# Accounting Frontline

***KPMG IFRS Seminar***

DUBAI
3 March 2016
9.00 am – 13.00 pm

**ABU DHABI**
10 March 2016
9.00 am – 13.00 pm

*See Page 12 for more details*

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# Editorial

Welcome to the first edition of ***Accounting Frontline***.

With increasing regulations and complexities in the accounting arena, it is vital to understand any new developments. Accounting Frontline shares KPMG's insight on what's new in the accounting field and our outlook on various accounting aspects, including specific issues encountered in the Middle East.

In January 2016, the International Accounting Standards Board ('IASB') announced a new leasing standard, IFRS 16 *Leases* which comes into effect on 1 January 2019 and supersedes IAS 17 Leases. In this issue, we broadly cover what will change with IFRS 16. This issue also covers the classification of financial assets under IFRS 9, gives a bird's eye view of IFRS 15 *Revenue* and a separate section focuses on the International Public Sector Accounting Standards (IPSAS).

Our forthcoming practical seminar on IFRS – with updates on IFRS 10, IFRS 15 and IFRS 9 – will encourage the sharing of leading practice based on the experience of our seminar leader and other participants. Our style is collective and questions and participation are encouraged.

Our next newsletter will cover IFRS 9's impairment model and the various implications of IFRS 15 for construction companies.

We would be delighted to hear suggestions on what we could cover in future editions, as well as any comments or questions you might have.

**Yusuf Hassan**
Partner
Accounting Advisory Services
KPMG Lower Gulf

# IFRS 16 Leases: Operating leases on balance sheet

Many companies in the Middle East rent or lease assets. Depending on the materiality of their lease portfolio, the lease accounting standard could significantly impact companies' financial statements.

After several years of work with the Financial Accounting Standards Board ('FASB'), the International Accounting Standards Board ('IASB') announced a new leasing standard in January 2016. IFRS 16 *Leases* comes into effect on 1 January 2019 and supersedes IAS 17. Early adoption is possible where Companies adopt new IFRS 15 *Revenue*.

Under the existing standard, leases are classified as either finance leases or operating leases, depending on whether the risks and rewards of ownership are substantially transferred to the lessee or not. Operating leases are not recognized in the balance sheet. Rentals are charged to the income statement over the term of the lease and related minimum payments are disclosed as off-balance lease commitments. With the new IFRS 16, lessees bring leases on to their balance sheet and so will appear to be more asset-rich but also more heavily indebted. For the lessors, the dual lease accounting model remains similar to current practice.

## How should you identify a lease agreement?

Under IFRS 16, a lease is a contract that conveys the right to control the use of an identified asset for a period of time in exchange for a consideration, where:

- an identified asset is either explicitly specified in a contract or implicitly specified at the time it is made available for use by the lessee, and
- the company obtains substantially all of the economic benefits from use of the identified asset throughout the period of use, and it directs the use of the identified asset.

A lessee can elect not to apply the lessee accounting model to short-term leases – that is, leases where the term is less than 12 months - or to leases of low-value items - assets with a value of up to US$5,000 when they are new.

## How should most leases be recognized?

A lessee applies a single accounting model under which it recognizes all major leases on its balance sheet. Under this model (similar to the current finance lease accounting), the lessee recognize a right-of-use asset (representing the right to use the underlying asset) and a lease liability (representing the obligation to make lease payments).

**In practice, identifying all lease agreements is likely to require significant additional data about the leases**

## How will the new standard impact your financial ratios?

Across the Middle East, companies often enter into lease agreements and commit financial covenants with a financial institution. For companies with material off-balance sheet leases, IFRS 16 will significantly affect a company's balance sheet (increasing lease assets and financial liabilities), its income statement (higher profits before interest) and its cash flow statement (increasing cash flow from operating activities and decreasing cash flow from financing activities). IFRS 16 will affect almost all key financial metrics. As a result, the standard might impact debt covenants or a company's ability to pay dividends.

