

# IFRS Foundation: Special Interest Sessions

Morning of Monday 23 June 2014—Lancaster hotel in London, UK

## Investor-focused IFRS Update

To assist the investor and analyst communities understand the effects of new and amended IFRSs, the IFRS Foundation will hold a workshop immediately before the IFRS conference, on the morning of 23 June 2014. This session will also be useful to investor relations personnel who communicate changes in accounting requirements to investors and analysts.

In this session:

- An IASB member will summarise particular new IFRS principles;
- A panel of analysts, investors and preparers will then discuss the effects of the changes on financial analysis and valuation.

09:00 **Registration and refreshments**

09:30 **Introduction**

**Stephen Cooper, Member, IASB**

09:35 **Panel discussion and Q&A**

**Chair—Fred Nieto, Investor Education Manager, IASB**

**Panellists:**

- **Stephen Cooper, Member, IASB**
- **Patricia McConnell, Member, IASB**
- **Peter Joos, Global Head of Valuation & Accounting, Morgan Stanley Research**
- **Dennis Jullens, Lecturer, Researcher, Valuation & Accounting, Rotterdam School of Management, Erasmus University**
- **Richard Mathieson, Managing Director, Scientific Active Equities, BlackRock Investment Management (UK) Limited**
- **Peter Reilly, Head of Capital Goods Sector Equity Research, Deutsche Bank**

**Topics:**

Analysing recently implemented IFRS standards and new disclosures to extract investment insights:

- Employee Benefits (IAS 19).
- Consolidated Financial Statements (IFRS 10)
- Joint Arrangements (IFRS 11)
- Disclosure of Interests in Other Entities (IFRS 12)

New Accounting Standards on Revenue Recognition and Leases:

- Examine areas of financial analysis and valuation that investors can anticipate will see changes resulting from the new information when these accounting standards are implemented.

11:55 **Concluding comments**

**Stephen Cooper, Member, IASB**

12:00 **Close session**



**IFRS Foundation**  
**IFRS Conference**  
Monday 23 and Tuesday 24 June 2014  
Lancaster Hotel, London

**Special Interest Session**

**Investor-focused IFRS update**

**FRED NIETO**

*Investor Education Manager*  
**IASB**

**STEPHEN COOPER**

*Member*  
**IASB**

**PATRICIA McCONNELL**

*Member*  
**IASB**

**PETER JOOS**

*Global Head of Valuation & Accounting*  
**Morgan Stanley Research**

**DENNIS JULLENS**

*Lecturer, Researcher, Valuation & Accounting*  
**Rotterdam School of Management, Erasmus University**

**PETER REILLY**

*Head of Capital Good Sector Equity Research*  
**Deutsche Bank**

**RICHARD MATHIESON**

*Managing Director, Scientific Active Equities*  
**BlackRock Investment Management (UK) Limited**



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## Investor-Focused Update IFRS Conference London

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### Who we are:

- **IASB:**
  - Stephen Cooper
  - Patricia McConnell
- **Investor perspectives:**
  - Peter Joos
  - Dennis Jullens
  - Peter Reilly
  - Richard Mathieson

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## How will this session work?

- For each topic:
  - **IASB members** will discuss:
    - principal reporting changes effective in 2013,
    - select proposed reporting changes
    - new information available for investors, and
    - effects on financial statements and ratio analysis

## How will this session work?

- For each topic:
  - **Investor representatives** will discuss:
    - Benefits of the new information,
    - insights that can be obtained,
    - unresolved issues or questions, and
    - implications for valuation

## Main new requirements effective 2013

- **Consolidated Financial Statements** – control and new guidance for investment entities ([IFRS 10](#))
- **Joint Arrangements -- Proportionate Consolidation** – removal of this accounting method ([IFRS 11](#))
- **Disclosures**
  - for unconsolidated structured entities and disclosures of risks associated with interests in other entities ([IFRS 12](#))
- **Employee Benefits**—Removal of the corridor method ([IAS 19](#))
- **Fair Value Measurement and Offsetting Disclosures**
  - fair value disclosures ([IFRS 13](#)), and
  - offsetting financial instruments ([IFRS 7](#))
- **Presentation** – of other comprehensive income (IAS 1) and changes in “own credit” ([IFRS 9](#))

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## Convergence Projects

- **Revenue recognition**— a more robust framework for the recognition of revenue designed to eliminate inconsistencies across industries and improve disclosures
- **Lease Accounting**— greater transparency about the effects of leasing activities, including: leverage, risks and the assets an entity uses in its operations.

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# Consolidated Financial Statements

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## IFRS 10 -- Key Messages

- The use of a single consolidation model that applies to all entities (voting and non-voting interest entities) which removes uncertainty about which guidance to apply.
- Like the previous guidance, the model is based on determining whether an entity controls an investee.
- However, the concept of control is described differently: Control is power, exposure to variable returns, and an investor's ability to use power to affect its amount of variable returns.

