Guide to new Standards
IFRS 9, IFRS 15, IFRS 16
and research opportunities

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Agenda

- Introduction and objectives
- IFRS 9 *Financial Instruments*: the basics
- IFRS 15 *Revenue from Contracts with Customers*: the basics
- IFRS 16 *Leases*: the basics
- Wrap up
Introduction and objectives
Changes ahead – are they worth it?
## Messages on the new Standards

<table>
<thead>
<tr>
<th>Effective 2018</th>
<th>Effective 2019</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financial Instruments</strong></td>
<td><strong>Revenue</strong></td>
</tr>
<tr>
<td>Users disappointed in disclosure prior to effective date</td>
<td>Mixed news on visibility in first interims</td>
</tr>
<tr>
<td><strong>Classification &amp; Measurement</strong></td>
<td><strong>Impairment</strong></td>
</tr>
<tr>
<td>Limited changes in classification overall</td>
<td>Significant challenge, but some benefits for risk management &amp; governance</td>
</tr>
<tr>
<td>More practice questions than expected</td>
<td>Generally manageable effect on regulatory capital</td>
</tr>
<tr>
<td>Disclosure should be a big gain</td>
<td>Many may have limited quantitative impact</td>
</tr>
</tbody>
</table>
Don’t forget about disclosure

Effective date
IFRS 9, 15
FYE
December

1 Jan 2018
31 March 2018
31 Dec 2018

First interim financial statements
First annual financial statements

2017 f/s: IAS 8 disclosures
Separating impact of accounting change from results of period
IFRS 9 *Financial Instruments*: Overview of the basics
IFRS 9 at a glance

- Issued in 2014
- Effective annual reporting periods from 1 January 2018
- Replaces IAS 39

Key points:
- Classification and measurement
  - a logical, single classification approach driven by cash flow characteristics and how financial instruments are managed
- Impairment
  - forward-looking ‘expected loss’ model
- Hedge accounting
  - better aligns accounting with risk management
Classification and measurement

IFRS 9 Financial Instruments
Classification of financial assets

Useful information about the future cash flows

Approach

Business model + Contractual cash flows
**IFRS 9 classification of financial assets**

<table>
<thead>
<tr>
<th>Cash flows are solely payments of principal and interest (SPPI)</th>
<th>Business model = hold to collect</th>
<th>Business model = hold to collect and sell</th>
<th>Other business models</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortised cost</td>
<td>FVOCI*&lt;br&gt;Balance sheet: FV&lt;br&gt;Profit or loss: AC</td>
<td>FVTPL</td>
<td>FVTPL</td>
</tr>
<tr>
<td>Other types of cash flows</td>
<td>FVTPL</td>
<td>FVTPL</td>
<td>FVTPL</td>
</tr>
</tbody>
</table>

* Different from OCI category for equity investments
**Contractual cash flows characteristics**

**Amortised cost is calculated using the effective interest method.**

**Effective interest method allocates interest over the relevant time period**

**Amortised cost measurement provides useful information about the amount, timing and uncertainty of future cash flows, if...**
Solely payments of principal and interest

- **Solely payments of**
  - PRINCIPAL
    - Fair value at initial recognition
  - INTEREST
    - Time Value of Money
    - Credit risk
    - Other costs & profit
Other consideration

Alternative classification of financial assets

- Fair value option
- OCI election for particular equity instruments

Financial liabilities - own credit

- Required for all fair value option liabilities, unless doing so would create or enlarge an accounting mismatch
Impairment

IFRS 9 Financial Instruments
How accounting for credit losses improves

Addressing ‘too little, too late’
- Broader range of information to consider
- Timely recognition of credit losses
- Addresses ‘front-ending income, back-ending losses’

One impairment approach
- For all instruments in scope

Enhanced disclosures
- More information about credit risk and how it is managed
## Overview of general model

<table>
<thead>
<tr>
<th>Change in credit risk since initial recognition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected credit losses</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Interest revenue</td>
</tr>
<tr>
<td>Gross basis</td>
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<tr>
<td></td>
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<td></td>
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<tr>
<td></td>
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<tr>
<td>Net basis</td>
</tr>
</tbody>
</table>
12-month expected credit losses (ECL)

Expected [lifetime] shortfall in all contractual cash flows given probability of default occurring in next 12 months

NOT:
- Expected cash shortfalls in next 12 months
- Credit losses on instruments expected to default in next 12 months

Example:
- Portfolio of 10m loans repayable over 5 years
- 2% probability of a default occurring in next 12 months
- Entire loss that would arise on default is 10%
- 12-month expected credit losses = 20,000 (2%×10%×10m)
Measuring Expected Credit Losses

