KPMG

Upcoming changes to FRS 102

It's time to review your revenue and lease arrangements.

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With you today

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Agenda

01 Revenue from contracts with customers

02 Lease accounting: Lessees

03 Other amendments to FRS 102

04 Q & A

Revenue from contracts with customers

The five steps

Revenue will now be recognised when, or as, control over the goods or services is transferred to the customer.

In contrast, previously you would recognise revenue when risks and rewards of ownership would transfer.

The core principle is to align revenue recognition with the transfer of control of goods or services to customers which may either be over time or at a point in time.

The revenue recognition model

Step 1: Identify the contract(s) with a customer

Ask yourself:

Do we have a binding contract with a customer?

Consider the following

- Contract has been approved by both parties
- Both parties are committed to perform their obligations
- Each party's rights can be identified
- Payment terms can be identified
- The contract has commercial substance
- It is probable that consideration will be collected

The revenue recognition model

Step 2: Identify the performance obligations in the contract

Ask yourself:

What do I need to deliver?

A performance obligation is a promise to transfer to the customer either:

a) A good or service that is distinct

b) A series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer.

Goods or services are distinct if **both** of the following criteria are satisfied:

1. Criteria 1: The customer can benefit from it either on its own or together with other resources that are readily available to the customer.
2. Criteria 2: The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract. (do they modify one another, are they significantly interrelated?)

Illustrative example: Scenario 1

An entity enters into a contract to design and build a hospital for a customer. The entity is responsible for the overall management of the project and identifies various promised goods and services, including engineering, site clearance, foundation, procurement, construction of the structure, piping and wiring, installation of equipment, and finishing.

The entity identifies that many of the goods and services to be provided meet **Criterion 1**; this is because the customer could benefit from the goods or services on their own – each construction material is sold separately by numerous suppliers or could be resold for more than scrap value by the customer – or together with other readily available resources such as additional materials or the services of another contractor.

However, the entity determines that **Criterion 2** is not met because it provides a significant service of integrating the goods or services to produce the output (the hospital) for which the customer has contracted.

As a result, **because Criterion 2 is not met,** the entity would account for the contract as a single performance obligation.

Illustrative example: Scenario 2

An entity enters into a contract to provide a software license, install the software and provide software updates and technical support to the customer. The software can work without the updates and technical support. The contract specifies that the software will be installed by the company, however despite the contractual limitations, it is theoretically possible that the software could be installed by a third party.

How many performance obligations exist in this scenario?

a) One

b) Two

c) Three

d) Four

Illustrative example: Scenario 2

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How many performance obligations exist in this scenario?

a) One
b) Two
c) Three
d) Four ✓

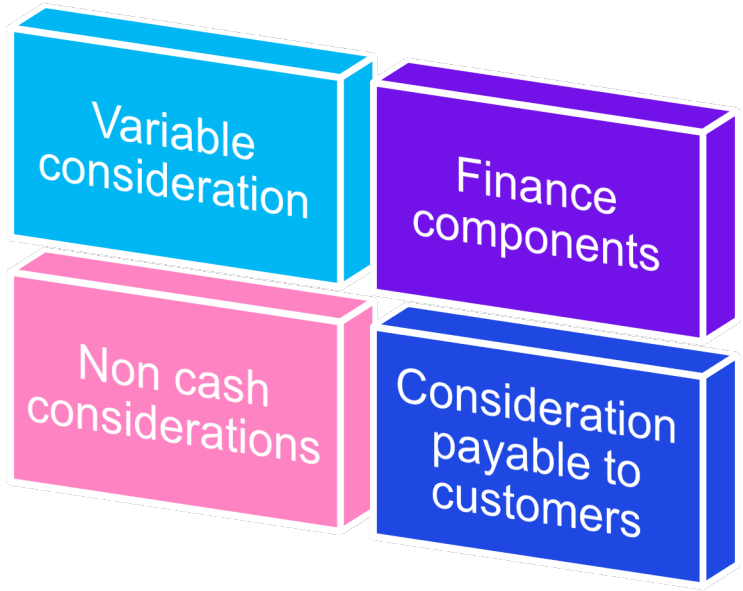
The revenue recognition model

Step 3: Determine the transaction price

Ask yourself:

What do I expect to get paid?

Sometimes, identifying the transaction price in the contract will be relatively straightforward However, it is important to ascertain complex considerations within a contract, which may include:



Illustrative example: Variable consideration

Company A provides construction services. A customer engages company A for the construction of an office building on land owned by the customer. They agree on a fixed consideration of 500,000 Euros. Assume that there is no need for unwinding of discount in this scenario.

