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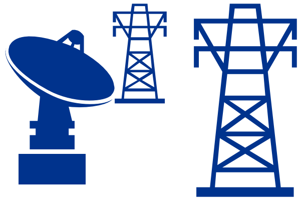
IFRS® 15 Revenue: The five step model

December 2019

Why is this important?

- The new revenue standard affects almost all entities.
- Revenue is a key metric for many entities.
- IFRS 15 introduces a new five step model for the timing and amount of revenue.
- It introduces comprehensive application guidance on specific issues of revenue generating transactions.

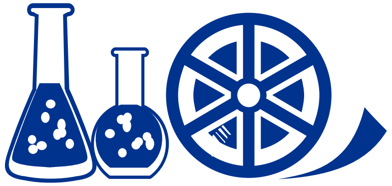
Some key sectors impacted



Telecommunication and cable

Real estate and construction

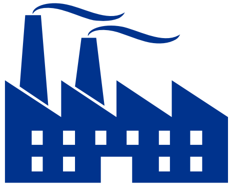
Software



Licensors – pharma, film and entertainment franchisors

Aerospace and defence

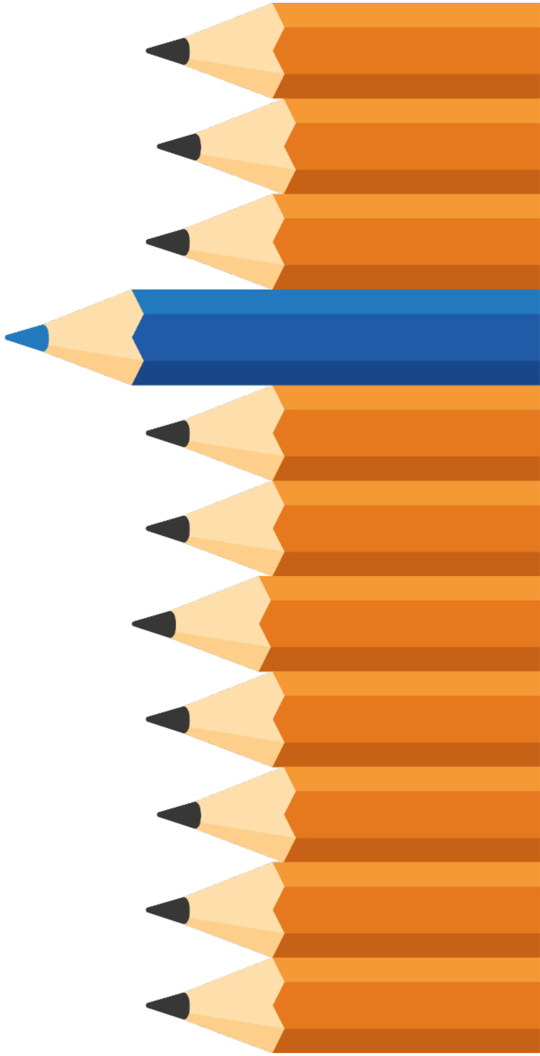
Asset managers



Contract manufacturers

Agenda

1. Overview and scope
2. The five step model
3. Key points to remember!



Overview and scope

Development of IFRS 15

In May 2002 the project on revenue was added to the IASB's agenda.

In June 2010 the IASB released an exposure draft.

In November 2011 the IASB released an exposure draft (revised).

In May 2014 the IASB issued IFRS 15 *Revenue from Contracts with Customers*.

In April 2016 the IASB issued the Clarifications to IFRS 15.

This new Standard is effective for annual periods beginning on or after 1 January 2018.

Changes to the cor principle

	Previous requirements		IFRS 15 requirements
Recognise revenue	on the basis of the transfer of risks and rewards	→	on the basis of the transfer of control of the promised goods or services
Measure revenue	at the fair value of the consideration receivable	→	at the amount of consideration to which the entity expects to be entitled to
Specified transactions	Provide very limited guidance	→	• Licences of intellectual property • Principal versus agent considerations • Options to purchase additional goods or services • Repurchase agreements • Non-refundable upfront fees • Warranties …
Contract costs	Provide no relevant guidance	→	• Costs to obtain a contract • Costs to fulfil a contract

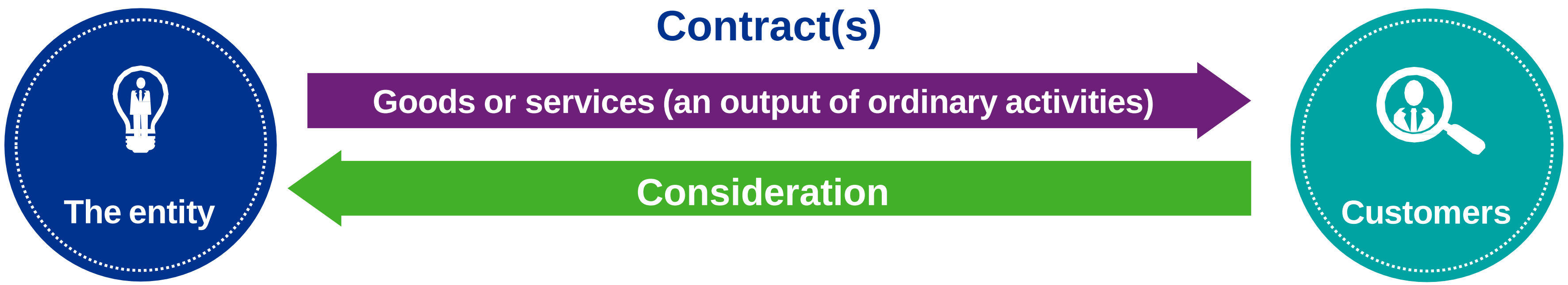
The five step model overview

STEP 1	Identify the contract(s) with a customer
STEP 2	Identify the performance obligation(s) in the contract
STEP 3	Determine the transaction price
STEP 4	Allocate the transaction price to the performance obligations in the contract
STEP 5	Recognise revenue when (or as) the entity satisfies a performance obligation

The core principle

An entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

Scope



Except the following:

- lease contracts (IFRS 16);
- insurance contracts (IFRS 4);
- financial instruments and other contractual rights or obligations (IFRS 9, etc.);
- non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers.

