FIA Technical Workshop

Getting prepared for IFRS 15 and IFRS 16

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Today's agenda

IFRS 15: Revenue from Contracts with Customers

- Transition and implementation
- Common application issues
- Presentation and disclosure consequences

IFRS 16: Leases

- Presentation and disclosure consequences
- Common application issues
- Transition and implementation

IFRS 15: Revenue from Contracts with Customers
Transition and implementation

Effective date (IFRS 15.C1)

Effective date	Annual periods beginning on or after 1 January 2018 and interim periods within those annual periods
Early adoption?	Permitted

IFRS 15: Revenue from Contracts with Customers
Transition and implementation

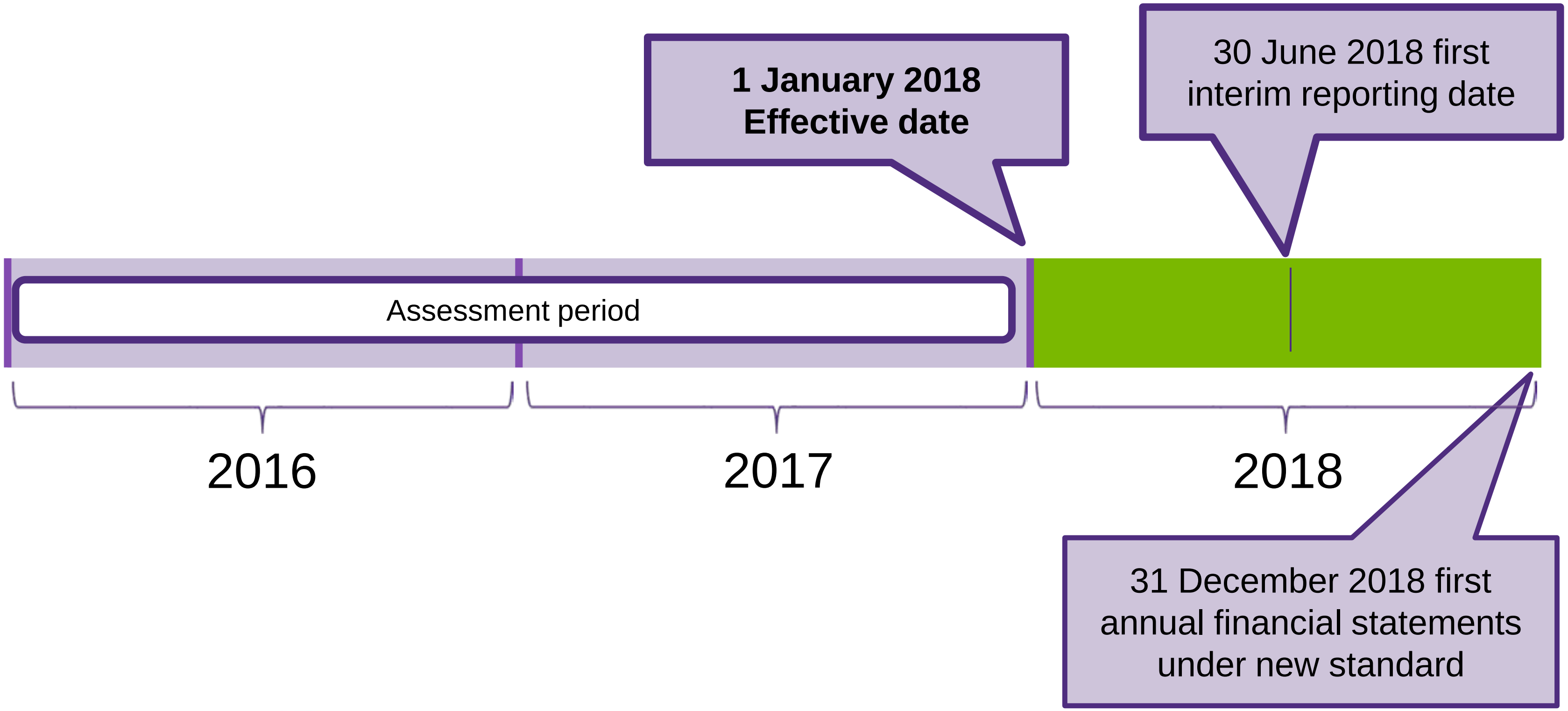
Transition (IFRS 15.C2-C9)

Retrospective application either to:

1. Each prior period presented (practical expedients available), or
2. The current period only, with the cumulative effect adjustment applied to opening retained earnings
   – Apply only to contracts not complete at date of initial application (IFRS 15.C7)
   – Some additional disclosures apply (IFRS 15.C8)

IFRS 15: Revenue from Contracts with Customers
Transition and implementation

Implementation timeline – Modified retrospective method (IFRS 15.C3(b))



IFRS 15: Revenue from Contracts with Customers
Transition and implementation

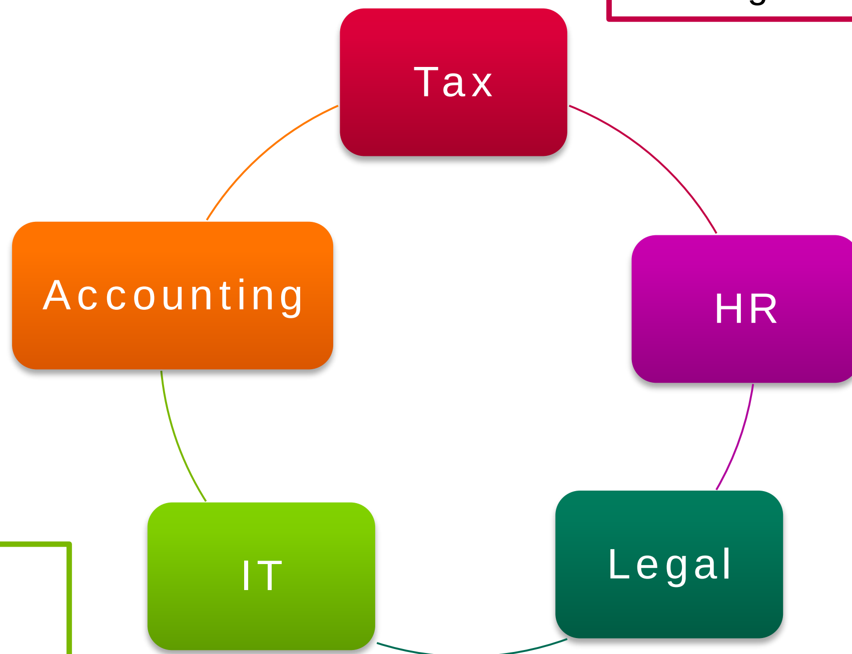
Transition – Method 1's practical expedients

- For completed contracts:
  - Ignore if begin and end in the same annual reporting period
  - Variable consideration - use transaction price at date contract completed
- For periods before date of application – ignore IFRS 15.120 disclosure
- Must disclose:
  - Expedients used
  - Qualitative assessment of estimated effect of applying

Cross-functional impact

- assess whether changes in book revenue recognition will change tax revenue recognition method
- understand tax provision and return filing implications
- understand laws/regulations for changes to tax methods

- determine transition method
- evaluate revenue streams to identify differences
- establish/update accounting policies
- design and implement internal controls over adoption and transition
- draft disclosures



- review incentive compensation arrangements

- explore need for system changes (or new systems)
- prepare system for parallel accounting, if necessary
- design internal controls over IT processing

- determine impact on debt covenants
- look at present wording in sales contracts

Today's agenda

- Transition & implementation
- Common application issues
- Presentation and disclosure consequences

IFRS 15: Revenue from Contracts with Customers
Overview

- **New guidance** on a variety of topics:
  - Multiple element arrangements
  - Variable consideration
  - Customer options (material rights)
  - Licensing
  - Repurchase agreements
  - Warranties, and more!

IFRS 15: Revenue from Contracts with Customers
Overview

Five step approach to a new control-based model

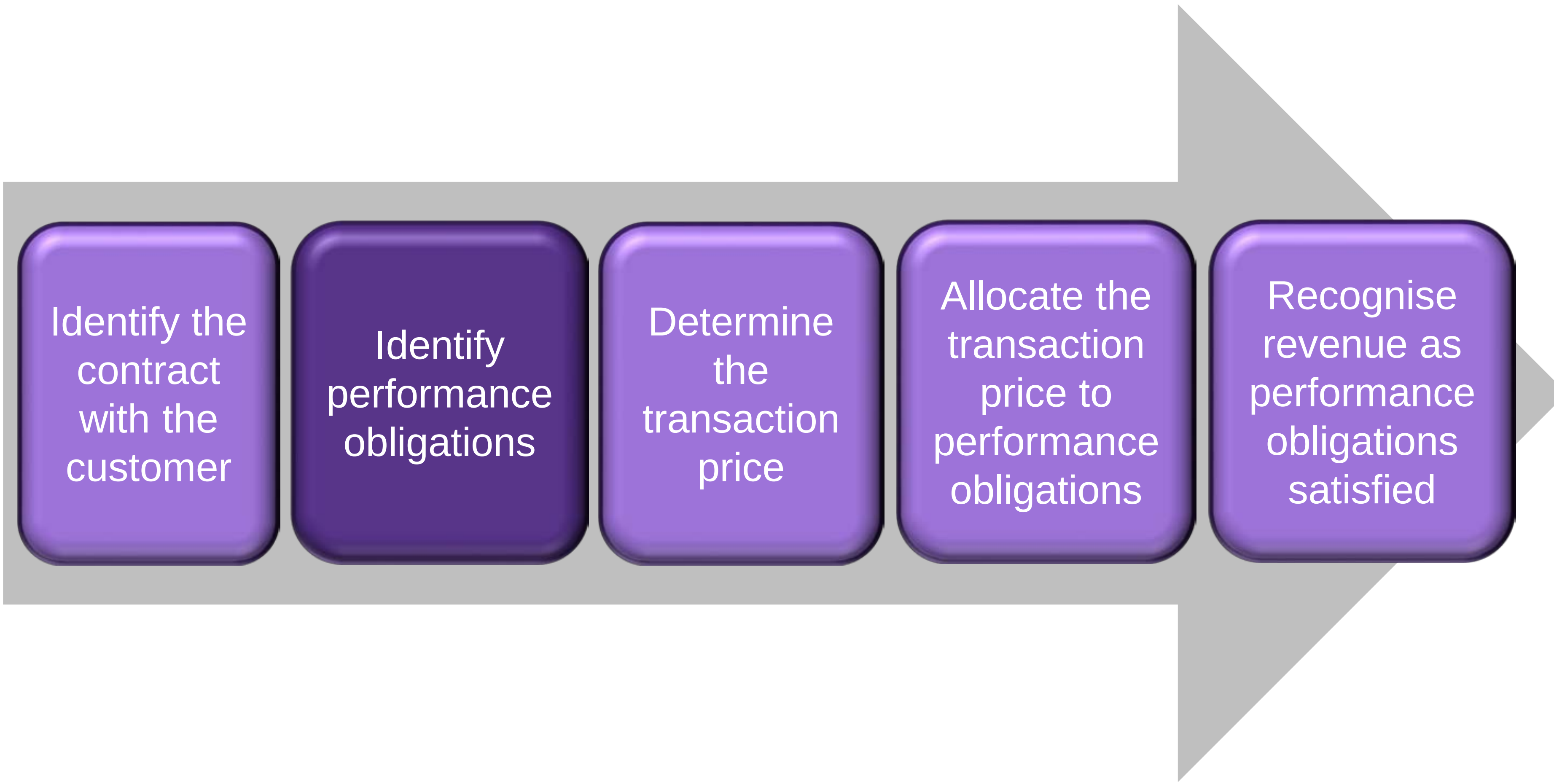
1. Identify the contract with the customer
2. Identify performance obligations
3. Determine the transaction price
4. Allocate the transaction price to performance obligations
5. Recognise revenue as performance obligations satisfied

