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Times of change

What CFO's need to know about the new IFRS accounting standards

How accounting changes will change your business

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Changing your ***perspective***

If you use ***leases*** *as a means to obtain access to assets, your company is about to face a major change as the accounting requirements for leases change.*

The new leases standard eliminates operating leases for lessees and will affect almost all commonly used financial metrics, with substantial changes to both balance sheet and income statement presentation and knock-on effects on a company's arrangements with various stakeholders.

If you earn ***revenue*** *and apply IFRS, your company is about to face a major change as the accounting requirements for revenue change.*

The new revenue standard will impact your revenue cycle, key performance indicators, systems and processes.

If you have ***financial instruments*** *and apply IFRS, your company is about to face a major change as the accounting requirements for financial instruments change.*

The new financial instruments standard introduces significant changes to classification and measurement, impairment and hedge accounting. Its impact is sure to reach far beyond finance to areas such as credit risk, systems, data, tax, internal audit and others.

The time to act is ***now***

5 questions CFO's should be asking

1. **What is management's transition strategy, timeline and budget?**
2. **What are the key issues, impacts and risks specific to our industry and company?**
3. **How will the change impact our business, beyond the financial statements (e.g. strategy, budgeting/planning, processes, systems, controls, key performance indicators (KPIs), remuneration, debt covenants, regulatory compliance, treasury, taxes, sales/procurement, etc.)?**
4. **How and when are we communicating changes to stakeholders?**
5. **How are our competitors addressing transition?**

IFRS 16: the new model

The new standard presents a single lease model, a significant change from the dual model approach currently used in IAS 17.

The new standard requires lessees to recognise nearly all leases on their balance sheet reflecting their right to use an asset for a period of time and the associated liability to make rental payments. Recognition of interest on the lease liability and amortisation of the asset is required in the income statement. One consequence of the single model is that the pattern of lease expense recognition is front-ended due to the higher interest charge in the early period of the lease.

The IASB has included an optional exemption for certain short-term leases and leases of low-value assets to be applied by lessees. The lessor's accounting model largely remains unchanged.

The IASB is supporting a single lease model that recognises interest and depreciation in the income statement.

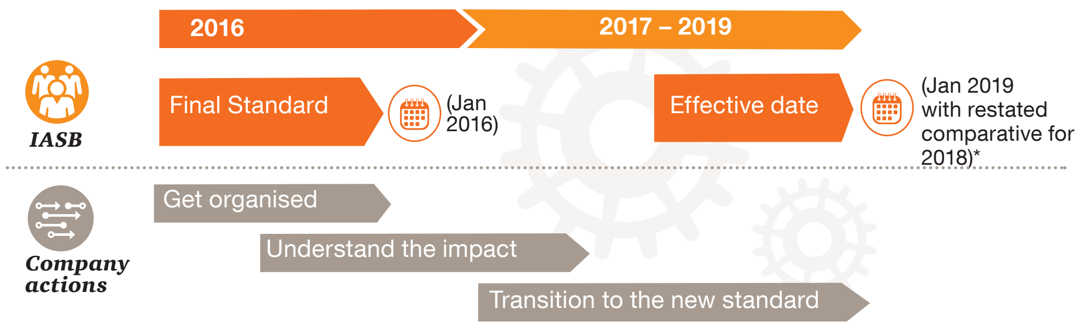
Presentation	Operating Lease Accounting	Finance Lease Accounting	Lease Accounting
Asset	No asset recognised	Property, Plant & Equipment (PP&E)	Right-Of-Use (ROU) asset
Liability	No liability recognised	Lease liability	Lease liability
Income statement	Operating lease expense	Depreciation & interest expense	Depreciation & interest expense
	IAS 17		*IFRS 16*

Global lease capitalisation impact by industry*

Lessees	Average increase in interest-bearing debt	Median increase in total assets	Average increase in EBITDA
All companies	22%	5%	13%
Retail and trade	98%	22%	41%
Professional services	42%	5%	15%
Accommodation and food services	14%	3%	8%
Transport and warehousing	24%	7%	20%
Construction	14%	2%	8%
Manufacturing	21%	3%	14%
Financial services	6%	1%	6%

* Global PwC Lease Capitalisation Research 2015

What action should companies take and when?