ECLs need to reflect:

- Probability-weighted outcome
  - must consider possibility that default will/will not occur

- Time value of money
  - discount at effective interest rate or an approximation thereof

- Reasonable and supportable information
  - available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions

Particular measurement methods are not prescribed – designed to accommodate different information availability
Hedge accounting

IFRS 9 Financial Instruments
Feedback on IAS 39

- Lack of an overarching principle; complex and rule-based
- Difficult for preparers to reflect hedging activities in financial statements
- Hard for users to understand risk management practices

Solutions in IFRS 9

- Align accounting treatment with risk management activity
- Enable preparers to better reflect hedging in financial statements
- Provide disclosures to help users understand risk management and its impact on the financial statements
Major improvements

- A principle-based hedge effectiveness prospective assessment … and all ineffectiveness in P&L
- Designate risk components of non-financial instruments
- Ability to hedge aggregated exposures (combinations of derivatives and non-derivatives)
- Introduction of ‘costs of hedging’ to improve the transparency around some hedging instrument
- Disclosures that meet the objectives of understanding the hedged risks, how those are managed and the effect of hedging

For now, entities can choose to continue to apply IAS 39 hedge accounting

Dynamic Risk Management is a separate project
Transition to IFRS 9

Classification and measurement

- Assessment of business model as at date of initial application
- Impracticability alternatives

Impairment

- Undue cost or effort

Restatement of comparative reporting period not required
Investor considerations

• Must fundamental change– expected credit loss model

• Some changes to measurement of financial assets and use of OCI including ‘own credit’ effect for liabilities

• AFS accounting eliminated for equity investments. *Election to use OCI (with no recycling permitted)*

• Entities may continue to apply IAS 39 hedge accounting

• Application of hedge accounting likely to change for corporates

• Improved hedge accounting disclosures for all
Research Opportunities IFRS 9

• IFRS 9 brings many changes to accounting for FI. Studies that provide evidence about the impact of these changes will be helpful. Studies may use a range of methods.

• Pre and post application: what changes in accounting practice are observed. What are the financial impacts of the changes.

• What are the effects for market participants of the changes. What market outcomes are observed.

• Specific issues – see next slides
Research Opportunities IFRS 9

1. New expected credit loss model. What is impact on reported numbers and financial ratios. How do entities’ calculations relate to economic fundamentals. How do entities, industries and countries compare in their application of the model. In the long term, how does better measurement of impairment contribute to goals such as financial stability.

2. There is no available for sale category. How many entities are affected by this change. What new policies are used. How many entities make use of the FVOCI election. What are the characteristics of these entities. How do investors respond to choices made.

3. What is the impact of new hedging requirements. Are any investor or market impacts observable. What is extent of adoption of new requirements compared to continuing to use IAS 39 requirements.

5. More disclosures are provided under IFRS 7. The Standards introduces more objective based disclosure requirements. Can researchers observe changes in entities’ disclosures because the drafting of disclosure requirements are different. What factors are associated with better disclosures under IFRS 7. Are costs or benefits of better disclosure observable.
IFRS 15: Overview of the basics
IFRS 15 at a glance

- Issued in 2014
- Effective 1 January 2018
- Replaces IAS 18 and IAS 11

Key points:
- Framework for all revenue recognition
- Developed jointly with FASB
The 5 steps to apply IFRS 15

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

Recognise revenue to depict transfer of goods or services in an amount of consideration to which the entity expects to be entitled.
Identify the contract

Existence of a contract
- Must meet specified criteria to apply the model, including collection of consideration is probable

Combine contracts
- Criteria to identify if legally separate contracts are in substance a single contract

Contract modifications
- Guidance to identify whether changes create additional new obligations or modify existing ones
**Objective:** To identify the promised goods or services that are distinct and should be accounted for separately

**Promise to transfer a distinct good or service, or series of substantially similar distinct goods or services**

**Good or service is capable of being distinct**
- Customer can benefit from good or service:
  - on its own; or
  - together with other readily available resources

**Distinct within the context of the contract**
- Is the entity’s promise to transfer:
  - each of the goods or services separately; or
  - a combined item to which the goods or services are *inputs*
Determine transaction price

• Transaction price is the amount to which the entity expects to be entitled in exchange for transferring goods or services

• Specific guidance on:

  - Variable consideration
    Estimate using:
    • Expected value
    • Most likely amount but ‘constrained’ (next slide)

  - Significant financing
    Adjust promised consideration if timing provides customer or entity with significant benefit of financing

  - Non-cash consideration
    Measure at fair value unless FV cannot be reasonably estimated

  - Consideration payable to customer
    Reduction of the TP unless in exchange for a distinct good or service
When to recognise variable consideration

Include estimate of variable consideration in the transaction price only to extent it is *highly probable* a significant reversal of revenue will not occur when uncertainty is resolved.

