New IFRS 15 & IFRS 16 standards
The impact on M&A transactions

Contents

Information included in this document provides a high level overview of the changes in accounting for revenue from contracts with customers and accounting for leases. For the full text we refer to the standards IFRS 15 and IFRS 16, for additional guidance please visit www.iasplus.com.

What is the impact of new IFRS 15 & IFRS 16 standards on respectively revenue from contracts with customers and accounting for leases?

Executive summary

The purpose of this document is to summarise the major impacts of the new IFRS 15 standard on revenue from contracts with customers respectively the new IFRS 16 standard for leases on the reported financial statements.

IFRS 15

IFRS 15 is the new standard on revenue recognition. This standard may become a point of reference for investors. Implementation of IFRS 15 may significantly impact revenue and profitability levels and trends. Furthermore, it may have broader implications on tax positions, loan covenants and KPIs.

The new revenue recognition standard can have significant impact, especially when the following situations (non-exhaustive) apply to a company:

- bundled products
- milestone payments
- non-refundable upfront fees
- rights of return
- bill and hold arrangements
- warranty
- customer loyalty programs
- modification of customer contracts during the contract term
- slotting fees
- contract manufacturing
- financing arrangements
- real estate development

Transitioning to IFRS 15 may require significant effort to determine the appropriate accounting treatments, restate historical data, change system set up, processes and internal controls. Companies may also want to consider changes to customer contracts to avoid negative accounting consequences.

We suggest you investigate if and what the impact of IFRS 15 will be for your (portfolio) company as we expect this will become relevant for M&A transactions. Potential investors may want to understand the impact of applying IFRS 15 and will therefore ask accounting firms to analyse the impact of IFRS15 when performing due diligence.

IFRS 16

Where past accounting standards differentiated between financial and operational leases, IFRS 16 no longer makes this distinction and all leases in principle will become “on balance sheet” of the lessee. Hence, the new leases standard will significantly impact lease accounting for lessees. . Lessors, however, continue to classify leases as operating or finance, with IFRS 16’s approach to lessor accounting substantially unchanged from its predecessor, IAS 17.

Furthermore, it will have an impact on EBITDA, cash flows and total assets and as such will affect e.g. loan covenants and KPIs.

Apart from the on balance sheet recognition of the lease liability and the right-of-use asset for the lessee, other impacts of the standard may be (not limitative):

- Change in performance indicators such as EBITDA as under IAS 17 the expenses for leases classified as operating lease were recorded within operating expenses. Applying IFRS 16 results in these lease expenses being included in depreciation/ amortisation and interest expenses;
- Statement of cash flows is to be affected as payments need to be split between repayment of the principal amount, included in investment cash flows, and interest expenses, included in financing cash flows;
- More lease expenses recognised in the early periods of a lease, and less in the later periods. ‘Front loading’ of costs relating to the finance charge on the lease liability versus straight-line expenses under the old leases standard;
- Effect on debt covenants;
- Re-assessment of key performance indicators; and
- Debt like items in M&A transactions may be affected.

The new leases standard will impact all companies reporting under IFRS and currently using financial or operational leases and will significantly impact lease companies and the financial services, real estate, retail and telecom industries.

We expect the implementation of IFRS16 will have a significant impact on M&A transactions as reported EBITDA, reported net debt and free cash flow as reported in a cash flow statement is likely to change as a result of applying IFRS16. Consequently multiples and cash flows to be used in DCF models may change or have to be restated. In addition multiples for companies applying IFRS 16 versus companies not applying this standard are incomparable.

This publication sets out the new standards in more detail.

New revenue recognition standard – IFRS 15

Introduction

Before the publication of IFRS 15, IFRS contained limited specific guidance in relation to revenue recognition policies. IFRS 15 becomes applicable for annual reports beginning on or after 1 January 2018 (subject to EU endorsement) and provides detailed guidance on how revenue should be recognised. The standard includes a number of transition reliefs.