To separate relevant parts of the contract if partially in the scope of the revenue and other standards

The five step model

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Identify the contract

STEP
1

A contract exists if...

... collection of consideration is considered probable.

... rights to goods or services and payment terms can be identified.

... it has commercial substance.

... it is approved and the parties are committed to their obligations.

Combining contracts

STEP
1

Contracts may be combined and accounted for as a single contract.

IFS 15

Contract 1 **Contract 2**

Contracts are combined if entered into at or near the same time with the same customer (or its related parties) and one or more of the following criteria are met.

- Negotiated as package with a single commercial objective.
- Consideration in one contract depends on the other contract.
- Goods and services are a single performance obligation.

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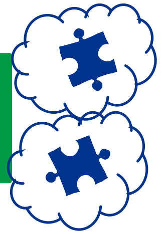
Identify performance obligations

STEP 2

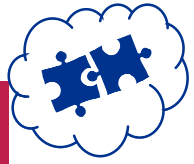
Performance obligation (PO) = promise to deliver good or service that is

Criterion 1: Capable of being distinct	+	**Criterion 2: Distinct within context of the contract**
Can the customer benefit from the good or service either on its own or together with readily available resources?		Promise to transfer the good or service is separately identifiable from other promises in the contract?

Yes → Distinct performance obligation



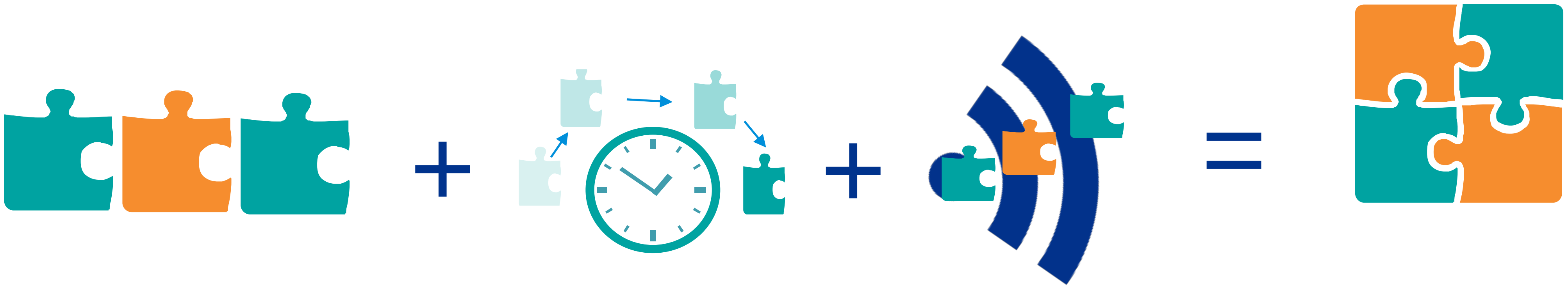
No → Not distinct – combined with other goods and services



Identify performance obligations – series exception

STEP
2

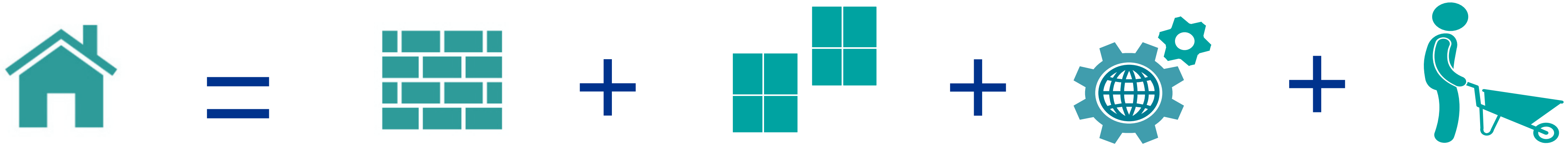
A series of distinct goods or services is treated as a single performance obligation if the criteria below are met.



Distinct goods or services are substantially the same + Each distinct good or service is satisfied over time + Same pattern of transfer = Single performance obligation

Single performance obligation?

STEP
2



Contract to build a house

Bricks

Windows

Fittings

Construction service

Do the goods and services individually meet the criteria?

Criterion 1 – Benefit on its own or with other resources

Each material could be used with another readily available item.

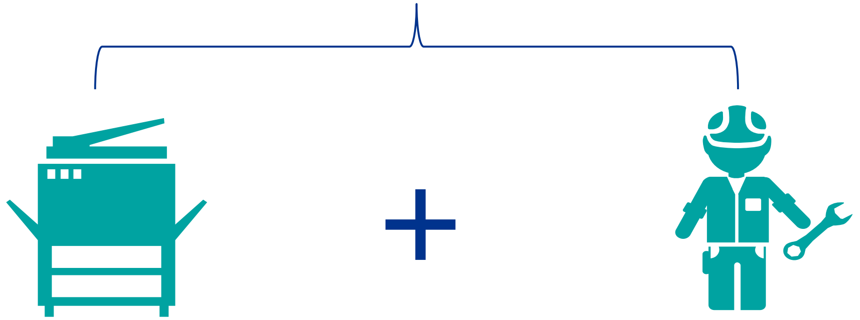
Criterion 2 – Good or service is separately identifiable

Entity is providing a significant integration service.

Multiple performance obligations?

STEP 2

Contract



Machine + Standard installation

Installation services are also offered by third party providers.

Does the machine meet the performance obligation criteria?

Criterion 1 – Benefit on its own or with other resources	**Criterion 2 – Good or service separately identifiable**
✓ Machine can be used with other available inputs (such as third party installation).	✓ No significant integration service; installation is a standard service.

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Determine the transaction price

STEP 3

Variable consideration and the constraint

Consideration payable to a customer

…reduction to the transaction price unless it's a payment for a distinct good or service.

Transaction Price

Non-cash consideration

…measured at fair value unless it cannot be reliably measured.

Significant financing component

Exception: Variable consideration is not estimated for sales- or usage-based royalties on licences of intellectual property.