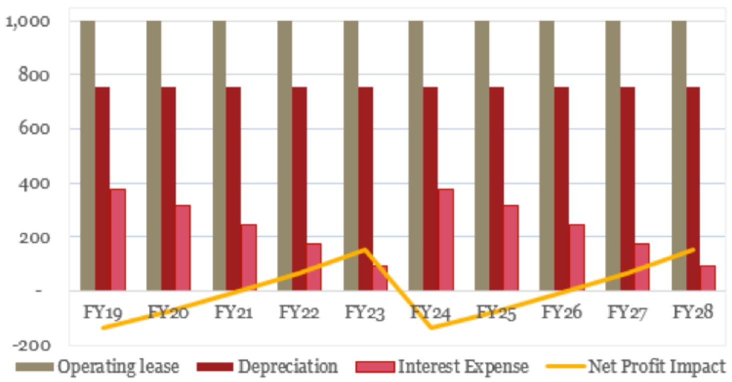
* There are detailed accounting options that companies need to consider, relating to how they transition.

The new leases standard may change key accounting metrics

Virtually every company uses rentals or leasing as a means to obtain access to assets and will therefore be affected by the new standard.

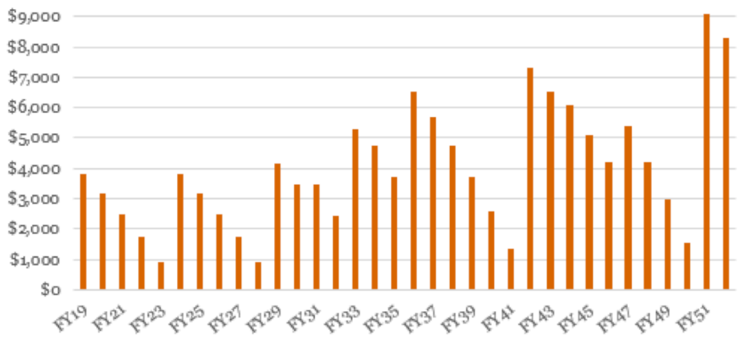
The new standard will affect virtually all commonly used financial ratios and performance metrics such as gearing, current ratio, asset turnover, interest cover, EBITDA, EBIT, operating profit, net income, EPS, ROCE, ROE and operating cash flows. These changes may affect loan covenants, credit ratings and borrowing costs, and could result in other behavioural changes. These impacts may compel many organisations to reassess certain ‘lease versus buy’ decisions.

There will also be a change to both the expense character (operating lease expenses replaced with depreciation and interest expense) and recognition pattern (acceleration of lease expense relative to the recognition pattern for operating leases today) which will cause income statement volatility.



The impact of simple five-year leases on net profit over a 10 year period

Renewals of key leases will also increase lease liabilities overnight, creating volatility in the balance sheet too.



How the timing of key lease renewals may affect the lease liabilities on the balance sheet

The change will also require an ongoing lease contract management process which many companies do not currently have in place.