The new revenue recognition standard may significantly impact revenue and profit recognition. We believe this may affect M&A transactions, as investors (especially corporate buyers, but also private equity buyers) will want to understand the effects of the new standard on profitability levels, sales and profitability growth trends, loan covenants and other KPIs.

Even in case a target applies local GAAP standards, if revenue recognition policies applied under local GAAP deviate from the guidance in IFRS 15, we believe this could become a cause of discussion in an M&A transaction, as IFRS 15 may be seen as a reference.

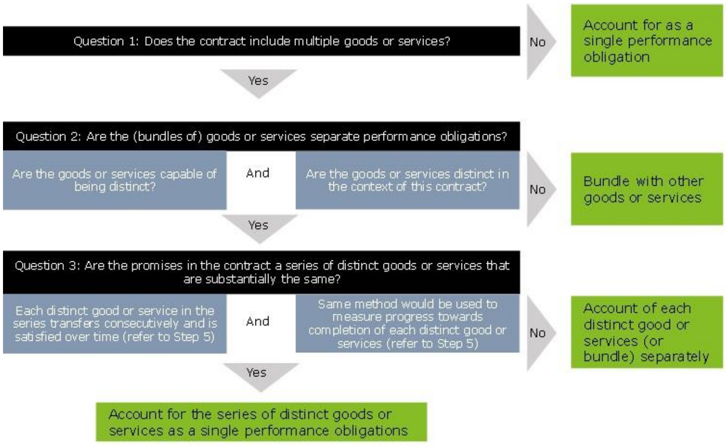
The new IFRS 15 standard

IFRS 15 applies to all contracts with customers, except for financial instruments, leasing and insurance contracts and except for contracts where the accounting is covered by other IFRS standards.

IFRS 15 has defined the following five-step model:

1. Identify the performance obligations in the contract

Step 2 is depicted as follows:

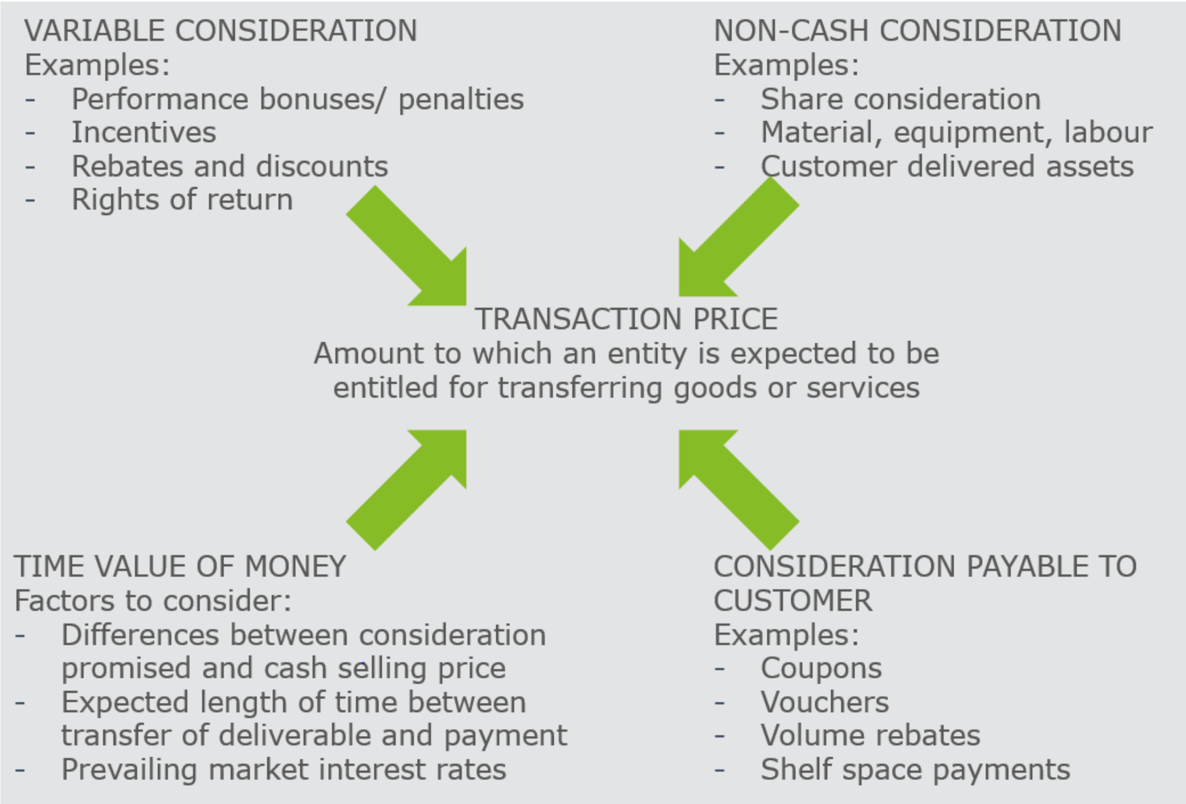


Typical examples where contracts would comprise multiple performance obligations are mobile phone subscriptions with a "free" handset, software contracts with a year of "free" maintenance and support or, in certain circumstances, warranty provided on a product.

Careful consideration and judgement is required to determine if and into what parts a revenue contract should be unbundled.

2. Determine the transaction price

Determining the transaction price is not always straightforward and there are several factors to be considered:



3. Allocate the transaction price to the performance obligations in the contract

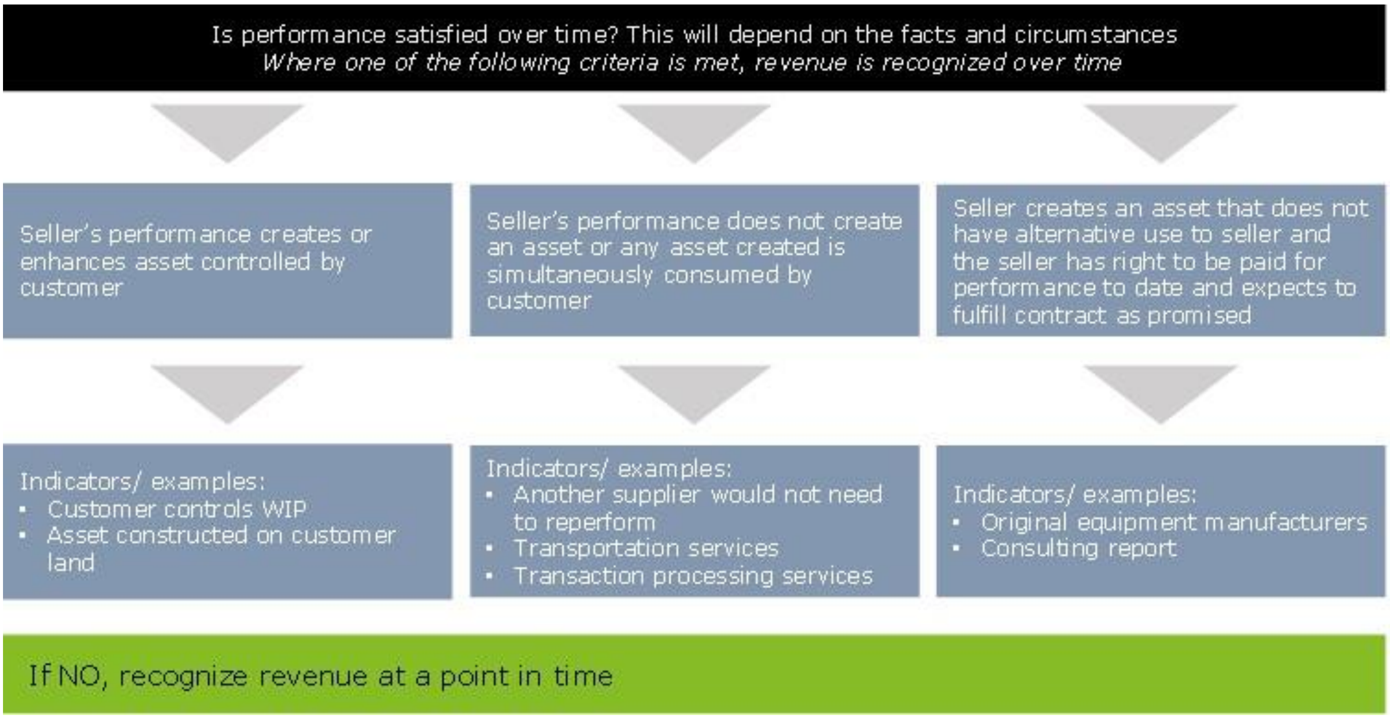
Where a contract has multiple performance obligations, an entity will allocate the transaction price to the performance obligations in the contract by reference to their relative standalone selling prices. [IFRS 15:74] If a standalone selling price is not directly observable, the entity will need to estimate it. IFRS 15 suggests various methods that might be used, including: [IFRS 15:79]