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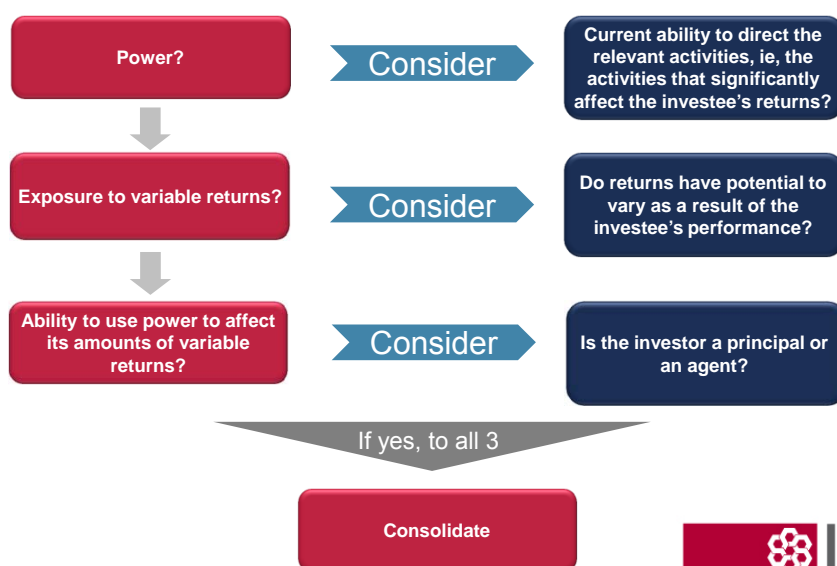
## IFRS 10 -- Key Messages

- Some less-than majority owned entities that were not consolidated, may now be consolidated.
- Application guidance added to deal with situations difficult to assess:
  - Agency relationships,
    - Relationships with entities that are designed so that voting rights are not the dominant factor in assessing control, such as structured entities,
    - Potential voting rights and control without a majority of voting rights.
- Enhanced Disclosures
- Investment companies are not required to consolidate investees that are controlled.

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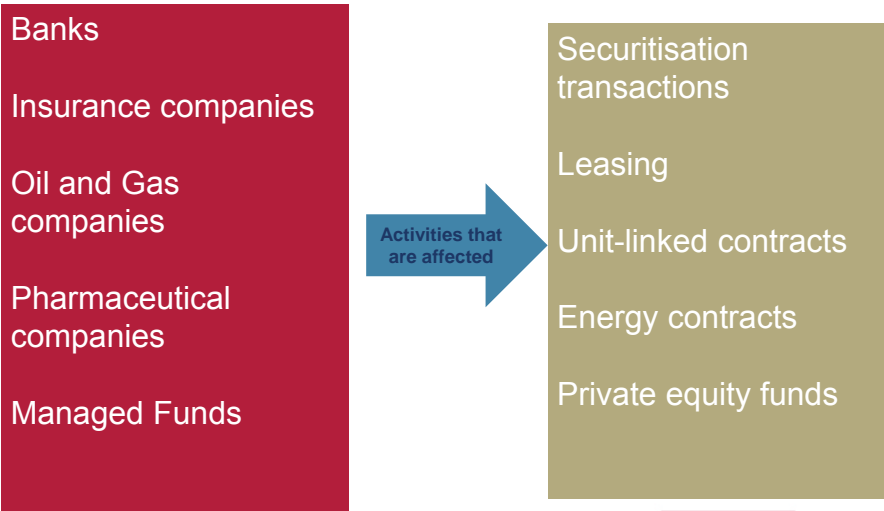
## Consolidation Decision Process



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## Who and What are affected?



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## Financial Statement Effects

### Balance Sheet

- Assets, liabilities and equity may increase or decrease depending on consolidation decision and previous accounting method.
- Ratios to consider: ROA, Debt/Equity, Book value

### Statement of Profit or Loss and OCI

- Income, expenses and other comprehensive income may increase or decrease depending on consolidation decision and previous accounting
- Ratios to consider: Interest coverage, Return on sales

### Notes to Financial Statements

- Information about the investee balance sheet and risks (eg: leases, employee benefit plans, commitments)
- Information related to recurring or non-recurring components of income or expense (eg: significant gains or losses, concentration risks)

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# Examples

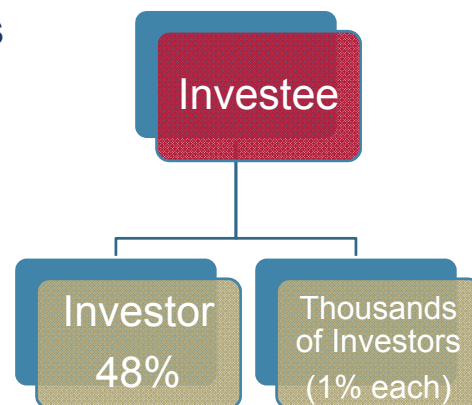
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## Example 1: rights

- An investor acquires 48% of the voting rights of an investee.
- Remaining voting rights held by thousands of shareholders, with less than 1% each

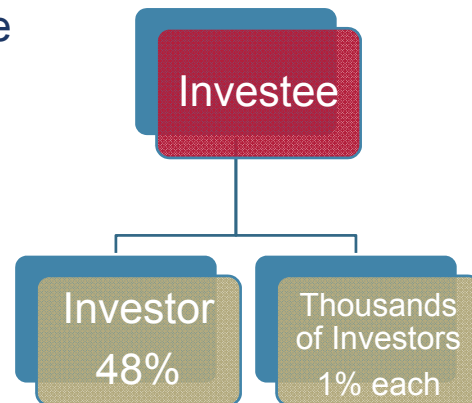


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## Example 1: Analysis

- Based on the relative size of the other shareholders, investor concludes that a 48% interest would be sufficient to give it control.

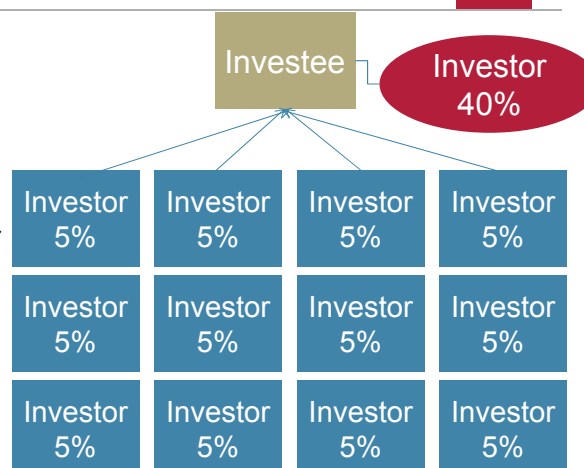


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## Example 2: rights

- Investor A holds 40% of the voting rights of an investee.
- Twelve other investors each hold 5% of the voting right.
- Shareholder agreement: investor A has the right to appoint, remove and set the remuneration of management responsible for directing the relevant activities.
- Two-thirds majority vote of the shareholders is required to change the agreement.