Variable consideration

STEP
3

Variable consideration can be

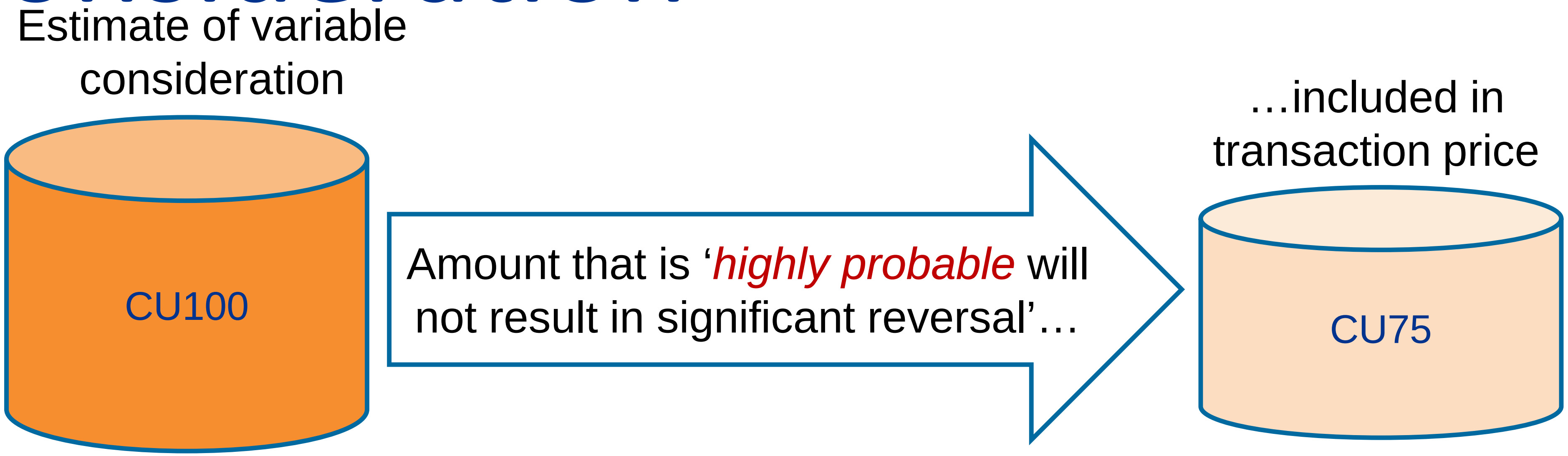
- Discounts
- Credits
- Incentives
- Performance bonuses
- Many more...

Variable consideration is estimated using most appropriate method of either:

- Expected value
- Most likely amount

Constraint on variable consideration

STEP
3

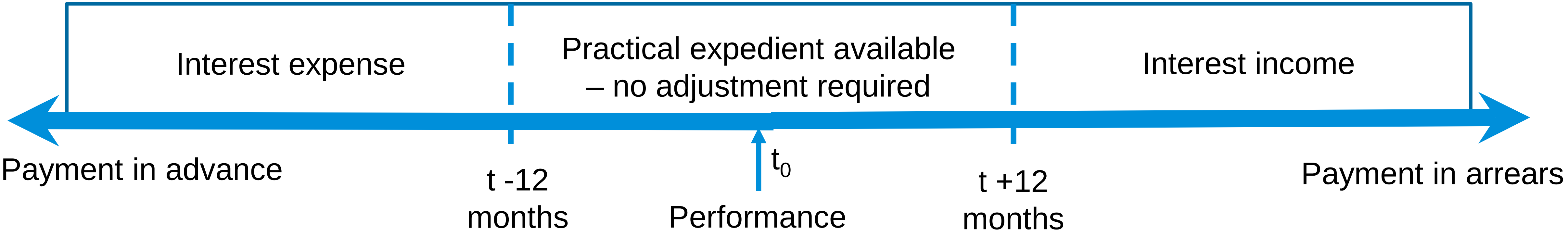


Qualitative Assessment

- The risk of a reversal arising from an uncertain future event.
- The magnitude of the reversal if the uncertain event occurs.

Significant financing component

STEP 3



To make the assessment all relevant factors are considered – in particular the:

- Difference between the transaction price and the cash selling price of the goods or services;
- Combined effect of the length of time between payment and performance and the prevailing interest rates;
- Other reasons for the payment terms.

Discount rate

- Interest rate that would be used in a separate financing transaction between the entity and customer.

Significant financing component

STEP 3

No significant financing component in the contract if any of these factors exist:

The timing of the transfer of goods to the customer is **at the customer's discretion** -

- E.g. prepaid minutes on a phone card; or
- customer award points.

A substantial portion of the consideration is **variable** and resolution of the variability **is outside the control of the entity and the customer** -

- E.g. a sales-based royalty

The difference between the promised consideration and the cash selling price of the good or service arises **for non-finance reasons**, and the difference between those amounts **is proportional to** the reason for the difference -

- E.g. protection against the counterparty not completing its obligations under the contract.

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Allocate transaction price to performance obligations

STEP 4

Allocate based on relative stand-alone selling prices

Performance obligation 1

Performance obligation 2

Performance obligation 3

Fair value measurement

Determine stand-alone selling prices

Best evidence

Observable price

If not available

Estimate price

Adjusted market assessment approach

Expected cost plus a margin approach

Residual approach only if selling price is highly variable or uncertain

Estimating the selling price - example

STEP 4

Two year contract – CU650

Phone

Data, calls and texts plan

Entity sells phone and plan separately

CU350

24 month plan for CU15 per month – CU360 (24XCU15)

Methods for estimating stand alone selling price

- Observable price
- Adjusted market
- Cost plus
- Residual

Transaction price allocated to phone = CU650 x (CU350/CU710) = CU320
Transaction price allocated to plan = CU650 x (CU360/CU710) = CU330

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Recognise revenue

STEP 5

Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.

Model based on transfer of control of the promised goods or services

Over time		At a point in time
If one of the relevant criteria is met	or	If none of the relevant criteria is not met

Performance obligations satisfied over time

STEP 5

An performance obligation is satisfied over time if either:

1	Customer simultaneously receives and consumes the benefits as the entity performs.	Routine or recurring services.
2	The customers controls the asset as the entity creates or enhances it.	Asset built on customer's site.
3	The entity's performance does not create an asset with an alternate use and there is a right to payment for performance to date.	Asset built to order.