- Adjusted market assessment approach
- Expected cost plus a margin approach
- Residual approach (only permissible in limited circumstances).

4. Recognise revenue when (or as) the entity satisfies a performance obligation

Revenue is recognised as control is transferred, either over time or at a point in time. Control of an asset is defined as the ability to direct the use of and obtain substantially all of the remaining benefits from the asset.

Criteria for recognising revenue over time is depicted as follows:



Application examples

Telecom – typically when entering into a new mobile phone subscription, the telecom provider would offer a "free" handset to the customer. In the past, these transactions may have been accounted for as a single performance obligation with recognition of revenue over time. IFRS 15 will likely result in unbundling of the sale of a handset and the service of a phone subscription. This could result in more revenue being recognized at the start of a contract.

Manufacturer – An entity enters into a contract with a customer on 1 January 2018 for the sale of a machine and spare parts. The manufacturing lead time for the machine and spare parts is two years. Upon completion of manufacturing, the entity demonstrates that the machine and spare parts meet the agreed-upon specifications in the contract. The promises to transfer the machine and spare parts are distinct and result in two performance obligations that each will be satisfied at a point in time. On 31 December 2019, the customer pays for the machine and spare parts, but only takes physical possession of the machine. Although the customer inspects and accepts the spare parts, the customer requests that the spare parts be stored at the entity's warehouse because of its close proximity to the customer's factory. The customer has legal title to the spare parts and the parts can be identified as belonging to the customer. Furthermore, the entity stores the spare parts in a separate section of its warehouse and the parts are ready for immediate shipment at the customer's request. The entity expects to hold the spare parts for two to four years and the entity does not have the ability to use the spare parts or direct them to another customer.

The entity identifies the promise to provide custodial services as a performance obligation because it is a service provided to the customer and it is distinct from the machine and spare parts. Consequently, the entity accounts for three performance obligations in the contract (the promises to provide the machine, the spare parts and the custodial services). The transaction price is allocated to the three performance obligations and revenue is recognised when (or as) control transfers to the customer.

Control of the machine transfers to the customer on 31 December 2019 when the customer takes physical possession. The entity assesses the indicators [in paragraph 38] of IFRS 15 to determine the point in time at which control of the spare parts transfers to the customer, noting that the entity has received payment, the customer has legal title to the spare parts and the customer has inspected and accepted the spare parts. In addition, the entity concludes that all of the criteria [in paragraph B81 of] IFRS 15 are met, which is necessary for the entity to recognise revenue in a bill-and-hold arrangement. The entity recognises revenue for the spare parts on 31 December 2019 when control transfers to the customer.

The performance obligation to provide custodial services is satisfied over time as the services are provided. The entity considers whether the payment terms include a significant financing component in accordance with paragraphs 60–65 of IFRS 15.

Impact

The new revenue recognition standard can have significant impact, especially when the following situations (non-exhaustive) apply to a company:

- bundled products
- milestone payments
- non-refundable upfront fees
- rights of return
- bill and hold arrangements
- warranty
- customer loyalty programs
- modification of customer contracts during the contract term
- slotting fees
- contract manufacturing
- financing arrangements
- real estate development

The efforts to determine the impact of IFRS 15 on the revenue recognition should therefore not be underestimated. .