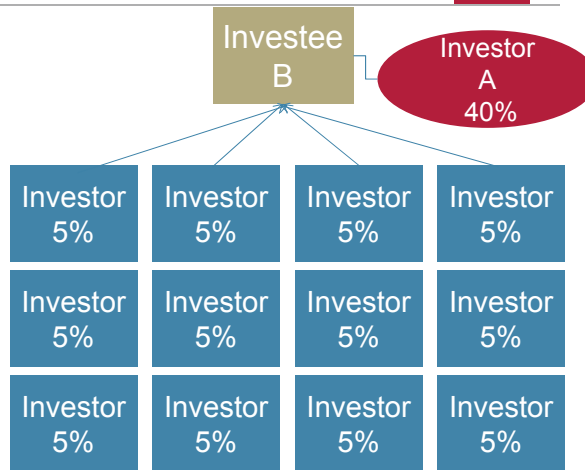


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## Example 2: Analysis

- Given the ability of Investor A to direct the relevant activities of Investee B through the combination of the shareholders' agreement and the 40% voting interest, Investor A concludes it controls Investee B, and should consolidate.
- Investor A's shareholding prevents other parties from changing the contractual relationship it has to direct the relevant activities of Investee B, because such a change requires a two-thirds majority.



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## Investor Considerations

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## Investor Considerations

### What are the benefits and insights provided by the new standard/disclosures?

1. Nature, extent and financial effects of an entity's interests in investees (eg: returns and variability of returns).
2. Nature of the risks associated with subsidiaries and unconsolidated entities (eg: implicit or explicit commitments to fund subsidiaries or unconsolidated entities)
3. Information about non-controlling interests (significant potential voting rights or puts)
4. Understanding of business strategy: (eg: R&D or production facilities previously unconsolidated, but now consolidated)
5. Identification of earnings and dividend flows (eg: are there tax implications or regulatory restrictions on earnings)

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## Joint Arrangements

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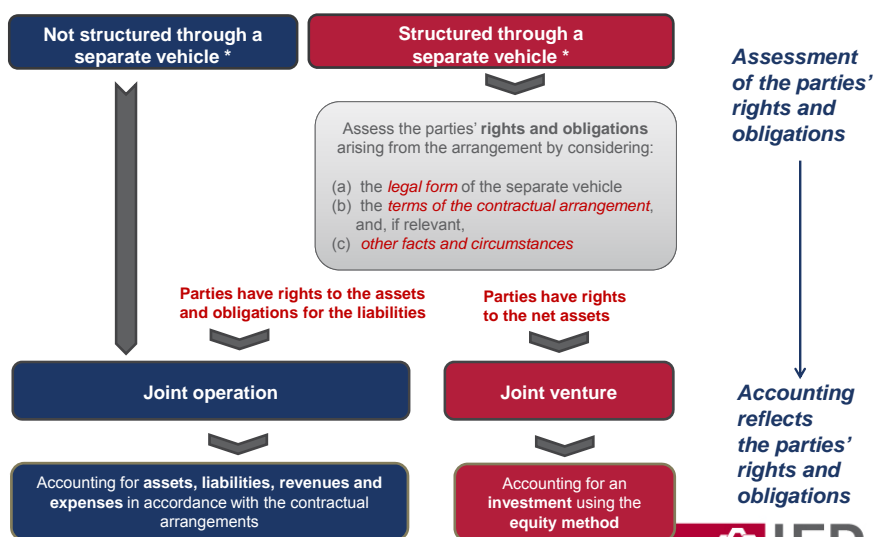
## Principal Changes

- Jointly controlled entities as defined in IAS 31 (entities structured through a separate vehicle) will now be accounted for in one of two ways:
  - Some may be treated as **joint operations** (JOs), which would require the separate recognition of each parties' assets, liabilities, revenues and expenses.
  - Some may be treated as **joint ventures** and, thus, are no longer permitted a choice between proportionate consolidation or the equity method. Parties must use the equity method.

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## Joint Arrangement Decision Process



(\*) A separate vehicle is a separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality.



## Who is affected?

JV deals by industry (1990–2010)		
Industry	JV deals	Relative relevance
Business services	17,610	20.45%
Software	6,718	7.80%
Wholesale trade: durable goods	5,840	6.78%
Investment and commodity firms	4,980	5.78%
Electronic	3,321	3.86%
Telecommunications	2,545	2.95%
Wholesale trade: non-durable goods	2,300	2.67%
Mining	2,297	2.67%
Oil and gas	2,166	2.51%
Real estate	1,781	2.07%
Others	36,577	42.46%
<b>Total number of JV deals</b>	<b>86,135</b>	<b>100.00%</b>

Data source: Thomson Financial SDC Platinum Alliances/Joint Ventures database

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## Who is affected?

Country	% companies with Joint Ventures using proportionate consolidation
France	80.00%
Germany	33.33%
Italy	33.33%
Netherlands	56.25%
Spain	86.66%
Sweden	50.00%
Switzerland	50.00%
United Kingdom	18.75%

Source: von Keitz, I. (2006) The Application of IFRS: Choices in Practice. KPMG

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## Who is affected?