Scenario 1:

The customer has also stated that they will provide a 10% bonus to the company if the building is constructed in 2 years; If it takes 25 months the bonus will be 5%; and if it is completed within 27 months, only the contract price will be paid.
The company uses an expected value method to derive the variable consideration to determine the transaction price.
The company estimates that there is a 50% chance that the building will be completed within 25 months, 10% chance that it will be completed in 2 years, and 40% chance it will be completed in 27 months.
Probable figures are as follows:

Details	% chance of completion	x Bonus amount (Euro)	= Expected value (Euro)
Within 2 years	10%	50,000	5,000
Within 25 months	50%	25,000	12,500
Within 27 months	40%	-	-
Total			**17,500**

The transaction price using the **expected value method** would be €517,500 (expected value of the bonus + fixed consideration).

Illustrative example: Variable consideration

Scenario 2:

Tweaking the previous example, let's say that the consideration stipulated in the Contract is 500,000 Euros, but instead of there being a bonus for on-time completion, the contract states that if the building does not meet an A3 BER rating, there will be a penalty imposed of 30,000 Euros. Based on historic experience with similar projects, there is a 65% chance that the building will not meet the A3 BER rating.

In this scenario, the fixed consideration will not be the 500,000 Euros as identified in the contract. Rather, as per the new guidance, the fixed consideration within the contract is 470,000 Euros (500,000 - 30,000). The penalty which can be imposed under the contract creates variability in the consideration that will be received.

Fixed consideration = 470,000 Euros
Variable consideration = 30,000 Euros.

In this scenario, the company may use the most likely amount method to estimate the variable consideration to include in the transaction price. This is because there are only 2 possible outcomes, either the building will meet the standards or not.

Using the "single most likely amount" method our transaction price in the contract would be 470,000 Euros. The key reason for this is that there is a 65% chance that the building will not meet the A3 BER rating, and therefore it is not ***highly probable*** that the entity will be entitled to that additional 30,000 Euros of consideration.

As the contract progresses, at the end of each reporting period the entity should then update the estimate of variable consideration included in the transaction price to reflect any relevant changes in circumstances (i.e. has the probability of achieving an A3 BER rating improved?)

Any change in prediction of variable consideration will be treated prospectively as a change in estimate.

The revenue recognition model

Step 4: Allocate the transaction price to the performance obligations in the contract

Allocate the consideration

Assign consideration to each PO identified in the contract.

To do this, the entity will need to determine the standalone selling prices at contract inception of each distinct good/service underlying each performance obligation.
If standalone prices are not available, the entity may estimate the price on the following basis under the new FRS 102:

Illustrative example

A company sells gaming computer components. Assume a gaming computer would include a Graphic card, a CPU, a motherboard, and a VRAM. The company sells these items separately at their own respective prices, or as a package for 1,000 Euro per gaming computer. The company can sell each component at their standalone selling prices. Each product is priced at:

	Euro
Graphic card	500
CPU	300
Motherboard	150
VRAM	100
Assembly (Service)	50
Total	**1,100**

To simplify, we will assume assembly of the computer and the sale of the computer are separate POs, and the company has an enforceable right to payment for assembly services.

Illustrative example

We can now allocate the contract price based on standalone selling prices:

Item	Standalone selling price (Euro)	SASP %	Allocation (Euro)
Graphic card	500	45.45%	455
CPU	300	27.30%	273
Motherboard	150	13.60%	136
VRAM	100	9.1%	91
Assembly (Service)	50	4.55%	45
Total contract price	**1,100**	**100%**	**1,000**

What does this mean?

Upon completion of the computer assembly, revenue of €45 will be recognised in accordance with the contract terms. This amount reflects the allocated transaction price for the assembly service, which would otherwise be valued at €50 on a standalone basis.

The remaining €955 will be recognised when control of the completed computer transfers to the customer, consistent with the performance obligation related to the delivery of the final product.

The revenue recognition model *(continued)*

Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation *(continued)*

Ask yourself:

Have I earned it?

Under the new standard, the entity shall recognise revenue when (or as) the entity satisfies the performance obligation.

The performance obligation is satisfied when control of the good is transferred or the service is delivered, or in other words when a performance obligation is satisfied.

The entity shall take into account certain indicators in ascertaining whether control has been transferred or not.