Conclusion impact IFRS 15

The new revenue recognition standard may significantly impact revenue and profit recognition and related underlying trends. Furthermore, it may have broader implications on tax positions, loan covenants and KPIs.

Transitioning to IFRS 15 can be a significant effort to determine the appropriate accounting treatments, restate historical data, change system set up, processes and internal controls. Companies may also want to consider changes to customer contracts to avoid negative accounting consequences.

Even in case your (portfolio) company applies NL GAAP, this new IFRS standard may have an impact on contemplated M&A transactions, as potential investors may want to understand the impact of applying IFRS 15 and those performing due diligences will likely consider the guidance when performing due diligence.

New lease standard – IFRS 16

Introduction

The objective of the IASB was to develop a new lease accounting standard that sets out the principles that both parties to a contract, applied to provide relevant information about leases in a manner that faithfully represents those transactions. The previous accounting model for leases required lessees and lessors to classify their leases as either finance or operating leases. Finance leases were recorded on balance sheet of the lessees with assets and liabilities recognized on the balance sheet and lease expenses included below EBITDA, within financing cost and amortisation/ depreciation. Operational leases were 'off balance sheet leases' for the lessees, with no recording on the balance sheet of the related assets and liabilities and the lease expenses were included in operating expenses within EBITDA.

IFRS 16 was issued in January 2016 and will be effective for reporting periods beginning on or after January 2019 with earlier adoption allowed [IFRS 16:C2] (subject to EU endorsement). The standard includes a number of transition reliefs.

The new IFRS 16 standard

IFRS 16 sets out a model for the identification of lease arrangements and their treatment in the financial statements of both lessees and lessors. In principle and with regard to lessee accounting, IFRS 16 requires the on balance sheet recognition of all leases.

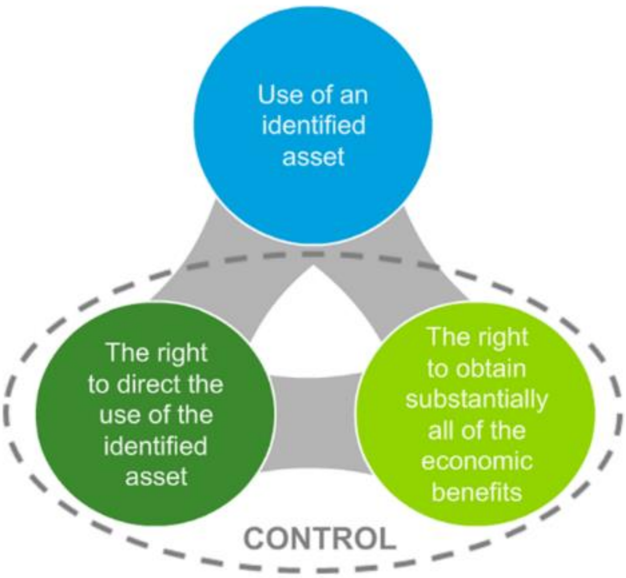
Aside the scope limitations as included in IFRS 16:3 a lessee may elect not to apply the new standard to [IFRS16:5]:

- Short-term leases; and
- Leases for which the underlying asset is of low value.