- Variable consideration is a broad term
  - includes rebates, refunds, price concessions
- Estimate of transaction price updated each period
- Expectations of revenue reversal assessed using 5 indicators

*Variable consideration must be assessed – no default to nil*
Allocate to each performance obligation the amount to which entity expects to be entitled in exchange for satisfying that performance obligation

- Relative standalone selling price basis
  – estimate selling prices if not observable
  – residual estimation techniques may be appropriate

- Discounts and variable amounts allocated entirely to specific performance obligation if specified criteria met
Recognise revenue when (or as) a performance obligation is satisfied

**Step 5**

*Introduction and objectives*

- As good or service is transferred
- Test: when does customer obtain control?

**Satisfied over time?**

- Percentage of completion
- Select single measure of performance that reflects progress

**When is PO satisfied?**

**If not then point in time**

- If fail criteria for POT then recognise point in time
- When entire PO is satisfied
Disclosure requirements

To enable users to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

**Revenue**
- Disaggregation of revenue
- Amounts recognised relating to performance in previous periods

**Contracts**
- Information about contract balances and changes
- Information about performance obligations
- Amounts allocated to remaining performance obligations

**Significant judgments**
- Timing of and methods for recognising revenue
- Determining the transaction price and amounts allocated to performance obligations
Application guidance on…

- Performance obligations satisfied over time
- Methods for measuring progress
- Sale with a right of return
- Warranties
- **Principal versus agent considerations**
- Customer options for additional goods or services
- Customers’ unexercised rights
- Non-refundable upfront fees
- **Licensing**
  - Point in time versus Over time
  - Royalties
- Repurchase agreements
- Consignment arrangements
- Bill-and-hold arrangements
- Customer acceptance
- Disclosure of disaggregated revenue
- **Contract costs**
Principal versus agent

Who are you?
I am a ‘principal’. I control the good or service before the customer gets it. My performance obligation is to provide the good or service...

Who are you?
I am an ‘agent’. I don’t control the good or service before the customer gets it. My performance obligation is to arrange for the good or service to be provided...

It’s all about control
Licensing intellectual property

**Does the licenced IP change?**

- **Right to use IP**
  - IP has significant standalone functionality
  - Revenue at point in time

- **Right to access IP**
  - Change in form or functionality of IP
  - Benefits substantially derived/dependent on licensor’s activities
  - Revenue over time
Sales-based or usage-based royalties for licence of IP

License of IP AND IF Consideration is sales or usage based

Recognise at LATER of
- Sale/usage
- Satisfaction of PO

Exception applies if:

• Royalty relates only to a licence or
• Licence is the predominant item (eg licence to show a movie and additional promotional goods or services)
### Contract costs

**Acquire a contract**
- Capitalise if incremental (except if contract \(\leq 12\) months)

**Set-up costs**
- No revenue recognition
- Capitalise if create resource for future use

**Fulfilment costs**
- No WIP if PO satisfied over time
## Transition

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Full retrospective</td>
<td>Cumulative catch-up</td>
<td>Contracts under new standard</td>
<td></td>
</tr>
<tr>
<td>Modified</td>
<td></td>
<td>Cumulative catch-up</td>
<td>Contracts under new standard</td>
</tr>
<tr>
<td>retrospective</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Optional reliefs that permit
- use of hindsight in restating modified contracts
- not to apply IFRS 15 to contracts that are completed contracts at the date of transition to IFRS 15

Completed contract is a contract for which the entity has transferred all of the goods or services identified in accordance with previous revenue Standard.
### Explaining IFRS 15 transition

<table>
<thead>
<tr>
<th>Category</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>Recognition of revenue over the life of major contracts and active software licences spread more evenly</td>
</tr>
<tr>
<td>Costs</td>
<td>Certain transformation spend, previously expensed, now capitalised as contract fulfilment assets and released over the contract life. Redundancies expensed upfront. Increased focus on cost reduction</td>
</tr>
<tr>
<td>Profit</td>
<td>Phasing of profits on major contracts may be shaped differently, with potentially lower profits or losses in the early years on contracts – but overall contract profitability unchanged – just the timing</td>
</tr>
<tr>
<td>Balance sheet</td>
<td>Net liabilities reflects increase in deferred income on contracts where we have been paid to undertake transformation prior to delivering planned outcomes for clients</td>
</tr>
<tr>
<td>Presentation</td>
<td>Underlying result further analysed to separately disclose results of significant new contract wins and restructuring</td>
</tr>
<tr>
<td>Cash</td>
<td>No change</td>
</tr>
</tbody>
</table>
Investor considerations IFRS 15