IFRS 15: Revenue from Contracts with Customers
Step 1: Identify the contract

A **contract** is defined as:

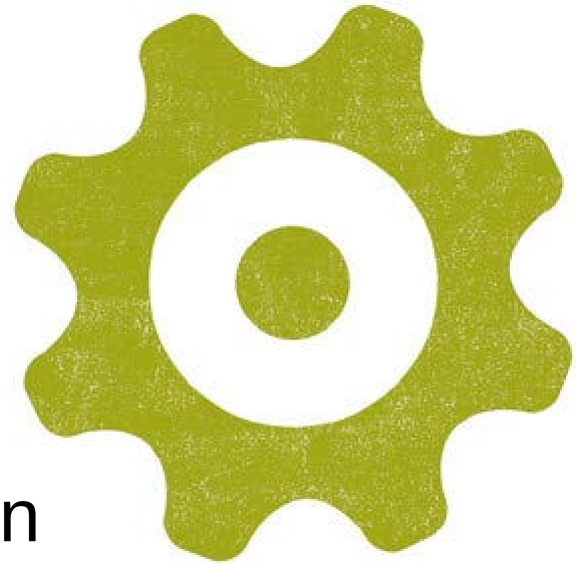
- An agreement between two or more parties that creates enforceable rights and obligations (IFRS 15.10)
  - Enforceable by law
  - Written, oral, or implied
  - Will vary across jurisdictions, industries, and entities

IFRS 15: Revenue from Contracts with Customers
Five step approach to the model



IFRS 15: Revenue from Contracts with Customers
Step 2: Identify the performance obligations

- A **performance obligation** is a promise to transfer to the customer either: (IFRS 15.22)
  – a good or service that is **distinct**, or
  – a **series** of distinct goods or services that are substantially the same and have the same pattern of transfer



- Includes **implied promises** that create a valid customer expectation (IFRS 15.24)

IFRS 15: Revenue from Contracts with Customers
Step 2: Identify the performance obligations

What does "distinct" mean? (IFRS 15.27)

- Customer can benefit from good/service either on its own or with other "**readily available**" resources, AND
- Promise is "**separately identifiable**" from other promises in the contract

Readily available = either sold separately or already obtained (IFRS 15.28)

IFRS 15: Revenue from Contracts with Customers

Step 2: Identify the performance obligations

What if a promised good or service is not distinct?

"…an entity shall combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct. In some cases, that would result in the entity accounting for all the goods or services promised in a contract as a single performance obligation." (IFRS 15.30)

Case Study 1

IFS 15: Revenue from Contracts with Customers

Step 2: Identify the performance obligations

Case study 1 – Performance obligations

Go Fast Computing enters into contracts with ETNZ to:

- Transfer software license
- Install and customise to add functionality and interface with ETNZ's legacy software
- Provide 2 years' unspecified updates and 2 years' technical support

Entity sells license, installation, and technical support separately (but not the updates)

Other entities could provide customisation

Step 2: Identify the performance obligations

Case study 1– Solution

What are the performance obligations?

- Software licence
- Installation and customisation
- Unspecified updates
- Tech support

IFRS 15: Revenue from Contracts with Customers
Step 2: Identify the performance obligations

Customer options
When is an option a performance obligation?

- When it provides a **material right** the customer would not receive without entering into that contract (IFRS 15.B40)
- For example: a discount incremental to that typically given
- If price reflects SSP, it's not a material right (it's a marketing offer) (IFRS 15.B41)

IFRS 15: Revenue from Contracts with Customers
Step 2: Identify the performance obligations

Up-front activities (IFRS 15.25)

- Set-up or other administrative tasks <u>not</u> a performance obligation unless they transfer a service to the customer as performed
- This is so even if activities MUST be undertaken in order to fulfill a contract
- Activities even excluded when measuring progress on other promised goods or services (IFRS 15.42)

IFRS 15: Revenue from Contracts with Customers
Step 2: Identify the performance obligations

Example - Payroll services

Entity enters into 3-year contract to perform payroll processing services for up to 3,000 employees:

- JE's, monthly/annual reports, remittances
- Upfront services to load employee data and benefits elections and link to customer's system ($15,000)
- To deliver services, entity purchases additional hardware worth $10,000

What are the performance obligations?

IFRS 15: Revenue from Contracts with Customers

Five step approach to the model

Identify the contract with the customer

Identify performance obligations

Determine the transaction price

Allocate the transaction price to performance obligations

Recognise revenue as performance obligations satisfied

IFRS 15: Revenue from Contracts with Customers
Step 3: Determine the transaction price

Transaction price: "*the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer*" (IFRS 15.47)

- May be fixed, variable, or both
- Excludes amounts collected on behalf of third parties
- Assume customer will not renew, modify, or cancel the contract (IFRS 15.49)

IFRS 15: Revenue from Contracts with Customers
Step 3: Determine the transaction price

Factors to consider: (IFRS 15.48)

A. Variable consideration (and related constraint)

B. Significant financing component?

C. Non-cash consideration

D. Consideration payable to a customer

We will examine each of these further.

IFRS 15: Revenue from Contracts with Customers
Step 3: Determine the transaction price

Variable consideration
Significant financing
Non-cash consideration
Payable to customer

Group Question: Variable consideration (Scenario 1)

- Contract to build manufacturing plant
- Agreed price of $25 million
- 18 months to complete construction
- 15% bonus if complete in 16 months
- 90% likelihood of receiving the bonus

How will the performance bonus impact the transaction price?

IFRS 15: Revenue from Contracts with Customers

Step 3: Determine the transaction price

Variable consideration

Significant financing

Non-cash consideration

Payable to customer

Answer: Variable consideration (Scenario 1)

- Estimate:
  - Using MLA approach $3.75m is included in the transaction price (15% x $25million)
- Constraint:
  - Company concludes it is highly probable that a significant reversal will not occur, so amount is not constrained

IFRS 15: Revenue from Contracts with Customers
Step 3: Determine the transaction price

Variable consideration
Significant financing
Non-cash consideration
Payable to customer

Group Question: Variable consideration (Scenario 2)

Complete in	Bonus (%)	Bonus ($)	Probability
15 months	15%	$3,750,000	20%
16 months	10%	$2,500,000	50%
17 months	5%	$1,250,000	20%
18 months	0%	nil	10%

How will the performance bonus impact the transaction price?

IFRS 15: Revenue from Contracts with Customers

Step 3: Determine the transaction price

Variable consideration

Significant financing

Non-cash consideration

Payable to customer

Answer: Variable consideration (Scenario 2)

- Company uses expected value approach and **estimates** variable consideration = $2,250,000
- Company considers whether any of the amount should be **constrained**

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IFRS 15: Revenue from Contracts with Customers
Step 3: Determine the transaction price

Variable consideration
Significant financing
Non-cash consideration
Payable to customer

Group Question: Management fees/constraint

- 5-year contract for asset management services
- Quarterly fee = 2% of assets managed at end of each quarter
- Performance-based incentive fee of 20% of [fund's return>index] over 2 yrs
- Is a single performance obligation (series)

IFRS 15: Revenue from Contracts with Customers
Step 3: Determine the transaction price

Variable consideration
Significant financing
Non-cash consideration
Payable to customer

Answer: Management fee /constraint

Is any of the consideration variable?

- Quarterly fee?
- 2-year performance bonus?

Constraint: Are these fees included in the transaction price from inception? Or are they excluded by the constraint?

IFRS 15: Revenue from Contracts with Customers
Step 3: Determine the transaction price

Variable consideration | Significant financing | Non-cash consideration | Payable to customer

Answer: Management fee/constraint (cont'd)

Why initially excluded from the TP?