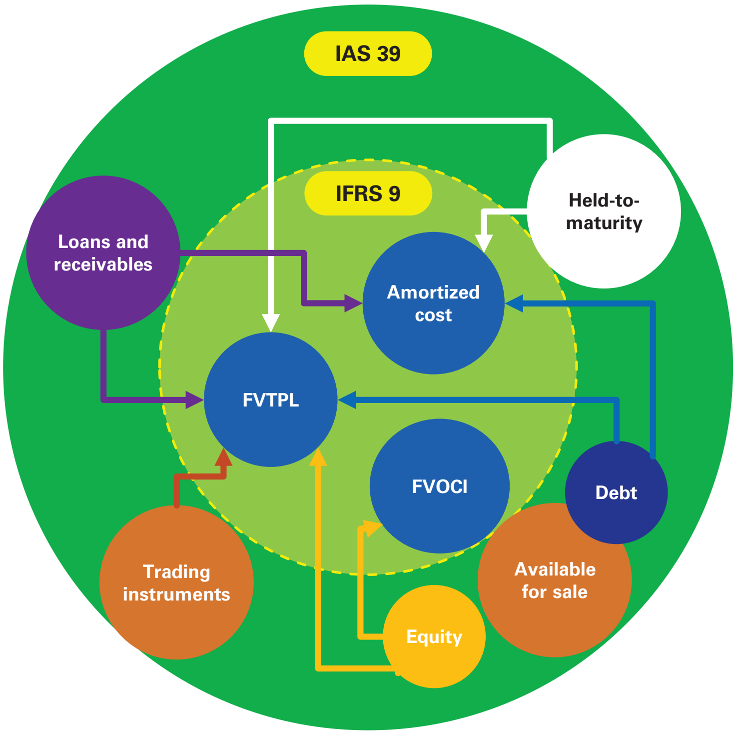
## Do companies have to apply the new definition to all contracts?

On transition to IFRS 16, companies can choose whether to apply the new definition of a lease to all of their contracts or to apply a practical expedient to 'grandfather' their previous assessment. Under the practical expedient, a company will apply IFRS 16 to leases previously identified as being in accordance with IAS 17 and IFRIC 4 and assess contracts entered into after the date of the initial application of the new standard.

# IFRS 9 Financial Instruments: Classification of financial assets

Coverage of IFRS 9 so far has focused mainly on the banking sector, however, many aspects of IFRS 9 will also affect non-financial entities. In this edition of the newsletter, we highlight the most significant impacts from the new asset classification model. The impairment loss model, classifications of financial liability and other implications of IFRS 9 will be covered in a future newsletter.

In July 2014, the IASB issued the final version of IFRS 9 *Financial Instruments* which replaces IAS 39. It is effective for periods beginning on or after 1 January 2018, with early adopted permitted (subject to local requirements).




## Classification and measurement of financial assets

IFRS 9 replaces the four classification categories for financial assets contained in IAS 39 (financial assets at fair value with changes processed through profit and loss (FVTPL), held-to-maturity, loans and receivables, and available-for-sale) and requires that assets be classified as measured at amortized cost, FVTPL or fair value through other comprehensive income (FVOCI).

## Equity on debt instruments

All equity instruments should be measured at FVTPL, however, if these instruments are not held for trading, entities can measure them at FVOCI.

Complexity arises when dealing with debt instruments. The requirements to measure debt instruments at amortized cost have become very stringent and require a great deal of judgment from management. IFRS 9 requires the cash flows resulting from debt instruments, as well as an entity's intention for holding such instruments, to be closely analyzed.

## FVOCI

FVOCI is a new classification category that is applied to assets which have passed the cash flows characteristics test and which are held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

In addition, an entity has the option on initial recognition to irrevocably designate a financial assets as at FVTPL, if doing so would eliminate an accounting mismatch.

## FVOCI (continued)

The cash flows characteristics test, commonly referred to as the ‘solely payments of principal and interest’ (SPPI) test, requires management to analyze whether or not the return on an asset is similar to those of a normal financing transaction. Any clauses which may affect the asset’s cash flows, such as prepayment features or interest rate step-ups, need to be analyzed in detail.

FVOCI may be used for assets that would otherwise need to be measured at FVTPL because they don’t comply with business model requirements for the amortized costs. This will decrease the profit and loss volatility.