• Changes can be complex: Transition disclosures are important and need to be communicated early

• Many investors struggled to understand the impact of IFRS 15
  – Confusion over revenue ‘double counting’ and ‘black-holes’
  – Annoyance with transition options
  – Suspicion if revenue shows greater divergence from cash

• The IFRS 15 disaggregation of revenue disclosure is key and unlikely to be met by preparers’ segment information

• Disaggregating revenue more than one way will often be necessary to satisfy the disclosure objective
Research opportunities IFRS 15

• Matters of interest are: pre/post application affecting recognition, measurement and disclosure – impact for preparers, auditors, investors and regulators.

• Specific to IFRS 15
  – What are the financial impacts of the new standard. How do industries and countries differ.
  – How does point in time and over time revenue recognition change pre/post application.
  – Expected industry impact regarding IP: What is observed. What is impact of change.
Research opportunities IFRS 15

• Specific to IFRS 15 (continued)
  – What choices were made on transition. How have transition disclosures benefited analysts and investors.
  – What is the quality of disclosure about the new policies and their impact. Is quality sufficient. Do ‘good’ disclosers benefit.
  – Does the standard get the right balance of disclosure objectives and disclosure requirements.
IFRS 16 Leases: Overview of the basics

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IFRS 16 at a glance

- Issued in January 2016
- Effective 1 January 2019
- Replaces IAS 17

Key points:
- Brings leases onto the balance sheet
- Changes lessee accounting substantially; little change for lessors
- Early application permitted (only with application of IFRS 15)
Leases are an important and flexible source of financing – listed companies using IFRS Standards or US GAAP estimated to have US$3.3trillion lease commitments.

Over 85% of lease commitments do not appear on balance sheet today.

This creates challenges for users of financial statements.
The need for change: 
Currently a lack of information

- Six retail chains that ultimately went into liquidation

<table>
<thead>
<tr>
<th>Retailer</th>
<th>Off balance sheet leases (undiscounted)</th>
<th>Off balance sheet leases (discounted)</th>
<th>On balance sheet debt</th>
<th>Discounted leases as multiple of debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Borders (US)</td>
<td>$2,796M</td>
<td>$2,152M</td>
<td>$379M</td>
<td>5.68</td>
</tr>
<tr>
<td>Circuit City (US)</td>
<td>$4,537M</td>
<td>$3,293M</td>
<td>$50M</td>
<td>65.86</td>
</tr>
<tr>
<td>Clinton Cards (UK)</td>
<td>£652M</td>
<td>£525M</td>
<td>£58M</td>
<td>9.05</td>
</tr>
<tr>
<td><strong>HMV (UK)</strong></td>
<td><strong>£1,016M</strong></td>
<td><strong>£809M</strong></td>
<td><strong>£115M</strong></td>
<td><strong>7.03</strong></td>
</tr>
<tr>
<td>Praktiker (DEU)</td>
<td>€2,268M</td>
<td>€1,776M</td>
<td>€481M</td>
<td>3.69</td>
</tr>
<tr>
<td>Woolworths (UK)</td>
<td>£2,432M</td>
<td>£1,602M</td>
<td>£147M</td>
<td>10.90</td>
</tr>
</tbody>
</table>

1 Based on averaged published financial statement data available for 5 years before company entered Chapter 11 (US), liquidation (UK) or bankruptcy (DEU).

2 Estimated using (i) a discount rate of 5% and (ii) estimated average lease terms based on the information disclosed in the financial statements.

3 Off balance sheet leases (discounted) as a multiple of on balance sheet debt.
What has changed for lessees?

Changes to lessee accounting

- Former operating leases \textit{capitalised}

- All\(^1\) leases accounted for similarly to today’s finance leases
  - ROU asset and lease liability recognised
  - Depreciation of all ROU assets
  - Interest expense for all lease liabilities

\(^1\) Exemptions for short-term leases and leases of low-value assets
What has changed for lessees?