- Both fees depend on market, so highly susceptible to factors outside entity's influence (IFRS 15.57(a))
- Bonus has large range of possible outcomes (IFRS 15.57(e))
- Bonus not expected to be resolved for long period of time (IFRS 15.57(b))

IFRS 15: Revenue from Contracts with Customers
Step 3: Determine the transaction price

Variable consideration
Significant financing
Non-cash consideration
Payable to customer

Significant financing component (IFRS 15.60-.65)

- Adjust transaction price when <u>significant</u> financing benefit present for either party
- Not required to be explicitly stated in contract
  – may be <u>implied</u> by the agreed terms (IFRS 15.60)
- Transaction price should reflect <u>cash selling price</u> ("CSP") at time of transfer to customer (IFRS 15.61)

IFRS 15: Revenue from Contracts with Customers

Step 3: Determine the transaction price

Variable consideration

Significant financing

Non-cash consideration

Payable to customer

Practical expedient (IFRS 15.63)

Not required to account for the time value of money if at contract inception the period between the transfer of goods and the receipt of consideration is expected to be one year or less

IFRS 15: Revenue from Contracts with Customers
Step 3: Determine the transaction price

Variable consideration
Significant financing
Non-cash consideration
Payable to customer

Non-cash consideration (IFRS 15.66-.69)

- Many forms: goods, services, equities, etc.
- Measure at FV. If can't reasonably estimate FV, use SSP of promised goods/services
- If FV of noncash consideration varies for reasons other than only the form of consideration (e.g. entity's performance), apply constraint
- If customer contributes goods/services for use in a contract (e.g. equipment, labour) and entity obtains control, account for as noncash consideration

IFRS 15: Revenue from Contracts with Customers
Step 3: Determine the transaction price

Variable consideration
Significant financing
Non-cash consideration
Payable to customer

Consideration payable to a customer
(IFRS 15.70-.72)

- Amounts entity pays or expects to pay to customer (or customer's customer)
  - For example: manufacturer's rebate offered by OEM to either dealer or dealer's retail customer
- Includes cash, credits, coupons, rebates, etc.
- Evaluate whether payment is for <u>distinct</u> good or service

Case Study 2

IFRS 15: Revenue from Contracts with Customers

Step 3: Determine the transaction price

Variable consideration | Significant financing | Non-cash consideration | Payable to customer

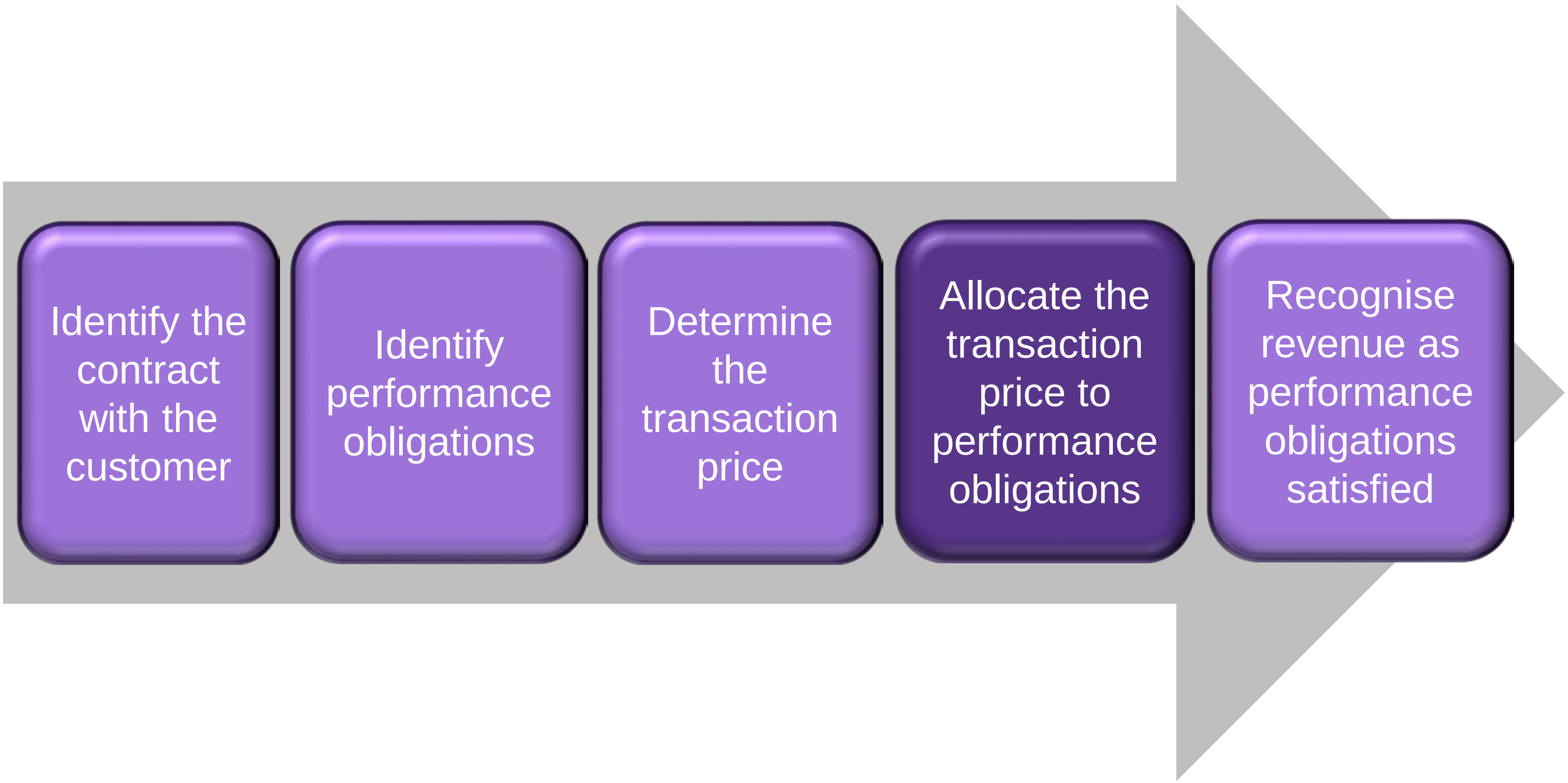
Case study 2 – Consideration payable to customer

- Good Looking Inc has one year contract with Yachting New Zealand to sell its manufactured goods
- YNZ's minimum purchase must be $15M
- GLI makes $1.5M nonrefundable upfront payment for customer to update retail display

How does GLI account for the upfront payment to YNZ (its customer)?

IFRS 15: Revenue from Contracts with Customers

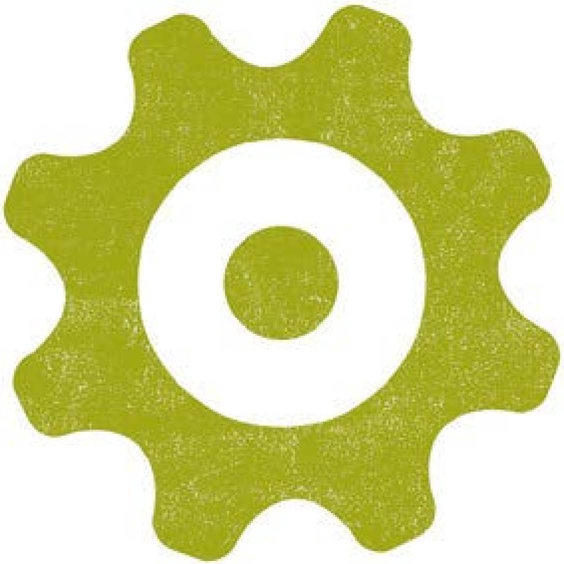
Five step approach to the model



IFRS 15: Revenue from Contracts with Customers
Step 4: Allocate the transaction price

Core principle is to allocate:

- the transaction price to performance obligations in an amount that reflects the consideration to which the entity <u>expects to be entitled in exchange</u> for those goods or services
(IFRS 15.73)



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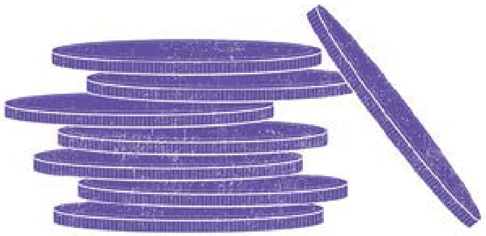
IFRS 15: Revenue from Contracts with Customers
Step 4: Allocate the transaction price

- The objective is accomplished by allocating revenue using the relative stand-alone selling price basis (IFRS 15.74)

- Special rules exist for allocation of:
  – certain discounts (IFRS 15.81-.83)
  – certain variable consideration (IFRS 15.84-.86)



IFRS 15: Revenue from Contracts with Customers
Step 4: Allocate the transaction price

Determining stand-alone selling price

Methods include (but not limited to): (IFRS 15.79)

- Adjusted market assessment approach
- Expected cost plus margin approach
- Residual approach (limited availability)

Apply methods consistently in similar circumstances

IFRS 15: Revenue from Contracts with Customers

Step 4: Allocate the transaction price

Example – Determining the SSP

- Entity sells Products A, B, & C for $100
- Entity regularly sells Product A on its own for $50
- The standalone selling prices for B and C are not directly observable

How should Entity determine the SSPs for Products A, B, and C?

IFRS 15: Revenue from Contracts with Customers

Step 4: Allocate the transaction price

Example – Answer

- Product A = directly observable price
- Product B = estimate using either adjusted market or expected cost plus margin approach
- Product C = same as B

Can the residual approached be used? No

IFRS 15: Revenue from Contracts with Customers

Step 4: Allocate the transaction price

Allocating a discount

- **General rule** = relative SSP (proportionate allocation of discount) (IFRS 15.74)
- **Special rule** = must allocate discount entirely to one or more performance obligations when all of the following criteria are met: (IFRS 15.82)
  - regularly sell each distinct good/service (or bundle) on stand-alone basis
  - regularly sell sub-group on a stand-alone basis, at a discount,
  - discount on sub-group is substantially the same as the contract discount

IFRS 15: Revenue from Contracts with Customers
Step 4: Allocate the transaction price

Group Question A – Applying the special discount allocation rule (IFRS 15.82)

- Entity sells Products A, B, and C for a total of $100
- A, B, and C are regularly sold separately for $40, $55 and $45 respectively
- B, C are regularly sold together for $60

How would the transaction price be allocated?