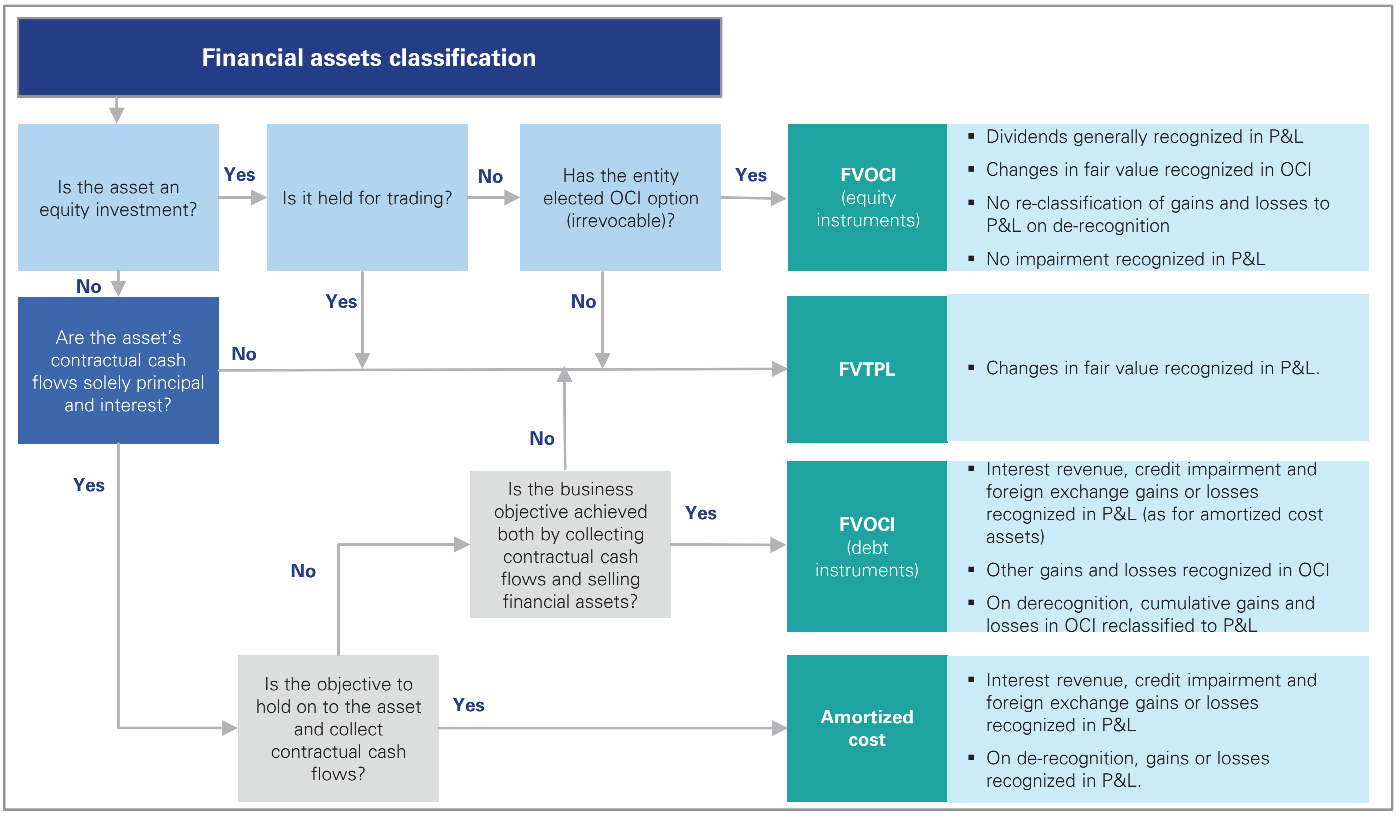
***FVOCI is especially relevant to entities that invest in long-term debt instruments and manage their overall return by collecting cash flows and selling assets to reinvest at another time to gain a greater return. This business model may be adopted, for example, for working capital purposes or to fund capital expenditure in the short to medium term.***

## FVOCI is not available for sale

FVOCI should not be seen as a ‘catch-all’, but rather a distinct category with defined criteria. FVOCI debt instruments will need to be considered for impairment under the new expected loss model.

***Many non-financial entities are adopting IFRS 9 early to classify certain investments, previously held as available for sale under IAS 39, as FVTPL under IFRS 9. This improves the ‘bottom-line’ during the adoption by allowing entities to recognize their reserves on their profit and loss statement.***

## Classifying financial assets under IFRS 9



# IFRS 15 *Revenue*: A five step model

## What is the best option for your business?

IFRS 15 will significantly impact certain key industries. It may be easier for some industries than others to make the transition.

The new standard moves away from industry and transaction-specific requirements under US GAAP, which are also used by some IFRS preparers in the absence of IFRS guidance.

Companies will have two years to prepare for the implementation of IFRS 15 which will be effective for annual periods beginning on or after 1 January 2018, with early adoption permitted.