Industry	% companies with Joint Ventures using proportionate consolidation
Consumer Markets	46.66%
Financial Services	48.65%
Industrial Markets	53.97%
Information, Communications and Entertainment	47.37%
Infrastructure and Healthcare	40.00%

Source: von Keitz, I. (2006) *The Application of IFRS: Choices in Practice*. KPMG

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## Financial Statement Effects

### Balance Sheet

- Transition from proportionate consolidation to equity method or transition from equity method to direct recognition will affect gross assets and liabilities.
- Ratios to consider: ROA, Debt/Equity, Book value

### Statement of Profit or Loss and OCI

- Transition from proportionate consolidation to equity method or transition from equity method to direct recognition will affect revenues and expenses.
- Ratios to consider: Interest coverage, Return on sales

### Notes to Financial Statements

- Information about the investee balance sheet and certain risks (eg: leases, employee benefit plans, commitments)
- Information related to recurring or non-recurring components of income or expense (eg: significant gains or losses, concentration risks)

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## Examples

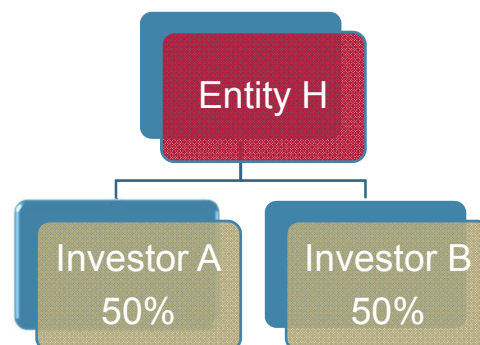
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### Example 1: Contractual terms reverse the legal features of the separate vehicle

- Investors A and B (the parties) set up a separate vehicle (entity H) and a **Joint Operating Agreement (JOA)** to undertake oil and gas exploration, development and production activities.
- The main feature of entity H's **legal form** is that it causes the separate vehicle to be considered in its own right.

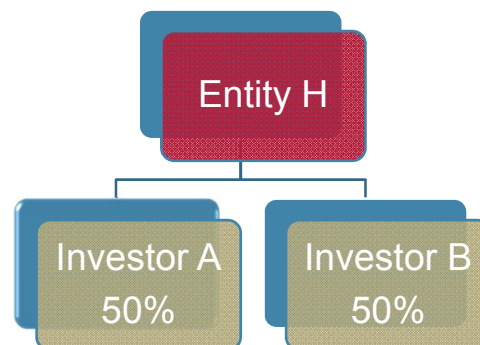


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## Example 1: *continued*

- The board of Entity H consists of a director from each investor. Each investor owns 50% of Entity H. Unanimous consent is required for any resolution.
- The **JOA** specifies that the rights and obligations arising from the exploration, development and production activities shall be shared between the parties (i.e. the permits, the production obtained, all costs associated with the activities, taxes payable etc.) in proportion to each party's shareholding.



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## Example 1: *Analysis*

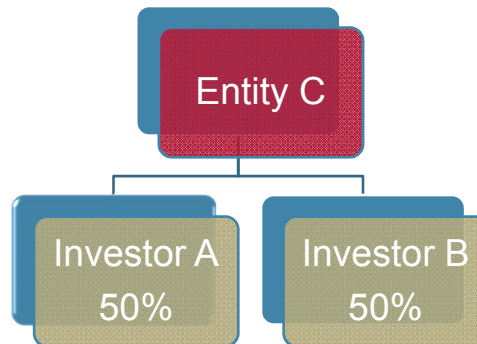
- The parties carry out the **JOA** through a separate vehicle whose **legal form** confers separation between the parties and the separate vehicle.
- The parties have been able to reverse the initial assessment of rights and obligations arising from the **legal form** of the separate vehicle in which the arrangement is conducted. This is achieved by agreeing to terms in the **JOA** that entitle them to rights to assets (permits, production, etc.) and obligations for the liabilities (all costs and obligations arising from the activities) that are held in Entity H.
- **Therefore, the joint arrangement is a Joint Operation.**

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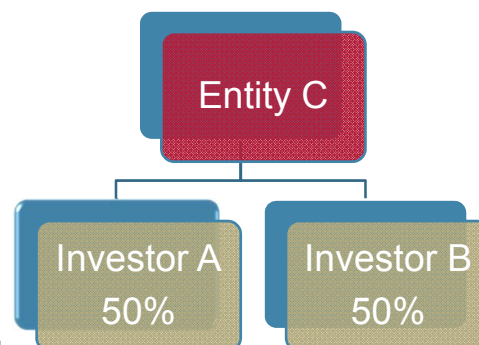
## Example 2: Other facts and circumstances

- Two parties structure a joint arrangement in an incorporated entity (entity C) in which each party has a 50 per cent ownership interest. The purpose of the arrangement is to manufacture materials required by the parties for their own individual manufacturing processes.
- The **legal form** of entity C (an incorporated entity) through which the activities are conducted initially indicates that the assets and liabilities held in entity C are the assets and liabilities of entity C.
- The **contractual arrangement** between the parties does not specify that the parties have rights to the assets or obligations for the liabilities of entity C.



## Example 2: *continued*

- The **parties are each obliged to purchase all of the output produced** by entity C. Entity C cannot sell any of the output to third parties, unless this is approved by the two parties to the arrangement. Because the purpose of the arrangement is to provide the parties with output they require, such sales to third parties are expected to be uncommon and not material.
- The price of the output is set at a level that is **designed to cover the costs of production and administrative expenses incurred by entity C**. On the basis of this operating model, the arrangement is intended to operate at a break-even level.