Measuring performance over time

STEP 5

For each performance obligation an entity chooses a method that depicts its performance.

Output method	**Input method**
▪ Surveys	▪ Costs incurred
▪ Milestones reached	▪ Labour hours
▪ Units delivered	▪ Machine hours

- Units delivered and similar methods not appropriate if work in progress is material.
- Adjustments required for wastage and uninstalled materials when cost method used.

Performance obligations satisfied at a point in time

STEP 5

Recognise revenue when customer obtains control of the promised asset.

Indicators that control has transferred include the customer has…

- A present obligation to pay
- Legal title
- Physical possession
- Risks and rewards of ownership
- Accepted the asset

Exception: Separate requirements for distinct licences of intellectual property.

Application guidance on specific issues

- Performance obligations satisfied over time
- Methods of measuring progress
- Sale with a right of return
- Warranties
- Principal vs. agent considerations
- Customer option for additional goods or services
- Customers’ unexercised rights
- Non-refundable upfront fees
- Licensing
- Repurchase agreements
- Consignment arrangements
- Bill-and-hold arrangements
- Customer acceptance
- Disclosure of disaggregated revenue

Warranties

Does the customer have the option to purchase the warranty separately?

Yes → Performance obligation (i.e. service warranty)

No ↓

Are services in addition to assurance that the product complies with agreed specifications provided as part of warranty?

Yes → Performance obligation (i.e. service warranty)

No ↓

Not a separate performance obligation (i.e. assurance warranty)

Apply IAS 37

STEP 2

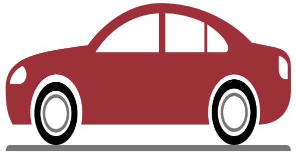
STEP 4

Factors to consider when making the assessment:

Is it required by law?	Length of the warranty?	What tasks are performed?

Warranties – example

Car manufacturer N sells to Customer A



Car

+

Standard warranty:
3 years or 36,000 miles

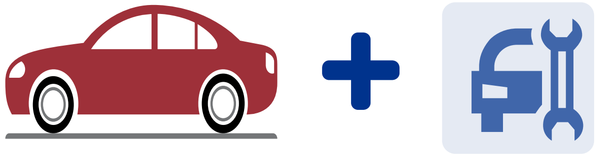
+

Extended warranty:
extra 3 years or up to
70,000 miles for CU5,000

How many performance obligations are there in the contract?

Warranties – example solution

Performance obligations



AND

Car and standard warranty

Extended warranty

Standard warranty is an assurance type warranty

Apply IAS 37

- The customer has the option to purchase the extended warranty separately.
- The extended warranty provides additional services to the customer.

Contract costs

Costs to obtain a contract

Capitalise incremental costs if:

- ✓ Incurred only as result of obtaining the contract
- ✓ Recovery is expected

(e.g. sales commission)

Practical expedient: Amortisation period < 1 year? Expense costs as incurred

Costs to fulfil a contract

Capitalise as fulfilment costs if:

- ✓ Not in the scope of another standard
- ✓ Directly related
- ✓ Generate or enhance resources
- ✓ Recovery is expected

Subject to amortisation (on a systematic basis, consistent with the pattern of transfer of the good or service to which the asset relates) and impairment assessment if capitalised

Key points to remember!

Key points to remember!

- New revenue standard will impact all entities, in different ways. It requires new estimates and judgements
- The 5-step model:
  - Separating goods and services in contract
  - Variable consideration and the constraint
  - Transaction price allocated using selling prices not fair value
  - New guidance on recognising revenue over time
- Specific application guidance in addition to the general requirements of the 5-step model.
- New requirements to capitalise costs of obtaining a contract.

Resources from KPMG

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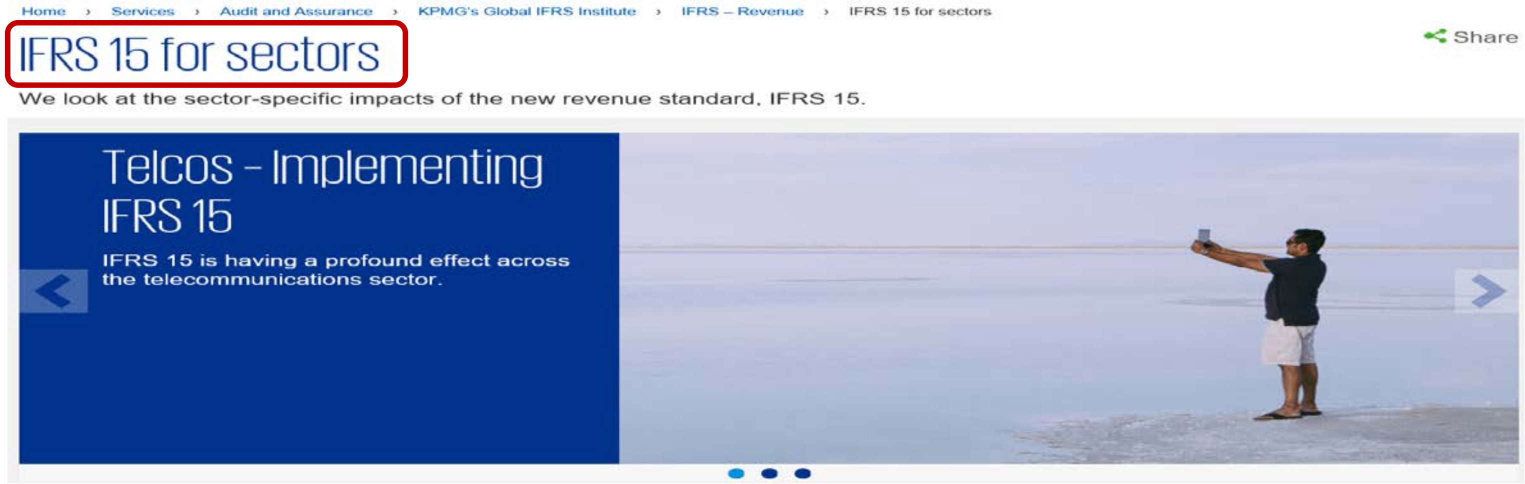