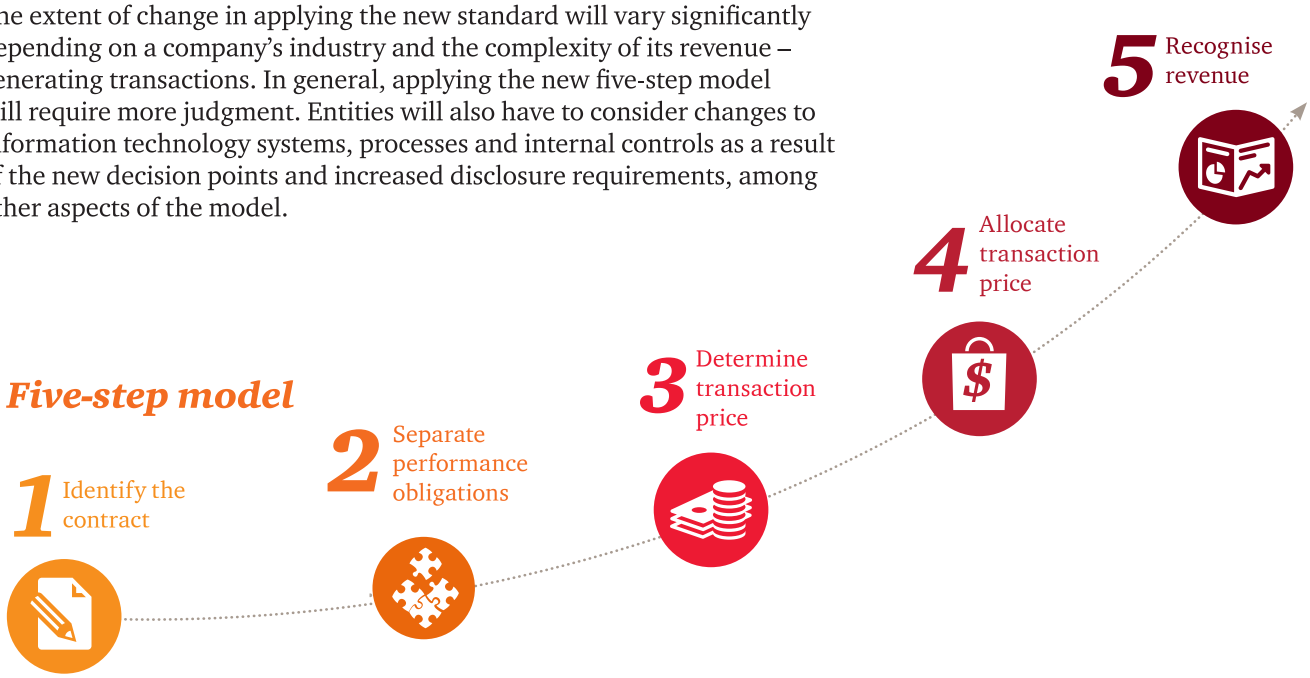
Although lessor accounting remains largely unchanged, lessors are expected to be affected due to the changed needs and behaviours of customers which impact their business model and lease products.

IFRS 15: the new model

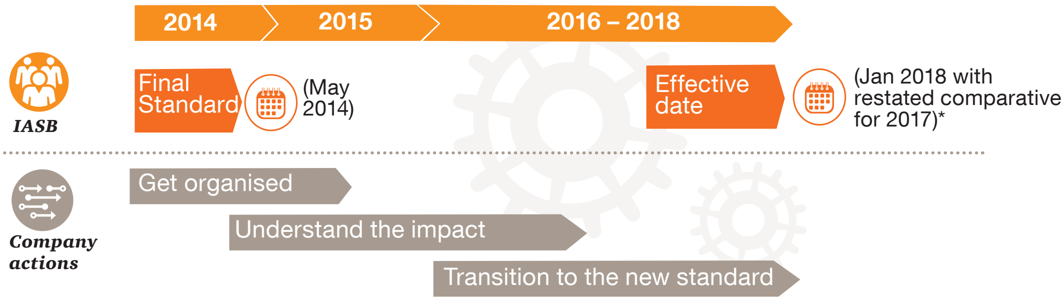
The new standard presents a single, principles-based five-step model that applies to all industries.

The extent of change in applying the new standard will vary significantly depending on a company's industry and the complexity of its revenue – generating transactions. In general, applying the new five-step model will require more judgment. Entities will also have to consider changes to information technology systems, processes and internal controls as a result of the new decision points and increased disclosure requirements, among other aspects of the model.

Five-step model



What action should companies take and when?



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The new revenue standard may change when revenue is recognised

While the extent will vary depending on industry and complexity of contracts, all entities with revenue will be affected by the new standard.