## Example 2: Analysis

- The parties carry out the manufacturing through entity C whose legal form confers separation between the parties and the entity.
- Even though neither the **legal form** nor the **contractual arrangement** dealing with the manufacturing activity specifies that the parties have rights to the assets, and obligations for the liabilities, **other facts and circumstances** indicate that the arrangement is a JO.
  - The parties are obliged to **purchase all of the output produced**
  - The price of the output is set at a level that is **designed to cover the costs of production and administrative expenses incurred by entity C.**
- Consequently, A and B have rights to substantially all the economic benefits of the assets of the manufacturing arrangement. And, the exclusive dependence of H on the parties to purchase all of its output indicates its liabilities will be settled through the parties' purchases. **Therefore, the joint arrangement is a joint operation.**

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## Investor Considerations

### What are the benefits and insights provided by the new standard/disclosures?

1. The shift in accounting methods may influence how future joint arrangements are structured: Issues to consider are: debt arrangements (recourse to non-recourse), borrowing capacity, and covenants.
2. Disclosures providing information about off-balance sheet activities and the implications for the financial flexibility of the reporting entity, particularly information about commitments to contribute funding.
3. Elimination of accounting choices makes the understanding of off-balance sheet activities more comparable and understandable.
4. Performance measures for management compensation may be adjusted because of the effects on reported ratios and pre-tax income.
5. Summarised financial information will be available for each material JV, subject to some aggregation tests. These disclosures are more detailed and more disaggregated compared to those under IAS 31

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## IFRS 12 – Disclosure of Interests in Other Entities

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## Scope

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Combined disclosure standard for:

- Subsidiaries
- Joint arrangements
- Associates
- Unconsolidated structured entities

## IFRS 12 – Key Messages

- IFRS 12 contains disclosure requirements for an entity's special relationships with other entities. This will address the issues highlighted by the crisis dealing with the lack of transparency about the risks to which entities were exposed from their involvement with “off-balance sheet” vehicles.
- IFRS 12 also contains disclosure requirements about an entity's interests in subsidiaries, JVs and associates, and unconsolidated structured entities that provide information about the profit or losses and cash flows available to the investor.

## Meeting the disclosure objective

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### Disclosures

- significant judgements and assumptions made
- information about interests in:
  - subsidiaries
  - joint arrangements and associates
  - unconsolidated structured entities
- any additional information that is necessary to meet the disclosure objective

Strike a balance between overburdening financial statements with excessive detail and obscuring information as a result of too much aggregation

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## Joint arrangements and associates

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### Nature, extent and financial effects of interests in joint arrangements and associates, eg

- List and nature of interests in individually-material joint arrangements and associates
- Detailed quantitative summarised financial information for each individually-material JV and associate, and in total for all others
- Fair value of investments in individually material JVs and associates (if published quoted prices available)
- Unrecognised share of losses of JVs and associates
- Nature and extent of any significant restrictions on transferring funds

### Nature of, and changes in, the risks associated with the involvement

- Commitments and contingent liabilities

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# Employee Benefits

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## Principal Changes

- Reduction in choices available for the recognition of actuarial gains and losses:
  - **Previously:**
    - Immediate recognition through OCI
    - Immediate recognition through P/L
    - Deferred recognition through P/L ('corridor approach')
  - **Now:**
    - Immediate recognition through OCI
- Remeasurements in other comprehensive income
- Use of the net interest approach in reporting changes in defined benefit plans

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## Who is affected?

- Only companies who do not immediately recognise actuarial gains and losses through OCI

Country	Index	Immediate through OCI	Corridor	Immediate through P&L
UK	FTSE 100	89%	8%	3%
Germany	DAX 30	67%	33%	0%
Germany	Non-DAX 30	25%	64%	11%
France	CAC 40	55%	45%	0%
France	Non-CAC 40	46%	48%	5%

Source: Street, D.L. and Glaum, M. (2010), *Methods for recognition of actuarial gains and losses under IAS 19, ACCA*.

## What is the size of the impact?

Country	Index	Mean unrecognised actuarial gains and losses (€mm)	Unrecognised actuarial gains and losses divided by equity
UK	FTSE 100	(2,074.50)	(0.02)
Germany	DAX 30	(410.45)	(0.02)
Germany	Non-DAX 30	(4.20)	(0.00)
France	CAC 40	(242.60)	(0.01)
France	Non-CAC 40	(53.05)	(0.02)

Source: Street, D.L. and Glaum, M. (2010), *Methods for recognition of actuarial gains and losses under IAS 19, ACCA*.

## Financial Statement Effects

### Balance Sheet

- Equity may decrease (increase) if a company has unrecognised actuarial losses (gains) at transition.
- Comparability enhanced because actual deficit /surplus in DBP will be reported on balance sheet.
- Ratios to consider: ROA, Debt/Equity, Book value

### Statement of Profit or Loss and OCI

- Net profit may be reduced because it will no longer reflect the expectation of higher returns on assets.
- OCI may fluctuate more because all market related assumptions will be reported here.
- Ratios to consider: Interest coverage, Return on sales

### Notes to Financial Statements

- Simplifies the reporting of changes in defined benefit plans by introducing the net interest approach
- Information related to average duration of the DBO
- Consider effects on loan covenants or borrowing capacity