Over time vs Point in time

An entity transfers control of a good or service over time and therefore satisfies a performance obligation and recognises revenue over time if one or more of the criteria is met:

The customer simultaneously receives and consumes the benefits; or

The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or

The entity's performance does not create an asset with an alternative use and the entity has an enforceable right to payment for performance completed to date.

Entities will recognise revenue at point in time if the over time criteria has not been met.

Illustrative example

Scenario 1:

An entity enters into a contract to provide a certain quantity of goods to a customer over the year. The entity provides the goods at 300 Euro per unit. The total agreed quantity of the goods over the year is up to 12,000 Units.

The total contract consideration is hence 300 Euro per unit * 12,000 units = 3.6 million Euros.

How should the entity recognise its revenue?

a) At a point in time upon delivery of goods based on purchase order quantities
b) Recognise 3.6 Million revenue over the period of 12 months
c) It depends

Illustrative example

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a) At a point in time upon delivery of goods based on purchase order quantities ✓
b) Recognise 3.6 Million revenue over the period of 12 months
c) It depends

Illustrative example

Scenario 2:

An entity enters into a 12 month contract with a customer for providing consulting services. Under the contract, the customer will receive professional opinions on matters requested by the customer during the term of the contract. The contract price is agreed at 30,000 Euros per annum. Additionally, there will be a specific fee for each opinion provided as well. The entity estimates it will provide 15 opinions during the contract term. Assume the stand alone selling prices for the performance obligations are the same as if they were outside of this contract.

How should the entity recognise its revenue?

a) Recognise all revenue (actual + estimated) evenly over the 12 month period
b) Recognise a portion of the contract price along with specific fee at point in time
c) Recognise contract price over time and specific fee at point in time upon receipt of opinion
d) it depends

Illustrative example

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c) Recognise contract price over time and specific fee at point in time upon receipt of opinion ✓
d) it depends

Differences between new FRS 102 standard and IFRS

	As per IFRS 15	As per Section 23 – FRS 102
Costs to obtain a contract	Capitalisation of costs only if entity expects to recover the costs	Accounting policy choice on whether an entity capitalises its costs to obtain a contract
Significant financing components	Adjusting time value of money on payments received in advance is not optional	Adjusting time value of money on payments received in advance is optional
Transitional provisions	Retrospective application	Choice: • Retrospective; or • Modified retrospective; where no restatement of comparatives required - Adjust to equity/RE on date of initial application

Lease accounting by a lessee

Steps to record lease liabilities and ROU assets

Step 1

Identify the contract: What is a lease contract?

For accounting purposes, a lease contract should convey the **right to control the use** of an **identified asset** for a **period of time** in **exchange for consideration**