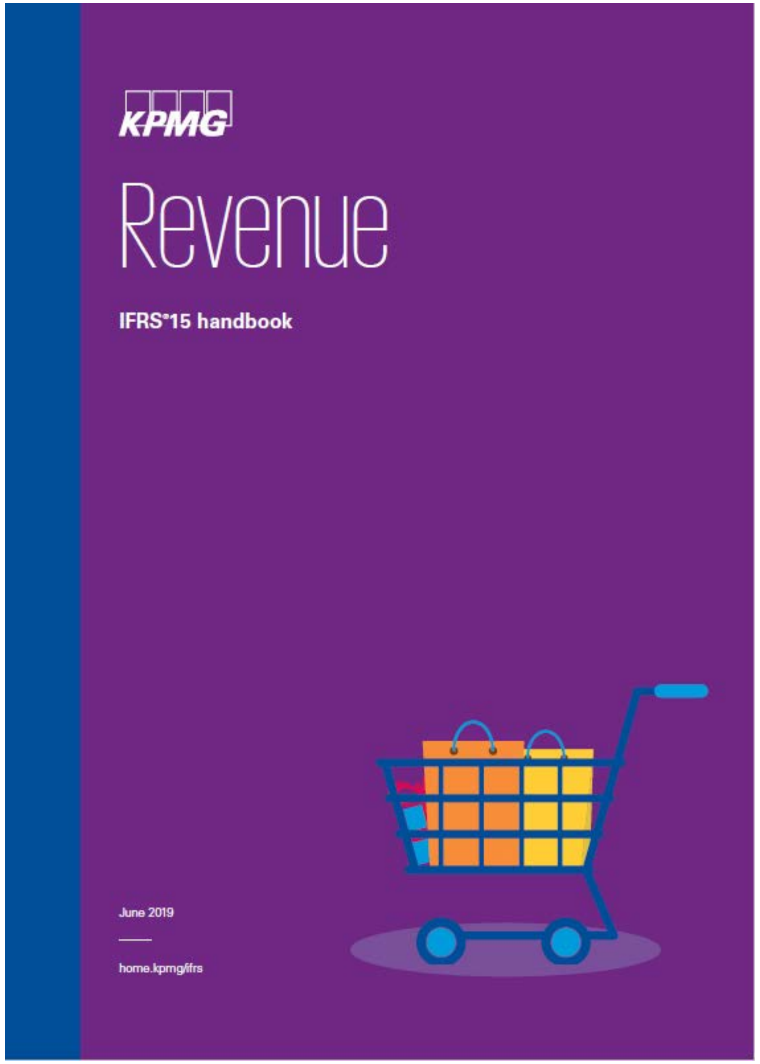

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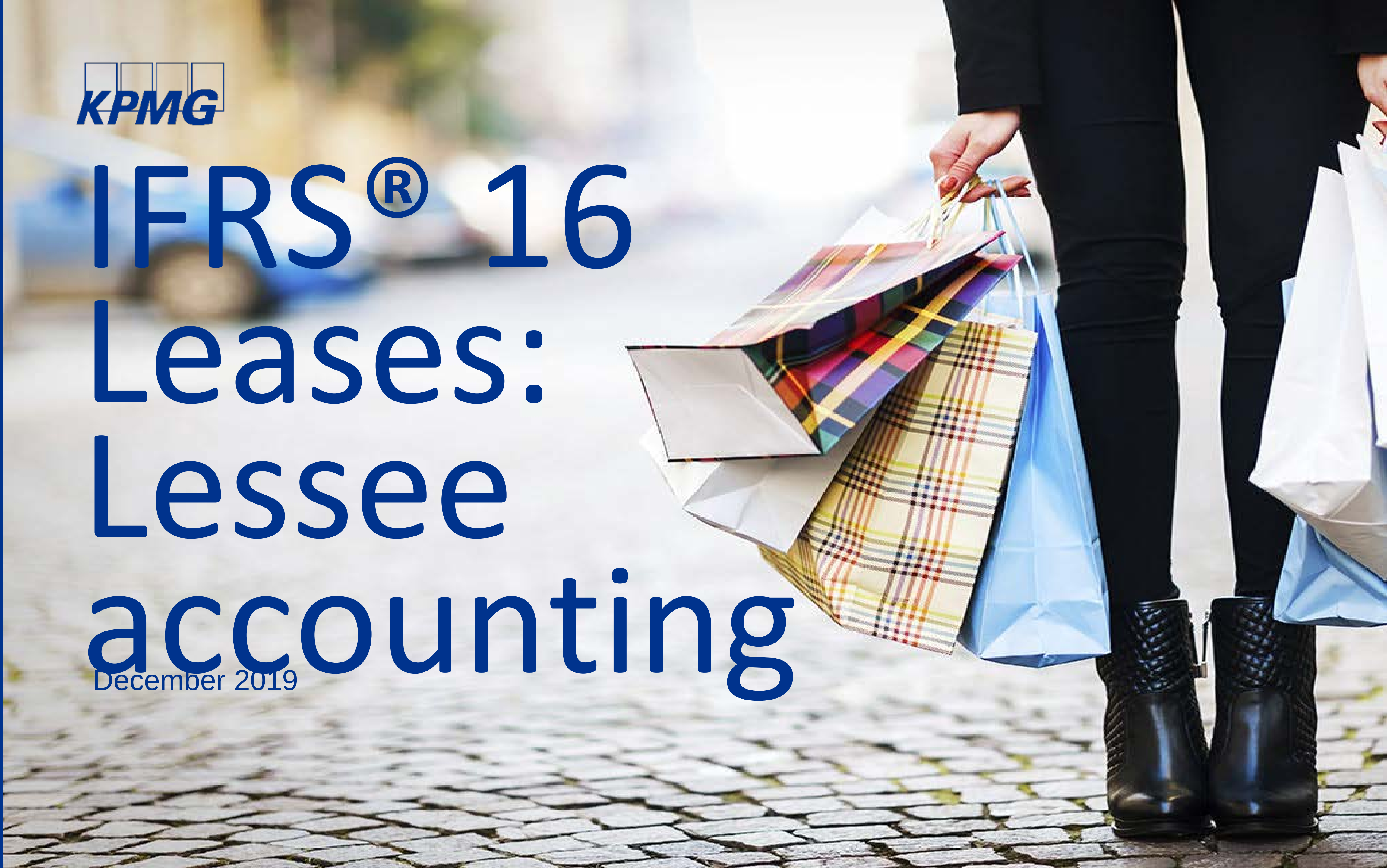
IFRS® 16 Leases: Lessee accounting

December 2019



Why is this important?