IFRS 15: Revenue from Contracts with Customers
Step 4: Allocate the transaction price

Group Question A – Answer

- Regular "relative selling price" rule in IFRS 15.74 is **overridden**.
- Total discount in contract = \$40 = same as discount when B and C bundled
- Apply **special rule** in IFRS 15.82
- Results in discount being allocated entirely to B and C
  (A=40, B=[55/100x\$60], C=[45/100x\$60])

IFRS 15: Revenue from Contracts with Customers

Step 4: Allocate the transaction price

Group Question B – Applying the special discount rule with the residual approach (situation 1)

- Entity sells to customer Products A, B, C, and D for **$130**
- Products A, B, C regularly sold separately for $40, $55 and $45 respectively
- B and C regularly sold together for $60
- Product D has recently been sold at a broad range of prices ($15 - $45)

How should the entity allocate the transaction price?

IFRS 15: Revenue from Contracts with Customers
Step 4: Allocate the transaction price

Group Question B – Answer

- Product A = $ 40
- Products B and C = $ 60
- Product D = $30 (by residual)

Reality check: Is IFRS 15.73 objective met?
Yes – because $30 is within range of recent sales for D [$15 to $45]

IFRS 15: Revenue from Contracts with Customers
Step 4: Allocate the transaction price

Group Question C – Applying the special discount rule with the residual approach (situation 2)

- Entity sells to customer Products A, B, C, and D for **$105**
- Products A, B, C regularly sold separately for $40, $55 and $45 respectively
- B and C regularly sold together for $60
- Product D has recently been sold at a broad range of prices ($15 - $45)

How should the entity allocate the transaction price?

IFRS 15: Revenue from Contracts with Customers
Step 4: Allocate the transaction price

Group Question C – Answer

- Product A = $ 40
- Products B and C = $ 60
- Product D = $5 (by residual)??

Reality check: Is IFRS 15.73 objective met?
NO – because $5 is not within range of recent sales for D ($15 to $45). Therefore residual method cannot be applied.

SSP of Product D must be estimated using another technique, then relative SSP method applied

Case Study 3

IFRS 15: Revenue from Contracts with Customers
Step 4: Allocate the transaction price

Case Study 3 – allocating to material rights

- Sale of fountain pens for $100 includes a discount voucher entitling ETNZ supporters to 40% off future purchases up to $100 in next 30 days
- Assume SSP of the fountain pen = $100
- Smart Pens Limited offers all its customers a 10% discount as part of seasonal promotion over next 30 days
- 80% likelihood that ETNZ supporter will redeem voucher
- Estimated average customer purchases by ETNZ supporters with voucher = $50

How would the transaction price be allocated?

IFRS 15: Revenue from Contracts with Customers

Five step approach to the model

Identify the contract with the customer

Identify performance obligations

Determine the transaction price

Allocate the transaction price to performance obligations

Recognise revenue as performance obligations satisfied

IFRS 15: Revenue from Contracts with Customers
Step 5: Recognise revenue

Core principle:

- To recognise revenue when a promised good or service is transferred to the customer (i.e. customer obtains control)
  (IFRS 15.31)

IFRS 15: Revenue from Contracts with Customers
Step 5: Recognise revenue

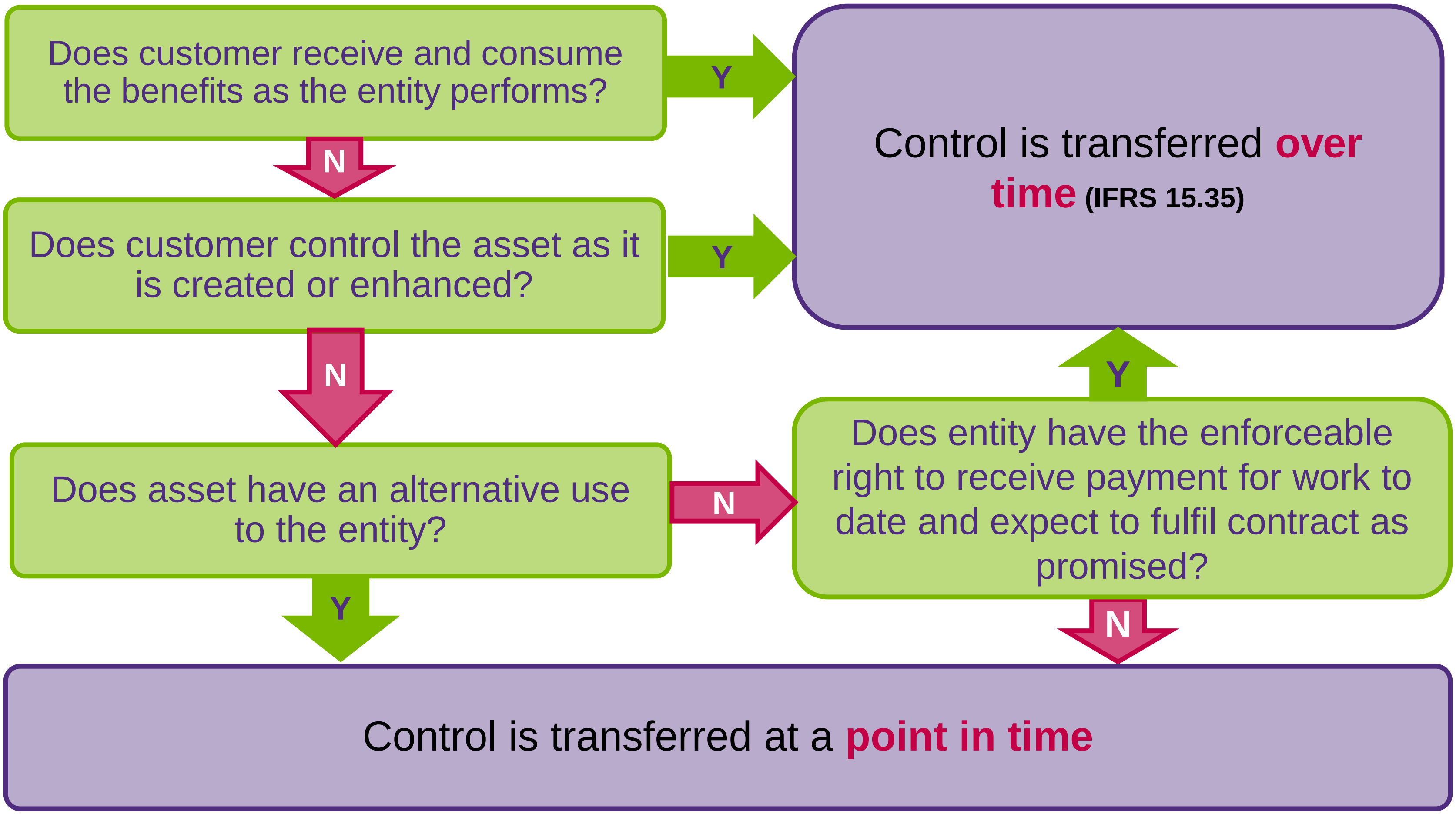
Definition of control (IFRS 15.33)

Control is the ability to direct the use of and obtain substantially all of the remaining benefits from an asset. Control includes the ability to prevent other entities from doing the same.

Control transfers either over time or at a point in time

IFRS 15: Revenue from Contracts with Customers

Step 5: Recognise revenue



IFRS 15: Revenue from Contracts with Customers
Step 5: Recognise revenue

Transfer over time – criteria

Criterion 1: Simultaneous receipt and consumption of benefits (IFRS 15.B4)

- Another entity would <u>not</u> need to substantially reperform the work completed to-date
- Disregard potential contractual or practical limitations (that would prevent you from transferring the remaining work to another party)

IFS 15: Revenue from Contracts with Customers

Step 5: Recognise revenue

Transfer over time – criteria

Criterion 2: Customer controls asset as it is created/enhanced (IFRS 15.B5)

- Assess whether customer has control (IFRS 15.31-.34 and .38)
- Asset could be tangible or intangible
- Services are considered to be assets (even if momentarily) when they are received and used

IFRS 15: Revenue from Contracts with Customers

Step 5: Recognise revenue

Transfer over time – criteria

Criterion 3(a): Asset with no alternative use

(IFRS 15.B6-.B8)

- Assess at contract inception
- Consider contractual restrictions and practical limitations
  - contractual: could customer enforce its rights to the asset if entity tried to redirect for another use?
  - practical: significant economic losses to redirect for another use
- Do not update assessment unless contract is modified

IFS 15: Revenue from Contracts with Customers

Step 5: Recognise revenue

Transfer over time - criteria

Criterion 3(b): Right to payment for performance completed to-date (IFRS 15.B9-B13)

- Enforceable
- Amount at least compensates for performance to date
- Consider contractual terms, laws, and legal precedent
- Must include reasonable profit margin (not just a right to recover potential losses)
- Does not need to be a present unconditional right to payment
- Consider entity's practice of enforcing or waiving payment rights

IFRS 15: Revenue from Contracts with Customers
Step 5: Recognise revenue

Point in time

When IFRS 15.35 criteria fail, then revenue is recognised at a **point in time**. But *when*? (IFRS 15.38)

Consider the following **indicators** that control has transferred:

- Present right to payment
- Customer has legal title to the asset
- Customer has physical possession of the asset
- Customer has significant risks and rewards of ownership
- Customer has accepted the asset

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IFRS 15: Revenue from Contracts with Customers

Step 5: Recognise revenue

Point in time

In some situations, physical possession may not indicate control:

- Repurchase agreements: **customer** may have possession, but **seller** may have control
- Consignment arrangements: **consignee** may have possession, but **consignor** may have control
- Bill and hold arrangements: **seller** may still have possession, but **customer** may have control

Case Study 4

IFRS 15: Revenue from Contracts with Customers
Step 5: Recognise revenue

Case Study 4 – Over time vs point in time

- GVL is developing multi-unit residential complex
- Binding sales contract for a specific unit
- Contract prohibits GVL from redirecting the unit
- Customer to make progress payments
- If customer defaults, GVL has an enforceable right to all consideration if it completes construction of the unit (IFRS 15.B11)

How should GVL's revenue be recognised?

