrow, over a similar term and with a similar security, the funds necessary to obtain an asset of a similar value to the cost of the right-of-use asset in a similar economic environment.

Given the definition of the incremental borrowing rate the following factors should be considered:

- The rate calculated should be the rate at which the entity could borrow over the term of the lease. What's important however is it should be the rate at which an entity would need to borrow to acquire an asset of similar value to the right of use asset, rather than to acquire the entire underlying asset (unless in cases where the lease term is for substantially all the life of the underlying asset).

- The rate should reflect that of a secured borrowing for a similar asset (being the right of use asset and not the underlying asset) rather than that of an unsecured borrowing or general line of credit.

- The rate should reflect the credit standing of the entity and the rate it would need to borrow at in a similar economic environment. Therefore for example if the group can borrow at a certain rate, it would not be appropriate for the entity to use that rate unadjusted. Appropriate adjustments must be made to reflect the credit standing and economic environment of the entity.

- As mentioned on the previous slide, the rate calculated should be the rate at which the entity could borrow. The rate should therefore not reflect the cost of equity financing. Therefore using an unadjusted WACC (weighted average cost of capital) for example would not be appropriate.

Thank you