- Radical overhaul of lessee accounting.
- Significant changes in key reporting metrics due to an increase in reported assets and liabilities.
- Many judgemental issues.
- Impact on terms and structures of lease agreements/business models.
- Controversial standard that the company's stakeholders/investors will want to understand the impact on the business.

The $3 trillion standard

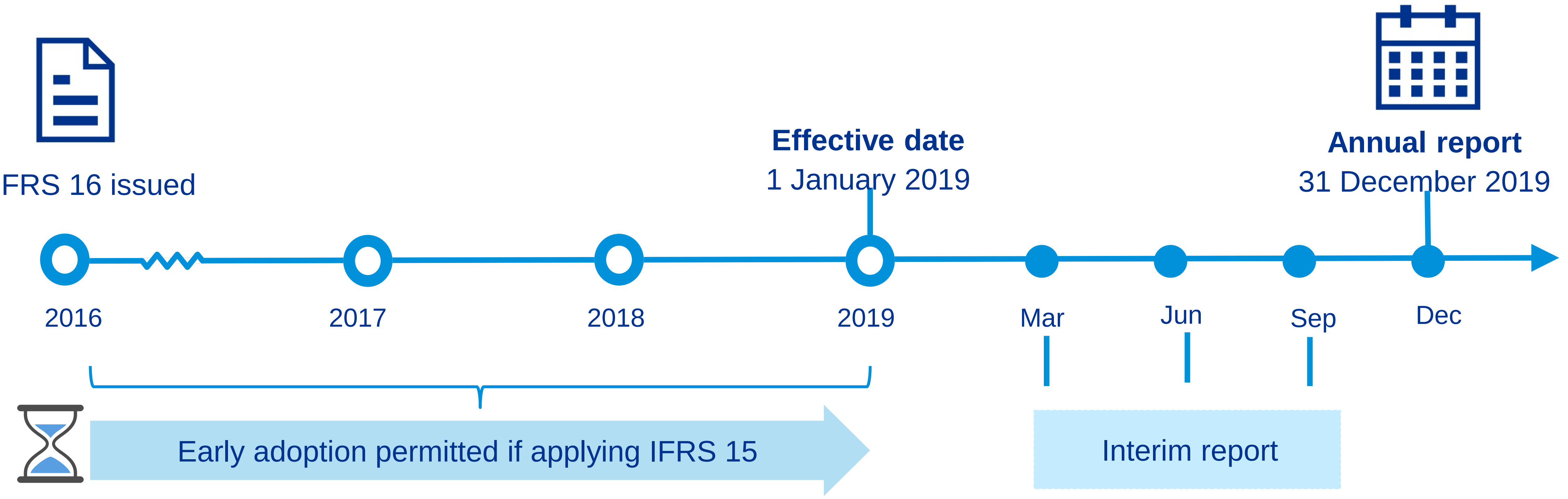
“One of my great ambitions before I die is to fly in an aircraft that is on an airline’s balance sheet…”

Sir David Tweedie
April 2008

“Listed companies are estimated to have US$3.3 trillion of lease commitments, over 85% of which do not appear on their balance sheets…”

Hans Hoogervorst
January 2016

Effective date



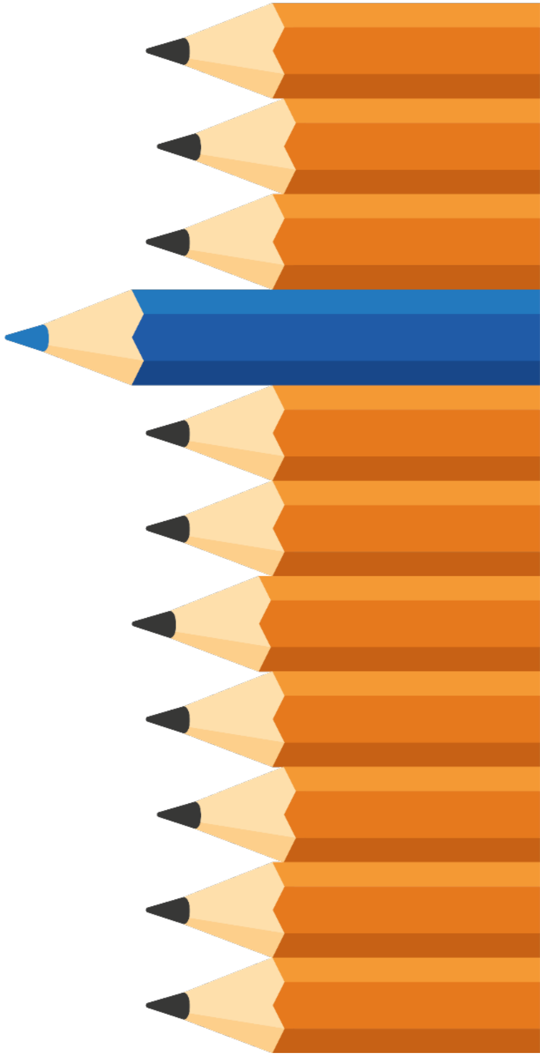
IAS 17 to IFRS 16 – transition impact

Lessee operating lease	Lessee finance lease	Lessor operating lease	Lessor finance lease
Full retrospective	Full retrospective	No adjustment	
Modified retrospective with practical expedients	Modified retrospective		
High	Medium	Low	

what's THE IMPACT ?

Agenda

1. New definition
2. Overview
3. Initial measurement
4. Subsequent measurement
5. Key points to remember!



New definition

Lease definition

The new on/off-balance sheet test for lessees – a key judgement area

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.