IFRS 15: Revenue from Contracts with Customers

Today's agenda

- Transition and implementation
- Common application issues
- Presentation

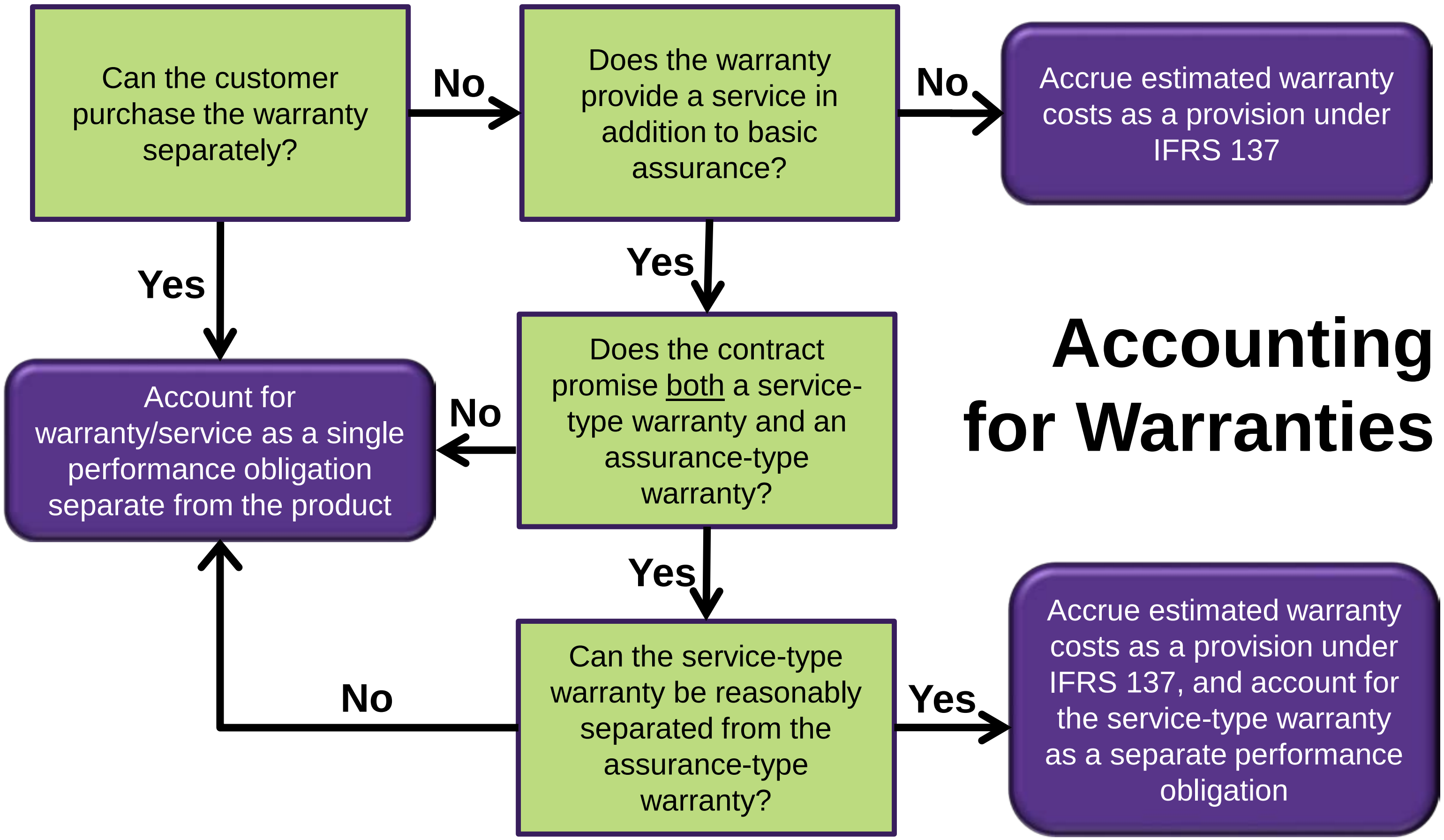
IFRS 15: Revenue from Contracts with Customers
Warranties

Warranties (IFRS 15.B28-B33)

- Nature of warranty is key. May involve:
  - basic assurance that product will function as intended (complies with agreed-upon specifications)
  - additional service(s)
- Additional services? Consider:
  - whether warranty required by law
  - length of warranty coverage period
  - nature of the tasks to be performed

IFRS 15: Revenue from Contracts with Customers
Warranties

Accounting for Warranties



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IFRS 15: Revenue from Contracts with Customers
Warranties

Differences from existing IFRS?

- Overall, major changes unlikely for most entities
- Watch out for provision of "subsequent servicing":
  - previously accounted for under IFRS 118.IE11, and allocated an amount equal to expected costs plus reasonable profit
  - Under IFRS 15, allocate based on relative SSP

IFRS 15: Revenue from Contracts with Customers

Principal versus Agent

Principal (gross) versus Agent (net)

(IFRS 15.B34-B38)

- Unit of account = performance obligation (not contract)
- Indicators you are an agent:
  - Other party primarily responsible for fulfillment
  - No inventory risk before or after customer order
  - No discretion in setting prices
  - Paid in the form of a commission
  - Not exposed to customer credit risk

Case Study 5

Non-refundable upfront fees

Case Study 5 – Non-refundable upfront fee

- One year of transaction-processing Services for ETNZ
- Non-refundable upfront fee for activities needed to set up ETNZ in the system
- ETNZ can renew services without paying additional set up fee

How should the payroll processing company recognise the non-refundable upfront fee?

IFRS 15: Revenue from Contracts with Customers
Licences

Licences (IFRS 15.B52-B63)

- Is licence distinct from other promised goods/services?
- If not distinct, then account together with other goods/services (e.g. software that runs your Blu-ray player)

IFRS 15: Revenue from Contracts with Customers
Licences

Licences

Is licence distinct from other goods/services in the contract?

N

License is not distinct and is accounted for together with other promises as a single performance obligation. Entity assesses whether control transfers over time or at a point in time

Y

License is a distinct performance obligation and accounted for separately from other promises. Assess nature of entity's promise related to the licence.

Is licence a "right to use" the IP as it exists when the licence is granted, or a "right to access" the IP as it exists throughout the licence period?

Right to use

Control transferred at point in time

Right to access

Control is transferred over time

Case Study 6

IFRS 15: Revenue from Contracts with Customers
Licences

Case Study 6 - Licences

- ETNZ licenses keel design patent rights to Fast Boats Limited for 10 years
- ETNZ will also manufacture the keel for the customer
- Manufacturing process not unique/special
- ETNZ will not undertake any activities that will significantly affect underlying IP

1. **How many performance obligations exist?**
2. **How should revenue be recognised?**

IFRS 15: Revenue from Contracts with Customers
Contract costs

Two kinds of contract costs:

- Contract *acquisition* costs (IFRS 15.91-94)
  - Incremental costs to obtain a contract that would not be incurred if not obtained (Eg sales commission)
- Contract *fulfilment* costs (IFRS 15.95-98)
  - Costs to fulfil (i.e. perform/deliver) a contract
  - Consider deferral under IFRS 15.95 only if not already within scope of another standard (eg. IFRS 102, IFRS 116, IFRS 138).

IFRS 15: Revenue from Contracts with Customers

Contract costs

Example – Contract acquisition costs

- Two sales commission plans
- Commission rate dependent on sales figures
- Supervisors also receive annual bonus based on annual sales targets

Is the entity required to defer/amortise these costs under IFRS 15.91?

IFRS 15: Revenue from Contracts with Customers
Contract costs

Answer – Contract acquisition costs

- Sales commissions
  - **Yes**, as long as commissions are incremental (directly attributable) to specific contracts
- Annual bonus to supervisors
  - **No**, bonuses are not incremental (directly attributable) to specific contracts

IFRS 15: Revenue from Contracts with Customers
Contract costs

Contract fulfilment costs (IFRS 15.95-98)

- If not under another standard, then recognise as an asset under this standard if costs:
  - Directly relate to a contract (or anticipated contract), such as direct labour and materials, indirect costs of production, etc.
  - Generate or enhance resources that will be used to satisfy performance obligations in the future, AND
  - Expect to be recovered

IFRS 15: Revenue from Contracts with Customers
Contract costs

Contract fulfilment costs (IFRS 15.95-98)

- Certain costs are always expensed as incurred:
  - General and administrative costs (unless chargeable to customer)
  - Costs of wasted materials,
  - Costs related to satisfied performance obligations
  - Costs where entity cannot tell whether relates to satisfied or unsatisfied performance obligations

IFRS 15: Revenue from Contracts with Customers
Contract costs

Amortisation (IFRS 15.99-100)

- Use systematic basis consistent with the pattern of transfer of the related goods or services
- Update amortisation estimate if expected pattern of transfer changes

Impairment loss (IFRS 15.101-104)

Impairment loss = carrying amount less remaining profit*

*Remaining profit = remaining amount of consideration entity expects to receive for related goods and services, less the costs to provide those goods or services not yet recognised in expense.

Case Study 7

Case Study 7 – Fulfilment costs

- Quick Computers Limited will manage ETNZ's information technology data center
- Term = 5 years plus two 1-yr renewal options
- Average customer relationship is 7 years
- QCL pays a $10k sales commission
- Design and build $350k technology platform to accommodate outsourcing contract:

Design services	40,000
Hardware	120,000
Software	90,000
Migration and testing of data centre	100,000
TOTAL	**350,000**

IFRS 15: Revenue from Contracts with Customers

Today's agenda

- Transition & implementation
- Common application issues
- Presentation and disclosure consequences

IFRS 15: Revenue from Contracts with Customers

Presentation

does the entity have a right to consideration for g/s that it has transferred to a customer?