Step 2

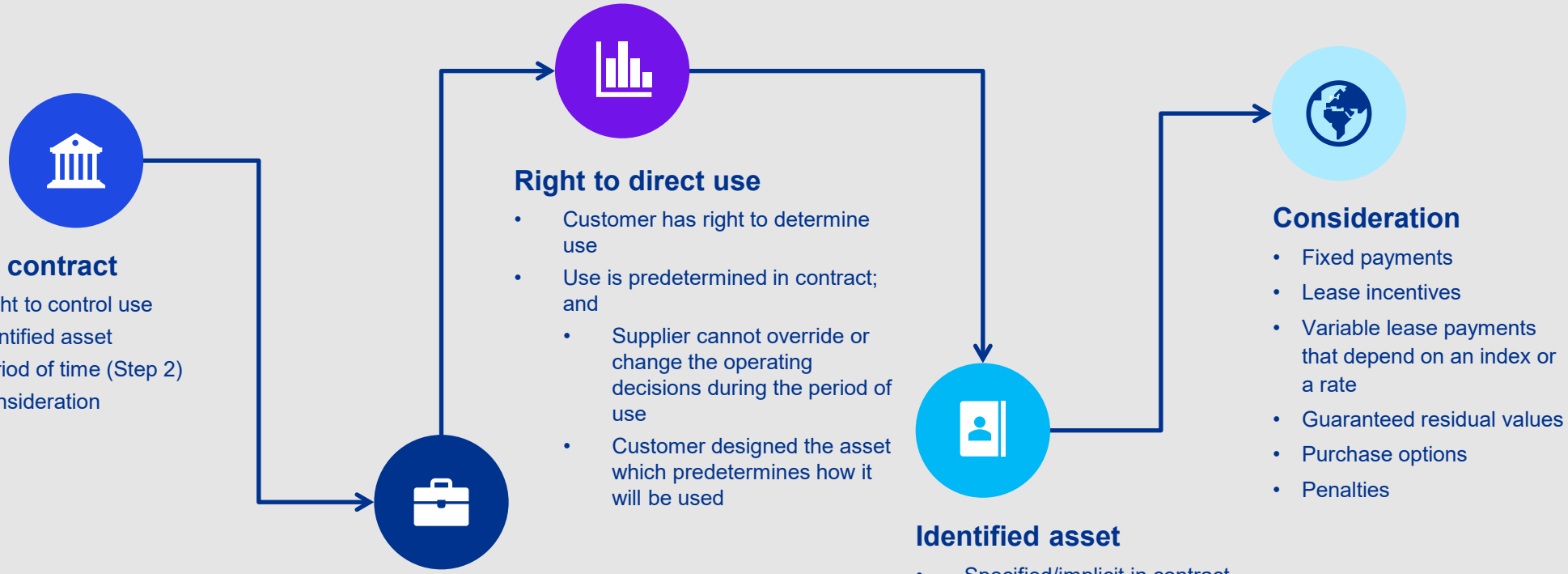
Identify the lease term

Non cancellable period of lease + expected extension period

Step 3

Recognise right of use asset and lease liability at commencement date

Step 1: What is a lease contract?



Lease contract

- Right to control use
- Identified asset
- Period of time (Step 2)
- Consideration

Right to control

- Obtain substantially all of the economic benefits from use
- Right to direct use

Right to direct use

- Customer has right to determine use
- Use is predetermined in contract; and
  - Supplier cannot override or change the operating decisions during the period of use
  - Customer designed the asset which predetermines how it will be used

Identified asset

- Specified/implicit in contract
- No substitution right with supplier

Consideration

- Fixed payments
- Lease incentives
- Variable lease payments that depend on an index or a rate
- Guaranteed residual values
- Purchase options
- Penalties

Illustrative example 1

A customer and a freight carrier (supplier) form a contract where the supplier will provide the customer with the use of 10 rail cars of a particular type for 5 years.

The rail cars are specified in the contract, but under the ownership of the supplier. However, the customer defines when, where and which goods to transport with the cars, with some limitations like artillery or illegal items. The customer may also use the cars for other purposes.

If the car is to be serviced, the supplier will provide replacement cars. The supplier cannot retrieve the cars before the end of 5 years.

The contract also requires the supplier to provide an engine and a driver when requested by the customer.

Engines are at supplier premises and the supplier can attach other cars to the engine as well. The engines are not specified in the contract. The supplier may choose any one of several engines to fulfil the contract.

Options:

1) Both rail cars and engines are under a lease contract
2) Both rail cars and engines are not under a lease contract
3) Only rail cars are part of the lease contract
4) Only engines are part of the lease contract

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2) Both rail cars and engines are not under a lease contract
3) Only rail cars are part of the lease contract ✓
4) Only engines are part of the lease contract

Illustrative example 2

A customer and a freight carrier (supplier) form a contract where the supplier will provide the customer with the use of an equivalent of 10 rail cars of a particular type for 5 years.

Supplier has a large pool of similar cars of that type that can be used to fulfil the requirements of the contract. The type of goods and supplier quantity to be transported are specified in the contract.

The contract also requires the supplier to provide an engine and a driver when requested by the customer.

Engines and cars are at supplier premises and supplier can attach other cars to the engine as well. The engines are not specified in the contract. The supplier may choose any one of several engines to fulfil the contract.

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Step 2: Identify the lease term

Non cancellable period of lease

Option to extend the lease, if reasonably certain for option to be exercised

Lease term

Who has right to terminate?

What is the impact of termination of lease?

Option to terminate the lease if reasonably certain not to be exercised

Lease inception:

- When agreement is signed
- For assessment purpose only

Lease commencement:

- Lessee gains control of asset
- Lease recognition date

A lease term is no longer enforceable when the lessee and the lessor **EACH** have the right to terminate the lease without permission from the other party with no more than an insignificant penalty

[Lease term]

Illustrative example: Lease term

1) Lessee has option to extend:

A company leases an office space for 5 years, with an option to extend for another 3 years.

The lease includes significant leasehold improvements made by the lessee, which are expected to have a useful life of 10 years.

What is the lease term:

a) 5 years
b) 3 years
c) 8 years
d) 10 years

Illustrative example: Lease term

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b) 3 years
c) 8 years ✓
d) 10 years

This is because it is considered reasonably certain that the lessee will exercise their option to extend the lease for a further 3 years because they have made significant leasehold improvements that have a useful life of 10 years!