	Lease classification test	ON	OFF
New standard	✗	**Lease**	**Service**
Old standard	✓	**Finance lease**	**Operating lease/ Services**

Overview of lease definition

Identified asset? — No → Contract does not contain a lease

Yes ↓

Lessee obtains substantially all of the economic benefits? — No → Contract does not contain a lease

Yes ↓

Lessee directs the use? — No → Contract does not contain a lease

Yes ↓

Contract is or contains a lease

No

Contract does not contain a lease

Exemptions for lessees

Short term leases

≤ 12 months and
no purchase option

Leases of low value items

≤ USD5,000
(for example)
and not subject to a sublease

Lessors

Lessee accounting – overview

Single lease accounting model

Balance sheet

Asset

= 'Right-of-use' (ROU) of underlying asset

Liability

= Obligation to make lease payments

P&L

Lease expense

Depreciation

\+ Interest

= Front-loaded total lease expense

Sir David Tweedie’s aircraft

Five year lease of an aircraft

CU1,000,000 per annum due at 31 Dec

No renewal no purchase option

Discount rate: 7%

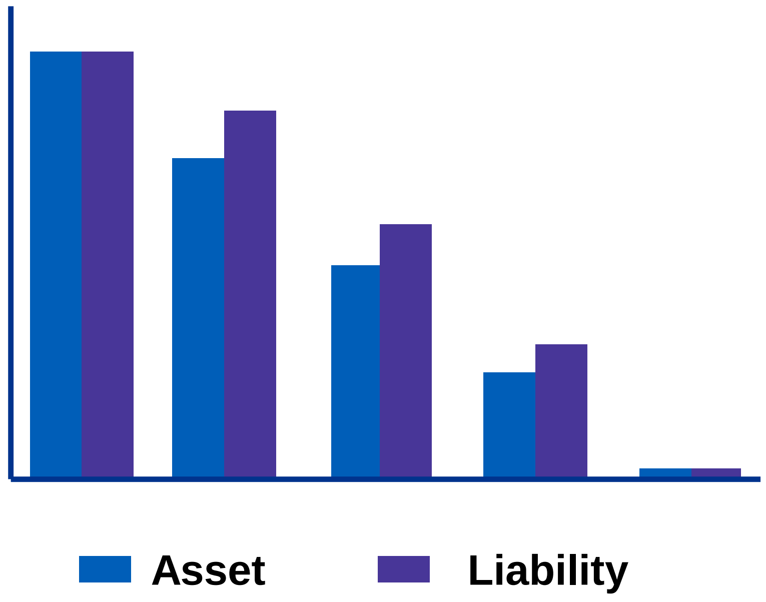
Aircraft useful life: 20 years

Journal entries

1 January 20X1	Debit (CU)	Credit (CU)
ROU asset (present value of 5 x CU1,000,000 @ 7%)	4,100,000	
Lease liability		4,100,000
31 December 20X1		
Depreciation expense (CU4,100,000/5)	820,000	
ROU asset		820,000
Interest expense (CU4,100,000 * 7%)	287,000	
Total P&L expense	**1,107,000**	
Lease liability	713,000	
Cash		1,000,000

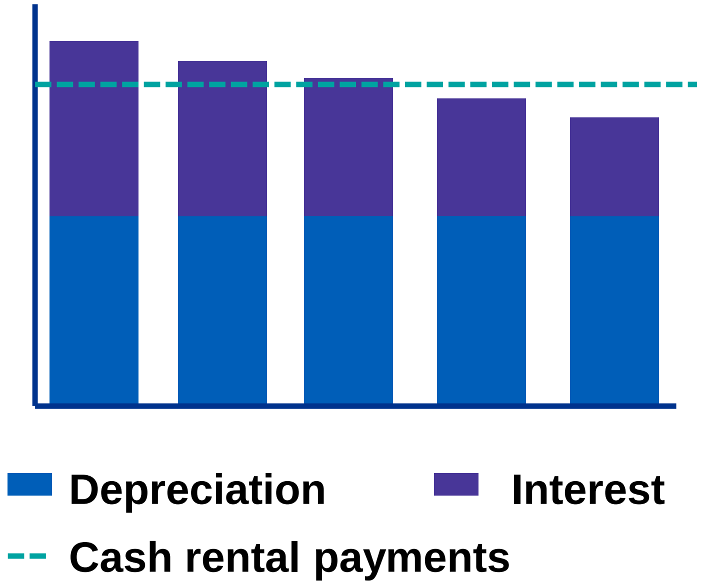
What’s the impact?

Balance sheet



- Airline appears to be more ***asset-rich***, but also more ***heavily indebted.***

Profit/loss



- Total lease expense is ***front-loaded*** even when cash rentals are constant.

Impact on financial ratios

	Profit/loss	Balance sheet	Ratios
↑	EBITDA	Total assets	Gearing
↓	EPS (in early years)	Net assets	Interest cover Asset turnover

Lessee accounting – initial measurement

Measuring the lease liability

Lease liability = **Present value of lease rentals** + **Present value of expected payments at end of lease**

Lease term

Lease payments

Discount rate

Lease term

Lease term = ***Non-cancellable*** period + Optional renewal periods if lessee ***reasonably certain*** to exercise + Periods after optional termination date if lessee ***reasonably certain not*** to exercise

Lease term – example

Five year lease of a machine

CU10,000 annually at 31 Dec (current market rate)

Option to ***terminate*** after 12 months for significant penalty

Option to ***renew*** for two further periods of 5 years, each at market rate

Lessee uses the machine to manufacture car parts, which it must supply for 10 years

Significant installation cost

"Why is the lease term important?"

Lease term?	Lease liability*
1 year	CU9,000
5 years	CU41,000
10 years	CU70,000
15 years	CU91,000

* Based on 7% discount rate

Lease payments

Lease payments

Fixed payments (include in-substance fixed payments)

Termination penalty (if termination is ***reasonably certain***)

Purchase options (exercise price if ***reasonably certain***)

Residual value guarantees (***expected*** amount payable)

Variable lease payment based on ***index or rate***

Lease payments – include in lease liability?

Termination penalties	Exercise price of purchase option	Variable payments based on sales or usage	Variable payments based on an index or rate	Residual value guarantee
?	?	✗	✓	?
Based on assessment of lease term	If reasonably certain to exercise		Based on current value of index or rate	Based on expected payment

Discount rate

The rate implicit in the lease, if readily available

OR

The lessee's incremental borrowing rate

Lessor

"Why is the discount rate important?"