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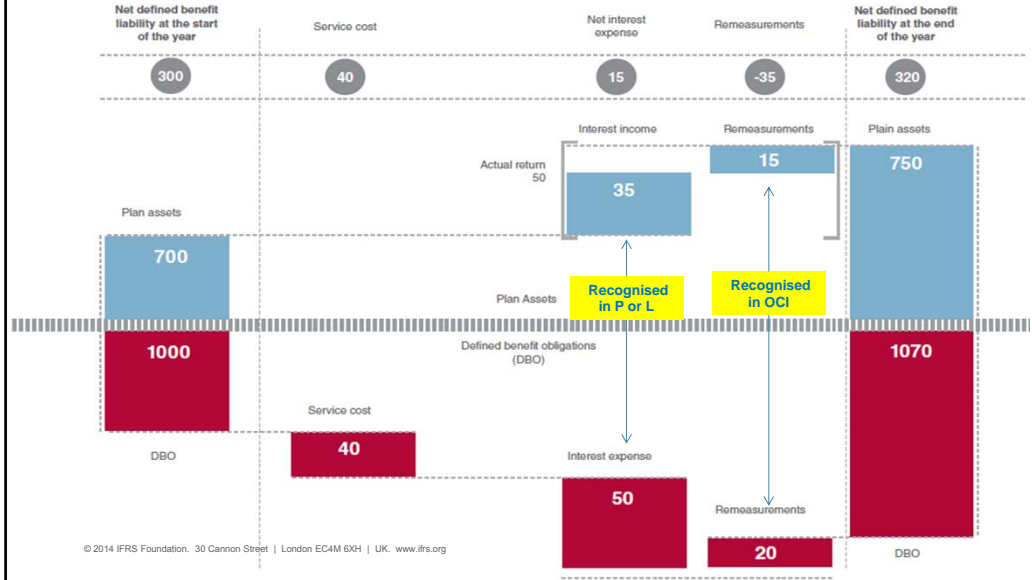
Example

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# Example



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## Investor Considerations

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## Investor Considerations

### What are the benefits and insights provided by the new standard/disclosures?

1. Balance sheets will reflect the actual funded status of an entity, which will improve comparability between reporting entities.
2. Statements of comprehensive income will reflect actual economic outcomes – no more smoothing
3. Perception of financial leverage (and hence financial strength) may affect current or prospective borrowing arrangements
4. Expansion of disclosure requirements should provide a better understanding of how to evaluate the financial effect of DBP assets and liabilities on the SCI and SFP.
5. Key disclosures to consider: expected contributions in the next reporting period, maturity profile of DBP, sensitivity analysis of DBO, disaggregation of fair value of plan assets.

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## Convergence Projects

Board Member

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# Leases

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## Questions for investors and analysts

1. Do you believe leases create assets and liabilities?
  - Should they be reported on the balance sheet?
2. Do you agree with the lease presentation on the income statement?
3. When considering the package of information in the main statements, together with the disclosures:
  - What is missing?
  - What is included but not useful for your analyses?

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## Why a Leases project?

### Lessee

Most lease assets and liabilities are off-balance sheet  
Limited information about operating leases

**\$1.25 trillion**  
of off-balance sheet operating lease commitments for SEC registrants\*

\* Estimate according to the 2005 SEC report on off-balance sheet activities

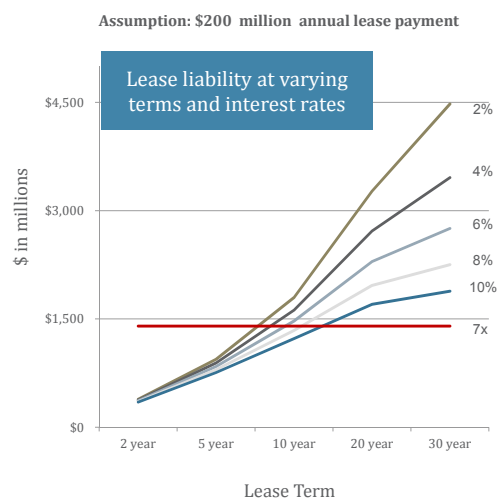
## Current adjustments to capitalise leases

### Multiplying current lease expense *(see graph)*

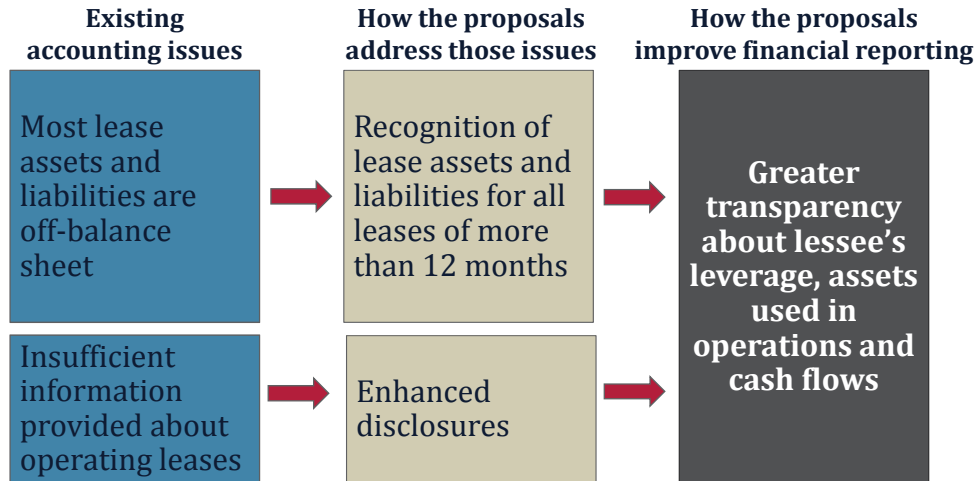
- Doesn't take into account differences in lease terms or interest rates

### Discounted projected lease payments

- Assumptions based on limited information in note disclosures



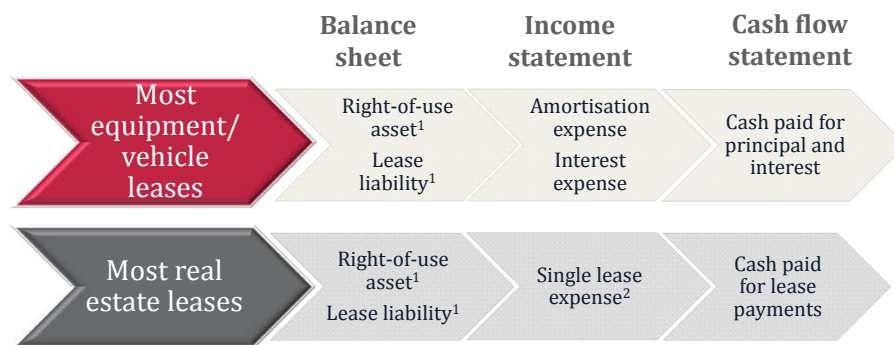
## How the proposals improve financial reporting



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## Lessee accounting model



<sup>1</sup> Excludes variable lease payments linked to sales or use and most payments in renewal periods—decision taken to reduce cost and complexity.