### Balance sheet

<table>
<thead>
<tr>
<th></th>
<th>IAS 17</th>
<th>IFRS 16</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Finance leases</td>
<td>$\leftarrow$</td>
<td>$\leftarrow$</td>
</tr>
<tr>
<td>Operating leases</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>All leases</td>
<td>$\leftarrow$</td>
<td>$\leftarrow$</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td>$\rightarrow$</td>
<td>$\rightarrow$</td>
</tr>
<tr>
<td>$\rightarrow$</td>
<td>$\rightarrow$</td>
<td>$\rightarrow$</td>
</tr>
<tr>
<td>Off balance sheet rights / obligations</td>
<td>---</td>
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<tr>
<td>$\rightarrow$</td>
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<td>$\rightarrow$</td>
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</tbody>
</table>

### Income statement

<table>
<thead>
<tr>
<th></th>
<th>IAS 17</th>
<th>IFRS 16</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td>$\times$</td>
<td>$\times$</td>
</tr>
<tr>
<td><strong>Operating costs</strong> (excl. depreciation and amortisation)</td>
<td>---</td>
<td>Single expense</td>
</tr>
<tr>
<td><strong>EBITDA</strong></td>
<td></td>
<td>$\uparrow\uparrow$</td>
</tr>
<tr>
<td><strong>Depreciation and amortisation</strong></td>
<td>Depreciation</td>
<td>---</td>
</tr>
<tr>
<td><strong>Operating profit</strong></td>
<td></td>
<td>$\uparrow$</td>
</tr>
<tr>
<td><strong>Finance costs</strong></td>
<td>Interest</td>
<td>---</td>
</tr>
<tr>
<td><strong>Profit before tax</strong></td>
<td></td>
<td>$\leftrightarrow$</td>
</tr>
</tbody>
</table>
Definition of a lease

Based on which party controls the use of an identified asset

Customer has control

Supplier has control

Lease

Service
Optional recognition exemptions

- **Short-term leases**
- **Leases of low-value assets**

- If exemption is taken, account for these leases similarly to operating leases in IAS 17
- ie recognise *expense in P&L*
Balance sheet measurement: Lease liability

Lease liability = Lease payments during the lease term × Discount rate

- If readily determinable: rate implicit in the lease
- Otherwise: lessee’s incremental borrowing rate
Balance sheet measurement: Lease liability

Lease payments:

- **Fixed payments**
  - Variable payments (that depend on an index or rate OR that are in-substance fixed)
  - Optional payments (that are reasonably certain to occur)
  - Residual value guarantees (amounts expected to be payable)

- **Variable payments** (that depend on sales or use of the underlying asset are not included)

- **Optional payments** (that are not reasonably certain to occur are not included)
Lessor accounting

- **Substantially retained** the lessor accounting model in IAS 17
- Feedback on 2013 ED
  - Lessor accounting in IAS 17 is *not broken*
  - Concerns about *cost and complexity*

Subleases

Enhanced disclosures
Investor considerations IFRS 16

• Awareness of impact of changes to assets, liabilities, equity, income and expenses as well as cash flows, financial ratios and KPIs

• Entities need to communicate with banks, lenders, investors and others regarding financial impacts

• Understand the judgements and estimates made (eg lease vs service; lease terms; discount rates) and choices made on transition

• Additional disclosures will be provided, including for complex features (eg variable lease payments, extension options and residual value guarantees)
Research opportunities IFRS 16

• Impact of IFRS 16 – it’s been a long time coming!
• On transition: What is the financial impact, observable in the financial statements, of the capitalisation of leases. What are the impacts on financial ratios. How do observed effects compare with expected effects.
• What is observed about choices on transition and the usefulness of transition disclosures. What are the attributes of entities making various choices and providing more useful disclosures.
Research opportunities IFRS 16

• In what ways are IFRS 16 disclosures useful for investors. How are companies meeting the disclosure objectives of the Standard.

• What are investor reactions/capital market benefits of the changes to recognition and disclosure.

• In what ways has the comparability of lease accounting improved for IFRS adopting entities in different industries and countries.

• Long term: do investors benefit from more capitalisation of leases.
In conclusion...

• The new IFRS Standards 9, 15 and 16 bring many changes
• IASB is seeking evidence of impact
  – Impact for preparers, auditors, investors, regulators
  – Capital market impact; also application issues
  – Post implementation reviews around 3 years after implementation
  – Range of research methods will be useful
• Researchers can benefit from the experience of investigating 2005 adoption effects
Relevant materials

- **IFRS 9**

Relevant materials

- **IFRS 15**
Relevant materials

- **IFRS 16**

- Overview: [https://www.ifrs.org/issued-standards/list-of-standards/ifrs-16-leases/](https://www.ifrs.org/issued-standards/list-of-standards/ifrs-16-leases/)


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