Discount rate	Lease liability (5 year lease @ CU10,000 per annum)
3%	CU46,000
5%	CU43,000
7%	CU41,000
10%	CU38,000

Incremental borrowing rate - lessee

Interests payable by a lessee… (lessee's debt paying ability and credit status)

Funds borrowed for obtaining an asset with similar value as the ROU asset (i.e. amount of lease liabilities)	
Similar security (i.e. nature and quality of the underlying asset)	
Similar term (i.e. lease term)	
Similar economic conditions (including jurisdiction, pricing currency, date at which the contract is entered into, etc.)	

Measuring the right-of-use (ROU) asset

ROU asset

=

Lease liability + Initial direct costs + Prepaid lease payments + Costs to dismantle or restore (IAS 37) − Lease incentives

Lessee accounting - subsequent measurement

Subsequent measurement

Lease liability	▪ Amortised cost using the effective interest method.
ROU asset (cost model)	▪ Depreciated in accordance with IAS 16 *Property, Plant & Equipment*. ▪ Depreciation period is the shorter of lease term/useful life. ▪ Impairment testing under IAS 36 *Impairment.*
ROU asset (alternative models)	▪ Revaluation model under IAS 16. ▪ Fair value model under IAS 40 *Investment Property.*

Re-measurement of lease liability

Re-measure to reflect reassessment of any changes in:

▪ Expected amount payable on the residual value guarantee ▪ Index or rates ▪ In-substance fixed payments	**A**
▪ Lease term ▪ Floating interest rates ▪ Assessment of purchase options	**B**

For each trigger:
Which discount rate ?

A. Unchanged discount rate ?

B. Revised discount rate ?

Re-measurement of ROU asset

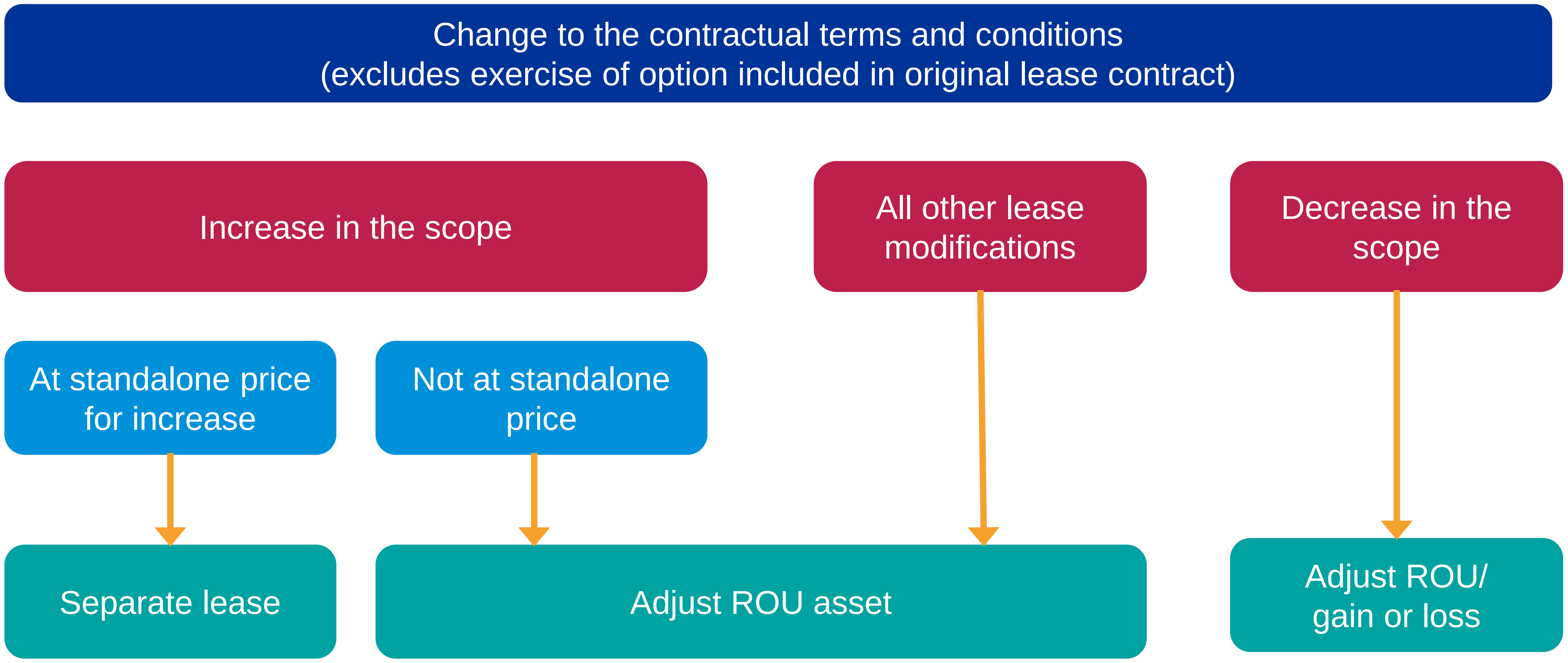
Changes in carrying amount of lease liability due to:

- Reassessment of lease term, purchase option and residual value guarantee
- Reassessment of in-substance fixed payments and variable lease payments depending on an index or rate
  - Relates to future periods
  - Relates to current period
- Variable lease payments not depending on an index or rate

Adjust ROU assets
(recognise in profit or loss if zero balance)

Recognise in profit or loss

Lease modifications



Key points to remember!

Key points to remember!

- Lease definition changes – assessing whether there is a lease can be very judgemental.
- Lessee recognises leases on-balance sheet – IFRS 16 changes many financial ratios.
- Lessee-only exemptions for short term leases and leases of low value items.
- New requirements may be complex to apply and require significant judgement.

Resources from KPMG

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IFRS - Leases

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Share

Insights and analysis on the impact of the new leases standard, IFRS 16.

Leases handbook

The unit of account for lease accounting

Chapters released to date

- **Transition**
  - Transition options
- **The lessee model**
  - Lease definition
  - Discount rates
  - Lease payments
- **Ongoing application**
  - Lease modifications
  - Lease components
- **Sector-specific**
  - Real estate: The tenant perspective

Thank you