Y

is the entity's right to consideration unconditional?

Y

receivable

N

contract asset

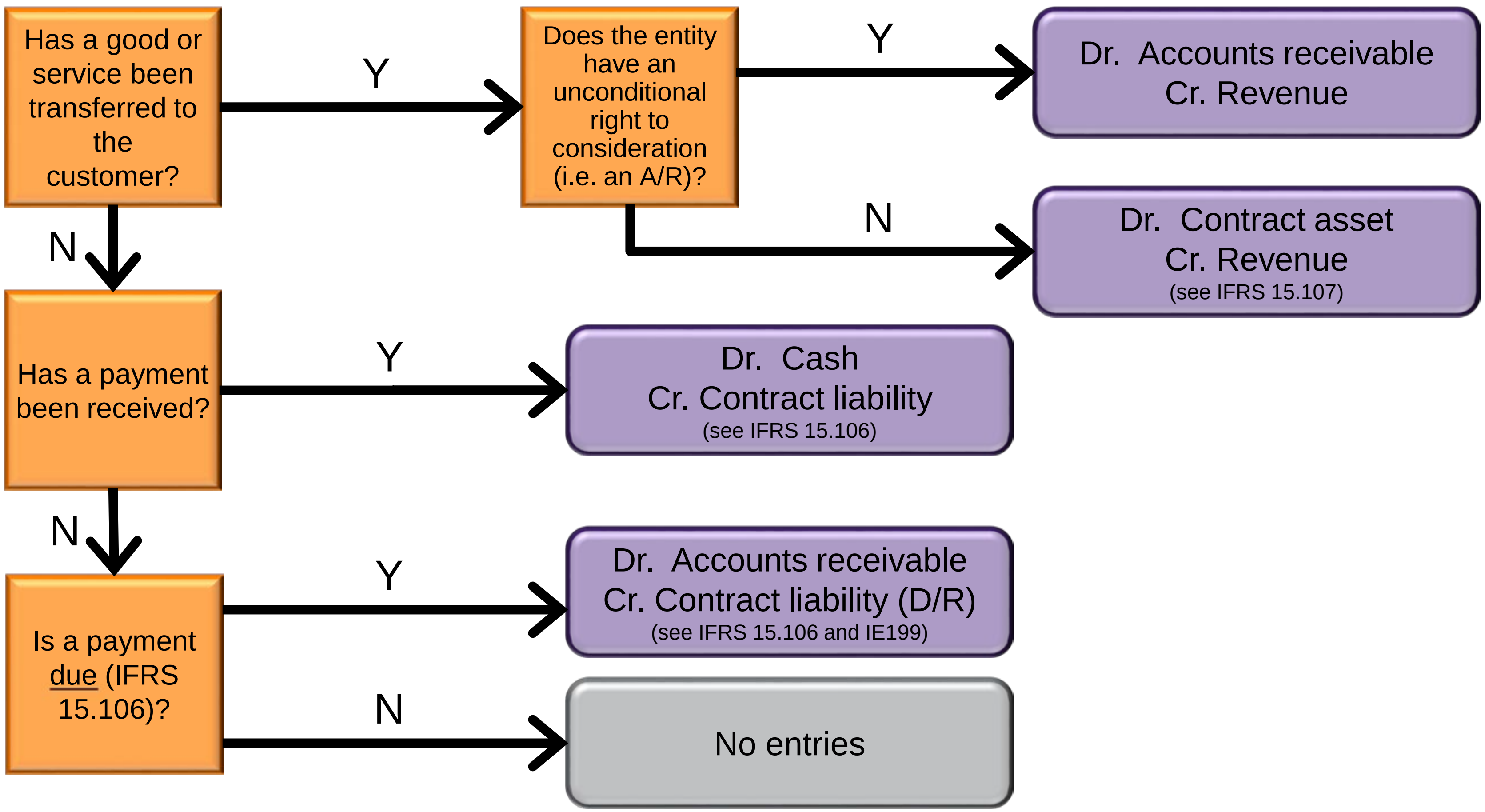
does the entity have an obligation to transfer g/s to a customer for which the entity has received consideration (or an amount is due)?

Y

contract liability

IFRS 15: Revenue from Contracts with Customers

Presentation and disclosure



Questions & Feedback

Today's agenda

IFRS 15: Revenue from Contracts with Customers

- Transition & implementation
- Common application issues
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IFRS 16: Leases

- Presentation and disclosure consuquences
- Common application issues
- Transition and implementation

IASB's impact analysis

Industry	Future payments for off balance sheet / total assets	PV of future payments for off balance sheet leases / total assets
Airlines	28.8%	22.7%
Retailers	28.3%	21.4%
Travel and leisure	28.6%	20.7%
Transport	15.5%	11.6%
Telecommunications	7.7%	6.1%
Energy	7.7%	5.5%
Media	7.0%	5.5%
Distributors	5.4%	4.3%
Information technology	3.7%	3.0%
Healthcare	3.8%	2.9%
Others	2.9%	2.2%

Lessee disclosures - Quantitative information about leases (generally in tabular form)

- depreciation charge for right-to-use assets by class of underlying asset
- interest expense on lease liabilities
- expenses relating to low-value and short-term leases (other than leases of one month or less) if exemptions elected
- commitments for short term leases if expense disclosed reflects a dissimilar lease portfolio to the period end commitments
- additional information about right-to-use assets that are investment property or revalued under IAS 16

Lessee disclosures - Quantitative information about leases (generally in tabular form)

- expense relating to variable lease payments not included in lease liabilities
- income from subleasing
- total cash outflow for leases
- additions to right-to-use assets
- gains and losses from sales and leaseback transactions
- carrying amount of right-to-use assets (by class of asset)
- maturity analysis of lease liabilities

Lessee disclosures - Additional qualitative information about leases

- nature of leasing activities
- future cashflows to which the lessee is potentially exposed that are not reflected in lease liabilities including
  - Variable lease payments
  - Extension and termination options
  - Residual value guarantees
  - Leases not yet commenced
- restriction or covenants imposed by leases
- sale and leaseback transactions

Lessor disclosures - information about leases (generally in tabular form)

- Operating leases
  - lease income, separating disclosing income for variable lease payments that do not depend on an index or rate
  - as applicable for underlying asset, relevant disclosures in
    - NZ IAS 16 for leases of PPE disaggregated by class of assets
    - NZ IAS 36, NZ IAS 38, NZ IAS 40 and NZ IAS 41
  - maturity analysis of lease payments
  - *Additional qualitative and quantitative information about leasing activities as necessary to meet disclosure objectives including the nature of the leasing activities and how risk associated with any rights retained in the underlying asset is managed*

Lessor disclosures - information about leases (generally in tabular form)

- Finance leases
  - selling profit or loss
  - finance income on the net investment in the lease
  - income relating on variable lease payments not included in the net investment in the lease
  - qualitative and quantitative explanation of significant changes in net investment in the lease
  - maturity analysis of the lease receivables
  - *additional qualitative and quantitative information about leasing activities as necessary to meet disclosure objectives including the nature of the leasing activities and how risk associated with any rights retained in the underlying asset is managed*

Today's agenda

IFRS 15: Revenue from Contracts with Customers

- Transition and implementation
- Common application issues
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IFRS 16: Leases

- Presentation and disclosure consuquences
- Common application issues
- Transition and implementation

What is in IFRS 16?

- Scope of standard
- Definition of a lease
- The new lessee accounting model
- Lessor accounting
- Sale & leaseback
- Presentation & disclosure
- Effective date & transition

Scope

- all leases for both lessees and lessors, (except the below)
- scope exclusions
  - leases to explore for or use minerals, oil, natural gas & similar non-regenerative resources
  - leases of biological assets
  - service concession arrangements
  - licences of intellectual property granted by a lessor
  - rights held by a lessee under certain licencing agreements (e.g., films, video recordings)
- recognition exemptions (short-term leases / low-value assets)

What is in IFRS 16?