<sup>2</sup> Interest on lease liability available in note disclosures.

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## Lessee disclosures

### Qualitative

General description of leases

Terms of:

- variable lease payments
- extension/termination options
- residual value guarantees

Restrictions and covenants

Information about leases not yet commenced

### Quantitative

Maturity analysis of undiscounted cash flows for each of first 5 years plus total thereafter

Reconciliation of lease liability

Expense relating to variable lease payments

Reconciliation of right-of-use asset by asset class (IASB only)

### Judgments & Risks

Nature and extent of risks arising from leases

Significant assumptions and judgments

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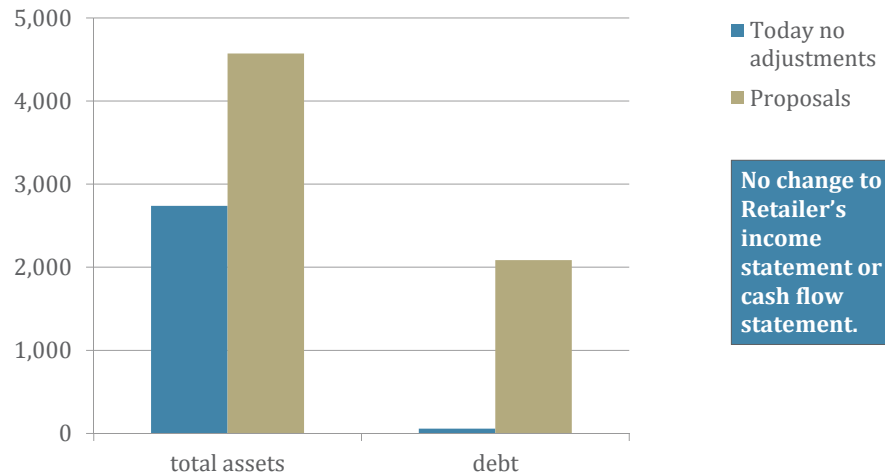
Examples

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## Balance sheet impact — Retailer



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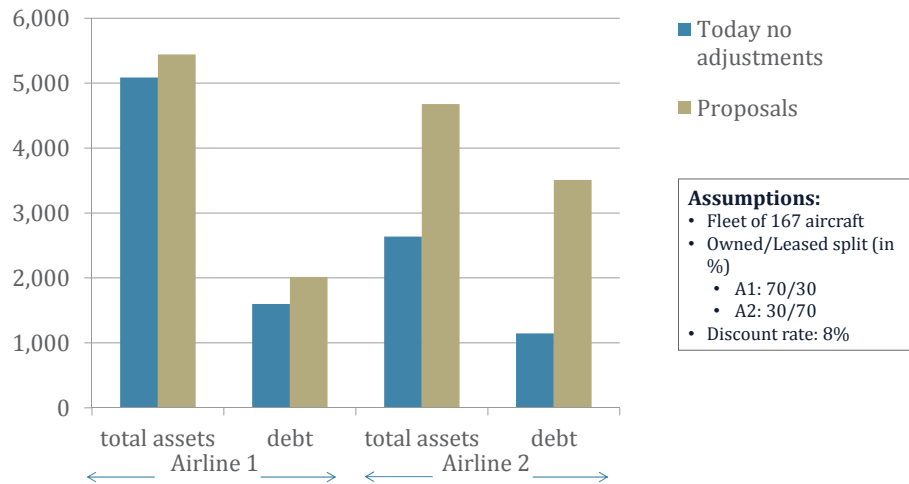
## Disclosures - Retailer

- Qualitative information about leases, including terms of variable lease payments and extension options
- Quantitative information about amount of variable lease payments linked to sales
- Maturity analysis of undiscounted lease payments for each of first five years and thereafter
- Rollforward of right-of-use asset (IASB only) and lease liability

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## Balance sheet impact — Airlines 1 and 2



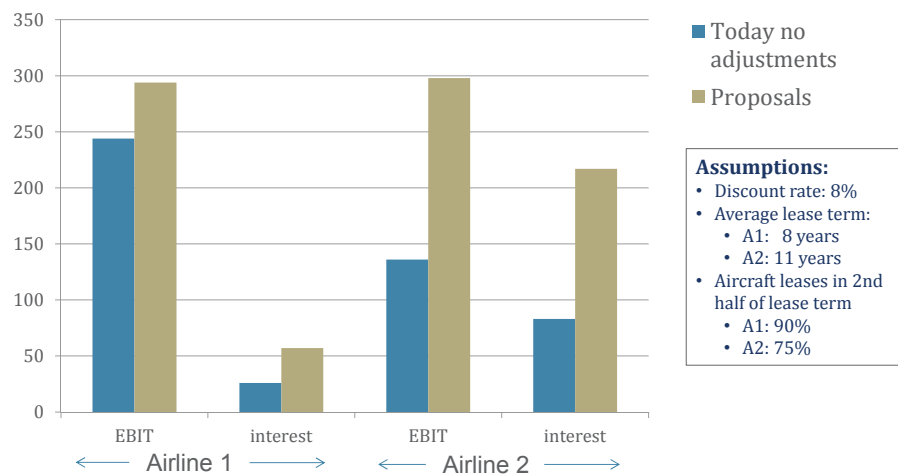
**Assumptions:**

- Fleet of 167 aircraft
- Owned/Leased split (in %)
- A1: 70/30
- A2: 30/70
- Discount rate: 8%