The structure and terms of revenue transactions usually vary and may contain more complex features:

Feature	Impact
Long-term contracts likely to be modified over the contract term	The standard provides explicit guidance on how to treat contract modifications which may be different from the current treatment
Multiple goods and / or services provided together in one transaction	Revenue must be allocated to these items in line with strict criteria – this might not be the price written in the contract
Free goods and / or services provided to the customer	An amount of revenue must also be allocated to these items in line with strict criteria
Licenses that provide the customer with access to intellectual property	Guidance is explicit on how to treat licenses – which may change the timing of revenue recognition
The customer receives many different goods and / or services over the length of the contract	Identifying 'performance obligations' is a difficult and judgemental area, requiring disclosure in the financial statements
There are varied terms which impact when risks and rewards pass to the customer (e.g. warehouse deliveries, customer acceptance, long-term freight, use of resellers)	The guidance uses 'transfer of control' to indicate when revenue will be recognised, this new concept may lead to differences against current treatment

Areas impacted may include:

- the number of deliverables in a contract to which revenue must be allocated
- the allocation of revenue to those deliverables
- timing of revenue recognition
- other recognition and measurement areas, such as the accounting for collectability, contingent revenue, variable consideration, and accounting for contract costs (e.g. sales commissions)
- disclosures – such as disaggregation of revenue, performance obligation determinations and allocations, and judgements for when revenue recognition occurs

IFRS 9: the new model

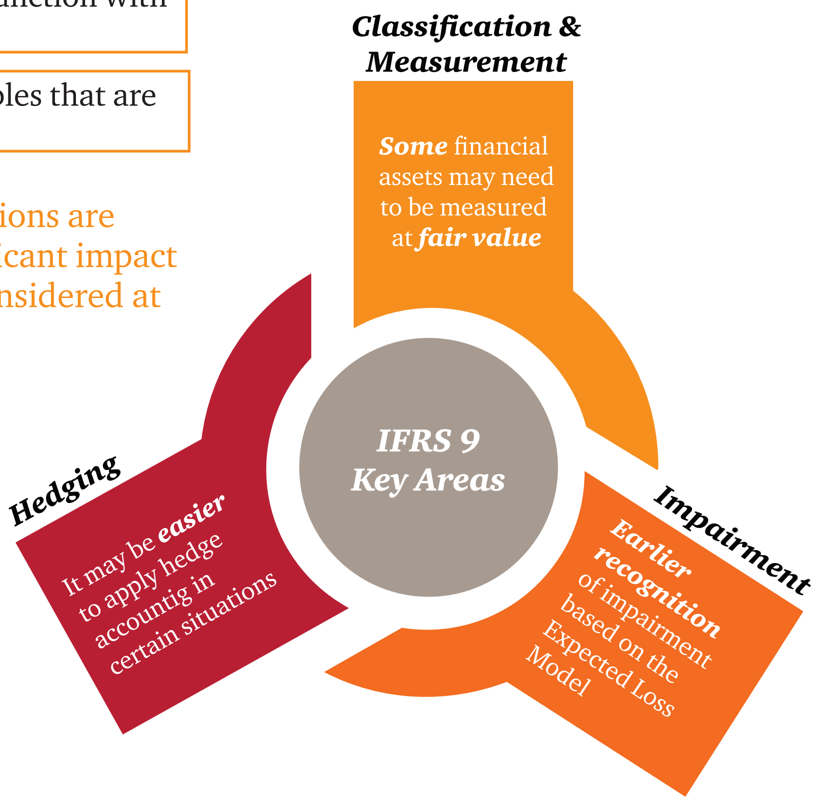
The new standard presents new guidance for each of the following:

- A new model for classification and measurement of financial assets and liabilities
- A new impairment model from the incurred credit loss approach to an expected credit loss model
- New guidance for hedging with less stringent quantitative testing requirements that applies to all industries

If you are not a financial services entity, the key questions to ask about IFRS 9 are:

1. Do you engage in hedging activities?
2. Do you have complex treasury function with substantial financial assets?
3. Do you have significant receivables that are long term in nature?

If the answers to any of these questions are ***Yes***, then IFRS 9 will have a significant impact on your company and should be considered at an earlier stage.