Identifying a lease

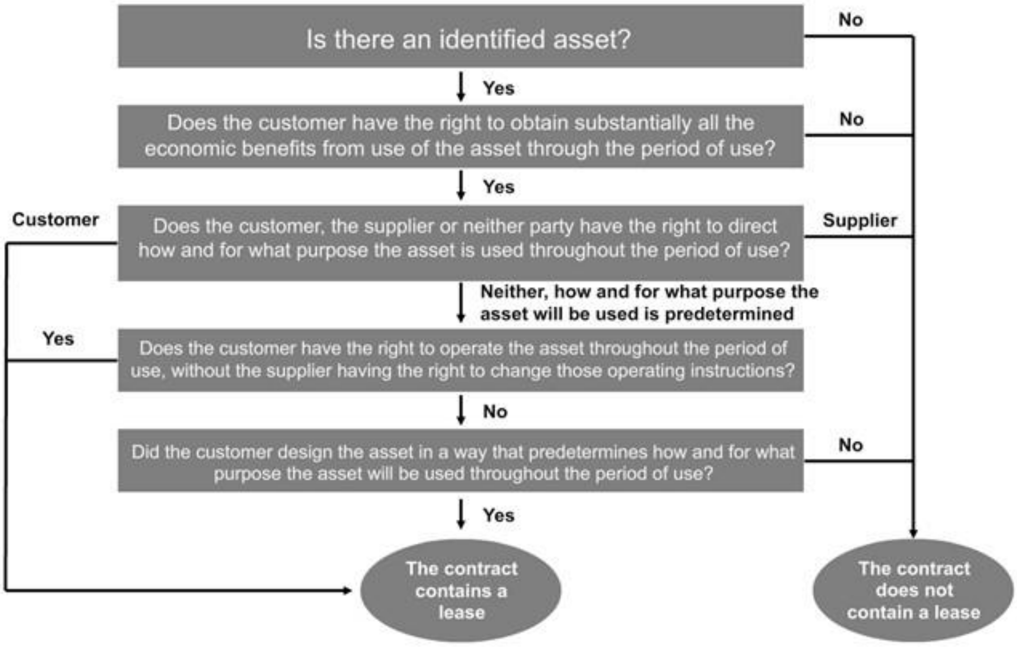
A contract is, or contains, a lease if it meets **both** of the following criteria:

- Fulfilment of the lease depends on the use of an **identified asset**; and
- The contract conveys the **right to control** the use of the identified asset for a period of time in exchange for consideration [IFRS16:9].



The assessment if a contract contains a lease should be performed at the start of the contract, rather than at the start of the lease term.

The following flowchart summarises the steps involved in the assessment as to whether a contract is, or contains, a lease [IFRS16:B31].



Separating components of a contract

If a contract is, or contains, a lease, an entity is required to account for each lease component within the contract as a lease separately from the non-lease components of the contract. IFRS 16 provides detailed guidance on how to split a contract between a lease and a non-lease component.

Separating non-lease components reduces the amounts recognised as the leased asset and lease liability. This will provide the option of a smoother expense profile, though the expense related to the non-lease component is classified as operating expense within EBITDA.

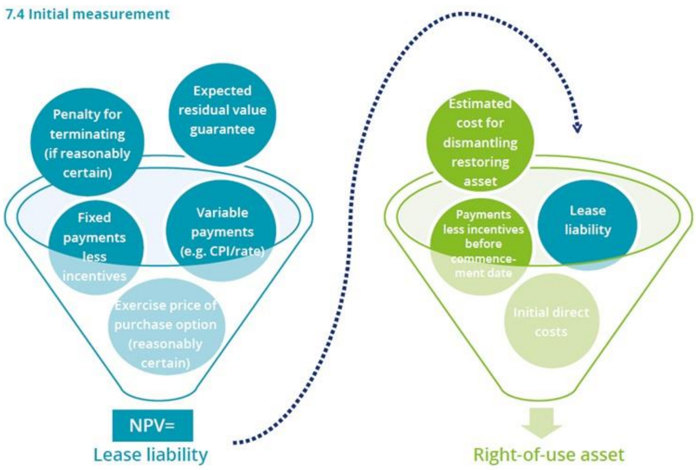
Accounting by lessees

For a contract that is or contains a lease a lessee is required to recognise at the commencement date of a lease [IFRS16:22]:

- A right-of-use asset; and
- A lease liability.

As indicated previously exemptions apply to short-term leases (leases are considered short-term if lease period is less than 12 months) and leases for which the underlying asset is of low- value. In these cases, lease payments are recognised as an expense over the lease term. If a short-term lease contains a purchase options, the lease cannot be classified as a short-term lease [IFRS16: Appendix A].

The figure as per below is a depiction of factors to be included in the valuation of the lease liability and the right-of-use asset.