- Background
- Definition of a lease
- The new lessee accounting model
- Lessor accounting
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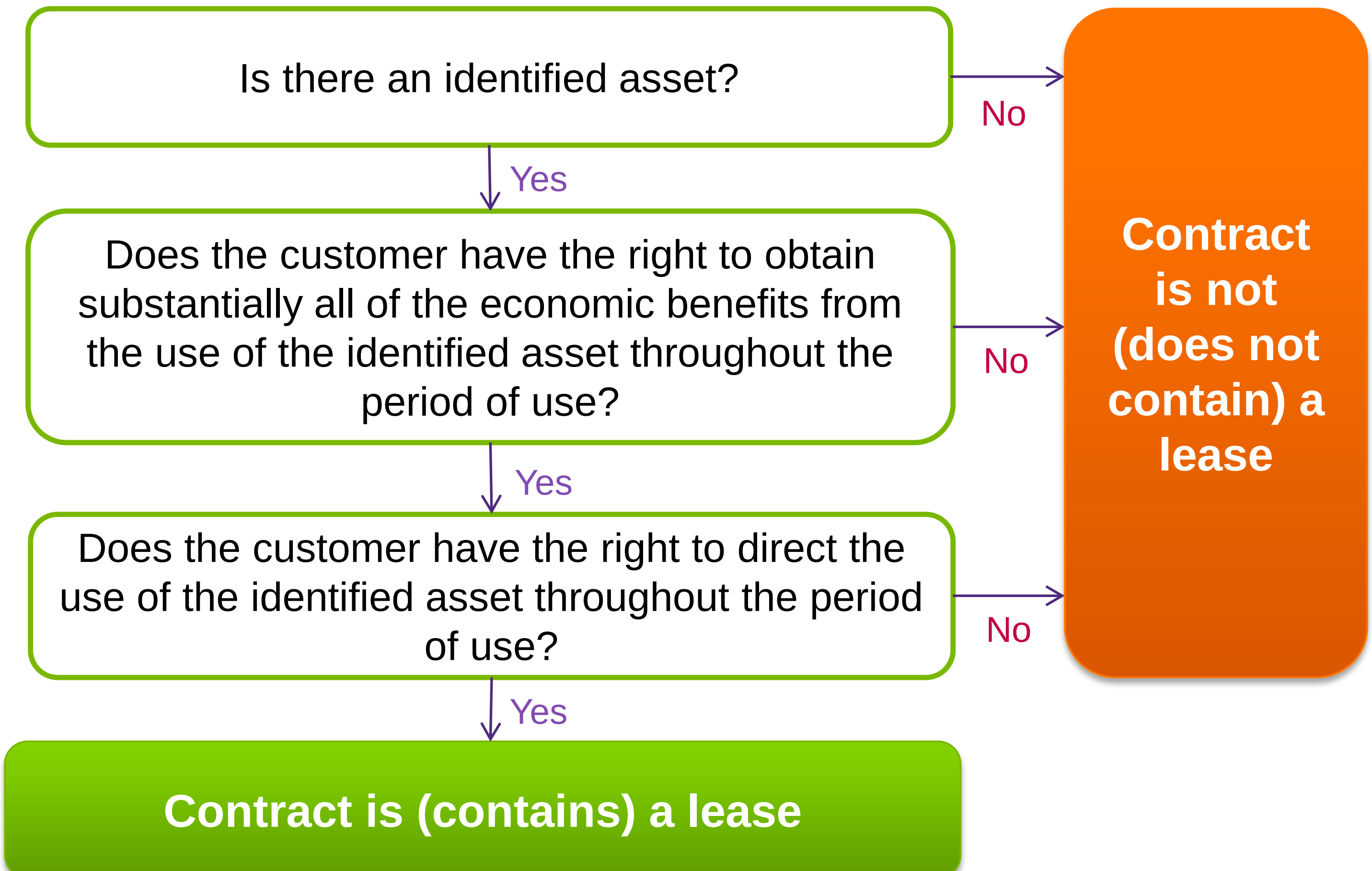
Definition of a lease

"A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration"



Definition of a lease
Example 1 – Executive jet

- ETNZ enters into a five-year contract with an aviation company for the exclusive use of a particular executive jet
- the contract details the interior and exterior specifications for the jet
- the aviation company is permitted to use an alternative aircraft but this would be uneconomic due to various factors such as the cost of customising the aircraft to meet the contractual specifications
- subject to certain restrictions, the customer decides where the executive jet will fly and which passengers will use it. The aviation company operates the aircraft using its own crew.

Definition of a lease
Example 2 - Ship

- A boat buiding company enters into a contract with a shipping company to transport yachts from Auckland to San Francisco in the US
- the contract specifies a particular ship and the yachts to be transported, which will require the full capacity of the ship
- the shipping company operates and maintains the ship and is responsible for the safe passage of the yachts from Auckland to San Francisco
- The yacht manufacturer is not able to make changes (eg to the destination or nature of the cargo) once the contract has been signed.

Definition of a lease
Separating components

Lease and non-lease components are accounted for separately

- each lease component – apply NZ IFRS 16
- each non-lease component – apply other standards

Practical expedient:

- lessees can make a policy election (by underlying asset class) to account for lease and non-lease components as lease components

Allocate consideration to lease and non-lease components:

- lessees – on a relative standalone price basis (unless the practical expedient is elected)
- lessors – using IFRS 15

What is in IFRS 16?

- Scope
- Definition of a lease
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Lessee accounting
Recognition & measurement at a glance

Initial recognition & measurement	• initially measure right-or-use (ROU) asset* & lease liability at present value of lease payments
Subsequent measurement of lease liability	• accrete the lease liability based on the effective interest method using a discount rate at lease inception** • reduce lease liability by payments made
Subsequent measurement of ROU asset	• depreciate ROU asset based on IAS 16 • alternative measurement of ROU asset under IAS 16 & IAS 40
Profit or loss	• generally 'front-loaded' expense for individual lease • separate interest & depreciation

** Initial measurement of the ROU asset would also include the lessee's initial direct costs, prepayments made to the lessor less lease incentives received from the lessor, if any, and restoration, removal and dismantling costs*

*** As long as a reassessment and a change in the discount rate have not occurred*

Optional accounting simplifications

- available if the lease term is 12 months or less at commencement
- cannot qualify if the lease contains a purchase option
- use of this exemption is an accounting policy choice that must be made consistently for **each class** of underlying asset

Short-term leases

- assessment of value is based on the absolute value of each leased asset when new
- a value when new of around US$5,000 or less
- leases of assets such as low value IT equipment, office equipment and furniture would typically qualify
- use of this exemption is an accounting policy choice that can be made on a **lease-by-lease** basis

Low-value asset leases

Optional accounting simplifications
Example: short-term leases

- a ferry company company has entered into several leases of passenger boats
- each lease has a stated term of 36 months, but with break clauses allowing the company to terminate each lease after 12 months and 24 months without penalty
- at the commencement date of each lease the ferry company assesses the likelihood that it will exercise its 12-month termination option. This assessment considers all relevant facts and circumstances that create an economic incentive to not terminate the lease early
- management concludes that it is 'reasonably certain' that the termination option will be exercised. In reaching this conclusion, management takes into account that:
    - there is no significant termination penalty
    - the rentals in years 2 and 3 are not below market
    - the business's transport needs tend to change with sufficient speed that the existing vehicle fleet may no longer be optimal in 12 months' time and alternative ferries could be sourced and introduced into the operations without significant cost or disruption.

Optional accounting simplifications
Example: short-term leases – Analysis

- the leases of the ferries qualify for the short-term exemption
- the ferry company has an accounting policy choice to either apply the general IFRS 16 lessee model or account similarly to operating leases under IAS 17 (ie recognise the lease payments on a straight-line basis over the lease term or another systematic basis if more representative of the pattern of benefit)
- this accounting policy must be applied consistently to all short-term leases of underlying assets of the same class (eg all short-term leases of transport vehicles).

Optional accounting simplifications
Example: low-value assets

- ETNZ enters into a single lease contract for ten office printers/copiers
- the lease has a three year, non-cancellable term
- one of the assets is a high-end production printer with a purchase price when new of US$20,000
- the other nine assets are more basic models with prices when new of US $3,000 each
- although the ten assets are under the same lease, the company concludes that each asset is a separate 'lease component' because:
  - the company benefits from each asset on its own
  - the assets are not highly interrelated

Optional accounting simplifications
Example: low-value assets – Analysis

- because each asset is a distinct lease component, IFRS 16 treats this contract as containing ten separate leases in principle. The total lease payments are then allocated to each of the ten components on a relative stand-alone selling price basis
- ETNZ can then elect to apply the low-value asset exemption to some or all of the nine basic model lease components. If it does so, these are accounted for similarly to operating leases under IAS 17
- the lease of the high-end production printer must be accounted for 'on-balance sheet'.

Initial measurement of the lease liability

Fixed (and in-substance fixed) future payments for lease elements, less any lease incentives receivable over the lease term (including payments in optional extension periods if extension 'reasonably certain')

+

Variable payments linked to an index/rate based on level of index/rate at commencement

+

Amounts expected to be payable under residual value guarantees

+

Exercise price of a purchase option if the lessee is reasonably certain to exercise that option

+

Termination penalties if lease term reflects exercise of a termination option

Discounted at rate implicit in the lease (or lessee's incremental borrowing rate)

Initial measurement of the right-of-use asset

Initial amount of lease liability

+

Lease payments made to lessor at or before commencement date

-

Lease incentives received

+

Initial direct costs

+

Estimated cost of removing and/or restoring leased asset

Right-of-use asset

Subsequent measurement of the right-of-use asset & lease liability

- right-of-use asset is accounted for similarly to a purchased asset
- lease liability is accounted for similarly to a financial liability
- accordingly:
  - the right-of-use asset is depreciated
  - the lease liability is accounted for using the effective interest method
  - lease payments are apportioned between interest expense and a reduction of the lease obligation.

Variable lease payments

Type of payment	Initial accounting	Subsequent accounting
Variable lease payments that depend on an index or a rate	Include in lease liability and asset based on level of index/rate at the commencement date	Adjust lease liability and asset when revised index/rate changes the lease payments (using original discount rate)
Other variable lease payments (eg payments linked to sale or usage)	Exclude from lease liability and asset	Recognise an expense in the period that the event or condition that triggers the payments occurs
In-substance fixed lease payments	Treat as fixed lease payments	Treat as fixed lease payments

Lease modifications

Does modification (i) **increase the scope** of the lease by adding a right to use one or more underlying assets; and (ii) **increase consideration by an amount commensurate with stand-alone price** for increased scope (and any appropriate price adjustments to reflect circumstances)?

Yes → Account for new terms as a separate lease

No → Does modification **decrease scope** of lease (ie is it a full or partial termination)?

- **No** → Adjust liability to reflect revised consideration, with corresponding adjustment to asset
- **Yes** → Adjust lease liability to reflect revised consideration; adjust asset to reflect change in scope plus effect of revised pricing and discount rate (with termination gain/loss in P/L)

Lessee accounting for a simple three-year lease Example

- on 1 Jan 2016, ETNZ enters into a three-year lease that will become its base for boat construction
- the rentals are CU10,000 payable at the end of each year
- there are no services or other non-lease elements
- no initial direct costs are incurred or incentives received
- the applicable discount rate is 5%.

Lessee accounting for a simple three-year lease Example – Analysis

- The initial measurement of the right-of-use asset and lease liability is:

CU27,232 (CU10,000/1.05 + CU10,000/1.05^2 + CU10,000/1.05^3)

Cash flow and P&L (CU):	1.1.2016	2016	2017	2018
Lease payments	-	10,000	10,000	10,000
Depreciation expense	-	9,077	9,077	9,078
Interest expense	-	1,362	930	476
Total expense	-	10,439	10,007	9,554

Balance sheet (CU):				
Right-of-use asset	27,232	18,155	9,078	-
Lease liability	27,232	18,594	9,524	-

Lessee accounting for a simple three-year lease Example – Analysis (Cont.)