## Standards impacted

IFRS 15 standard replaces:

- IAS 11 *Construction contracts*
- IAS 18 *Revenue*
- IFRIC 13 *Customer loyalty programs*
- IFRIC 15 *Agreements for the construction of real estate*
- IFRIC 18 *Transfers of assets from customers*
- SIC-31 *Revenue-barter transactions involving advertising services*

## Key sectors impacted

The new standard will significantly impact:

- Telecoms
- Software
- IT services
- Aerospace and defense
- Real estate
- Building & construction
- Contract manufacturers
- Licensors
- Franchisors
- Media
- Pharmaceuticals
- Automotive

## IFRS 15 application model

**Step 1** Identify the contract

**Step 2** Identify performance obligations

**Step 3** Determine the transaction price

**Step 4** Allocate the transaction price

**Step 5** Recognize revenue

## How should IFRS 15 be applied?

### Step - 1 Identify the contract

Certain criteria have to be met for a contract to exist. Contracts may be combined only in specific circumstances. A portfolio approach may be used in some cases. A contract modification is treated as a separate contract when specified criteria are met.

### Step – 2 Identify performance obligations

Account for 'distinct' performance obligations separately.

### Step – 3 Determine the transaction price

Estimate the amount of consideration to which the entity expects to be entitled – including variable considerations (constraining it to an amount that is 'highly probable'), non-cash considerations, financing and any considerations payable to customers.

### Step – 4 Allocate the transaction price

The allocation is based on the relative stand-alone selling price of goods or services.

### Step – 5 Recognize revenue

Recognize revenue when or as the customer obtains control of the goods or services. This is dependent on specific criteria and may be at a point in time or over time.

**Companies also need to recognize certain costs of obtaining and fulfilling contracts as separate assets when specified criteria are met.**

## So what should you do now?

- Understand the new requirements.
- Identify if you are in a 'high impact' sector.
- Analyze the complexity involved in determining whether you will be impacted.
- If impact and complexity are both assessed as low, determine whether you can evaluate in-house.
- If impact or complexity is assessed as high, consider whether you need professional advice.
- All companies need to determine whether there will be an impact and the likely materiality of this impact. This will only be determined after an initial impact assessment.

# IPSAS corner

## Globally, the government sector is on the verge of converting to international public sector accounting standards (IPSAS).

The global financial and sovereign debt crises have underlined the need for better financial reporting by governments worldwide, and the need to improve the management of public sector resources. As many Middle Eastern governments strive to cope with this issue, many are concluding that one major drawback of the current system is the lack of consistency and transparency. Government entities often prepare financial reports based on a cash basis or by using local government entity accounting requirements.

Global momentum to adopt IPSAS reporting, which can be under a cash basis or accrual basis, is growing. Emerging economies including Russia are moving towards IPSAS on an accrual basis.

The framework is a global reporting standard that caters to the unique challenges of the public sector. Some of the advantages of the IPSAS framework include:

- Improved accountability
- Greater transparency
- Greater credibility
- Improved overall management and planning
- Improved program management
- Harmonization of reports and statements across different entities

***Stay tuned for further IPSAS updates***

# KPMG IFRS seminar

## IFRS 16 - Leases and other updates

Changes to IFRS 16 will impact the financial ratios of entities with long term operating leases.

### Why is this important?

- **Most companies lease assets** – IFRS 16 will impact companies with material off-balance sheet leases under IAS 17.
- **Lessees face major changes** – IFRS 16 does not substantially change how lessors account for leases. Lessees, however, must now bring leases on to their balance sheets.
- **Financial ratios will change** – Stakeholders and investors will want to understand the impact of IFRS 16.
- **IFRS 16 can be applied in different ways** – A lessee can choose to apply the standard retrospectively or as a 'big bang'.

### Our seminar leader:

**Yusuf Hassan**

Partner,
KPMG Lower Gulf Limited

### Agenda:

| Talking points |
|---|
| IFRS16 - Leases |
| Update on IFRS15 - Revenue |
| Update on IFRS 9 - Financial instruments |
| IFRS 10 and other IFRS updates |

### Who should attend?

The seminar is recommended for CFOs, finance directors and other senior decision makers who are leading IFRS 16 implementation projects. All participants will be given attendance certificates at the end of the seminar.

*Please contact **Victoria Abakumova** at vabakumova1@kpmg.com*

*for more details on availability and Seminar fees*

### Venue, dates & times:

DUBAI
**3 March 2016**
**9.00 am – 13.00 pm**
The Address Hotel | Dubai Marina

ABU DHABI
**10 March 2016**
**9.00 am – 13.00 pm**
Jumeirah at Etihad Towers

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