Illustrative example: Lease term

2) Only lessor has option to cancel:

A company enters into a 10-year lease for a warehouse, but the lessor has a unilateral break clause at the end of year 4. The lessee has invested in custom racking systems that are not transferable and has a long-term distribution contract dependent on this location.

What is the lease term:

a) 4 years
b) 10 years
c) No lease since inception
d) It depends

Illustrative example: Lease term

2) Only lessor has option to cancel:

A company enters into a 10-year lease for a warehouse, but the lessor has a unilateral break clause at the end of year 4. The lessee has invested in custom racking systems that are not transferable and has a long-term distribution contract dependent on this location.

What is the lease term:

a) 4 years
b) 10 years ✓
c) No lease since inception
d) It depends

This is because if only the lessor has the right to terminate the lease, the non-cancellable period of the lease includes the period covered by the lessor's option to terminate the lease.

Step 3: Example 1 – Consideration and variable consideration

Lease contract

Company A and Company B form a lease contract for the use of machinery for production

The lease terms are as follows:

- Annual fixed payments: €40,000 payable at the end of each year for 5 years
- Discount rate implicit in the lease: 10%
- Additional variable payments: €5,000 per year based on usage (e.g., hours of equipment use)

What do I do?

- Calculate the lease liability based on the fixed annual payments of €40,000 discounted at 10%.
- Ignore variable payments of €5,000 per year because they are not linked to an index (for e.g. CPI or SOFR).

Step 3: Example 2 – Consideration and variable consideration

Lease contract

Company A and Company B form a lease contract for the use of machinery for production

The lease terms are as follows:

- Imagine a lease where the annual payment is €100,000 plus an additional amount linked to CPI.
- Discount rate implicit in the lease: 10%
- At inception of lease, CPI is 1%.

What do I do?

At the start of the lease, CPI is 1%, so the initial lease liability is calculated using that 1% rate.

If CPI later rises to 3%, the lease payments increase accordingly, but the adjustment is made prospectively — the liability is remeasured based on the new payments from that point forward.

Step 3: Recognise ROU asset and lease liability at commencement date – calculation example 1

Calculate present value of lease payments at the interest rate implicit in the lease.

If interest rate implicit in the lease is not available, then use either the incremental borrowing rate (IFRS 16) or the obtainable borrowing rate (FRS 102).

Example measurement:

Annual payments payable at the end of the year are €40k for 5 years. Discount rate implicit in the lease is 10%.

Year	Amount	Discount Factor @ 10%	PV of Payments
1	40,000	1.1^{-1}	36,364
2	40,000	1.1^{-2}	33,057
3	40,000	1.1^{-3}	30,052
4	40,000	1.1^{-4}	27,320
5	40,000	1.1^{-5}	24,838
Total			**151,631**

Assuming there are no other initial direct costs, book the following initial journal entry:

	Debit	Credit
Right of use asset	151,631	
Lease liability		151,631

Step 3: Recognise ROU asset and lease liability at commencement date – calculation example 1

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If interest rate implicit in the lease is not available, then use either the incremental borrowing rate (IFRS 16) or the obtainable borrowing rate (FRS 102).

Example measurement:

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Year	Amount	Discount Factor @ 10%	PV of Payments
1	40,000	1.1^{-1}	36,364
2	40,400	1.1^{-2}	33,388
3	40,804	1.1^{-3}	30,656
4	41,212	1.1^{-4}	28,148
5	41,624	1.1^{-5}	25,845
Total			**154,401**

Assuming there are no other initial direct costs, book the following initial journal entry:

	Debit	Credit
Right of use asset	151,631	
Lease liability		151,631

Step 3: Recognise ROU asset and lease liability at commencement date

Subsequent measurement

Lease liability	Amount	Interest at 10%	Payment	Principal repayment	Net balance
Y1	151,631	15,163	(40,000)	(24,837)	126,795
Y2	126,765	12,679	(40,000)	(27,321)	99,474
Y3	99,474	9,947	(40,000)	(30,053)	69,421
Y4	69,421	6,942	(40,000)	(33,058)	36,364
Y5	36,364	3,636	(40,000)	(36,364)	-

Right of use:

Depreciate over useful life (shorter of the lease term or useful life)

151,631 / 5 = 30,326

Subsequent journal entries

	Debit	Credit
Y1 – Lease liability		
Interest expense	15,163	
Lease liability	24,837	
Bank		40,000
Y1 – Right of use asset		
Depreciation expense	30,326	
Accumulated depreciation		30,326