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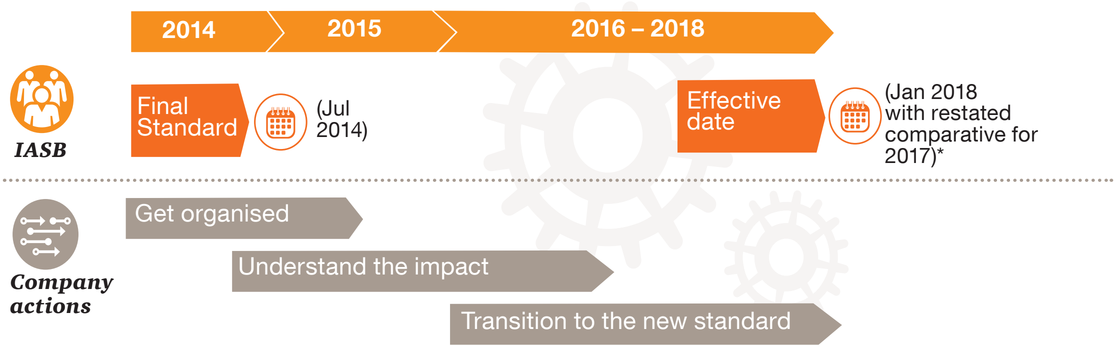

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What else should be on your mind?

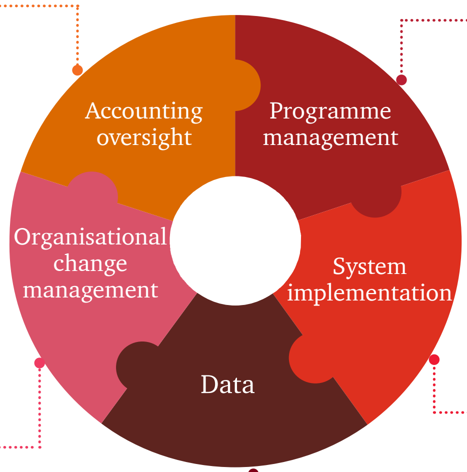
The implications are not limited to accounting – the new standards may also change the way you do business.

Cross-functional impacts

Stakeholder awareness and communication

Areas companies need to consider

- Understanding and application of new rules
- Ensuring accounting policy alignment across the organisation
- Collaborating with IT team to ensure accounting inputs into system design, testing, and training
- Reviewing business requirement and functional design specifications



- Developing and managing the overall project plan, which includes resources, activities, and costs
- Implementing a strong programme infrastructure that includes best practices and frameworks for quality management and programme assurance
- Ensuring tight integration of all workstreams leveraging a comprehensive governance model

- Determining the organisational impacts, training strategy, and post-go-live support model
- Collaborating with Programme Management and Implementation to lead employee mobilisation, training, and knowledge transfer
- Understanding the programme plan activities and milestones to develop and execute against a communication strategy

- Developing the data migration strategy
- Integrating with Accounting Oversight and Systems Implementation to enrich and convert data as per policy and system requirements

- Facilitating the future-state process and enabling capabilities working with Finance and Accounting
- Leading the overall implementation of the solution and providing inputs to IT
- Working with Programme Management to utilise a standardised implementation approach and to track programme progress

Five-step approach to successful transition

PwC's accounting standards change methodology

	Get organised	Understand the impact		Transition to the new standard	
	Identify	***Plan***	***Understand***	***Develop***	***Implement***
What you need to do	Identify accounting change	Determine road map	Understand business impact (incl. IT)	Develop solutions	Effect changes
What PwC can bring	Detailed insight into the issue and the impact it has on your company to help you focus on the real issues	Enabling technology and tools to accelerate the data analysis	Deep understanding of the impact on the industry and market trends to help you understand cross functional impacts	Global reach of specialists with proven change methodology and approach to advise you on design of the business process and technical requirements	Detailed understanding of implementation process to embed changes to business processes, systems and controls across your organisation and ensure compliance with the new standard
Your benefits	***Focus & speed***	***Efficient & complete***	***Insightful & optimal***	***Smart & proven***	***Controlled & measured***

How we can help

PwC's Capital Markets and Accounting Advisory Services team offers a wide range of experience and deep technical expertise on accounting issues. Our approach provides a unique combination of integrated services, tailored to accommodate your specific circumstances and needs.

Contacts

For more information about the new accounting standards and how we can help, please speak with your local engagement partner or one of our accounting advisory contacts below.

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