The lease liability needs to be discounted using [IFRS16:26]:

- The interest rate implicit in the lease; or
- If the interest rate implicit in the lease cannot be readily determined, the lessee's incremental borrowing rate.

Accounting by lessors

Lessors shall classify each lease as an operating lease or a finance lease. [IFRS 16:61].

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. Otherwise a lease is classified as an operating lease. [IFRS 16:62].

At the commencement date a lessor should recognise assets held under a finance lease in its statement of financial position and present them as a receivable at an amount equal to the net investment in the lease [IFRS 16:67].

It is expected that the impact for accounting of leases for lessors is less significant than for lessees, however it is expected that:

- Lease contracts might be renegotiated or restructured for existing and future leases;
- Business and legal structures supporting leases should be reassessed to evaluate if the desired set-up of the structure is still applicable.

Lessees and lessors may need to consider renegotiating or restructuring existing and future leases.

Sale and leaseback transactions

In considering whether a transaction should be accounted for as a sale and leaseback transaction, it first needs to be determined if the criteria relating to IFRS 15 to be accounted for as a sale are satisfied.

For a sales and operating leaseback under the old lease standard, the seller-lessee would have recognised the full profit on sale at fair value. IFRS 16 contains a restriction of the gain to those rights of the assets transferred result in a lower gain on the sale.

Impact

Apart from the on balance sheet recognition of the lease liability and the right-of-use asset for the lessee, other expected impacts are as follows (not limitative):

- Change in performance indicators such as EBITDA as under IAS17 the expenses for leases classified as operating lease were recorded within operating expenses. Applying IFRS 16 results in these lease expenses being included in depreciation/ amortisation and interest expenses;
- Statement of cash flows is to be affected as payments need to be split between repayment of the principal amount, included in investment cash flows, and interest expenses, included in financing cash flows;
- More lease expenses recognised in the early periods of a lease, and less in the later periods. 'Front loading' of costs relating to the finance charge on the lease liability versus straight-line expenses under the old leases standard. Based upon an analysis of 50 listed companies (AEX, AMX and ASx, excluding financial institutions and real estate) Deloitte concluded that the reported debt position of these entities will increase with approximately €40 till 50 billion as a result of the new standard;
- Effect on debt covenants;
- Re-assessment of key performance indicators;
- Debt like items in M&A transactions may be affected.

Conclusion impact IFRS 16

The new leases standard will significantly impact lease accounting for lessees and to a much lesser extent for lessors. Furthermore, it will have an impact on EBITDA, cash flows and total assets and as such will affect e.g. loan covenants and KPIs. Based upon an analysis of 50 listed companies (AEX, AMX and ASx, excluding financial institutions and real estate) Deloitte concluded that the reported debt position of these entities will increase with approximately €40 till 50 billion as a result of the new standard.

An identification of future impact for contemplated M&A transactions is required as to assess the impact of applying IFRS 16 on cash flows and to determine the potential debt like items included in a transaction. Even if your (portfolio) company is applying NL GAAP, contemplated M&A transactions might be impacted as potential investors may also want to understand the impact of applying IFRS 16. The new leases standard might also be considered by those performing due diligences.

Old standard

Balance Sheet	FY 20xx $
Income statement	**FY 2015 $**
Lease payments	xxx
EBITDA	**xxx**
Profit before tax	**xxx**

New standard

Balance Sheet	FY 20xx $
Lease assets	xxx
Lease liabilities	xxx
Income statement	**FY 2015 $**
Low-value/short-term leases	xxx
EBITDA	**xxx**
Depreciation and amortisation	xxx
Finance cost	xxx
Profit before tax	**xxx**

We can assist you in assessing impact of the new standards

Assist in analysing the impact

The possible significant impact on revenue, profit recognition and related underlying trends of the new revenue recognition standard can be difficult to assess. Furthermore, it may have broader implications on tax positions, loan covenants and KPIs. Lease accounting under IFRS 16 will significantly impact lessees and will impact EBITDA, cash flows and total assets.

We can assist you in analysing the impact of these new standards on your M&A transactions. We welcome the opportunity to further discuss the impact for your specific situation.

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