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## Income statement impact — Airlines 1 and 2



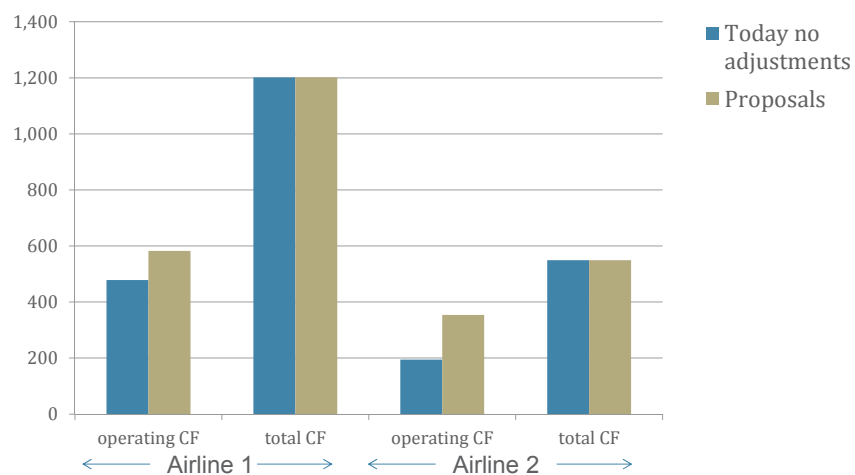
**Assumptions:**

- Discount rate: 8%
- Average lease term:
- A1: 8 years
- A2: 11 years
- Aircraft leases in 2nd half of lease term
- A1: 90%
- A2: 75%

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## Cash flow statement impact — Airlines 1 and 2



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## Disclosures—Airlines 1 and 2

- Qualitative information about leases
- Maturity analysis of undiscounted lease payments for each of first five years and thereafter
- Roll-forwards of right-of-use asset by asset class (IASB only)
- Roll-forwards of lease liabilities related to aircraft leases and real estate leases

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# Investor Considerations

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## Investor Considerations

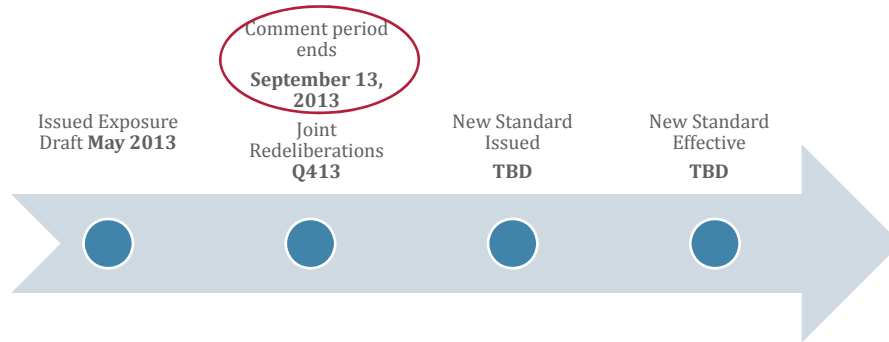
### What are the benefits and insights provided by the new proposals?

1. Assets -- Capitalisation of existing operating leases by lessees will increase asset balances, resulting in lower asset turnover and return on asset ratios compared to operating lease accounting.
2. Liabilities -- For both real estate and equipment leases, reported leverage by lessees will more faithfully reflect economic leverage. At transition, the increase in reported debt will cause working capital ratios to decrease, while debt to equity and other leverage ratios will increase.
3. Income and expense -- The effects on profitability metrics will vary – both at transition and over time.
4. Cash flows -- Capitalisation of operating leases by lessees will cause operating and financing cash flows to change –the change will depend on the nature, classification and size of each lessee's portfolio and whether the portfolio is increasing or decreasing.
5. Will make companies that primarily lease assets more comparable to companies that purchase assets.

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## Next Steps



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Revenue

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# Revenue recognition

## Core Principle

Recognise revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services

When?

The company satisfies a performance obligation by transferring a good or service to customer

How much?

Amount of the transaction price allocated to the transfer of goods or services (ie satisfied performance obligation)



# Disclosure requirements

**Objective:** To enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers

Qualitative information about

Estimates and judgements used

Performance obligations

Disaggregation of revenue

Contract assets and contract liabilities (eg unbilled A/R and deferred revenue)

Assets recognised from the costs to obtain or fulfil a contract

Remaining performance obligations (ie Information about long-term contracts)



## Transition, effective date and early application

- **Effective date:** annual reporting periods beginning on or after 1 January 2017
- Early application permitted (IFRS)
- **Transition methods**
  - Retrospective transition method (with optional practical expedients); or
  - Alternative transition method (ie cumulative catch-up method)

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# Investor Considerations

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## Investor Considerations

### What are the benefits and insights provided by the new standard/disclosures?

1. Removing inconsistencies and weaknesses in existing revenue recognition standards/practices
2. Providing a more robust framework for analysing revenue – particularly transactions involving multiple elements and delivery of goods or services over time.
3. Simplifying the number of accounting standards an investor must understand across industries and sectors.
4. Improving comparability of revenue across companies and geographies.
5. Establishing a common set of disclosures to permit investors to ask comparative questions and to develop expectations of changes over time.