Lessee accounting

SOFP

Asset

- ‘Right of use’ assets

Liability

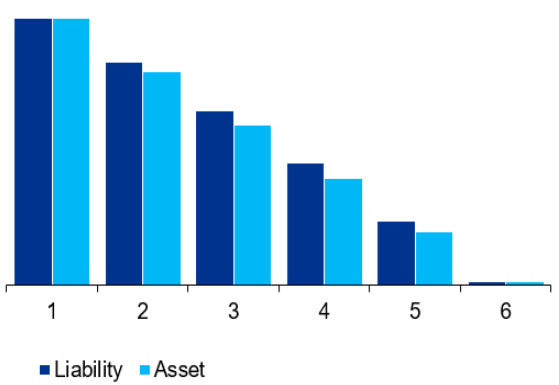
- Current lease liabilities (repayments within 12 months)
- Long term lease liabilities

SOCI

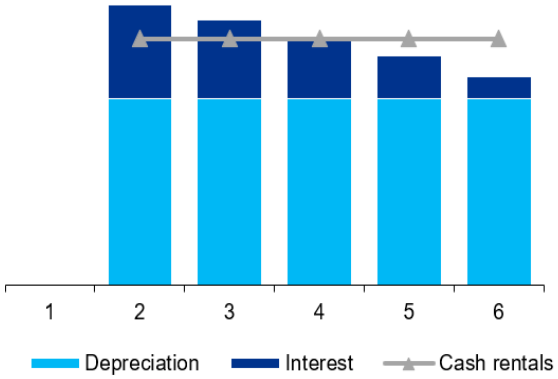
Lease expense

Depreciation
+
Interest expense
=
Front loaded total lease expense

Optional exemption for short-term leases and leases of low value assets (operating expenses)



Companies with operating leases will appear more asset-rich but also more heavily indebted



Total expense will be front-loaded even when cash rentals are constant

	Profit/loss	Balance sheet	Ratios
↑	EBITDA	Total Asset / Liabilities	Gearing
↓	EPS (Early years)	Net assets	Interest cover Asset turnover Current ratio

Differences between new FRS 102 standards and IFRS

	As per IFRS 16	As per Section 20 – FRS 102
Discount rates	Interest rate implicit in the lease or the incremental borrowing rate	Additional option of obtainable borrowing rate
Low value assets	IFRS gives guidance on what constitutes a low value asset and illustrative examples	Provides guidance on what may be a low value asset and examples of which assets cannot be a low value asset
Sale and leaseback arrangements	Under IFRS (where its a sale) the ROU asset is measured at the retained portion of the previous carrying amount.	Under FRS 102 (where it's a sale) accounting policy choice available in measuring the ROU asset.
Lease modifications	Under IFRS (where not a separate lease) there will be a revised discount rate.	Using FRS 102 (where not a separate lease), in certain circumstances, can use original discount rate.
Transitional provisions	Retrospective or Modified Retrospective application	• Modified Retrospective application; or • Use of IFRS 16 calculations • Practical expedients

Other amendments to FRS 102

Other amendments to FRS 102

01

Financial Instruments

Entities not already applying IAS 39 recognition and measurement principles for financial instruments can no longer adopt such policies under Section 11 and 12 of FRS 102, subject to Para B11.5A.

02

Supplier Financing

Section 7 of FRS 102 will now require additional disclosures about supplier finance arrangements and their impact on SOFP and cash flows.

03

Fair value measurements

A new Section 2A (Fair Value Measurement) replaces the Appendix to Section 2 of FRS 102, incorporating the principles of IFRS 13 – “Fair value measurement.”

04

Going concern disclosures

Section 3 of FRS 102 has new requirements for management to affirm consideration of future information and to disclose significant judgments on going concerns.

05

Business combinations

Section 19 of FRS 102 has been updated to include guidance on the identification of an acquirer in a business combination similar to the principles of IFRS 3 – “Business combinations.”

06

Share based payments

Section 26 of FRS 102 includes enhanced guidance on accounting for vesting conditions, fair value determination and SBPs with cash alternatives.

07

Uncertain tax treatments

Section 29 of FRS 102 includes guidance for uncertain tax treatments, which aligns with IFRIC 23 – “Uncertainty over Income Tax Treatments” principles.

The above does not cover all amendments, such as concepts and pervasive principles, accounting policies and estimates, investment property, employee benefits and a host of incremental improvements

Q&A

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.

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