Accounting entries on initial recognition:

	Dr. CU	Cr. CU
Right-of-use asset	27,232	
Lease liability		27,232

Subsequent accounting entries at the end of 2016:

	Dr. CU	Cr. CU
Depreciation expense	9,077	
Interest expense	1,362	
Lease liability	8,638	
Cash		10,000
Right-of-use asset		9,077

The accounting entries in years 2017 and 2018 continue in the same pattern.

What is in IFRS 16?

- Scope
- Definition of a lease
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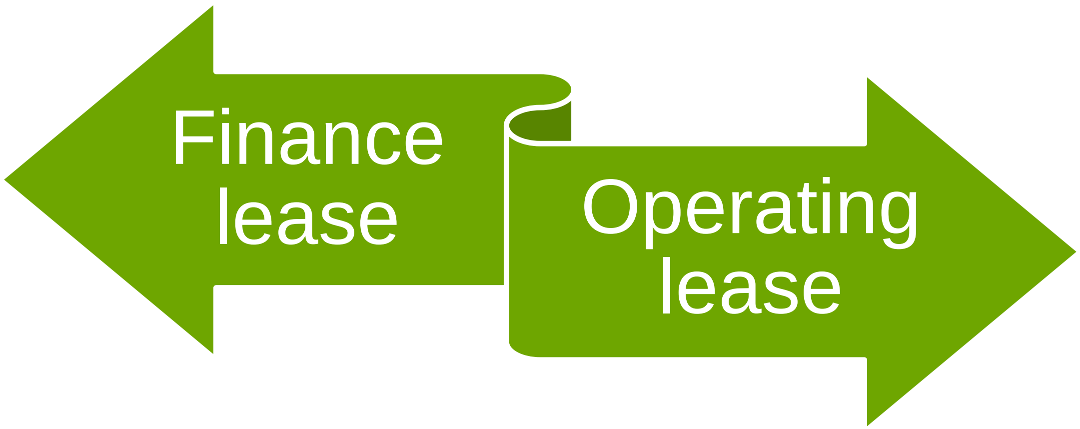
Lessor accounting



- Lessor accounting requirements are similar to NZ IAS 17's:
  - the distinction between finance and operating leases is retained.
  - the definitions of each type of lease, and the supporting indicators of a finance lease, are substantially the same
  - the basic accounting mechanics are also similar, but with some different/more explicit guidance in a few areas such as sub-leases.

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Sale and leaseback accounting

Determine whether the transfer of the asset is a sale

- Apply IFRS 15
- Presence of a leaseback does not preclude a sale

Transfer is a sale

Seller-lessee will:

- derecognise the underlying asset
- recognise the sale at fair value
- recognise only the gain/loss that relates to the rights transferred to buyer-lessor
- recognise a ROU asset as proportion of previous carrying amount of underlying asset
- recognise a lease liability

Transfer is not a sale

Seller-lessee will:

- not derecognise the underlying asset
- recognise a financial liability – NZ IFRS 9/NZ IAS 39

Buyer-lessor will:

- not recognise the transferred asset
- recognise a financial asset – NZ IFRS 9/NZ IAS 39

Sale and leaseback accounting
Example

- SellCo sells a super yacht to BuyCo for cash of CU1,800,000, which is its fair value at that date
- the previous carrying value of the yacht is CU1,000,000
- at the same time, SellCo enters into a lease with BuyCo conveying back the right to use the super yacht for 18 years
- annual payments are CU120,000 payable at the end of each year, which is at market rate
- the transfer qualifies as a sale based on the guidance on satisfying a performance obligation in IFRS 15.
- the rate implicit in the lease is 4.5%

Sale and leaseback accounting
Example – Analysis

(a) SellCo

- present value of the annual payments

  = **CU1,459,200** (18 payments of CU120,000, discounted at 4.5%).
- right-of-use asset retained through the leaseback

  = CU1,000,000 x [CU1,459,200/CU1,800,000] = **CU810,667**
- total gain on sale of super yacht

  = CU1,800,000 – CU1,000,000 = **CU800,000**
- total gain on sale is split into:
  - o the portion relating to the rights to use the building retained by SellCo

    = CU800,000 x [CU1,459,200/CU1,800,000] = **CU648,533**
  - o the portion relating to the rights retained in the underlying asset at the end of the leaseback by BuyCo

    = CU800,000 x [(CU1,800,000 – CU1,459,200)/CU1,800,000] **= CU151,467**

Sale and leaseback accounting Example – Analysis (Continued)

At the commencement date, SellCo's accounting entries are:

	Dr. CU	Cr. CU
Cash	1,800,000	
Right-of-use asset	810,667	
Buildings		1,000,000
Gain on sale		151,467
Lease liability		1,459,200

(b) BuyCo

At the commencement date, BuyCo's accounting entries are:

	Dr. CU	Cr. CU
Building	1,800,000	
Cash		1,800,000

BuyCo classifies the lease as an operating lease taking into account, among other things, that the present value of the lease payments is 19% less than the fair value of the super yacht. BuyCo accounts for the lease accordingly.

What is in IFRS 16?

- Scope
- Definition of a lease
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Presentation

Lessees are required to:

Balance sheet

- either present right-of-use assets separately from other assets on the balance sheet or disclose separately in the notes
- either present lease liabilities separately from other liabilities on the balance sheet or disclose separately in the notes

Income statement

- show interest expense on the lease liability separately from the depreciation charge for the right-of-use asset

Statement of cash flows

- present cash payments for the principal portion of the lease liability within financing activities
- present cash payments for the interest portion either within operating or financing activities in accordance with NZ IAS 7

Presentation

For lessors:

- largely the same as IAS 17's requirements
- in summary:
  - o for finance leases the net investment is presented as a receivable in the balance sheet
  - o assets subject to operating leases are presented according to the nature of the underlying asset

Disclosures

Disclosure objective: to enable users of financial statements to assess the effect leases have on the financial position, financial performance and cash flows of the lessee.

Lessees	Lessors

• breakdown of lease expense (including depreciation, interest, expense for short-term or low value leases, variable lease payments not included in lease liabilities)
• total lease cash outflows
• additions to ROU assets
• gains or losses from sale and leasebacks
• maturity analysis of lease liabilities
• carrying amount of ROU assets by class of underlying asset
• additional information, if relevant (eg. extension and termination options, variable lease payments (VLPs), residual value guarantees)
• single location; table of quantitative disclosures
	• finance leases: selling profit or loss, finance income, lease income on VLPs, changes in the net investment, maturity analysis
	• operating leases: lease income, NZ IAS 16 requirements, maturity analysis
	• additional information necessary to meet the disclosure objectives, including but not limited to:
	  • nature of leasing activities
	  • how the risk associated with any rights retained in the underlying asset is managed
	• table of quantitative disclosures

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IFRS 16: Leases

- Presentation and disclosure consequences
- Common application issues
- Transition and implementation

Transition

- Full retrospective application
  - with restatement of comparative in accordance with IAS 8
- Partial retrospective application
  - without restating comparatives
    - the cumulative effect of initially applying IFRS 16 is recognised as an adjustment to equity at date of initial application (DOIA)
    - lessors are not required to make any adjustment, except lessors with sub lease
    - relief from reassessing whether contracts in place actually contain a lease

Optional reliefs

- low value assets leases and leases which end within 12 months of DOIA
- use of a single discount rate for a portfolio of leases with reasonably similar characteristics
- relying on IAS 37 “onerous contracts” assessment instead of an impairment review on transition (in which case the right to use asset is reduced by the amount of any onerous lease provision)
- excluding initial direct costs from the right-to-use asset(s)
- use of hindsight in determining the lease term if lease contains extension or termination options

Consequences of partial transition

- lease liability at DOIA is measured at PV of remaining leases, discounted at the incremental borrowing rate at DOIA
- choice for right-to-use asset
  - Carrying amount as if IFRS 16 had applied since commencement, but discounted at incremental borrowing rate
  - Amount of lease liability adjusted for prepaid or accrued rentals
- the right-to-use asset is measured at FV at the DOIA for leases of investment property accounted for as operating leases, but to which the IAS 40 FV model will apply in future

Effective date & transition

- effective from 1 January 2019
  - early application permitted if IFRS 15 is also applied
- lessees are permitted to choose between two transition methods and apply the election consistently to all leases
  - full retrospective approach
  - partial retrospective approach
- lessors are not required to make any adjustments on transition
  - except for intermediate lessors in a sub-lease
- neither lessees nor lessors are required to reassess whether contracts are, or contain, a lease
  - option to be applied to all contracts that are ongoing at the date of initial application

Effective date & transition
Partial retrospective approach (Lessees)

Existing operating leases

- do not restate comparative periods
- lease liability = present value of remaining lease payments
- choice of measurement of ROU asset
- practical expedients, e.g:
  - exemption for low-value & short-term assets
  - rely on onerous lease assessment
  - Exclude initial direct costs from ROU asset
  - may use hindsight only if lease contains extension or termination options

Existing finance leases

- carry forward asset and lease liability from IAS 17

Session recap

IFRS 15: Revenue from Contracts with Customers

- Transition and implementation
- Common application issues
- Presentation and disclosure consequences

IFRS 16: Leases

- Presentation and disclosure consuquences
- Common application issues
- Transition and implementation

Questions & Feedback

Disclaimer

- This presentation is not a comprehensive analysis of the subject matters covered and may include proposed guidance that is subject to change before it is issued in final form. All relevant facts and circumstances, including the pertinent authoritative literature, need to be considered to arrive at conclusions that comply with matters addressed in this presentation. The views and interpretations expressed in the presentation are those of the presenter and the presentation is not intended to provide accounting or other advice or guidance with respect to the matters covered.